

TESTIMONY OF

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ON

THE CURRENT PROBLEMS OF THE SAVINGS AND LOAN INDUSTRY  
AND THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

BEFORE THE

House COMMITTEE ON WAYS AND MEANS  
UNITED STATES HOUSE OF REPRESENTATIVES

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Good morning, Mr. Chairman and members of the Committee. I am pleased to testify today concerning the problems of the savings and loan ("S&L") industry, and the Federal Savings and Loan Insurance Corporation ("FSLIC").

The Federal Deposit Insurance Corporation ("FDIC") believes President Bush's "Reform Plan for the Savings and Loan Industry" ("Bush Reform Plan"), announced February 6th, generally is a sound proposal. It provides for prompt action to resolve the S&L situation and proposes structural and regulatory reforms designed to make the federal deposit insurance system cost-effective. These changes will help prevent a recurrence of the factors that led to this most costly problem.

#### BACKGROUND

As the insurer of bank depositors, the FDIC has been concerned that the thrift industry's problems pose a threat to the profitability -- and potentially even the stability -- of many banks.

The FDIC has had firsthand experience dealing with many problems similar to those faced by the thrifts and the FSLIC. These include high and volatile interest rates, increased competition from nonbank providers of financial services, a boom-to-bust economy in the Southwest, and fraud and insider abuse.

These adverse conditions have contributed to the record number of bank failures over the past several years. In 1988 alone, the FDIC fund dealt with \$80 billion of problem bank assets -- more than the combined total of assets handled during its first fifty years. As a result, the insurance fund declined from over \$18 billion to approximately \$14 billion -- our first operating loss ever.

Concern over the high cost of providing deposit insurance led the FDIC to undertake a year-long review of ways to improve the current deposit insurance system. Our recently released study, Deposit Insurance for the Nineties: Meeting the Challenge, contains recommendations for reforming the deposit insurance system and provides an outline for a restructured federal deposit insurance system. I would like to submit the executive summary of our study for the record. As part of our review, we studied the size and estimated cost of the thrift problem, and analyzed alternative funding sources.

I would like to turn now to the S&L problem.

#### BUDGETARY IMPACT OF PROBLEM

Size of the problem. In order to estimate fully the budgetary implications of the thrift problem, ascertaining the size of the insurance loss is critical. At the beginning of 1988, there were approximately 500 insolvent thrifts under generally accepted accounting principles ("GAAP") with assets over \$200 billion. During 1988, the Federal Home Loan Bank Board ("FHLBB") took action on more than 200 S&Ls at a reported cost of over \$39 billion on a present value basis. We understand that the General Accounting Office ("GAO") soon will release a cost analysis of S&L transactions during 1988.

As of the end of the third quarter of 1988, there were about 220 thrifts that were insolvent under regulatory accounting principles ("RAP"), not including those thrifts handled by the FHLBB in 1988, and another 119 GAAP insolvent thrifts. Our latest estimates suggest that current operating losses at these

RAP and GAAP insolvent S&Ls are about \$200 million per month. That figure will be higher if S&Ls experience deposit outflows, as they have recently, and must fund with higher cost deposits.

We have stated in the past that reliable cost estimates of resolving the insolvent S&Ls can be made only through detailed on-site examinations. We are in the process of making such estimates pursuant to the joint oversight effort discussed below. Our best estimates at this time are in the same range as the Treasury Department's estimated cost of \$90 billion.

Bush Reform Plan financing proposal. Regarding the financing package, the Treasury Department and the Office of Management and Budget are its architects, and are in the best position to comment on its efficacy. From our viewpoint, the Plan appears viable and sound. The Bush Reform Plan provides for an equitable sharing of the financial burden between the S&L industry and the Treasury.

Appropriately, banks are not required to pay for the S&L losses. While the Plan places a heavy burden on the S&L industry to pay for its problems, the S&L industry should be required to bear as much of the cost as possible without jeopardizing their sound institutions.

Ability of banks and S&Ls to pay increased premiums. The Bush Reform Plan calls for increased insurance premiums for both banks and S&Ls. The increased premiums for the S&Ls will be used to partially offset the cost of that industry's problems. The banks' increased premiums will be used to strengthen the FDIC insurance fund. Both premium increases will add to general federal revenues for budgetary purposes.

In our recently released study on deposit insurance, we concluded that FDIC deposit insurance premiums should be adjusted for the risk and costs incurred by the insurance fund. The FDIC spent \$7 billion dollars last year, and our fund declined by about \$4 billion, or over 20%. Our fund's reserves at year-end will be reduced to 83 cents per \$100 of insured deposits, well below desired levels. Without regard to the S&L industry problems, the FDIC study recommended that bank premium rates be increased to reflect more accurately recent loss experience of the FDIC fund.

The Bush Reform Plan calls for such an increase -- and we support this proposal. Raising bank premiums from their current level of 8.33 basis points to 12 basis points next year, and then 15 basis points the year after, is reasonable. We estimate going to 12 basis points will increase premiums about \$700 million, and that 15 basis point will bring in almost \$600 million more.

The increase in premium expenses translates to about 2.1 percent and 3.8 percent of pre-tax earnings at 12 and 15 basis points, respectively. To some extent, this increase probably could be offset by repricing of services, but the ability to do this is constrained by today's competitive market place. Assuming that all the increase resulted in earnings reductions, we estimate that fewer than 100 institutions out of over 13,000 that are now profitable would be made unprofitable.

The majority of the banks that would suffer the most significant decline in profitability from higher assessments are located in the Southwest and Midwest regions, the two regions that have experienced the greatest difficulties during this decade.

Given recent FDIC loss experience, the increases are consistent with our study's conclusions and should not pose an unreasonable burden to the banking system. Importantly, the revenues generated from these premiums will go solely to build the FDIC fund.

Under the Bush Reform Plan, once the FDIC insurance fund moves up from .8 to 1.25 percent of insured deposits, banks can expect premium rebates. Our preliminary estimate is that rebates could begin as early as the mid-1990s under the President's plan.

We recently completed an evaluation of the rebates the FDIC paid from 1950 through the early eighties. We added all rebates from that period back into our fund and applied the yield we would have earned on those funds. We discovered that, if no rebates had been paid during that time, the FDIC today would have another \$26 billion in its insurance fund.

This indicates that the current rate of 8 basis points was more than sufficient to meet costs if no rebates had been paid. Thus, a return to lower premiums may be indicated at some future date.

As to the proposed increased premiums on the thrift industry, the thrift industry should shoulder as much of the burden of the industry's problems as possible. Since increased premiums affect profitability, and potentially even solvency, it is important to the insurer to levy rates that will leave the S&L industry viable -- and not drive more institutions into the federal safety net.

Based on the rough estimates we have at this time, increasing the thrift deposit insurance premiums from 20.833 basis points to 23 basis points does not appear unreasonable. This increase of just over 2 basis points will have little additional negative impact on thrift earnings. The many factors that affect the future profitability of the thrift industry make a judgment in this area uncertain, but it appears this increase would not impose a life-threatening burden on the industry. We are in the process of conducting further analysis on this subject using both our resources and industry studies.

#### FDIC AND FSLIC TAX PROVISIONS

The Tax Reform Act of 1986 significantly increased the tax burden on our nation's commercial banks, especially through limitations on deducting both bad debt reserves and interest on debt used to purchase tax-exempt obligations. While certain provisions in the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") will benefit the industry as a whole, they are unlikely to reduce this increased burden to an appreciable extent.

TAMRA. As you, Mr. Chairman, and the members of your Committee are well aware, TAMRA extended but reduced the tax incentives provided to FSLIC-assisted transactions. At the same time, it extended limited tax incentives to FDIC-assisted transactions to provide parity with FSLIC transactions. We again would like to express appreciation to you and the Committee for your efforts in including these much-needed FDIC-related provisions in that legislation.

We want to stress that we will use these tax provisions to minimize the government's total cost of handling failing institutions. When the FDIC determines whether the most cost-effective solution is an assisted transaction or the liquidation of the problem institution, we will consider both the direct cost to the FDIC and our best estimate of the tax expenditure to the federal government.

These provisions will help to handle the massive amounts of losses that must be absorbed to resolve the S&L and bank caseloads. In this regard, the Committee needs to make clear that these provisions apply to assistance provided through the Reconstruction Trust Corporation, proposed as part of the Bush Reform Plan. We also hope the Committee will extend the applicability of these provisions beyond year-end 1989. If not extended, the increased cost will be directly reflected in increased Treasury expenditures for S&L case resolutions under the Bush Reform Plan.

TAMRA, as it relates to FDIC transactions, is important for two reasons. First, it clarifies the tax treatment of FDIC assistance transactions. Prior to the passage of TAMRA, there was significant confusion concerning the proper tax treatment of these transactions. The confusion resulted in a double negative from the standpoint of the federal budget. The FDIC enjoyed no reduction of its assistance costs because bidders minimized the value of tax attributes because of the uncertain tax consequences of such transactions. At the same time, we believe taxpayers took aggressive reporting positions following these transactions in a way that resulted in reduced tax revenues. The clarifications that have been provided through TAMRA go a long way toward avoiding this double negative result, and minimize the government's total cost of handling failed institutions.

Second, the FDIC now has an opportunity to receive the maximum benefit from the tax attributes of assistance transactions, and thereby minimize the government's overall assistance costs. This will reduce the "on-budget" cost of FDIC-assisted transactions, and have a positive effect on the deficit in the current budgetary year. Of course, there also is an offsetting revenue cost associated with these transactions.

In addition to this tax-related reduction in FDIC assistance cost, there is another cost savings that we expect to realize as a consequence of the TAMRA provisions. Specifically, we believe that we will be able to complete more "whole bank" transactions. In these transactions, the purchasers of failed banks acquire all or most of the banks' assets, including the nonperforming or troubled assets. Such transactions differ from "clean bank" transactions where the purchaser takes only the good assets. Where we are able to do a whole bank transaction, as compared with a clean bank transaction, the FDIC's net cost is less. This savings results from a higher asset realization through management of the troubled assets by the purchaser, rather than by the FDIC.

Implementation steps. To ensure that the FDIC and the overall federal budget realize the maximum savings benefits from the TAMRA provisions, we have moved as quickly as possible to implement the tax law changes and educate prospective failed bank purchasers of their benefits. This effort has taken several forms.

First, we are conducting internal seminars for FDIC employees on the operation of the provisions. Second, we are working with the Internal Revenue Service to further clarify the new provisions so they operate in an efficient manner. Third, we are sponsoring extensive seminars throughout the country for potential bidders concerning the nature of the new provisions and the methods by which the FDIC is implementing them. Fourth, we are providing notices to potential bidders for failed banks describing the operation of the tax changes and the impact they should have on the need for FDIC assistance. Fifth, we are providing information with respect to each failed bank as part of the initial bid information that analyzes the impact of the tax provisions. And sixth, trained tax coordinators will be present at bid meetings to make sure all tax-related considerations are understood.

Cost savings. As indicated during my testimony before the Committee in late January, the FDIC is currently refining its methods for analyzing the effect of the TAMRA tax provisions on our transactions, and on the overall cost of government assistance. We will make a complete report to the Committee as soon as we have analyzed enough transactions to provide more reliable information.

Although we may not yet be realizing the maximum benefits from the changes in the tax law, we believe that the implementation steps noted above -- most significantly the education of bidders concerning the value of the tax provisions -- will result in increased competition and a maximization of assistance savings in the near future.

As stated above, we are working closely with the Internal Revenue Service to clarify certain provisions applicable to FDIC-assisted transactions. The IRS recently has confirmed that individual certification is a statutory requirement necessary for the purchaser of a failed bank to obtain the various tax attributes of the acquired bank. We believe this clarification will give us increased leverage in achieving appropriate savings by withholding certification if the assuming bank is not properly valuing the tax benefits.

We will continue to employ these tax provisions in a reasonable and cost-effective manner, and we respectfully urge the Committee to extend these provisions into 1990.

#### INTERAGENCY OVERSIGHT EFFORT

I would now like to turn to the interagency oversight effort underway to deal with the currently RAP insolvent S&Ls.

As part of the Bush Reform Plan, the President recently requested that the FDIC lead a joint effort to evaluate and oversee most of the RAP insolvent thrifts. In addition to the FDIC and the FSLIC, the Federal Home Loan Bank Board, the Federal Reserve, and the Office of the Comptroller of the Currency are participating in this interagency initiative.

The purpose of this interagency effort is to limit the growth of problems in our nation's insolvent thrifts until a comprehensive reform of the deposit insurance system, and the necessary funding, are authorized by the Congress. Insured deposits will remain fully protected throughout this process.

In the last two weeks a joint task force of regulators, led by the FDIC, took control of 36 of the insolvent thrifts. We expect to assume oversight of almost 200 other RAP insolvent thrifts in the next four to six weeks.

The FSLIC has contracted with the FDIC to take control of these institutions that are being placed in conservatorship or receivership. That means the FDIC, with the help of other regulators, will oversee operations of the insolvent thrifts. Managements of the various institutions are subject to the regulators' authority. From the customer's perspective, however, the only visible difference will be a few more people in the institution's offices. Day-to-day operations will continue to preserve basic services to deposit and loan customers.

One of the first priorities of these oversight efforts will be to evaluate the losses at each institution. Such on-site examinations are necessary to produce accurate estimates of the cost of the thrift problem. Once our estimates are completed and GAO has issued its report on the cost of FSLIC's 1988 deals, the total cost of this problem can be determined.

Another top priority is to identify and stop any abuse, waste, or fraud that may be present. A further priority will be to prepare a business plan for the institution and seek cost reduction through consolidations and more efficient operations.

While in control of these institutions, we will seek to stop any unsafe or unsound practices. We will limit their growth, and downsize them through asset liquidations where possible. However, we will avoid firesales of assets and emphasize the need to sell at values that reflect current appraised values.

Finally, we will develop longer-term solutions to these problems. Our staff will recommend different approaches -- from liquidating the institutions to selling them to qualified purchasers. But our current job is a holding action only. We will not issue notes or enter into income maintenance agreements.

The FDIC has established four task groups to address these responsibilities. These task groups are designed to ensure stable operations in the insolvent thrifts and to evaluate options for permanently resolving their insolvency once funding is approved by Congress.

One of our most important task groups is our new Fraud Squad. As President Bush has said, "unconscionable risk-taking, fraud and outright criminality have also been factors [in the thrift problem]." Investigators assigned to this Fraud Squad will constitute a mobile unit. Whenever our on-site teams discover evidence that fraud or insider abuse may have occurred, the Squad will be sent to conduct a full-scale investigation. This includes looking for ways to get back misappropriated assets when possible, and helping send some to jail when appropriate.

Our three other task groups have separate but complementary assignments.

Our Oversight and Evaluation task group will examine these institutions' condition, provide guidance to these institutions, and take steps to reduce operating costs where possible.

Our Planning and Restructuring task group will recommend steps to restructure and consolidate institutions where appropriate.

And our Transaction and Acquisition task group will begin the process of seeking out buyers for institutions, real estate and other assets. We will seek to reach agreements with purchasers subject to resources being made available to provide assistance.

The FDIC and the FHLBB have agreed that, until the agencies review the status of the insolvent thrift institutions placed under joint regulatory oversight, only cash assistance transactions will be undertaken by the FSLIC.

We also must note that these additional responsibilities in addressing the S&L situation will place a strain on FDIC resources. We are dedicated to this new task and will strive for success, but we do expect to experience growing pains and recognize our need to climb a learning curve in the process.

#### RECOMMENDED DEPOSIT INSURANCE REFORMS

Any legislated resolution of the FSLIC problem, in addition to providing appropriate funding, should reform the system to protect against recurrence of the problems that led to the current S&L situation. As mentioned above, detailed recommendations for improvements to the system are contained in the recent FDIC study. However, I would like to summarize some of the most important concepts.

One of the fundamental changes recommended in our study is that the federal insurer be allowed to operate as much as possible like an independent private insurer. This principle is central to improving the system. To maintain adequate resources, the insurer must have additional controls over revenues, including the ability to adjust insurance premiums paid by insured institutions and to require an entrance fee from those newly obtaining insurance. The insurer also must be able to control costs. This necessitates the ability to set standards for insurability for all insured institutions and to promptly terminate insurance privileges when an institution is operating in an unsafe manner. The Bush Reform Plan, for the most part, includes these important changes to the operating structure of the federal deposit insurance system for S&Ls.

To accomplish private insurer status, the FSLIC and FDIC also should be as financially, operationally, and organizationally independent as possible. To ensure political independence, the insurer should continue to be funded by premiums paid by the insured institutions. It should have a budget separate from the general federal budget and should not be allowed to obligate general federal revenues. The insurer also should remain independent from the Congressional appropriations process. The insurer should remain accountable to Congress on an annual basis. The insurer's ability to issue notes or like obligations should be restricted as provided in the Bush Reform Plan.

#### CONCLUSIONS

We believe the Bush Reform Plan is a generally sound proposal, and hope Congress acts on it promptly. Congressional funding will be necessary for a cost-effective solution to these problems. Any legislated resolution of the S&L situation should improve the federal deposit insurance system to protect against a recurrence of existing problems.

We appreciate the passage of the recent amendments to the tax laws concerning FDIC-assisted transactions, and are working to maximize our savings for the government as a result of those amendments.

We would be happy to work with the Committee on any aspect of the S&L situation where we may be helpful. I would be pleased, at this time, to answer any questions the Committee may have.