FDIC speech binder

TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

ON

THE SAVINGS AND LOAN INDUSTRY AND THE FEDERAL SAVINGS
AND LOAN INSURANCE CORPORATION

BEFORE THE

Senate COMMITTEE ON THE BUDGET
UNITED STATES SENATE

10:00 a.m.
March 2, 1989

Good morning, Mr. Chairman and members of the Committee. I am pleased to testify today on the current problems of the savings and loan ("S&L") industry and the Federal Savings and Loan Insurance Corporation ("FSLIC"). As requested in the Committee's letter of invitation, our testimony today will focus on the costs involved in resolving the S&L situation.

The Federal Deposit Insurance Corporation ("FDIC") generally supports President Bush's Reform Plan for the S&L industry, announced February 6th, and the recently proposed legislation -- that was introduced last week as S. 413 -- to carry out that plan. We believe it is a sound, constructive and farsighted proposal that should be enacted. S. 413 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.

BACKGROUND

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.

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. In addition, there would be another 100 insolvent S&Ls under banking standards -- namely, if goodwill were eliminated. 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 should be made by on-site examinations. We are in the process of making such estimates pursuant to the joint oversight effort discussed below. Once our estimates are completed and GAO has issued its report on the cost of the FSLIC's S&L transactions in 1988, we will have a more accurate total estimate of the S&L situation. Our best estimates at this time are in the same range as the Treasury Department's estimated costs. See the attached Charts A and B.

When discussing cost figures, it is important not to confuse present value with actual dollars spent over the life of the workout. Charts A and B provide information on those cost figures. The present value is the appropriate figure to focus on -- it represents the cost in today's dollars. The actual dollar figure mixes apples and oranges because a dollar spent in the future is worth less than a dollar today.

For example, consider buying a house that sells for $100,000. One could either pay cash or finance it. If the purchase is financed with, say, a 30-year fixed rate mortgage at 10 percent annual rate, the monthly payment will be approximately $875. Over the thirty years, the payments add up to $316,000. Even though the person who finances the house outlays, over the life of the mortgage, more than three times the number of dollars than the person who pays cash, we do not say that the house costs three time as much for people who finance.

The cost estimate which is projected by the President's proposal is based on today's dollars. If the rescue plan is financed, the actual dollars outlayed will be substantially higher than that amount, but the cost will not be.

BUSH REFORM PLAN FINANCING PROPOSAL

The Treasury Department and the Office of Management and Budget are the architects of the financing provisions of S. 413, and thus are in the best position to comment on them. From our viewpoint the financing plan, while complex, appears viable and sound. The attached Chart C provides information on the sources and uses of funds under the proposed financing plan. Chart D is a diagram of a more direct financing approach that we developed at the request of Senator Riegle for the Banking Committee hearing earlier this week.

Ability of banks and S&Ls to pay increased premiums. In general, we believe S. 413 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.

The bill would impose 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 percent. 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 points 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 bank insurance fund of the restructured FDIC.

Under S. 413, once the bank 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. In fact, there should be careful consideration of the effect of the premium level on the industry's viability when coupled with the significantly increased capital requirements, goodwill write-off and the loss of income from the FHLB System. This is a complex question which requires that flexibile authority be provided to the insurer.

INTERAGENCY OVERSIGHT EFFORT

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.

Since the program was announced by President Bush on February 6th, a joint task force of regulators, led by the FDIC, has taken control of 36 of the RAP insolvent thrifts. We are going into another 37 today and expect to assume oversight of the rest of the over 200 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. As already noted, 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 more accurately.

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. We would like to highlight, however, two needed improvements.

Separate budget. One concept contained in the study, within the jurisdiction of this Committee, is that the FSLIC and FDIC insurance funds should be separately budgeted and should not be part of the general operational federal budget. In essence, the basic purpose and mandate of the funds is to save for emergencies. For decades the insurance funds have been depositing their unspent premium income into the U.S. Treasury. While the insurance trust funds receive no taxpayer dollars, these deposits to the Treasury nonetheless are counted as income to the government rather than savings reserved for future problems in the industry. When funds are withdrawn from the Treasury to deal with a problem institution, that action is treated as a government expenditure. Instead, it should be treated as a payback of money on deposit.

As the present system is designed, it creates a disincentive for saving for future problems. Moreover, because of the immediate negative impact on the general budget, the insurer may be hesitant to draw upon funds to deal with industry problems at an early stage.

For these reasons, we urge the Committee to consider setting up a separate budget for the deposit insurance funds. The President's plan does not provide for such a separate budget.

Independence of the Insurer. Another fundamental change recommended in our study is that the federal insurer be allowed to operate as much as possible like an independent private insurer. Although the President's proposed legislation provides for progress in the independence of the former FSLIC, certain provisions of the plan run counter to the principle of establishing an independent deposit insurer. In fact, in each of the following instances, the legislation would make changes to the existing independence of the FDIC that would limit its independence.

First, the bill would permit the President to appoint and remove, with or without cause, the Chairman and Vice Chairman of the reconstituted FDIC Board of Directors. At present, the Board of the FDIC elects its Chairman. We believe such removal authority could compromise significantly the independence of the FDIC, and recommend that it be deleted. If a change is needed, we would suggest that a system similar to the Federal Reserve System -- appointment for a term with the consent of the Senate -- be adopted.

Second, another provision of S. 413 would place limits on the FDIC's borrowing authority. We believe it is appropriate to limit the FDIC's ability to issue notes and other debt obligations. However, the proposed limitations are impractical and overly restrictive and could seriously undermine the safe and cost-effective operations of the insurer in the near term.

To put the proposed limit in perspective, it would restrict the FDIC's obligations to $7 billion. We are almost at the proposed cap already. Currently the FDIC has about $6 billion in obligations. In each case the liability was properly recorded with the appropriate charge taken against net worth.

The FDIC's $14 billion of net worth represents the unencumbered assets available in excess of that needed to satisfy all actual and contingent liabilities. In other words, the FDIC has not used debt because it does not have the necessary resources, but because of other valid business reasons. Examples of such reasons include providing failed bank acquirors additional flexibility in markets with weak loan demand, avoiding untimely portfolio sales and even maintaining some additional leverage to ensure buyers hold up their end of the bargain.

Thus, instead, we recommend a very simple borrowing limit: No notes can be issued which will put the agency into a deficit net worth position. Thus, the FDIC would be able to obligate neither itself nor the general government revenues in an amount beyond the limits of the FDIC's resources as determined by GAO audit. By imposing the limit that we recommend, the insurer could not issue debt if it does not have its own resources to repay that debt and, thus, could not obligate taxpayer funds.

Third, S. 413 would require the FDIC to submit quarterly reports to both the Secretary of the Treasury and the Director of the Office of Management and Budget on the FDIC's financial operating plans and forecasts. We believe it should be sufficient to file such reports with the Administration through the Treasury and that the reports should be those prepared by the FDIC in the ordinary course of its business.

CONCLUSION

In conclusion, while we know this Committee is acutely aware of the need for expeditious legislative action, we want to stress that point. Nothing of major substance can be accomplished to correct this problem until the Congress acts to provide funding and guidance.

We believe S. 413 is a sound bill, and hope Congress acts on it promptly. 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.

Attachments

3rd QUARTER SUMMARY SHEET DATA ON FINANCIAL TROUBLED S&Ls ($BILLIONS)

S&L Group	NO.	Total Assets	Total Liab.	Annual Income	Est. Cost #1	Cost To Assets	Est. Cost #2	Cost To Assets
Handled by FSLIC in 1988	208	$103.2	$120.1	$-10.2	$38.9	.38	$42.9	.42
Other:								
RAP - Insolvent & Unprofitable	217	$56.9	$65.6	$-5.3	$22.8	.40	$25.0	.44
RAP - Insolvent & Profitable	5	$2.5	$2.5	$0.0	$0.4	.16	0.6	.24
SUBTOTAL	430	$162.6	$188.2	$-15.5	$62.1	.38	$67.9	.42
RAP Solvent but GAAP - insolvent & unprofitable	72	$24.2	$23.7	$-0.3	$3.6	.15	$4.8	.20
RAP - Solvent but GAAP - insolvent & profitable	45	$12.1	$11.7	$0.3	$1.6	.13	$2.2	.18
SUBTOTAL	547	$198.9	$223.6	$-15.5	$67.3	.34	$74.9	.38
RAP & GAAP - solvent but tangible insolvent and unprofitable	69	$55.1	$53.2	$-0.5	$8.3	.15	$10.9	.20
RAP & GAAP solvent but tangible - insolvent and profitable	52	$66.4	$63.5	$0.2	$6.8	.10	$10.9	.16
SUBTOTAL	668	320.4	$340.3	$-15.8	$82.4	.26	$96.7	.30
Marginally solvent but unprofitable	154	$101.1	97.6	$-0.7	$9.6	.09	$14.9	.15
TOTAL	882	$421.5	$437.9	$-16.5	$92.00	.22	$111.6	.26

[1] Estimated Cost #1 :Failed-bank cost formula with zero loss assigned to residential mortgages and pass-through securities.

[2] Estimated Cost #2 :Failed -bank cost formula with 10% loss assigned to residential mortgages and mortgage pass-through securities.

CHART A

CHART B

ADMINISTRATION'S FINANCING PROPOSAL*
(in billions of dollars)

Time to Maturity

Interest Rate	10 years	20 years	30 years
2%	100-125	115-140	125-150
4%	115-140	135-165	160-200
6%	125-160	160-200	200-250
8%	140-170	190-230	250-300
10%	150-180	215-265	300-350

*Cash flows represent actual dollars spent if net present value cost of $90-110 billion is financed over different time periods at interest rates shown in chart.

CHART C

ADMINISTRATION'S FINANCING PROPOSAL

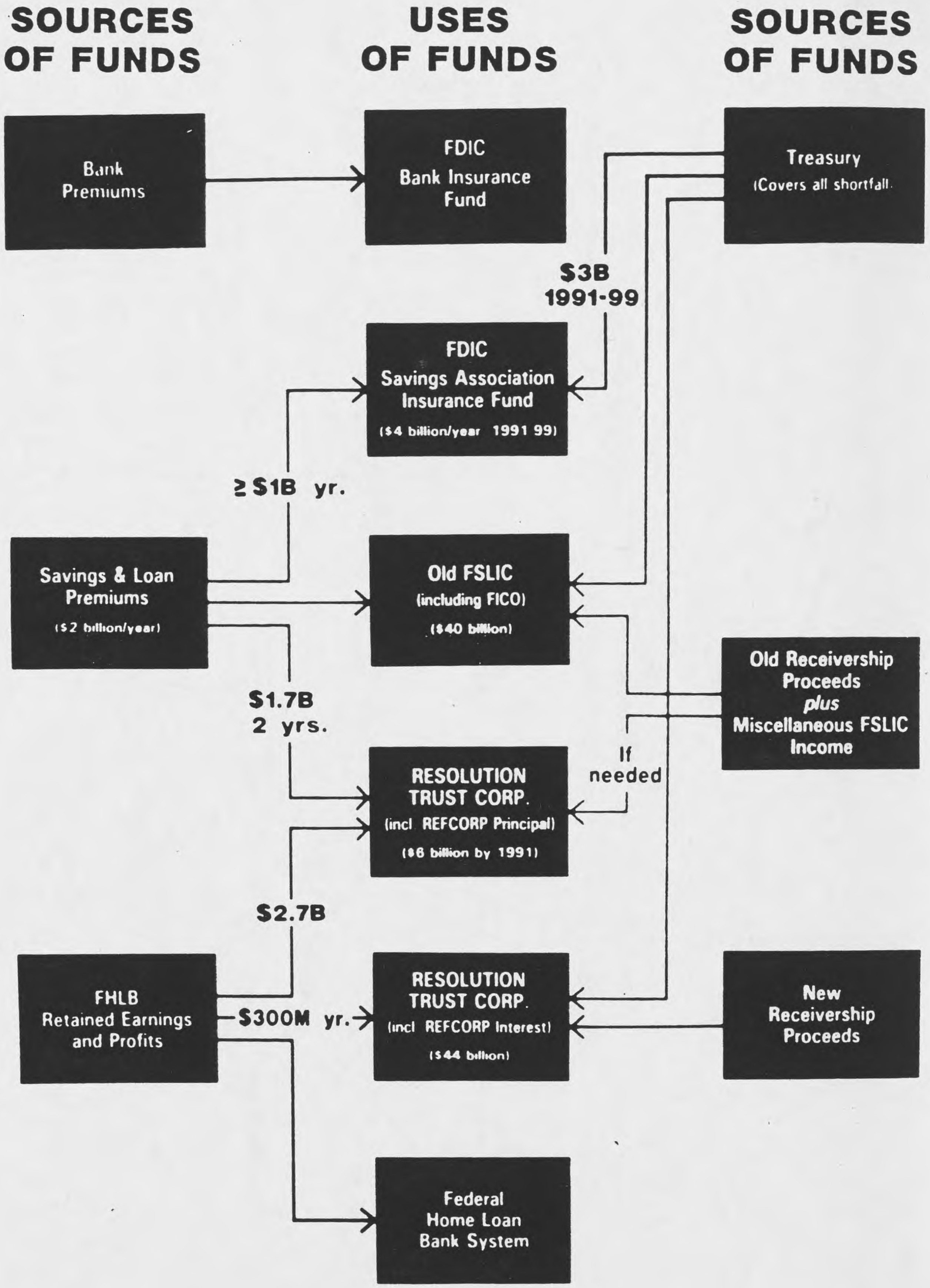
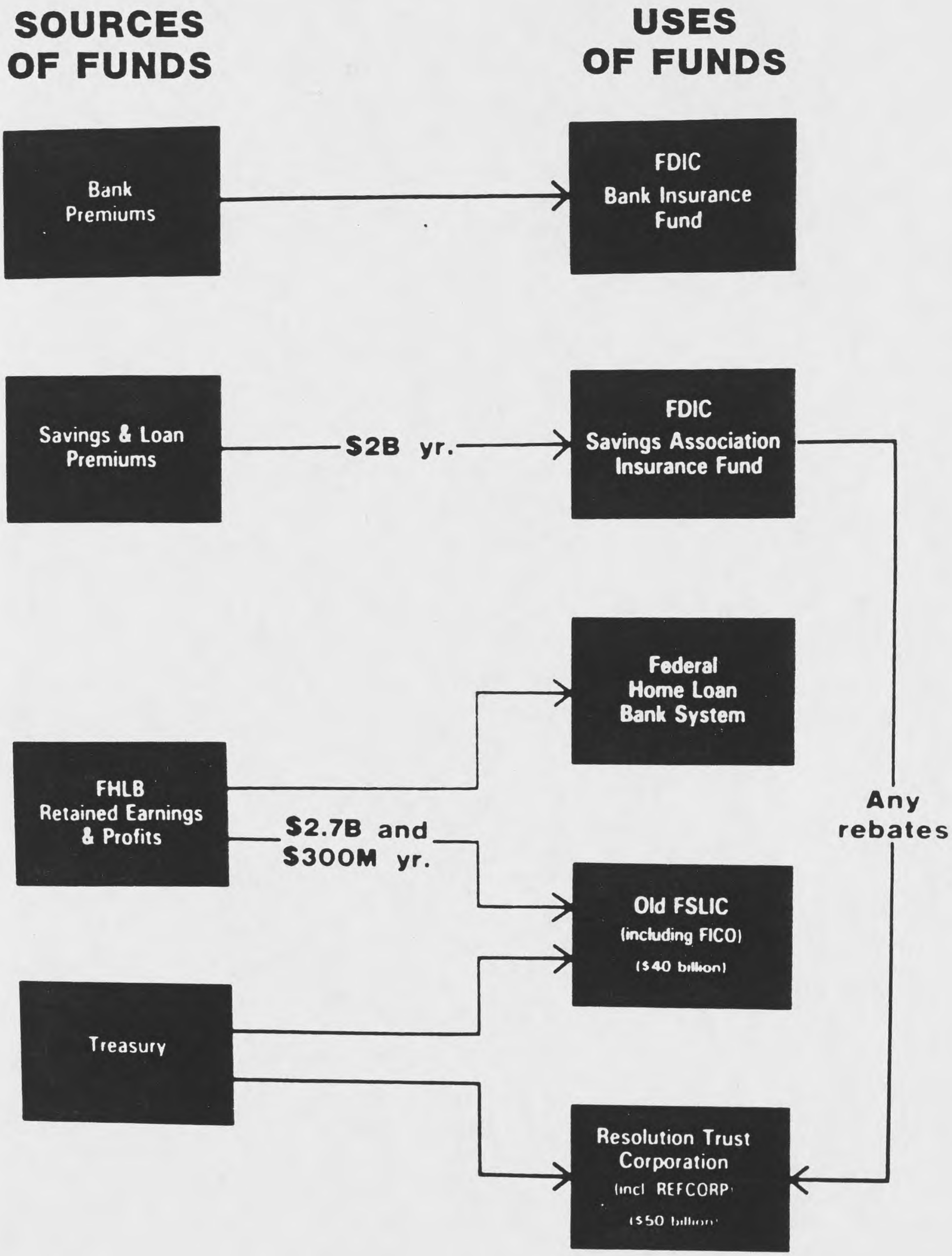

SOURCES OF FUNDS
USES OF FUNDS
SOURCES OF FUNDS
Bank Premiums
FDIC Bank Insurance Fund
Treasury (Covers all shortfall.
$3B 1991-99
FDIC Savings Association Insurance Fund ($4 billion/year 1991 99)
≥ $1B yr.
Savings & Loan Premiums ($2 billion/year)
Old FSLIC (including FICO) ($40 billion)
Old Receivership Proceeds plus Miscellaneous FSLIC Income
$1.7B 2 yrs.
If needed
RESOLUTION TRUST CORP. (incl REFCORP Principal) ($6 billion by 1991)
$2.7B
FHLB Retained Earnings and Profits
$300M yr.
RESOLUTION TRUST CORP. (incl REFCORP Interest) ($44 billion)
New Receivership Proceeds
Federal Home Loan Bank System

CHART D

ALTERNATIVE FINANCING PROPOSAL



SOURCES OF FUNDS

USES OF FUNDS

Bank Premiums

FDIC Bank Insurance Fund

Savings & Loan Premiums

$2B yr.

FDIC Savings Association Insurance Fund

Federal Home Loan Bank System

FHLB Retained Earnings & Profits

$2.7B and $300M yr.

Any rebates

Old FSLIC (including FICO) ($40 billion)

Treasury

Resolution Trust Corporation (incl REFCORP) ($50 billion)