TROUBLED FINANCIAL INSTITUTIONS

Solutions to the Thrift Industry Problem

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GAO

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Comptroller General
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The Honorable Henry B. Gonzalez
Chairman, Committee on Banking,
Finance and Urban Affairs
House of Representatives

The Honorable Gerald D. Kleczka
House of Representatives

The Honorable Stan Parris
House of Representatives

The Honorable Steve Bartlett
House of Representatives

This final report is in response to your request that we study solutions to the savings and loan industry problem. The final report is very consistent with the draft made available to you, other Members of Congress, and the Administration for comment on December 9, 1988.

The draft report provided the basis for testimony we delivered earlier this year to your Committee, the House Budget Committee, and the Senate Banking Committee containing our recommendations for solving the problem. Several factors could well push higher our December estimate of $85 billion in additional funds that will be needed to solve the problem. For example, costs could increase if interest rates go up further, a recession occurs, or the condition of thinly capitalized, but solvent, institutions deteriorates. Rather than develop new estimates for the final report, we believe it is best to await the details of the Administration's plan and analyze the dollar implications then. In that regard, we are pleased that the outline of the plan President Bush proposed on February 7, 1989, is consistent with the thrust of the reforms we have recommended—such as dealing quickly with remaining insolvent savings and loans, providing sufficient funds to accomplish the task, and making the supervisory agency independent of the Federal Home Loan Bank Board.

We look forward to continually assisting the Committee as it addresses this critical issue during the next several months. We are providing copies of the report to other interested Members of Congress, appropriate committees, executive branch agencies, and the public.

Charles A. Bowsher

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of the United States

Executive Summary

Purpose

The federal deposit insurance system for banks and thrift institutions was established by the federal government in the early 1930s. This system, which protects about $2.7 trillion in deposits in the Nation's banks, thrift institutions, and credit unions, plays a vital role in sustaining public confidence in the safety and soundness of the U.S. financial system. It has, however, incurred unprecedented costs in recent years, and the fund that insures thrift institutions, the Federal Savings and Loan Insurance Corporation (FSLIC), has become insolvent.

The House Banking Committee asked GAO to look into the possibility of merging FSLIC with the Federal Deposit Insurance Corporation (FDIC), the fund that insures deposits in commercial banks and some savings banks, as one option for preserving the soundness of the deposit insurance system. Accordingly, this report discusses the pros and cons of merger as well as a number of steps that need to be taken to restore the deposit insurance system to financial health and to ensure that FSLIC's experience is not repeated.

Background

In the last few years, insured depository institutions have become insolvent at rates that were only exceeded during the Great Depression: 200 banks failed in 1988 and although FSLIC acted on about that same number of thrifts in 1988, at the end of the year about 350 insolvent thrifts were still open.

As of December 31, 1987, FSLIC had a capital deficit of nearly $14 billion, and steps that have been taken to augment its funding with higher premiums and an additional $10.8 billion recapitalization loan are proving inadequate. Although FDIC had reserves of $18.3 billion at the end of 1987, the ratio of its reserves to insured deposits at that time was at its lowest point in years. In 1988 FDIC reserves declined and they are now below the minimum standard of fund adequacy—1.1 percent of insured deposits—set forth in legislation.

Results in Brief

Three things need to be done, as concurrently as possible, to help restore the deposit insurance system to financial health and to best ensure that FSLIC's experience is not repeated: (1) FSLIC needs to use different procedures to resolve insolvencies as quickly as possible. (2) To minimize the ultimate magnitude of insurance fund losses, the federal regulatory structure needs to be reformed so that both FDIC and FSLIC can better manage risks. These reforms include reorganizing FSLIC and removing it from the jurisdiction of the Federal Home Loan Bank Board (FHLBB).

(3) Adequate funding must be provided to resolve problem cases and to restore FSLIC's reserves to an adequate level.

Unfortunately, no one knows precisely how much it will cost to restore FSLIC to financial health. GAO estimates that if action is taken quickly to deal with insolvent institutions and if interest rates remain at their current levels, FSLIC will need at least $85 billion more than the funding it anticipates receiving over the next 10 years.

Of this $85 billion in additional funding, $26 billion is for covering cases acted on in 1988, $34 billion to resolve the remaining 350 insolvent cases, $5 billion for unanticipated losses, and $20 billion for establishing an adequate reserve. Although the thrift industry can probably contribute some of the additional money needed, as much as $75 to $80 billion may have to come from the federal government unless others, such as FDIC-insured banks and depositors, are required to share the cost.

Certain drawbacks make it inadvisable to merge the FSLIC and FDIC insurance funds at this time. But merger of the administrative functions of the two agencies could help provide the independence and staff capability needed to effectively deal with the remaining insolvent thrifts.

GAO's Analysis

New Resolution Approach

Regulators and Congress have resisted massive closings of insolvent savings and loans in the hope that the fortunes of these institutions would reverse themselves. This hope has proven both futile and costly, as indicated by industry losses of $9.4 billion through September 1988. Quick action is needed to avoid further escalation of costs and damage to our financial system and to create the environment for implementation of badly needed reforms to regulations. (See pp. 45 to 50.)

In late 1988 FSLIC increased the rate at which it acted on the cases of insolvent thrifts. FSLIC's strategy, developed in part to get around its lack of funds, has depended heavily on assisted merger agreements that defer cash outlays for as long as 10 years through the use of notes and guarantees.

GAO is concerned because extensive government financial commitments beyond FSLIC's available resources were made without first undertaking needed reforms. In addition, GAO believes that the assisted merger agreements may be more costly than other approaches that could have been used if FSLIC had enough money. FSLIC, pursuant to its laws, only considers costs to its fund, not the government as a whole, in deciding what course of action to take. For example, FSLIC does not count tax losses to the government as costs. The magnitude of this problem requires a broader perspective to be taken. (See pp. 52 to 55).

GAO believes FSLIC should abandon its approach of tying its actions on problem cases so closely to the type of deals it has been using. Instead, the government should promptly take control of insolvent institutions until they can be rehabilitated, merged, or liquidated on an orderly and cost-effective basis. It would be desirable for an arrangement to be devised by which FSLIC could make use of the personnel resources of FDIC or other federal agencies to carry out such a policy. (See pp. 56 to 59.)

Deposit Insurance Reform

Higher capital requirements, better adherence to rules for closing insolvent institutions, better supervision of problem institutions, and more flexibility in setting insurance premiums are all needed to minimize the chance that the deposit insurance system in the future will not once again face the prospect of significant unfunded insurance losses. The need for these reforms is illustrated by the existence at the end of 1987 of 685 solvent but weak thrifts and commercial banks with assets of about $370 billion. If the condition of undercapitalized institutions were to deteriorate further, as would happen, for example, if interest rates were to rise significantly, insurance losses for FDIC and FSLIC could increase sharply. (See pp. 66 to 72.)

To most effectively implement these reforms, FSLIC will need more independence. Presently, FSLIC is under the direction of the Federal Home Loan Bank Board, which promotes, as well as regulates, the thrift industry. GAO believes that FSLIC should be reorganized under independent management so that it consists of two parts: a "good company" fund for thrifts that are healthy or can become so in a reasonable period of time; and a "bad company" fund for those institutions that need to be rehabilitated, merged, or liquidated. Good company institutions should be responsible for capitalizing their fund. Bad company institutions would be restricted from making new loans and would also be restricted in the rates they pay on deposits. (See pp. 83 to 86.)

Healthy thrifts that meet FDIC's capital adequacy criteria should be offered a choice of joining the FDIC or the good company fund. The healthy thrifts should be required to pay the same capital contribution and regular premiums regardless of which fund they join. Part of this total amount would be used to pay a portion of the bad fund bills. (See p. 89.)

This approach has several benefits. First, institutions in the bad company fund would be isolated from the rest of the depository institutions industry and unable to compete with it. Second, an industry contribution could be structured to devote most of it to funding the insurance needs of healthy thrifts, thereby benefitting the financial system as a whole because healthy thrifts would immediately come under the authority of an independent, adequately funded insurance fund. (See pp. 83 to 89.)

Finally, the business decisions made by individual healthy thrifts about whether to join FDIC or the new good company fund would provide useful insight into the need for, and viability of, an independent thrift industry as it is presently structured. (See p. 89.)

Provision of Adequate Funding

Even if action is taken quickly to resolve insolvent institutions and no adverse upward movement occurs in the level of interest rates, GAO believes that FSLIC will need at least an additional $85 billion to resolve problems in the industry and restore its financial condition. Delays in dealing with insolvent institutions or increases in the level of interest rates will only worsen the condition of insolvent institutions and push weak institutions into insolvency, thereby adding to the costs of ultimately dealing with the problem. (See pp. 34 to 42.)

GAO believes the thrift industry should pay as much of the shortfall as possible. GAO recognizes that the industry already has a substantial commitment resulting from the special premium assessment that FSLIC expects to continue for the next 30 years and, possibly, beyond. This special assessment has, since 1985, more than doubled thrift insurance premiums. Continuation of the special assessment or additional charges on industry revenues could weaken healthy thrifts and thereby prove self defeating. (See pp. 80 to 83.)

In deciding how to finance the $85 billion shortfall, Congress must make difficult choices about who should pay. No objective basis exists for fairly dividing up the burden of paying the costs of making FSLIC financially sound; this has to be decided on the basis of value judgments that can be made only by Congress. Congress must decide whether to rely on general revenues, other industry contributions, or a combination of the two. Industry sources that can be considered include banks, credit unions, other financial services firms offering deposit-like products, and depositors. GAO believes that if reliance is placed on seeking funds from any of these industry sources, the contribution should be spread as widely as possible to minimize the burden of individual contributions and to avoid placing some sectors of the industry at a competitive disadvantage. (See p. 97.)

Why Full Merger Is Not Appropriate at the Present Time

Simply merging the insurance funds cannot solve the FSLIC problem. GAO strongly advises against further weakening the deposit insurance system through a merger in which FDIC's reserves and premium income, both of which are needed for bank problems, are simply diverted to attempt to cover some of FSLIC's losses. (See p. 104.)

Before considering a full merger of the deposit insurance system, Congress first should implement changes to establish comparable regulatory ground rules for the two industries and ensure that both funds are financially sound. Congress must also decide whether there is a need for specialized housing finance institutions. After these actions have been accomplished, full merger might better be considered as part of an overall effort to further ensure the integrity of the deposit insurance system and to simplify the regulatory structure for depository institutions. (See pp. 100 to 104.)

Recommendations

GAO recommends that Congress quickly adopt a comprehensive plan to pay FSLIC's bills and to minimize the chance that the FSLIC situation is repeated. To accomplish this at as low a cost as possible, GAO is recommending a specific set of actions designed to

- promptly take control of insolvent institutions and fully resolve these cases as quickly as possible. To facilitate such action, an administrative merger of FDIC and FSLIC should be considered (see p. 62);
- change the regulatory structure to make FSLIC independent, and provide FSLIC and FDIC with the authority needed to better ensure the soundness of the deposit insurance system (see p. 77);
- implement a plan for raising at least $85 billion over the next 10 years (the majority of which is needed in the next 3 years), financed as much as possible from thrift industry contributions (see p. 98);
- reorganize an independent FSLIC into good company and bad company funds and permit the new entities to draw on the personnel of FDIC or

other federal regulatory agencies to help in resolving problem cases (see p. 98);

- allow healthy thrifts to convert to FDIC's insurance fund with payment of appropriate fees (see p. 98); and
- establish a special board to protect taxpayers' interest by overseeing the expenditures of any federal funds provided to resolve these cases over the next several years (see p. 98).

Agency Comments

FHLBB, FDIC, the Department of the Treasury, the Board of Governors of the Federal Reserve, and the National Credit Union Administration provided written comments on a draft of this report (see pp. 140 to 151). FHLBB agreed that additional funds were needed and that the FSLIC and FDIC funds should not be merged. However, FHLBB disagreed with GAO's recommendations for taking immediate control of insolvent institutions and for making FSLIC independent because it did not see where such actions would result in additional benefits over and above those attainable by providing additional funding to FSLIC.

FDIC, Federal Reserve, and the National Credit Union Administration generally agreed with GAO's findings regarding insurance fund merger and the need for new funding, quick action, and deposit insurance reform.

In a January 26, 1989, letter, Treasury declined to comment on our findings and recommendations pending development of the Administration's proposal. But the President's February 7, 1989, proposal appears to incorporate many of the key features recommended in this report.

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Abbreviations

CEBA	Competitive Equality Banking Act of 1987
DIDMCA	Depository Institutions Deregulation and Monetary Control Act of 1980
DINB	Deposit Insurance National Bank
FDIC	Federal Deposit Insurance Corporation
FHLBank	Federal Home Loan Bank
FHLBB	Federal Home Loan Bank Board
FHLBS	Federal Home Loan Bank System
FICO	Financing Corporation
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	Generally Accepted Accounting Principles
GAO	General Accounting Office
GNP	Gross National Product
ICC	Income Capital Certificates
MCP	Management Consignment Program
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
NWC	Net Worth Certificate
OCC	Office of the Comptroller of the Currency
RAP	Regulatory Accounting Principles
ROA	Return on Assets

Introduction

The federal deposit insurance system for banks and thrift institutions was established by the federal government in the early 1930s. The system has experienced heavy costs in recent years, and the fund that insures thrift institutions, the Federal Savings and Loan Insurance Corporation (FSLIC), has become insolvent. The Chairman and three Members of the House Committee on Banking, Finance and Urban Affairs asked us to look into the possibility of merging the deposit insurance funds as one option for preserving the soundness of the deposit insurance system. This report discusses the pros and cons of merger in the context of a number of steps that we believe need to be taken to help restore the deposit insurance system to financial health and to best ensure that FSLIC's experience is not repeated.

Background

Federal deposit insurance protects depositors' money up to $100,000 when insured financial institutions fail and plays a vital role in sustaining public confidence in the safety and soundness of the U.S. financial system. Deposit insurance is administered by three federal agencies that together make up the deposit insurance system. The Federal Deposit Insurance Corporation (FDIC), an independent agency, insures deposits in all commercial banks and some savings banks. FSLIC, an affiliate corporation of the Federal Home Loan Bank System (FHLBS) governed by the Federal Home Loan Bank Board (FHLBB), insures deposits in all savings and loan associations and other savings banks. In this report, "thrift" is used to refer to all FSLIC-insured institutions. The National Credit Union Share Insurance Fund (NCUSIF), a fund administered by the National Credit Union Administration (NCUA), insures the share deposits of credit unions. These three agencies insure $2.7 trillion in deposits in about 32,000 depository institutions that have total assets of $4.7 trillion. (See table 1.1.)

Table 1.1: Characteristics of Depository Institutions as of December 31, 1987

Dollars in billions

	FDIC	FSLIC	NCUSIF[a]
Number of insured institutions	14,184	3,147	14,364
Amount of total assets in insured institutions	$3,263	$1,252	$174
Amount of deposits in insured institutions	$2,540	$933	$159
Insured deposits	$1,659	$855	$157
Uninsured domestic deposits over $100,000	$543	$78	$2
Uninsured foreign deposits	$338	i	•
Insured deposits as a percentage of total assets (percent)	51%	68%	90%

[a]Includes 29 federally insured corporate credit unions with assets of $12 billion and deposits of $11 billion.

Sources:
FDIC: FDIC 1987 Statistics on Banking and FDIC's 1987 Annual Report.
FSLIC: GAO Thrift Industry Data Base Compiling Institutions' Quarterly Reports of Condition.
NCUSIF: NCUA 1987 Statistics for Federally Insured Credit Unions and NCUA 1987 Annual Report.

The biggest problem facing the deposit insurance system is FSLIC's financial condition. At the end of 1987, 505 of FSLIC's 3,147 insured thrift institutions were insolvent, and another 435 were inadequately capitalized as measured by generally accepted accounting principles (GAAP). In its audited December 31, 1987, balance sheet, FSLIC reported a capital deficit of $13.7 billion. However, FDIC has also experienced large insurance costs in recent years. Although FDIC had reserves of $18.3 billion at the end of 1987, the ratio of its reserves to insured deposits at that time was the lowest it has been in years. FDIC expects the financial statements for 1988 to show that reserves declined by about $4 billion, and, in 1988, for the first time, the reserve ratio has fallen below the legislative standard for adequate reserves.[1] NCUSIF, even though it has experienced some years of relatively large losses since the late 1970s, is currently in the best condition of the three funds because it was recapitalized in 1985 by congressional action.[2] Table 1.2 shows insurance expenses since 1980 for the three funds.

[1]The standard for insurance fund reserves that exists in legislation is discussed in appendix II.

[2]The Federal Credit Union Act Amendment to the Omnibus Deficit Reduction Act of 1984 (Public Law 98-369) required each insured credit union to deposit and maintain in the insurance fund 1 percent of its insured member share accounts. The deposits are accounted for as assets on the books of the individual institutions. See appendix VI for a more detailed discussion.

Table 1.2: Annual Deposit Insurance Expenses During the 1980s

Dollars in millions

Year	FDIC	FSLIC	NCUSIF[a]
1980	$(34.6)[b]	$23.2	$32.5
1981	720.9	936.1	43.9
1982	869.8	865.3	79.3
1983	834.0	1,018.4	55.6
1984	1,148.0	2,113.5	28.1
1985	1,778.7	3,414.3	25.5
1986	2,783.5	13,269.7	37.9
1987	3,064.9	10,925.4	55.7

[a]NCUSIF totals are for the fiscal years ending September 30.

[b]FDIC recovered more from adjustments to prior years' losses than it spent on insurance and assistance in 1980.

Source: Audited annual financial statements.

The Insurance Funds Are Part of a Complex and Conflicting Regulatory Framework

State and federal laws define allowable activities for banks and thrifts, and federal and state regulatory authorities grant charters that can only be revoked by these same agencies. State and federal regulatory and supervisory agencies also establish and monitor compliance with standards for safe and sound operation and can order an institution to halt improper practices. Because of the role played by these agencies, the deposit insurance funds, in many instances, act much more as passive insurers than do property and casualty insurance companies that provide automobile, liability, and similar insurance coverage.

The insurance funds bear the financial loss if those responsible for chartering, regulating, and supervising institutions fail to constrain an institution's risk within the limits that its capital can absorb.[3] In some situations, the insurance fund will provide financial assistance to keep an institution operating, an action that may be accompanied by replacing an institution's management. However, the insurance funds usually obtain control of an institution only when its charter is revoked. The insurance funds then pay off depositors or transfer their accounts to another institution, absorbing any loss when the actual value of the failed institution's liabilities exceeds the value of its assets.

[3]Capital held by depository institutions represents the ownership claim on the institution and also serves as a buffer against losses to the insurance fund. However, capital is defined in different ways. Under GAAP, capital consists almost entirely of equity capital—common stock and retained earnings. Capital as defined by bank and thrift regulators includes other items as well. Throughout this report we use the GAAP definition of capital as we have done in previous reports on the condition of the industry and the insurance funds.

Similarities and differences in the treatment of banks and thrifts by the federal and state chartering and regulatory agencies have created an administratively complex and conflicting environment for managing deposit insurance risks. Banks and thrifts compete for essentially the same deposits. However, they operate under different rules regarding their allowable activities, capital requirements, and branching and merger authority, among other things. Within each industry component, rules also differ between state and federally chartered institutions.[4] Table 1.3 summarizes the different relationships between chartering agency, regulator/supervisor, and insurer according to whether the institution is a bank or thrift, state or federally chartered, or a member or nonmember of the Federal Reserve System. The table also shows the number of institutions and total assets for each category of institution.

Table 1.3: Structure of the Regulatory/Supervisory Environment of Insured Institutions, December 31, 1987

Dollars in billions

Type of institution	Number of institutions	Total assets in institutions	Chartering agency	Regulator/ supervisor
FDIC-Insured				
National banks	4,620	$1,775	OCC	OCC
State member banks	1,087	529	State	FRS/State
State nonmember banks	7,992	697	State	FDIC/State
Federal savings banks	22	45	FHLBB	FHLBB
State savings banks	463	217	State	FDIC/State
FSLIC-Insured[a]				
Federal savings institutions	1,379	$437	FHLBB	FHLBB
State savings institutions	1,768	814	State	FHLBB/State

OCC = Office of the Comptroller of the Currency
FRS = Federal Reserve System
[a]Total assets for FSLIC-insured institutions does not equal the total asset amount in table 1.1 due to rounding.

In addition, FDIC and FSLIC present two different models of the deposit insurance function. FSLIC is under the authority of FHLBB and is therefore not independent. Although this relationship provides the potential for close coordination of regulatory, supervisory, and insurance matters, it also compromises the independence of the insurance function. The insurance function is compromised because the FHLBB must balance its

[4]For example: banks are more limited than thrifts in the types of securities they can own; certain state-chartered banks are permitted to sell insurance, while national banks are not; and federal savings and loans also have greater restrictions on their directly owned real estate investments than some of their state-chartered counterparts.

concern with accomplishing what is best for maintaining a sound insurance fund against other activities, such as promoting the thrift industry's housing finance role. FDIC is more independent, both in structure and operation. For this model to work, however, FDIC must coordinate with federal and state regulatory and chartering authorities.

The complexity of the relationship between the deposit insurance agencies and the chartering and regulatory agencies, as well as the largely passive role played by the insurance funds in controlling risk taking, greatly complicates issues that need to be considered in deciding how best to improve management of risks underwritten by the deposit insurance agencies.

Deposit Insurance Financing

Deposit insurance is set up as an industry-financed arrangement subject to federal requirements. Institutions pay premiums, called assessments, that are used to pay for operating expenses and current insurance losses and to build up reserves against future losses. Interest income earned by investing reserves in Treasury securities and income from liquidating assets supplement premium income. The maximum premium levels are set by law, with each institution within an insurance fund paying at the same rate, regardless of that institution's activities or financial condition. FDIC and FSLIC can attain additional flexibility in funding by borrowing, issuing promissory notes, taking over responsibility for repaying loans, and issuing guarantees. The powers FDIC and FSLIC have for setting premiums and borrowing are summarized in table 1.4.

Table 1.4: Sources of Financing for FDIC and FSLIC

Power	FDIC	FSLIC
Annual premium assessment	One-twelfth of 1 percent of total domestic deposits.	One-twelfth of 1 percent of total deposits.
Supplemental assessment	None	One-eighth of 1 percent of total deposits (annually levied in four installments for the first time in 1985).
Borrowing from insured institutions	None	Deposit from insured institutions of up to 1 percent of total institution deposits can be required. Interest must be paid on the deposit.
Treasury borrowing	$3 billion	$750 million
Other borrowing	None	Borrowing from Federal Home Loan banks (no statutory limit).
Other financing	Promissory notes and guarantees issued to assisted institutions (no statutory limit). Assumption of the liability for repaying loans that a failed or assisted bank had obtained from a Federal Reserve bank or a Federal Home Loan bank.	Promissory notes and guarantees issued to assisted institutions (no statutory limit). Assumption of the liability for repaying loans that a failed or assisted thrift had obtained from a Federal Reserve bank or a Federal Home Loan bank. $10.8 billion recapitalization program authorized by the Competitive Equality Banking Act of 1987 (CEBA).[a]

[a]CEBA authorized FHLBB to establish a special entity, the Financing Corporation (FICO), that has begun to borrow up to its $10.8 billion ceiling to be used to recapitalize FSLIC. The principal will be repaid by zero coupon bonds purchased by FICO with funds provided by the Federal Home Loan banks; the interest will be paid from FSLIC premium income and, if necessary, the supplemental assessment pledged for this purpose.

How FDIC and FSLIC Resolve Failed Institutions

When the deposit insurance funds obtain control of a problem institution, they usually resolve the case through either a liquidation or a merger. In a liquidation, the insurance fund can pay off the insured depositors and, in return, as receiver, acquire control of all of the failed institution's assets. The insurance fund can then sell these assets to try to recover as much value as possible, a process that can take months or several years.[5] The proceeds from the sale are used to pay back the

[5]In the liquidation process, an insurance fund may sell some acquired assets right away and may manage others for quite a while before selling them. The fund can either manage assets itself or contract with other parties. In deciding when and how to sell assets, the insurance fund, as receiver, seeks to obtain maximum return for itself and for other creditors of the receivership.

insurance fund, uninsured depositors, and general creditors on a pro rata basis (i.e., according to the size and priority of their claims against the institution).

In merger transactions, which are used much more frequently than liquidation, the insurance funds combine one or more insolvent institutions with a solvent one, transfer some or all of the insolvent institution's assets and liabilities to another institution, or arrange for the institution to be acquired by an individual or company that currently does not own that type of institution. Mergers usually require a smaller contribution from the fund because the acquiring institution assumes the deposits of the failed bank and the insurance fund's outlay is reduced to that needed to make the arrangement attractive to the purchasers and economically viable.[6] In the past several years, and especially during 1988, FSLIC has kept its initial cash outlays as low as possible by paying its contribution to the acquiring institution in promissory notes or guarantees rather than making cash payments at the time of the merger.

When problem cases are resolved by merger, they have the effect of protecting all liabilities of insured institutions because the acquiring institution usually assumes responsibility for all of the failed institution's liabilities, not just insured deposits. As a result, de facto protection has usually been provided for deposits over $100,000, foreign deposits, and other creditors of depository institutions.

Objectives, Scope, and Methodology

In their letter of May 14, 1987, the Chairman and three Members of the Subcommittee on Financial Institutions, Supervision, Regulation, and Insurance of the House Committee on Banking, Finance and Urban Affairs requested that we examine the advisability and feasibility of merging FDIC, FSLIC, and/or NCUSIF. This broad request also asked us to assess the outlook for each of the funds and to consider the financial, personnel, and policy issues associated with a funds merger.

In subsequent discussions, we agreed on objectives and scope limitations in light of the continued deterioration of FSLIC's financial condition and our related work. We agreed that our report would describe the condition of FSLIC and FDIC and discuss their future revenue requirements. We agreed that we would examine the question of merger in the context of

[6]The funds' outlays can involve eliminating the net worth deficit of the insolvent institution and/or purchase of substandard assets that the acquiring institution does not want to retain. In the cases where the insurance fund acquires assets, these are managed and liquidated in the same way as in a regular liquidation.

alternatives for improving the financial condition of the insurance funds and discuss administrative processes that would be affected by a funds merger. We also agreed to exclude the NCUSIF in our assessment and to concentrate as much as possible on deposit insurance issues rather than issues more generally associated with the regulatory status of depository institutions. We worked on this assignment between July 1987 and February 1989.

Our Approach to Assessing the Advisability and Feasibility of an Insurance Fund Merger

It is now widely recognized that something must be done to restore FSLIC to a solid financial footing and to improve the management of risks underwritten by the deposit insurance funds so that FSLIC's current condition is not repeated. In achieving this result, decisions are needed on (1) how to equitably distribute the burden of financing resolution of the thrift industry's insolvent and otherwise troubled institutions and (2) how to better protect the deposit insurance funds from risks generated by depository institutions. These issues are fundamental and must be resolved regardless of whether or not the deposit insurance funds are merged. Our approach to the merger question therefore involved an assessment of whether or not various types of mergers of the funds could, after the benefits and costs are weighed, in any way contribute to the quality of actions to resolve these issues.

A large amount of judgment is involved in working through the difficult choices that must be made about how to restore financial soundness and improve the management of risk in the deposit insurance system. In this report we render a number of judgments on how those objectives can best be met. These judgments are based on our past work on the deposit insurance system; on the structure of depository institutions' regulation, oversight, and supervision; and on the financial condition of the depository institutions industry.

Our Approach to Estimating the Financial Needs of FSLIC

In May 1988, we pointed out in congressional testimony that "the eventual costs of restoring the thrift industry's financial health are likely to exceed the funds that FSLIC will have available."[7] The estimates contained in this report attempt to provide as realistic a basis as possible for analyzing the choices for restoring FSLIC's financial soundness. Our estimate includes money to resolve presently identified problem cases, provide for insurance losses among other institutions, bring reserves to

[7] The Federal Savings and Loan Insurance Corporation—Current Financial Condition and Outlook, (GAO/T-AFMD-88-12, May 19, 1988), p. 11. This is referred to below as the Wolf statement.

an adequate level so the insurance funds have the resources to close insolvent institutions in the future, and pay administrative expenses and financing costs.

In developing our estimates of FSLIC's need for money, we carried our analysis out to the end of calendar year 1998. We assume that the goals of paying the full costs for resolving problem cases and of restoring adequate reserves could both be accomplished by that date. We selected this period because FSLIC has used it in presentations to Congress and because we believe that it is long enough to deal with the FSLIC insolvency and to finance activities associated with resolving the cases of problem thrifts.

The starting points in our analysis of FSLIC's financial needs were audited insurance fund financial data as of December 31, 1987, and industry condition as of that same date. We then made estimates of activity for the 11-year period from 1988 through 1998 based on FHLBB published data on fund revenue and expenses. We assumed that any new funding arrangements could be provided beginning in 1989 and extended as needed through 1998. Our estimates are based principally upon information available as of September 30, 1988. We did, however, adjust our analysis to take into consideration the readily available data concerning resolution activity that occurred in the last quarter of 1988. See page 39.

Our estimates of insurance losses represent the full cost of acting by 1991 to resolve the cases of inadequately capitalized thrifts that already are insolvent or are likely to become so by 1991, with insolvency measured on a GAAP basis. Full resolution as we have used the term means resolving problem thrift cases so that (1) the full economic loss inherent in each situation has been dealt with and (2) all surviving institutions involved in FSLIC transactions meet prevailing capital adequacy standards without the need for continuing guarantees or other insurance fund involvement.[8]

Because of uncertainties regarding the true condition of problem thrifts and the future economic environment, it is not possible to estimate

[8]This concept of full resolution is that generally followed by FDIC in resolving the cases of failed institutions. FDIC has departed from the full resolution concept in dealing with some large bank failures.

FSLIC's financial needs with much precision.[9] The problems that have given rise to FSLIC's losses have arisen through a combination of factors that include fraud and insider dealing, changes in interest rates and other economic conditions, continuing problems in certain regional sectors of the economy, poorly implemented deregulation of financial markets, and increased competition in markets. Factors such as these are not predictable. As a result, we made certain assumptions that are explained in the next section.

Assumptions Used in Our Estimates

Over the past decade, the combined deposits in thrifts and FDIC-insured banks grew at 8.2 percent, approximately the same rate as the 8.5 rate of increase of nominal Gross National Product (GNP). Although there were significant variations in the year-to-year pattern of growth within each industry, overall thrift deposits grew at a faster rate than FDIC-insured bank deposits (9.6 percent and 7.7 percent, respectively). To simplify our analysis, we have made our revenue calculations on the assumption that deposits in both FSLIC- and FDIC-insured institutions will grow at an average annual rate of about 7 percent per year, approximately the rate of increase in nominal GNP projected by Data Resources Incorporated. This assumption of deposit growth is the same one FSLIC has used in its projections.[10] Nevertheless the ability of thrift institutions to continue to attract deposits in line with GNP growth is by no means a foregone conclusion. The possibility that FSLIC-insured institutions may experience slower growth in deposits is discussed in chapter 2.

Any estimates of deposit insurance costs are, of course, greatly dependent on the assumptions made about the economic environment. In making our assessment of the magnitude of the financial demands facing the deposit insurance funds, we have tried to avoid both overly optimistic and unduly pessimistic assumptions regarding economic events. We have therefore made the following simplifying assumptions:

[9]Our estimate of what FSLIC needs to regain financial health will be greater than either (1) the estimate of the minimum amount of money FSLIC needs through 1998 simply to maintain a positive cash flow or (2) the provision for loss that would be appropriate to include in FSLIC's financial statement. An estimate based on maintaining a positive cash flow can reflect deferral of problem recognition and arrangements to deal with problems that do not reflect full costs. A provision for loss in FSLIC's financial statement is based primarily upon supervisory cases that have been referred to FSLIC for case resolution, whereas we have also tried here to take into account other losses and expenses that could reasonably be anticipated for purposes of planning to restore FSLIC to sound financial condition.

[10]Instead of an exact 7-percent annual rate, FSLIC applies a growth rate of 1.75 percent per quarter, which translates to an annual growth rate of 7.2 percent. We have followed FSLIC's assumption.

- The economy will not experience an extended recession or other new significant setbacks.
- Presently depressed sectors of the economy, such as those involving energy, agriculture, and real estate in certain areas of the country, will experience neither a dramatic recovery nor suffer added major adversities.
- The level and structure of interest rates in the economy will not change significantly, and interest rates faced by the insurance funds in financing resolution costs will be 8 percent for intermediate-term notes (average maturity of 5 years) and 10 percent for long-term bonds financed through FICO.
- FSLIC will experience losses on assets of resolved institutions that range between the high rates it is currently experiencing and the lower rates FDIC is currently experiencing.

The assumptions regarding the economy and interest rates correspond to those that FSLIC has used in making projections. FDIC officials said that they are reasonable to use for planning purposes.

Sources of Information

To complete our analysis, we obtained information from the laws governing the deposit insurance system; professional literature concerned with deposit insurance risk management and fund condition; statistical data prepared by FDIC, FHLBB, NCUA, and other regulatory agencies; agency records; and discussions with officials of FDIC, FHLBB, NCUA, the Federal Reserve board, the Office of the Comptroller of the Currency (OCC), representatives of industry trade groups, and several academic experts.

We also reviewed legislative proposals, congressional hearings, and reports by federal agencies. In addition, we analyzed data from commercial banks' reports of condition and income (call reports) and quarterly financial reports for savings and loan institutions. Finally, we made extensive use of information developed from our financial audits of FDIC and FSLIC and other assignments analyzing the condition of the thrift and commercial banking sectors. A listing of these sources appears at the end of this report.

Because our review focused on deposit insurance policies, we have not attempted to evaluate actions taken by insurance fund officials or federal regulators in particular circumstances. Nor did we analyze the condition of particular institutions or industry segments in detail. We also did not audit the accuracy of the insurance funds' calculations of liquidation and case resolution costs.

Agency Comments

FHLBB, FDIC, the Department of the Treasury, the Board of Governors of the Federal Reserve System, and NCUA provided written comments on a draft of this report. Relevant portions of their comments are presented and evaluated at the end of chapters 2 through 7. The comments are reprinted in their entirety as appendixes VIII through XII, respectively.

Outlook for FSLIC

It is quite difficult to estimate the amount of money FSLIC will need to resolve troubled thrift institutions and to return to a solid financial footing. The principal difficulty is that the available information on the financial condition of problem institutions is not a reliable guide to the true economic value of these institutions. Nevertheless, we believe the evidence is clear that FSLIC does not have enough money to pay for insurance losses and to establish the level of reserves that will be necessary to enable it to function effectively as an insurer of deposits in the future.

On the basis of our assessment of the situation, we estimate that over the next decade FSLIC will need at least $85 billion more than its anticipated revenues to resolve the cases of its problem institutions, provide for future institution failures, and establish a reserve for losses. Of this amount, about $50 billion will be needed to pay for case resolution costs in the next 3 years.

Condition of the Thrift Industry

As explained in appendix I, during this decade there has been a steady deterioration in the financial condition of the thrift industry. As shown in table 2.1, on December 31, 1987, there were 940 thrift institutions (33 percent of the industry) whose capital on a GAAP basis was below 3 percent. These institutions held $395 billion in assets, about 32 percent of the industry's total. All of these institutions can be considered problem thrifts because they operate with levels of capital that are generally recognized as inadequate.

Of the 940 institutions, 505 insolvent institutions reported $140.3 billion in assets and negative GAAP net worth of about $18 billion, or 12.83 percent of assets. Their annualized return on assets (ROA)[1] of -9.52 percent at December 1987 was so large that it resulted in a negative ROA for the entire industry. Of the 505 insolvent institutions, 205 institutions with $52 billion in assets were in FSLIC's caseload. That is, the district banks had turned these over to FSLIC for resolution because the banks believed they were incapable of being rehabilitated without FSLIC assistance.

Of the 435 institutions with GAAP capital between 0 and 3 percent, 72 institutions with $35 billion in assets were unprofitable during both 1986 and 1987. These institutions, which already had negative tangible

[1] ROA is the ratio of total net income to total assets.

net worth[2] of $1.3 billion (almost 4 percent of assets), appeared to be headed for insolvency on a GAAP basis in the near future.

Table 2.1: Insolvent and Low Net Worth FSLIC-Insured Institutions, December 31, 1987

Dollars in billions

Category of thrifts	Number of thrifts	Total assets	Tangible Net Worth
GAAP insolvent institutions			
Institutions recognized in FSLIC's caseload	205	$52	$-14.6
Other insolvent	300	88	-6.5
Total insolvent	505	$140	$-21.1
Low net worth institutions			
(0-3 percent on a GAAP basis)			
Lost money in 1986 and 1987	72	$35	$-1.3
Other low net worth	363	220	-1.1
Total low net worth	**435**	**$255**	**$-2.4**
Total	**940**	**$395**	**$-23.5**

Source: FHLBB Thrift Financial Reports.

If there were signs that GAAP insolvent or low net worth institutions that were unprofitable 2 years in a row were recovering, the level of concern over the condition of the industry and the implications for potential demands on FSLIC resources by so many undercapitalized institutions probably would not be so high. However, to date there is little evidence to suggest that the demands these institutions are likely to place on FSLIC will diminish.

In fact, there are more reasons than not to believe that these insolvent and low net worth, unprofitable institutions' financial condition will worsen. As a group, they continue to incur both operating losses[3] and

[2]Tangible net worth is a more narrowly defined net worth measure than GAAP. Tangible net worth is GAAP net worth minus goodwill, which consists principally of the amount over book value paid by an institution to acquire other institutions and other intangible assets.

[3]Operating losses occur when interest paid on deposits and other operating expense items exceed income from investments and fees. These losses translate into reduced assets and/or rising liabilities (increased borrowing) and a worsening of the thrifts' net worth position. Operating losses can result from interest-rate spread problems that occur during periods of rising interest rates when institutions that rely on long-term fixed interest rate sources of income, such as 30-year mortgages, earn less than they must pay to obtain funds.

nonoperating losses.[4] In 1987, their losses were $10 billion (see table 2.2), and losses continued in 1988. Relatively few of these institutions recover.[5] And, new problem cases have been growing at a faster rate than old ones have been recovering.

Table 2.2: Losses in FSLIC-Insured Problem Thrifts in 1987

Dollars in billions

	Insolvent thrifts	Low net worth thrifts that were unprofitable in both 1986 and 1987	Totals
Net (after tax) income in 1987	$−9.6	$−.4	**$−10.0**
Net operating income in 1987	−4.3	−.3	**−4.6**
Net nonoperating income in 1987	−5.3	−.1	**−5.4**

Source: FHLBB Thrift Financial Reports.

In assessing the financial implications of restoring FSLIC to financial health, the extent of the potential threat that the remaining 363 low net worth thrifts pose to FSLIC, while less clear, is an extremely important factor. For this group of institutions, there was a buffer of only about $4 billion in GAAP capital supporting $220 billion in assets, and their tangible net worth deficit of $1.1 billion is cause for concern about the quality of their capital. While some of these institutions may be expected to recover on their own, others will no doubt fail or require some FSLIC assistance. If efforts are not made to control risk taking in this group, the eventual losses to FSLIC out of this poorly capitalized group could become quite large.

Estimation Difficulties

A number of problems prevented us from precisely estimating the cost to FSLIC of fully resolving the problems of distressed thrifts.

- The ultimate cost depends upon many factors that are either beyond the control of the insurance funds or subject to future policy and management decisions. These factors include the future state of the national

[4]Nonoperating losses are also indicative of the poor prospects for recovery of problem thrifts. These losses, which consist almost entirely of losses on the sale of assets and the provision for losses for non-earning assets, reveal the extent of asset quality problems in thrift's portfolios. Unlike interest-rate spread problems, which may ease if interest rates fall or if thrifts take steps to reduce interest-rate risk, bad assets have little potential for recovery. Unless the underlying factors, such as adverse economic conditions or poor management, that contributed to the asset quality problems improve, thrifts' assets may deteriorate even further and the ultimate cost of the resolution borne by FSLIC will continue to grow.

[5]See pp. 109-110.

economy and of regions and sectors within the economy, interest rates, competition within the financial services industry, and the timing of actions taken to resolve cases. For example, experience suggests that the economy is likely to experience a recession at some time in the next 10 years, but it is difficult to predict when and how severe it will be and how well financial institutions will withstand it. Therefore, while it is reasonable to expect economic conditions in particular regions of the country to change, there is no assurance that the changes will be for the better.

- Allowing insolvent institutions to remain open creates an incentive for managers of insolvent and undercapitalized institutions to gamble by investing in high-risk, high-return assets, which generate above average profits if a high return is realized but additional losses that subsequently accrue to FSLIC if the return is not realized.[6]
- It is difficult to decide which inadequately capitalized institutions represent cases that FSLIC must resolve. Unfortunately, accounting information drawn from the reports these institutions file (call reports) with FHLBB provide only general guidance as to the condition of these institutions. Call report information tends to understate problems because this information is based on historical cost rather than current market values.
- Institutions are reluctant to write off bad loans and investments, and the inability to generate operating income can be masked by gimmicks, such as selling the better assets on which capital gains can be realized, to boost their apparent profitability. The true financial condition of the institutions cannot be determined without a very detailed examination of the institutions' assets and accounting records.
- FSLIC's past experience does not provide a clear picture of losses that can be expected from resolving problem thrift cases. FSLIC resolution costs vary greatly from case to case, but the average costs FSLIC has incurred in resolving cases have risen sharply in recent years.

In 1982, FSLIC's average loss ratio in resolving cases (expressed as a percent of assets) was 4.2 percent. In 1986 the loss ratio averaged about 15 percent and in 1987 it soared to nearly 41 percent. For the cases resolved through the end of September 1988, the loss factor averaged 61 percent of assets. At face value, this trend in loss ratios on case resolutions is very disturbing. But it is not obvious how this trend should be interpreted in trying to estimate losses in the future. For example, if FSLIC has been acting on its worst cases, the trend might be expected to reverse. On the other hand, the condition of many insolvent institutions

[6]For additional discussion, see appendix III.

can be expected to deteriorate with the passage of time, and instead of acting on the worst cases, FSLIC may have been acting on cases that, on average, were more attractive to outside investors, and thus easier to resolve.

- Finally, some of the merger actions taken by FSLIC have not resulted in full resolution of the problems, making reliance on FSLIC's estimates of resolution costs problematic. For example, four institutions that acquired failed thrifts with FSLIC assistance during 1987 had negative tangible net worth at the end of the year.[7] Furthermore, FSLIC's resolution of problem Southwest thrifts has not completely recognized and paid for the losses in these institutions. Instead, a series of guarantees on acquired assets in institutions that remain thinly capitalized has exposed FSLIC to losses in the future.

Analysis of FSLIC's Cash Flow Projection

In the summer and fall of 1988 the Bank Board had a goal of resolving problem institutions at a rate of one per week in addition to resolving more than 140 institutions in the Southwest under what is known as the Southwest Plan. All told, FSLIC said it would resolve 259 cases in 1988 and 1989. In 1988, as of September 30, FSLIC had already acted on 124 institutions, with assets of about $33 billion. FSLIC estimated it would take up to the end of fiscal year 1992 to complete action on the balance of the 505 GAAP insolvent institutions.

To determine the net amount of money FSLIC would have available to pay for insurance fund losses through 1998, we analyzed the FSLIC cash flow projection for fiscal years 1988 through 1998 that FHLBB presented to Congress July 7, 1988. This was the latest projection available at the time we did our study. Since July, FHLBB has increased its estimates of insurance losses and is preparing a revised forecast that will cover fiscal years 1989 through 1999. We believe, however, the July forecast still provides a reasonable basis for our analysis. Our analysis depends principally on a number of items that affect FSLIC's revenues over the next decade that are not likely to be materially affected by the forthcoming revision. These items include premiums; interest on reserves; commitments that were entered into prior to January 1, 1988; and the financing characteristics of the $10.8 billion recapitalization bonds. Also, our analysis does not concentrate on exact year-by-year cash flows that are essential for assessing FSLIC's liquidity situation and that could be more affected by a revised forecast.

[7] Wolf statement, p. 6.

In our analysis, we made a number of adjustments to convert FSLIC's presentation from a fiscal year to a calendar year basis so that it would tie into December 31, 1987, audited financial statement data.[8] We also converted FSLIC's presentation into terms that show net insurance losses more clearly. Our summary of FSLIC's financial forecast is presented in table 2.3.

[8]We did not have a basis for adjusting some line items which are relatively small such as "miscellaneous income: and "administrative, nonadministrative, and other expenses." For these items we used the fiscal year figure from the July 7, 1988 FSLIC cash flow projection.

Table 2.3: FSLIC's Estimate in July 1988 of Funds Available to Pay Insurance Losses: 1988 Through 1998[a]

Dollars in billions

Money Available for Insurance Fund Operations:		
Premiums:		
Regular[b]	$13.0	
Special assessment[b]	19.4	
Total		**$32.4**
Recapitalization proceeds		9.6
Recoveries from resolutions that occurred prior to 1988		4.8
Interest on investments		1.2
Miscellaneous income[c]		3.2
Decrease in cash balance		2.8
Total money available:		**$54.0**
Anticipated Expenses other than those directly incurred in case resolution actions occurring after January 1, 1988:		
Administrative, non-administrative, and other operating expenses[d]		2.7
Interest on recapitalization bonds[b]		9.6
Repayment of secondary reserve[b]		0.8
Principal and interest on notes issued before 1988		5.8
Total anticipated expenses:		**$18.9**
Funds available to pay case resolution expenses:[e]		$35.1
Interest on notes issued after January 1, 1988, to resolve cases		$7.6
Funds available to pay insurance losses on cases acted on after January 1, 1988[f]		$27.5

[a]On July 7, 1988, FSLIC submitted a budget outlay estimate covering the 11-year period of fiscal years 1988 through 1998. This table is based on this submission but covers the 11-year calendar year period from January 1, 1988, to December 31, 1998. We used this period so we could use FSLIC's audited financial statements of December 31, 1987, as a starting point.

Because the table is built up from budget estimates, the amounts in the table represent the sum of estimated values in each of the years covered by the projection; these amounts are not on a present value basis.

[b]The $9.6 billion associated with the payment of interest on the FICO recapitalization bonds and the $.8 billion associated with the repayment of secondary reserves are actually deducted from FSLIC's regular and special premium income, respectively, before FSLIC receives its money. We have shown the FICO bond interest and secondary reserve repayment as expenses so that the table more clearly shows the total amount of premiums expected to be paid by the thrift industry. The secondary reserve was the equity of certain institutions in FSLIC based on prepaid premiums and related interest not yet paid to these institutions. Because FSLIC suffered losses during calendar year 1986 in excess of all of its reserves, the secondary reserve was eliminated in order to reduce losses to the primary reserve. Title III Section 307 of the Competitive Equality Banking Act of 1987 (CEBA) authorizes insured institutions to offset against future special assessment premiums their pro rata share of $823.7 million that was previously in the secondary reserve.

[c]Includes recoveries from assets acquired before 1988, income from capital certificates FSLIC purchased from institutions to supplement their net worth, and other miscellaneous income.

[d]Includes administrative expenses, liquidation and non-administrative expenses, other operating expenses, and expenses to acquire certain assets from insured institutions.

[e]The estimate of $35.1 billion is the net amount of funds available to pay for insurance losses and associated financing costs after subtracting other anticipated expenses from the total revenue available to the fund. The estimated funds available to pay for insurance losses is net of the proceeds from liquidating assets acquired in cases acted on after January 1, 1988.

The availability of these funds is spread over the 11-year period corresponding to the timing of revenues. FSLIC expects to use notes as part of its case resolution actions so that it can resolve problems more quickly. FSLIC's forecast indicates that it will finance about 41 percent of its outlays for case resolutions with notes and that the notes will result in interest expense of $7.6 billion during the 11-year period. Paying these interest costs lowers the amount of insurance losses FSLIC will be able to absorb to $27.5 billion.

[f]The $27.5 billion can be used to make cash payments, pay the principal on notes, or pay the amount due on guarantees. FSLIC's projection assumed that the principal on all notes issued would be paid off by year-end 1998, and the projection made no explicit mention of guarantees extending beyond that date.

Of the $54 billion in funds that FSLIC said it would have available, about $32 billion is from premiums—$13 billion is from regular premiums and $19.4 billion from continuing the special premium of 1/8 of 1 percent of total deposits through 1998.[g] In addition, $9.6 billion is anticipated from the sale of recapitalization bonds. With the funds available, FSLIC's projection shows it would be able to absorb insurance losses of $27.5 billion, net of recoveries on assets in receiverships, through 1998. FSLIC's cash flow is based on the assumption that almost all of the cases can be resolved by assisted mergers rather than liquidations. In this projection FSLIC expected to issue $13.8 billion in notes and to pay off all of them by the end of 1998.

Besides the insurance losses, the other major expense category FSLIC faces is interest and the repayment of prior obligations. The FSLIC projection shows that interest costs (plus repayment of principal on $4.9 billion in notes issued before 1988) will claim about $23 billion of its resources. The interest on issued recapitalization bonds is in essence paid by pledging a portion of FSLIC's regular and special premium income. By the time the entire $10.8 billion in recapitalization bonds has been issued, FSLIC expects the interest payments on these bonds to exceed $1 billion per year, and over the next 11 years to total $9.6 billion. In addition, the FSLIC forecast indicated that the $13.8 billion in notes it plans to issue in resolving institutions between January 1, 1988,

[g]FHLBB officials have said that the special premium may have to be continued for at least 30 years.

and December 31, 1993, will result in interest costs of $7.6 billion through 1998.[10]

Our Assessment

The FSLIC budget projection is based on several optimistic assumptions and could be upset by any one of several occurrences affecting revenues, expenses, or both.

Looking first at revenue, FSLIC's assumption of a 7-percent growth in deposits is reasonable by historical standards. The projected growth in FSLIC deposits is in line with a reasonable forecast of the growth in nominal GNP, assuming no recession. However, some of the growth in FSLIC-insured deposits that has occurred in the past can be attributable to the high rates of interest paid by insolvent or undercapitalized thrifts. This contributing factor to growth in FSLIC-insured institutions should decline as problem cases are resolved.

In addition, premium income could decline if institutions are allowed to withdraw from FSLIC in favor of FDIC or if the public decided to place a greater portion of its deposits in FDIC-insured institutions.[11] If the rate of growth in FSLIC deposits over the decade averaged 3 percent rather than 7 percent, FSLIC's premium revenues would be about $7 billion lower over the decade than the amount shown in table 2.3.

Insurance losses and interest payments represent the two key elements of FSLIC's expenses. As of September 30, 1988, FSLIC had acted on 122 institutions with about $32 billion in assets. Measured by assets, FSLIC had acted on 23 percent of all insolvent institutions that existed at the end of 1987. The expected cost to the fund of those actions is about

[10]The amount of these notes ($13 billion) is not identified in table 2.3. The projection assumes they would be paid off before the end of the period.

[11]Under CEBA, institutions that meet FDIC's insurance standards can leave FSLIC for FDIC if they pay FSLIC an exit fee equal to twice the then prevailing regular and special premium. In 1988 this exit fee would have been about .41 percent of total deposits. This exit fee goes to FICO. Since the payment of exit fees to FICO reduces the need for a portion of FSLIC's premium income to be paid to FICO, we have made no provision for reflecting exit fees in our estimate of FSLIC revenues. If the special premium of 1/8 of 1 percent deposits is to be continued indefinitely, there will be added incentive for institutions to apply to leave FSLIC. CEBA imposed a moratorium on transfers that has been extended to August 1989.

The public may determine that it is more appropriate to place money in FDIC-insured rather than FSLIC-insured institutions if it perceives that there is a problem with FSLIC or if higher insurance premiums or regulatory restrictions reduce the rate of interest FSLIC-insured institutions could pay on deposits relative to FDIC-insured institutions.

$19.8 billion—about 72 percent of the $27.5 billion for insurance losses included in FSLIC's cash flow projection.[12]

FSLIC actions taken through September 30, 1988, left only about $8 billion to finance losses for actions on all of the remaining insolvent institutions having about $107 billion in assets. Resolution costs per dollar of assets in insolvent institutions would thus have to average about 7 percent in order for FSLIC's $27.5 billion insurance loss estimate to be borne out. This rate of losses on assets is considerably lower than the loss rate of about 61 percent which FSLIC experienced in resolution actions in 1988 through September.

As for interest expenses, in the first 9 months of 1988, FSLIC had issued about $10 billion in notes with maturities ranging from 6 months to 15 years, and it anticipated issuing more notes in its future actions. Because most of the notes it has been issuing are for 10 years and at a rate (approximately 9 percent) higher than in the July 1988 forecast, interest costs over the next decade are likely to be higher than those contained in the forecast.

A detailed analysis of FSLIC's near-term liquidity situation was outside the scope of our work on this assignment. However, we are concerned about the liquidity implications of FSLIC's projections. FSLIC assumes that it will be able to operate throughout the decade with a cash balance that averages about $1 billion. Such a small cash balance provides little room for flexibility given the uncertainties associated with FSLIC's operations. At the present time, FSLIC is acting on cases at a rate that cannot be sustained within its available resources, paying for its actions mostly with notes and guarantees that defer cash outlays. At the same time, there are elements in FSLIC's cash flow that it cannot fully control, such as the proceeds from asset sales or the timing of payments on certain guarantees. Although FSLIC has options for borrowing in an emergency situation, use of these options could heighten public anxiety over FSLIC's condition.

[12]Because of FSLIC's shortage of cash, most of these actions were accomplished with notes and guarantees that defer cash outlays. The FSLIC projection assumed that these obligations would, however, be paid off by 1998.

Estimate of FSLIC's Additional Funding Need

We estimate that FSLIC's projection of the resources available to it through 1998 falls short of what the fund will need to become financially sound.

- Even if FSLIC's revenue assumptions are realized, we estimate that over the 3 years 1989, 1990, and 1991, FSLIC will need additional funds for insurance losses on presently insolvent or undercapitalized institutions amounting to at least $50 billion.
- In addition, we estimate FSLIC will need $5 billion for future insurance losses related to institutions that are not now severe problem cases, $10 billion to cover financing costs for case resolutions, and $20 billion to establish adequate insurance fund reserves.
- In total, therefore, we estimate that to be restored to sound financial condition FSLIC will need at least $85 billion over the next decade in addition to the amounts included in FSLIC's cash flow projection. The basis for these estimates is described in the following sections.

Insurance Losses in Presently Identified Problem Institutions

The largest single increase in our estimate over that made by FSLIC involves the additional losses in resolving cases of presently identified problem thrifts. In view of the uncertainties associated with the cost of resolving problem institutions, we adopted a building block approach for estimating FSLIC's case resolution costs. We separately estimated the cost of resolving FSLIC's caseload, other insolvent institutions, and low net worth institutions. We estimate that it could cost at least $77 billion to fully resolve insolvent and low net worth institutions over the next 3 years—1989, 1990, and 1991. The amount not provided for in FSLIC's projection is about $50 billion.[13] (See table 2.4.)

[13]In interpreting these numbers, it should be recognized that we have made an assumption about how FSLIC resolves cases that minimizes the calculation of FSLIC's need for cash. We have assumed that at the time it takes actions to resolve cases, FSLIC will pay out cash or notes only in the amount of the full value of the economic loss. By making this assumption, which reduces the amount of cash flowing into and out of FSLIC, it is easier to focus on the implications of financing the underlying economic loss that FSLIC faces. In reality, when FSLIC implements a merger or liquidation, it often makes an outlay in the form of cash or notes which is larger than the expected loss, and then recovers a portion of the outlay when it sells acquired assets or obtains agreed-upon future payments from the acquirer. When the liquidation of assets is completed or all future payments made, the net loss to the fund (on a present value basis) is the same as the loss amounts in our estimates.

Table 2.4: Estimated Costs for Full Resolution of Problem Thrift Cases[a]

Dollars in billions

Category	
FSLIC caseload (205 cases with $52 billion in assets)[b]	$26.7
Other insolvent institutions (300 cases with $88 billion in assets)[c]	39.9
Low net worth institutions that lost money in 1986 and 1987 (72 cases with $35 billion in assets)[d]	10.5
Total cost of resolution	**77.1**
Less: funds available to pay for losses bases on FSLIC's forecast (from Table 2.3)	27.5
Net additional cost	**$49.6**

[a]Estimates assume that actions to resolve the cases of these institutions would be taken within the next 3 years—i.e., by the end of 1991.

[b]Our estimate assumes that the overall cost of resolving FSLIC's caseload will be significantly higher than FSLIC's original estimate and will average 51 percent of assets. This cost of $26.7 billion was calculated by applying FSLIC's recent loss experience of 61 percent of assets to $19.7 billion in caseload institutions acted on through the end of September and adding to it a loss of 45.3 percent on the remaining $32.4 billion in assets. We used 45.3 percent of assets because it is the midpoint of FSLIC's recent loss ratio of 61 percent and the approximately 30 percent of assets associated with FDIC's loss experience for resolving insolvent commercial banks with assets of less than $500 million during 1985, 1986, and 1987.

[c]Our estimate is based on a loss of 45.3 percent of assets. The basis for this percentage is the same as that stated in note b.

[d]Our estimate assumes that all these institutions will become insolvent and thus require FSLIC resolution. We assume that FSLIC will resolve these cases closer to the point at which they enter insolvency than has occurred in the past. To calculate our estimate we used FDIC's average loss ratio for cases of commercial banks with assets less than $500 million. This ratio was approximately 30 percent of assets for the 3 years 1985, 1986 and 1987.

Costs of Resolving FSLIC's Caseload

The best information available on the costs for resolving problem thrifts is that concerning the 205 institutions in the FSLIC caseload. Cases are referred to FSLIC only when FHLBS officials have determined that it is not possible to resolve the problems through supervised work out or unassisted merger and, thus, some FSLIC assistance is inevitable.

The financial statements of institutions in FSLIC's caseload are more likely to closely approximate underlying market value than the financial statements of other insolvent or inadequately capitalized institutions because the caseload institutions have been more carefully scrutinized by supervising officials. However, the losses FSLIC has incurred in resolving these cases have thus far exceeded by a considerable amount the losses FSLIC had estimated from the information available to supervisory officials.

In its 1987 financial statement, FSLIC recognized a liability of $17.4 billion for the expected cost of resolving the 205 institutions in its caseload and several other institutions.[14] The amount associated with institutions in the caseload represented an average loss of about 31 percent of the $52 billion in assets in those institutions.

In auditing FSLIC's financial statements, we determined that FSLIC's estimate was reasonable on the basis of information available at that time. We note, however, that the losses incurred by FSLIC in 1988 through September 30 are, on average, almost twice the estimated 31 percent of assets.[15] FSLIC says that its costs have been substantially greater than anticipated in its 1987 financial statement primarily because institutions continued to incur losses between the time of the estimate and the time of closing, and the assets in institutions FSLIC has closed were found to be more seriously impaired than originally anticipated.

If FSLIC has been acting on the worst institutions in its caseload, as the Bank Board has often suggested, FSLIC's costs for the remaining institutions in its caseload may not be as high as the costs in 1988 FSLIC incurred through September. In making our estimates for FSLIC, we have also been mindful of FDIC's recent expenses in resolving bank failures. In 1985, 1986, and 1987, FDIC's losses in acting on cases of commerical banks with less than $500 million in assets have averaged 20, 36, and 32 percent of assets, respectively, with an overall average for the period of 29.4 percent. We think it unlikely that FSLIC's loss percentages could fall significantly below the approximately 30 percent of assets that FDIC has been experiencing in cases other than large commercial banks.[16] FSLIC will be acting upon institutions that have been GAAP insolvent for some time but which the FHLBB or state charterer have permitted to stay open. Such institutions are likely to have larger losses than banks that FDIC is

[14]In FSLIC's 1987 financial statement, as noted above, FSLIC included a provision for loss of $17.4 billion primarily associated with the 205 institutions with assets of $52 billion in FSLIC's caseload. The $17.4 billion included about $1.3 billion associated with other unspecified institutions that FSLIC expected to resolve in 1988, but that were not part of the caseload.

[15]In 1988, through the end of September, 40 of the 124 cases FSLIC had acted on were institutions with assets of $12.9 billion that were not part of its caseload at December 31, 1987. Most of these institutions were included in mergers in which costs are not allocated to each institution. Because of the difficulty in precisely determining the costs of these 40 institutions, we have included their cost in our calculations of the average loss percentage in FSLIC's caseload. We have not, however, included the assets of these noncaseload institutions in our calculations of the percentage of caseload institutions that have been resolved.

[16]FDIC has experienced a loss ratio of about 10 percent of assets in resolving the cases of commercial banks with over $500 million in assets. We believe FDIC's 30-percent loss experience for commercial banks under $500 million is relevent for estimating FSLIC's potential loss, because the average asset size of the 505 thrifts that were insolvent as of December 31, 1987, was $227 million.

resolving because FDIC-insured institutions have generally been acted upon closer to the point of their insolvency. We also note that FSLIC's actual loss experience in 1988 (through September 30) for cases not in the Southwest Plan was about 45 percent of assets. Based on the above case resolutions, we assume that the average loss percentage FSLIC will incur on the remaining institutions in its caseload is about 45 percent of assets—the midpoint of FDIC's loss experience of 30 percent and FSLIC's 1988 loss experience of 61 percent of assets through the end of September.[17] Thus, we estimate that the costs of fully resolving FSLIC's total caseload will be about $27 billion.

Cost of Resolving Cases of the Other Insolvent Institutions

There is no way to know how the true condition of the other 300 insolvent institutions compares with the cases already in the FSLIC caseload. If the supervisory system is working as it should, the FSLIC cases should be worse than those that have not been referred. However, both the supervisory system and FSLIC's ability to resolve cases have been severely strained. On the basis of information currently available, we think the distinction between cases that are, and are not, in FSLIC's caseload cannot be relied upon in making judgments about the condition of other insolvent thrifts.[18]

We estimate that FSLIC will incur costs of nearly $40 billion to resolve these institutions on the basis of a loss percentage of about 45 percent of assets. This percentage is the midpoint of FDIC's 30-percent loss experience for cases of commercial banks with less than $500 million in assets and FSLIC's actual loss experience in 1988 of 61 percent of assets. Our estimate thus assumes that the insolvent institutions that are not in FSLIC's supervisory caseload are on average in about the same condition as those remaining in the caseload.

[17]As noted in chapter 4, some FSLIC actions have not fully resolved problem cases, and FSLIC's cost calculations do not reflect tax losses to the Treasury that result from FSLIC's assistance agreements. Our use of actual FSLIC loss ratios thus may tend to understate the full resolution costs.

[18]In its 1987 financial statements, FSLIC recognized that it would likely incur some losses for the 300 insolvent institutions not already in its caseload. FSLIC estimated losses equal to the tangible net worth deficit, about $5.3 billion, might be expected for the 300 insolvent institutions not yet included in its caseload. The $5.3 billion would be, however, a loss of only 6 percent on these institutions.

Costs of Resolving Insolvencies That May Occur Among Presently Identified Low Net Worth Institutions

We believe it is reasonable to expect the low net worth institutions that have been unprofitable for the last 2 years to continue incurring losses and become insolvent. We have assumed that FSLIC will act on these cases at a point close to insolvency and for this reason will incur resolution costs similar to those that FDIC incurs in acting on commercial banks with less than $500 million in assets. We therefore applied a loss estimate of 30 percent to the $35 billion in assets in these 72 institutions. Thus, our loss estimate for these institutions amounts to $10.5 billion.

Financing Costs

Our $50 billion estimate of FSLIC's additional funding requirement represents money needed to pay the costs involved in taking action during 1989, 1990, and 1991 to fully resolve the cases of institutions that are already insolvent or will be during that time period. The potential for additional interest expense arises if means are used to borrow some or all of the $50 billion or to defer cash outlays through the issuance of notes.[19] The amount of interest that would be paid can vary according to the length of time and interest rate associated with different borrowing options.

We estimate that FSLIC's financing costs will be about $10 billion more than the amount FSLIC included in its estimate.[20] If present policies of financing costs by issuing notes or by using other forms of borrowing (including guarantees) continue, a significant increase in interest expenses could be incurred. For example, if all of the $50 billion were obtained by a long-term borrowing arrangement similar to the existing $10.8 billion recapitalization program, additional interest costs of about $40 billion would be incurred. Our $10 billion estimate assumes that half of the $50 billion in additional insurance losses we anticipate would be paid for with the type of notes FSLIC used in its July 1988 projection—5-year notes that carry an 8-percent rate of interest. If notes or other borrowing were to have a longer maturity, interest costs would increase. And, if principal repayments are delayed beyond 1998, interest and principal payments would carry over to 1998 and beyond and would represent a claim on future FSLIC premium income. It should be noted that interest payments on the 30-year recapitalization bonds already

[19]Although not counted by FSLIC as an explicit interest expense, a comparable cost is implicitly involved if cash outlays are deferred by guarantees paid at a later date.

[20]If FSLIC obtained the additional funds needed to resolve the cases of its problem thrifts from sources that do not involve borrowing, FSLIC would not have to pay additional interest expenses on the $50 billion.

represent a significant claim on FSLIC premium revenue well beyond 1998.

Future Insurance Losses

FSLIC has not included any estimate for funding institution failures within the 1988 to 1998 time frame beyond those which were already insolvent as of December 31, 1987. Our estimate of FSLIC losses has already included an amount for resolving the problems of the more troubled low net worth institutions—72 that had lost money 2 years in a row. We also believe it is reasonable, in developing funding estimates, to plan for some additional losses from the 2,570 remaining institutions insured by FSLIC, 363 of which have less than 3 percent GAAP net worth. Although we have no empirical basis for estimating such losses, we have included $5 billion in our funding estimate to formally recognize the potential for losses from these institutions. Losses could easily become larger than this estimate should a recession or periods of high interest rates occur or if no improvements are made in the ability of the deposit insurance system to manage its exposure to possible losses. These improvements, which have particular relevance for the 363 low net worth institutions that had $220 billion in assets, are discussed in chapter 5.

Reserves

In addition to the amounts needed to cover losses, FSLIC will also need to build reserves if it is to return to financial health. The FSLIC projection makes no provision for this. To estimate the reserve amount, we have applied a factor of 1.1 percent of projected thrift industry insured deposits as of 1998. This percentage is consistent with the standard for minimum insurance fund reserves contained in deposit insurance legislation. The estimate of the level of insured deposits is based on (1) FSLIC's assumptions about deposit growth[21] and (2) an assumption that the current ratio of insured deposits to total deposits (about 92 percent) will be maintained over the decade. The result is the need for $20 billion to rebuild reserves to the target level.

Updated Outlook as of December 31, 1988

In the last quarter of 1988, FSLIC acted on a total of 101 cases at a total cost to the fund (in present value terms) of $19 billion. Most of this flurry of activity represented assisted merger deals, which are described

[21] If FSLIC's projected deposit growth rate is not realized, the amount of reserves needed (calculated as a percent of deposits) would be reduced. However, as noted above, the lower growth rate would also translate into lower premium income. The need for revenue to replace projected premium income would more than offset the savings that would be associated with a lower reserve requirement.

more fully in chapter 4. In total in 1988, FSLIC acted on 223 institutions at a total cost to the fund (on a present value basis) of $38.6 billion. FSLIC activity during 1988 is summarized in table 2.5.

Table 2.5: Summary of FSLIC Actions During 1988

Dollars in billions

Categories of Thrifts	Number of thrifts	Assets	FSLIC's Estimated costs on a present value basis	Cost of assets
Institutions acted on 1/1/88 - 9/30/88:				
Insolvent at 12/31/87	115	$29.4		
Other institutions	7	2.6		
Total	**122**	**$31.9**	**$19.7**	**61.5%**
Institutions acted on 10/1/88-12/31/88:				
Insolvent at 9/30/88	94	41.1		
Other institutions except for American S&L	6	7.1		
Subtotal	**100**	**$48.2**	**$17.3**	**35.9%**
American S&L (Financial Corp of America)	1	30.1	1.7	5.6%
Total	**101**	**$78.3**	**$19.0**	**24.3%**
Grand Total	**223**	**$110.2**	**$38.6**	**35.0%**

Sources: Preliminary analysis by GAO based on FHLBB data and Thrift Financial Reports.

As of December 31, 1988, we estimate that there were still at least 338 insolvent thrifts with about $100 billion in assets whose cases need to be resolved. However, the number of insolvent institutions that FSLIC must resolve is a moving target. Our estimate is probably understated because it does not include institutions that may have become insolvent during the last quarter of the year. A summary of the number of insolvent thrifts at selected points from December 31, 1987, to December 31, 1988, is shown in table 2.6.

Table 2.6: Insolvent Thrifts at Different Times: December 31, 1987 to December 31, 1988

Dollars in billions

Time	Number of Thrifts	Assets
December 31, 1987	505	$140.3
September 30, 1988	432	$138.2
less: FSLIC 4th quarter actions involving institutions that were insolvent at 9/30/88	94	41.1
December 31, 1988[a]	338	$97.1

[a]Assumes no new insolvent institutions during the 4th quarter of 1988.

Sources: Preliminary analysis by GAO based on FHLBB data and Thrift Financial Reports.

Earlier in the chapter we estimated FSLIC's additional needs for insurance expenses at $60 billion — $50 billion for insurance losses and $10 billion for interest. As a result of the activity that occurred in 1988, it is useful to divide the $60 billion another way. Part of the $60 billion is needed to pay for unfunded costs of activity taken in 1988. The other part is needed to resolve the remaining insolvent institutions.

In the 223 cases that were acted on in 1988, we estimate that FSLIC will need a total of about $60 billion through 1998 to pay for all of the expenses associated with those actions. Those expenses include repayment of principal on notes, interest payments, and payment of all guarantees that are required to fully resolve the cases under the deals that have been made. However as things stand now, FSLIC will only have about $34 billion in revenue from regular and special premiums and from the remainder of the borrowing through FICO. The result is that we estimate FSLIC will need another $26 billion to pay for the costs that cannot be funded from FSLIC's basic revenue sources. Table 2.7 summarizes our estimate of FSLIC's need for funds if it is to pay for all of the costs of its 1988 actions by the end of 1998.

Table 2.7: Estimated Funding Shortfall for FSLIC Actions Taken in 1988

Dollars in billions

Category	Present Value Cost to FSLIC	Cost to FSLIC Through 1988 on Cash Basis [a]
Total funds needed Southwest plan deals	$24.6	$44.2[b]
Other case resolutions	14.0	15.8[c]
Total	**38.6**	**60.0**
Total funds available (Deduct)		34.0[d]
Funding shortfall		$26.0

[a]Assumes that all obligations are paid for by 1998.

[b]The major components are principal payments on notes ($9.2 billion), interest on notes ($8.6 billion), capital loss coverage ($15.6 billion) and yield subsidy payments ($10.9) billion). These deals are explained in more detail in chapter 4.

[c]GAO estimate.

[d]Calculated from table 2.3. The amount ($35.1 billion) shown in that Table for funds available to pay case resolution expenses has been reduced by about $1 billion to pay additional interest expenses on FICO borrowing, which is expected to occur at a faster pace than was assumed in FSLIC's July 1988 cash flow projection.

Source: FHLBB and preliminary GAO estimates.

Our overall estimate of FSLIC's need for additional funds to pay for insurance losses and interest is $60 billion, and we have just shown that $26 billion will be needed to pay for actions already taken in 1988. This leaves an estimated $34 billion to pay for insurance losses and financing costs associated with resolving the remaining 338 insolvent institutions.

We are by no means sure that this will be enough money to resolve the rest of the insolvent thrifts, but at this time we have no basis for revising this estimate. If insurance losses in the remaining cases turn out to be lower than those incurred in 1988, the $34 billion could prove to be sufficient. There are, however, two factors that could well push the cost estimate higher. One is that additional problem institutions are likely to become insolvent in the near future. As of September 30, 1988, there were 154 thrifts with $166 billion in assets that were solvent on a GAAP basis but which already had negative tangible net worth. In addition, cash needs will increase if FSLIC continues to resolve cases with deals that involve notes and guarantees and little up-front cash.

Summary

Our estimate that FSLIC needs at least an additional $85 billion to pay for insurance losses and restore adequate reserves is summarized in table 2.8. Our estimate assumes that approximately $50 billion will be needed by 1991. With this funding, a significant proportion of the insurance losses can be paid with cash, which will reduce the ultimate cost to the government.

Table 2.8: Summary of Estimated Funds Needed by FSLIC Through 1998 in Excess of Those Anticipated in FSLIC's July 7, 1988, Projection

Dollars in billions

Category	Amount
Unfunded Resolution Costs From 1988 Actions	$26
Amount Needed for Remaining Insolvent Cases	34
Amount Needed for Future Losses	5
Amount Needed for Adequate Reserve	20
Total	**$85**

If there were a dramatic turnaround in the regional economies in which many problem thrifts are located, the amount of money required by FSLIC could conceivably turn out to be less than the $85 billion we have estimated. However, we believe that on balance, it is likely that more than the $85 billion may be needed. For example, more than $85 billion will be needed if

- The growth of deposits in the thrift industry slows down.
- Interest rates in the economy increase.
- A recession or additional regional economic problems occur.
- Average loss ratios incurred are higher than those used in our cost estimates. (Our cost estimates, based largely on FSLIC's actual experience, make no explicit adjustment for continued losses until cases can be resolved.)
- Additional insolvencies occur.
- More deals are made that rely heavily on notes and guarantees to defer cash outlays.

Conclusion

If FSLIC is to return to financial soundness, it will need funds to pay for actions it has already taken, resolve its current backlog of problem thrifts, pay for the additional interest expense associated with financing its case resolution operations, and establish adequate insurance fund reserves. On the basis of FSLIC's projection of its available resources over the next 11 years, we estimate that FSLIC faces a funding shortfall of at least $85 billion. This estimate assumes that permanent action is taken to resolve insolvent cases by the end of 1991.

Agency Comments and Our Evaluation

NCUA, FDIC, and FHLBB discussed our estimate of the size of FSLIC's funding need in their comment letters. NCUA said that our study parallels its research that substantial funding must be provided to resolve what it termed as "this massive problem in the S&L industry."

FDIC generally agreed with our estimate of the cost of resolving the S&L industry's problems and with our conclusion that the size of the problem is well beyond FSLIC's available resources. FDIC agreed that it may be appropriate to use FDIC's 30 percent loss to asset ratio in estimating S&L failure costs but asked that we clarify our explanation of the 30 percent loss rate since it applies to resolving bank failures having less than $500 million in assets. (FDIC's loss ratio in resolving larger bank failures has been about 10 percent.) We revised the notes in Table 2.4 and amended the explanation of our method for estimating FSLIC's potential losses (pages 35 and 36) to clarify the meaning of FDIC's 30 percent loss rate. We also explained on page 36 why, in our judgment, FDIC's 30 percent loss experience is relevent for estimating potential FSLIC losses.

FHLBB concurred with our view that FSLIC will require more funds than are anticipated over the next 10 years noting that it has made cash-flow projections showing a need to extend the special assessment for at least 30 years, even though it recognizes that such an extension is not realistic. FHLBB said it was premature to comment directly on our $85 billion estimate because the cost of resolving remaining problems is currently under reassessment.

Why FSLIC's Problems Should Be Resolved as Soon as Possible

The additional money FSLIC needs over the next 10 years to close insolvent institutions and to establish adequate reserves—at least $85 billion—is quite large. With so many other problems facing the country, the question arises as to how important it is to deal with FSLIC now. Is there not some prospect that insolvent institutions can cure themselves? Why not work within the constraints of FSLIC's revenue stream to resolve cases even if it means that many years must pass before the problem is finally resolved? What are the risks of not moving quickly?

FSLIC thus far has been able to function on the basis of ad hoc changes in operating procedures and in funding sources. As with some of the insolvent thrifts it insures, FSLIC appears to have the ability to operate so long as people remain confident that the federal government stands behind it. There are, however, a number of compelling reasons for moving as quickly as possible to do more than the minimum necessary to keep FSLIC operating from year to year.

- The problem is getting worse.
- A swiftly implemented comprehensive approach can save money and minimize the impact on the budget deficit.
- FSLIC's insolvency is damaging the U.S. financial system.
- Failure to deal quickly and effectively with FSLIC's problems may make it harder to ensure the soundness of FDIC.

The Problem Is Getting Worse

The losses insolvent and undercapitalized thrift institutions experienced in 1987 and 1988 represent a continuation of the industry's deterioration that has been occurring since the early 1980s. In 1987, total losses in insolvent and low net worth thrifts were accumulating at a rate of about $27 million per day. In the first quarter of 1988, these losses accumulated at a rate of about $50 million per day. The industry as a whole lost $9.4 billion in the first three quarters of 1988.

There are more reasons to believe that losses will continue as long as most insolvent thrifts remain open than there are reasons to believe that they will stop. Some of the losses reported each quarter do not affect FSLIC's eventual resolution costs because they simply represent belated recognition of losses that were incurred in the past. However, operating losses, which reflect both the lack of interest income on bad loans and cost factors, represent a dollar for dollar reduction in thrifts' net worth and an increase in FSLIC's cost of resolutions.

In addition, the reasons for current losses in insolvent thrifts are different from those of the early 1980s, when most thrift institutions were unprofitable because of the consequences of their exposure to interest-rate risk.[1] In that instance, when interest rates fell most of these institutions once again became profitable.

Now, the basic issue facing insolvent thrifts is one of asset quality. Even if there is some recovery in depressed sectors of the economy, it does not follow that problem assets will become performing ones. For example, it may take a long time for property values to return to their former levels even if economic measures such as the unemployment rate show signs of recovery. Also, interest rates could rise in the future, which would only accelerate the deterioration in already insolvent institutions.[2] Should a recession occur, this too would lead to further deterioration. Thus, a strategy that hopes for FSLIC recovery based on improvements in the economy risks greatly aggravating a problem that has already grown to serious proportions.

One of the strongest factors portending a worsening of the FSLIC situation is the harmful incentive at work in the current environment within which insured institutions operate. As noted in chapter 2, poorly capitalized and insolvent institutions have an incentive to take on additional risks because if the risks pay off, the owners win, while if the risk taking fails, the insurance fund pays most of the losses. FSLIC itself has added to the incentive problem because, on the one hand, it does not have the funds to effectively resolve all troubled institutions; and, on the other, as discussed in chapter 4 some institutions it has resolved through merger actions have not been adequately capitalized. FHLBB has, however, adopted regulations intended to permit little or no growth in the size of troubled or insolvent institutions.

[1] Interest rate risk here refers to the way changes in rates of interest affect the interest earnings and interest expenses of a thrift or any other financial institution. In the thrift situation referred to, most thrift money was invested in fixed-rate, long-term mortgages. However, most thrift deposits were in short-term or passbook savings accounts that could be withdrawn by the depositor. To retain these deposits, thrifts had to pay rates of interest higher than they were earning on their fixed-rate assets, and consequently the thrifts lost money.

[2] Rising interest rates would tend to increase the eventual resolution cost of problem thrifts by decreasing the value of the long-term, fixed-rate mortgage assets held by such institutions. While thrifts have proportionately reduced their holdings of all mortgage-related assets and increased their holdings of adjustable rate mortgages (ARM), fixed-rate mortgage assets still continue to dominate thrift portfolios. A rising interest rate environment could be expected to exacerbate problem thrift operating losses, reactivate interest rate spread problems, and create a slowdown in the housing market. (Interest rate spread is the difference between: (1) the interest earned on mortgages and other loans and investments, and (2) the interest thrifts must pay to obtain deposits and funds from other sources.) Operating expenses and return on capital must, for the most part, be financed out of the spread.

A Comprehensive Approach to the FSLIC Problem Can Save Money and Minimize the Impact on the Budget Deficit

Although much of the uncertainty associated with the ultimate cost of resolving the FSLIC situation results from lack of good information about the true condition of problem institutions, ultimate costs also depend on policy decisions. As we have just mentioned, prompt action to fully resolve cases saves money by reducing the time available for insolvent institutions to generate additional operating losses and take new risks. Strict regulatory and supervisory controls over these institutions until their cases can be resolved can also serve to reduce operating losses and reduce opportunities for risk taking.

The need for prompt action to reduce insurance losses extends beyond the institutions that already are insolvent. At the end of 1987, there were about $255 billion of assets in thrifts that were barely solvent. Potential losses in this group must be curtailed if the cost of resolving the FSLIC situation is to be contained. Prompt case resolution, which requires adequate funding, will put pressure on institutions that are thinly capitalized and in danger of failing, but capable of surviving, to make an all-out effort to seek private capital. However, strict oversight and supervision is also needed to contain future losses among thinly capitalized institutions.

FSLIC's receipts and outlays are included in the U.S. government's budget. The costs FSLIC must sooner or later incur to resolve the cases of insolvent institutions will, therefore, eventually affect the budget deficit. By developing a comprehensive approach to the problem, FSLIC's impact on the deficit can be minimized by heading off future growth of the problem, by finding lower cost solutions, and by making provisions for revenue sources. A comprehensive approach will also result in better projections of future budget impacts and, therefore, contribute to better budget control. Currently, projection of future budget outlays associated with the FSLIC problem are highly uncertain and open-ended.

FSLIC's Insolvency Is Damaging the U.S. Financial System

FSLIC's insolvency damages the U.S. financial system in a number of ways.

- Confidence in the thrift industry and perhaps in the whole U.S. financial sector is at risk.

We pointed out in chapter 2 that FSLIC anticipated operating throughout the next decade with a small cash balance, but that its cash needs were not entirely in its control. If the financing arrangements under which FSLIC is carrying out its functions led a significant portion of the public to doubt that FSLIC would be able to maintain its liquidity, a crisis could occur in the thrift industry.[3] If the crisis were not dealt with promptly, confidence in other financial institutions and markets could also be lost. In addition, allowing so many insolvent and severely undercapitalized institutions that FSLIC cannot close, but whose condition would further deteriorate with higher interest rates, to continue to operate jeopardizes confidence in the ability of monetary policy to act to achieve objectives such as controlling inflation.

- FSLIC's insolvency damages the economy by permitting inappropriate lending and investment decisions.

  As noted above, with FSLIC insolvent and unable to close insolvent institutions, managers and owners of insolvent and weak institutions have an incentive to undertake risky but potentially highly profitable business strategies. Such behavior distorts the function of capital markets because the costs of risk bearing are not borne by those taking the risks. This interferes with the risk/return trade-off and results in an uneconomical allocation of investable funds in the economy.

- FSLIC's insolvency raises the cost of funds for all depository institutions.

  The evidence suggests that insolvent and poorly capitalized thrifts have paid more than generally prevailing rates for deposits, especially in Texas.[4] This not only causes a misallocation of funds to risky institutions, but, to remain competitive, marginally healthy as well as healthy thrifts also have to offer higher rates, which increases their operating costs. This contributes to a weakening of the entire industry.

[3]This was amply illustrated in the 1985 Ohio thrift crisis. The failure of a small government securities firm in Florida brought down Ohio thrifts with which it had financial dealings. This, in turn, helped create runs on thrifts in Ohio that were not insured by FSLIC. FSLIC is by no means in the same situation as a private insurance fund insuring state-chartered thrifts. But the combination of borrowing, notes, and guarantees FSLIC is using to meet its demands could lead fearful market participants to take actions that could disrupt market stability.

[4]See Donald J. Bisenius, An Analysis of the Proposed Capital Requirements for Thrift Institutions, Staff Study, Federal Home Loan Bank Board, Office of Policy and Economic Research August 15, 1986, pp. 66-68. According to Mr. Bert Ely, of Ely and Company, Inc., in testimony before the House Committee on Banking, Finance and Urban Affairs on May 19, 1988, federally insured thrift deposits outside of Texas grew 56 percent nationwide between 1982 and 1987. In Texas, deposit growth was 148 percent.

Failure to Deal Effectively With FSLIC Problems May Make It Harder to Ensure the Soundness of FDIC

How FSLIC's problems are handled may have consequences for FDIC. Although FDIC's problems are not as severe as FSLIC's, it too faces potentially large demands. We noted in chapter 1 that, as a result of recent losses, FDIC's reserves in relation to deposits are at their lowest point in years and that more losses can be expected. FDIC officials have indicated that FDIC's reserves are likely to decline in 1988, after which they expect the condition of the fund to improve.

Our analysis of the outlook for FDIC suggests, however, that FDIC may have a difficult time maintaining adequate reserves over the next several years. Even if FDIC's view that its reserves will start to increase in 1989 proves correct, insurance losses in the years 1990 through 1992 would have to be extremely small in relation to experience over the past 5 years if FDIC is to bring its reserves up to the existing legislative standard of 1.1 percent of insured deposits by 1992. (See app. II.)

The way the FSLIC insolvency is handled may set a dangerous precedent for how the problems of insolvent and undercapitalized FDIC-insured banks are handled, thus weakening the regulatory process. An overriding policy choice that must be faced is whether to let bad regulatory practices in areas such as lack of enforcement of capital standards, closure policy, and the like become the standard for depository institutions, or whether to attempt to set a high standard for risk management that will eliminate the perpetuation of mistakes made in the past.

In this regard, we are particularly concerned about the growth in the number of weakly capitalized commercial banks—banks with less than 3 percent capital on a GAAP basis. (See table 3.1.) Many of these weakly capitalized banking institutions are operating under an explicit program of capital forbearance (i.e., relaxation of enforcement of capital standards) in the hope that their plans for restoring capital to adequate levels will prove successful. [5,6]

[5]In its January 10, 1989 comments on our draft report, FDIC said that there are currently 129 banks in its capital forbearance program and 31 banks that FDIC, as required by law, is allowing to defer losses on agricultural loans. FDIC noted that as of November 1988, 18 percent of the state banks admitted to its program have been closed or had their forbearance eliminated, while 10 percent improved or were merged with another institution.

[6]Under the risk-based capital guidelines that are being developed for banks, equity capital will have to be 4 percent of weighted assets, with weights based on credit risks of different asset categories. Total capital will have to be 8 percent. Banks are to achieve this goal by 1992.

Table 3.1: Insolvent and Weak Commercial Banks: 1980 Through June 30, 1988

Dollars in millions

Year[a]	Number of insolvent banks[b]	Assets in insolvent banks	Number of weak banks[c]	Assets in weak banks
1980	1	$17	14	$1,669
1981	2	37	21	4,054
1982	5	179	43	4,235
1983	14	3,249	74	5,445
1984	8	250	68	7,098
1985	25	1,379	110	8,432
1986	58	2,588	203	19,235
1987	66	8,772	250	114,728
1988 (June 30)[d]	80	25,129	231	92,864

Source: FDIC's consolidated reports of condition and income.

[a]Information is as of December 31 for each year except 1988.

[b]An insolvent bank has negative GAAP capital.

[c]A weak bank has a GAAP capital to asset ratio between 0 and 3 percent.

[d]In its comment letter, FDIC said there were 90 insolvent banks as of mid-year 1988. FDIC's figure is higher than ours because FDIC has been able to update its data base for banks that completed their June 30 reports after FDIC provided us the computerized data. FDIC also noted in its comment letter that 70 of the 90 institutions were either closed or merged out of existence in the second half of 1988, gained solvency during the third quarter, or have assistance proposals currently pending.

Conclusion

The message of this chapter is a simple one. It will be less expensive in the long run and better for the financial system as a whole if FSLIC can be restored to financial health as soon as possible.

To restore FSLIC to a sound financial footing, which includes ensuring to the greatest extent possible that the mistakes of the past are not repeated, three sets of outcomes must be realized:

- The manner in which insolvent thrift institutions are resolved must be changed.
- Risks that are underwritten by the insurance funds must be better managed than they have been in the past.
- The money to fully resolve insolvent institutions must be provided.

The manner in which we believe these outcomes can best be achieved is discussed in the next three chapters. The relationship of a merger of the funds to the efficacy of actions needed to achieve the outcomes is discussed in chapter 7.

Agency Comments and Our Evaluation

FDIC and NCUA provided comments relevant to this chapter. Both agreed that it was important to resolve insolvencies as soon as possible. FDIC also told us that there were 90 insolvent banks as of mid-year 1988 (versus our preliminary figure of 48 shown in the draft report), and FDIC also discussed actions taken on these institutions during the second half of 1988. FDIC said 70 of the 90 insolvent banks were either liquidated or merged out of existence, returned to solvency, or have assistance plans pending. FDIC noted that it anticipates that all of the remaining insolvent institutions will be closed, recapitalized, or otherwise resolved within the ensuing months.

In response to FDIC's comments we reviewed and revised our June 30, 1988, statistics on insolvent and weak banks in table 3.1 (and table II.3) and included an explanation of FDIC actions in a note to the tables.[7] The revision results in a somewhat higher number of both insolvent and weak banks maintaining the validity of our concern that nearly 4 percent of banking industry assets were in insolvent or weak banks as of June 30, 1988. (See app. II, table II.3 for this computation.)

In response to our concern about the number of weak banks, FDIC also provided data on its forbearance program explaining how it requires institutions to be both solvent and viable to qualify for the program and how institutions are removed from the program if they fail to adhere to their recapitalization plan. Because we have not recently evaluated FDIC's forbearance program, we have no basis to question FDIC's explanation of program operations. We included FDIC's statistics on forbearance activity in a footnote to our discussion of weak banks on page 49.

[7] As explained in the notes to table 3.1, figures in our data base still differ slightly from FDIC's because of information missing at the time FDIC provided us with the computerized data, but which was subsequently available to FDIC.

Procedures for Resolving Insolvent Thrifts as Quickly as Possible

In the last chapter, we emphasized the importance of dealing with insolvent thrifts as quickly as possible. The costs and damage from moving slowly are too high. While FSLIC has dealt with a large number of insolvent institutions recently, we are concerned that FSLIC is trying to resolve cases through assisted merger agreements even when this is not the most appropriate solution. We also believe FSLIC needs to implement an alternative case resolution approach that allows it to quickly take control of insolvent institutions even before final resolutions are decided upon.

Concerns Over FSLIC's Approach

The FSLIC strategy is to use assisted mergers as a means for resolving as many problem thrift cases as possible with the limited funds available. FSLIC's July 1988 cash flow projection anticipated that about three-fourths of its case resolution expenditures through fiscal year 1998 will be incurred in merger actions. In 1988, assisted mergers accounted for about 90 percent of the costs incurred in acting on problem cases.[1]

FSLIC analyses show that mergers are often less costly than liquidations, and FHLBB officials believe mergers are not as disruptive to the market because creditors and depositors are less affected by a merger than by a liquidation. We agree that well-designed mergers can be an important part of a strategy for resolving insolvent thrifts. However, FSLIC's estimates of its merger costs for many individual institutions are now approaching FSLIC's estimated liquidation costs for those same institutions. Also, lost tax revenues, uncertainties regarding the ultimate cost of mergers to the fund, and technical features of FSLIC's cost analyses may distort the calculations by understating the cost of mergers to the government.

The convergence of FSLIC's estimated merger and liquidation costs is shown in table 4.1. For those institutions that were merged, this table shows (1) the present value loss booked by FSLIC as a percent of total assets of the insolvent institutions that were merged and (2) FSLIC's estimated present value cost of liquidation as a percent of total assets of the same insolvent institutions.[2]

[1]Costs are calculated on a present value basis. Merger costs include stablization cases which are similar to assisted mergers but require further case resolution action.

[2]It should be noted that this table only deals with FSLIC merger actions (including 18 stabilization cases) and does not compare the estimated average cost of all FSLIC liquidations with the estimated average cost of all mergers.

Table 4.1: FSLIC Merger Actions: Average Estimated Merger Cost Booked by FSLIC and FSLIC's Average Estimated Cost of Liquidating Those Merged Thrifts (1985-1988)

	(Cost expressed as percent of the assets in cases acted on during the year)[a]	
Year	Merger cost	Estimated Liquidated Cost
1985	7.0%	19.4%
1986	5.5	9.5
1987	27.6	33.1
1988 (through September 30)[c]	59.0	66.4

[a]As noted in the text, in our opinion FSLIC's calculations on balance tend to understate the potential costs of merger to the federal government.

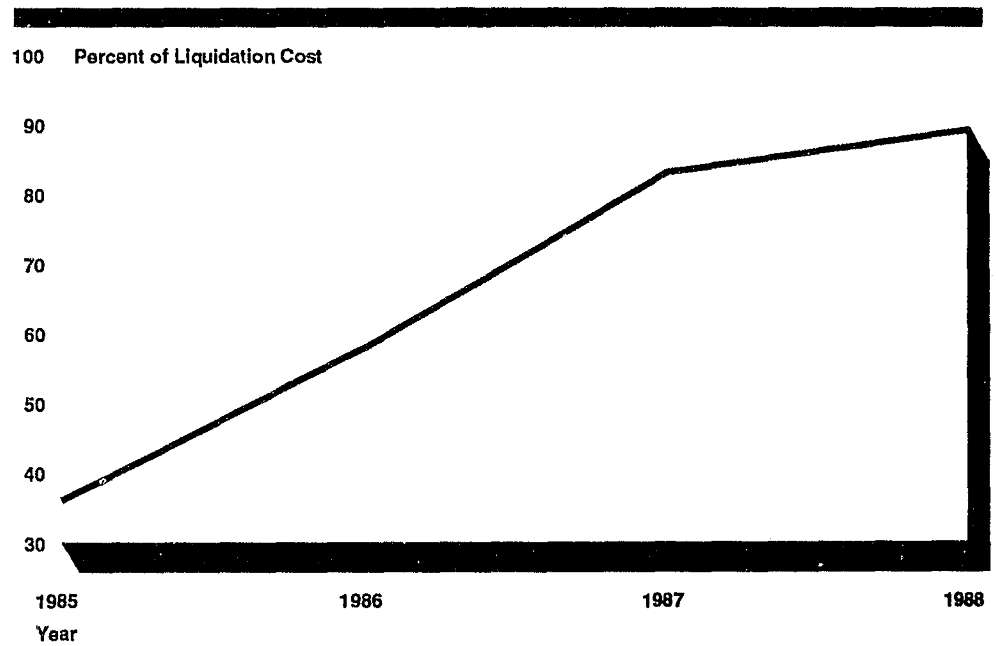
[b]Figures are a weighted average computed by summing the total present dollar value of estimated liquidation costs (or estimated merger costs) for thrifts that were merged during the time period and dividing by total assets as shown on the thrifts' most recent financial statements prior to merger.

[c]Includes stabilization actions. Excluding stabilizations, the percentages are 45.5% estimated merger costs and 54.9% for estimated liquidation cost.
Source: Federal Home Loan Bank Board.

Figure 4.1, based on the data in table 4.1, shows that estimated merger costs are approaching estimated liquidation costs. In 1988, for mergers conducted through September 30, FSLIC calculated that its merger agreements would cost on average 89 percent as much as liquidating those institutions.[3]

[3]Excluding stabilization actions, merger agreements were estimated to cost 83 percent as much as liquidating those institutions.

Figure 4.1: FSLIC Merger Actions: Estimated Merger Cost Booked by FSLIC as a Percentage of FSLIC's Estimated Cost for Liquidating These Same Institutions



Note: This chart is based on percentages contained in table 4.1.

When FSLIC is deciding how to resolve an insolvent thrift, it estimates on a present value basis how much it would cost to liquidate the thrift and compares it with the estimated cost of merging it, given the bid(s) on hand. There is a considerable element of uncertainty in both calculations. For example, when the decision is made, the actual market values of the thrift's assets are not known. There are some differences in the calculation of liquidation versus merger costs that, in our opinion, on balance tend to understate the potential costs of merger to the federal government.

One of these considerations is tax losses. Profitable institutions acquire an unprofitable thrift in part because they can use certain losses in the acquired institutions to reduce their federal tax liability. In addition, FSLIC assistance is tax free for deals arranged by December 31, 1988. The overall tax benefits to the acquirer are reduced for resolution transactions occurring after December 31, 1988. FSLIC generally reduces the amount of FSLIC assistance to take account of some or all of the acquirer's tax benefits. From FSLIC's standpoint, it makes sense not to count the acquirer's tax benefits as a cost to FSLIC of the merger when comparing that cost with the cost of a liquidation. However, from the point of view of the U.S. Treasury, all tax benefits including those used to reduce FSLIC's cost of merger calculations, represent lost revenue and therefore a real cost to the government.

Uncertainties associated with the merger agreements may also increase their cost as time goes on. For example, because of the capital loss and yield indemnification guarantees FSLIC has provided in recent mergers, it remains exposed to capital and operating losses on nonperforming assets in the merged institutions. Clearly, in a liquidation, FSLIC also is exposed to fluctuations in the value of nonperforming loans or their underlying collateral, but in that situation FSLIC maintains control of the liquidation process to maximize its return. In the case of assisted mergers in which nonperforming assets are transferred to the acquiring institution, FSLIC does not maintain the same degree of control over the liquidation of such assets. We question whether the yield maintenance and capital loss indemnification agreements offer sufficient assurance that the acquiring institution will behave in the best interest of FSLIC.

In addition, some institutions being created by FSLIC-assisted mergers are the result of merging two or more insolvent thrifts to create a thrift that is thinly capitalized. In other cases, ownership capital contributed by outside private investors has been below the capital adequacy standard for the industry. FSLIC estimates the viability of a potential acquisition over the next 5 to 10 years on the basis of the business plan submitted and information in the bid proposal. The viability assessment takes into account FSLIC assistance that would be provided. FSLIC does not expect the acquiring institution to be profitable initially. FSLIC expects to see evidence that a movement toward profitability (i.e., a reduction in negative net income) can be anticipated over the ensuing 5- to 10-year period.

We believe it is reasonable to expect that some of the resulting institutions may require further assistance—or liquidation—in the future, unless they become truly profitable. Because of their larger size, the new thrifts may be even harder to deal with if failure does occur. This potential for additional assistance cost, which does not exist when liquidation is used, is not taken into account when comparing the costs of liquidation and merger.

Finally, technical factors also may make FSLIC's deals less advantageous to the government.

- In estimating the present value cost of mergers and liquidations, FSLIC uses the FICO borrowing rate. If an adequate financing plan were available, it would be more appropriate to use the lower Treasury borrowing rate. This adjustment would tend to increase the relative cost of mergers.
- The costs of FSLIC's merger agreements have been compared with the most costly liquidation alternative—outright liquidation of all institutions included in the deals. With adequate funding, other alternatives for resolving the cases at lower cost to the government could be considered.

The first transaction under FSLIC's Southwest Plan, involving Coastal Savings, illustrates how small the difference between estimated merger and liquidation costs has been recently. The acquisition of four troubled thrifts by Coastal raised its assets from about $70 million to $540 million. FSLIC estimated this acquisition would cost the fund $146 million. FSLIC estimated that this cost represented a savings of about 6 percent over the cost of a liquidation. However, FSLIC continues to bear the risk of less favorable outcomes if Coastal is unable to profitably manage its new assets and become a viable institution, independent of FSLIC assistance.

In addition to cost consideration, we have concerns about many of the assisted merger agreements that FSLIC has used to act on cases in 1988.

- The institutions resulting from the assisted mergers are heavily subsidized by FSLIC, and they are competing with healthy nonassisted depository institutions at a cost advantage.
- FSLIC faces a huge task in effectively administering these complex agreements.

We have begun work to assess in detail the merger and other resolutions of specific insolvent thrifts that have occurred. This work will examine the risks to FSLIC and any controls it plans to utilize.

An Alternate Approach Is Needed

With the cost of mergers now approaching that of liquidation for many institutions, the desirability has increased for finding other ways to control costs. It would be unfortunate if the rate at which FSLIC is able to resolve cases continues to be largely dependent on FSLIC's ability to execute merger arrangements such as those described above.

A key to expeditiously resolving cases, while at the same time minimizing FSLIC's costs, is first to be sure there is enough money in the insurance fund to take the most appropriate action. With the money available, a process could then be applied in which FSLIC moves as soon as possible to resolve insolvent institutions. We think that this can best be done by having the government take control of all insolvent institutions. These institutions can then be adequately valued and liquidated or merged while additional economic cost is minimized. In accordance with the cost estimates discussed in chapter 2, we think it likely that case resolution decisions could be completed by the end of 1991.

Under this arrangement, the government would place the thrifts into receivership whenever necessary, remove directors, replace management, and sharply curtail the institutions' activities. The institutions would continue to provide certain services, but strictly as a convenience to their existing customers until such time as a decision is made to rehabilitate, merge, or liquidate them. Managers assigned to such institutions would concentrate on account servicing and evaluation of, and recovery on, assets. The institutions would shrink in size and be able to perform only specified functions to prevent risk taking, with all investment being restricted to government securities and other high-quality assets.

One of the principal problems with FSLIC's current approach to resolution is that, at the time mergers are accomplished, complete information on the financial condition of the institution is often not available. For this reason, FSLIC issues guarantees on broad asset categories to cover unknown losses. One of the advantages of FSLIC taking control is that it would allow time to make a better determination of what the losses in institutions might be, while not allowing management practices that permitted the institutions' insolvency to continue. Under this arrangement, the reliability of the decisions to rehabilitate, merge, or liquidate institutions, and the resulting cost estimates, would be more certain.

The deposit insurance system already provides several mechanisms for the deposit insurance agencies to use in taking control of failed institutions. One is in the thrift industry. For several years, FHLBB has placed selected thrifts into what it calls the Management Consignment Program (MCP). These thrifts have been placed into receivership or conservatorship and the boards of directors and management removed. It expects the new officials of the MCP to draw up business plans to keep the institutions from deteriorating further and, if possible, to rehabilitate them or make them more attractive to prospective purchasers. As of July 31, 1988, a total of 83 institutions at one time or other had been assigned to this program, and 56 were in the program at that date. Of the 27 MCP institutions that were no longer in the program, 17 were liquidated and 10 were merged with or acquired by another institution.

FDIC provides three methods for insurance fund control of failing or failed institutions. The least stringent of these is open bank assistance. In this approach, exemplified by the 1984 rescue of the Continental Illinois National Bank and Trust Company, FDIC exacts changes in the composition of the board of directors and in top management in return for providing assistance. The Competitive Equality Banking Act of 1987 authorized FDIC to establish another mechanism, termed bridge banks, under which an institution placed in receivership is given a temporary charter. In these instances, FDIC replaces directors and top management of the bank until the case is resolved. FDIC recently used a bridge bank in a Texas case. Finally, FDIC can also establish what are called Deposit Insurance National Banks (DINB). DINBS are used to keep failed banks open on a very restricted basis for up to 2 years until the institutions can be recapitalized and sold or liquidated on an orderly basis.

Of the various mechanisms, the DINB mechanism seems most appropriate for dealing with many of the insolvent thrifts, although some of the DINB restrictions, such as the 2-year limit, may need to be modified. The other approaches are more open ended and allow what are essentially nationalized institutions to seek new deposits, make new loans, and otherwise compete in providing the full range of services authorized under their charters. Because the purpose of taking control of the insolvent thrifts is to reduce losses and provide for their optimum resolution, the approach selected should include tight restrictions on investments and on the interest rates that can be paid on deposits.

Under an approach based on the DINB model, operating losses would continue but could be reduced. One reason the DINB approach could reduce operating losses is that premium interest rates to attract funds would be eliminated, as would expenses for advertising and marketing. Furthermore, some types of management expenses could be cut because there would be no need to attract or retain personnel skilled in making new loans or developing complex investment strategies. FSLIC would, however, have to be prepared to advance money for liquidity (or to arrange for such advances) if depositors withdraw funds quickly.

An alternative approach would be to place all insolvent institutions into receivership in a single federally controlled holding arrangement that would be supervised by a specially appointed board.[4] It would be clear that all institutions acted upon in this way had failed. Excessive risk taking and the accompanying losses would be eliminated. Furthermore, these institutions would no longer be competing with well capitalized thrifts and banking institutions in making loans or in offering premium interest rates on deposits.

Administrative Resources

Seeking to resolve FSLIC's problem cases by first taking control of a large number of institutions requires two principal tasks—deciding the true condition of each problem institution and overseeing either the liquidation or acquisition of the institutions' assets. Accomplishing these tasks would increase demands on FSLIC's and FHLBB's resources. Although FHLBB has already initiated reorganization in some areas in response to increased demands, accomplishing these tasks expeditiously will no doubt require additional staff.[5] In this regard, administering the merger deals that have already been completed will place heavy demands on FSLIC staff.

An initial determination of which institutions should be placed into receivership and which should be handled by other means could be accomplished through mobilization of the resources that exist within the federal regulatory structure. To help make the necessary determinations, FSLIC could arrange with FDIC, the Federal Reserve System, the Comptroller of the Currency, and state regulators to perform examination functions on a relatively short-term basis. A recent precedent for accomplishing this may be found in the cooperative response of the bank regulatory agencies in dealing with the 1985 crisis involving state-chartered thrifts in Ohio. In that instance, determinations needed to be made quickly about which uninsured state-chartered thrifts would qualify for FSLIC insurance coverage.

The management of assets to be liquidated would probably require a dramatic increase in FSLIC personnel and other changes to its asset management structure. FSLIC's current structure for dealing with assets places little reliance on federal employees to actually handle the assets.

[4] A proposal along these lines was contained in The FSLIC Crisis: Principles and Issues—a Call to Action, prepared by the American Bankers Association (Sept. 20, 1988).

[5] For a description of the restructuring that has taken place in the Bank Board during 1988, see pages 1-16 of the Statement of M. Danny Wall, Chairman of the Federal Home Loan Bank Board, before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, July 7, 1988.

As presently constituted, FSLIC is not in a position to immediately manage a dramatic increase in assets. When presented with the need to handle additional assets a few years ago, FHLBB created the Federal Asset Disposition Association (FADA); however, we recently found that its creation was not proper.[6]

If a major effort to quickly take control of insolvent thrifts were launched, FSLIC would immediately need additional asset management resources. If it is unable to fully resolve issues that have impeded its development of adequate resources using FSLIC employees, receivership personnel, and private-sector firms, FSLIC could consider use of FDIC's asset management structure and personnel.[7] FDIC is a much larger agency than FSLIC. FDIC has developed a flexible, decentralized structure for the in-house management of assets from failed institutions using temporary federal employees. While FDIC has a heavy asset management workload, it anticipates that its workload may decline in 1990. Even if the workload does not decline, FDIC's more flexible structure would permit it to add temporary staff more easily than would FSLIC's. FSLIC would have to retain enough control over the asset management process to meet its legal and fiduciary responsibilities.

Although FSLIC might need to use FDIC's structure and personnel only until it can develop its own system and resources, combining assets acquired from failed banks and thrifts for management and liquidation might provide some opportunity for the packaging of assets for sale and the pacing of sales that would improve the return to both FDIC and FSLIC. The deposit insurance funds could also take advantage of any economies of scale.[8]

[6]Letter to Sen. David Pryor, Chairman of the Subcommittee on Federal Services, Post Office, and Civil Service, Senate Committee on Governmental Affairs, (Sept. 6, 1988).

[7]A recent precedent for contracting with FDIC for assistance exists within the Farm Credit System. In 1988, the Farm Credit Administration contracted with FDIC for assistance with respect to the closing of the Federal Land Bank of Jackson, Mississippi.

[8]Our report entitled Failed Banks: FDIC's Asset Liquidation Operations (GAO/GGD-88-132, Sept. 28, 1988), describes the FDIC policies and process.

Taking Control of Insolvent Institutions Does Not Mean Assets Will Be Dumped

One of the arguments for slowing down liquidation of insolvent thrifts or, alternatively, for allowing them to remain open, is that closing these institutions more rapidly means dumping substandard assets in already depressed markets. Such a massive sell-off, it is argued, would gain FSLIC little and would create more hardship by further lowering asset values in areas of the country where markets are already depressed.

Moving quickly to take control of problem institutions does not necessarily mean that assets would be sold too quickly. Under receiverships, nonperforming loans, distressed real estate, and other assets owned by liquidated thrifts are not sold immediately. The rate of asset liquidation within a receivership is calculated to maximize the discounted net return to the receivership and therefore liquidation officials have an interest in timing asset sales so as not to unduly depress prices. In the past, there has been a significant lag before disposal of the assets. In computing the estimated costs of liquidation and merger for a 5-year receivership, for example, FSLIC assumes a reduction of 30 percent per year in years 2 through 4 and 10 percent in year 5 for all problem assets. Furthermore, economic theory suggests that asset prices in depressed markets are likely to already incorporate expectations about the existence of a large overhang of assets in insolvent institutions that may come on the market. Therefore, FSLIC takeovers of insolvent institutions would not necessarily depress markets.

Conclusions

FSLIC's plan to rely almost exclusively on assisted mergers to resolve insolvent thrifts ultimately ties the pace of case resolution to the availability of suitable acquirers. Of more fundamental importance, the unknown value of assets causes uncertainty over what FSLIC's costs will ultimately be on the recent assisted mergers. Cost calculations also do not include the possibility that the institutions created by the mergers will require additional assistance.

Alternative approaches are needed that allow FSLIC to take control of insolvent institutions as quickly as possible so it can reduce potential costs to the insurance fund by minimizing future losses and by eliminating the tendency for insolvent thrifts to pay higher interest rates than do solvent thrifts. FSLIC would also gain time to evaluate the true condition of the thrifts, make realistic estimates of the cost of liquidation or merger, and either negotiate with an acquirer or arrange for orderly liquidation. One approach, the rapid deployment of a combined regulatory task force, which occurred during the Ohio savings and loan crisis, could help identify asset quality and other problems in insolvent institutions.

FSLIC's current asset management structure and resources, however, may not presently be equipped to deal immediately with the large amount of assets that could be acquired. One solution to this problem would be entering into an arrangement with FDIC for needed assistance.

Recommendations

We recommend the following:

- The government should promptly take control of insolvent thrifts, placing these institutions in a receivership arrangement when necessary until a decision to rehabilitate, merge, or liquidate them can be made on the basis of a careful study of their asset portfolios and the net cost of each approach. In the interim, supervisory and insurance officials should limit the operations of these institutions to investing in high-grade securities, managing bad assets on the books, and accepting insured deposits from existing customers at market rates.
- FHLBB should form a task force of regulators and insurance officials to assess the quality of assets in insolvent thrifts for purposes of deciding which thrifts should be rehabilitated, merged, or liquidated.
- FSLIC should arrange with FDIC or other regulatory agencies for any required assistance.

Agency Comments and Our Evaluation

FHLBB and the Federal Reserve provided comments relevant to this chapter.

FHLBB said that all of its actions attempt to minimize insurance fund costs. It stated that with more cash it could perform additional liquidations, but that assisted mergers are the preferred course of action because they take advantage of the values represented by core deposits and mortgage origination business. FHLBB also said that its current case resolution process is consistent with our recommendations, citing particularly regulations restricting growth and several MCP and stabilization actions.

The FHLBB comments do not address our main point. We recognize that FHLBB has now adopted regulations controlling growth and other activities of insolvent institutions and that merger arrangements of some type often prove to be the best way to resolve cases. However, our main point is that the whole approach that the Bank Board has taken to resolving cases has been fundamentally flawed.

In recent years the federal government has been involved in several financial rescues of smaller magnitude than the FSLIC rescue. In 1984 we issued a report, based on the government's experience with Chrysler, New York City, and several other situations, containing guidelines about how such efforts should be structured.[9] The guidelines underscore the importance of developing an adequate plan for financing, implementing, and overseeing these types of situations.

The Bank Board's actions have not been consistent with these guidelines. The Bank Board began to close institutions and obligate the government to pay large amounts of money over the next 10 years without first implementing reforms or assuring that adequate sources of financing were available. As late as the summer and early fall of 1988 FHLBB presented information to Congress suggesting that it had the resources it needed. Furthermore, although its regulations concerning the activities of insolvent and weakly capitalized institutions have gotten much better, it has not had the administrative capability to fully take control of all insolvent institutions or to fully assess alternative ways to resolving problem cases.

In response to FHLBB's comments, we expanded our explanation of concerns about FSLIC case resolution deals. We recognize that FHLBB's lack of money limited its options.

FHLBB said that the extension by the government of full faith and credit to FSLIC notes and guarantees would reduce FSLIC's resolution costs. In our view the government's full faith and credit is already pledged. Should FSLIC be unable to pay on the notes and guarantees the government will be obligated to do so, although presently there is no source of funding designated for such payments by the government. To the extent Congress wishes to alleviate apparent uncertainty in the marketplace concerning the full faith and credit issue, it could enact legislation specifically pledging the government's faith and credit to FSLIC's notes and guarantees. However, we believe any consideration of the status of FSLIC notes and guarantees should also consider appropriate controls over the use of such obligations.

In its comments, the Federal Reserve said it recognizes the magnitude and complexity of the problems facing the thrift industry and is certainly willing to play a constructive and appropriate role in addressing the situation. After corroborating our description of its role in Ohio and

[9] Guidelines for Rescuing Large Failing Firms and Minicipalities (GAO/GGD-84-34, March 29, 1984).

Maryland thrift crises, the Federal Reserve said it remains ready to provide an appropriate measure of assistance to other federal and state regulators, consistent with its available resources and responsibilities for promoting safe and sound conditions within the banking and financial system.

Risk Management and Deposit Insurance Reform

To keep FSLIC's current situation from being repeated in either FSLIC or FDIC, better risk management in the deposit insurance system is needed.[1] This requires bringing funding sources and exposure to risk into better balance so that the insurance funds will have enough money to pay for the losses they expect to incur.

This chapter discusses immediate changes to risk management policies that are needed to protect the integrity of the deposit insurance system. We also discuss more far-reaching reforms to the deposit insurance system that need not be implemented right away but which could, in the future, reduce the likelihood of unfunded insurance losses.

Basis for Concern

Until the present decade, both banks and thrifts were protected from competition by regulations limiting entry into the industry, the interest rates they could pay, and the geographic areas in which they could operate. However, during the 1980s it became clear that changes in the economy, in the technology associated with financial services, and in the number and types of services offered by financial institutions of all types rendered many of the regulations limiting competition ineffective or even counterproductive in protecting the safety and soundness of depository institutions. Many regulations have been relaxed and it is unrealistic to return to the segmented, highly regulated markets of the past. Looking to the future, therefore, we think risk management decisions must be based on the assumption that risks facing the deposit insurance system are greater and more unpredictable than in previous decades when the deposit insurance system experienced few losses.

Without better management over the exposure of the deposit insurance system to today's risks, the losses that the funds may have to underwrite are potentially enormous. The loss potential is amply demonstrated by the number of insolvent institutions in the thrift industry, the heavy losses FSLIC has been experiencing, and by the fact that, in 1988 (through September 30), FSLIC experienced loss ratios in excess of 100 percent of the assets in at least eight of the institutions it acted on.

There are three interrelated elements of successful risk management:

- providing adequate funding sources to pay the bills because without funding, the credibility of other means of controlling losses to which the insurer is exposed becomes questionable;

[1] Risk is defined as the possibility of financial loss.

- ensuring the adequacy of insured institutions' capital that serves as a buffer to protect the deposit insurance funds from losses; and
- better managing exposure to losses through such things as more vigilant oversight and supervision and not permitting insolvent institutions to continue operating.

In response to continuing losses in both FSLIC and FDIC, federal regulatory officials have taken steps that use each of these approaches in addressing risk management issues.

- To raise funds, FHLBB has implemented a special premium and the $10.8 billion recapitalization.
- To provide a greater buffer for the insurance fund, regulators in both industries have also raised the amount of capital that is considered adequate for regulatory purposes.[2]
- To help control risks, FHLBB issued regulations to curtail both the growth of poorly capitalized thrifts and activities such as direct investments that are perceived to be particularly risky.[3]
- In addition, supervisory staff of both the banking and thrift regulators have been increased and efforts have been made to improve the quantity and quality of supervisory oversight, including examinations.

These actions represent steps in the right direction. But much more needs to be done to ensure that the types of experiences associated with FSLIC's insolvency do not occur again.

Approaches to Risk Management

There are two general approaches to achieving better control over risks borne by the deposit insurance system. One approach is to build on the current system, making improvements that will increase funding and reduce exposure to the risks that are insured under current arrangements in both FSLIC and FDIC. The other approach is more far-reaching and involves changing the kinds of risks that deposit insurance underwrites.

[2]Under CEBA, FHLBB must prescribe uniform accounting standards and capital requirements consistent with those for commercial banks.

[3]In 1983 and 1984, the thrift industry experienced significant deposit growth. This growth was also experienced by under-capitalized and insolvent institutions. For example, in 1983, deposits in GAAP-insolvent thrifts grew at a rate of 14.5 percent, while the industry growth rate was 21 percent.

Building on the Existing System

Building on the existing system of deposit insurance requires that changes be made to funding, capital requirements, and loss control policies to achieve a more satisfactory match between funding levels and risks underwritten by the funds. We believe that, at a minimum, six changes need to be made to provide reasonable assurance that FSLIC's insolvency is not repeated in the future.

These changes are

- providing more flexibility in funding,
- strengthening regulation and enforcement of capital adequacy,
- providing greater independence and ability to deposit insurance officials to protect the integrity of the deposit insurance funds,
- improving supervisory capability and related risk control infrastructure,
- clarifying the responsibilities of holding companies for maintaining adequate capital in their insured depository institutions, and
- achieving consistency in the regulation of banks and thrifts where differences can represent a material threat to the deposit insurance funds.

More Flexibility in Funding

Putting to one side the question of paying the bills on FSLIC's current problem cases, deposit insurance funding arrangements for both FDIC and FSLIC need to change. The law does not permit FDIC to raise its premiums above one-twelfth of 1 percent of domestic deposits, nor FSLIC to increase its premiums by more than the special premium now in effect. This inability to relate premiums to loss experience is an obvious limitation.

To be effective in discouraging risk taking by insured institutions, the deposit insurance funds need to have sufficient reserves to take prompt action to resolve the case of any institution that fails either to maintain adequate capital or to refrain from engaging in unsafe and unsound practices. If the cost of deposit insurance has risen, directors of the deposit insurance funds should be able to increase premiums, just as occurs in private sector insurance, so that adequate levels of reserves can be maintained. Additional borrowing authority should also be provided to both FDIC and FSLIC to minimize the chance that the ability of the system to operate would be compromised by temporary liquidity problems.

Strengthened Regulation and Enforcement of Capital Adequacy

To improve the buffer provided by capital in insured institutions, federal regulators of commercial banks are in the process of developing capital adequacy regulations that would reflect differences in the risk characteristics of assets held by individual institutions. These regulations, developed in cooperation with regulatory officials in other nations, for the first time bring a direct link between risk and capital into the capital structure of commercial banks.[4]

FHLBB has also proposed capital requirements that take into account differences in the activities of insured thrifts. The variations in the capital requirements that are or are likely to be applicable in both FDIC- and FSLIC-insured institutions fall far short of true pricing of risk. However, a link between risk and capital requirements and encouragement of subordinated debt to help meet higher capital needs may reduce the incentive for institutions to take excessive risks.[5]

Capital requirements have to be enforced if they are to be effective in influencing the risk-taking behavior of the owners and managers of depository institutions. Therefore, another change that needs to be made to the existing system is to make it clear that institutions will be closed whenever their capital, as defined in capital adequacy regulations, approaches zero. While this represents an improvement in the management of insurance fund risk, it will by no means eliminate insurance fund losses.

FDIC is experiencing average insurance losses of about 30 percent of assets on cases of banks under $500 million assets it had to resolve by liquidation or assisted merger. The basic reason for this seems to be that as reported levels of capital approach zero, real capital is well below that amount because managers of troubled firms are likely to have done everything possible to avoid or delay recognizing losses. The success of a closure policy in reducing insurance fund exposure to risk depends on the willingness of federal officials to monitor the condition of problem institutions closely and to close institutions promptly when their capital is gone.

[4]Under existing arrangements, on a judgmental basis, regulators impose additional capital requirements on institutions deemed to be too risky. Ability to do this would continue under the new regulations.

[5]Subordinated debt is debt whose claim on the assets of the institution if it should fail is of lower priority than that of the deposit insurance funds and other general creditors. See appendix IV for additional discussion of the limitations of risk-based capital.

We are particularly concerned about the FHLBB's willingness or ability to carry out a policy of promptly closing institutions. Most of FHLBB's supervisory activities are carried out by employees of the Federal Home Loan banks, which are owned by the industry. Because of FHLBB's responsibility for promoting the industry's role in housing finance, we also are concerned about whether closure policies for thrifts comparable to those provided for FDIC-insured banks can be achieved by FHLBB.

Another important part of enforcing capital standards is applying sanctions to institutions that are not insolvent but fail to maintain adequate capital. In 1987, the assets of 685 solvent but undercapitalized institutions (GAAP capital between 0 and 3 percent of assets) in the commercial banking and thrift industry totaled about $370 billion. (See table 5.1.) Given that financial statements are not prepared on a market value basis, this number of poorly capitalized institutions is cause for concern. If the condition of a large proportion of these institutions should deteriorate substantially, insurance losses for FDIC as well as FSLIC will increase.

As noted above, FHLBB, FDIC, and other bank regulatory officials recognize the dangers posed by undercapitalized institutions and they have taken steps to improve the monitoring and supervision of such institutions. To protect the deposit insurance funds, we believe these efforts need to be intensified and backed up with regulations and supervision that curb or forbid growth, nonconservative risk-taking strategies, and payment of above-market rates on insured deposits by undercapitalized institutions. Dividend payments and executive compensation are other areas in which more stringent controls on the practices followed by undercapitalized institutions may be needed.[6]

Table 5.1: Solvent but Undercapitalized Institutions in the Commercial Banking and Thrift Industries, December 31, 1987

Dollars in billions

Industry	Number of institutions	Assets
Commercial banking	250	$115
Thrifts	435	255
Total	685	$370

Note: Institutions with net worth on a GAAP basis of 0 to 3 percent.

Source: Tables 2.1 and 3.1.

[6]In curbing the growth of these weak institutions, FSLIC, the Federal Home Loan Bank System, FDIC, or the Federal Reserve System might have to be prepared to lend funds to institutions to replace funds withdrawn by market participants. This would be necessary if a sufficiently large number of depositors were no longer willing to place deposits in poorly capitalized institutions whose ability to offer above-market rates to attract deposits has been curtailed.

Greater Ability for Deposit Insurance Officials to Protect the Integrity of the Deposit Insurance Funds

Under current arrangements for chartering, regulating, supervising, and insuring depository institutions, responsibility for trying to keep both FSLIC and FDIC from experiencing unfunded losses in effect is shared among a number of federal and state officials. However, to help ensure that FSLIC's situation is not repeated, we believe deposit insurance officials need to have both a clear mandate and sufficient powers so that they can be held more accountable for protecting the integrity of the insurance funds they administer. The biggest problem now is FSLIC's lack of independence.

Because of our concerns over the ability of FHLBB to effectively regulate, oversee, and supervise the thrift industry while at the same time promoting the industry's interests, we have doubts that the independence of FSLIC can be appreciably enhanced as long as it remains an integral part of the FHLBB, subject to its direction. For this reason, we believe that FSLIC should be disengaged from FHLBB and made independent similar to the organizational model that exists for FDIC and the banking industry regulators.

One way to enable an independent FSLIC to better protect the insurance funds is to enable it to take steps to ensure that the kinds of risks being underwritten are reasonably consistent across federally and state-chartered institutions. FSLIC currently insures some state-chartered institutions that have greater freedom to engage in certain risky activities than do federally chartered institutions. As a result, these state-chartered institutions can often impose greater risks on FSLIC than can federally chartered thrifts.

Many observers have pointed out that state-chartered institutions have served as a major source of innovation within the banking industry. However, the disparity between the powers of federally and state-chartered institutions that exposes the insurance funds to losses is hard to justify in a flat-rate deposit insurance system. If this disparity cannot be eliminated, and if all institutions are to be charged the same premiums, then an independent FSLIC needs to be able to refuse to insure new state-chartered institutions whose powers are likely to generate risks substantially greater than those associated with federally chartered institutions.

Similarly, an independent FSLIC needs to be able to cancel insurance coverage expeditiously or to take other steps, such as increasing premiums, issuing cease and desist orders, or requiring increased levels of capital for any class of institutions that exercises powers that can be demonstrated to involve a material level of risk not found in federally chartered institutions. Similar powers are needed in situations involving individual undercapitalized federally or state-chartered institutions or other situations that threaten the fund.

With sufficient powers to protect the fund for good cause shown—and with adequate resources to accomplish this—an independent FSLIC would be in a much better position than FSLIC is now in to impose discipline in the thrift industry and to assure implementation and enforcement of actions that have a material effect on deposit insurance finances. Such an arrangement involves the possibility of creating some friction between deposit insurance and other federal or state chartering and supervisory officials. However, in our view, this is a lesser evil than leaving an independent FSLIC in a situation in which it is unable to take the actions needed to protect the integrity of the fund.

In carrying out its duties, an independent FSLIC will need to develop an adequate supervisory capability for both federally and state-chartered institutions. Because it will take time to acquire and train personnel to better monitor the industry condition and supervise problem cases, we believe an independent FSLIC should be able to enter into arrangements to draw, as needed, assistance from FDIC or other bank regulatory agencies.

Although the major problems of insurance fund authority exist in FSLIC, we have some concern about FDIC as well. Several years ago, we observed that FDIC had experienced some difficulty in coordinating its activities with other federal and state authorities. Efforts such as joint examination of some problem national banks with OCC appear to have improved the situation. At the present time it seems to be much less likely that information about a problem institution known to another regulator will be kept from FDIC, or that a chartering agency will keep institutions open that FDIC believes should be closed to keep insurance losses from mounting. Also, FDIC's ability to act independently is evident in the notices of intent to cancel insurance that have been issued by FDIC.[7]

[7]FDIC gave notice of its intent to cancel insurance to 12 of the 61 national banks that failed in 1987 and 33 of the 123 state-chartered banks that also failed in that year. In all of these instances, chartering officials revoked the charters of the institutions before the procedure to cancel insurance was completed. (In 1987, FSLIC did not issue any notices of its intent to cancel insurance.)

Nonetheless, some legal limitations on FDIC's authority remain. These limitations may be inconsistent with assuring the degree of independence for FDIC that we believe is needed for an independent FSLIC. For example, FDIC officials say that the procedure for cancelling deposit insurance is a cumbersome one. FDIC cannot issue cease and desist orders to national or state member banks, nor can it refuse insurance to a new national bank chartered by OCC or to a new state bank that becomes a member of the Federal Reserve System.

Improve Supervisory Capability and Related Risk-Control Infrastructure

It is now generally recognized that deregulation of financial services requires effective supervision to ensure that individual firms do not mismanage the opportunities to offer new services that deregulation makes possible. Although the Federal Home Loan Bank System and the banking regulatory agencies have taken steps to improve their supervisory capabilities, the task remains unfinished.

Within the private sector, both public accounting firms and appraisers of real property must also play key roles in assuring that depository institutions are not wittingly or unwittingly mismanaged.[8] In this regard, efforts to develop accounting, auditing, and reporting systems to allow regulators to assess the market value of institutions in deteriorating condition should be pursued vigorously. Deposit insurance and other federal regulatory officials should make every effort to hold those involved in the risk-control infrastructure accountable for their actions, and federal and state law enforcement officials and prosecutors also have an important role to play.[9]

[8]All thrifts and some commercial banks (those where stock is publicly held or traded) are required to have their financial statements audited by outside public accounting firms. Crucial elements of such audits involve evaluation of the internal controls of institutions and of the GAAP value of assets. We have reviewed efforts by FDIC and FSLIC to pursue monetary claims against independent accounting firms in cases where the agencies believed the work the accounting firms performed was negligent. See Bank Regulation: Information on Independent Public Accountant Audits of Financial Institutions (GAO/GGD-86-44FS, Apr. 21, 1986).

Real estate appraisals are important for depository institutions because one measure of prudent lending is that loans not exceed a certain percentage of the appraised value of real estate. Appraisals that are higher than market value can therefore lead to loans being made that will result in losses for the depository institution in the event that the loan goes into default. See Combatting Fraud, Abuse and Misconduct in the Nation's Financial Institutions: Current Federal Efforts are Inadequate, House Committee on Government Operations, U.S. House of Representatives (House Report 100-1088, Oct. 13, 1988), especially pp. 41 to 43.

[9]For a discussion of law enforcement and other activities, see the report by the House Committee on Government Operations cited in footnote 8.

Financial Responsibility of Banks and Thrift Holding Companies for Insured Depository Institutions

In recent years, the holding company structure has become a very common form of ownership for banks and thrifts. This structure allows a corporate organization to expand into a number of activities that are legally and economically separate from those of the insured bank or thrift. Proposals that would allow banking organizations to expand into securities or other nontraditional banking activities often require a holding company format.

Existing laws are intended to ensure that the insured depository institutions are not adversely affected by a holding company affiliate or by actions of the holding company itself. For example, restrictions exist regarding transfers of assets from banks to the holding company or its subsidiaries. An unresolved issue that has a bearing on the integrity of the deposit insurance system is the degree of financial support that holding companies should be required to provide for failing bank or thrift subsidiaries. Although Federal Reserve System policy says that bank holding companies should serve as a source of strength for bank subsidiaries, the degree to which this policy is legally binding has been questioned. It is also not clear exactly how this policy would work with respect to such matters as limits to holding company liability.

Those who oppose special financial responsibility rules for holding companies say this will discourage needed investment in banking organizations. However, the existence of deposit insurance is also a recognition that banks and thrifts are special institutions, different from other businesses. No matter how tightly drawn the laws and regulations may be, there are subtle ways that a holding company can charge costs to a bank or attribute revenue to the holding company and this can affect the ultimate profitability and soundness of the bank—and cause losses to the deposit insurance system.

We believe that it is appropriate to consider rules concerning the financial support responsibilities of bank holding companies to help protect the deposit insurance system from losses in the future. To this end, the Federal Reserve System should draw up a specific proposal to accomplish this objective.

Consistency in Requirements for Banks and Thrifts

Banks and thrifts are linked economically because they compete for the same deposit base and offer many of the same products. Therefore, differences in capital requirements, closure rules, powers, privileges, taxes, holding company arrangements, deposit insurance premiums, or sanctions for undercapitalized institutions can all translate into competitive advantages for one or the other class of institutions. To the extent that the riskier class of institutions can attract insured funds more easily than can the less risky class, the overall exposure of the federal government to deposit insurance losses is increased unless the premiums on the two industries can be adjusted properly. Any attempt to heavily regulate the affairs of one industry but not its competitors may thus prove counterproductive.

We therefore think it is essential from both an equity point of view and from the point of view of protecting the government's financial interest that the industries insured by FDIC and FSLIC be comparably regulated as soon as possible in those matters that are material to deposit insurance risk. Closure rules, similar schemes of capital regulation, and sanctions on undercapitalized institutions could be equalized fairly quickly. However, eliminating all material differences between the two industries and between state-chartered and federally chartered institutions within each industry is likely to take considerably longer to resolve.

Changing the Risks That Deposit Insurance Underwrites

In the last few years, a number of reform proposals that are more far-reaching than those just enumerated have been advocated by representatives of the industry and the regulatory and academic communities. Some of the problems that these reforms, discussed in more detail in appendix IV, are intended to cure are as follows:

- There is no market discipline on the owners and managers of insured institutions. Insured deposits can always be attracted by offering higher rates. So long as the depositors can depend on deposit insurance for their money, they have little incentive to curb risky behavior by depository institutions.
- Deposit insurance to individual institutions is underpriced.
- Risk underwriting by the deposit insurance system is extended because depository institutions or the holding companies that own them are diversifying their activities into more types of financial products.[10]

[10]One of the most perplexing problems facing the deposit insurance system concerns the powers that are appropriate for institutions that have deposit insurance. Diversification into new product lines provides well-managed institutions with opportunities to earn higher profits, and therefore pay higher interest rates, without taking on excessive risk. On the other hand, permitting diversification into areas of potential risk allows poorly managed institutions to take on an inordinately high degree of risk—as recent experience in the thrift industry makes abundantly clear. Furthermore, diversification increases the number of markets in which institutions operating with relatively low-cost insured deposits compete with those operating with funds raised from other sources. Thus, with diversification, the reach of deposit insurance and the supervisory activities of financial institution regulators extends further into the economy.

- Large institutions that are considered too big to fail received favored treatment.

One set of proposals to deal with these problems seeks to increase market discipline on banks by requiring parties other than the deposit insurance fund to experience losses if institutions fail. These proposals include modified payoffs,[11] co-insurance, reduced deposit insurance limits, and use of subordinated debt to meet higher capital requirements.

Other proposals would price risk by charging risk-based insurance premiums or by imposing risk-based capital requirements that would be intended, respectively, to fully compensate for, or fully buffer the insurance fund from, insurance losses under normal economic conditions. Still another set of proposals would have the effect of forcing insured institutions themselves to take steps to protect the insurance fund from losses. These latter proposals include closing institutions when the market value of an institution's capital hits zero, collateralizing deposits, or allowing insured deposits to be accepted only by what is termed a narrow bank—an entity required to invest only in certain low-risk assets. If these proposals for forcing insured institutions to take steps to protect the insurance fund proved to be successful in controlling risks borne by deposit insurers, we believe they would drastically reduce the cost of operating the deposit insurance system.

Unfortunately, there are practical difficulties associated with all of these proposals. The responses of depositors, depository institutions, and credit markets to any of these reforms is difficult to predict but may have important long-run and potentially damaging consequences for the financial system. For example, the proposals to increase market discipline may introduce types of market instability that have been considered unacceptable in the past, and they also require that depositors and general creditors know a great deal more than they now know about the condition of banks and thrifts.

Risk-based pricing of deposit insurance or capital, and closing institutions when the market value of their capital hits zero, also demand that regulators know more about the current condition of thrifts and banks.

[11] Modified payouts are a procedure under which uninsured depositors and general creditors receive only their pro rata share of projected asset liquidation values when an institution is closed and arrangements are made to have its insured deposits insured by another institution. For a more detailed explanation of this proposal, see Federal Deposit Insurance Corporation, "Market Discipline and the Federal Deposit Insurance System," Deposit Insurance in a Changing Environment (Apr. 15, 1983), p. III-5.

In addition, these proposals also require deposit insurers or regulatory officials to do things that are likely to prove politically difficult, such as sending out notices of huge insurance premium increases or closing institutions that are still solvent on a GAAP basis.

The proposals for forcing institutions to make provisions for risk through collateralization of deposits or the establishment of a narrow banking subsidiary may affect the patterns of financial flows and interest rates in the economy in ways that are difficult to anticipate. These options may also impair the banking sector's traditional and vital role of serving as a source of liquidity for firms throughout the economy, particularly during periods of financial difficulty.

The complexity of the reform issues and our uncertainty regarding how best to ultimately reform the system leads to the conclusion that more far-reaching reforms must proceed with caution. In moving as quickly as possible to resolve the FSLIC situation, it makes the most sense to take those steps already outlined that build on the current system and that can be done within the existing concept of deposit insurance. With these changes in place, it may then be appropriate to experiment with more fundamental changes in the types of risk that the insurance fund underwrites or in the pricing of risks.

We think it possible, for example, that opportunities may evolve in the future to offer depository institutions options to operate under a different deposit insurance arrangement. For example, a banking organization could be given the option of operating under the current system or, in return for agreeing to fully collateralize insured deposits or place all such deposits in a narrow bank, a banking organization could pay a much lower premium or be granted certain powers that otherwise would not be attainable.

Conclusions

FSLIC's present financial problems as well as recent FDIC losses show clearly that in today's financial environment, insuring about $2.5 trillion in deposits at banks and thrifts can carry great risk. While economic conditions have certainly played a role, the current condition of FSLIC is also the result of other factors that can be changed—for example, enforcing capital adequacy standards. In making changes, the risk management policies for thrifts and banks should be considered together because the two types of institutions compete for the same deposit base and provide many of the same services.

Unless a better balance is achieved between funding arrangements and the risks being underwritten, insurance losses may continue to be very large. The potential threat is illustrated by the existence in December 1987 of 685 undercapitalized thrifts and commercial banks with assets of about $370 billion that were not insolvent but that had less than 3 percent GAAP capital. Further deterioration of these undercapitalized institutions could place great strain on the deposit insurance system.

Current proposals for fundamentally reforming the nature of the deposit insurance system's risk underwriting activities offer the possibility of correcting some of the problems with the existing arrangements and, in some cases, of reducing funding requirements. However, they could also have major effects on the financial flows in the economy, the structure of interest rates, and the stability of the financial system. Because of their potential drawbacks and because their implementation is not necessary to correct the most glaring problems that have bankrupted FSLIC, we believe it is not essential that fundamental reforms be implemented at the same time that action is taken to resolve the FSLIC problem.

Recommendations

To help ensure that the situation that has befallen FSLIC is not repeated within the deposit insurance system, we recommend that Congress take the following steps:

- disengage FSLIC from the Federal Home Loan Bank Board and create an independent insurance function for the thrift industry that has adequate supervisory resources;
- enhance the ability of both an independent FSLIC and FDIC to place stringent controls on improperly operated and/or undercapitalized institutions and to withdraw insurance from such institutions;
- provide FDIC and FSLIC with the authority to raise assessments as needed to be able to meet future insurance costs, over and above whatever special arrangements are worked out for solving FSLIC's current crisis; and
- direct the appropriate agencies to establish consistency in regulation and supervision of banks and thrifts in matters that have a material effect on the government's exposure to deposit insurance losses.

We also recommend that FHLBB, FSLIC, and the bank regulatory agencies

- strengthen capital adequacy requirements and their enforcement,
- improve their supervisory capability, and

- undertake efforts to enhance the effectiveness of the related risk control infrastructure in the private sector.

In addition, we recommend that the Board of Governors of the Federal Reserve System develop a specific proposal for clearly defining holding company financial responsibility for insured depository institutions.

Finally, we recommend that Congress and the deposit insurance agencies, in consultation with federal and state chartering agencies, pursue a more comprehensive reform agenda after FSLIC's funding needs are met and the other recommendations implemented. This agenda should permit some experimentation so that all institutions will not necessarily have to fit into the same approach. For example, institutions could be offered a choice of whether they wanted to collateralize deposits or place their insured deposits in a narrow bank in return for lower premiums or enhanced powers.

Agency Comments and Our Evaluation

FHLBB, FDIC, and the Federal Reserve provided comments relevant to the content of this chapter.

FHLBB disagreed with our recommendation to separate FSLIC from the Bank Board because it believes we failed to justify how such independence improves regulatory oversight and supervision. FHLBB said even if FSLIC is managed independently of the Bank Board, it would have to coordinate with the Bank Board in much the same way as FDIC coordinates with chartering agencies now. FHLBB believes that with separate agencies, the industry could play one agency against the other. FHLBB also said that if in promoting the industry it makes decisions that are biased, it would be critical to correct this bias regardless of the administrative status of FSLIC. Finally, FHLBB said that this particular recommendation does not establish a structure, such as a reinsurance entity, that assures the current depository insurance system problems will not recur.

We believe the failure of the Bank Board over the years to recognize and deal with the risk that insolvent institutions posed to FSLIC is sufficient justification for an independent insurance fund. We recognize that separating the insurance function for thrifts similar to FDIC is not a perfect arrangement because, as we discuss on page 72, FDIC would also benefit from enhanced powers. Therefore, our recommendation to separate FSLIC from FHLBB is coupled with the need to provide the insurance function enough money and authority so it can act to protect itself. From this same perspective of the need for comprehensive action, the recommendation to separate FSLIC from FHLBB in this chapter is one part of our set of recommendations that we believe will help to ensure that the current problems are not repeated.

FDIC strongly supported our recommendations regarding deposit insurance reform, noting that many of our recommendations agreed with those in its recent deposit insurance study. FDIC said the spirit of the reform proposals is to allow the federal deposit insurer to have more independence and to protect the integrity of its fund by functioning more like a private insurance company.

The Federal Reserve agreed with our recommendations to improve financial oversight, describing in some detail its specific efforts to strengthen capital adequacy standards, enhance its supervisory capability, and obtain better information about the market value of financial institutions. (See app. XI, p. 149.) We believe that the actions described by the Federal Reserve are steps in the right direction.

The Federal Reserve said our recommendation to the Board of Governors for a specific proposal to clearly define holding company financial responsibility for insured depository institutions was not necessary. The Federal Reserve said its existing policy statement, although couched in terms of subsidiary banks, clearly affirms the Board's commitment to the principle that a bank holding company should serve as a source of strength to any insured depository institution subsidiary.

While the Board's policy statement may have confirmed the Board's commitment to the "source of strength principle," the issue is far from resolved and, in our judgment, still requires a specific proposal. FDIC discussed this issue in detail in its study Deposit Insurance for the Nineties: Meeting the Challenge, (pp. 229-233). FDIC stated that the validity of the source of strength doctrine has not been tested in the courts, and in recent relevant cases the Federal Reserve has not obtained a judicial determination. We are sympathetic to FDIC's concern on this issue because the extent of holding companies' financial responsibilities has been an issue in recent FDIC assistance actions.

Funding

In chapter 2, we estimated that through 1998 FSLIC will need at least $85 billion more than FSLIC anticipates it will have available. Of the $85 billion, $26 billion is required to help pay for actions taken in 1988, and $34 billion is needed for resolving the cases of the remaining insolvent institutions. The balance represents an allowance for the costs of unanticipated failures between 1989 and 1998, for the payment of interest on funds borrowed to finance insurance losses, and for a reserve that will put FSLIC on a solid financial footing by 1998.

Responsibility for the present condition of the industry and the significant funding shortfall can be allocated to a number of parties. Those who abused thrift institutions and the deposit insurance system through disregard of prudent management standards or outright fraud bear special responsibilities and should be made to pay as much as possible. However, a combination of adverse economic conditions, the unforeseen consequences of legislative changes in depository institutions regulation, weaknesses in federal and state systems for supervising thrifts, and changes in the tax code affecting commercial development have all contributed as well.

Furthermore, the owners of thrifts and their customers have all benefitted financially from the underpricing of deposit insurance for the level of risk regulators permitted. Looking ahead, all depository institutions, depositors, and the public at large have a stake in making sure that the deposit insurance system has the ability to perform its role in protecting deposits, stabilizing markets, and maintaining confidence in the Nation's banking system.

Decisions about who should contribute to the funding solution and the amounts of their respective contributions depend on assessments of ability to pay. But, more fundamentally, the decisions depend on judgments about what is fair. In our view, only Congress can appropriately make this value judgment.

Alternatives for Raising Funds From the Thrift Industry

Potential sources of funding from within the thrift industry include insured thrift institutions, the Federal Home Loan banks, and acquirers of problem thrifts.

Insured Thrift Institutions

Given the size of FSLIC's cash shortfall and the condition of the thrift industry, it is not realistic to expect that the thrift industry will be able to pay all of FSLIC's bills over the next decade. For example, the entire net income of the solvent portion of the industry in 1987 was 0.28 percent of assets (28 basis points) or less than $3 billion. (Over the past decade in periods that have been profitable by historical standards, earnings for the solvent part of the industry averaged about 0.7 percent of assets. At the present time, this percentage applied to the assets of solvent thrifts would yield earnings of about $7 billion.)

Thrift industry representatives point out that they are already contributing to paying FSLIC's bills through the special premium, which FSLIC estimates will provide $19 billion in cash flow if it is continued through 1998.[1] It has also been argued that

- a potential conflict exists in requiring the industry to raise capital levels while shouldering a burden of additional premium payments;
- imposing higher premium payments on insolvent institutions or those that are weakly capitalized would be self-defeating;
- healthy thrifts had no way to prevent the activities by other institutions that have resulted in such high FSLIC losses; and
- the deposit insurance premiums, which are the basis of industry financing, were never intended to cover losses as great as those FSLIC now faces.[2]

Although there are practical limits to how much the thrift industry can pay, it is not correct to assume that any increase in the deposit insurance premium will automatically result in a dollar-for-dollar reduction in net income or capital. Deposit insurance is but one item of expense. In 1987, the regular and special premiums of the industry accounted for about 1.6 percent of its total expenses. As with any unavoidable item of expense that increases in price, thrift institutions, all of which would face the same cost increase with respect to deposits, have choices within limits set by competitive market conditions about whether they charge more for loans; pay less for deposits; or reduce operating expenses

[1]The chairman of FHLBB has indicated that the special premium may need to be kept in place for at least 30 years.

[2]For example, see Statement of M. Danny Wall, October 5, 1988.

through branch closings, cutting salaries, reducing advertising, or by other means.[3]

Other developments could also make it feasible for thrift institutions to pay more to FSLIC than seems apparent simply by looking at industry profitability. As noted earlier, the high rate of interest that many insolvent or undercapitalized thrifts have paid for deposits has a tendency to raise the costs of funds to other institutions. If FSLIC takes control of insolvent institutions, as we suggest, the cost of funds for many healthy institutions will be reduced. This decrease in the cost of funds would enhance the ability of institutions to make further insurance contributions.

Furthermore, FSLIC's financial problem itself may have resulted in the need for some or all thrifts to pay higher rates than would otherwise be necessary to attract funds. The launching of an effort to rapidly deal with insolvent institutions and to restore FSLIC to health could, if successful, reduce or eliminate any tendency for the industry's and FSLIC's problems to increase the costs of funds to FSLIC-insured institutions.

Higher Insurance Premiums

One way to seek to obtain more money from the thrift industry is to raise insurance premiums still further. As a guideline to amounts that could theoretically be raised, we estimate that for each one basis point increase in deposit insurance rates for thrift institutions, as much as $1.5 billion could be raised over the next 10 years, using FSLIC's assumption that industry deposits grow by 7 percent per year.

Each one basis point of premium increase would constitute less than one-tenth of 1 percent of the industry's expenses. Alternatively, expanding the base on which the current deposit insurance premium is levied to include all liabilities could raise a maximum of $9.2 billion more over the next 10 years.[4]

[3]It has been estimated that about half of the Nation's 85,000 bank and thrift branch offices are losing money because most branches are simply not big enough to make money in today's market characterized by low interest margins. (See a study by Booz, Allen & Hamilton cited in an unpublished paper by Bert Ely of Ely and Co.)

[4]This estimate assumes that total liabilities also grow at an average annual rate of 7 percent. Broadening the base to include total liabilities can be questioned because the system only insures deposits up to $100,000. However, domestic deposits over $100,000 already pay premiums and in practice uninsured depositors and general creditors generally have received de facto protection. Uninsured liability holders also benefit from the stable market environment deposit insurance provides, and the superior claim on assets that some uninsured parties have increases the costs to the deposit insurer if the institution should fail.

The ability to collect higher premiums—as well as the $19 billion FSLIC has already projected for the existing special premium—depends on market forces over which thrifts and FSLIC have but limited control. The rates of interest paid by thrifts to depositors are set in competitive markets as are the rates of interest thrifts charge for loans. If thrifts attempt to recoup higher FSLIC insurance costs by reducing the rate of interest paid on deposits, these deposits may be withdrawn from the industry in favor of FDIC-insured deposits. This would reduce FSLIC's deposit base and perhaps introduce liquidity problems for some institutions. Similarly, if thrift institutions attempt to raise their loan rates, customers may seek loans elsewhere. Finally, in response to higher insurance rates, healthy thrift institutions themselves might seek FDIC insurance unless constrained from doing so as they currently are.

The above discussion illuminates a dilemma associated with the decision about how much money to raise from the thrift industry. The desire to be fair and avoid the setting of a dangerous precedent dictates that thrifts be required to contribute to the financing shortfall. But, in funding the financing shortfall, it would be foolhardy to damage healthy, well-managed thrift institutions and/or further exacerbate FSLIC's problems.

A Good Company/Bad Company Reorganization of FSLIC

One approach to obtaining a thrift industry contribution that we believe can overcome the difficult trade-off outlined above involves reorganizing an independent FSLIC to create two separate funds that can be termed "good company" and "bad company" funds. The good company fund would consist of the thrifts that initially meet a minimum standard of financial soundness—perhaps a GAAP capital level of at least 3 percent of assets.[5] (See table 6.1.) The bad company fund would contain all insolvent and undercapitalized institutions, including all institutions placed in receivership as suggested in chapter 4. Institutions initially qualifying for the good company fund but not meeting industry minimum capital adequacy standards would be given a limited period of time to reach the adequate level.

[5]The level of capital sufficient to initially qualify for the good company fund could be less than the regulatory minimum capital adequacy standard for the industry.

Table 6.1: Example of the Distribution of Institutions in a Good Company/Bad Company Reorganization of Fslic

	Number	Assets	Total Deposits
Composition of the good company fund: Thrifts with 3-percent or greater GAAP capital	2,207 (70%)	$856 (68%)	$628 (67%)
Composition of the bad company fund: Thrifts with less than 3-percent GAAP capital[a]	940 (30%)	395 (32%)	305 (33%)
Totals[b]	**3,147 (100%)**	**$1,252 (100%)**	**$933 (100%)**

Note:Based on information as of December 31, 1987.

[a]From table 2.1.

[b]Columns may not add due to rounding.

The good company fund would be set up in accordance with the risk management policies described in chapter 5. That is, the fund, with a board of directors independent of FHLBB, would operate under revised policies regarding enforcement of capital adequacy guidelines, sanctions on undercapitalized institutions, closure of insolvent institutions, and enhanced powers for the insurance agency to protect the integrity of the good company fund. As a result of these different operating rules, insurance losses in the good company fund could be expected to be quite low.

The good company fund would need to be capitalized with sufficient reserves to place it on a solid financial footing. Arrangements would also have to be made to cover the insurance losses of the bad company fund, with as much financing as possible provided by the thrift industry. The following section shows how this could be done.

Financing of the Good Company and Bad Company Funds

Capitalization of the good company fund could be done in several ways. For example, it could be accomplished in a manner similar to the NCUSIF recapitalization in 1984. Under this arrangement, which is described in more detail in appendix VI, each institution insured by the good company fund would make a capital contribution to the good company fund equal to 1.0 percent of insured deposits. By investing this capital contribution in government securities, the fund would earn interest income.

In 1989, if the good company fund was comprised of the firms with GAAP capital of at least 3 percent, the initial one-time capital contribution would be about $8 billion.[6] As institutions grow, they would continue to

[6]If desired to minimize the initial burden placed on insured institutions, the 1 percent contribution could be phased in over several years. However, a delay in making the capital contribution would reduce the interest income of the fund.

make capital contributions to maintain the 1 percent of insured deposits relationship. If deposits grow at the 7-percent-per-year rate FSLIC projects, and all thrift industry deposits are in good company fund institutions by 1998, the balance in the capital contribution account at that time would be $18 billion.[7]

Institutions in the good company fund could continue to pay insurance premiums, but we assume that they would be no higher than the existing regular assessment of one-twelfth of 1 percent of deposits. Given the capital contribution noted above, the existing special assessment could be eliminated. A working capital account (that also earns interest) within the good company insurance fund would be built up through accrual of interest on the asset contribution and through premium contributions. Insurance losses occurring in good company institutions would be paid from the working capital account, as would all administrative expenses. When the level of the working capital fund plus the 1-percent capital contribution reached a predetermined level (such as 1.3 percent of insured deposits), any excess money in the fund after expenses and other costs could, for a period of time (such as through 1998), be paid to the bad company fund to help pay the expenses of resolving the cases of insolvent thrifts. Thereafter, it could be rebated to good company thrifts, although arrangements would have to be made for interest payments on the remaining years of the 30-year FICO bonds.

An example of the financing of a good company FSLIC reorganization based upon the preceding discussion is summarized in table 6.2. Over the 10-year period, premium income and interest on reserves would provide the good company fund with about $23 billion in revenue. After deducting estimated insurance losses between 1989 and 1998 (assumed in this example to be $5 billion), administrative expenses, and working capital reserves, about $10 billion would be available in this example for payment to the bad company fund.

[7]The FHLBB currently has the authority to require insured thrifts to deposit 1 percent of their deposits with FSLIC to be used for liquidity purposes. FSLIC must pay interest on these deposits which amount to a loan to FSLIC.

Table 6.2: Example of Good Company Revenues and Uses of Funds for the 10-Year Period 1989 Through 1998

Dollars in billions	
Revenues	
Premium income (8.3 basis points)	$11.4
Interest earnings on reserves[a]	11.5
Total	**22.9**
Uses of Funds	
Administrative expenses	2.4
Assumption regarding insurance losses	5.0
Build up of working capital reserves	5.3
Total	**12.7**
Amount that can be paid to the bad company fund to help resolve problem thrift cases	10.2

[a]Reserve balances on which interest is earned result principally from capital contributions of 1 percent of insured deposits, which are not counted as fund revenues in this example. Interest is also earned on the buildup of working capital reserves.

Under this reorganization, the finances of the bad company fund would be the same as FSLIC's forecast through 1998 discussed in chapter 2, except for our higher estimate for resolving insolvent cases and for the removal of the revenues and expenses associated with the institutions moving to the good company fund. All obligations and liabilities incurred by FSLIC up to the date of the reorganization would remain the responsibility of the bad company fund. The most important impact of the reorganization is that most of the premium revenue FSLIC expected to have to resolve problem cases would no longer be available because healthy firms will have moved to the good company fund. A summary of the bad company finances is shown in table 6.3.

Table 6.3: Summary of Bad Company Financial Needs: 1989 Through 1998

Dollars in billions

	Change in funds needed for the bad company fund compared to FSLIC's 1998 cash flow estimate
Additional funds to pay for costs of cases acted on in 1988	+ $26
Additional expenses for resolving approximately 350 remaining insolvent cases	+ 34
Loss of regular and special premium revenue as a result of institutions transferring to the good company fund	+ 29
Reduced administrative expense for the bad company fund	- 2
Subtotal	**+ $87**
Contribution from the good company fund to help pay bad company expenses	- 10
Net additional amount needed from federal contribution or other sources	**$77**

Note: Bad company finances are the same as the FHLBB's projection for FSLIC, discussed in chapter 2, modified by the following two considerations:

(1) GAO's estimate of the cost to resolve and finance insurance losses presented in chapter 2.

(2) A good company/bad company reorganization of FSLIC as contained in the example of tables 6.1 and 6.2.

The amounts shown in the table represent additions to or subtractions from FSLIC's cash flow projection summarized in table 2.3. This projection includes payment of interest on FICO bonds through 1998.

An estimate of reserves for the bad company fund has not been included because the institutions in this fund will either be closed or will eventually transfer to the good company fund (or perhaps to FDIC) by way of merger or rehabilitation.

We estimate that the additional funds the bad company fund will need beyond what is included in FSLIC's projection will come to $87 billion—$26 billion unfunded costs of actions taken in 1988, $34 billion for action on other insolvent cases, plus $27 billion in revenues lost (net of savings in administrative expenses) due to the good company fund financing arrangements.[8] Of the $87 billion, $10 billion could be paid from a contribution from the good company fund. This leaves a deficit

[8]This $87 billion needed for the bad company fund is consistent with, but should be distinguished from, the overall $85 billion in additional funds for insurance expenses and reserves we estimate FSLIC will need.

of approximately $77 billion to be made up by a federal contribution or other sources.[9]

This example of good company/bad company financing over the next decade generates $10 billion more revenue from the thrift industry in the form of contributions from insured institutions and interest on reserves than is the case with FSLIC's July 7, 1988, cash flow projection.[10] Although the amount of the capital contribution received by 1998 would be slightly less than the special premium that otherwise would be collected, the capital contribution is paid in sooner and hence is able to earn interest that benefits the insurance fund. Nonetheless, the good company/bad company approach has the potential for not adversely affecting the condition of the industry as much as continuing the special premium for up to 30 years or even increasing it. The reason for this is that if losses in the good company fund are low, interest on the contributions eventually would serve to reduce future insurance premiums. The success of the good company fund depends, however, on whether a more

[9] A decision will also have to be made about how interest on the FICO recapitalization bonds will be paid after 1998.

[10] Under this good company/bad company reorganization example, the total amount of money obtained from insured institutions and insurance fund reserves for the 11-year period 1988 through 1998 would amount to about $44 billion—the sum of the capital contribution, premiums, and interest on reserves as follows:

Premium collections from all institutions in 1988 and from institutions in good company and bad company funds in 1989 and subsequent years	$14.4
Interest on reserves in the good company fund	11.5
Capital Contributions to establish and maintain reserves	17.8
	$43.7

FSLIC's cash flow projection for the period 1988 through 1998 assumed about $34 billion would be obtained directly or indirectly from the industry from premiums and interest earnings on reserves. The amounts are as follows:

Regular premiums	$13.0
Special premiums	19.4
Interest on reserves	1.2
	$33.6

To simplify the comparison, both calculations assume that deposits will grow in the industry at a rate of 7 percent per year.

rigorous approach to regulating and supervising the good company fund is able to keep insurance losses low.[11]

Permitting the Migration of Healthy Thrifts to FSLIC

Under this option, healthy thrifts that meet FDIC's qualifying criteria should be allowed to choose to migrate to FDIC upon paying some combination of an exit fee and a capital contribution to FDIC. The total cost of the fee and contribution, after taking into account FDIC premium assessments, should be equivalent to the cost of staying in the good company fund. One advantage of this approach is that as long as costs to healthy institutions were similar, the decision to migrate to FDIC versus migrating to the good company FSLIC fund would represent a market test of the value of a thrift industry charter and of the strength of thrift institutions' belief in the need for continuation of a specialized housing lender industry.

If a sufficiently large number of healthy thrifts migrate to FDIC either right away or after they have been able to bring their capital up to FDIC standards, the number of thrifts comprising the good company fund may not allow for enough risk diversification to provide a sound basis for a deposit insurance fund. If this occurs, it might be appropriate at that point to take steps to consider consolidating FDIC and the good company thrift fund since business decisions taken by individual thrifts would already have largely achieved that result.

Federal Home Loan Bank System

The 12 Federal Home Loan banks, which make up the System, are viewed in capital markets as having agency status, which makes it possible for them to raise money at favorable interest rates. They are an important source of funds for member institutions and are responsible for carrying out many important public functions, such as supervision of all federally chartered thrifts.[12] The banks are owned by the member thrift institutions. Each member institution is required to own stock in proportion to the level of the mortgage obligation holdings and the System advances it has received. In 1987, the banks, which have a combined capital/asset ratio of 8.9 percent ($13.7 billion/$154 billion), earned a profit of more than $1.3 billion, which allowed them to pay

[11] If losses in the good company fund are higher than expected, interest earnings on reserves would be reduced and insured institutions would also be expected to contribute additional amounts to maintain their contribution at a level of 1 percent of insured deposits.

[12] In 1987, the System raised $70.4 billion (much of it to refinance outstanding obligations) in consolidated bonds and discount notes sold by the Office of Finance, the fiscal agent for the System. Advances to member thrift institutions at the end of 1987 totaled $116.8 billion.

cash and stock dividends of over $1 billion. The System played a role in the recent recapitalization of FSLIC by providing the funds to purchase zero coupon bonds used to back the payment of principal on the FICO bonds.

It may be possible to find other ways to devote some or all of the System's capital and earnings to help solve FSLIC's funding needs. Although the System represents one of the strongest central credit facilities in the world, tapping a significant portion of its resources has the drawback of reducing the earnings or assets of the member thrifts that own stock in the banks. In other words, such steps would have effects similar to raising insurance premiums and could jeopardize the solvency of already weak thrifts and damage the competitiveness of healthy thrifts.

One way to involve FHLBS would be to expand the existing $10.8 billion recapitalization program. If FHLBS purchases Treasury zero coupon bonds to make provision for the payment of principal on FICO bonds, the cost to FHLBS depends upon the maturity of the bonds. At a 9 percent Treasury rate of interest, the cost of a 30-year zero coupon bond is about 7.1 percent of the amount of the principal payment that will be due on a FICO bond in 30 years. Thus, for each $10 billion in 30-year bonds sold by FICO, the cost to FHLBS would be about $710 million. If 15-year bonds at a 9 percent interest rate were used instead, the cost to FHLBS of the 15-year zero coupon bonds would be about 27 percent of the amount of the principal due in 15 years. Thus, for each $10 billion in 15-year bonds issued by FICO, the cost to FHLBS would be about $2.7 billion.

The problem with this approach to recapitalization is the payment of interest. In total, the interest payments far exceed the cost of FHLBS's zero coupon bond purchase. If FICO issued $10 billion in bonds paying 10 percent interest annually (the FICO rate has been about one full percentage point above the Treasury rate for comparable maturity), FSLIC or some other party would have to make annual interest payments of $1 billion for the length of the maturity of the bonds.

Quite apart from possibilities for paying for FSLIC's losses, the System's borrowing power may be useful in advancing funds to FSLIC or to insured institutions to facilitate the resolution of problem cases. Funds for such advances could come from the System's own resources or from its ability to access a $4 billion credit line with Treasury. However, the interest costs on System borrowing will be higher than if the borrowing were accomplished directly from the Treasury.

Liberalize the Laws on the Acquisition of Thrifts

FSLIC has authority to arrange mergers with virtually any type of institution willing to acquire a failing thrift. However, there are other constraints on the acquisition of thrifts which, if removed, might attract additional capital that could correspondingly reduce the amount of the $85 billion in funding that has to be raised from other sources. For example, under the provisions of the Bank Holding Company Act, banks or bank holding companies that acquire a thrift can only exercise thrift powers that are consistent with the more limited powers permitted for bank holding companies. Similarly, FHLBB generally has not allowed securities firms to acquire and use the full powers of the thrifts.

Although we do not know how significant the potential contribution to FSLIC funding needs might be, there is little question that if the range of product powers were expanded to provide an inducement for banks and others to acquire failing thrifts, the prices paid for those thrifts would rise. However, efforts to consciously enhance the value of the thrift charter would be counter to the recommendation we made in chapter 5 to reduce the differences between banks and thrifts. Moreover, major public policy issues on the uses that may be appropriately made of insured deposits have recently been debated by Congress. Until these issues are resolved, any relaxation of constraints on acquiring thrifts should be held in abeyance.

Financial Participation by the Federal Government

We believe that the need to solve the FSLIC problem as quickly and cheaply as possible is of such great importance that federal funds should be used to the extent necessary to accomplish this. Government policies have in various direct and indirect ways contributed to the FSLIC problem and there is a public good aspect to deposit insurance and financial market stability. There is ample precedent for federal funding of economically depressed sectors and institutions. Also, using federal funds is preferable to other schemes meant to hide or put off the cost.

However, federal participation should be conditioned on adoption of actions that change the way insolvent thrifts are currently resolved as well as actions that improve the quality and consistency of regulations to better manage risks and control losses in the future. Federal participation should also be conditioned on the existence of appropriate controls over expenditures of funds to assure that the government's interests and those of taxpayers are protected.

The amount of federal funding needed to pay insurance losses depends on decisions about the use of alternative sources of funding. The fewer the other sources of funding, the greater the commitment of federal funds will need to be. For example, if a good company/bad company reorganization of FSLIC is done and financial flows such as those discussed earlier materialize, then the remaining cash shortfall that would need to be financed by the federal government would be about $77 billion (see table 6.3).

Types of Federal Assistance That Could Be Provided

There are two types of federal assistance that could be provided to help restore the deposit insurance system to financial soundness. The first is helping to meet the funding shortfall needed to cover insurance losses and restore FSLIC to financial health. Federal funds for this purpose could be provided directly to FSLIC by purchase of stock in FSLIC or by other proposed methods that are, practically speaking, no different than federal outlays.

- The Federal Reserve System could be authorized to pay interest on the reserve accounts that thrifts and other depository institutions are required to keep at Federal Reserve banks, with the payment diverted to FSLIC until such time as the deposit insurance financing needs have been met. These payments would amount to about $3 billion per year.
- The Federal Reserve could pay some or all of its operating profits, currently running about $17 billion per year, to FSLIC rather than to the Treasury. Profits would be about $3 billion less annually if the Federal Reserve were also paying interest on deposited reserves.

Although we have not examined these suggestions in detail, we are concerned that their basic purpose is principally to mask the degree of the federal government's financial commitment that is likely to be involved in resolving the FSLIC situation. If these or other indirect measures for obtaining federal financing are adopted, they should be justified in their own right as sound policies, rather than as convenient financing expedients.

A second type of federal assistance would be to provide a source of borrowing so that FSLIC can move much more quickly to resolve problems. If the goal of acting to resolve all insolvent cases within 3 years is to be met, a high volume of short-term liquidity loans may also be needed to help with liquidations or to cover deposits withdrawn from institutions that have been taken over by FSLIC and are in the process of being closed. The Treasury can provide the cheapest, most flexible source of credit available.

To the extent that federal money is used, we recommend an on-budget approach that fully discloses the funding and outlays that are involved, even if this requires raising the Gramm-Rudman-Hollings deficit reduction targets. We also think that a restructured federal budget along the lines we have proposed elsewhere would better highlight the financing of FSLIC and similar business-like enterprises.[13]

To assure adequate controls of spending to protect the taxpayers' interests, we also believe it would be appropriate to create a special control board if federal funds are provided. This board, which should include the Secretary of the Treasury and possibly the Chairman of the Board of Governors of the Federal Reserve System, would be empowered to review spending plans before funds would be released. The board would continue to exist until all of the presently identified problem cases had been resolved.

To restore FSLIC to financial health with a significantly smaller federal financial commitment than $75 to $80 billion, other sources of financing outside of the thrift industry will have to be considered. These sources include other depository institutions and depositors themselves. Because of their size, the banking industry or depositors are the only other likely industry sources that could make major contributions to financing the shortfall.

Banking Industry

Clearly, the FDIC-insured banking industry is not responsible for the problems of the thrift industry or its insurer. In fact, many believe that the banking industry has been significantly damaged due to the behavior and regulation of the thrift industry.

Furthermore, in past federal rescues of troubled individual institutions or economic sectors, no private sector funding has been obtained from anyone other than the assisted entity(s). For example, in the Chrysler Corporation rescue, Ford and General Motors did not provide funds. In the recent Farm Credit rescue, funding was not obtained from its commercial bank competitors. Nor did other cities contribute to the New York City rescue. In these and other cases, financing to resolve the problem came from the distressed entity and/or from general taxpayer revenues on the grounds that the problem was national in scope, a solution was in the national interest, and general taxpayer financing distributed

[13]Financial Management Issues, (GAO/OCG-89-7TR, Nov. 1988), pp.10-12.

the financial burden most widely so that individual contributions were minimal.

Nevertheless, in view of the fact that both industries offer the same deposit products in competition with one another, FDIC-insured banks stand to benefit from prompt resolution of the FSLIC problem. For this reason, a contribution from the banking industry may be worth considering. The erosion of confidence in thrift industry deposit offerings has resulted in increased rates, which many believe have increased the rates banks must pay to attract deposits. Furthermore, as already noted, changes in, and equalization of, risk management policies could significantly enhance the ability of banks to compete for insured deposits. From the federal government's perspective, any contribution by the banking industry would reduce federal outlays needed to meet the funding shortfall. However, like the dilemma that exists for deciding on what the thrift industry can pay, if a contribution is sought from the banking industry it is essential that it not adversely affect the competitiveness or viability of FDIC-insured banks.

We believe a banking industry contribution to financing resolution of the FSLIC problem should only be considered if the following conditions are met:

- Significant steps are taken to equalize regulation of the two industries with regard to matters that have a material affect on deposit insurance risks: powers, capital requirements, closure rules, closure processes, the quality of supervision and oversight, and access to FHLBS advances to finance housing lending.
- Appropriate controls are in place over how contributions to financing are spent.
- Any thrift institutions that are resolved through merger or rehabilitation must be adequately capitalized from their inception to eliminate the possibility that banks would have to compete with undercapitalized thrifts.

These conditions represent changes that need to occur regardless of whether there is a contribution from FDIC-insured banks. They are important in their own right in restoring FSLIC to a solid financial footing, and ensuring that the mistakes of the past are not repeated. But, if a contributions were to be sought from FDIC-insured banks, the government would also have a special responsibility for ensuring that bank contributions were as well spent as contributions by taxpayers.

As is the case with thrifts, we have not fully assessed the banking industry's ability to make contributions to meeting the financing shortfall. As a guideline to amounts that could potentially be raised, we estimate that for each one basis point of premium levied on the domestic deposits of FDIC-insured banks, a total of $3.5 billion could be raised by 1988. Increasing the assessment base for banks to include all liabilities and charging the current one-twelfth of 1 percent deposit insurance premium could raise about $12.6 billion more through 1998 than what would be raised by charging a similar assessment against total deposits.

Like thrifts, the amount of additional insurance expenses FDIC-insured banks can be expected to pay without damage to healthy institutions depends upon earnings, ability to shift insurance costs to customers, and ability to reduce other items of expense. It is important to note in this regard that if a contribution is sought from both banks and thrifts that roughly equalizes their costs of insurance, the ability to pass those costs on to customers and therefore their ability to effectively compete for deposits would also tend to be more equivalent. Larger commercial banks do, however, have the additional problem of overseas competition with foreign banks.

Depositors

Depositors benefit directly from deposit insurance and they already indirectly bear a portion of the costs of deposit insurance assessments in the rates of interest that they earn. Though they bear no responsibility for the excesses or mistakes of thrift institutions managers, they have benefitted from past insurance arrangements, and they will benefit from efforts to restore the system to health. For these reasons and because it has become all too obvious that rates charged for deposit insurance by FSLIC have been too low for the level of risk that regulators have permitted, seeking contributions directly from depositors is another possibility.

Although a fee would no doubt be initially levied on the institution, legislation imposing the fee could specify that the charge had to be explicitly identified as a deduction from the rate of interest that otherwise would be paid on the account.[14] Because of competitive considerations, a depositor fee would probably need to cover all depository institutions, and perhaps as well the deposit-like products of certain other institutions. Levying a depositor fee only on thrifts would cause account balances to be transferred to banks or other institutions offering the same

[14] In practice, the ultimate incidence of the fee would be hard to determine because institutions may reduce other costs to depositors to remain competitive.

or similar deposits. At a minimum, therefore, such a fee would have to be levied on banks, thrifts, and credit unions. Consideration could also be given to imposing a fee on checking-like money market funds offered by broker dealers that are close substitutes for deposits in depository institutions.

A depositor fee levied across banks, thrifts, and credit unions has the potential for raising considerable sums of money. Each one basis point of fee could raise as much as $5.2 billion by the end of 1998. This means, for example, that a depositor fee of one-eighth of 1 percent (12.5 basis points) could provide about $65 billion through 1998. For each one basis point fee, the average depositor would pay about $1 per year in lost interest income (based on an average account balance of $9,500), while a depositor with a $100,000 account balance would pay $10 annually.[15] Another $.5 billion might be obtained from each basis point levy on checking-like accounts offered by the securities industry.

The principal attribute of using a broad-based depositor levy to fund the cash shortfall is that it would not compete with other budget priorities, while a solution funded with general revenues would.

There are, however, drawbacks from trying to raise significant amounts of money in this way. There is a fairly strong positive relationship between income levels and account balances in depository institutions. However, in contrast to income tax rates which are progressive, a flat rate levy on depositors would tend to be regressive, i.e., lower-income depositors would pay a higher amount of tax relative to their income than would higher income depositors. This problem could be moderated by exempting deposits under a certain amount from additional charges, but this would reduce revenue potential. A second drawback is that, in a competitive environment, singling out deposits for a special fee is likely to encourage development of close substitutes for deposits that are able to avoid the fee. Such efforts, designed solely to get around the consequences of a fee, do not necessarily contribute to the overall efficiency of the financial system. Also, depositors with higher income and account balances are most likely to be in a position to avoid charges by placing money in such nondeposit instruments.

[15]The effective burden of the fee would change as interest rates changed. The lower interest rates fall, the greater the burden of a flat rate fee and therefore the greater the incentive to shift deposits to another type of institution. Reduction in interest earnings from the imposition of a depositor fee would also reduce depositor tax liabilities, to some extent resulting in a decrease in tax revenues to the government.

Conclusions

There is no way to determine precisely how much money FSLIC will ultimately need. We estimate, however, that financing insurance expenses and adequate reserves will require at least $85 billion more than FSLIC projects that it will have available.

Decisions about who should contribute to the resolution of the thrift industry crisis depend on assessments of ability to pay and cross industry competitive consequences, and on judgments about what is fair. Judgments regarding what is fair are bound to differ, further complicating decisions about how funding a resolution of the thrift industry's problems should be accomplished.

We have not made an assessment of the full extent of the thrift industry's ability to pay more than the $34 billion in contributions through 1998 (premiums plus interest on reserves) currently assumed in FSLIC's projection. We believe, however, that to the extent possible, additional contributions from the thrift industry should be sought in a way that does not jeopardize the viability of healthy thrift institutions.

In our view, a good way to accomplish this result is to reorganize FSLIC into separate good company and bad company funds. The good company fund would be financed through capital contributions and premium assessments. The bad company fund would be financed out of (1) FSLIC's existing revenue sources (less the premiums that would have been paid by institutions moving to the good company fund), (2) payments by healthy thrifts to meet their mutual insurance responsibilities, and (3) contributions from the federal government and possibly other sources outside of the thrift industry. Well-capitalized thrifts that can meet FDIC's requirements should also be given the option of joining FDIC at a cost equivalent to that incurred in joining the good company thrift fund.

The arrangement cannot be expected to make a significant contribution to meeting the $85 billion cash shortfall. Unless contributions are sought from the banking industry and/or depositors, the government on behalf of taxpayers probably will have to provide $75 to $80 billion in funds. A contribution of this magnitude can be justified because the thrift problem is national in scope and government policies contributed significantly to its occurrence. Whatever financing plan is settled on, it should provide the majority of funding within the next 3 years to enable institutions to be resolved quickly.

While the banking industry bears no responsibility for the thrift industry's problems, it stands to benefit from both their quick resolution and the changes to regulations that will improve risk management and equalize the basis for competition between the two industries. Therefore, a contribution from FDIC-insured institutions or depositors of all insured institutions may, under some circumstances, be justified. But, the decision depends on value judgments that only Congress can make.

Recommendations

We recommend that Congress take the following actions:

- Adopt a funding plan that can provide at least $85 billion to pay for insurance losses and to restore FSLIC's reserve. (Because of the uncertainties associated with the condition of insolvent thrifts, the actual amount can later be increased or decreased based on experience.)
- Seek funds from the thrift industry through creation of good company and bad company funds under an independent FSLIC. The good company fund reserves should be established through capital contributions by thrifts.
- Allow well-capitalized thrifts the option of joining FDIC at a cost that is equivalent to joining the good company FSLIC fund.
- Require thrifts joining the good company fund or FDIC to make equivalent contributions to meeting the expenses of the bad company fund.
- Authorize FSLIC to undertake short-term borrowing for liquidity purposes to enable FSLIC to move as quickly as possible to resolve problem cases.
- Recognize in budget totals any federal funding that may be provided.
- Establish a special board to protect taxpayers' interest by overseeing the expenditures of any federal funds provided to resolve thrift cases over the next several years.

Agency Comments and Our Evaluation

The Federal Reserve complimented our presentation of the funding options, agreeing that the issue is best decided by Congress. Treasury commented on a statement in our Conclusions section, where we said that a large taxpayer contribution "can be justified because the thrift problem is national in scope and government policies contributed significantly to its occurrence." Treasury believed the statement was incomplete, citing numerous other contributing factors that it believed should be mentioned: high interest rates, technological innovations, commodity disinflation and an economic downturn in the Southwest, expanded state-authorized asset powers, imprudent thrift managers, and fraud. We agree with Treasury that these other factors contributed, and we discussed them at the beginning of the chapter and as applicable in our discussion of the rationale for contributions from industry sources.

Merger of the Insurance Funds

In the preceding chapters we pointed out that three things need to be done to solve the problems associated with FSLIC's insolvency and ensure that they are not repeated: (1) adopt new procedures to take control of insolvent institutions as soon as possible, (2) better manage the deposit insurance system's exposure to risk, and (3) provide enough money to resolve problem cases and establish adequate insurance fund reserves.

A merger of the insurance funds alone cannot accomplish any of these objectives, although it could provide a stimulus for developing an appropriate plan of action. However, in view of the drawbacks associated with undertaking an immediate merger of the funds, we believe it makes more sense to accomplish the objectives set forth above by reorganizing FSLIC and other means.

Before considering whether to merge the deposit insurance system, Congress first should implement changes to establish comparable regulatory ground rules for banks and thrifts, ensure that banks and thrifts are financially sound, and decide whether there is a need for specialized housing finance institutions. After these actions have been accomplished, merger could then be considered as part of an overall effort to further assure the integrity of the deposit insurance system and to simplify the regulatory structure for the depository institutions industry.

Impact of Merger on Taking Control of Insolvent Thrifts

In chapter 4, we concluded that FSLIC needed to take control of insolvent thrifts as soon as possible. Congress may, however, wish to further strengthen the administrative capability that applies to thrift deposit insurance by merging the administrative functions of FDIC and FSLIC. By merging the administrative functions, the combined resources of the two agencies—including FDIC's greater in-house capability for managing the case resolutions process—could be used for deciding the true condition of problem cases, managing the case resolution process, and monitoring the complex merger agreements that have already been arranged.

We also pointed out that merger of the funds is not necessary for achieving the resource gains and independent perspective that are needed to change the way problem thrift cases are resolved. FSLIC could draw on the personnel resources of FDIC or other federal regulatory agencies without merger, and independence could be achieved if FSLIC were reorganized with its own independent board of directors.

Risks and drawbacks associated with full merger of the insurance funds also make the non-merger or administrative merger alternative more attractive at this time. For example, if the insurance funds are merged, there is a risk that overall confidence in the nation's banking system would be adversely affected because the public may assume that the thrift industry's problems are being transferred to the banking system. Also with a full merger, all of the pressures that have and will be associated with resolving thrift industry cases could be transferred to FDIC, at a time when it needs to devote attention to problems in the banking system.

Another possible drawback is that full merger of the funds could be taken as a substitute for basic policy changes that need to be made. For example, existing forbearance policies need to be changed irrespective of whether the funds are merged.

Impact of Merger on Risk-Management Improvements

The risk-management improvements we discussed in chapter 5 to keep the FSLIC situation from recurring involve changes in laws and regulatory practice. Many of these changes have little to do with the subject of merger per se. For example, Congress can legislate similar capital requirements for both industries and can set rules for both thrift and bank holding companies regarding obligations to support failing depository subsidiaries. Also, FDIC and a reorganized, independent FSLIC could both be given powers to assert greater supervisory and regulatory control over undercapitalized and failing institutions.

The contributions to risk management that merger of the insurance funds might be able to make fall into two areas: equalizing the treatment of thrifts and banks and speeding up the implementation of policy changes. However, in our view, satisfactory results can also be accomplished in these areas without merging the funds.

Equalizing the Treatment of Thrifts and Banks

As we have noted, banks and thrifts are linked economically through their competition for the same insured deposit base and provision of many of the same services. This means that risk management policies adopted by only one of the industries affect the competitive position of the other and may be counterproductive in controlling the overall risk exposure of the federal government.

The most straightforward approach to resolving the differences in federal regulation and oversight would be to combine the entire federal regulatory apparatus for the banking and thrift industries, not just the insurance function. This would assure a common approach to federal regulation of the two industries without the uncertainties and possible failures associated with coordination of regulation.

To combine functions while making minimum changes to the existing regulatory structure, the chartering function for federal thrifts could be assigned to OCC, and FDIC could be given responsibility for supervising state-chartered thrifts. FDIC already supervises the state-chartered, non-member commercial banks and state-chartered savings banks that it insures. Consolidation of the chartering and supervision functions should make it easier to eliminate all regulatory distinctions between federally chartered thrifts and banks within a set period of time.

In combining functions, FHLBB need not necessarily be abolished, but it should no longer retain regulatory and supervisory responsibilities. Instead, it should concentrate exclusively on housing finance if this is considered necessary. Advances to institutions engaged principally in housing finance could then be made available to any qualifying depository institutions including commercial banks.

We favor efforts to resolve structural issues within the banking and thrift industries. However, we think some of these issues are similar to those discussed in chapter 5 concerning more far-reaching deposit insurance reform. We are most concerned that debate over whether to consolidate the regulatory structure could delay efforts to fund FSLIC's resolution costs and to improve risk management in the deposit insurance system.

It may take a considerable amount of time to reach a consensus about both the future of specialized housing lending institutions and what combination of powers now held by thrifts and banks will be appropriate for insured depository institutions in the future. Furthermore, differences in the regulation and supervision between federally and state-chartered thrifts and banks would have to be worked out. Thus, while we support efforts to simplify the regulatory structure, they are not necessary to correct the most glaring problems which might cause FSLIC's situation to be repeated.

Rather than proceeding right away with a full merger of the funds, we think it makes more sense to reorganize FSLIC, make it independent of FHLBB, and charge it with establishing a fund for thrifts which is run as closely as possible to the one for FDIC-insured institutions with respect to certain essential matters. These essential matters include financial reporting standards, enforcement of capital rules, and sanctions on poorly capitalized institutions. This approach would avoid the inherent problem associated with merger discussed above—namely, public perception of risk to the banking industry if the funds were merged right away. When parity between the two funds has been achieved and questions about the appropriate structure of depository institutions have been resolved, giving consideration to full merger of the funds would be more appropriate.

Accelerate Implementation of New Risk Management Policies

At the rate FSLIC has been acting on cases, it will take some time before all insolvent and weak institutions can be resolved. It may therefore not be possible to credibly implement and enforce new rules, especially in areas such as capital adequacy and closure policy, so long as institutions that cannot comply with the rules are able to continue to operate within the same regulatory and insurance system.

Full merger of the funds could help to accelerate implementation of new risk-management policies within the thrift industry as long as the merger decision is accompanied by changes in policy designed to isolate problem institutions from the rest of the industry as soon as possible. Isolation of problem thrifts can, however, be accomplished within the thrift industry itself if FSLIC were reorganized into good company and bad company funds independent of FHLBB as outlined in chapter 6.

Some of these same results can also be accomplished if thrifts meeting FDIC standards are allowed to switch to FDIC. CEBA imposed a moratorium on switching which is now set to expire in August 1989. If switching were permitted, thrifts that meet FDIC's standards could then switch to FDIC after meeting their mutual insurance responsibilities to FSLIC through payment of an exit fee or similar arrangements. If many institutions switched, this would result in a de facto merger of the insurance funds for FDIC-insured banks and well-capitalized, viable thrifts.

Impact of Merger on Funding Considerations

In chapter 6, we estimated what the order of magnitude for contributions to resolve the thrift industry problem might be if only the thrift industry and the federal government were involved in funding FSLIC's cash shortfall. We said that, without a contribution by other financial services industry participants, the government could anticipate a contribution of about $75 to $80 billion. We pointed out that under certain circumstances, a contribution from the banking industry or its depositors might be considered to reduce the funding that would have to be supplied from general revenues of the government. However, this is a value judgment only Congress can make.

The most obvious way that an insurance fund merger would help with meeting FSLIC's expenses would be to make FDIC's reserves available for this purpose. However, commingling the revenues, expenses, and reserves of the two funds would only provide about $14 billion in FDIC reserves (based on FDIC's estimate of reserves at the end of 1988) to help resolve the combined problems of FDIC and FSLIC. We believe that combining FSLIC and FDIC while leaving existing funding arrangements in place is not a realistic solution. To show the initial impact of combining the funds, we constructed a consolidated balance sheet for FDIC and FSLIC as of December 31, 1987. The results are shown in appendix VII.

As of December 31, 1987, the combined fund would have a reserve of less than $5 billion, or .17 percent of insured deposits.[1] Given the magnitude of the thrift industry's problem, the fund would be hopelessly weak. In addition, as explained more fully in appendix II, FDIC expects to suffer net losses in 1988. Thus, while a merger of existing fund financial resources could make additional funds available quickly to resolve thrift cases, it would be at the expense of a shortfall in funds needed for the banking industry. It would also run contrary to banks' general expectation that they had contributed money to FDIC for their own insurance needs.

Another option is to increase FDIC-insured bank premiums to help meet the funding shortfall. While we are not rendering a judgement on the merits of the option, we note that one advantage of such a contribution would be that it would tend to mitigate the negative competitive impact of attempting to raise money strictly from healthy thrifts.

If a financial contribution is sought from FDIC-insured banks, the case for merging the funds is strengthened due to the need to be sure that the money is well spent. However, merger is still not necessary. As we point out in chapter 6, controls that the federal government should put in place to assure that its interests are protected would provide the protection needed over expenditures of bank contributions.

[1] Unaudited financial data for both FDIC and FSLIC for September 30, 1988, show that the combined fund would be technically insolvent.

Conclusions

By itself, merger of the deposit insurance funds would not address the problems associated with FSLIC's insolvency. Indeed, combining the FDIC and FSLIC funds to gain access to FDIC's reserves could weaken the entire deposit insurance system. FDIC's resources, which are needed to deal with the banking system's problems, would be quickly depleted, leaving the deposit insurance system worse off than it is now because the fund insuring bank deposits would also be insolvent.

If it provided the stimulus for carrying out the actions to resolve the FSLIC problem that we have discussed, a merger of the administrative aspects of the insurance funds could in that sense be helpful. But these actions can, for the most part, be accomplished without a merger through the creation of a new FSLIC that is independent and organized into good company and bad company funds that could draw on the personnel resources of FDIC or other federal agencies.

The principal reason why alternatives to full merger should be sought is that merging the deposit insurance funds has some significant drawbacks.

- Public confidence in the Nation's banking system could be adversely affected.
- At least initially, attention could be diverted from problems within the banking industry and the pressures for action or inaction that have been directed toward FSLIC in its handling of the problem could be inappropriately redirected to FDIC.
- Fundamental decisions on regulatory structure and the continued usefulness of a specialized housing industry lender could be avoided or delayed causing a long-term cross subsidization within the fund of thrifts by banks.
- If it were felt that fundamental regulatory structure changes had to accompany merger of the funds, a protracted debate could follow which would delay implementation of a program to deal with the thrift industry problem.

In our view, a full merger of the funds is technically possible, but we recommend against it at this time. Only when comparable risk management policies are in place, when the viable portion of the industry is as financially sound as the banking industry, and when decisions have been made about the appropriate regulatory structure within which both thrifts and banks can compete on an equal footing would it be more appropriate to consider whether to merge the funds.

Matter for Consideration by the Congress

As an alternative way to provide the independent point of view and additional personnel resources and expertise needed both to identify and resolve problem thrift cases and to provide effective deposit insurance for healthy thrifts, Congress should consider merging the administrative aspects of FDIC and FSLIC.

Agency Comments and Our Evaluation

FHLBB and NCUA commented explicitly on the issue of merging the fund. FHLBB concurred with the view that a simple merger of the insurance funds will not solve either the thrift or commercial bank problem. FHLBB said it was proposing a complete reform of the system, including some type of reinsurance mechanism, on the grounds that the current system has no provision to cover catastrophic losses. NCUA agreed that a merger of deposit insurance funds was not required or advisable.

Thrift Industry's Condition

Thrifts as Mortgage Lenders

Public policy has supported the role of thrifts as primary lenders in the housing finance market. As a result of the problems experienced by the industry during the Great Depression, FHLBS was created by the Federal Home Loan Bank Act of 1932 to channel funds to thrifts to facilitate mortgage financing and thus promote home ownership. In addition to FHLBB, which charters federal thrift institutions and is responsible for all federal regulation of thrifts, FHLBS includes 12 district banks that borrow in capital markets and then lend funds to member thrift institutions in the form of collateralized bank advances.

Interest-Rate Spread Problems of the Early 1980s

Thrifts have traditionally earned their profits through the funding of long-term mortgage assets with lower interest rate short-term deposits. Though mortgage assets continue to dominate thrifts' portfolios, as a percent of total assets, mortgages have declined from nearly 86 percent in 1977 to 70 percent in 1987. From 1966 until 1980, interest rates thrifts could pay on time and savings deposits were constrained by the Federal Reserve Board's Regulation Q. When market interest rates would rise above Regulation Q ceilings, thrifts would experience decreased deposit inflows and occasionally net deposit outflows.

Until the early 1980s, the problems associated with disintermediation were not serious enough to severely impair thrift performance. However, the rapid rise of interest rates that began in 1980 prompted large deposit outflows from thrifts.

These outflows forced thrifts to raise interest rates paid on deposits and to rely on market-rate FHLB advances which also increased thrifts' cost of funds dramatically. Because fixed-rate mortgages comprised about 80 percent of thrift assets in 1980, it was difficult for thrifts to increase earnings on a large portion of their assets when interest rates increased. Consequently, in 1982, the thrift industry's cost of funds was over 11 percent while the average return on mortgage holdings was under 11 percent. The net interest margin (NIM) of the industry declined quickly and industry return on assets (ROA) reached a low of -.97 percent in June 1982.

The thrift industry experienced losses of $8.8 billion in 1981 and 1982 combined. The result was a depletion of thrift industry capital and an alarming increase in thrift insolvencies.

Congressional and Regulatory Response to Thrift Industry Problems

The unprecedented deposit outflows experienced by thrifts in the early 1980s caused Congress to act swiftly to deregulate interest rates paid on deposits. The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) provided for the phaseout of interest-rate ceilings on thrift and bank deposits. DIDMCA also allowed thrifts to diversify their asset portfolios into areas that were previously the domain of commercial banks. Further, in an effort to increase the interest rate sensitivity of thrift asset portfolios, FHLBB in 1981 authorized all federally chartered thrift institutions to make adjustable rate mortgages (ARM).

However, the net worth position of thrifts continued to deteriorate. In 1982, Congress passed the Garn-St Germain Depository Institutions Act. The act further expanded thrift asset powers in the areas of commercial and consumer lending. Although some institutions report large holdings of these assets, on average, thrifts have not taken advantage of these expanded powers. Commercial loans and consumer loans comprised only 1.88 and 4.41 percent of total thrift assets, respectively, at midyear 1987.

In the period following enactment of the Garn-St Germain Act, the thrift industry experienced extremely rapid growth. Assets in the industry increased about 40 percent between 1982 and 1984, a rate of growth much greater than the rate of growth of GNP or the rate of growth of commercial banking assets. This growth was financed in part with deposits over $100,000 and repurchase agreements. The current problems of the industry may stem, at least in part, from this period of rapid growth because institutions were able to use the insured deposits to finance what proved to be high-risk ventures.

Between January 1980 and December 1987, 331 FSLIC-insured institutions were closed.[1] In addition, many other insolvent thrifts were permitted to remain open. Only 21 operating FSLIC-insured institutions reported negative GAAP net worth as of June 1981. As of March 1988, this number had grown to 500 institutions.

The response of FHLBB to the deteriorating condition of the industry was one of showing forbearance to capital deficient thrifts. Forbearance involves delaying the closure of thrifts by either augmenting the value of capital they report for regulatory purposes (based on Regulatory Accounting Principles [RAP]) or lowering the minimum capital requirements thrifts must meet in order to be permitted to continue to operate.

[1] Closed institutions were liquidated or merged.

Forbearance through means of capital augmentation was first undertaken in 1981. At that time, thrifts were permitted to begin to defer over time any losses incurred on the sale of selected assets and to count income capital certificates (ICC) in RAP net worth.

In 1982, certificates similar to ICCs, known as net worth certificates (NWC), were authorized by the Garn-St Germain Act. Both NWCs and ICCs served to increase the RAP net worth of qualifying institutions to the regulatory minimum and thereby avoid a FSLIC takeover.

Both the RAP and GAAP net worth of the industry continued to decline from 1980 until December 1984 but, due to the use of these capital augmentation techniques, RAP net worth declined more slowly than GAAP. The other form of forbearance, that of lowering the capital requirements thrifts must meet, was first instituted in 1980 when the minimum RAP net worth requirement was lowered from 5 to 4 percent of assets. It was again lowered, to 3 percent, in 1982. In addition, FHLBB said in February 1987 that it was unlikely to take administrative action to enforce minimum capital requirements.

During the period of declining net worth and of a growing number of insolvent thrifts, FSLIC found itself increasingly unable to deal with problem cases. After a record 252 resolutions in 1982, the number of thrift closures dropped to 102 in 1983 and to 41 in 1984. During the same 3 years, the number of GAAP-insolvent institutions operating increased from 222 in 1982, to 281 in 1983, and then to 434 in 1984. Although FSLIC had reserves averaging $5.7 billion from 1982 through 1985, FHLBB estimated in 1985 that it would take $15.8 billion to close all GAAP-insolvent institutions.

Partly as a result of the deteriorating condition of the insurance fund, FHLBB in 1985 began to place institutions in the Management Consignment Program (MCP). The goal of MCP is to minimize the losses of FSLIC by taking control of those insolvent institutions that pose the greatest threat of future losses. When an institution is placed in the program, the board of directors and the management of the institution are replaced with new managers, usually from another thrift, who are chosen by FSLIC. In September 1987, GAO reported on the condition of the 45 institutions in MCP as of year-end 1986.[2] It was shown that these institutions still incurred great losses after they entered the program, reporting $2 billion of losses between the end of the quarter during which they

[2]Thrift Industry: The Management Consignment Program (GAO/GGD-87-115BR, September 1987).

entered MCP and year-end 1986. Their aggregate GAAP net worth declined from $-0.8 billion to $-3.49 billion over the same period. It is possible that the losses of these institutions could have been just as large or larger than they actually were had they not been put into MCP.

In May 1987, we reported on the ability of institutions that were shown forbearance to return to health.[3] In that report, the financial condition of the 222 thrifts that were insolvent at year-end 1982 were tracked through September 1986 to determine if, having been allowed to continue to operate, they attained a positive net worth position. Of the 222 institutions, 77 were liquidated, merged, or reorganized during the period and 145 remained open on September 30, 1986. Of the 145 operating thrifts, 80 remained insolvent while 65 had attained a positive level of GAAP capital. Of the 65 which had regained solvency, only 25, or 11 percent, of the original 222 had fully recovered.[4] It should be noted however, that the institutions in this sample were initially insolvent due principally to interest rate rather then asset quality problems.

We also examined the change in the condition of problem institutions in the thrift industry between the end of 1986 and 1987. These problem institutions were ones that were either GAAP insolvent as of December 31, 1986, or had lost money in 1986 and had less than 3 percent net worth. During 1987, 47 institutions with assets of about $11 billion were liquidated or merged with FSLIC assistance. By December 31, 1987, 59 institutions had recovered sufficiently to be either no longer insolvent or not losing money in 1987. This definition of recovery may not, however, provide a true measure of the economic condition of the institutions because it does not reflect an analysis of either the quality of the capital or of the net income of the institutions. Furthermore, during this period, an additional 197 institutions with assets of $126.7 billion (13 percent of the assets of those that were not defined as problem thrifts in 1986) entered the problem thrift category in 1987. (See table I.1.)

[3]Thrift Industry: Forbearance for Troubled Institutions 1982-1986 (GAO/GGD-87-78BR, May 1987).

[4]Full recovery was defined as having a GAAP net worth to assets ratio of at least 3 percent and being profitable during the first 3 quarters of 1986.

Table I.1: Change in Condition of Thrift Industry Institutions, 1986 to 1987[a]

Dollars in billions

Category of institutions	Total assets in 1986	Number
Weak in both 1986 and 1987	$137.3	458
Weak in 1986 to not weak in 1987	16.7	59
Not weak in 1986 to weak in 1987	126.7	197
Not weak in both 1986 and 1987	837.3	2,323
Existed in 1986 and did not exist in 1987[b]	47.3	183
Total	**$1,165.3**	**3,220**

[a]Weak is defined as (1) was insolvent or (2) 0-3 percent net worth and lost money in 1987.

[b]Includes institutions that failed, merged, or were acquired by another institution. Not all of these institutions represent problem cases.

Asset Quality Problems and the Current Condition of the Thrift Industry

As interest rates began declining in 1982, thrifts' interest-rate spread problems began to subside and overall profitability of the industry began to rise. Although nearly 7 percent of the industry remained insolvent, it appeared for a while that the industry was recovering. However, in early 1986, average ROA for the industry again began to decline. Since the fourth quarter of 1986, the industry as a whole has lost money in every quarter (through June 1988), except for the first quarter of 1987.

It is important to note that although a significant portion of the industry is insolvent and deteriorating, many thrift institutions are adequately capitalized. At year-end 1987, there were 3,147 FSLIC-insured institutions. Of these, 505 were insolvent on a GAAP basis, 435 had a GAAP capital to assets ratio of at least zero but less than 3 percent, 1,014 had a capital ratio between 3 and 6 percent, while the remaining 1,193 were adequately capitalized with a capital ratio of at least 6 percent. (See table I.2.) Nearly two-thirds of all thrifts made net profits during 1987. However, the $13.4 billion losses of the unprofitable thrifts outweighed the profits of the profitable thrifts which totaled $6.6 billion, resulting in a net loss of $6.8 billion for the industry in 1987.

Table I.2: Selected Financial Information for Savings and Loan Institutions as of December 31, 1987

Dollars in billions

GAAP net worth	Number of S&Ls	Percent of total	Total assets	Total deposits	GAAP net worth
Less than -12%	182	5.8%	$43.2	$49.3	(14.3)
From -12 to -9	33	1.0	5.5	4.7	(0.6)
From -9 to -6	61	1.9	23.0	19.6	(1.7)
From -6 to -3	75	2.4	17.5	14.8	(0.7)
From -3 to 0	154	4.9	51.1	40.4	(0.7)
From 0 to 3	435	13.8	255.2	175.7	4.0
From 3 to 6	1,014	32.2	555.9	398.7	25.0
From 6 to 9	743	23.6	231.0	177.1	15.9
From 9 to 12	290	9.2	38.6	31.6	3.9
More than 12	160	5.1	30.7	20.9	6.0
Total	3,147	100.0	$1,251.6	$932.7	$36.8

Note: Numbers may not add to total due to rounding.

The 577 problem thrifts[5] that we identified in chapter 2 (as of December 31, 1987) have a geographic concentration that suggests an underlying regional component to the problem.[6]

Nearly 50 percent are concentrated in the Dallas and Topeka FHLB districts. The Dallas district contains 205, or 36 percent, of these thrifts, and an additional 62, or 11 percent, are located in the Topeka district. Texas, Louisiana, and Oklahoma, three of the nine states that these two districts incorporate, have suffered particularly heavy losses due to the economic downturn in the agriculture, energy, and real estate sectors of the economy. The problem institutions located in these two districts account for 75 percent of the net losses experienced by problem thrifts during 1987 and account for 48 percent of the assets of problem thrifts.[7]

[5]We define a problem thrift as one that is either insolvent at year end 1987 or has a GAAP net worth as a percent of assets between 0 and 3 percent and has lost money throughout both 1986 and 1987. See tables 2.1 and 2.4.

[6]See page 2 of Danny Wall's testimony on May 26, 1988 before the Senate Committee on Banking, Housing and Urban Affairs. Also see pp. 21-22 of his July 7, 1988 testimony before the House Committee on Banking, Finance and Urban Affairs.

[7]The asset size of problem thrifts is also an important factor because insurance funds typically have a harder time resolving the problems of larger institutions. Of the $175.2 billion of the total assets in the 577 problem thrifts, 43 percent of the total assets are in 35 institutions with assets greater than $1 billion and 14 of these institutions are located in the Dallas FHLBB district. The average size of the 150 commercial banks closed by FDIC in 1987 was approximately $40 million.

The greatest problem insolvent institutions currently face is poor asset quality. That is, these thrifts are currently holding assets that are not producing income or are worth less today than what they were when they were first acquired. Over the last decade, thrifts have expanded their asset portfolios into areas beyond the single family mortgage loans traditionally originated and held by thrifts. Mortgages on one to four family dwelling units comprised 67.8 percent of thrift assets as of December 1980. By June 1987, this ratio had declined to 37.1 percent.[8] Thrifts have, however, acquired a significant volume of mortgage-backed securities. Nonetheless, as already noted, thrift mortgage assets as a percent of total thrift assets has declined. But over the same period, the percent of thrifts' assets in acquisition and development loans as well as in nonmortgage assets, such as commercial and consumer loans, direct investments, liquid assets, intangible assets, repossessed assets, and investment securities, have increased.

There has been considerable controversy surrounding thrift investment in some of these assets, especially direct investments. Believing that direct investments increase the cost to FSLIC of disposing of failed thrifts' assets, FHLBB passed a rule in March 1985 that limited thrift holdings of direct investments to the greater of 10 percent of an institution's assets or twice its regulatory net worth. In March 1987, the rule was revised and allowable direct investments holdings were more closely tied to thrift net worth levels.

Some thrifts suffering from spread problems in the early 1980s were successful in working out their problems in the lower interest rate environment of 1982 to 1986. However, if a policy of forbearance were now practiced in the hopes of encountering declining interest rates, it is unlikely that this would benefit thrifts whose current problem is bad assets. Further, it is unlikely that the problem assets of many of these thrifts will increase in value though they may deteriorate further.

Some studies have shown that failed institutions with asset quality problems stemming from direct investments are more expensive for FSLIC to resolve than failed thrifts which became troubled mainly due to interest rate spread problems. Estimates provided by FSLIC on its cost to resolve thrifts that required FSLIC assistance increased from an average of 7.3 and 4.2 percent of thrift assets resolved in 1981 and 1982, respectively, to 41.1 percent for thrifts resolved in 1987. In other words, FSLIC

[8]Though thrifts remain the dominant originators of long-term residential housing mortgages, their market share of originators has dropped from nearly 55 percent in 1976 to 47 percent in 1987.

lost an average of 41 cents on each dollar of assets of thrifts resolved in 1987.

In addition, the losses and resulting depletion of capital which occurred in the early 1980s may have produced an incentive for the management of capital-deficient thrifts to undertake greater risk to recoup their losses whether it be through reduced underwriting standards on loans, investing in areas in which they have little or no expertise, or investing in assets which are riskier in terms of the probability of loss but with a potentially large return should the venture be successful. Finally, other thrift analysts have pointed to relaxed examination and supervisory standards by the FHLBS as one of the factors contributing to the thrift industry's problems.

Whatever the cause of the industry's current condition, there is little disagreement that the existing thrift problems will be expensive to resolve. In addition, the continuing losses of the insolvent and capital deficient thrifts pose an ever-increasing threat to the FSLIC fund.

Condition of Commercial Banks and Saving Banks and the Outlook for FDIC

Commercial Bank Condition

Since the early 1980s, the financial condition and profitability of the commercial banking industry has been declining. Commonly cited reasons for this deterioration include interest rate volatility, inflation and its aftermath, increased competition both internationally and within the United States, and problems in the energy and agriculture sectors of the economy and their resulting impact on the real estate sector in certain regions of the country. In addition, the debt servicing problems of certain less developed countries have adversely affected bank earnings. The problems of the banking industry have been manifested in record numbers of bank failures over the last several years and a substantial increase in FDIC costs of those failures. (See table II.1.)

Table II.1: Condition of the Commercial Banking Industry (Ratios in Percentages)

Dollars in billions

Year	Return-on-assets[a]	Capital-over-assets[b]	Allowance-over-assets[c]	Total assets[d]	Number of commercial banks[e]	FDIC-assisted or failed banks
1980	0.75%	5.79%	0.54%	$1,856	14,435	11
1981	0.73	5.83	0.56	2,029	14,414	7
1982	0.68	5.87	0.61	2,194	14,452	34
1983	0.64	5.99	0.66	2,342	14,465	45
1984	0.63	6.15	0.74	2,509	14,482	79
1985	0.67	6.20	0.85	2,731	14,405	118
1986	0.60	6.21	0.97	2,941	14,198	144
1987	0.12	6.04	1.64	3,001	13,700	201

[a]Return-on-assets = net income divided by year-end assets.

[b]Capital-over-assets = year-end GAAP capital divided by year-end assets.

[c]Allowance-over-assets = year-end reserves for bad loans and leases over year-end assets.

[d]Total assets at year-end in FDIC-insured commercial banks.

[e]Number of commercial banks insured by FDIC.

Condition of FDIC-Insured Savings Banks

Savings banks insured by FDIC operate similarly to thrifts that are insured by FSLIC. In 1987, they held $217 billion in assets compared to over $3,000 billion in commercial bank assets. Their main source of funding, time deposits, is used primarily to make mortgage loans. Currently, most of these savings banks are located in the Northeast and the bulk of them are in Massachusetts, New York, and Connecticut.

As with thrifts and commercial banks, savings banks faced losses in the early 1980s due to mismatches between short-term deposit rates and long-term mortgage rates. Since 1985, however, savings banks have been performing well in contrast to many FSLIC-insured thrifts. (See table II.2.)

Table II.2: Condition of the FDIC-Insured Savings Bank Industry (Ratios in Percentages)

Dollars in billions

Year	Return-on-assets[a]	Capital-over-assets[b]	Allowance-over-assets[c]	Total assets[d]	Number of savings banks[e]
1982	−0.80%	5.36%	0.11%	$155	315
1983	−0.10	4.34	0.11	171	294
1984	0.07	4.66	0.15	179	291
1985	0.71	5.67	0.19	205	392
1986	1.00	7.41	0.24	237	472
1987	0.74	7.84	0.31	217	462

[a]Return-on-assets = net income divided by year-end assets.

[b]Capital-over-assets = year-end GAAP capital divided by year-end assets.

[c]Allowance-over-assets = year-end reserves for bad loans and leases over year-end assets.

[d]Total assets at year-end in FDIC-insured savings banks.

[e]Number of savings banks insured by FDIC.

FDIC Reserves

FDIC's statute does not set forth a level of reserves that FDIC must maintain at all times. Statutory language does, however, set a minimum standard for reserves of 1.10 percent of insured deposits.

FDIC's reserve requirements are as follows: when reserves are less than 1.10 percent of estimated insured deposits, the Board of Directors must increase the portion of assessment income (up to, but not to exceed 50 percent) placed in reserves to maintain a reserve level no less than 1.10 percent. Once reserves exceed 1.25 percent of estimated insured deposits, the Board may reduce the portion of assessments reserved but not below the point where reserves would become less than 1.25 percent of estimated insured deposits. If the ratio of reserves to estimated insured deposits exceeds 1.40 percent, the Board must reduce the portion of assessment income reserved to the point where reserves will not exceed 1.40 percent of estimated insured deposits. The provisions for FDIC reserves are similar to the statutory provisions concerning FSLIC and NCUSIF reserves.[1]

FDIC reserves increased from $11 billion at the end of 1980 to almost $18 billion at the end of 1985 and remained at about that level during 1986 and 1987. However, the ratio of insurance fund reserves to insured deposits declined from 1.24 percent at the end of 1981 to 1.10 percent at the end of 1987, the lowest ratio in FDIC's history.

In the fall of 1988, FDIC anticipated its reserves would fall by about $3 billion in 1988, with a level of reserves at the end of the year of approximately $15 billion. FDIC officials indicate that the level of reserves would then increase by about $500 million in 1989. After 1989, FDIC anticipated that the number of bank failures will become less of a problem.

Growth in Weak or Insolvent Commercial Banks

In December 1987, there were 66 insolvent banks which held a combined total of $8.8 billion in assets, more than triple that of the year before. Most of the open insolvent banks were located in the Southwest. There has also been a substantial increase in weak institutions in which capital is more than or equal to 0 percent of assets but less than 3 percent. In 1987 there were 250 institutions in this category with assets of about $115 billion. Although preliminary data show that the number of insolvent and weak institutions declined somewhat in 1988, 3.72 percent of commercial bank assets on June 30, 1988, were in insolvent or weak institutions. (See table II.3.)

[1] FSLIC's reserves have two components, primary and secondary. The primary reserves are from the regular assessments and the secondary from the special assessment established by Congress in 1962. Congress scheduled a payback of the secondary reserve to be put into effect when the total reserves exceeded 1.25 percent of total deposits. Congress suspended the payback because reserves fell below that minimum.

The Federal Credit Union Act amendments to the Omnibus Deficit Reduction Act of 1984 (P.L. 98-369) required insured credit unions to deposit, beginning in January 1985, an amount equal to 1 percent of their insured shares as of December 31, 1984. The law authorized NCUA to determine a normal operating level for fund reserves, which NCUA has set at 1.3 percent of insured shares—the maximum level prescribed in the act. The NCUSIF recapitalization is explained in appendix VI.

Table II.3: Growth in Insolvent and Weak Commercial Banks Insured by FDIC

Dollars in billions

Year	Number of insolvent[a] banks	Assets in insolvent banks	Number of weak[b] banks	Assets in weak banks	Number of insolvent and weak banks	Combined assets in insolvent and weak banks	Ratio of combined assets to total industry assets
1980	1	$0.017	14	$1.669	15	$1.686	0.09%
1981	2	0.037	21	4.054	23	4.091	0.20
1982	5	0.179	43	4.235	48	4.414	0.20
1983	14	3.249	74	5.445	88	8.694	0.37
1984	8	0.25	68	7.098	76	7.348	0.29
1985	25	1.379	110	8.432	135	9.811	0.36
1986	58	2.588	203	19.235	261	21.823	0.74
1987	66	8.772	250	114.728	316	123.500	4.12
1988[c]	80	25.129	231	92.864	311	117.993	3.86

Source: FDIC's consolidated reports of condition and income.

[a]Information is as of December 31 for each year except 1988.

[b]An insolvent bank has negative GAAP capital.

[c]A weak bank has a GAAP capital to asset ratio between 0 and 3 percent.

[d]In its comment letter, FDIC said there were 90 insolvent banks as of mid-year 1988. FDIC's figure is higher than ours because FDIC has been able to update its data base for banks that completed their June 30 reports after FDIC provided us the computerized data. FDIC also noted in its comment letter that 70 of the 90 institutions were either closed or merged out of existence in the second half of 1988, gained solvency during the third quarter, or have assistance proposals currently pending.

Our Assessment of FDIC's Resources

The existence of 66 GAAP insolvent and 250 low net worth banks with combined assets of $123.5 billion at year-end 1987 make it particularly difficult to assess the extent of the potential demand on FDIC's resources over the next 10 years. Another problem associated with projecting future losses for FDIC is that, as discussed previously in the report, the information contained in call reports may not provide a reliable picture of the condition of institutions. For example, in a report filed with the Federal Reserve by First RepublicBank Corporation 3 months before First RepublicBank first received FDIC assistance, the Corporation's balance sheet showed primary capital for regulatory purposes of about 7.6 percent of assets. Shortly thereafter, FDIC estimated initial outlays of $4 billion to arrange the acquisition of First RepublicBank by NCNB National Bank. The net cost to FDIC has not yet been determined but it is expected to be between $2 billion and $3 billion.

FDIC has not prepared an extended forecast for the period through 1998 that corresponds to that provided by FSLIC which we discussed in chapter 2. We have therefore concentrated on the outlook for FDIC over the next several years. Although we do not know what level of loss FDIC will experience, we believe FDIC will have difficulty in restoring its reserves to a level of 1.1 percent of insured deposits by 1992.

If FDIC's estimates about insurance losses for 1988 and 1989 that were mentioned above prove to be accurate, the reserve at the end of 1989 would be about $15.5 billion. If insured deposits in FDIC-insured institutions were to increase at a rate of about 7 percent per year—the same assumption FSLIC has used for its deposits—reserves at the end of 1989 would be .81 percent of insured deposits. This percentage is significantly below the 1.1 percent standard.

We have no basis for estimating FDIC's insurance losses beyond 1989. We have, however, considered the implications of trying to restore the FDIC reserve back to 1.1 percent of insured deposits by 1992, assuming that the level of reserves at the end of 1989 is the $15.5 billion anticipated by FDIC.

If FDIC deposits increase at about 7 percent per year, insured deposits in FDIC-insured institutions will be an estimated $2.3 trillion by 1992. The level of reserves needed to make a 1.1 percent reserves standard in that year would be $25.8 billion—$10.3 billion more than the $15.5 billion level FDIC officials anticipate for 1989. To obtain $10.3 billion for reserves, FDIC would have to devote virtually all of the premium and interest income that would be available to it in 1990, 1991, and 1992 to building up reserves. (See table II.4.)

Under the assumption set forth in the preceding paragraph, if FDIC is to achieve the 1.1 percent reserve level by 1992, the amount of money available to pay insurance losses in the years 1990, 1991, and 1992 would have to be less than the $.6 billion shown in table II.4. The reason for this is that insurance losses would reduce interest earnings on fund reserves. Such a low level of insurance losses in the 1990 to 1992 period seems highly unrealistic in view of the number of inadequately capitalized banks, recent insurance losses, and uncertainties that exist in the economy. For the 5 years 1983 to 1987, insurance expenses on a deposit base smaller than that which will exist in 1990 averaged $1.9 billion per year.

Table II.4: Analysis of Implications of Restoring FDIC Reserves to a Standard of 1.1 Percent of Insured Deposits by 1992, Assuming No Insurance Losses in 1990, 1991, and 1992

Dollars in billions	
Funds available	
Estimated premium and other income in 1990, 1991, and 1992, except income on investments	$7.0
Estimated income on investments in 1990, 1991, and 1992 assuming no insurance losses in that period[a]	4.7
Total funds available	**11.7**
Uses of Funds	
Estimated administrative and other miscellaneous expenses 1990, 1991, and 1992	.8
Additions to reserves	10.3
Total use of funds	**11.1**
Funds available in excess of those needed to restore reserves to a level of 1.1 percent of insured deposits	0.6

Note: The table assumes: (1) the level of FDIC reserves in 1989 is $15.5 billion (.81 of insured deposits); (2) deposits and insured deposits increase from 1987 through 1992 at a rate of 7.2 percent per year; and (3) the level of reserves needed in 1992 to achieve a standard of 1.1 percent of deposits is $25.8 billion.

[a]Insurance losses would reduce the interest income available because interest income would be lost on funds paid out in insurance losses.

Why Depository Institutions Have Incentives to Impose Risks on the Funds

A fundamental source of risk for deposit insurance agencies is moral hazard—the incentive for an insured institution to impose risks on the insurance fund. It arises because an insured party has less incentive to curtail risky behavior that can generate losses if the losses are covered, at least in part, by the insurer. Typically, moral hazard problems in private insurance arrangements are handled through deductibles and through constraints on the activities of the insured. In the case of deposit insurance, stockholder's equity may be viewed as the deductible, and federal and state supervision and regulation to promote safe and sound operations represent the analogous constraints on behavior.

The moral hazard problem associated with deposit insurance is particularly acute in the case of a near-insolvent or insolvent institution because such a firm has little or no capital of its own at risk. Moreover, managers of such an institution know that they will be removed if the chartering agency closes the institution. In such cases, the management and owners have the incentive to "bet the bank" by investing in assets with potentially large but highly variable rates of return. If the gamble pays off, the bank or thrift may return to solvency and management positions will be secure. If the gamble fails, most or all of the losses resulting from the gamble accrue to the deposit insurance fund.

Any insurance system should be structured to minimize the risk posed to the insurer by moral hazard. The deposit insurance funds attempt to achieve this through capital requirements and through supervision and regulation. However, a combination of factors, discussed below, have made the current approach inadequate. As a result, the deposit insurance funds, particularly the FSLIC fund, face current and future losses due to moral hazard.

Inadequate Funding and Performance

The moral hazard problem encountered by a deposit insurance fund is aggravated by inadequate funding and capital forbearance. An insurance fund with inadequate funding, such as FSLIC, cannot resolve its current caseload in a timely fashion, thereby leaving institutions open with little or no capital. When left open, these institutions have the greatest incentive to gamble since it is the insurance fund's money rather than the owners' depleted capital that is most at risk.

Flat Rate Premiums

Currently, risk is priced implicitly by increased supervision and oversight of problem institutions. However, this implicit cost for risk-bearing occurs with a lag and is assessed after the fact. The moral hazard problem with flat-rate premiums then, is that banks do not bear the full social cost of their risk-taking. In principle, the solution to this problem is to set the premiums charged commensurate with the anticipated risk of loss that the institution poses to the insurer.[1]

De Facto Coverage of All Deposits

When a depository institution fails, only deposit accounts up to the insurance limit are guaranteed. In practice however, full coverage has usually been extended to all depositors and creditors, particularly of larger banks. Such de facto 100 percent coverage diminishes the incentive of uninsured depositors and creditors to monitor institutions' risk-taking. Therefore, market-induced incentives to curtail risk-taking have been dampened.

Lack of Market-Value Data

Minimizing moral hazard requires closing institutions prior to, or at the point of economic insolvency, in order for the deductible feature of deposit insurance to work. Lack of market-value data makes this particularly difficult to accomplish. Without sufficient information, regulators may inadvertently leave open an institution without any capital. These institutions pose the greatest moral hazard risk to the insurance funds.

Inadequate Supervisory and Examination Resources

As noted above, regulation and supervision are the principal tools used by the deposit insurance agencies and other federal and state agencies to control moral hazard. Many observers, including ourselves, have commented on FHLBB's as well as other bank regulators' lack of resources necessary to carry out required oversight. This situation worsens the moral hazard problem.

[1] If the premium is set according to the risk of loss an institution poses to its deposit insurer, the institution internalizes the cost of its risk-bearing. In practice, however, risk-based pricing can be difficult to implement. See the discussion in appendix IV. The objectives of protecting the fund from risk through risk-based premiums can also be accomplished by risk-based capital requirements for insured institutions. This is also discussed in appendix IV.

Deposit Insurance Reform Proposals

In the last few years a number of proposals for reform of the deposit insurance system have been advocated by representatives of the industry, regulatory, and academic communities. These reforms have been designed to solve a number of problems with the existing deposit insurance system. The following are some of the problems cited.

- The methods typically employed in disposing of a failed institution limit the market discipline imposed by uninsured depositors and creditors because their probability of loss is sharply curtailed. As a result, both insured and uninsured deposits can always be obtained by offering higher rates on deposits.
- Deposit insurance is underpriced.
- Risk underwriting by the deposit insurance system is extended because depository institutions or the holding companies that own them are diversifying their activities into more types of financial products.[1]
- Large institutions that are considered too big to fail receive favored treatment.

A discussion of some of the reform proposals that have been made follows.

Modified Payouts, Co-Insurance, Reduced Deposit Insurance Limits, and Use of Subordinated Debt to Meet Higher Capital Requirements

To deal with lack of market discipline on insured institutions' risky activities, several proposals have been advanced to require that parties other than the deposit insurance fund bear losses if institutions fail. There are several proposals to accomplish this. For example, deposit insurance coverage could be scaled back to some lower amount such as $40,000; a deductible of, say, 10 percent of deposits over $20,000 could be imposed; or insurance could cover only principal at the beginning of a stated period and not accumulated interest. By such measures, depositors could no longer with impunity send their money to the bank or thrift that advertises the highest rates. A problem with these approaches, however, is that depositors may be unable to determine the true condition of the insured institution. This problem is more likely to be experienced by depositors than by investors. Therefore, requiring institutions to make increasing use of subordinated debt, which in most instances would be supplied by knowledgeable investors, represents a particularly attractive way of increasing market discipline.

[1]See footnote 10 of chapter 5, p. 74.

The credibility of plans for cutting back insurance coverage or making use of subordinated debt depends upon the certainty with which uninsured depositors or bond holders will actually lose money if institutions fail. To strengthen this credibility, as well as to alleviate equity issues associated with the "too-big-to-fail" problem, proposals have been made to eliminate de facto insurance for uninsured depositors and general creditors by requiring the deposit insurance funds to use what is termed a modified payout if institutions are merged rather than liquidated. Under this approach, if an institution fails, FDIC or FSLIC would immediately pay all insured depositors in full. The agency would, however, advance to uninsured depositors and general creditors the present value of their estimated share of the value of the assets, an amount that could easily be less than 50 cents on the dollar.

This proposal, like the ones for reduced insurance coverage, suffers from the problem of how uninsured depositors are to know about the condition of their bank. Concerns have also been expressed that these sorts of proposals could destabilize the banking system because at the first hint of problems (which may not actually exist), uninsured depositors may run from the bank. This concern is particularly important because the largest banks in the country fund their activities with large amounts of uninsured deposits. Runs on large banks could lead to runs on other banks. Those suggesting the modified payout and the other proposals that would increase depositor discipline counter that with enlightened monetary policy, it is unlikely that the failure of one bank would lead to a disastrous contraction of the U.S. banking system.

Risk-Based Insurance Premiums and Capital Requirements

Under the current system, each insurer charges its institutions a flat premium rate per dollar of deposits. As a result, there is no explicit price put on the riskiness of individual institutions. This encourages risk taking and creates inequities because prudently managed institutions subsidize those posing a greater risk to the insurance fund. Additionally, banks and thrifts each face uniform capital requirements, regardless of the risk inherent in their portfolios. FHLBB is phasing in new capital standards that contain adjustments for interest rate risk exposure and the bank regulators are completing new capital guidelines that are based on credit risk.

Currently, risk is priced implicitly by increased supervision and oversight of problem institutions. However, this implicit cost for risk bearing occurs with a lag and is assessed after the outcome of risk taking has occurred. In principle, the solution to this problem is to set the premiums charged so that they reflect the expected loss to the insurer inherent in the asset portfolio selected; that is, when the risk is undertaken, not when the outcome is learned.[2]

There are two ways to price the risk to the deposit insurer: adjusting the insurance premium charged or adjusting the capitalization level required based on the prospective riskiness of each institution's portfolio.

Risk-Based Premiums

A risk-based premium adjusts the premium charged each institution to reflect the expected loss to the insurer from the institution's risk taking. Pricing according to risk has been advocated as a means of forcing an institution to realize a greater proportion of the cost of its risk taking, thereby reducing the moral hazard problem. This approach has received considerable attention and has generated a number of specific reform proposals.[3]

The first problem in setting a risk-based premium is determining what measure(s) to use in judging risk. Three general approaches have been discussed. The first estimates risk from either the portfolio mix and/or capital base of an institution. The second utilizes a put-option model to calculate the expected value of the institution. The third uses call report data on the balance sheet and earnings, possibly in conjunction with examiner CAMEL ratings.[4,5] Premiums may be set on an institution-by-institution basis or institutions may be grouped into risk groups with each group charged the same premium rate. While the former is more desirable theoretically, the latter is more easily implemented.

The advantages to risk-based premiums include reducing the subsidy provided to relatively risky institutions at the expense of more prudently managed ones. Moreover, proper pricing of risks forces banks

[2]By setting the premium according to the expected risk of loss an institution poses to its deposit insurer, the institution is forced to internalize the cost of its risk bearing.

[3]See Arthur J. Murton, "A Survey of the Issues and the Literature Concerning Risk-Related Deposit Insurance," in Federal Deposit Insurance Corporation Banking and Economic Review, September/October 1986, pp. 11-20, for an overview of this literature. See Eric Hirschorn, "Developing a Proposal for Risk-Related Deposit Insurance," pp. 3-10, in the same issue for a discussion of the FDIC proposal for risk-based pricing.

[4]CAMEL ratings are judgments made by examiners on a 1-5 point scale. Ratings are given for each of five areas plus an overall rating. The five areas examined are capital adequacy, asset quality, management, earnings, and liquidity.

[5]The FDIC proposal utilizes this approach to measuring risk, using call report data and CAMEL ratings. See "Developing a Proposal for Risk-Related Deposit Insurance."

and thrifts to recognize the true cost of their risk taking, thereby altering the incentive to undertake such activity. Properly priced, premiums also should produce income sufficient to offset expected future losses. However, a number of problems exist in implementing such a proposal.

- First, it is important that risk be measured at the time a risk is undertaken, not when the outcome is known. Furthermore, assessing increased premiums after an institution has begun to show losses resulting from risk taking may be counterproductive. The point of risk-based pricing is to have each institution pay a premium commensurate with the expected loss its behavior implies for the insurance fund. Ideally, risk-based premiums should be designed to deter excessive risk taking, not punish it.
- Second, at the time the risk is undertaken, measures of risk are not directly available and proxy measures such as CAMEL ratings may be available only with a lag. Further, risk is not a static condition but rather may continually change. The data problems are most severe for the put-option model. It is also argued that use of CAMEL ratings may adversely affect the process of conducting bank exams because the use made of the rating may influence the objectivity of the examination.
- Third, the differences in premiums charged must be significantly large to reflect differences in risk. In practice, especially given the monopoly nature of federal deposit insurance, a political problem may arise if very large bills are sent to various insured institutions by a federal agency.

Risk-Based Capital Enhanced Capital Standards

Rather than pricing risk directly through the premium charged, capital requirements may be adjusted according to the level of risk undertaken since capital serves as the cushion against losses. By increasing capital requirements as the possibility of loss increases, the protection of the insurance fund is maintained. Alternatively, uniform capital standards can be maintained but the required levels increased. Further, capital reporting could be required on a market value basis or the elements of capital could be modified. For example, loan loss allowances could be reduced as a component of capital or unlimited amounts of subordinated debt could be included.[6]

Risk-based capital proposals have some advantages over risk-based premiums. First, potentially large amounts of money do not have to be paid to the insurance fund as would be the case with a risk-based premium. In addition, risk-based capital proposals introduce an element of actual market pricing because capital (including subordinated debt) must be raised in competitive capital markets. In these markets, institutions perceived by investors to be more risky will have to pay more to obtain a given amount of capital.

Risk-based capital also, however, has some of the same problems as risk-based premiums. Prospective risk is hard to measure and there are questions as to whether the political environment within which deposit insurance is administered will permit capital requirements for individual institutions to be varied enough to really account for actual differences in riskiness.

Risk-based capital also has several drawbacks compared to risk-based premiums. Insurance premiums are likely to be able to be adjusted much more frequently than capital requirements, and it may take more time for an institution to come into compliance with a higher capital requirement. Also, capital requirements are generally set by the primary supervisory agency, whereas the deposit insurance funds could set risk-based insurance premiums.

[6]The FDIC, the OCC, and the Federal Reserve Board have developed a joint risk-based capital proposal developed in conjunction with representatives from the central banks and supervisory agencies from 12 major industrial countries. (The countries include the United States, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, Switzerland, and Luxembourg.) Each of the U.S. agencies issued its own specific set of proposed guidelines, but the framework for each is the same.

This framework consists of two types of capital, core and supplemental, which summed must be at least 8 percent of risk-weighted assets by 1992. Core capital, which must be at least 4 percent of risk-weighted assets, consists primarily of common stock and retained earnings. Supplemental capital could include loan loss reserves, preferred stock, and subordinated debt, subject to limitations. Supplemental capital counted toward the total capital requirement cannot exceed core capital. Asset categories and off-balance-sheet items are assigned weights from zero to one based principally on their credit risk.

A major objective of this proposal is to include off-balance-sheet risk in the capital standard. This and similar proposals reduce the risk to the insurer by establishing a capital cushion that increases with risk, including that posed by off-balance-sheet items. Assigning different weights to asset categories recognizes differences in credit risk across asset types and reduces disincentives to holding liquid, low-risk assets.

There are several additional criticisms of the risk-based capital proposals.

- First, capital is measured using a historical basis rather than at market value.
- Second, the weights assigned are ad hoc and do not necessarily reflect risk differences across categories, and they do not allow for possibly substantial risk differences across assets within a category.
- Third, they do not account adequately for interest-rate risk or for the risk-reducing benefits of asset diversification.
- Fourth, proposals that would adjust capital according to risk in the United States by more than that done in other countries could weaken the competitiveness of U.S. banks.

Forcing Insured Institutions Themselves to Absorb Risks by a Market Value Closure Rule, Collateralizing Deposits, or Narrow Banking

Risk-based premiums and capital proposals attempt to prospectively put a price on risk taking. As indicated, there are a number of significant limitations to actually achieving this result. However, another set of proposals designed to limit the insurer's risk may have the same intended effect of making institutions bear the cost of risk taking without the problems associated with federal officials having to make specific decisions about insurance premiums or capital levels. These include

- closure at zero market value,
- collateralizing deposits, and
- significantly limiting the uses made of insured deposits.

Market Value Closure Rule

Currently, FDIC and FSLIC each use their own definition of regulatory capital in setting capital standards, granting capital forbearance, and making closure decisions. In recent years, these measures may have drastically overstated the true economic value of depository institutions, particularly undercapitalized and insolvent institutions. If insured institutions were closed when their economic value was zero, the deposit insurance agencies could liquidate them and suffer little or no loss. In addition, if this were to occur, the deposit insurer would not have to maintain a large amount of reserves to underwrite risks taken by the insurance fund.

Critics argue that determining the economic value of institutions through so-called "mark-to-market" accounting is not feasible because certain assets of banks and thrifts do not have the strong secondary markets necessary to determine current market values. Advocates argue, however, that while there are difficulties in implementing mark-to-market accounting, close approximations for regulatory purposes can usually be made. Such adjustments, while imperfect, improve upon the GAAP and RAP standards employed today.[7] Under a mark-to-market system of accounting, any institution whose market value fell below the minimum level would become subject to close regulatory oversight and perhaps certain restrictions. If the institution failed to recapitalize itself or find a merger partner within a short period of time, or if deterioration continued so that the institution's economic capital declined below a stipulated positive level, the institution would then be closed or merged with another institution.

Collateralizing Deposits

Requiring that institutions collateralize deposits is another approach that would impose more of the costs of risk taking on the institution. All insured deposits would have to be collateralized with assets of quality acceptable to the deposit insurance agency. Virtually any kind of asset could serve as collateral but the amount of collateral required would increase with the credit risk or interest-rate risk of the assets used. If the bank failed, the deposit insurance agency would take possession of the collateral whose value would be sufficient to pay the claims of insured depositors. The principal administrative problem for the deposit insurance agencies would therefore be looking after the value of collateral.

A precedent for collateralization exists within FHLBS. Savings institutions that are members of FHLBS must post collateral for all advances obtained from a Federal Home Loan bank. These advances totaled $116.3 on December 31, 1987, and constituted about 10 percent of the liabilities of FSLIC-insured institutions. Federal Home Loan banks have never experienced a loss on an advance despite all of the problems that have beset their member institutions.

[7] Besides improving the information available to regulators, mark-to-market accounting would benefit banks and thrifts by helping them to focus on the true economic consequences of their decisions. In particular, it should help them focus on their sectoral diversification and their interest-rate risk exposure. Problems arising from such exposures would no longer be hidden. This information would remove a large amount of uncertainty from valuation of institutions.

Narrow Banking

A similar but more restrictive alternative to collateralizing deposits is the so-called "narrow bank" model.[8] The objective of narrow banking is to separate insured deposit taking from lending, thereby removing the ability to invest insured deposits in risky assets. Deposits in a narrow bank generally could only be invested in liquid, safe securities such as U.S. Treasury bills or other short-term marketable securities of high quality. Other activities of banking organizations would have to be financed by other means. The principal risk to deposited funds under this framework is that of fraud.

The concept of a narrow bank could be modified to include certain types of home-mortgage loan origination and financing activities that have low credit risk. However, in this case (or in the case of investments in longer term government securities) the deposit insurance premium could be adjusted to account for interest-rate and credit risk, and capital could be marked to market.

Drawbacks

The potential that these proposals have for transferring much of the cost of risk taking to those who take the risks and for running a deposit insurance system at a lower cost makes them especially promising.[9] However, they have possible drawbacks that need to be considered.

The first of these possible drawbacks is that these proposals may tend to reduce the role of depository institutions in providing longer term credit, especially credit at rates of interest that are fixed or that are not fully adjustable to changes in market interest rates. If deposits were collateralized, there may be a disincentive to engage in long-term lending if

[8]Narrow banking is not a new idea but it has received renewed attention in recent years from advocates such as Robert Litan and James Tobin. See, for example, Robert E. Litan, What Should Banks Do?, The Brookings Institution, 1987. Also see James Tobin, "The Case for Preserving Regulatory Distinctions," in Restructuring the Financial System, a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 20-22, 1987, (pp. 167-183). Litan advocates narrow banking as a quid pro quo for expanding bank powers but Tobin advocates the model simply on its own merits. A narrow bank proposal such as Litan's would allow financial institutions to diversify into any financial or nonfinancial product line only if they separate deposit taking from lending. The narrow bank affiliate of the financial institution would accept insured deposits but would not make loans. Deposited funds would be invested only in liquid, safe securities. Banks not wishing to expand into activities beyond those currently allowed under the Bank Holding Company Act would continue to operate as they do today with the same deposit insurance. Banks under a certain size could be exempted from the necessity of forming a narrow bank affiliate in order to expand their activities under the premise that only large bank failures pose a problem to the insurance fund.

[9]Premiums would still be needed because institutions would still be susceptible to fraud, the insurance fund might make mistakes in estimating the condition of institutions, or relevant market values could change too rapidly for the insurance funds to take action. In addition, the insurance funds would still need funds to meet their own liquidity needs. However, in total, these demands would be far less than those now associated with bank or thrift failures.

the amount of collateral required for a given level of deposits rises as the term to maturity of the collateral rises. Under a mark-to-market accounting regime, reluctance to engage in certain forms of longer term lending can be expected because the economic value of such loans is more sensitive to interest-rate fluctuations and changes in economic conditions than is the case with shorter term loans. Narrow banking would prohibit any expansion of credit funded by insured deposits beyond that which is very short term and of the highest quality.

Under the mark-to-market, collateralization, and narrow bank options, we would expect that banking organizations could still engage in intermediate or long-term lending. But we would also expect a significant reduction, if not complete elimination, in the use of insured bank deposits in funding such loans. Insured institutions would have greater incentives to make variable-rate loans, sell loans in the secondary market, and hedge risks with futures and options.

There is nothing inherently wrong with these incentives in that they would tend to make the insured institutions safer and therefore tend to reduce insurance fund losses. However, as a result of these changes, some alterations in the institutional arrangements for extending and financing credit can also be expected. For example, the traditional risk-taking role of banks—both with respect to interest-rate and credit risks—on balance would be reduced. Other sources of credit, such as pension funds, life insurance companies, and other intermediaries, may, however, be able to take over some of the long-term credit financing role now played by banks. Furthermore, revenues that banks would earn on insured deposits would be reduced to varying degrees because they would be invested in lower risk assets. In general, in financial markets rates of return are positively related to risk. Therefore, rates of interest paid on insured deposits would also be expected to decline. Because of the uncertainty that we have about how disruptive the changes might be to the credit allocation process, we believe that great care would have to be exercised in implementing any one of these deposit insurance reform alternatives.

A second, more important drawback of this group of reform proposals is that they may significantly impair the liquidity provision function of banks. This function has proven to be very important during periods of market turbulence—the last of which occurred during the market crash of 1987 when banks roughly doubled their lending to securities firms. This lending, buttressed by actions of the Federal Reserve, proved crucial in enabling securities firms to meet their obligations. If banks had not been able to lend at all, as would occur under the narrow bank proposal, or if collateralization requirements inhibited their ability to do so, the only remaining source of liquidity might have to be some form of direct Federal Reserve lending to nonbank firms.

Conclusion

There are practical difficulties associated with each of the reform proposals discussed in this appendix. The responses of depositors, depository institutions, and credit markets to any of these reforms is difficult to fully forecast. Nonetheless, each proposal offers solutions to at least some of the problems with our current system and each is worthy of serious consideration.

Administrative Aspects of a Merger

This appendix describes the effects a merger would have on the administrative matters pertaining to the operations of the insurance funds and identifies areas in which decisions must be made if a merger occurs.

FDIC and FSLIC present two models of the deposit insurance function. FDIC is more independent in its structure and operations. This type of "arms length" model of insurance requires coordination with federal and state regulatory and chartering authorities to be effective. FDIC appears to have been reasonably successful in working out such arrangements with OCC and the Federal Reserve. For state-chartered nonmember banks, FDIC has been aided by its role as the federal regulator and supervisor which enables it to have more direct control over these institutions.

In contrast, FSLIC is not independent but is governed by FHLBB. FHLBB, which is charged with promoting the availability of funds for home ownership, regulates the thrift industry and promotes the industry in its role as specialized housing lender. Federal Home Loan Bank personnel monitor institutions and attempt to resolve problems. Authority and control for all areas of FSLIC's operations rests with FHLBB.

FDIC has a sizable staff of its own employees working in Washington and in regional offices throughout the country. Staff needed for liquidation activity are hired on a temporary basis to assist permanent staff. FSLIC has a staff level of about 1/8 the size of FDIC; FHLBB performs the overhead functions and the Home Loan Banks handle the field work. In addition, FSLIC contracts out more of its receivership operations than does FDIC.

Table V.1 shows the relative sizes of FSLIC and FDIC staff and operating expenses.

Table V.1: Comparative Statistics on Size of FDIC and FSLIC

Dollars in millions

	FDIC	FSLIC
Corporate Full Time Staff Equivalents[a]	3,266	383
Total Corporate Personnel Compensation (FY 1987)	$105.7	$13.5
Corporate Administrative/Operating Expenses[a]	$200.8	$25.3[b]
Full Time Staff Involved in Liquidating Assets as of 2-29-88	4,072	850
Total Expense for Liquidation Operations CY 1987	$401	$228
Book Value of Assets Managed/Liquidated[c]	$12,274[d]	$5,688[e]

[a]Fiscal year 87 actual figures from fiscal year 1988 budget submission.

[b]FSLIC paid FHLBB $24,084 of this amount for providing certain services and facilities.

[c]The definitions of value used by the two agencies may not be comparable.

[d]Figure as of December 31, 1987.

[e]Figure is the sum of April 19, 1988, corporate FSLIC assets ($156) and February 29, 1988, FSLIC as a receiver assets ($5,532).

For purposes of the discussion in this appendix, we assume that merger of the deposit insurance funds would involve removing insurance authority from FHLBB but that chartering and primary supervisory authority for the thrift industry could remain with FHLBB. This could result in a relationship between the new insurance fund and FHLBB that would be comparable to FDIC's relationships with OCC, the Federal Reserve, or FHLBB itself with respect to some savings banks. For purposes of our discussion in this appendix, we will assume that FSLIC is either combined with FDIC or the two funds are combined in a new agency which would be formed around FDIC.

The sections that follow briefly discuss the following topics associated with a merger of FSLIC and FDIC:

- Executive structure of the agency.
- Powers of the insurance fund.
- Monitoring and examinations.

Executive Structure of the Agency

FDIC is governed by a board of three appointees. One is the Comptroller of the Currency. One of the other two serves as chairman. Terms of office are 5 years for the Comptroller and 6 years for the other appointees. No more than two of the directors can belong to the same political party.

If the funds are merged, decisions need to be made about the composition of the governing board. The current FDIC board could be expanded to provide representation for the Chairman of FHLBB. Alternatively, OCC could be dropped from the board or the board could be left unchanged because national banks have more assets than any other single group of depository institutions. If the board were too big, it might prove to be unwieldy.

Powers of the Insurance Fund

In chapter 5, we pointed out the importance of improving the management of the deposit insurance system's exposure to risk. In keeping with that discussion, if the deposit insurance funds are merged, the new entity needs to have sufficient powers and resources to be held accountable for the financial integrity of the fund.

The combined fund therefore needs to be able to

- adjust insurance premiums;
- deny insurance coverage or charge higher premiums to institutions engaged in activities that entail inordinate risk to the fund; and
- take actions, including expeditious termination of insurance, to enforce capital adequacy standards.

If the funds are merged, banks and thrifts, which could then receive comparable treatment in the insurance system, might still be subject to differing supervisory and regulatory systems that could put one industry at a competitive disadvantage with the other. Comparable standards on matters that are material to insurance fund losses are important to ensure that a fair balance be maintained between banks and thrifts with respect to premium levels, capital standards, allowable activities, and regulatory/supervisory rigor and to ensure that risks are adequately managed.

Monitoring and Examinations

Insurance funds can obtain data on institutions from financial reports submitted by the institution (off-site monitoring), by direct on-site examinations of the institution, or by reviewing examination reports made by bank supervisory agencies. Both FDIC- and FSLIC-insured institutions are required to file quarterly reports (call reports) with their principal federal supervisory agency. The content of the call reports for banks and thrifts are not identical. A merged fund needs the power to ensure that it has data sufficient to make comparable judgments about the condition of both banks and thrifts.

Currently, both FDIC and FHLBB evaluate the capital adequacy, asset quality, management, earnings, and liquidity of banks and thrifts by combining off-site monitoring with data provided by examinations. FDIC may also examine banks that the other regulators have indicated have problems in the course of regular examination. Examination frequency is based on the institution's last CAMEL rating. With a merger of the funds, the insurance agency would need at least the same power to examine potential problem thrifts that it has with respect to national or state member banks.

Recapitalization of the National Credit Union Share Insurance Fund

Our report discusses a good company/bad company merger of FSLIC and FDIC. We envision that recapitalization of the good company fund would be similar to the NCUSIF recapitalization under the Federal Credit Union Act amendment to the Omnibus Deficit Reductions Act of 1984 (Public Law 98-369). This appendix explains the key provisions of the NCUSIF arrangement and discusses briefly how the NCUSIF plan has worked thus far.

The NCUSIF Recapitalization

During the 1970s NCUSIF was funded primarily by annual premium assessments, from which it had built capital and reserves to 0.3 percent of insured shares in 1979—a level below the 1 percent level prescribed in the Federal Credit Union Act. Beginning in the late 1970s, NCUSIF faced financial problems because economic fluctuations, poor investments, and stiffer competition had caused a number of credit unions to fail. Reserve levels fell and remained below 0.3 percent through 1983 in spite of a special premium assessment which increased assessment income by 67 percent in 1982 and by 100 percent in 1983.

The Federal Credit Union Act amendment to the Omnibus Deficit Reduction Act of 1984 provided that a credit union applying for federal insurance would pay and maintain a deposit of 1 percent of the value of insured shares (deposits) with the insurance fund. The act also provided that the normal operating level for NCUSIF reserves would be determined by the NCUA Board. The Board has thus far set it at the maximum level prescribed in the act—1.3 percent of insured deposits. The act also provided that credit unions would pay annual premiums of 1/12 of 1 percent if required by the NCUA Board to maintain the normal operating level after payment of insurance expenses. If reserves exceed the normal operating level, the Board could waive the subsequent insurance premium, rebate the previous premium, or distribute the excess amount to the credit unions as a dividend.

The NCUSIF plan had two key features. First, the 1-percent deposit is carried on each credit union's books as an asset and is fully refundable to the institution if insurance coverage is terminated, other insurance coverage is obtained, or if NCUSIF operations are transferred from NCUA. The deposit is not refunded if the institution is liquidated due to insolvency or bankruptcy. Like any asset, the deposit can be carried at full value so long as its value is not materially impaired. Therefore, so long as the insurance fund is not experiencing losses so large that it must use the 1-percent deposit to pay expenses, the cost to the credit unions of financing the insurance fund is equal to the net effect of the following items:

foregone income that could have been earned by investing the 1-percent deposit in other ways, the premiums avoided, and any dividend rebated by the insurance fund.

The second key feature of the NCUSIF plan is that the contribution by the credit unions was considered a revenue item for the fund and a revenue item for federal budget purposes primarily because all NCUSIF funds are maintained in an account with Treasury. Thus, when NCUSIF was recapitalized, the initial deposit resulted in a credit of $844 million[1] which was treated as revenue, thereby reducing the federal deficit and offsetting the deficit-increasing effect of expenditures on case resolutions.

Experience Under the Recapitalization Plan

The NCUSIF recapitalization seems to have worked well. NCUSIF reached its target operating level in the first year while simultaneously acting to resolve problem cases. The credit unions have not had to pay an annual insurance premium since the recapitalization—avoiding $387 million in premiums over the 1985-1988 period. (A 1-year waiver equals about an 8.3 percent dividend on the credit unions' 1-percent contribution.) The credit unions' investment in NCUSIF has not been at risk, so credit unions have been able to carry their contribution as a fully valued investment asset. From a federal budget perspective, NCUSIF recapitalization increased the government's net receipts over $800 million in 1985 and about $100 million in 1986.

[1] The credit union actual payment was $760 million. The remainder of the $844 million represented the value of the premium waiver and a dividend for 1985 which were credited as part of the capital contribution.

FDIC and FSLIC Combined Financial Statements, December 31, 1987

FEDERAL DEPOSIT INSURANCE CORPORATION AND
FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
STATEMENTS OF FINANCIAL POSITION
DECEMBER 31, 1987
($ thousands)

Assets	FDIC	FSLIC	FDIC+FSLIC
Cash	$18,499	$12,415	$30,914
Investment in U.S. treasury obs	16,098,874	3,357,173	19,456,047
Interest receivable on:			
Int rec on invest & oth assets	464,292	1,000	465,292
Int rec on lns to receivers		3,767	3,767
Int rec on oth lns to insured inst		10,533	10,533
Certs, notes & oth rec from insured inst:			
Income capital certificates		656,742	656,742
Net worth certificates		225,025	225,025
Other	557,638		557,638
Net rec from assistance to insured inst	1,664,515		1,664,515
RE mrtg lns oth assets in proc liq		173,437	173,437
Collateralized lns to insured inst		900,000	900,000
Other loans to insured institutions		214,181	214,181
Net rec from failures of insured inst:	3,549,268		3,549,268
Subrogated accounts from receivers		3,988,495	3,988,495
Collateral advances from receivers		814,047	814,047
Loans to receivers		113,573	113,573
Other assets			
Other		19,009	19,009
Ins premiums and accts receivables		506	506
Contributions subject to repayment		18,544	18,544
Property and buildings	73,438		73,438
Total assets	$22,426,524	$10,508,447	$32,934,971

Liabilities and insurance fund reserves	FDIC	FSLIC	FDIC+FSLIC
Accounts payable, accrued liab & other	$1,296,488	$102,230	$1,398,718
Assistance to failed or insured inst:			
Liab incurred assist insured inst	2,623,472		2,623,472
Liab incurred fails of insured inst	204,122		204,122
Note pay & oth liab to insured inst		4,947,463	4,947,463
Accr int on nts pay to insured inst		99,905	99,905
Notes payable to FHLBanks		900,000	900,000
Posble loss under exist asst agrmnts		749,069	749,069
Estimated loss from corp litigation	600		600
Estimated liability for unresolved cases		17,400,000	17,400,000
Total liabilities	$4,124,682	$24,198,667	$28,323,349
Insurance fund reserves			
Capital stock		$129,500	$129,500
Capital certificates		1,070,500	1,070,500
Primary reserve	$18,301,842	(14,890,220)	3,411,622
Total reserves	$18,301,842	($13,690,220)	$4,611,622
Total liabilities and reserves	$22,426,524	$10,508,447	$32,934,971

FEDERAL DEPOSIT INSURANCE CORPORATION AND
FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
CONSOLIDATED STATEMENT OF INCOME AND EXPENSE AND RESERVES
FOR THE YEAR ENDED DECEMBER 31, 1987
($ thousands)

INCOME	FDIC	FSLIC	FDIC+FSLIC
Insurance premiums	$1,697,208	$734,021	$2,431,229
Special assessment premiums	0	1,119,582	1,119,582
Gross assessments	1,697,208	1,853,603	3,550,811
Provision for assessment credits	1,250	0	1,250
Net assessments	1,695,958	1,853,603	3,549,561
Interest on investments	1,534,937	112,552	1,647,489
Other interest income:			
Interest on collateralized advances		8,814	8,814
Interest on advances to insured inst		47,051	47,051
Int on oth lns to insured inst		28,010	28,010
Int on collat lns to insured inst		101,240	101,240
Int mrtg lns oth assets in proc liq		17,159	17,159
Interest on NWC's & ICC's		60,607	60,607
Other income:			
Gain on transfer of insured account		31,710	31,710
Gain on sale of assets		32,299	32,299
Other	84,922	102,084	187,006
Total income	$3,315,817	$2,395,129	$5,710,946

EXPENSES	FDIC	FSLIC	FDIC+FSLIC
Insurance settlement:			
Ins setlmnt & admin exp for FSLIC		$192,593	$192,593
Merger assistance losses & expense	$20,256		20,256
Nonrecoverable insurance expenses	47,732		47,732
Administrative expenses	202,381	25,604	227,985
Interest expense:			
Int on notes payable to FHLBanks		78,928	78,928
Int notes payable to insured inst		237,789	237,789
Provision for possible future losses on:			
Subrogated accounts from receivers		1,623,060	1,623,060
Collateral advances from receivers		145,313	145,313
RE mortg lns & oth asts in proc liquid		106,943	106,943
Loans to receivers		24,225	24,225
Income capital certificates		281,793	281,793
Assistance agreements		1,334,730	1,334,730
Estimated losses for unresolved cases		6,900,000	6,900,000
Other	2,996,923		2,996,923
Total expenses	$3,267,292	$10,950,978	$14,218,270
Net income (loss) from operations	$48,525	($8,555,849)	($8,507,324)
Primary reserve at beginning of year	18,253,317	(6,332,891)	11,920,426
Secondary reserve adjustments		(1,480)	(1,480)
Capital stock		129,500	129,500
Capital certificates		1,070,500	1,070,500
Reserves at end of year	$18,301,842	($13,690,220)	$4,611,622

Comments From the Federal Home Loan Bank Board

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

January 19, 1989

Mr. Richard Fogel
Assistant Comptroller General
for Programming
Government Accounting Office
441 G Street, N.W.
Room 3853
Washington, D.C. 20548

Dear Mr. Fogel:

The Federal Home Loan Bank Board has completed its review of your report "Troubled Financial Institutions: Solutions to the Thrift Industry Problem." The most immediate issue identified in the report is the need for more funds to resolve all insolvent thrifts. We certainly concur with this recommendation. However, other issues raised in the report appear to be inadequately addressed or already consistent with current policy. The accompanying document lists the major issues, with the report's recommendation as well as our comment.

We appreciate the opportunity to review and comment on this report.

Sincerely,

M. Danny Wall
Chairman

Roger F. Martin
Board Member

Lawrence J. White
Board Member

Federal Home Loan Bank Board

Comments
on

"Troubled Financial Institutions: Solutions to the Thrift Industry Problem"

U.S. General Accounting Office

I. Issue - FSLIC Funding

Recommendation

GAO recommends that FSLIC be provided with more funds to resolve troubled thrifts. It believes that at least $85 billion more than FSLIC anticipates receiving over the next ten years will be required. GAO does not provide a recommendation regarding exactly where the funds are to be obtained.

Comments

The Bank Board concurs with the view that FSLIC will require more funds than are anticipated over the next ten years. Indeed, this has already been publicly stated and is reflected in cash-flow projections showing a need to extend the special assessment for at least 30 years. However, it has also been noted that such an extension is not realistic since it places thrifts at a competitive disadvantage vis-a-vis other financial service firms.

Since the cost of resolving remaining problem cases is currently under reassessment, it is premature to comment directly on the $85 billion figure. However, the GAO figure does not appear to be strictly a present-value estimate and includes $20 billion for reestablishing a reserve for the FSLIC. More importantly, as GAO correctly points out, "there is no way to determine precisely how much money FSLIC will ultimately need" (p. 144). To demonstrate this point, the recent changes in the tax treatment of FSLIC assistance may well raise the cost of resolving troubled thrifts. As a result, any cost estimates based upon simple experience factors are likely to underestimate FSLIC's costs to the extent this important determinant of resolution costs is not fully accounted for.

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Related to the funding issue is the treatment of FSLIC notes and guarantees. The extension of full faith and credit to these obligations would certainly reduce the costs imposed upon the FSLIC to resolve insolvent thrifts.

II. Issue - Merger of FSLIC and FDIC

Recommendation

GAO recommends against a merger of the insurance funds on the grounds that such a merger "cannot solve the FSLIC problem" (p.7).

Comments

The Bank Board concurs with the view that a simple merger of the insurance funds will not solve either the thrift or commercial bank problems. For this reason the Bank Board is proposing a complete reform of federal deposit insurance on the grounds that as it currently exists there is no provision for covering catastrophic losses (i.e., losses that swamp the reserves of an insurance fund). Establishment of a reinsurance-type entity would be one way to deal with the problem and be sure that no depository insurance fund be put into the same situation as the FSLIC has been in the last few years.

III. Issue - FSLIC Case Resolution Process

Recommendation

GAO criticizes the current case resolution process and recommends that it be changed. Instead of focusing on assisted mergers, it is recommended that insolvent institutions be temporarily placed in a receivership. In the interim, the risk-taking activities of these institutions should be contained and due diligence performed so as to enable one to determine the most appropriate disposal action.

Comments

The Bank Board believes this criticism and recommendation overlooks the fact that if the FSLIC were provided with more funds immediately--as the GAO recommends--the preferred course of action would indeed be assisted mergers to take advantage of a thrifts on-going value as reflected, for example, in its core deposits or mortgage-originations business.

However, at the margin, more cash would facilitate some additional liquidations. But with more funds there would simply be no need to adopt an interim strategy. Beyond this, it should be emphasized that all FSLIC's actions attempt to minimize the cost to the insurance fund. Liquidations, assisted mergers, MCPs and stabilizations are collectively designed to control risk-taking and provide proper incentives to reduce the ultimate cost to the FSLIC for resolving insolvent thrifts. Of course, FSLIC has been constrained by the resources--both human and monetary--available to it. It must also follow procedures established by law and regulation.

Experience also indicates that temporary receiverships do not really resolve problems. Tight supervision and careful monitoring of assisted mergers is a far more preferable strategy.

In any event, GAO's criticism of the case resolution process is not supported by any factual information. This is perhaps not surprising since the report admits that GAO has just "begun work to assess in detail the merger and other resolutions of specific insolvent thrifts that have occurred" (p.78). More importantly, the recommendation itself is entirely consistent with the current FSLIC case resolution process and Bank Board policies--such as growth limitations and asset restrictions--designed to control risk-taking activities. Recently, moreover, the Bank Board proposed a new minimum capital regulation and early intervention rule that will protect the FSLIC from future losses. In addition to ongoing examinations at insolvent thrifts, MCPs and stabilizations specifically permit due diligence so as to determine the least costly disposal action. More specifically, the recent actions involving Silverado and several thrifts in Oklahoma appear to be exactly the type of transactions being recommended by GAO. Performing due diligence before taking action would only slow the resolution process when the need to act is now.

IV. Issue - Restructuring the FSLIC

Recommendation

GAO recommends that FSLIC "be reorganized under independent management [i.e., removed from the jurisdiction of the FHLBB] so that it consists of two parts: a 'good company' fund for thrifts that are healthy or can become so in a reasonable period of time, and a 'bad company' fund for those institutions

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that need to be rehabilitated, merged or liquidated" (p.5). Furthermore, "healthy thrifts that meet FDIC's capital adequacy criteria should be offered a choice of joining the FDIC or the good company fund" (p.5).

Comments

In recommending a management structure similar to the bank regulators, GAO fails to justify the need for a separate chartering authority and insuring authority and how such independence improves regulatory oversight and supervision. More generally, even if FSLIC is managed independently of the Bank Board, it would have to operate in cooperation with them and also with state chartering agencies, as the FDIC must operate with the OCC, the Federal Reserve Board, and the state banking agencies. If the Bank Board "promotes" the thrift industry and thereby makes decisions that are biased, it would seem to be critical to correct this bias, regardless of the administrative status of FSLIC. Besides, with separate agencies the industry would be in a position to play one agency against the other.

Lastly, this particular recommendation does not actually establish a structure, such as a reinsurance entity, that assures the current depository insurance system problems will not recur.

Comments From the Federal Deposit Insurance Corporation

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

January 10, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

I commend you on the GAO's excellent study, Troubled Financial Institutions: Solutions to the Thrift Industry Problem. Resolving the problems facing the savings and loan industry and the FSLIC is of the utmost importance in preserving the integrity of the federal deposit insurance system and to the financial system generally. Your study is a comprehensive and very valuable contribution to this important debate.

The FDIC is in broad agreement with the findings of your study, and strongly supports your recommendations regarding deposit insurance reform. Many of your deposit insurance reform proposals are recommended in our own study, Deposit Insurance for the Nineties: Meeting the Challenge. The spirit of these reforms is to allow the federal deposit insurer to have more independence and to protect the integrity of its fund by functioning more like a private insurance company.

We generally agree with your estimate of the cost of resolving the S&L industry's problems. However, there is one point made in your discussion of cost estimates that we believe should be clarified. In recent bank failures, the FDIC has lost on average about 30 percent of assets in resolving bank failures under $500 million in assets. The average loss in resolving banks over $500 million in assets, however, has been about 10 percent of assets. Overall, the asset-weighted average loss rate is about 13 percent of assets. While it may be appropriate to use the 30 percent figure in estimating S&L failure costs, it is not accurate to refer to it as "the cost to the FDIC of handling bank failures."

We also agree with your conclusions that the size of the problem is well beyond FSLIC's available resources, and that it is important to resolve the insolvencies as soon as possible. In this regard, we would like to emphasize that the resolution process should be structured in a way that is consistent with the appropriate incentives. For example, because it is against human nature for people to put themselves out of a job, we oppose the creation of a new, limited-life liquidation agency.

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As a final comment, your study notes that 48 insolvent banks and 210 solvent banks with GAAP capital of less than three percent were in operation as of the end of the second quarter of 1988. Actually, there were 90 GAAP-insolvent banks open at mid-year 1988, but 70 of these institutions were closed or merged out of existence during the second half of the year, gained solvency during the third quarter, or have assistance proposals currently pending. Please be assured the FDIC monitors these institutions closely and works closely with chartering authorities to encourage prompt resolution of failing institutions. We anticipate that all of the remaining insolvent banks will be closed, recapitalized, or otherwise resolved within the ensuing months.

We also would like to point out that only two of the remaining 20 insolvent banks are under the primary supervision of the FDIC. None of the insolvent institutions are participants in our capital forbearance program. The FDIC will not admit any bank into its forbearance program that is insolvent or does not have a reasonable plan for restoring capital to safe levels. Once admitted, banks are closely monitored and are promptly eliminated from the program if they fail to adhere to their recapitalization plan. As of the end of November, 1988, 18 percent of the state banks admitted to our capital forbearance program have been closed or otherwise taken off forbearance for failure to perform satisfactorily. Fortunately, another 10 percent have either improved or merged with healthier institutions to get off forbearance. Currently, there are 129 banks in FDIC's forbearance program. As required by law, the FDIC also allows 31 banks to defer losses on agricultural loans. Again, however, essentially the same standards are applied, in that the institution must be both solvent and viable.

Once again, congratulations on having produced a well-reasoned and important document.

Sincerely,

L. Wm. Seidman

L. William Seidman
Chairman

Comments From the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

January 26, 1989

Dear Mr. Fogel:

We have reviewed your December 1988 draft of a proposed GAO report entitled, "Troubled Financial Institutions: Solutions to the Thrift Industry Problem". We appreciate your invitation to comment on the draft.

Treasury is presently studying the problems in the thrift industry and will shortly be issuing recommendations on ways to finance the continued resolution of troubled institutions and to prevent the recurrence of current industry problems. As a result, we are not in a position to discuss the substance of your report.

However, we would like to comment on a statement made on page 145 of the study that a large taxpayer contribution ($75 to $80 billion) "-- can be justified because the thrift problem is national in scope and government policies contributed significantly to its occurrence."

We believe your statement is incomplete, and that numerous factors have contributed to the crisis in the thrift industry including, but not limited to: (1) a period of high interest rates during the early 1980's, which drastically reduced the industry's aggregate capital; (2) technological innovations which made possible the securitization of mortgage loans and thus increased competition, reducing the interest spreads and profit margins of thrifts; (3) commodity disinflation and an economic downturn in the Southwest; (4) expanded state-authorized asset powers which permitted state-chartered thrifts to make investments Congress has felt are too risky for federally-insured institutions; (5) imprudent thrift managers; and (6) fraud.

Sincerely,

David W. Mullins, Jr.
Acting Assistant Secretary
(Domestic Finance)

Mr. Richard L. Fogel
Assistant Comptroller General
General Government Division
General Accounting Office
Washington, D.C. 20548

Comments From the Board of Governors of the Federal Reserve System

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

WILLIAM TAYLOR
STAFF DIRECTOR
DIVISION OF BANKING
SUPERVISION AND REGULATION

January 9, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel,

I am writing in response to your request of December 9, 1988 for the Board's comment on your draft report, "Troubled Financial Institutions: Solutions to the Thrift Industry Problem". Your report provides useful insights into a complex problem with potentially far-reaching implications for the domestic financial industry. As you note, the range of alternative solutions to the problems of the thrift industry involves value judgments that are best decided by the Congress. Your report, however, helps to identify the relevant issues and possible solutions and should advance the debate on this matter.

The report contains several recommendations that have implications for Federal Reserve policies and resources. The first recommendation calls on the Federal Reserve to develop a specific proposal for clearly defining holding company financial responsibility for insured depository institutions. As you know, in April 1987, the Board reiterated its longstanding policy that holding companies should act as sources of strength to their subsidiary banks.

A key element of this policy is that a bank holding company should "stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks . . ." While this policy is couched in terms of subsidiary banks, the Board believes that it is equally relevant in defining a bank holding company's responsibility to any affiliated thrift institution. We believe that this policy statement clearly

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affirms the Board's commitment to the principle that a bank holding company should serve as a source of strength to any insured depository institution subsidiary.

A second recommendation in your report is that the Federal Savings and Loan Insurance Corporation request help from the federal banking agencies in examining certain savings and loan institutions on a short-term basis. The Federal Reserve recognizes the magnitude and complexity of the problems facing the thrift industry and is certainly willing to play a constructive and appropriate role in addressing the situation. As noted in your report, in 1985 the Federal Reserve worked closely with examination and supervisory personnel from the Federal Home Loan Bank Board and state examination departments to monitor conditions and assess problems in non-Federally insured thrift institutions during the Ohio and Maryland thrift crises. The Federal Reserve remains ready to provide an appropriate measure of assistance to other Federal and state regulators, consistent with our available resources and our responsibilities for promoting safe and sound conditions within the banking and financial system.

The report further indicates that the financial institution regulatory agencies should strengthen their capital adequacy standards and their supervisory capability, and that they should obtain better information about the market values of financial institutions. The Federal Reserve whole-heartedly supports these recommendations. As you know, the Federal Reserve and the other federal bank regulatory agencies. in cooperation with authorities abroad, have recently taken steps to strengthen capital standards by adopting new capital standards that relate an institution's capital requirements directly to the estimated risks it undertakes. The Board's specific standards relate to bank holding companies and state member banks and will go into effect next month. Other elements of the standard, such as factoring interest rate risk into the measure, are still being developed and should lead to further improvement in the capital adequacy of U.S. banking organizations.

The Federal Reserve has also emphasized capital adequacy in reviewing bank dividend policies and in evaluating plans to undertake significant expansion. In this regard, the Board has required banking organizations undertaking significant growth or expansion to operate with capital positions well above supervisory minimums and has generally not permitted institutions to reduce their financial strength in order to fund expansion proposals.

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Within the last several years, the System has also strengthened its examination staff, increased the frequency of on-site examinations and certain supervisory reporting, and improved its techniques for communicating with bank boards of directors. The Federal Reserve has also augmented the resources devoted to carrying out supervisory enforcement actions and to training examiners and other supervisory personnel. As part of its planning process, the System will continue to evaluate the adequacy of its supervisory resources and policies and will modify them as conditions warrant.

During the last several years, the Federal Reserve, in conjunction with the other federal banking agencies, has also reaffirmed its policy that bank real estate loans should be supported by up-to-date appraisals that realistically reflect current market values. The banking agencies, under the auspices of the Federal Financial Institutions Examination Council, have also strengthened their policies regarding appropriate securities investment and trading activities of commercial banks. It has been a long standing policy of the agencies to require banks to segregate the securities they hold for trading purposes from their other assets and that they mark those securities to market at least quarterly. The banking agencies also require that the market values of investment (i.e., nontrading) account securities be reported on a quarterly basis.

With regard to the question of market value information for loans and other bank assets, it should be noted that the Financial Accounting Standards Board is currently addressing the appropriateness of market value reporting in connection with its financial instruments project. The Federal Reserve has provided comments on FASB's draft proposals on this subject and will continue to work with FASB on the development of any related accounting standards.

I believe this information is responsive to your request for comments on your report. Please let me know if we can be of any further assistance.

Sincerely,

Comments From the National Credit Union Administration

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

January 4, 1989

OFFICE OF THE CHAIRMAN

Richard L. Fogel
Assistant Comptroller General
United States
General Accounting Office
Washington, D. C. 20548

Dear Mr. Fogel:

I agree with the basic facts outlined in your report entitled, Troubled Financial Institutions: Solutions to the Thrift Industry Problem. Your key points that the merger of deposit insurance funds is not required or advisable, that substantial funding must be provided and that quick action needs to be taken parallels our own research for resolving this massive problem in the S&L industry.

In addition, I appreciate the extremely favorable comments about the National Credit Union Share Insurance Fund and the credit union system. Credit unions have a long history of working cooperatively to deal with both their problems and their successes.

Thank you for this opportunity to comment.

Sincerely,

Roger W. Jepsen

ROGER W. JEPSEN
Chairman

Related GAO Products

Commercial Banking Supervision and Regulation

Failed Banks: FDIC's Asset Liquidation Operations (GAO/GGD-88-132, Sept. 28, 1988).

Budget Issues: Information on FDIC and FSLIC Notes Payable (GAO/AFMD-88-71FS, Aug. 5, 1988).

Commercial Banking: Trends in Performance From December 1976 Through June 1987 (GAO/GGD-88-106BR, July 28, 1988).

Financial Audit: Federal Deposit Insurance Corporation's 1987 and 1986 Financial Statements (GAO/AFMD-88-43, Apr. 22, 1988).

Bank Powers: Issues Related to Repeal of the Glass-Steagall Act (GAO/GGD-88-37, Jan. 22, 1988).

Deposit Insurance: Analysis of Reform Proposals (GAO/GGD-86-32, 32a, 32b, Sept. 30, 1986).

Thrift Industry

Financial Audit: Federal Savings and Loan Corporation's 1987 and 1986 Financial Statements (GAO/GGD-88-67, Aug. 24, 1988).

Thrift Industry: Trends in Thrift Industry Performance: December 1977 Through June 1987 (GAO/GGD-88-87BR, May 17, 1988).

Thrift Industry: Federal Home Loan Bank Board Advances Program (GAO/GGD-88-46BR, Mar. 9, 1988).

Thrift Industry: Forbearance for Troubled Institutions 1982-1986 (GAO/GGD-87-78BR, May 6, 1987).

Thrift Industry: The Management Consignment Program (GAO/GGD-87-115BR, Sept. 10, 1987).

Thrift Industry: The Treasury/Home Loan Bank Board Plan for FSLIC Recapitalization (GAO/GGD-87-46BR, Mar. 3, 1987).

Thrift Industry: Cost to FSLIC of Delaying Action on Insolvent Savings Institutions (GAO/GGD-86-122BR, Sept. 9, 1986).

Testimony

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