

March 27, 1995

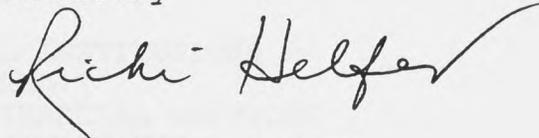
Dear Chief Executive Officer:

Because of the extraordinary interest that banks and savings associations have expressed in the Federal Deposit Insurance Corporation's proposals on deposit insurance premiums, I am sending you the attached copy of the testimony that I submitted to the House Financial Institutions subcommittee on March 23, 1995.

The testimony focuses on the undercapitalization of the Savings Association Insurance Fund. Beginning on page 27, it discusses three standards that should be applied to any proposed solution to that undercapitalization. It then discusses the wide range of solutions that have been proposed, applying the three standards to a discussion of each in turn. The testimony does not take a position on any of the proposed solutions.

The comment period on the deposit insurance premium proposals closes April 17, 1995. All the interested parties are urged to make their views known. Please send your written comments to the Office of the Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street NW, Washington, D.C. 20429.

Sincerely



Ricki Tigert Helfer
Chairman

Attachment

TESTIMONY OF

RICKI TIGERT HELFER
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

THE CONDITION OF THE BIF AND THE SAIF AND RELATED ISSUES

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT
COMMITTEE ON BANKING AND FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

THURSDAY, MARCH 23, 1995
ROOM 2129 RAYBURN OFFICE BUILDING

INTRODUCTION

Madam Chairman and Members of the Subcommittee, I am here today to present the views and analyses of the Federal Deposit Insurance Corporation (FDIC) concerning the condition of the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). We face a compelling problem -- and one that has grown more compelling this year. The BIF is in good condition and its prospects appear favorable. Despite the general good health of the thrift industry, however, the SAIF is troubled. Any solution to the SAIF problem requires action by the Congress. Indeed, the need for Congressional action is more urgent today than ever before.

Beginning later this year, a substantial disparity between the deposit insurance premiums paid by BIF members and SAIF members is likely to occur. The disparity is mandated by current statutory provisions. The FDIC cannot avoid bringing the disparity into being. Only Congress can change the laws that will soon require the FDIC to promulgate significantly different assessments for the two deposit insurance funds. Like the tip of an iceberg, the premium disparity is only the visible manifestation of a larger difficulty, most of which lies beneath the surface.

This difficulty -- which most recently has been described in depth in a report by the General Accounting Office -- has three dimensions.

One, as Chart 1 shows, the SAIF is significantly underfunded. At year-end 1994, the SAIF had a balance of \$1.9 billion -- or 28 cents in reserves for every \$100 in insured deposits. This amounts to six percent of the assets of SAIF-insured "problem" institutions. The \$21.8 billion BIF, in contrast, amounts to 52 percent of the assets of BIF-insured problem institutions. Assuming that loss experience from failed thrifts does not increase significantly from today's levels, the SAIF is not expected to be fully capitalized at \$1.25 in reserves for every \$100 in insured deposits until at least 2002.

Two, an ongoing fixed draw of \$779 million on SAIF revenue arises from the obligation to pay interest on bonds issued by the Financing Corporation (FICO) in the 1980s. This draw alone creates a premium differential between BIF members and SAIF members that likely would persist for 24 years until the bonds are repaid. This differential, at least 11 basis points, could provoke further shrinkage in the SAIF assessment base and a shortfall of assessment revenue to pay the FICO obligation, which would lead to default on the bonds. If you have ever tried to fill a bucket with a hole in it, you understand what I mean.

Three, for the first time, the SAIF will assume responsibility for resolving failed thrifts after June 30 of this year. Given the underfunding of the SAIF, significant insurance losses in the near-term could render the SAIF insolvent and put the taxpayer at risk. This risk stems from the fact that deposit insurance carries with it an implicit U.S. Government guarantee.

THE SEARCH FOR A SOLUTION

To establish parity between the BIF and the SAIF today would require about \$15.1 billion, or about 25 percent of the total equity capital of SAIF members. Of this total, \$6.7 billion would be needed to increase the SAIF from its unaudited year-end 1994 balance of approximately \$1.94 billion to \$8.66 billion, the amount that currently would achieve the designated reserve ratio required by Congress of 1.25. The remaining \$8.4 billion of the \$15.1 billion is the amount that would be necessary at current interest rates to defease the FICO obligation. That is to say, it is the amount that would have to be invested today to generate an income stream sufficient to service the FICO bonds until maturity between the years 2017 and 2019.

Requiring these amounts to be collected entirely through SAIF insurance premiums raises difficult questions. What will be the effect on the ability of SAIF members to raise new capital, to prosper, and to compete effectively? Will erosion of the SAIF

assessment base and changes in its composition jeopardize the ability of the FICO to meet its obligations? Should some of the burden be shared? And by whom?

There is no magic answer to these questions. No matter how the \$15.1 billion cost is borne, there will be an outcry by at least one constituency that a great injustice is being done. There is no way for the FDIC to resolve this issue through the exercise of its regulatory authority.

For two reasons, the need to find solutions to the problems grows more urgent. One, as mentioned earlier, starting July 1, 1995, the cost of all new thrift failures must be paid out of the SAIF. Two, recently announced efforts by some SAIF-insured institutions to transfer deposits into BIF-insured institutions raises the specter that the insured deposit base of the SAIF could shrink so rapidly that, under current assessment rates, debt service on the FICO bonds would quickly run into trouble.

Although the need for immediate Congressional action concerning the SAIF is evident, there is considerable disagreement over precisely what action should be taken and whether it should be taken this year or later. The most frequently mentioned sources of money to address SAIF's needs include the thrift industry, the banking industry, and the U.S. Treasury. Others have been mentioned, too, as having an interest

in resolving the problems. None of the possible sources of funding is happy about the prospect of footing the bill for capitalizing the SAIF and funding the FICO interest payments.

The first section of this testimony describes the conditions of the BIF and the SAIF and the reasons for the coming disparity in their assessment rates. The second section of the testimony summarizes the statutory constraints that prevent a regulatory solution to the problems. The third section of the testimony discusses the unprecedented public hearing on this subject held on March 17 before the Board of Directors of the FDIC. This is followed by an analysis of the various proposals for addressing the SAIF problem, measured against three standards set out in the testimony.

THE CONDITION OF THE BIF AND THE SAIF

Bank Insurance Fund

The good news in this testimony is about the Bank Insurance Fund. The fund balance is rapidly approaching the recapitalization level specified in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and confirmed in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). As noted before, that level -- the designated reserve ratio -- is 1.25 percent of insured

deposits -- or \$1.25 for every \$100 insured deposits. At year-end 1994, the BIF had a balance of \$21.8 billion, which was 1.15 percent of insured deposits.

The BIF has made a remarkable recovery. Three years ago, at year-end 1991, the BIF had a negative balance of \$7.0 billion. From this nadir, the lowest level in the bank fund's six decades of existence, the balance improved to a negative \$100 million at year-end 1992 and a positive \$13.1 billion at year-end 1993.

In other words, since year-end 1991, the BIF has grown by almost \$29 billion. Two factors contributed to the restoration of the BIF. One, fewer banks failed than had been anticipated. While the number and assets of failed banks reached record levels in the late 1980s and early 1990s, both fell sharply in the last two years. As a result, declining insurance losses enabled the FDIC to recapture reserves that had been set aside before 1992. In fact, over the last three years (1992 through 1994) reversing provisions for insurance losses increased BIF net income by \$12.8 billion.

Second, banks have paid significantly higher premiums to the BIF than they paid previously. Beginning in 1990, assessment rates were increased sharply. Rates are now almost three times higher than the rate paid in 1989. In the last three years,

insured institutions have paid nearly \$17 billion in assessments to the BIF.

The recovery of the BIF reflects the recovery of the banking industry from the problems of the late 1980s and early 1990s. Since 1990, the earnings of the industry have been on an impressive upward trend: \$16.1 billion for 1990, \$18.6 billion for 1991, \$32.2 billion for 1992, \$43.1 billion for 1993, and \$44.7 billion for 1994. The results for 1992, 1993, and 1994 were successive earnings records.

Ninety-one percent -- more than nine of every ten -- BIF-member institutions are currently in the lowest risk category and pay the lowest assessment rates. These institutions hold 88 percent of all BIF-member assets. They meet the highest regulatory capital standards and have the strongest examiner ratings. These institutions are not expected to cause losses to the BIF in the near-term.

As bank earnings have improved, bank failures have declined dramatically. The number of BIF-insured failures in 1994 was 13, the lowest total since 1981. These 13 failures marked the continuation of a seven-year downward trend: 221 in 1988, 207 in 1989, 169 in 1990, 127 in 1991, 122 in 1992, and 41 in 1993. The estimated costs for these 13 failures last year is \$139 million, all of which had been reserved in prior years. Consequently, no

additional expenses for failures were incurred by the BIF in 1994.

As a result of the recovery of both the banking industry and its insurance fund, the BIF is projected to reach the 1.25 statutory designated reserve ratio between May and July of this year. Thereafter, absent a factual basis for a higher reserve ratio, the FDIC has a statutory mandate to set deposit insurance assessments to maintain the balance of the fund at the 1.25 ratio, at the same time retaining a risk-related system of premiums and assessing each BIF member at least \$1,000 semiannually. Therefore, when the designated reserve ratio for the BIF is reached -- an event that appears imminent -- the law requires the FDIC to reduce assessments for BIF members.

In January of this year, the FDIC Board of Directors issued a proposal to lower assessment rates for all but the riskiest BIF members once the fund attains the designated reserve ratio. Because the SAIF is significantly undercapitalized, the FDIC Board proposed maintaining assessment rates for SAIF members at current levels. If the two proposals are adopted, a significant disparity will exist between the assessment rate schedule for BIF-insured institutions and the assessment rate schedule for SAIF-insured institutions, regardless of whether the Board retains the current SAIF rate schedule or reduces SAIF assessments to the statutory minimum weighted average of 18 basis

points. The FDIC has asked for public comments on the assessment rate proposals, and the 60-day comment period extends until April 17. The FDIC also held an unprecedented public hearing on issues related to the BIF and SAIF assessment rate proposals, as discussed in the next section.

Savings Association Insurance Fund

There is also good news about the health of the savings and loan industry. Eighty-seven percent of all SAIF-member institutions with 71 percent of SAIF-member assets are in the lowest risk category and pay the lowest assessment rates.

Despite the good news in the savings and loan industry, the SAIF -- as noted earlier -- is troubled. It is significantly underfunded. Assessment revenue is constantly being diverted to meet obligations from savings and loan failures in the 1980s. The SAIF must begin paying for thrift failures that occur after mid-year. This testimony discusses each of these three issues in turn.

First, the SAIF is undercapitalized. As noted earlier, the SAIF had a balance of \$1.9 billion, or only 0.28 percent of insured deposits at year-end 1994. Thus, the current insurance reserve amounts to only six percent of the assets of SAIF-insured "problem" institutions. The \$21.8 billion BIF balance, in

contrast, amounts to 52 percent of the assets of BIF-insured problem institutions. At the current pace, and under reasonably optimistic assumptions, the SAIF would not reach the minimum reserve ratio of 1.25 percent until at least the year 2002. Consequently, it would be impossible to lower SAIF premiums to the proposed levels for the BIF for at least seven years, and because of the continuing need to fund interest payments on the FICO bonds, probably much longer.

Second, SAIF assessments have been diverted to purposes other than the fund. This problem was described in detail in the recent General Accounting Office report. In short, from 1989 to 1994, \$7 billion -- approximately 95 percent of SAIF assessments -- was diverted from the SAIF to pay off obligations from thrift failures in the 1980s through the Resolution Funding Corporation (REFCORP), the Federal Savings and Loan Insurance Corporation Resolution Fund (FRF), and the Financing Corporation (FICO) (see Attachment B). Of the \$9.3 billion in SAIF assessment revenue received from 1989 to 1994, a total of \$7 billion was diverted: \$1.1 billion was diverted to REFCORP; \$2 billion was diverted to FRF, and \$3.9 billion to date, was diverted to FICO. SAIF assessment revenue currently amounts to just over \$1.7 billion a year, while FICO interest payments run \$779 million a year, or about 45 percent of all SAIF assessments. Without these diversions, the SAIF would have reached its designated reserve ratio in 1994. The REFCORP and FRF no longer have claims on SAIF

assessments, but the FICO claim will remain as an impediment to capitalizing SAIF for 24 years.

Third, the SAIF will be under stress beginning on July 1, 1995, when it takes over responsibility for resolving all new failures of SAIF-insured savings associations. One large or several sizable thrift failures could bankrupt the fund. Two funding sources may be available to pay for losses: (1) an authorization for payments from the U.S. Treasury of up to \$8 billion for losses incurred by the SAIF in fiscal years 1994 through 1998; and (2) unspent RTC money during the two years following the RTC's termination on December 31, 1995. To obtain funds from either of these sources, the FDIC must certify to Congress that an increase in SAIF premiums would reasonably be expected to result in greater losses to the Government, and that SAIF members are unable to pay assessments to cover losses without adversely affecting their ability to raise and maintain capital or maintain the assessment base.

Congress required these certifications in an effort to ensure that SAIF members pay the highest rates possible before taxpayer funds are used to cover losses. Of course, this would have the effect of exacerbating the impending premium differential. It may require extremely grave conditions in the thrift industry in order for the FDIC to certify that raising SAIF assessments would result in increased losses to the

Government. Moreover, these sources of funds cannot be used to capitalize the fund -- that is, to provide an insurance reserve, which was the original purpose of requiring a 1.25 reserve ratio. A detailed discussion of the legislative history of the SAIF funding scheme is contained in Attachment A.

By far the largest of the drains on SAIF assessment income, the FICO was established by Congress in 1987 in an attempt to recapitalize the defunct Federal Savings and Loan Insurance Corporation (FSLIC). The FICO was provided with approximately \$3.0 billion in capital by the Federal Home Loan Banks. The capital was used by the FICO to purchase zero-coupon U.S. Treasury securities. These securities in turn served as collateral for the issuance of 30-year interest-bearing debt obligations by the FICO. The proceeds from these obligations were channeled by the FICO to the FSLIC. From 1987 to 1989, the FICO issued approximately \$8.1 billion in bonds. When they mature, the principal values, or face amounts, will be paid with the proceeds of the simultaneously maturing zero-coupon Treasury securities. No FICO bonds were issued after 1989, and the FICO's issuing authority was terminated in 1991.

The Competitive Equality Banking Act of 1987 made FSLIC-insured institutions responsible for the annual interest payments. FIRREA abolished the FSLIC, created the SAIF, and

reaffirmed the FICO's first priority to assess SAIF members. The FICO bonds do not mature until 2017 to 2019 and are not callable.

In enacting FIRREA, Congress in 1989 recognized that draws on the SAIF by the FRF, REFCORP, and FICO would delay the capitalization of the insurance fund. At that time, the GAO notes, the Administration projected annual thrift deposit growth of six to seven percent. Since SAIF's inception, however, total SAIF deposits have declined an average of five percent annually.

FIRREA authorized the appropriation of funds to the SAIF in an aggregate amount of up to \$32 billion to supplement assessment revenue by ensuring an income stream of \$2 billion each year through 1999 (not to exceed \$16 billion in the aggregate) and to maintain a statutory minimum net worth through 1999 (not to exceed \$16 billion in the aggregate). Subsequent legislation extended the date for receipt of Treasury payments to 2000. Despite requests by the FDIC to the Department of the Treasury and the Office of Management and Budget, the Treasury never requested any appropriations for these purposes, and the SAIF never received any of the authorized funds.¹

¹The issue of the SAIF's need for appropriated funds to reach mandated reserve levels has been recognized by the FDIC since the creation of the SAIF. It was raised on January 10, 1992, in a letter from William Taylor, Chairman of the FDIC, to Richard Darman, Director, U.S. Office of Management and Budget, and it was raised again in a letter, dated February 20, 1992, from Stanley J. Poling, Director, FDIC Division of Accounting and Corporate Services, to Jerome H. Powell, Assistant Secretary for Domestic

The outlook for the SAIF is further complicated by the fact that the law limits SAIF assessments that can be used for FICO payments to assessments on insured institutions that are both savings associations and SAIF members. Two types of institutions that pay assessments to the SAIF, Oakar and Sasser institutions, are not savings associations that are SAIF members. An Oakar is a BIF member that has acquired SAIF-insured deposits and therefore pays deposit insurance premiums to the BIF and the SAIF. Between late 1989 and year-end 1994, 715 banks had purchased \$180 billion of thrift deposits -- or 25 percent of year-end 1994 SAIF domestic deposits.

A Sasser institution is a commercial bank or a state savings bank that has changed its charter from a savings association to a bank but remains a SAIF member. There are 319 "Sasser" banks holding deposits of \$53 billion -- or 7.4 percent of SAIF domestic deposits.

Because assessment revenue from Oakar banks and from Sasser banks cannot be used to meet debt service on FICO bonds, almost 33 percent of SAIF-insured deposits were unavailable to meet FICO

Finance, U.S. Treasury. More recently, the issue was addressed at the time Congress was considering the RTC Completion Act in a letter dated September 23, 1993, from Andrew C. Hove, Jr., Acting Chairman, to the House and Senate Banking Committee Chairmen and Ranking Minority Members. (Copies of this correspondence are appended in Attachment C.) See also the Testimony of Andrew C. Hove, Jr., on "The Condition of the Banking and Thrift Industries," before the United States Senate Committee on Banking, Housing and Urban Affairs, September 22, 1994.

payments in 1994 (see Chart 1).² This portion was up from 25 percent at the end of 1993. This shift contributed significantly to a 7.9 percent decline in 1994 in the SAIF assessment base available to service FICO, even though the overall insured deposit base of the SAIF declined by only 1.1 percent in 1994. At current assessment rates, an assessment base of \$325 billion is required to generate revenue sufficient to service the FICO interest payments. The FICO-available base at year-end 1994 stood at \$486 billion. The difference of \$161 billion can be thought of as a cushion which protects against a default on the FICO bonds. If the 7.9 percent rate of shrinkage in the SAIF assessment base available to FICO were to continue, this FICO-cushion would be eliminated within five years.

The disparity that would arise from the FDIC's premium proposals would further complicate the outlook for SAIF. The proposed assessment rate schedules for BIF and SAIF members are shown in Table 1. The proposals would result in SAIF members

²See Notice of FDIC General Counsel's Opinion No. 7, 60 FR 7055 (February 6, 1995), confirming a 1992 opinion of the FDIC Legal Division that assessments paid by banks on deposits acquired from SAIF members should remain in the SAIF and not be allocated among the FICO, REFCORP, or FRF. In a letter to the FDIC Board of Directors, dated May 11, 1992, the Comptroller General described this conclusion and treatment of Oakar assessments as "reasonable." See letter from Charles A. Bowsher, Comptroller General of the United States, to the FDIC Board of Directors, dated May 11, 1992. In addition, the FDIC General Counsel's opinion states the FDIC Legal Division's position that assessments paid by any former savings association that has converted to a bank and remains a SAIF member are not available to the FICO. See GAO Report 95-84, Deposit Insurance Funds, March 1995, p. 15.

paying an average assessment rate of 24 basis points, 19.5 basis points higher than the average rate of 4.5 basis points for BIF members. This premium differential could adversely affect SAIF members in a number of ways, including increasing the cost of remaining competitive, impairing their ability to generate capital internally or externally, and causing marginally higher rates of failure.

Historically, savings associations have paid somewhat higher deposit insurance premiums than have banks. From 1935 to 1980, this differential was 4 to 5 basis points, and from 1980 to 1991 the differential ranged as high as 12.5 basis points. In 1992, the differential was zero. Since 1992, under risk-related assessments, SAIF members have paid an average rate about 1 to 2 basis points above the average rate for BIF members. It is not clear that these historical differentials are instructive when evaluating the impact of the differential that would result from the current assessment-rate proposals. Previous premium differentials were smaller and the marketplace is widely considered to be more competitive today.

By way of background, from 1966 until 1984, thrifts were allowed to pay slightly higher rates of interest on deposits under Regulation Q. This interest rate differential was most frequently set at 25 to 50 basis points and was justified by the advantage that banks had in accepting interest-free demand

deposits and engaging in commercial lending. The Regulation Q advantage may have lessened the burden of higher insurance premiums for thrifts. All these advantages were eventually dissipated by innovation, market forces and legislation.

We have considered the effect of a differential on pricing, on capital and on failures.

Pricing. If BIF-members pass all or some of their assessment reductions to their depositors by paying higher interest rates or to their borrowers by charging lower rates, SAIF members would be forced to incur higher costs in order to remain competitive. It is difficult to predict the eventual size of the effective differential because this will be determined by BIF- and SAIF-member management. In the extreme case where SAIF members absorb all of the differential, pretax earnings in the aggregate would be reduced by \$1.4 billion. For the 25 percent of SAIF members earning a return on assets of 1.13 percent or higher in 1994, a differential of 20 basis points would reduce pretax earnings by 6.8 percent. For SAIF members with the median ROA of 0.86 percent in 1994, pretax earnings would be reduced about 12 percent. Earnings reductions this large would be significant. The likely impact, however, promises to be less dramatic. BIF members are likely to use some portion of their assessment savings to increase dividends or otherwise enhance shareholder value, and SAIF members can offset some portion of

the differential by increasing revenues or reducing other expenses.

Capital. To the extent SAIF members' earnings are reduced by a premium differential, their ability to generate or raise capital could be impaired. Thrifts' average returns on assets and equity already lag significantly below those of banks, and the industry faces longer-term structural problems that will be difficult to overcome. This is primarily due to the fact that the business of mortgage lending has become increasingly competitive, reducing the profitability of holding mortgage loans to maturity. However, current tax laws require thrifts to maintain a certain percentage of their tangible assets in "qualified thrift investments" in order to realize the tax benefits available under a thrift charter. In recent years, we have seen some thrifts successfully raise new capital, even in some instances where the institutions were unprofitable, and we must conclude that the potential for a future premium differential was known at the time of issue. However, investors cannot be expected to suffer low returns indefinitely.

Failures. We are particularly concerned about the possible effects a premium differential could have on weaker institutions and whether a differential would cause any increase in failures. We analyzed the group of SAIF-insured institutions with FDIC supervisory ratings of 3 or higher and projected their

performance for a five-year period, incorporating a 20-basis point differential and a variety of interest-rate and asset-quality assumptions. The results showed a slight increase in failures attributable to the differential, but we feel these additional failures should be manageable by the SAIF provided there is no unforeseen spiking of losses attributable to other factors, such as an economic downturn. In fact, in our projections the factors relating to interest rates and asset quality had a greater effect on failure rates than did a premium differential. The potential cumulative effect of all three factors could be substantial. Our analysis is included as Attachment C.

Most recently, the outlook for the SAIF has been further clouded by dramatic new developments. On March 1, 1995, Great Western Financial Corporation, the parent company of a SAIF-member federal savings bank with offices in California and Florida, announced that it had submitted applications for two national bank charters. Under the applications these commercial banks would share Great Western's existing branch locations.³ By mid-March, five other SAIF-insured institutions announced that they were considering similar actions.

³In its press release of March 1, 1995, Great Western noted the proposed premium differential and said the company's plan would "ensure its ability to offer deposit products at rates which will be competitive with commercial banks."

If these or other efforts in converting SAIF-insured deposits to BIF-insured deposits are successful, others are likely to follow. That would mean the SAIF assessment base could shrink significantly -- and quickly. These six institutions have approximately \$80 billion in SAIF deposits, which represent 50 percent of the FICO-cushion mentioned earlier. Removal of those deposits from the SAIF would result in a significantly smaller base from which to generate the fixed FICO assessment.

Such a large shift in deposits would also have ramifications for the BIF. An additional \$80 billion in BIF-insured deposits would require an additional \$1 billion in BIF reserves -- 1.25 percent of \$80 billion. While these announcements are unlikely to result in a large enough shift in insured deposits from the SAIF to the BIF by midyear to delay recapitalization of the BIF, such a shift could ultimately push the reserve ratio below 1.25 percent. If this were to occur, premiums paid by banks would have to be increased in order to again reach and maintain the 1.25 target ratio. The six new BIF members would begin contributing assessments to the BIF, but other BIF members would pay the preponderance of the needed \$1 billion addition to reserves.

It is estimated that many more thrift institutions are considering ways of shifting deposits to the BIF. The announced proposals require various approvals associated with chartering

new institutions, but there are other means to achieve the same ends that do not require such approvals, and are likely to lead to a further shrinkage in the SAIF assessment base. For example, existing affiliations between BIF and SAIF members enable deposit-shifting without the need for new charters or approvals by regulators. In general, we can expect the market to respond to cost differences, and those who suggest that regulators can prevent the movement of deposits out of the SAIF appear to underestimate the market's ability to innovate around constraints. If the rate of shrinkage in the SAIF assessment base increases 4 percent per year as a result of all available techniques, debt service on the FICO bonds is threatened as early as 2001. If the rate of shrinkage in the SAIF assessment base increases to 10 percent per year, debt service on the FICO bonds is threatened as early as 1977 (see figure 4 of Attachment C).

CONSTRAINTS

A number of legal constraints prevent a regulatory solution to the SAIF problem and, therefore, require Congressional action if the problem is to be addressed. Among the constraints:

- The law requires that the FDIC Board set assessments to maintain each deposit insurance fund's reserve ratio at the minimum designated reserve ratio (DRR) of 1.25 percent of estimated insured deposits once that ratio has been achieved.

- The FDIC Board may increase the DRR above 1.25 percent for any year only if the Board determines that circumstances exist raising a significant risk of substantial future losses to the fund for the year.
- Assessment rates and the DRR of the BIF and SAIF must be set independently.
- The BIF and the SAIF must be maintained separately, with no commingling of assets, liabilities, revenues or expenses.
- The FDIC Board must maintain a risk-based assessment system and assess each fund member at least \$1,000 semiannually after a fund is capitalized.
- Until January 1, 1998, the FDIC Board is required to set SAIF assessments to increase the reserve ratio to the designated reserve ratio. Beginning January 1, 1998, the FDIC is required to promulgate a SAIF recapitalization schedule that achieves the DRR.
- As long as the SAIF remains undercapitalized, until January 1, 1998, SAIF assessments must average at least 18 basis points; thereafter, SAIF assessments must average at least 23 basis points.
- Assessment revenue from SAIF deposits that have been purchased by BIF members (Oakar banks) and from savings associations that have converted to bank charters (Sasser banks) is deposited in the SAIF and is not available to the FICO.

- FICO bonds are not an obligation of the FDIC, but of the FICO. Although the FICO is a mixed-ownership U.S. government agency, FICO bonds do not carry the full, faith and credit of the United States.
- Until 2019, the last maturity date of FICO's bonds, with the approval of the FDIC Board, the FICO has first priority to assess savings associations that are SAIF members to cover FICO's debt service needs.
- In setting SAIF assessments, the FDIC Board is required to consider the fund's expected operating expenses, case resolution expenditures and income, the effect of assessments on members' earnings and capital, and any other factors the Board determines to be appropriate.
- FICO assessments is a relevant "other factor" that the FDIC Board may consider in setting SAIF assessments.

GOING FORWARD

Public Hearing

On Friday, March 17, the FDIC Board of Directors held an unprecedented public hearing on the agency's proposals to reduce deposit insurance premiums for most banks while keeping insurance rates unchanged for savings associations. These proposals were issued for public comment on January 31, and although written

comments are not due until April 17, more than 600 comment letters already have been received.

The FDIC Board decided that a public hearing would provide a unique opportunity to explore all of the issues relevant to its consideration of the proposed assessment rates, the problems facing the SAIF, and the need for Congressional action. The format consisted of an open dialogue with representatives of both BIF-insured and SAIF-insured institutions and other interested parties. We heard not only from the major financial institution trade associations, but also from private citizens and individual bank and thrift executives from both large and small institutions.

I think I speak for the entire FDIC Board, as well as our witnesses and many observers, when I characterize these discussions as enlightening, thought-provoking, and extremely beneficial. In general there was agreement that while there is no easy solution, there is a very real problem. A problem that needs to be addressed sooner, rather than later.

There was not unanimous agreement on the timing of problems for the SAIF and the FICO bonds. The majority of the participants, however, conceded that a very real crisis looms on the horizon. One of our witnesses characterized himself as an historian and urged us not to repeat mistakes of the past "where

policymakers have avoided decisions and waited for crises to occur." In a similar vein, others cautioned against temporizing.

I will not attempt to summarize the positions of all parties who spoke at the hearing.⁴ A variety of alternatives were presented and discussed. These ranged from the purchase of FDIC-issued interest-bearing obligations by SAIF-member institutions to recapitalize the SAIF, to a one-time special assessment on SAIF-member institutions, to use of interest on RTC funds remaining at year-end to pay interest on the FICO bonds, to using the excess RTC funds in some form to meet future losses to the SAIF, to merging the two insurance funds. We intend to consider the views of all of the witnesses, as well as the many comment letters received, as we continue our analysis of the proposed assessment rates.

One area in which I would like to believe that a consensus was reached is a willingness by bank and thrift executives alike "to come to the table and talk." To be sure, there was a hesitancy on the part of many commercial bankers about bringing their wallets with them, and also a suggestion that the table be enlarged to include a broader range of financial institutions. In fact, I think our witnesses were quite candid in expressing

⁴The FDIC has a transcript of the hearing available to distribute to all who are interested.

that competitive inter-industry rivalries continue to exist, that there is a strong feeling among many banks that the SAIF "is not our problem," and that this is a very emotionally charged issue. It was even suggested that finding a solution that everyone can live with may be akin to resolving the baseball strike. We at the FDIC certainly hope that is not the case!

Of particular interest was the testimony of individual bankers about surviving the savings and loan crisis, the agricultural bank crisis, and the demise of the Ohio Deposit Guarantee Fund, to name a few. There were lessons learned that will not be soon forgotten. The common thread was the effect on financial institutions and their depositors when there is a crisis of confidence. Therefore, when queried as to whether they would be concerned if the SAIF failed, several bankers commented that "FDIC insured" is like a prized brand name to customers -- the logo on the door of a financial institution represents confidence -- and the integrity of that name must be preserved.

Clearly, there are no easy solutions to the problems of capitalizing the SAIF and meeting the FICO debt obligation, but I am encouraged by the willingness expressed by so many of our witnesses "to do the right thing" and to work together to find a constructive resolution. Several witnesses expressed their belief that the FDIC has a "moral obligation" to bring these problems to your attention and "the responsibility to articulate

a comprehensive solution to the Congress." I now would like to turn to a discussion of possible legislative options.

A large number of proposals to address the SAIF problem have been made. In weighing the options, we must seek a real and permanent solution, not one that simply defers the issue to a later time while leaving in place the conditions that are the source of the problem.

Standards

In that regard, any solution should be judged by how well it accomplishes three goals. First, it should reduce the premium disparity between BIF- and SAIF-member institutions, and eliminate to the extent possible the portion of the SAIF premium attributable to the FICO assessments. This disparity encourages SAIF members to engage in legal and regulatory maneuvering to avoid SAIF assessments and in my view renders infeasible the existing mechanism to fund the FICO. This standard leaves open the question of what level of premium disparity between BIF and SAIF members would be small enough to eliminate the incentive for SAIF members to flee the SAIF. Second, it should result in the SAIF being capitalized relatively quickly, perhaps no later than 1998. The longer we allow the SAIF to be undercapitalized, the greater the possibility that unanticipated losses will deplete the fund. Third, a solution should address the immediate problem

that on July 1, the SAIF will take over from the RTC the responsibility of handling thrift failures. Unfortunately, the SAIF will assume this responsibility in a vulnerable and grossly undercapitalized condition.

The progress towards capitalization, in other words, should be "front-loaded," with a substantial chunk of the capital coming quickly.

We must also be concerned with the means used to achieve these ends. In that regard, we must consider the precedent that is being set for the use of the deposit insurance funds. To ensure sufficient insurance reserves to meet future losses and to protect the FDIC's independence, the deposit insurance funds should be used only for deposit insurance purposes. Ideally, the converse should also be true that deposit insurance expenses should not be paid out of public funds, although the savings and loan crisis is evidence of an unfortunate breach of the latter principle, and the diversions from the SAIF for other purposes proves the rule about the former. We also must carefully consider the fairness of the solution to all concerned. Finally, to the extent that Congress may wish to consider options involving the use of RTC money to address the problems outlined here, there may be budgetary issues outside the purview of the FDIC.

Options

A number of options for addressing these issues are described below. The options are grouped as follows: one, no action; two, options using public funds; three, options involving a special assessment on the SAIF assessment base; four, options that would use investment income of the insurance funds to pay the FICO assessments; five, options using no public funds, including merging the funds and sharing the FICO assessments between BIF members and SAIF members; and six, options that combine the above approaches. Each option is described and evaluated in terms of how well it achieves the three goals just described. Other relevant advantages and disadvantages also are discussed. Information about each option is presented in Table 2.

No Action

Without any legislative action, SAIF members would bear the entire \$15.1 billion cost of bringing the BIF and the SAIF into parity (option 1 of Table 2). Under a scenario that assumes no major unanticipated losses, a gradual shrinkage of the SAIF assessment base and a gradual increase in the portion of the base ineligible for the FICO assessment, the SAIF would not reach the designated reserve ratio until 2002. The premium disparity would be on the order of 19 basis points until the SAIF capitalizes.

After capitalization, and assuming equal expenses for the two funds, the disparity would simply equal the basis-point equivalent of the fixed \$779-million-per-year FICO obligation. Under the assumptions used regarding the shrinkage of the SAIF assessment base, this would amount to 12 basis points at the time of capitalization and would increase gradually until the FICO bonds mature.⁵

Taking no action does not satisfy any of the three standards stated above. One, a premium disparity would continue to exist for 24 years and would almost certainly render the existing FICO funding mechanism obsolete. Two, the SAIF would not capitalize for at least seven years even assuming no major unanticipated losses. Three, there is no early injection of capital into the SAIF to alleviate the immediate problem of significant undercapitalization in the face of the requirement that the SAIF take over from the RTC the responsibility of handling failures of thrift institutions beginning July 1.

Approaches Using Excess RTC Funds

It has been estimated that there will be between \$10 billion and \$14 billion in RTC funds that have been appropriated but not

⁵The analysis in Table 2 assumes that the FDIC would set assessments at the rate necessary to fund FICO interest payments after the SAIF achieves its designated reserve ratio. The law leaves the decision to the discretion of the FDIC Board.

spent -- the so-called excess RTC funds. It has been suggested that these funds be used either to pay the FICO assessments or to capitalize the SAIF, or some or all of both. Two such approaches are discussed below.

Use of Unspent RTC Funds to Pay the FICO Obligation. Under this approach, the FICO obligation would be paid out of excess RTC funds. This approach is presented in Table 2 as option 2. The approximate cost to the Treasury of this option is \$8.4 billion.

Under our proposed standards, one, there would be no premium disparity arising from the FICO obligation and no chance of a FICO shortfall. Two, under this approach SAIF capitalization would occur in 1998 assuming no large unanticipated losses, significantly more quickly than currently expected. Three, this approach, however, would not address the immediate vulnerability of the SAIF beginning July 1.

There are several other public-policy issues related to this approach. The Congress recognized in FIRREA that statutory draws on the SAIF fund to support the FICO, the REFCORP, and the FRF could result in an undercapitalized SAIF for an extended time. Consequently the Congress authorized up to \$32 billion in income and net worth supplements for the SAIF -- monies that never were appropriated. In light of this legislative intent, it may be

appropriate for excess RTC funds to be used to pay the FICO obligation.

Another issue with this approach would relate to budgetary scoring. Under current law, deposit insurance outlays do not trigger offsetting reductions in other federal spending or require increased revenue; FICO assessments, however, are counted as interest outlays rather than deposit insurance outlays. In this regard it should be noted that resolutions of failing banks can often give rise to obligations that require the insurer to make periodic payments. Such periodic payments have been scored as insurance outlays for budgetary purposes. Congress may wish to consider similarly classifying FICO assessments as insurance outlays for budgetary purposes.

Use of Excess RTC Funds to Capitalize the SAIF. Under this approach, the excess RTC funds described above would be contributed to the SAIF in the amount needed to allow the fund to achieve its designated ratio of 1.25 percent of insured deposits (option 3). This would amount to \$6.7 billion at year-end 1994.

Under our three proposed standards, one, this approach by itself would do nothing to alleviate the 24-year premium differential arising from the FICO assessments. Without some means to alleviate this differential, we could not rule out further shrinkage in the SAIF assessment base, a resulting

increase in the premium disparity, and a deficiency in premium income to service the FICO assessment base. Two, the SAIF would capitalize much much more quickly than under the status quo. Three, the short-term vulnerability of the SAIF would be eliminated.

As noted earlier, excess RTC funds are available to cover insurance losses of the SAIF provided the FDIC certifies that an increase in SAIF premiums would reasonably be expected to result in greater loss to the Government, and that SAIF members are unable to pay assessments to cover losses without adversely affecting their ability to raise and maintain capital or maintain the assessment base. Congress required those certifications in an effort to ensure that SAIF members pay the highest rates possible before taxpayer funds are used to cover SAIF losses. Of course, this would have the effect of exacerbating the impending premium differential. In addition, it may be difficult for the FDIC to certify that increasing SAIF assessments would result in increased losses to the government prior to the SAIF being at or near depletion. Consequently, making RTC funds immediately available to capitalize the SAIF would require modifying or removing the existing certification requirements.

A closely-related alternative to providing excess RTC funds to capitalize the SAIF would be to make such funds available to cover insurance losses from thrift failures if they occur over a

specified time period. As discussed above, this would have to be accompanied by modification or removal of the certification requirements to provide meaningful relief from the possibility of the SAIF being depleted. This option for capitalizing the SAIF is fundamentally different from others described in this testimony in that it would involve contingent assistance rather than upfront funded amounts.

There are substantial public-policy concerns with the precedent set by using public funds to capitalize the SAIF. Independence is vital to the effective functioning of the deposit insurance system. This does not mean freedom from accountability but independence to constrain undue risk-taking and to protect the insurance funds. The exercise of safety-and-soundness powers, pricing risk for insurance purposes, and closing and disposing of insolvent institutions all are accomplished most effectively when they are insulated from the political process. Capitalization of the SAIF with appropriated money could create a climate in which the FDIC's exercise of its insurance responsibilities would be influenced by policy concerns outside the scope of the FDIC's mission.

Approaches Involving a Special Assessment on the SAIF Base

Under this approach (option 4 of Table 2), a special one-time assessment that contributes to the capitalization of the

SAIF would be levied against the SAIF assessment base. This special assessment could amount to some or all of the \$6.7 billion needed as of year-end 1994 to capitalize the SAIF. In order to collect the full \$6.7 billion, a special assessment of about 70 basis points would have to be levied over and above the current average assessment of about 24 basis points. The question of how many additional thrift failures would be triggered by such a special assessment is discussed below.

One, a special assessment would not eliminate the premium disparity -- even if large enough to recapitalize the SAIF -- because of the continuing FICO obligation. Two, it would substantially reduce, or eliminate, the time needed to reach the designated reserve ratio. Three, it would inject funds quickly, addressing the short-term vulnerability of the SAIF. A special assessment on SAIF members could act to short-circuit the types of legal and regulatory assessment-avoidance tactics described earlier. To put it bluntly, a special assessment could tax SAIF deposits before they can escape the fund. In this regard, Congress may wish to consider a cut-off date for a special assessment that would ensure that institutions attempting to avoid the assessment pay their fair share. A special assessment also would reduce to some extent the need for SAIF members to engage in assessment-avoidance tactics by reducing the capitalization component of the premium disparity.

If the full \$6.7 billion were not collected at once, the SAIF would fall short of the 1.25 minimum reserve ratio. Under current law this would mean that SAIF premiums would have to average at least 18 basis points until 1998, and at least 23 basis points thereafter, until the required reserve ratio is achieved. Thus, there would continue to be a premium disparity on the order of 14 to 19 basis points until the SAIF is capitalized, and possibly thereafter if FICO bonds remain a SAIF obligation.

For a variety of reasons, however, if a special assessment were levied against the SAIF assessment base, it may be reasonable to eliminate the 18 basis-point statutory minimum average assessment rate required under current law. Assuming that the FICO-related premium disparity were eliminated by one of the options described above, a premium disparity would exist because of the need to complete the capitalization of the SAIF. The greater the special assessment, the less would be the need for additional assessment revenues to complete the capitalization of the SAIF. Table 3 shows how the size of the special assessment (treated as an addition to the existing premiums) and the time allowed to achieve capitalization affect the premium necessary for the SAIF to capitalize in the desired time.

For example, under a special assessment of 30 basis points, and assuming we wish the SAIF to reach the 1.25 reserve ratio in

1998, we would have to charge a SAIF premium of 15.5 basis points and the resulting premium disparity would be approximately 11 basis points under the current proposal. Alternatively, if we were willing to impose a 40-basis point special assessment and extend the deadline to capitalization to 1999, the necessary SAIF premium would be about 9 basis points and the disparity would be about 5 basis points. These numbers assume that the minimum assessment rate for BIF members would be 4 basis points, and that there are no major unanticipated losses for either fund. They also assume that the FICO assessment and the current statutory minimum assessment rates for SAIF could be eliminated.⁶

Depending on the size of the special assessment, a disadvantage would be that there could be additional failures of SAIF members as a result. Under a one-time assessment on the SAIF assessment base of 94 basis points, the full amount needed to bring the SAIF to its designated ratio (70 basis point special plus 24 basis point current assessment), three SAIF members with total assets of \$500 million would become critically undercapitalized, based on year-end 1994 financial reports, and another 103 SAIF members would be downgraded one notch from current capital categories.

⁶If the FICO assessment were shared pro rata, both BIF and SAIF premiums would be about 2.4 basis points higher than indicated here.

Approaches Using Investment Income of the Insurance Funds to
Pay the FICO

There have been a number of proposals to use investment income of the insurance funds to pay the FICO assessments. Two such proposals are considered here as option 5 of Table 2. One proposal would inject RTC funds into the SAIF in the amount needed to achieve the 1.25 reserve ratio. The interest on the SAIF's investment portfolio would then be used to pay a portion of the FICO assessments. With a fully invested fund at today's interest rates, this would yield approximately \$600 million annually as compared with the \$779 million required to meet FICO debt service obligations.

Another option that has recently been proposed would allow investment income equal to two basis points of the BIF assessment base to be used to pay the FICO assessments. Based on the current BIF assessment base, about \$500 million of the \$779 million annual FICO assessment would be paid by the BIF under this approach.

The first option does not constitute a complete solution to the problems posed by the difference in the condition of the two funds, but simply changes the form in which the FICO assessment would be paid by the SAIF industry. Instead of being paid by the SAIF members through assessments, the FICO would be serviced by

garnishing the SAIF's income. If the BIF and the SAIF started at the same reserve ratio, had the same loss experience going forward, and maintained their respective 1.25 ratios, SAIF premiums would have to be higher than BIF premiums by a sufficient amount to offset the drain in the SAIF's income caused by the FICO service. Otherwise, if there were no premium differential, the BIF reserve ratio would increase continuously relative to the SAIF reserve ratio during the full 24-year period in which the FICO bonds are outstanding, and SAIF members would have to be assessed higher premiums to make up the difference if losses to the SAIF dropped the balance below the 1.25 ratio.

The advantage of the approach is delaying the SAIF premium increase until justified by losses. On the other hand, over the long term, this approach does not address the first standard set out above, address the premium disparity arising from the FICO assessment, as well as the incentive of SAIF members to avoid these assessments, and the resulting difficulties in funding the FICO debt. Our proposed standards two and three are met, because the SAIF would be capitalized immediately.

Looking at the approach involving BIF investment income, first, a premium differential arising from FICO assessments would still exist to the extent the SAIF's share of the remaining portion of the FICO assessment is greater than the investment income of the SAIF. Based on the current assessment bases of the

two funds, the SAIF would pay about two basis points more than the BIF for its share of the FICO assessment. This differential could change over time if the BIF and SAIF assessment bases grew at different rates. The differential is not likely to be substantial, but could increase somewhat over time. Two, this option would capitalize the SAIF in 1999 under current conditions. Three, it would do nothing to address the short-term vulnerability of the SAIF.

Using investment income of the BIF to pay FICO assessments would set a precedent for using BIF funds to pay expenses not related to the BIF, although use of only investment income would be a more limited precedent. In addition, diverting investment income of the BIF would increase the likelihood that assessment rates for BIF members would have to be increased at some future time to replace the contribution investment income would have made to covering losses to the BIF from failed banks.

Use of No Public Funds

Options 6 and 7 in Table 2 present two approaches that rely solely on FDIC-insured institutions to raise some or all of the \$15.1 billion needed to bring the SAIF into parity with the BIF. These are sharing the FICO assessments between the BIF and the SAIF without merging the funds (option 6) and merging the BIF and the SAIF (option 7).

The BIF Share of the FICO Obligation Without a Merger.

Under this option, the BIF members would be assessed for a portion of the FICO assessments. For example, a pro rata sharing of the FICO assessments between the BIF and the SAIF, based on insured deposit levels in the two funds, would cost BIF members about \$6.5 billion in present-value terms. The BIF's share of the annual \$780 million obligation would be about \$600 million, or 2.4 basis points per year because 77 percent of the total domestic deposits of FDIC-insured institutions are held by BIF members, and 23 percent by SAIF members.

Under our proposed standards, this approach would, one, eliminate any premium disparity arising from the FICO obligation, currently about 11 basis points of the proposed 19 basis point differential. By making the entire assessment base of both funds available to service the FICO debt, it would virtually rule out a deficiency of premium income to service the FICO assessment. Two, this approach would enable the SAIF to capitalize significantly more quickly than currently anticipated by eliminating most of the FICO drain on SAIF assessment revenue. Assuming no large unanticipated losses, capitalization would occur in 1999, three years earlier than currently projected.

Three, this approach would do nothing to address the concern that the SAIF will begin resolving thrift failures on July 1 in a significantly undercapitalized position and remain there for

several years. This makes the SAIF very vulnerable to unanticipated losses. It thus leaves open the possibility that the SAIF could be bankrupted and that both SAIF- and BIF-insured institutions would suffer from the resulting negative publicity. The other concern with this approach has already been discussed. By using BIF funds for purposes other than paying for deposit insurance costs, this approach sets a precedent that could erode the effectiveness and independence of the deposit insurance system.

Another alternative for this approach would be for the BIF to contribute 50 percent of the cost of servicing the FICO obligation (option 6(b) of Table 2). This currently would amount to approximately 1.5 basis points annually for BIF members, or about a \$4.2 billion present-value cost.

Under our proposed standards, this approach, one, would not eliminate the premium disparity. Unlike the pro rata sharing approach, this approach retains a 24-year premium disparity, although at lower levels than some other options. To illustrate, with the 50 percent sharing described here, equal shares of the annual FICO cost by the BIF and the SAIF of \$390 billion would amount to about 1.5 basis points for BIF members and 5.5 basis points for SAIF members. Thus, after the SAIF is capitalized, there would remain a premium disparity of about four basis points

that could grow larger if the SAIF assessment base were to shrink.

Two, this approach would not achieve SAIF capitalization as quickly as the alternative in which the BIF shares the FICO assessments on a pro rata basis -- 2000 rather than 1999 --, thus leaving the SAIF undercapitalized for one more year. Three, this option also does not address the short-term vulnerability of the SAIF.

In addition, this approach sets a precedent by using BIF resources for other purposes. BIF members probably would argue, however, that equal dollar sharing is less unfair than proportional sharing because it entails less use of BIF resources.

Merging the BIF and the SAIF. Under this option, the two funds would be combined and the existing premium rates maintained until the combined fund meets the designated reserve ratio. FICO assessments would continue to be paid by the thrifts. The designated reserve ratio for the combined fund could be expected to be achieved in 1996.

The cost to the BIF of this approach is estimated at \$5.5 billion, or the equivalent of a one-time charge of 22 basis points on the BIF assessment base. By our proposed standards,

one, there would be no premium disparity until capitalization of the combined fund occurred. At capitalization the disparity would equal the size of the fixed \$779 million FICO charge relative to the SAIF assessment base. This would be about 11 basis points in 1996, assuming no drastic change in the SAIF assessment base during the next year.

This option meets standard two and three because there is an immediate and substantial capital injection into the SAIF and the combined fund recapitalizes quickly. The resulting 11-basis point disparity, based on the current SAIF assessment base, would nevertheless appear large enough to provide an incentive for further legal and regulatory maneuvering by SAIF members to avoid assessments. If successful, SAIF assessment revenue would prove insufficient to fund the FICO earlier than otherwise.

Merging the funds would set an unfortunate precedent for the use of the resources of the deposit insurance funds -- in this case the BIF. Existing law requires that BIF resources be used to cover only BIF expenses; merging the funds would violate that principle. There is a danger in overriding the law governing the use of insurance fund resources solely for the sake of expediency. If an insurance fund's resources can be used for purposes other than protecting the depositors of that fund, where should we draw the line about what charges to deposit insurance reserves are appropriate? Such "other uses" of deposit insurance

funds weaken the distinction between those funds and general federal monies and pose a danger to the independence of the deposit insurance system. Moreover, there is a significant question of fairness to BIF member banks, who have paid \$22 billion during the last four years to recapitalize the BIF at the level mandated by the Congress. Finally, the current problem of capitalizing the SAIF as a result of the diversions of SAIF assessment revenue for other purposes illustrate the effect of using deposit insurance funds for other purposes.

Combination Options

This section presents some options that involve combinations of the approaches outlined above. These are grouped under option 8 in Table 2. All of these options share a common theme: they are designed to enhance some of the approaches above that did not address the long-term premium disparity arising from the FICO assessments.

The first such option involves merging the funds and having BIF and SAIF share the FICO assessments proportionately. The most important shortcoming of merging the funds would be that, taken by itself, it would do nothing to resolve the 24-year premium disparity. By providing that the FICO burden be shared proportionately between current BIF and SAIF members this problem could be mitigated. The cost to the BIF would be \$11.7 billion,

or the equivalent of a one-time charge of 47 basis points on the BIF assessment base. This option would entail proportional sharing between the BIF and the SAIF of the total \$15.1 billion cost of bringing the two funds into parity.

Under this approach, there would be no premium disparity, and, because the SAIF would be capitalized quickly, there would be an up-front substantial injection of funds. It would, therefore, meet our three standards. On the other hand, as emphasized above, there would be an unfortunate precedent set in using the BIF for purposes other than BIF insurance costs.

The second option would be to combine RTC capitalization of the SAIF with a pro rata sharing of the FICO assessments between BIF and SAIF. The drawback in using the excess RTC funds to capitalize the SAIF is that such an approach by itself would not alleviate the long-term premium disparity arising from the FICO assessments. This problem could be alleviated by combining this approach with a pro rata sharing of the FICO assessments between the BIF and the SAIF. This approach would eliminate the premium disparity and would result in an immediate capitalization of the SAIF, thus meeting our proposed standards. As emphasized above, however, these advantages come at a cost: the use of public funds and all that entails for the independence of the deposit insurance system.

A special assessment on the SAIF assessment base, either in combination with a BIF and SAIF sharing of the FICO or with excess RTC funds being used to pay the FICO assessment constitutes the third and fourth options. A special assessment by itself does nothing to resolve the premium disparity arising from the FICO assessments. Either two approaches could correct this problem. Either of these two approaches are presented in Table 2 under the assumption that the entire \$6.7 billion needed for the SAIF to achieve the reserve ratio is collected at once through a special assessment. Approaches involving smaller special assessments were discussed above (see Table 3 and the accompanying discussion). Both approaches have advantages. One, there would be no long-term premium disparity; two and three, the SAIF is capitalized immediately.

CONCLUSIONS

There is an urgent need for legislative action to reduce the disparity in the financial condition of the BIF and the SAIF. This immediate need arises from three sources. First, on July 1 the SAIF will assume the responsibility for handling failures of thrift institutions. It will not assume this responsibility in a position of strength, because it is grossly undercapitalized. This condition is directly attributable to the fact that until 1993, most assessment revenues from SAIF members were statutorily diverted from the SAIF to pay for past losses related to the

thrift crisis. In addition, revenue and net worth supplements totalling \$32 billion that Congress had authorized for the SAIF never were appropriated. As a result of this history, the existing SAIF balance simply does not provide an adequate margin of comfort. The resources of the SAIF are insufficient to absorb the cost of the failure of one large or a few medium-sized thrifts, or other substantial unanticipated losses.

Second, as a result of the SAIF's significant undercapitalization, there can be no assurance that the Congress will not again have to address these issues. If there are no major unanticipated losses, the SAIF balance should inch up to its target over the next seven years. Over this length of time, it is difficult to take comfort that unanticipated losses will not prevent the SAIF from reaching its target. The longer the time before the SAIF capitalizes, the greater the chance the SAIF might fail to capitalize.

Third, the current structure for funding the FICO obligation is not viable. Requiring this fixed cost to be paid from deposit insurance assessments on the SAIF creates enormous economic incentives for the targeted group to engage in legal and regulatory maneuvering to reduce their potential costs. We are already seeing such maneuvering in the current interest expressed by some large thrifts in opening new banks and by applications from thrifts to operate branches that would share bank and thrift

operations. As stated earlier, the question is not whether there will be insufficient premium income to service the FICO obligations, but when the deficiency will occur.

Any solution to these problems should address all three concerns. It should eliminate the long-term premium differential caused by the FICO assessments. It should greatly reduce the time needed to capitalize the SAIF. The longer the SAIF is allowed to remain undercapitalized, the greater the chance that unanticipated losses will prevent us from reaching the target or will force Congress to consider these issues again. Finally, the solution should include an immediate injection of funds into the SAIF or a ready source of backup funding for SAIF losses. As matters stand now, the SAIF will begin its responsibilities for handling thrift failures after June 30 in a dangerously vulnerable condition.

Madam Chairwoman, the FDIC is committed to finding solutions that address these three concerns in a manner that is consistent with good public policy: We stand ready to assist the Subcommittee in this effort in the weeks ahead. I commend your foresightedness in holding this hearing, and I look forward to your questions and to questions from members of the Subcommittee.

TABLE 1

**Proposed Assessment Rate Schedules
Second Semiannual 1995 Assessment Period
FDIC-Insured Institutions**

Proposed BIF Rate*

Capital Category	Supervisory Risk Group		
	Group A	Group B	Group C
1. Well	4	7	21
2. Adequate	7	14	28
3. Under	14	28	31

Estimated Annual Assessment Revenue: \$1.1 Billion
Average Annual Assessment Rate: 4.5 bp
Rate Spread: 27 bp

Proposed SAIF Rate*

Capital Category	Supervisory Risk Subgroup		
	Group A	Group B	Group C
1. Well	23	26	29
2. Adequate	26	29	30
3. Under	29	30	31

Estimated Annual Assessment Revenue: \$1.7 Billion
Average Annual Assessment Rate: 24 bp
Rate Spread: 8 bp

*Rates are in basis points

Resulting obligation to:
(basis points in parentheses)

Option	BIF	SAIF	Treasury	SAIF* Capitalization	Premium* Disparity	FICO* Problem
8. Combination Options						
a) Merge BIF/SAIF, BIF/SAIF pay FICO <u>pro rata</u>	11.7 (47)	3.4 (47)	0	1996	none	none
b) RTC capitalizes SAIF, SAIF/BIF share FICO <u>pro rata</u>	6.5 (26)	1.9 (27)	6.7	immediate	none	none
c) Special assessment on SAIF, BIF/SAIF share FICO <u>pro rata</u>	6.5 (26)	8.6 (120)	0	immediate	none	none
d) Special assessment on SAIF, RTC funds pay FICO	0	6.7 (94)	8.4	immediate	none	none

* Based on baseline assumptions as of 3-9-95.

Notes:

- (i) Current estimated cost to defease FICO = \$8.4 billion, discounting at 7.96%, the current (3/7/95) rate on Treasury IO strips due in 2018.
- (ii) Amount needed at year-end 1994 to enable SAIF to meet 1.25% designated ratio = \$6.7 billion (the amount needed to incurease the SAIF from its year-end 1994 balance of \$1.936 billion to 1.25% of year-end SAIF insured deposits of \$693 billion, or \$8.66 billion).
- (iii) Pro rata shares are 77% BIF, 23% SAIF.
- (iv) The one-time premium necessary to obtain \$1 billion is about 4 basis points for BIF and 14 basis points for SAIF.
- (v) Reducing SAIF premium from 23 bp to 18 bp would increase time to capitalization by about two years.
- (vi) Results in right hand three columns rely on FDIC's baseline assumptions.

Table 2
Options For Resolving Issues Related to the SAIF
(\$ billions)

Resulting obligation to:
(basis points in parentheses)

Option	BIF	SAIF	Treasury	SAIF* Capitalization	Premium* Disparity	FICO* Problem
1. No Action	\$0	\$15.1 (211)	\$0	2002	19 bp before, 12 bp at recap date	likely within 10 years
2. Use unspent RTC appropriations to pay FICO						none
a) SAIF capitalizes itself	0	6.7 (94)	8.4	1998	19bp before, 0 after	none
3. Use unspent RTC appropriations to capitalize SAIF						
a) SAIF pays FICO	0	8.4 (118)	6.7	immediate	11 bp at recap date	less likely but possible
4. Special assessment on SAIF to capitalize SAIF						
a) SAIF members continue to pay FICO	0	15.1 (211)	0	immediate	11 bp at recap date	less likely but possible
5. Use BIF or SAIF investment income to pay FICO						
a) RTC funds pay SAIF; SAIF investments pay FICO	0	8.4 (118)	6.7	immediate	uncertain	uncertain
b) 2 bp of BIF investment income pays part of FICO	5.3 (21)	9.8 (137)	0	1999	uncertain	uncertain
6. BIF/SAIF pay FICO, no merger						
a) <u>pro rata</u> shares	6.5 (26)	8.6 (120)	0	1999	16.5 bp before, 0 after	none
b) 50% shares	4.2 (17)	10.9 (153)	0	2000	17.5 bp before, 4 bp at recap date	less likely but possible
7. Merge BIF and SAIF						
a) SAIF pays FICO	5.5 (22)	9.6 (134)	0	1996	0 bp before, 11 bp at recap date	less likely but possible

* Based on baseline assumptions as of 3-9-95.

Table 3

Assessment Rate Necessary to Capitalize the SAIF by Given Year
Under Various 1995 Special Assessments

Special Assessment	Assessment Rates			
	1998	1999	2000	2001
1995				
10 bp	23.0 bp	18.0 bp	14.5 bp	12.5 bp
20	19.0	15.0	12.0	10.5
30	15.5	12.0	9.5	8.0
40	11.5	9.0	7.0	6.0
50	8.0	6.0	4.5	4.0

Resulting obligation to:
(basis points in parentheses)

Option	BIF	SAIF	Treasury	SAIF* Capitalization	Premium* Disparity	FICO* Problem
8. Combination Options						
a) Merge BIF/SAIF, BIF/SAIF pay FICO <u>pro rata</u>	11.7 (47)	3.4 (47)	0	1996	none	none
b) RTC capitalizes SAIF, SAIF/BIF share FICO <u>pro rata</u>	6.5 (26)	1.9 (27)	6.7	immediate	none	none
c) Special assessment on SAIF, BIF/SAIF share FICO <u>pro rata</u>	6.5 (26)	8.6 (120)	0	immediate	none	none
d) Special assessment on SAIF, RTC funds pay FICO	0	6.7 (94)	8.4	immediate	none	none

* Based on baseline assumptions as of 3-9-95.

Notes:

- (i) Current estimated cost to defease FICO = \$8.4 billion, discounting at 7.96%, the current (3/7/95) rate on Treasury IO strips due in 2018.
- (ii) Amount needed at year-end 1994 to enable SAIF to meet 1.25% designated ratio = \$6.7 billion (the amount needed to incurease the SAIF from its year-end 1994 balance of \$1.936 billion to 1.25% of year-end SAIF insured deposits of \$693 billion, or \$8.66 billion).
- (iii) Pro rata shares are 77% BIF, 23% SAIF.
- (iv) The one-time premium necessary to obtain \$1 billion is about 4 basis points for BIF and 14 basis points for SAIF.
- (v) Reducing SAIF premium from 23 bp to 18 bp would increase time to capitalization by about two years.
- (vi) Results in right hand three columns rely on FDIC's baseline assumptions.

ATTACHMENT A

LEGISLATIVE HISTORY OF SAIF FUNDING SCHEME

This legislative history reviews the primary statutes that established the funding scheme intended by Congress to resolve the thrift crisis of the 1980s and to provide capital to the Savings Association Insurance Fund (SAIF) and its predecessor, the Federal Savings and Loan Insurance Corporation (FSLIC). Although these laws cover a broad range of issues with respect to insured institutions, this review is limited to those provisions that concern the funding of the FSLIC and the SAIF.

Background

From the inception of federal deposit insurance, insured banks and thrifts were charged a flat rate for deposit insurance. That flat-rate system generated sufficient revenue to cover the costs of failures through the mid-1980s when bank and thrift failures began to escalate rapidly. In 1987, the Federal Home Loan Bank Board (FHLBB), as the agency with oversight responsibility for the FSLIC, the thrift insurance fund, announced that the FSLIC was insolvent.

Competitive Equality Banking Act of 1987

Congress passed the Competitive Equality Banking Act of 1987 (CEBA) against a backdrop of an increasing rate of thrift failures. One of the primary purposes of CEBA was to recapitalize the FSLIC through a combination of capital market borrowings and thrift industry contributions. CEBA authorized the FHLBB to charter the Financing Corporation (FICO) to issue bonds in the capital markets, the net proceeds of which were used to purchase redeemable nonvoting capital stock and nonredeemable capital certificates of the FSLIC. The FICO was authorized to sell up to \$10.825 billion in 30-year bonds to the public. Of that amount, \$10 billion was to be used for FSLIC operations and the remainder was to replace secondary reserve losses. The FICO issued 30-year non-callable bonds in a principal amount of approximately \$8.1 billion which mature in 2017 through 2019.

The principal amount of the FICO debt was to be paid by the Federal Home Loan Banks (FHLBs). To cover interest costs, the FICO was authorized to impose on each institution insured by the FSLIC, both a regular assessment not to exceed 8.3 basis points and, if required, a supplemental assessment not to exceed 12.5 basis points. The FICO assessment was to be subtracted from the insurance premium of 8.3 basis points charged by the FSLIC. If

the full amount of the regular assessment authorized had been assessed by the FICO, no funds would have remained to replenish the FSLIC. No institution could be required to pay more than the maximum regular and supplemental assessment amounts, whether paid to the FSLIC, the FICO or a combination of both. The FICO's assessment authority does not expire until 2019, the maturity year of its last bond issuance.

A key element of the capitalization scheme was the moratorium on changing insurance funds established in CEBA. By prohibiting thrifts from leaving the FSLIC, the moratorium provided the FSLIC with a captive funding source so that the fund could be built up. In addition, it ensured that FSLIC members would bear the burden of paying interest on the bonds issued by the FICO, thereby contributing toward the payment of the fund's past losses. CEBA also provided the FICO with authority (with FHLBB approval) to levy an exit fee on insured institutions that terminated their FSLIC insurance.

Financial Institutions Reform, Recovery, and Enforcement Act

In 1989, with losses from thrift failures continuing to mount and the condition of the bank insurance fund beginning to deteriorate, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) for the purpose of reforming, recapitalizing and consolidating the federal deposit insurance system by 1) placing the deposit insurance funds on a solid financial footing and 2) strengthening the supervisory and enforcement authority of federal bank and thrift regulators.

FIRREA restructured the deposit insurance funds by abolishing the FSLIC and establishing in its place the SAIF, which was to be managed by the FDIC. The FDIC's Permanent Insurance Fund was renamed the Bank Insurance Fund (BIF). FIRREA established a designated reserve ratio (DRR) for each fund set at 1.25 percent of estimated insured deposits and directed the FDIC to set rates and the DRR for the BIF and the SAIF independently. FIRREA also departed from the previous flat-rate assessment system by establishing a schedule of minimum annual assessment rates for both BIF and SAIF members. The FDIC was authorized to increase the minimum rates as necessary to achieve the DRR, but the rate could not exceed 32.5 basis points, nor could it be increased by more than 7.5 basis points in any one year. Until 1998, the minimum assessment schedule set for SAIF members was higher than that for BIF members, ranging from a difference of approximately 12.5 basis points at enactment to 3 basis points through 1997.

To continue to ensure a captive source of assessments to the SAIF, FIRREA extended for an additional five years the moratorium

on changing insurance funds with certain exceptions for troubled institutions and for transfers of "an insubstantial portion of total deposits," typically involving sales of branches by healthy institutions. FIRREA further established entrance and exit fees to be paid by institutions that engaged in permissible transfers between insurance funds. Any institution that transfers deposits from the SAIF to the BIF must pay an entrance fee to the BIF to prevent dilution of the BIF reserve ratio and an exit fee to the SAIF (currently 90 basis points). Exit fees received in connection with transfers from the SAIF to the BIF are held in a segregated account and may be made available to the FICO if the FDIC and the Secretary of the Treasury determine that the FICO has exhausted all other sources of funding for interest payments on its bonds.

One of the exceptions to the moratorium authorized a bank holding company that controlled a savings association to merge the savings association with a subsidiary bank. These so-called "Oakar" banks pay premiums to the SAIF on deposits attributable to the former savings association (the adjusted attributable deposit amount). The moratorium did not affect the ability of thrift institutions to convert to bank charters so long as the resulting institution remained a member of the SAIF ("Sasser" banks).

The funding framework established in FIRREA to pay for the escalating cost of thrift resolutions created three new entities, the FSLIC Resolution Fund (FRF), the Resolution Trust Corporation (RTC) and the Resolution Funding Corporation (REFCORP). The FRF was created to liquidate the assets and liabilities of the FSLIC. The FRF paid to the SAIF all amounts needed for administrative and supervisory expenses from creation of the SAIF through September 30, 1992. The FRF received funds from amounts assessed against SAIF members by the FDIC that were not required for principal payments on bonds issued by the REFCORP or interest payments on bonds issued by the FICO.

FIRREA established the RTC to manage and resolve all troubled thrift institutions previously insured by the FSLIC as well as future thrift resolutions through August 9, 1992. This date was subsequently extended to June 30, 1995. Since enactment of FIRREA, the SAIF's resolution responsibility has been limited to the SAIF-insured portion of BIF-member Oakar banks and thrifts chartered since 1989. The SAIF will assume resolution responsibility for thrifts on July 1, 1995.

Finally, pursuant to FIRREA, the REFCORP was created to provide funding for the RTC by issuing bonds. The principal of REFCORP bonds was to be paid by the FHLBs, up to a maximum annual amount of \$300 million or 20 percent of net earnings per FHLB. To the extent that monies from the FHLBs were insufficient to pay the principal amount, with the approval of the Board of Directors

of the FDIC, the REFCORP was authorized to assess SAIF members. The amount of REFCORP's assessment could not exceed the amount authorized to be assessed by the FDIC, less any FICO assessment.

Under the funding scheme established in FIRREA, the FICO continued to retain first priority on SAIF assessments followed by the REFCORP and the FRF, limited by the maximum amount authorized to be assessed by the FDIC. If the FICO, REFCORP and FRF assessments exhausted the amount of the FDIC's authorized assessment, then no funds were available to deposit in the SAIF.

Congress recognized in FIRREA that the diversion of SAIF assessments to the FICO, REFCORP and FRF would necessarily delay the capitalization of the SAIF. Therefore, in addition to assessment revenue, Congress authorized the appropriation of funds to the SAIF in an aggregate amount of up to \$32 billion to supplement SAIF revenue and to maintain a statutory minimum net worth. Congress authorized an annual appropriation to SAIF to supplement assessment revenue by ensuring an income stream of \$2 billion (after subtracting the amounts diverted to the FICO, REFCORP and FRF) each year through 1999, not to exceed \$16 billion in the aggregate, and to meet statutorily mandated minimum net worth targets through 1999, not to exceed \$16 billion in the aggregate. Subsequent legislation extended the date for receipt of appropriated funds to 2000.

Federal Deposit Insurance Corporation Improvement Act of 1991

In December 1991, faced with continuing bank and thrift failures and the impending bankruptcy of the BIF, Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). In FDICIA, Congress focused its efforts on preventive actions to protect the insurance funds by 1) requiring a variety of regulatory and supervisory measures intended to limit the risk of loss to the insurance funds and 2) restructuring the deposit insurance assessments system.

FDICIA restructured completely the basis upon which deposit insurance assessments are determined by replacing the flat-rate assessment system with a risk-related assessment system in which an institution's insurance premium is a function of the risk posed to the applicable fund by that institution. Congress intended the system to serve as an incentive to curtail activities that posed a greater risk to the funds. In addition to the implementation of a risk-related system, Congress authorized the FDIC to set assessments to maintain the reserve ratio at the DRR once that level is achieved. However, until that time, the FDIC is required to set rates not lower than the statutory minimum assessments. Currently, SAIF members are

assessed risk-related rates ranging from 23 basis points to 31 basis points, which is higher than the statutory minimum assessment of a weighted average of 18 basis points. If the SAIF is not recapitalized by January 1, 1998, or if the SAIF has outstanding Treasury borrowings on that date, the FDIC must promulgate a recapitalization schedule for the SAIF and the statutory minimum assessment will increase to a weighted average rate of 23 basis points. Finally, FDICIA reaffirmed that FICO assessments must be subtracted first from the assessments established by the FDIC for SAIF members.

In early 1992, because of the continuing weak position of the SAIF, the FDIC asked the Treasury Department and the Office of Management and Budget to request funding for the revenue and net worth supplements authorized under FIRREA. Despite these requests, no funds were ever requested or appropriated for these purposes.

Finally, to provide additional avenues for resolution of troubled institutions, Congress broadened the "Oakar" exception to the moratorium on conversions to permit acquisitions by banks not in a holding company structure and to enable SAIF-insured institutions to acquire BIF-insured institutions. The resulting SAIF-insured institution would pay assessments to the BIF for the deposits attributable to the former BIF member.

In 1992, the FDIC Legal Division determined that as a matter of law assessments paid by BIF-member Oakar banks on deposits acquired from SAIF members must remain in the SAIF and may not be allocated among the FICO, REFCORP, or FRF. The FDIC General Counsel recently reaffirmed this opinion and further stated the Legal Division's position that assessments paid by any former savings association that has converted to a bank and remains a SAIF member (Sasser banks) are not available to the FICO. (See Notice of FDIC General Counsel's Opinion No. 7, 60 FR 7055 (Feb. 6, 1995)).

Resolution Trust Corporation Completion Act

The Resolution Trust Corporation Completion Act (RTCCA) was enacted in 1993 to "provide for the remaining funds needed to assure that the United States fulfills its obligation for the protection of depositors at savings and loan institutions. . ." and to provide the final funding for the RTC. The RTCCA extended the moratorium on transfers between insurance funds to such time as the SAIF first attains the DRR and authorized the FDIC to extend any SAIF recapitalization schedule beyond the 15-year time limit specified in FDICIA to a date that will maximize the amount of semiannual assessments received by SAIF. The RTCCA also replaced the revenue and net worth supplements authorized in FIRREA with an authorization to use up to \$8 billion of

appropriated funds for losses incurred by the SAIF in fiscal years 1994 through 1998. In addition, the RTCCA authorized the use by SAIF of unexpended RTC funds for losses incurred or reasonably expected to be incurred. In both cases, these funds can be received only if the FDIC certifies to Congress that 1) assessments on SAIF members cannot be increased further without causing additional losses to the Government and 2) SAIF members cannot pay higher assessments to cover losses to the SAIF without adversely affecting their ability to raise and maintain capital or to maintain the assessment base.

ATTACHMENT B

FLOWS IN AND OUT OF THE SAVINGS ASSOCIATION INSURANCE FUND

Summary

The Savings Association Insurance Fund (SAIF) was created by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) as the successor to the Federal Savings and Loan Insurance Corporation (FSLIC). The SAIF will have resolution authority for all failed thrifts as of no earlier than January 1, 1995, nor later than July 1, 1995. Consequently, there have been limited demands on the SAIF for insurance losses since its inception. Through 1992, the majority of SAIF-member assessment revenue was diverted to thrift resolution funding needs other than the SAIF. Because uses of funds have nearly equalled sources of funds since 1989, the SAIF began Fiscal Year 1993 with a minimal balance of approximately \$200 million.

The SAIF received nearly \$0.17 billion in net assessment revenue in Fiscal Year 1993. For many reasons, it is difficult to project the SAIF's exposure. If insurance losses exceed assessment revenue, the SAIF may be required to access its other sources of funds. Under the Resolution Trust Corporation Completion Act of 1993 (RTCCA), up to \$8 billion total is authorized to be appropriated for Fiscal Years 1994 through 1998 to the SAIF for loss purposes only, subject to certifications by the FDIC's Board of Directors. Absent such funds, the SAIF would be authorized to borrow from the FDIC's \$30 billion credit line with the Treasury, with borrowings to be repaid over time with SAIF-member assessments.

Background

FIRREA abolished the FSLIC and the Federal Home Loan Bank Board (FHLBB). Their functions were transferred to the FDIC, the Office of Thrift Supervision (OTS), the Federal Housing Finance Board (FHFB), and the RTC. Under FIRREA, the FDIC became the administrator of two separate and distinct insurance funds: the Bank Insurance Fund (BIF), formerly the Deposit Insurance Fund, and the SAIF, the successor to the FSLIC Fund. Both insurance funds are maintained separately to carry out their respective legislative mandates, with no commingling of assets or liabilities.

A third separate fund under FDIC management is the FSLIC Resolution Fund (FRF). The FRF is funded through assessment revenue from SAIF-member institutions (through calendar year 1992) Congressional appropriations and asset sales. The RTC will resolve all troubled thrift cases that occur from January 1, 1989 through at least December 31, 1994, but not later than June 30, 1995, after which the SAIF will resolve all new thrift cases. The FRF will complete the resolution of all thrifts that failed or were assisted before January 1, 1989, and also will complete the resolution of any RTC conservatorships that are unresolved as of the RTC's termination in December 1995. Resolution responsibility is summarized in Table 1.

Primary Sources and Uses of Funds

The primary source of funds for the SAIF is assessment revenue from SAIF-member institutions. Since the creation of the SAIF and through the end of calendar year 1992, however, almost all assessments from SAIF-member institutions were diverted to other needs, as stipulated by FIRREA and as described below. Only SAIF assessment revenue generated from BIF-member institutions that acquired thrifts under Section 5(d)(3) of the Federal Deposit Insurance Act (FDI Act), *i.e.*, Oakar banks, was deposited in the SAIF throughout this period.

Through 1992, assessment revenue from SAIF-member institutions was diverted to the Financing Corporation (FICO)¹, the Resolution Funding Corporation (REFCORP)², and the FRF. Under Section 21 of the Federal Home Loan Bank (FHLB) Act, the FICO has an ongoing first claim on SAIF assessment income through the year 2019 to fund the interest payments on bonds issued by the FICO. Section 21 of the FHLB Act also requires that SAIF assessment income be used, if necessary, to provide funding for REFCORP.³ Because REFCORP's principal fund is fully funded, SAIF assessment income was not required for REFCORP purposes in 1992. During the period beginning on the date of enactment of FIRREA and ending on December 31, 1992, Section 11 of the FDI Act requires that "to the extent funds are needed" the sources of funds for the FRF shall include amounts assessed against SAIF members by the FDIC pursuant to Section 7 that are not required by FICO or REFCORP. Table 2 summarizes the flow of assessment revenue from 1989 through 1994.

Because most of SAIF's assessment revenue has been diverted since its inception, net revenue to the SAIF has been limited. However, there have been only limited demands on the SAIF, as losses were small and it was reimbursed by the FRF for administrative and supervisory expenses through September 30, 1992. SAIF's balance as of December 31, 1994, was \$1.9 billion and the fund is not expected to reach the 1.25 percent reserve ratio until 2002.

As noted above, assessment revenue net of the FICO obligation began flowing into the SAIF on January 1, 1993. SAIF now is obligated to fund its administrative and supervisory expenses, although the draw is relatively minor. By not sooner than January 1, 1995, and not later than

¹The FICO was created by the Competitive Equality Banking Act of 1987 (CEBA) as a mixed-ownership government corporation to recapitalize the FSLIC; its funds were used by the FRF after the enactment of FIRREA. The FICO's authority to issue obligations was terminated on December 12, 1991, by the Resolution Trust Corporation Thrift Depositor Protection Reform Act of 1991.

²The REFCORP was created by FIRREA as a mixed-ownership government corporation to provide funding for the RTC.

³SAIF assessment revenue was used to purchase zero-coupon bonds to repay the REFCORP obligations at maturity.

July 1, 1995, the SAIF will have responsibility for all new thrift resolutions.

Table 1 RESOLUTION RESPONSIBILITY: SAIF-MEMBER INSTITUTIONS			
	FRF	RTC	SAIF
Thrifts previously insured by FSLIC:			
Fail prior to 1/89	X		
Fail 1/89 - at least 12/31/94 but not later than 6/30/95		X	
Fail after not sooner than 1/1/95 and not later than 7/1/95			X
Conversion banks: Oakars and Ssassers⁴			X
Fail after 8/89			
Thrifts chartered post-FIRREA			X
Fail after 8/89			
Thrifts in RTC conservatorship, and all remaining RTC assets and liabilities as of December 1995	X		

⁴Under the "Oakar" Amendment, insured depository institutions are allowed to merge without changing insurance coverage for the acquired deposits. Oakar bank SAIF deposits are deposits insured by the SAIF but held by BIF-member banks. There were approximately \$154 billion in Oakar bank SAIF deposits as of March 31, 1994. Sasser deposits are insured by the SAIF but belong to banks that previously had been thrift institutions.

Table 2
Application of SAIF-Insured Institution Assessments
Dollars in Millions

Calendar Year	Cash Assessment Revenue	Assessments Diverted to:			Total Assessments Diverted	Cash Assessments Retained by SAIF
		FICO	REFCORP	FRF		
1989	\$ 394	\$ 295	\$ 0	99	\$ 394	\$ 0
1990	1,828	738	1,090	0	1,828	0
1991	1,883	757	(29)	1,155	1,883	0
1992	1,777	772	0	740	1,512	265
1993	1,690	779	0	0	779	911
1994	1,729	596	0	0	596	1,133
Total	9,302	3,937	1,061	1,994	6,993	2,309

Other Sources

There are several potential sources of funds for the SAIF apart from assessment revenue.⁵ First, a total of up to \$8 billion is authorized to cover insurance and losses under RTCCA for Fiscal Years 1994 through 1998. Funds may be appropriated for covering incurred losses only, subject to the following certifications to the Congress by the FDIC Board ("certification funds"):

- (1) SAIF members are unable to pay additional assessments at rates required to cover losses OR meet a repayment schedule for Treasury borrowings without adversely affecting the ability of SAIF members to raise and maintain capital or to maintain the assessment base; AND

⁵Although these provisions were replaced by those of RTCCA, 1) as revenue supplements, if needed to supplement net assessment revenue to reach \$2 billion annually for each of the Fiscal Years 1993 through 2000; and 2) as net worth supplements, to pay for any amounts that may be necessary to ensure that the SAIF meets the statutory specified minimum net worth for each of the Fiscal Years 1992 through 2000. No funds were ever appropriated under the FIRREA authorization.

- (2) An increase in assessment rates needed to cover losses OR repay Treasury borrowings could reasonably be expected to result in greater losses to the Government.

One problem with this language is the ambiguity concerning the definition of "unable to pay." Moreover, the two-pronged nature of the test makes it difficult for the FDIC Board to make the certification except under extreme conditions.

Any unexpended RTC funds before the end of the two-year period beginning at the date of the RTC's termination may be provided to the SAIF to cover losses, provided that the above certifications to the Congress are made by the Board.

FIRREA also authorizes the SAIF to obtain working capital by borrowing funds from the Federal Financing Bank (FFB). For loss funds, the SAIF may borrow from the Treasury (as part of the FDIC's \$30 billion line of credit). Additionally, the SAIF may borrow from the Federal Home Loan Banks. Finally, FIRREA allows for discretionary payments to be made to the SAIF by the RTC.⁶

Outlook

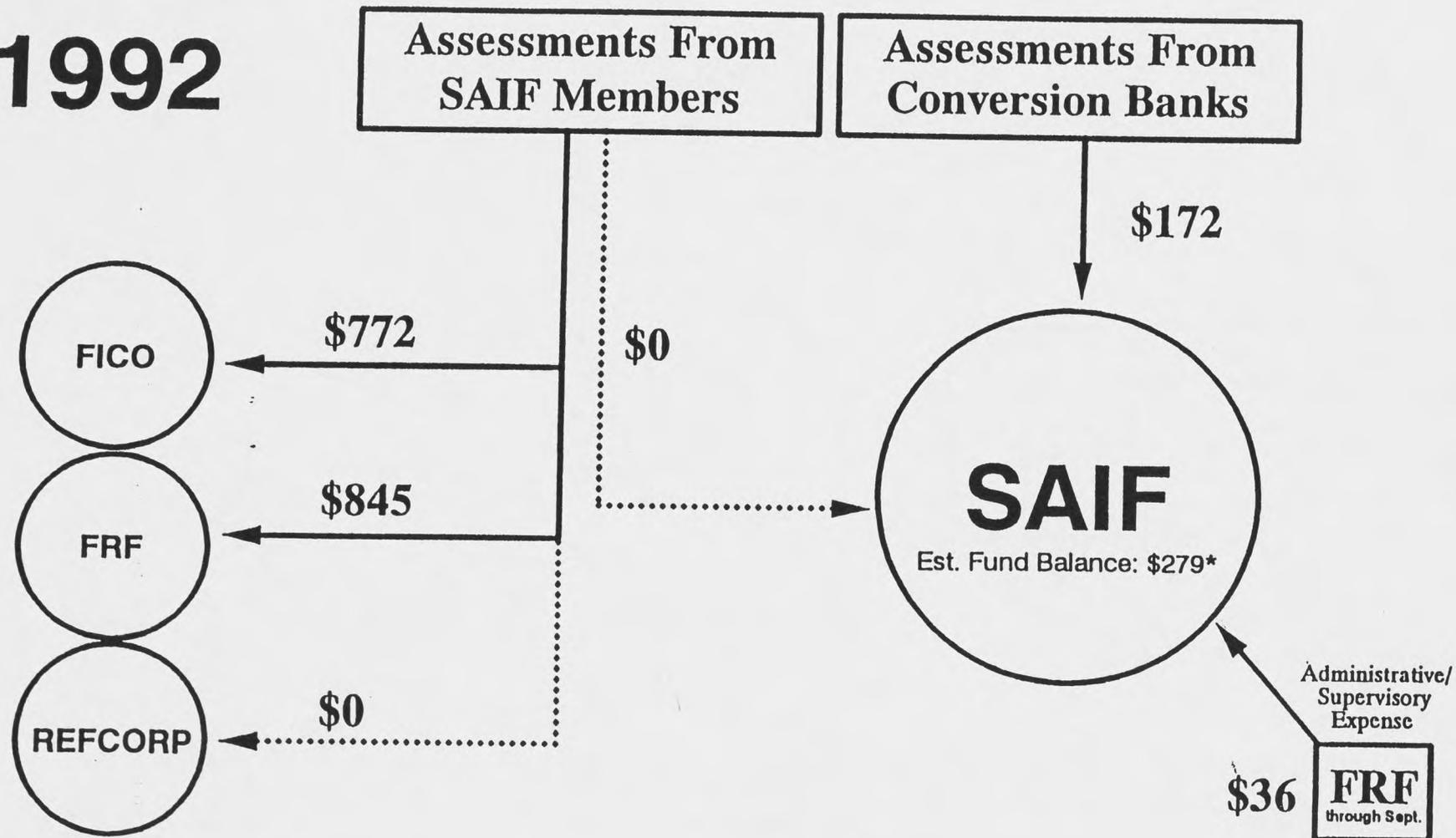
There is tremendous uncertainty regarding the future caseload of SAIF. If the economy falters, it is possible that the SAIF would need to borrow from the \$30 billion credit line if it is responsible for resolving a large number of thrifts. Alternatively, the need to borrow could be avoided if certification funds were appropriated upon meeting the required certifications.

The attached diagrams illustrate the sources and uses of SAIF funds between 1991 and June 30, 1994.

⁶These sources are shown in the diagram illustrating sources of funds for the SAIF for 1993, but not earlier, because these sources have not been accessed yet.

SAIF: Sources of Funds

1992

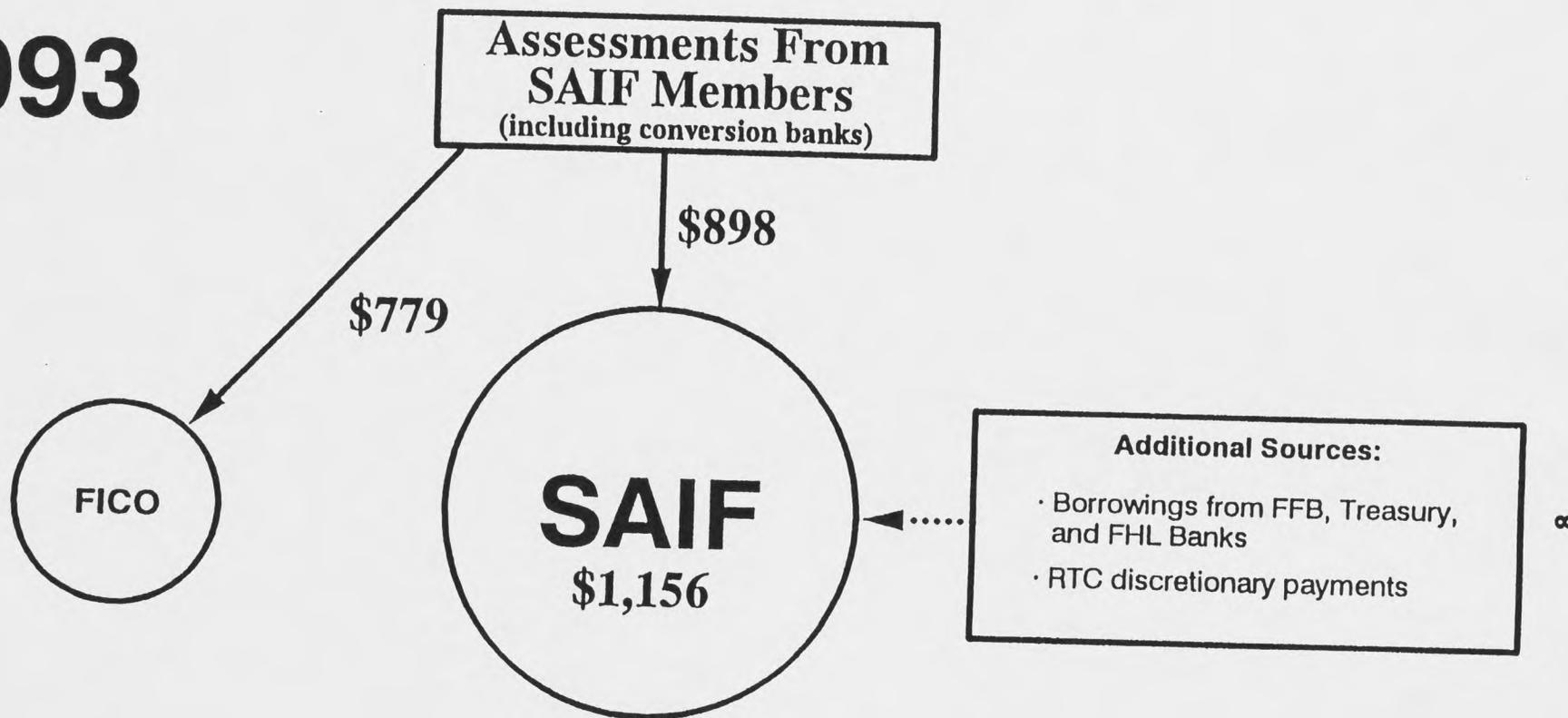


All dollar amounts in millions.

* Estimated year-end fund balance.

SAIF: Sources of Funds

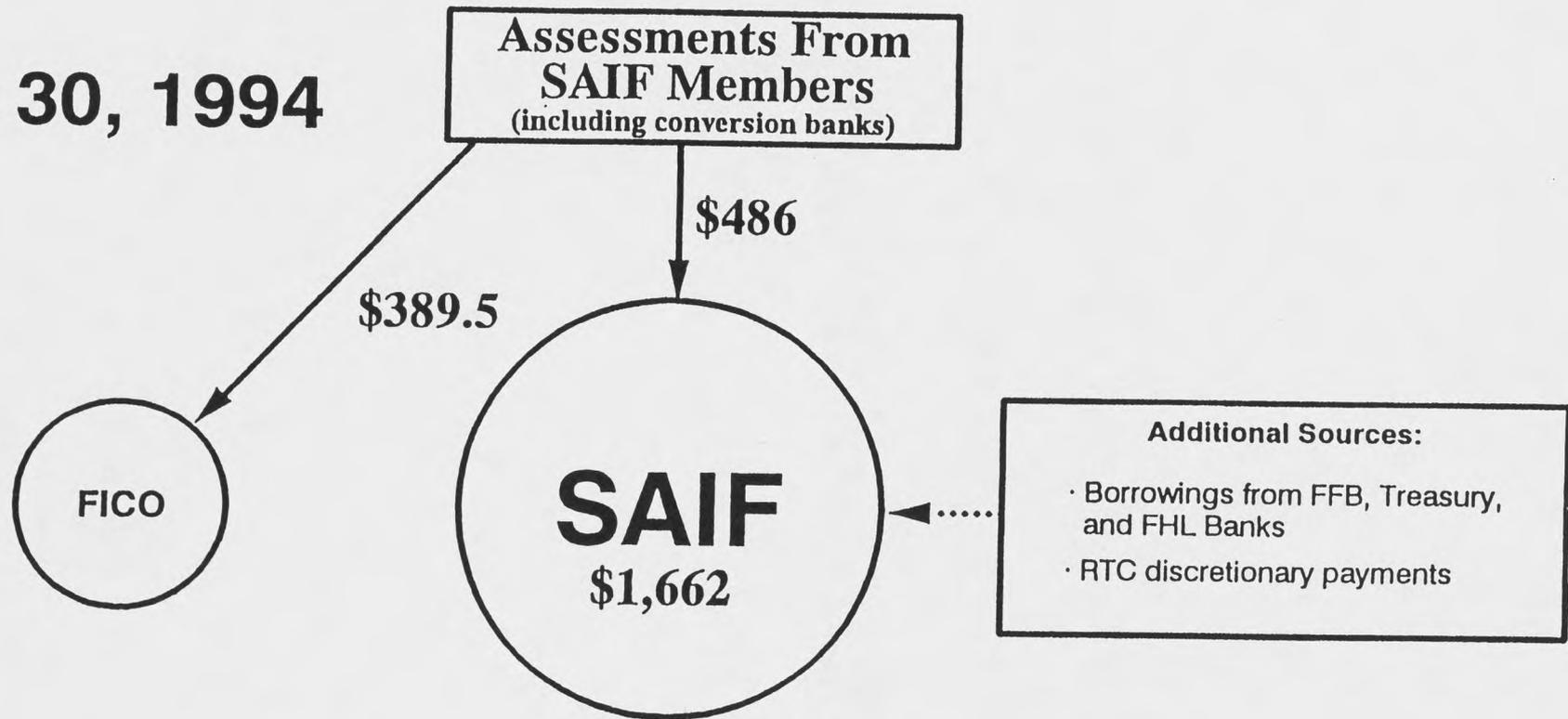
1993



All dollar amounts in millions.

SAIF: Sources of Funds

June 30, 1994



All dollar amounts in millions.

Analysis of Issues Confronting the Savings Association Insurance Fund



**Federal Deposit Insurance Corporation
Division of Research and Statistics**

March 1995

Executive Summary

In its recent proposals on deposit insurance assessment rates, the FDIC Board of Directors (Board) proposed to lower assessment rates for all but the riskiest BIF-insured institutions upon recapitalization of the BIF. However, as the SAIF is much farther away from capitalizing, the Board proposed to retain the existing assessment rates for the SAIF. If adopted as proposed, there would be a rate differential between the average BIF assessment rate of 4.5 basis points and the average SAIF assessment rate of 24 basis points. This so-called "SAIF differential" would be approximately 19.5 basis points. This premium differential arises for two reasons discussed below--the need for SAIF members to build their fund to the designated reserve ratio and the draw on SAIF revenues from assessments levied by the Financing Corporation (FICO).

The SAIF currently is substantially undercapitalized; its year-end 1994 unaudited fund balance of about \$1.9 billion is \$6.7 billion shy of the amount needed to achieve the designated reserve ratio. The SAIF would have capitalized by year-end 1994 if assessment revenue had not been diverted for other purposes. These diversions began with the inception of the SAIF in 1989 and totaled \$7 billion through 1994: \$3.9 billion for the Financing Corporation (FICO), \$2 billion for the FSLIC Resolution Fund and \$1.1 billion for the Refinancing Corporation. As a result of this history, SAIF resources are inadequate to handle the failure of a large thrift or several medium-sized thrifts. The longer the undercapitalization is allowed to persist, the greater the chance that unanticipated losses will prevent the SAIF from meeting its target. This is a particular concern because the analysis shows that while under a relatively optimistic baseline assumption the SAIF capitalizes in 2002, this date is extremely sensitive to assumptions about the volume of assets in failing thrifts.

The FICO assessment is currently the primary obstacle to capitalizing the SAIF as well as the primary source of the premium differential. The FICO assessment, which pays interest on 30-year FICO bonds issued between 1987 and 1989, amounts to approximately \$780 million per year, or 45 percent of current SAIF assessment revenue. The FICO has a first claim on SAIF-member assessments that will continue until the year 2019. The premium disparity arising from the FICO assessment thus will last for 24 years and currently amounts to 11 basis points paid by SAIF members; this figure is likely to increase given the probable shrinkage of the SAIF assessment base. The SAIF assessments that are available to FICO, however, are limited by law to those assessments paid by institutions that are both SAIF members and savings associations. Two types of institutions, so-called "Oakar" and "Sasser" institutions, do not meet both criteria. As a result, FICO payments depend on revenues raised from approximately 67 percent of the SAIF assessment base.

There are two potential effects of the premium disparity that are of concern. First and most immediate is the potential for a substantial shrinkage or change in composition of the SAIF assessment base that could imperil the ability of the FICO to service its obligations. This can occur in two ways. One is through Oakar acquisitions or Sasser conversions, in which case the deposits stay in the SAIF but are not available for FICO payments. The second way is for deposits to migrate from the SAIF to the BIF. This can come about as thrifts lose deposits to bank competitors who pass on the differential to customers or through legal, regulatory, or other

maneuvering by thrift holding companies that attempt to migrate deposits into new or existing banking subsidiaries. Even assuming minimal shrinkage of two percent per year in the FICO-available assessment base and a moderate increase in Oakar acquisitions, FICO interest payments cannot be serviced at current assessment rates by the year 2005. Rapid shrinkage of 10 percent per year creates a FICO problem within two years. Such a scenario is not unrealistic in light of recent announcements by thrift institutions attempting to establish new banking charters, and the existence of other methods of transferring SAIF deposits to the BIF that do not require regulatory approval.

The second concern is that the premium disparity could adversely affect the health of the thrift industry and could result in increased losses to the SAIF. A premium differential could adversely impact SAIF-insured institutions by increasing the cost of remaining competitive with BIF-member institutions. Of particular concern to the FDIC is the impact a differential could have on weaker SAIF-insured institutions and on failure rates for these institutions. An analysis using a thrift model based on 1994 performance shows that under a variety of interest-rate and asset-quality assumptions a premium differential of 20 basis points appears unlikely to increase failures beyond a level manageable by the SAIF. The analysis shows that the possible effects of rising interest rates and/or deteriorating asset quality may have greater effects on failure rates -- and therefore pose greater risks to the SAIF -- than would a differential. Such potential effects have led the FDIC to express concern about the undercapitalization of the SAIF since its creation.

An Analysis of the Issues Confronting the Savings Association Insurance Fund

I. The Problems Facing the SAIF

The SAIF Is Undercapitalized

The FDIC Board of Directors (Board) recently issued for public comment separate proposals on assessment rates for the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). The BIF is rapidly approaching recapitalization; the reserve ratio of the BIF to estimated insured deposits is expected to reach the statutory minimum Designated Reserve Ratio (DRR) of 1.25 percent between May 1 and July 31, 1995. As of December 31, 1994, the BIF had a fund balance of \$21.8 billion (unaudited) and an estimated reserve ratio of 1.15 percent. Upon recapitalization, the fund balance is expected to be almost \$25 billion. The BIF has reached this goal much more rapidly than originally projected; as a result, an average BIF assessment rate of 23 basis points, or 23 cents for every \$100 of insured deposits, will no longer be required by law.¹ The law requires that BIF assessment rates be set to maintain the DRR after that ratio has been achieved. There is currently no factual basis for raising the DRR above 1.25 percent because at present there is no indication of significant risk of substantial future losses to the fund. Accordingly, in order to maintain the DRR at the statutory target of 1.25 percent, the Board proposed to lower assessment rates for all but the riskiest BIF-insured institutions, while maintaining a risk-based assessment rate structure.²

However, the SAIF is much farther from achieving the DRR of 1.25 percent of estimated insured deposits mandated by Congress and is not expected to become fully capitalized until the year 2002. As of year-end 1994, the fund balance stood at \$1.9 billion (unaudited), while the target is approximately \$8.7 billion. Thus, the SAIF currently remains undercapitalized. It has been widely recognized for some time that this is the fundamental problem facing the SAIF.³

¹The legal requirement for a weighted average assessment of 23 basis points will become operative if the reserve ratio remains below the DRR for at least a year.

²In addition to a new assessment rate schedule, the Board proposed to widen the rate spread of the current risk-based assessment rate structure applicable to BIF-insured institutions. The assessment rate for institutions in the best risk classification would be reduced from 23 to 4 basis points; the weakest institutions would continue to pay 31 basis points. The resulting rate spread from best-rated to weakest would be 27 basis points. The average assessment rate under the proposed schedule would be 4.5 basis points. Assessment rates for all nine risk categories are shown in the proposed BIF assessment rate schedule (Attachment 1). See Federal Register 60 (February 16, 1995): 9270-79.

³This issue has been recognized by the FDIC since the creation of the SAIF. It was raised on January 10, 1992, in a letter from William Taylor, Chairman of the FDIC, to Richard Darman, Director, U.S. Office of Management and Budget, and it was raised again in a letter,

Beginning July 1, 1995, the SAIF will assume responsibility for resolution of failures of SAIF members from the Resolution Trust Corporation (RTC). As the insurer, the FDIC, in particular, is concerned about the ability of the SAIF to handle a large failure or several mid-sized failures without additional capitalization.

The Board has the authority to reduce SAIF assessment rates to 18 basis points, or 18 cents for every \$100 of insured deposits, until January 1, 1998, after which the average rate must remain at 23 basis points or higher until the SAIF is capitalized. However, reduction of the average rate to 18 basis points is projected to delay capitalization of the SAIF by three years, until 2005. Moreover, if assessment rates were lowered to 18 basis points as allowed, it is projected that available SAIF assessment revenues would not be sufficient to cover fully the interest payment on FICO bonds as early as 1996.⁴ Given that the SAIF remains undercapitalized and that the SAIF soon will begin resolving failures of SAIF members, the Board chose to retain the existing assessment rates for the SAIF. The existing SAIF assessment rate schedule yields an average assessment rate of 24 basis points, or 24 cents for every \$100 of insured deposits.⁵ The details of the FDIC's projections for SAIF capitalization are discussed in the following section of this report.

Why the SAIF Is Undercapitalized

The SAIF is behind in meeting its target because for the first three years of its existence, 1989 to 1992, SAIF-member assessment revenue did not flow to the SAIF; instead it was used to pay for Federal Savings and Loan Insurance Corporation (FSLIC) losses incurred before the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). From 1989 through 1992, approximately 95 percent of total SAIF assessment revenue was diverted to the FSLIC Resolution Fund (FRF), the Resolution Funding Corporation

dated February 20, 1992, from Stanley J. Poling, Director, FDIC Division of Accounting and Corporate Services, to Jerome H. Powell, Assistant Secretary for Domestic Finance, U.S. Treasury. More recently, the issue was addressed in a letter dated September 23, 1993, from Andrew C. Hove, Jr., FDIC Acting Chairman, to the House and Senate Banking Committee Chairmen and Ranking Minority Members. (See Attachment 2.) See, for example, the Testimony of Andrew C. Hove, Jr., Acting Chairman of the FDIC, on "The Condition of the Banking and Thrift Industries," before the United States Senate Committee on Banking, Housing and Urban Affairs, September 22, 1994.

⁴FICO bonds and FICO's assessment authority on SAIF assessment revenues are discussed in the following section.

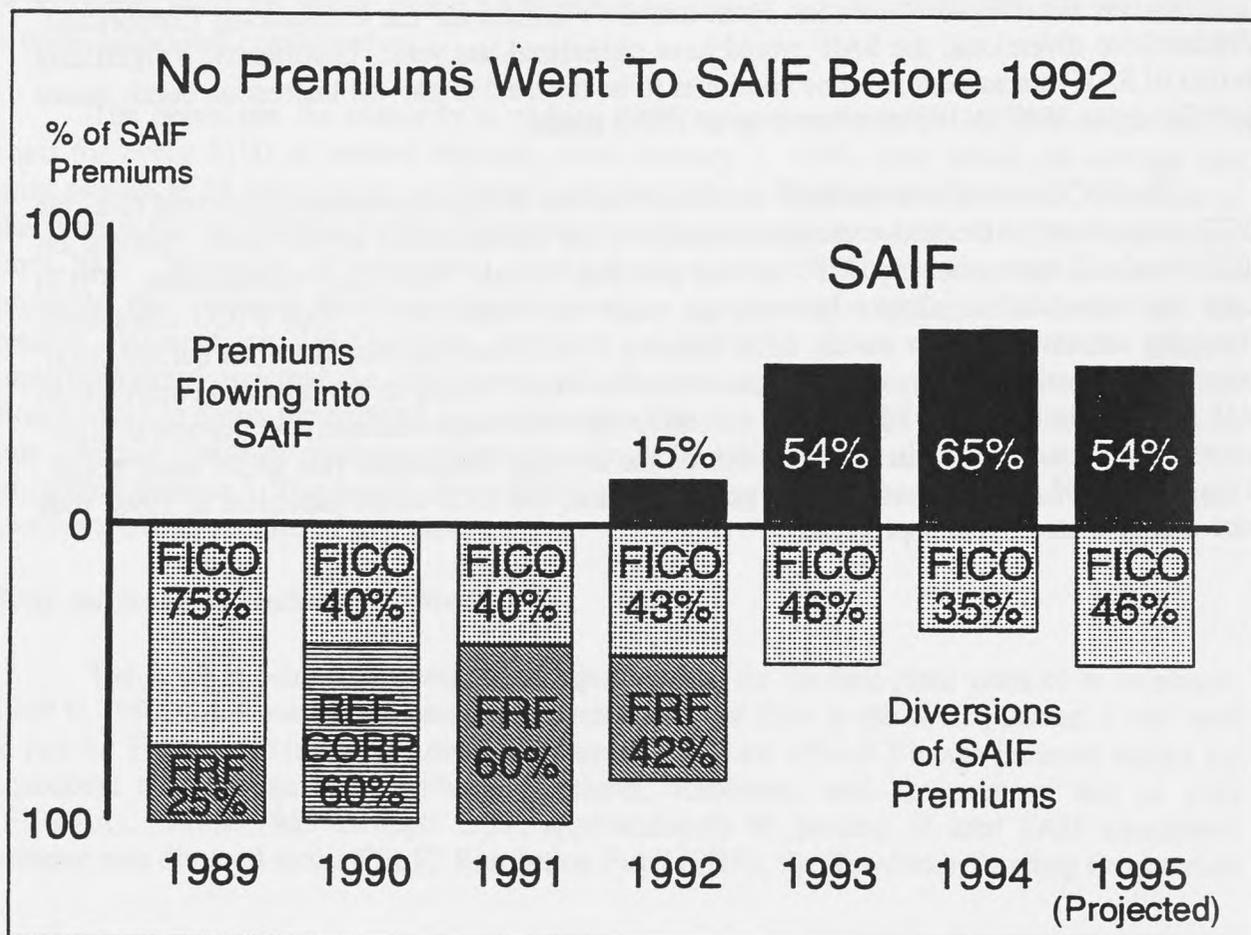
⁵The proposed SAIF assessment rate schedule is shown in Attachment 1. See Federal Register, 60 (February 16, 1995): 9266-70.

(REFCORP) and the Financing Corporation (FICO).⁶ As detailed in Figures 1 and 2, these diversions totaled \$7 billion through 1994: \$3.9 billion for the Financing Corporation (FICO), \$2 billion for the FSLIC Resolution Fund and \$1.1 billion for the Refinancing Corporation. Without these diversions, the SAIF would have capitalized last year. Importantly, a significant portion of SAIF assessment revenue continues to be diverted to pay the interest on bonds issued by FICO from 1987 to 1989, referred to as FICO bonds.

The FICO assessment on SAIF members that are savings associations, referred to as the FICO assessment, is the major current obstacle to the capitalization of the SAIF. Interest on FICO bonds of approximately \$780 million per year is paid from SAIF assessments. FICO bonds are scheduled to mature between the years 2017 and 2019. This FICO assessment effectively amounts to a tax on the thrift industry. FICO has the first draw on current SAIF assessment revenue, draining revenue that otherwise would belong to the fund and contribute to SAIF's capitalization. The FICO draw currently represents approximately 45 percent of SAIF assessment revenue, or 11 basis points out of the average assessment rate of 24 basis points. In the absence of the FICO assessment going forward, the SAIF could capitalize in 1998, four years earlier than currently projected.

⁶The remaining 5 percent consists primarily of assessment revenue from BIF-member banks that owned SAIF-insured deposits. Until July 1, 1995, the SAIF's total resolution responsibility is limited to the SAIF-insured portion of these BIF-member institutions.

FIGURE 1



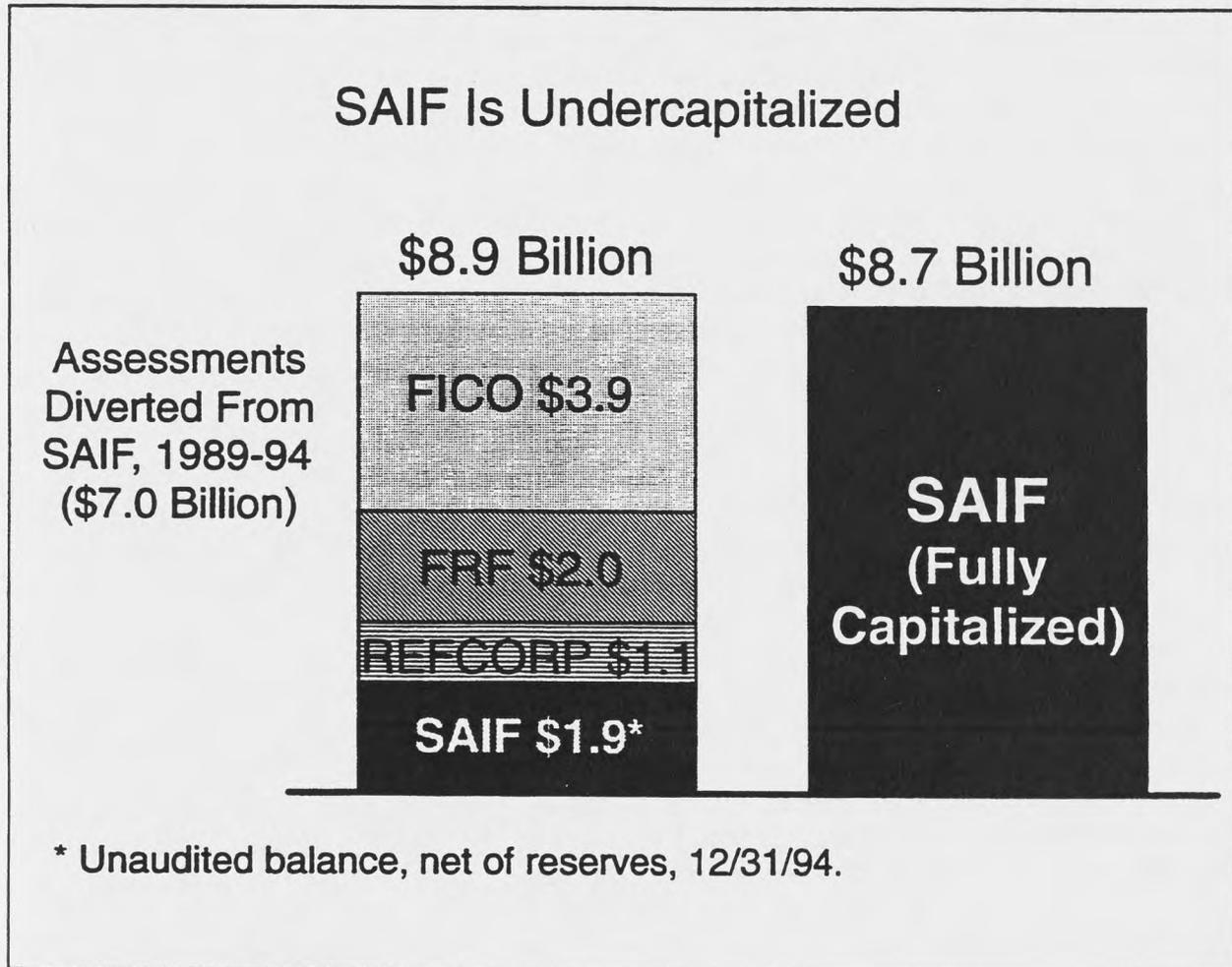
Dollars in Millions)

Diversion of SAIF

Assessments, Total	1989	1990	1991	1992	1993	1994	1995
Assessments, Total	\$394	\$1,828	\$1,883	\$1,512	\$779	\$596	\$779
FICO	295	738	757	772	779	596*	779
FRF	99	0	1,155	740	0	0	0
REFCORP	0	1,090	(29)	0	0	0	0
Cash Assessments							
Flowing into SAIF	0	0	0	265	911	1,133	903
Total SAIF Assessment Revenue	\$394	\$1,828	\$1,883	\$1,777	\$1,690	\$1,729	\$1,682

*The 1994 FICO payment reflects a one-time \$185 million refund of excess cash by FICO.

FIGURE 2



The Ability of the SAIF to Fund FICO

The SAIF assessments that are available to FICO are limited by law to those assessments paid by institutions that are both SAIF members and savings associations.⁷ Two types of institutions, so-called "Oakar" and "Sasser" institutions, do not meet both criteria. Oakar institutions, which are created from the purchase of SAIF-insured deposits by a BIF member, pay assessments to both the BIF and the SAIF based on the proportion of BIF- and SAIF-insured deposits held by the institution at the time of purchase. They are BIF members. Oakar institutions held 25.2 percent of the SAIF assessment base as of year-end 1994. Sasser institutions are SAIF members that have switched charter type and primary federal supervisor without changing insurance fund membership; that is, they are either commercial banks (state- or federally chartered) or FDIC-supervised state savings banks. They are not savings associations. Sasser deposits as of year-end 1994 comprised 7.4 percent of the SAIF assessment base.

Since 1989, Oakar and Sasser institutions have increased their combined share of the SAIF assessment base to approximately 33 percent as of the fourth quarter of 1994. FICO payments depend on revenues raised from the remaining 67 percent of the assessment base. If the Oakar and Sasser portion of the SAIF assessment base continues to increase, it will become increasingly difficult to make FICO interest payments from current SAIF assessment revenues. A legislative change to make Oakar and Sasser assessment revenue available to FICO would reduce the likelihood of a near-term FICO shortfall, but would not address the fundamental implications of the drain from the SAIF represented by the FICO draw on SAIF assessments.

In the absence of further movement of the SAIF deposit base into Oakar and Sasser institutions, the ability of the SAIF to fund FICO will be affected by continued overall shrinkage of SAIF deposits. The issues relating to such shrinkage of deposits are discussed below.

The SAIF Differential

One important effect of the FICO assessment is to exacerbate any differential that may exist between BIF and SAIF assessment rates. A "SAIF differential," that is, a difference between the average BIF assessment rate and the average SAIF assessment rate, will be created whenever the BIF recapitalizes and BIF assessment rates are lowered. The FDIC's proposed

⁷A 1992 FDIC legal opinion determined that FICO assessments can be made only on savings associations that are SAIF members. This opinion was described as "reasonable" by the Comptroller General in a letter to the FDIC Board of Directors, dated May 11, 1992 and recently reconfirmed by the FDIC. See Federal Register 60 (February 6, 1995): 7055-58.

change in BIF rates, if ultimately adopted by the Board, would create a SAIF differential of approximately 19.5 basis points (24 basis points minus 4.5 basis points).⁸

The presence of a SAIF differential likely would create an incentive for SAIF members to avoid assessments. However, there is currently a moratorium on fund conversions that generally prohibits institutions from converting their fund membership from the SAIF to the BIF. The moratorium on conversions will continue until the SAIF reaches the DRR of 1.25 percent. At that time, a SAIF differential would create an incentive for SAIF members to convert, thus further reducing the SAIF assessment base. Nonetheless, conversions from the SAIF to the BIF will not be costless: SAIF members will be required to pay an exit fee to the SAIF and an entrance fee to the BIF.⁹ SAIF members choosing to convert also will face costs related to the tax treatment of their cumulative loss reserve deductions. These costs would limit the extent to which conversions from the SAIF to the BIF will occur after the SAIF has capitalized, absent alternatives for shifting deposits from the SAIF to the BIF.

As part of their efforts to minimize the impact of a differential, thrifts could reduce premium costs by shrinking their assessable deposits. Nonassessable liabilities, such as Federal Home Loan Bank advances, could be substituted for assessable deposits, or funding needs could be reduced through securitization. Because the FICO assessment is a fixed annual amount, further shrinkage in the SAIF assessment base could increase the FICO "tax" from the current 11 basis points, which would create an additional incentive to reduce the use of SAIF deposits.

The Great Western Proposal. A SAIF differential also creates an incentive to migrate deposits from the SAIF to the BIF. For example, deposit migration between SAIF- and BIF-member institutions within a holding company structure could occur. On March 1, 1995, Great Western Financial Corporation, the parent company of a SAIF-member federal savings bank with offices in California and Florida, announced that it had submitted applications for two national bank charters. These commercial banks would share Great Western's existing branch locations. Presumably, with higher deposit interest rates being offered by the BIF subsidiary, customers would be enticed to move their deposits from the SAIF subsidiary to the BIF subsidiary, and these transfers would not be subject to exit and entrance fees. By mid-March, five other SAIF-insured institutions had indicated that they are considering similar actions. If these efforts are successful, certainly others will follow, and there is a potential for dramatic shrinkage in the SAIF assessment base. These first six institutions have about \$80 billion in SAIF deposits, or nearly 12 percent of the SAIF assessment base. Removal of these deposits

⁸An analysis of the impact of a SAIF differential on troubled SAIF-insured institutions is presented in Section III of this report.

⁹The SAIF exit fee is 90 basis points applied to the amount of insured deposits that are transferred from the SAIF to the BIF. The BIF entrance fee is the BIF reserve ratio applied against the amount of insured deposits transferred.

from the SAIF would result in a significantly smaller base from which to generate the fixed FICO assessment.

Such a large shift in deposits would also have ramifications for the BIF. An additional \$80 billion in BIF-insured deposits would require an additional \$1 billion in BIF reserves -- 1.25 percent of \$80 billion. While these announcements are unlikely to result in a large enough shift in insured deposits from the SAIF to the BIF by midyear to delay recapitalization of the BIF, such a shift could ultimately push the reserve ratio below 1.25 percent. If this were to occur, premiums paid by banks would have to be increased in order to again reach and maintain the 1.25 target ratio. The six new BIF members would begin contributing assessments to the BIF, but other BIF members would pay the preponderance of the needed \$1 billion addition to reserves. It is estimated that many more thrift institutions are considering ways of shifting deposits to the BIF.

While the announced proposals require various approvals associated with chartering new institutions, there are other means to achieve the same ends that do not require such approvals, and are likely to lead to a further shrinkage in the SAIF assessment base. For example, existing affiliations between BIF and SAIF members enable deposit-shifting without the need for new charters or approvals by regulators. Markets respond to cost differences; those who suggest that regulators can prevent the movement of deposits out of the SAIF appear to underestimate the market's ability to innovate around constraints. If the rate of shrinkage in the SAIF assessment base increases to 4 percent per year as a result of all available techniques, then the ability of SAIF to fund FICO is threatened as early as 2001. Rapid shrinkage of 10 percent per year creates a FICO problem within two years. Such a scenario is not unrealistic in light of recent announcements by thrift institutions attempting to establish new banking charters, and the existence of other methods of transferring SAIF deposits to the BIF that do not require regulatory approval.

Conclusions

Lower BIF premiums are not the fundamental problem, and an overcapitalized BIF is not the solution. If BIF premiums were not reduced until the SAIF reserve ratio reaches 1.25 percent of insured deposits, as mandated by the Congress, the BIF would grow under reasonable assumptions regarding bank failures to approximately \$70 billion, or 3.2 percent of insured deposits and \$45 billion more than the \$25 billion the BIF is expected to have upon recapitalization. Overcapitalization of the BIF does not facilitate the capitalization of the SAIF, which is the fundamental issue.

The existence of a differential is likely to initiate actions by thrifts to lessen or even eliminate its effects and also may cause the rate of failures to increase as the profitability of the thrift industry declines. As subsequent analysis will show, however, the premium differential by itself is not likely to cause a substantial increase in failures. Nevertheless, the SAIF remains vulnerable to unanticipated increases in losses. As illustrated in Figure 3, if thrift failures rise minimally to one-half the level that banks have experienced over the past twenty years, that is,

22 basis points or about \$2 billion per year, the SAIF would capitalize by 2002. If thrift failure rates are slightly more than double the rate experienced by banks over the past twenty years, SAIF will not capitalize and the fund will become insolvent early next century.

It is difficult to anticipate how thrifts will react to the differential, but it is certain that there is a potential for rapid shrinkage of the SAIF assessment base. This can come about in two ways. One is through Oakar acquisitions or Sasser conversions, in which case the deposits stay in the SAIF but are not available for FICO payments. The second way is for deposits to migrate from the SAIF to the BIF. This can come about as thrifts lose deposits to bank competitors that pass on the differential to customers or through defensive maneuvering by thrift holding companies who attempt to migrate deposits into new or existing banking subsidiaries. Under a baseline assumption incorporating minimal shrinkage of 2 percent per year in the FICO-eligible SAIF deposits and a moderate increase in Oakar purchases, FICO interest payments cannot be serviced at current assessment rates by the year 2005. Rapid shrinkage of 10 percent per year creates a FICO problem within two years, a scenario that is not unrealistic in light of recent announcements referred to above. Such scenarios are considered in Figure 4.

FIGURE 3

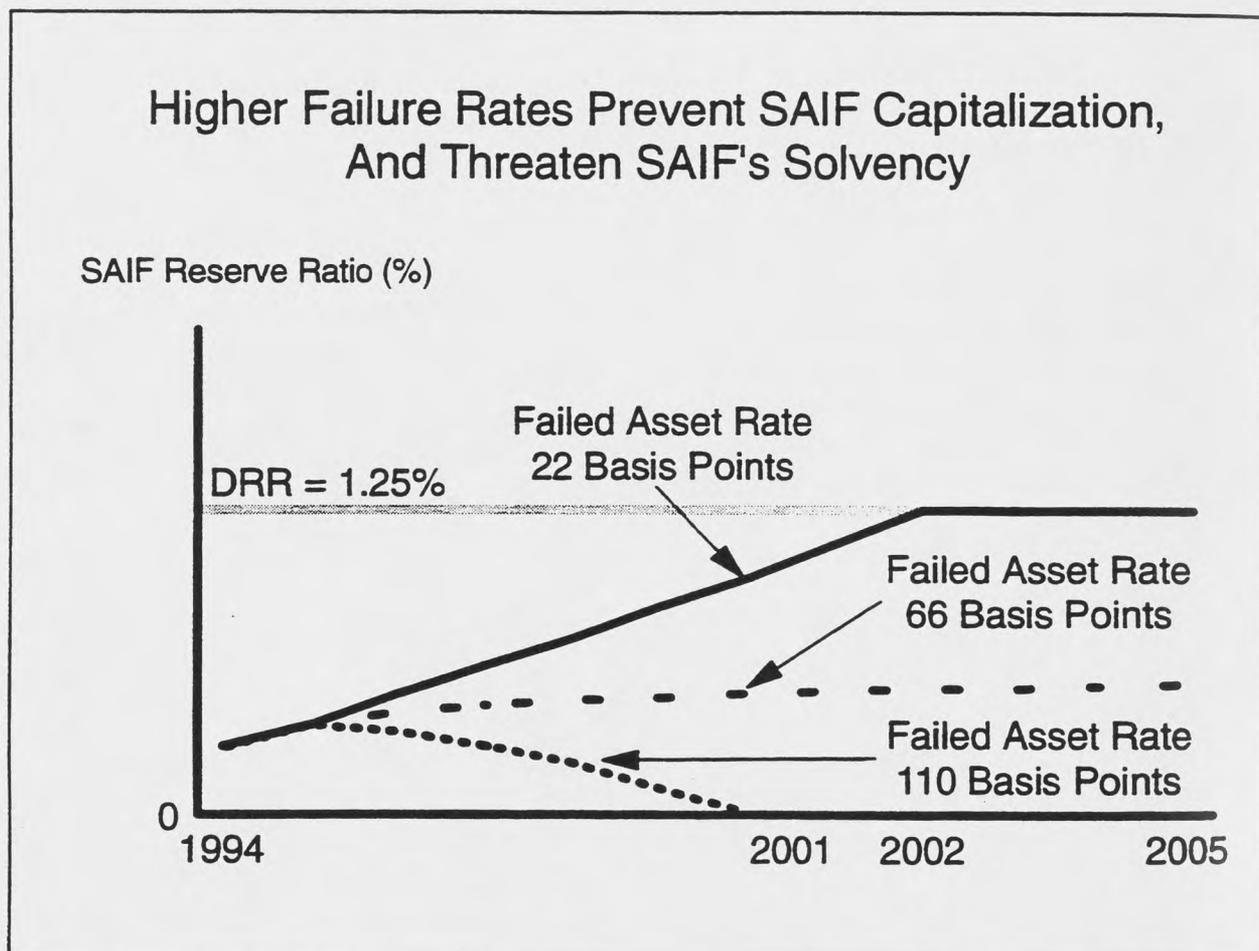
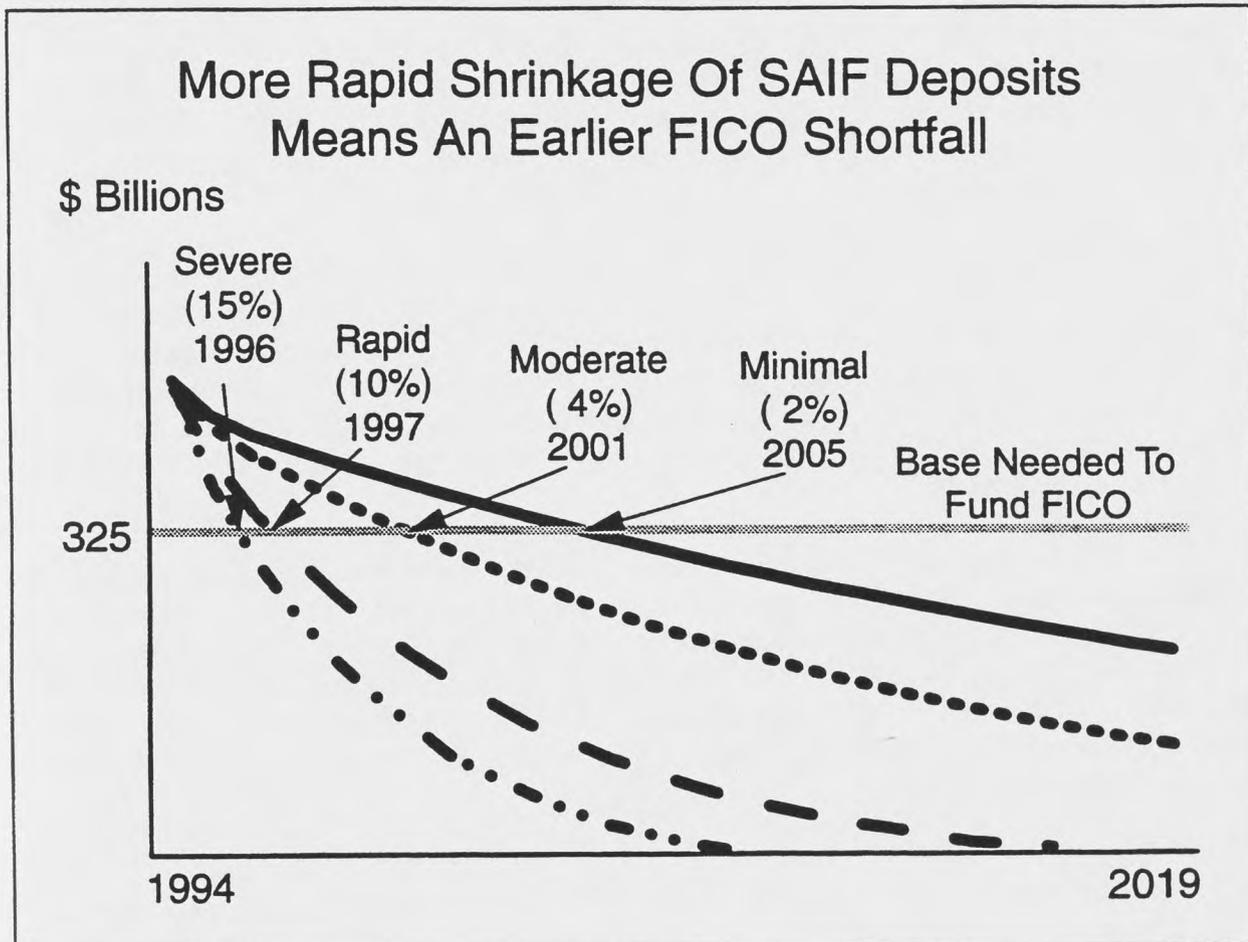


FIGURE 4



II. FDIC "Baseline" Projections for the SAIF

The ability of the SAIF to capitalize and to meet the FICO assessment will be affected by a variety of factors. The growth or shrinkage of thrift deposits, the number of thrift failures and the dollar amount of failed assets going forward will affect the SAIF's fund balance. Other factors, such as the percentage of thrift industry deposits held by Oakar and Sasser institutions, in light of statutory constraints on the use of those institutions' assessments for FICO payments, also will have an influence.

Assuming modest insurance losses, moderating growth of Oakar institutions, and a slight decline in thrift deposits over the next few years, the FDIC's "baseline" projection shows that the SAIF is expected to capitalize by reaching the DRR of 1.25 percent of insured deposits in the year 2002. This result is unchanged from previous projections made in September 1994 and January 1995. Under these assumptions, it also is expected that there would be sufficient assessment revenue to cover the FICO interest payment through the year 2004, but a shortfall will occur in the year 2005.

It must be emphasized that these assumptions are for analytical purposes, and while the projections cover a period of 20 years or more, their fundamental purpose is to support the setting of assessment rates for a six-month period, in this case the second semiannual assessment period of 1995. A significant variation in any one of the assumptions could substantially affect the ability to fund FICO or capitalize the SAIF, or both. The sensitivity of these factors to changing assumptions is discussed in Section IV. A discussion of the assumptions used in the baseline projection follows:

- Failed-institution assets for 1995 and 1996 are based on estimates made by the FDIC's interdivisional Bank and Thrift Failure Working Group¹⁰. In November 1994, the Working Group estimated failed SAIF-insured institution assets at \$3 billion for 1995 and \$2 billion for 1996. The 1995 estimate of \$3 billion is based on the Division of Supervision's projected failure of specific institutions that could occur in the second half of the year, when the SAIF assumes resolution responsibility from the RTC. Beyond 1996, the assumed failed-asset rate for SAIF will be 22 basis points, or about \$2 billion per year.¹¹

In the FDIC's projections, banks and thrifts were assumed to face similar longer-run loss experience. The BIF's historical average failed-asset rate from 1974 to 1994 was about

¹⁰The Working Group's membership is comprised of representatives of the Divisions of Research and Statistics, Supervision, Finance, and Resolutions.

¹¹The failed-asset rate is based on the total assets of SAIF members, adjusted for Oakar deposits.

45 basis points. However, a lower failure rate than the recent historical experience of the BIF was assumed because the thrift industry is relatively sound following the RTC's removal of failing institutions from the system, and the health and performance of the remaining SAIF members has improved markedly. As of year-end 1994, 86 percent of all SAIF-member institutions were in the best risk classification of the FDIC's risk-related premium matrix.

One of the purposes of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) was to minimize losses to the insurance funds. FDICIA increased regulatory oversight and emphasized capital. Specifically, FDICIA requires the closing of failing institutions prior to the full depletion of their capital, limits riskier activities by institutions that are less than adequately capitalized, and establishes audit standards and statutory time frames for examinations. The law also requires the implementation of risk-related assessments, which have provided effective incentives for institutions to achieve and maintain the highest capital and supervisory standards. In light of these provisions, the high levels of thrift failures and insurance losses experienced over the past decade are not an appropriate baseline for the industry's future performance.

- The nominal loss rate on failed-thrift assets will be 13 percent. The expected loss rate rises to 15 percent when the present value of the interest cost over the life of a receivership is included. This loss rate approximates the loss experience of the BIF since 1986.
- The asset growth rate for SAIF members will be zero, based on the industry's recent experience reflected in Table 1, which shows a slowing in asset shrinkage as fewer institutions are placed into RTC conservatorship. Since the beginning of 1993, the total assets of those SAIF members not in conservatorship have been quite stable, even increasing slightly in each of the last three quarters of 1994. During this period, SAIF-member failures declined to nine in 1993 and two in 1994.

Table 1
Total Assets of SAIF-Member Institutions
(\$ Millions)

Year: Qtr	Not In Conservatorship		In Conservatorship		Total	
	Assets	4-Qtr Change	Assets	4-Qtr Change	Assets	4-Qtr Change
94:4	772,342	2.0%	1,993	-90.9%	774,335	-0.6%
94:3	764,121	0.6	3,574	-87.2	767,705	-2.5
94:2	756,385	-1.1	11,999	-62.9	768,384	-3.6
94:1	752,522	-2.4	19,744	-39.8	772,266	-4.0
93:4	757,358	-8.1	21,901	-41.3	779,259	-9.6
93:3	759,745	-9.0	28,010	-12.0	787,755	-9.2
93:2	764,429	-10.6	32,361	48.1	796,790	-9.1
93:1	771,236	-11.5	32,816	28.1	804,052	-10.4
92:4	824,266	-6.7	37,289	-15.5	861,555	-7.1
91:4	883,187	-11.8	44,150	-43.9	927,337	-14.2
90:4	1,001,804	-12.7	78,658	-14.3	1,080,462	-12.8
89:4	1,147,611	--	91,768	--	1,239,379	--

- The SAIF assessment base will continue to shrink, at 2 percent per year. Deposit shrinkage since 1989 is shown in Figure 5 and Table 2. Although the emergence of a SAIF differential may encourage less reliance on SAIF-assessable liabilities, the higher overall shrinkage rates of recent years have slowed dramatically, from around 7 percent per year in the years 1990 through 1992 to 1.2 percent in 1994.

As can be seen in Figure 5, a significant portion of the shrinkage is attributable to the decline in RTC conservatorships. Since 1989, the cumulative reduction in deposits from the time when institutions were placed in conservatorship to when they were resolved was \$82 billion. Although some portion of these deposits were transferred to other

FIGURE 5

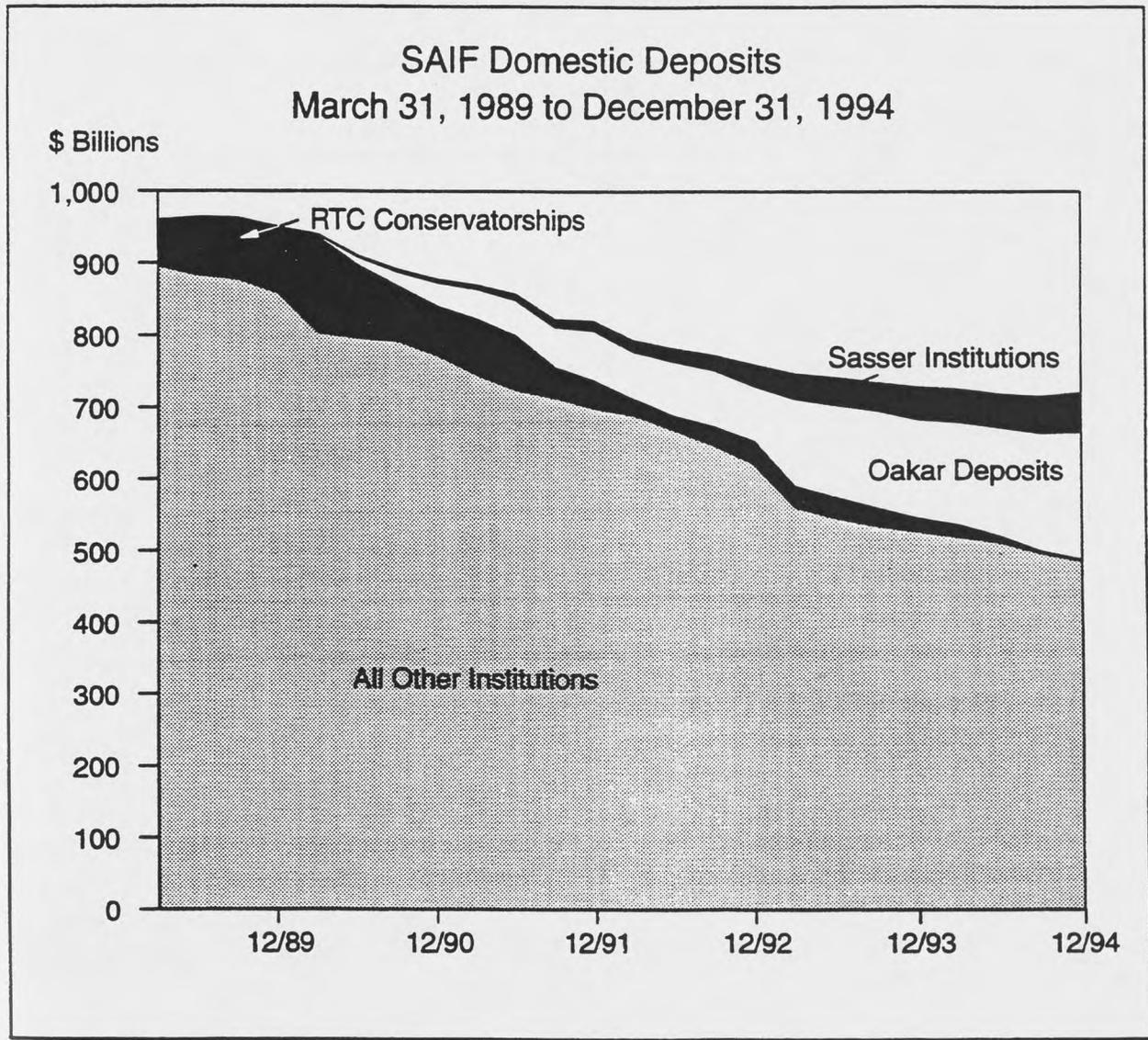


Table 2
SAIF Assessment Base: Domestic Deposits (\$ Millions) and
Percentage Change from Prior Year-End

Year	Oakars *	Sassers *	Conservatorships **	Other **	SAIF Total
1994	180,118 28.8%	52,848 21.4%	1,629 -90.9%	486,228 -5.6%	720,823 -1.2%
1993	139,795 80.6%	43,520 51.2%	17,913 -43.1%	528,211 -15.2%	729,429 -4.1%
1992	77,395 9.9%	28,788 139.5%	31,480 -15.4%	622,813 -11.1%	760,475 -7.3%
1991	70,434 107.3%	12,018 333.2%	37,202 -45.1%	700,574 -9.4%	820,228 -6.5%
1990	33,971 1,494.1%	2,774 NM%	67,767 -24.4%	773,151 -9.9%	877,663 -7.6%
1989	2,131	0	89,687	858,457	950,275

* Not available for FICO assessment

** Available for FICO assessment

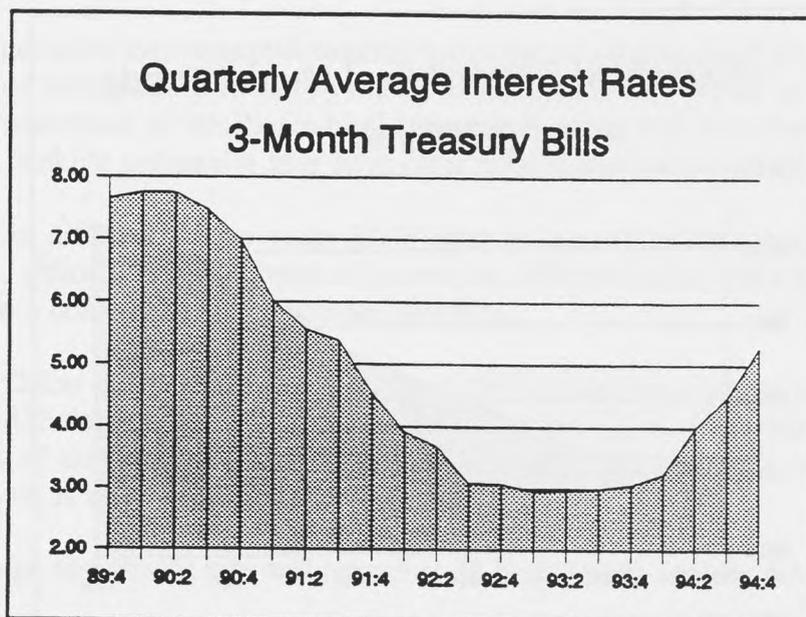
healthy SAIF-insured institutions, the shrinkage is characteristic of weakened and failed institutions, and because the number of such institutions has been greatly reduced, related shrinkage can be expected to slow. Other evidence indicates that shrinkage was more prevalent at weaker thrifts during periods when some better-managed thrifts experienced deposit growth.¹²

Brokered deposits were another factor in the shrinkage of SAIF deposits, falling from \$64 billion at the end of 1989 to \$9.8 billion at year-end 1994. This decline is due in part to continuing legislative and regulatory constraints placed on their use by insured institutions.

Another factor accounting for SAIF deposit shrinkage was depositor flight from the declining or low interest rates which prevailed from 1990 to the latter part of 1994, as shown in Figure 6.

¹²Larry Cordell et. al., Deposit Flows at SAIF- and BIF-Insured Institutions: December 1988 to September 1992 (Washington, D.C.: Office of Thrift Supervision, January 1993).

Figure 6

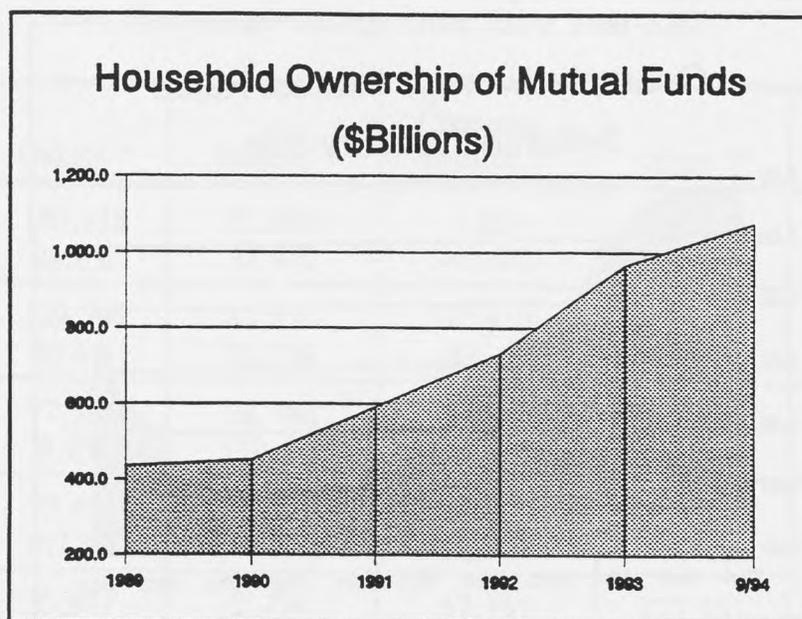


Source: Derived from monthly average rates in the Federal Reserve's H.15 Statistical Release.

In seeking higher returns, many customers of depository institutions moved their investments out of depository institutions and into mutual funds. Figure 7 shows that household ownership of mutual funds more than doubled after short-term interest rates began falling in early 1990.

It is recognized that the proposals by Great Western and others discussed in Section I pose a potential for substantially faster shrinkage of the SAIF assessment base. However, because the proposals have not been acted upon, this potential shrinkage has not been factored into the baseline projection but rather is discussed in the sensitivity analysis in Section IV.

Figure 7



Source: Federal Reserve's Flow of Funds Accounts, Third Quarter 1994.

- Oakar deposits will grow at 2 percent per year, the estimated growth rate for BIF-member deposits. The purchase rate for Oakar deposits, while still positive, will decline. The purchase rate of Oakar deposits will be 4 percent and 2 percent for the years 1995 and 1996, respectively, and will decline to 1 percent per year beginning in 1997.

Under FDICIA, Oakar deposits are adjusted annually by the acquiring institution's overall domestic deposit growth rate (net of acquisitions). BIF-member domestic deposits grew more than 9 percent per year in 1985 and 1986, but since then the growth rate has slowed considerably. Since 1990, these deposits have increased, on average, 0.6 percent per year, including a 0.3 percent rise in 1994. This reflects a greater reliance on foreign-office deposits and other nonassessable liabilities. However, BIF-member domestic deposits increased 1.9 percent during the fourth quarter of 1994, and with the proposed reduction in BIF assessment rates, BIF-insured deposits will become more attractive. For these reasons, BIF-member deposits in these projections were assumed to grow by 2 percent per year, which -- according to FDICIA -- becomes the growth rate for their Oakar deposits.

As shown in Figure 5 and Table 2, Oakar deposits have grown rapidly in recent years, in part because a significant portion of those deposits were acquired from failed

institutions through the RTC. However, as the RTC completes the clean-up of the thrift industry, these opportunities have all but disappeared.

Another incentive that prompted banking companies to acquire SAIF deposits was the use of failed or failing thrifts as entry vehicles to states otherwise closed to them. However, with the enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, banking companies may have other options available to them.

A premium differential may make SAIF deposits less attractive for acquisition by BIF members, although the likelihood of an eventual differential has been known and should have been a consideration in purchase decisions.

In 1994, Oakar deposit growth for the year (\$40 billion) represented 6.8 percent of the pool of SAIF deposits available for Oakar acquisition, that is, non-Oakar deposits, at the beginning of the year. For the reasons stated above, this purchase rate is expected to slow, which is reflected in the baseline assumptions.

- The average assessment rate will remain at 24 basis points until the SAIF is capitalized.

As mentioned previously, the Board has the option of temporarily lowering the SAIF assessment rate to 18 basis points until January 1, 1998, but the need to capitalize the SAIF as soon as possible was given priority in the Board's proposal.

III. The Impact of a SAIF Differential on Troubled Institutions

The SAIF Differential

In the second half of 1995, the average assessment rate paid by BIF-insured institutions would fall to 4.5 cents per \$100 dollars of domestic deposits under the Board's proposal, while the rate for the SAIF will remain at an average of 24 cents. If assessment savings for BIF members were to be passed on to depositors or borrowers, SAIF members would incur higher costs to remain competitive in the pricing of deposits and loans. An analysis was undertaken to estimate the impact of this differential on the failure rate of troubled SAIF-insured institutions and the implications for the SAIF.

Summary of Methodology

The analysis was based on the 272 SAIF-insured institutions that had FDIC supervisory ratings of 3, 4 or 5 as of December 31, 1994.¹³ Five-year projections were run under a variety of interest-rate and asset-quality scenarios. The model was relatively simple, with a basic premise that institutions would continue to perform as they did during 1994, with some adjustments for high levels of problem assets and restructuring charges. Annual net interest income was reduced by an amount equal to the differential multiplied by an institution's SAIF-assessable deposits. Differentials between 5 and 20 basis points (0.05 percent and 0.20 percent) were tested. Below are the results of the tests for 5 and 20 basis points. (Analysis revealed that the results for 10- and 15-basis point differentials were distributed proportionally between those of 5- and 20-basis points.)

Summary of Results

Within the framework and assumptions of this model, it appears unlikely that a 20-basis point differential by itself would cause failures to increase beyond a level manageable by the SAIF, within the five-year period considered in this analysis. The incremental failures indicated by the model were generally smaller institutions. Unfavorable economic conditions that adversely impact interest-rate spreads and asset quality generally have a greater effect on failure rates, according to our study, than does a 20-basis point premium differential.

The projections indicated that a 5-basis point differential would have a minimal effect on failures, while a differential of 20 basis points would increase the number of failures and failed-institution assets by as much as one-third, depending on the assumptions in a particular scenario. Of all the scenarios considered, the highest amount of failed-institution assets attributable to the differential was \$4.7 billion (over five years). Although actual losses would vary from year to

¹³Supervisory ratings range from 1, for the strongest institutions, to 5, for the weakest institutions. The group of 272 institutions included 22 BIF-member Oakar banks which held some SAIF-insured deposits.

year, on average this equates to a loss to the SAIF of \$140 million per year, based on a loss rate of 15 percent of failed-institution assets.¹⁴ This level of potential loss would be manageable for the SAIF provided that losses from other causes, such as adverse economic conditions, are not unexpectedly high. Moreover, the model's failure projections are probably at the high end of the range of what would be likely to occur because the model included some pessimistic assumptions on the earnings impact of the differential.¹⁵

Methodology and Assumptions

As stated, five-year projections were run for the 272 SAIF-insured institutions with FDIC supervisory ratings of 3, 4 or 5. These institutions had total assets of \$207 billion at the end of 1994.

- The model assumed institutions would continue to perform as they did in 1994, with the following exceptions:
 - ▶ Institutions with above-average expected losses in their loan portfolios that were not covered by existing reserves were forced to set aside sufficient reserves over the first two years of the projection to cover their "excess" loss. An institution's expected loss was estimated as the greater of (a) 15 percent of its past due and nonaccruing loans (the industry's recent loss experience on these assets) or (b) the industry's 1994 average loss of 0.50 percent of average loans.
 - ▶ A few institutions booked substantial restructuring charges in 1994. It was assumed that these were one-time charges that would not recur in subsequent periods.
 - ▶ Consistent with the model's basic assumption of holding 1994 performance constant, the model assumed no asset growth and no asset or liability repositioning.
- The differential was defined as the cost that SAIF members would incur in order to remain competitive if BIF members pass their assessment reductions on to depositors or borrowers. This cost to SAIF members was based on their SAIF-assessable deposits and

¹⁴As noted earlier, the FDIC's failed-asset recovery rate has been 85 percent since 1986.

¹⁵The model assumed BIF members would pass on their entire assessment savings to their customers and that SAIF-insured institutions would absorb the entire cost of this competitive disadvantage. The likelihood of these and other qualifying factors are discussed at the end of Section III.

was included as an added interest expense or reduced interest income, both of which result in reduced net interest income.

- The income tax rate of 36 percent was based on thrift industry results for 1994. Institutions with positive earnings for a given year paid income tax, and those losing money did not.
- For the purpose of the model, annual loan-loss provisions were assumed to equal annual net charge-offs. For any given year, provisions may exceed loan losses, or *vice versa*, but over the longer term (such as the five-year period used here), these fluctuations would be expected to level out.
- Institutions that paid dividends in 1994 continued to pay the same amount. Some institutions that paid dividends despite being unprofitable were assumed to continue to pay dividends to enable parent companies to service obligations such as preferred stock and subordinated debt.
- Institutions were considered to have failed when their tangible equity ratio fell to 2 percent or less, the regulatory standard for "critically undercapitalized."

The Scenarios

Scenarios were designed to test the effects of 5- and 20-basis point differentials under stressful interest-rate and asset-quality conditions. The following sets of tables show (1) a "baseline" scenario, which shows the effects of a differential with no interest-rate or asset-quality factors, (2) a "moderate" scenario and (3) a "severe" scenario. Results also are shown for differentials at three different levels: zero, 5 basis points and 20 basis points. The interest-rate and asset-quality scenarios were run separately and then in combination.

Interest-Rate Scenarios

Rising short-term interest rates experienced in 1994 and early 1995 have reduced net interest margins¹⁶ for many banks and thrifts. Historically, deposit rates have adjusted more quickly to changes in market interest rates than have asset yields, so in a rising interest-rate environment net interest margins can be expected to narrow. This analysis was based on the performance of these thrifts for 1994, and because short-term interest rates have increased further since then, additional deterioration in some institutions' net interest margins can be expected.

¹⁶The net interest margin is the ratio of interest income minus interest expense, as a percentage of average earning assets.

The most recent period of prolonged rising interest rates occurred in the late 1980s, but changes in thrifts' net interest margins during that period may also have been affected by the industry's severe credit-quality problems and other turmoil attributable to the savings-and-loan (S&L) crisis. With no comparable recent precedent, changes in net interest margins were examined from the fourth quarter of 1993 to the fourth quarter of 1994. For SAIF-member institutions, the weighted-average net interest margin fell 13 basis points during this period to 3.12 percent, but one out of every eight of these institutions incurred a decline of 50 basis points or more.¹⁷ This decline is attributable, at least in part, to rising market interest rates. The distribution of changes in net interest margins is shown in Table 3.

Table 3
Changes in SAIF-Member Institutions' Net Interest Margins
Fourth Quarter 1993 to Fourth Quarter 1994

Gains or Losses (basis points)	Percent of Institutions
Up 50 or More	6.0
Up 25 to 49	10.1
Up 1 to 24	21.1
Unchanged	1.2
Down 1 to 24	28.4
Down 25 to 49	20.2
Down 50 or More	13.1

In order to test the impact of a SAIF differential in a more stressful interest-rate environment, the effects of rising interest rates were incorporated as percentage decreases in the net interest margin. For example, the average decline from 3.25 to 3.12 mentioned above is about 4 percent. A 10 percent reduction in the margin equates to about 33 basis points and a 15 percent decline is about 50 basis points. In the interest-rate cycle used in this model, it was assumed that interest rates would climb for two years, the same length of time as the recent rate decline, from 1990 to 1992 (see Figure 6). Net interest margins would worsen during this

¹⁷The average commercial bank net interest margin was 4.42 percent for the fourth quarter of 1994. Bank margins, on average, are somewhat higher than those of thrifts, in part because banks have larger proportions of lower-cost demand deposits and higher-yielding commercial and industrial loans.

period and then begin to recover as interest rates stabilize or decline and asset repricing catches up with increases in deposit costs. In the model, institutions' net interest margins were reduced from their 1994 levels by the percentages shown in Table 4.

Table 4
Interest-Rate Assumptions:
Percentage Change in Net Interest Margins

Scenario	Year				
	1	2	3	4	5
Baseline	0	0	0	0	0
Moderate	-5	-10	-5	0	0
Severe	-10	-15	-10	-5	0

The results for these scenarios are shown in Table 5. The table shows the number of failures and failed-institution assets over five years attributable to the differential (the incremental failures). Thus, in the "baseline" scenario, which included no interest-rate factors, a differential of 5 basis points would cause no additional failures compared to a differential of zero, and a 20-basis point differential would cause 11 additional failures compared to a differential of zero. Under the "moderate" scenario, a differential of 5 basis points would cause six additional failures compared to a scenario with "moderate" interest-rate assumptions and no differential.

Table 5
Interest-Rate Scenarios:
Incremental Failures Caused by the SAIF Differential
(Assets in Millions)

Scenario	5 Basis Points		20 Basis Points	
	Number	Assets	Number	Assets
Baseline	0	0	11	\$1,282
Moderate	6	\$816	17	\$3,811
Severe	4	\$336	15	\$3,071

Under the 20-basis point differential, there were fewer failures attributable to the differential in the "severe" scenario (15) than in the "moderate" scenario (17). This is because the "severe" interest-rate factors caused a greater proportion of the failures than did the differential, when compared to the "moderate" scenario. This phenomenon also occurs in other tables presented in this section.

The estimated loss per year to the SAIF can be estimated using the FDIC's recovery rate on failed-institution assets since 1986 of 85 percent. For example, failed assets of \$3.8 billion over five years (from the table above) represent an average of \$762 million per year, and the expected loss per year would be 15 percent of \$762 million, or \$114 million.

More detailed results are presented on the following page.

Table 6
Results of Interest-Rate Scenarios
For Institutions Rated 3, 4 and 5

Base Case: No SAIF Differential

\$ Millions	Baseline	Moderate	Severe
Failed Insitutions			
Number	47	52	65
Assets	13,771	14,215	17,197
SAIF Deposits	10,341	10,695	12,985
Remaining Institutions			
Number	225	220	207
Assets	193,865	193,421	190,439
Number Less than Adequately Capitalized	32	35	32

SAIF Differential of 5 Basis Points

\$ Millions	Baseline	Moderate	Severe
Failed Insitutions			
Number	47	58	69
Assets	13,771	15,031	17,533
SAIF Deposits	10,341	11,362	13,280
• Increase from No Differential			
Number of Failures	0	6	4
Assets	0	816	336
Remaining Institutions			
Number	225	214	203
Assets	193,865	192,605	190,104
Number Less than Adequately Capitalized	36	30	29

SAIF Differential of 20 Basis Points

\$ Millions	Baseline	Moderate	Severe
Failed Insitutions			
Number	58	69	80
Assets	15,053	18,026	20,268
SAIF Deposits	11,378	13,739	15,536
• Increase from No Differential			
Number of Failures	11	17	15
Assets	1,282	3,811	3,071
Remaining Institutions			
Number	214	203	192
Assets	192,584	189,610	187,368
Number Less than Adequately Capitalized	30	31	31

Asset-Quality Scenarios

In the model, deteriorating asset quality is characterized by rising loan losses. For 1994, the thrift industry's loan-loss rate was 0.50 percent of average loans. For recent full years, the industry's loan-loss rates were as follows:

<u>Year</u>	<u>Loss Rate</u>
1994	0.50 %
1993	0.65
1992	0.59
1991	0.65
1990	0.61

The industry's condition at the end of 1994 showed substantial improvement over recent years, and because of the reduction in problem loans, loan losses for the near term can be expected to remain near their recent low level. The thrift industry's noncurrent loans were 1.48 percent of total loans on December 31, 1994, down from 2.10 percent at the end of 1993 and 2.58 percent at year-end 1992.¹⁸ A variety of problems can contribute to asset-quality deterioration, either individually or in combination. National or regional economic downturns or poor credit-underwriting judgments would be contributors, but other possible factors include fluctuations in interest rates, competition and changes in the regulatory environment. A premium differential could contribute to asset-quality problems for SAIF-insured institutions if they take on additional risk in attempting to increase asset yields to offset the cost of a differential.

Table 7 shows the loan-loss rates used in the asset-quality scenarios. In the "moderate" scenario, the loss rate returns to its highest level of recent years before recovering, while in the "severe" scenario the loss rate rises steadily to 0.90 percent. While the thrift industry experienced substantially higher loss rates in the mid- to late 1980s, it seems highly improbable that the industry could deteriorate to that level within the five-year time horizon used for this analysis given the industry's current condition, the vast amount of problem assets removed by the RTC and by the industry's own clean-up effort, and the increased emphasis on capital levels and prudential supervision. Currently, 86 percent of SAIF members are in the best risk category for deposit insurance premiums.

¹⁸Noncurrent loans include loans past due 90 days or more and those in nonaccrual status.

Table 7
Asset-Quality Assumptions:
Loan-Loss Rates (Percent of Average Loans)

Scenario	Year				
	1	2	3	4	5
Baseline	0.50	0.50	0.50	0.50	0.50
Moderate	0.50	0.60	0.65	0.65	0.60
Severe	0.50	0.60	0.70	0.80	0.90

The summary results of the asset-quality scenarios are presented in Table 8.

Table 8
Asset-Quality Scenarios:
Incremental Failures Caused by the SAIF Differential
(Assets in Millions)

Scenario	5 Basis Points		20 Basis Points	
	Number	Assets	Number	Assets
Baseline	0	0	11	\$1,282
Moderate	1	\$92	12	\$2,021
Severe	3	\$452	17	\$2,816

As can be seen in this table and on the following page in greater detail in Table 9, the asset-quality factors caused somewhat fewer failures when compared to the interest-rate factors (see Tables 5 and 6). The premium differential had less of a marginal effect on failures in the asset-quality scenarios than in the interest-rate scenarios.

Table 9
Results of Asset-Quality Scenarios
For Institutions Rated 3, 4 and 5

Base Case: No SAIF Differential

\$ Millions	Baseline	Moderate	Severe
Failed Insitutions			
Number	47	50	54
Assets	13,771	14,114	14,595
SAIF Deposits	10,341	10,626	11,002
Remaining Institutions			
Number	225	222	218
Assets	193,865	193,522	193,041
Number Less than Adequately Capitalized	32	35	34

SAIF Differential of 5 Basis Points

\$ Millions	Baseline	Moderate	Severe
Failed Insitutions			
Number	47	51	57
Assets	13,771	14,206	15,047
SAIF Deposits	10,341	10,691	11,374
• Increase from No Differential			
Number of Failures	0	1	3
Assets	0	92	452
Remaining Institutions			
Number	225	221	215
Assets	193,865	193,430	192,589
Number Less than Adequately Capitalized	36	35	34

SAIF Differential of 20 Basis Points

\$ Millions	Baseline	Moderate	Severe
Failed Insitutions			
Number	58	62	71
Assets	15,053	16,135	17,411
SAIF Deposits	11,378	12,173	13,252
• Increase from No Differential			
Number of Failures	11	12	17
Assets	1,282	2,021	2,816
Remaining Institutions			
Number	214	210	201
Assets	192,584	191,501	190,225
Number Less than Adequately Capitalized	30	33	31

Combination Scenarios

The interest-rate and asset-quality scenarios were run independently in order to make the effects easier to interpret. However, in a higher interest-rate environment, credit quality is likely to suffer eventually as lenders take additional risks in seeking higher returns to offset shrinking net interest margins and borrowers encounter repayment difficulties.

These scenarios combined the "moderate" interest-rate parameters with the "moderate" asset-quality parameters, and the "severe" interest-rate parameters with the "severe" asset-quality parameters (see Tables 4 and 7). The summary results are shown in Table 10.

Table 10
Combination Scenarios:
Incremental Failures Caused by SAIF Differential
(Assets in Millions)

Scenario	5 Basis Points		20 Basis Points	
	Number	Assets	Number	Assets
Baseline	0	0	11	\$1,282
Moderate	4	\$823	17	\$4,661
Severe	3	\$363	9	\$1,770

As noted earlier, in some instances the differential had less of a marginal effect on failures in the "severe" scenario than in the "moderate" scenario because the interest-rate and asset-quality factors caused a greater proportion of the failures. Under the 20-basis point differential in the table above, the "moderate" economic factors pushed 17 institutions (with \$4.66 billion in assets) to near-failure, and the addition of the differential caused them to fail. The "severe" economic factors cause some of these 17 institutions to fail and left nine (with assets of \$1.77 billion) on the brink of failure that were caused to fail by the differential. Table 11 presents these results in greater detail.

Table 11
Results of Combination Scenarios
For Institutions Rated 3, 4 and 5

Base Case: No SAIF Differential

\$ Millions	Baseline	Moderate	Severe
Failed Insitutions			
Number	47	59	78
Assets	13,771	15,085	20,007
SAIF Deposits	10,341	11,404	15,298
Remaining Institutions			
Number	225	213	194
Assets	193,865	192,551	187,629
Number Less than Adequately Capitalized	32	33	30

SAIF Differential of 5 Basis Points

\$ Millions	Baseline	Moderate	Severe
Failed Insitutions			
Number	47	63	81
Assets	13,771	15,908	20,370
SAIF Deposits	10,341	12,065	15,620
• Increase from No Differential			
Number of Failures	0	4	3
Assets	0	823	363
Remaining Institutions			
Number	225	209	191
Assets	193,865	191,728	187,267
Number Less than Adequately Capitalized	36	33	29

SAIF Differential of 20 Basis Points

\$Millions	Baseline	Moderate	Severe
Failed Insitutions			
Number	58	76	87
Assets	15,053	19,746	21,777
SAIF Deposits	11,378	15,218	16,676
• Increase from No Differential			
Number of Failures	11	17	9
Assets	1,282	4,661	1,770
Remaining Institutions			
Number	214	196	185
Assets	192,584	187,890	185,859
Number Less than Adequately Capitalized	30	28	34

Conclusions

This analysis indicates that failed-institution assets attributable to a premium differential could range from zero to \$4.7 billion over five years, depending on the effective size of the differential and contributing economic factors. The higher failed-asset figure would amount to an average annual loss to the SAIF of about \$140 million attributable to the differential, but losses of this magnitude should be manageable for the SAIF over the next five years, provided there is no unexpected spiking of losses attributable to other factors.

The model's interest-rate factors had more of an impact than the asset-quality factors, but with the availability of hedging instruments, interest-rate fluctuations are likely to have fewer adverse effects than they have had historically.

However, both interest rates and asset quality had a greater effect on failure rates than did a premium differential, even at the 20-basis point level. Therefore, to the extent these results are actually realized, it can be concluded that these economic factors pose greater risks to the SAIF than does the differential.

Caveats with Respect to the Methodology and Assumptions

The model assumes BIF-insured institutions would pass on their entire assessment reduction to depositors or borrowers. While some institutions may do this, others will pass along some or none of their savings to depositors or borrowers, electing instead to enhance shareholder value. Decisions on deposit pricing are based on funding needs, funding alternatives and competition, while decisions on loan pricing are a function of risk, investment alternatives, funding costs and competition.

The model assumes thrifts would absorb the entire cost of the differential. In reality, they could lessen the impact by raising revenues, reducing other expenses or substituting liabilities that are not SAIF-assessable, such as FHLB borrowings and reverse repurchase agreements. Also, a number of the thrifts included in this analysis have been paying more than the minimum assessment rate of 23 basis points.¹⁹ Therefore, since 1992 they have already been operating with a differential of up to 8 basis points compared with many of their bank and thrift competitors. Moreover, in earlier years -- 1984 to 1989 -- the premium differential between banks and thrifts was about 12.5 basis points. Section V discusses historical differentials in greater detail.

Also, the model does not allow for management actions that could result in turnarounds. Institutions losing money in 1994 are projected to continue to do so, whereas in reality one

¹⁹Within the risk-related assessment rate matrix which has been in effect since 1992, rates vary from 23 basis points to 31 basis points, based on an institution's capital and supervisory categories.

would expect to see portfolio restructurings, asset sales and recapitalizations, among other things, in an effort to improve results.

Failed-asset figures are somewhat overstated to the extent they include the total assets of failed BIF-member Oakar banks. Costs to resolve the assets of failed Oakars would be allocated to the BIF or the SAIF based on the proportion of the institution's deposits each fund insures. In the scenario that resulted in the greatest amount of failed assets, about 2 percent of the total would be resolved by the BIF, not by the SAIF.

Some parameters were determined by industry averages, but significant differences may exist among institutions according to portfolio composition and institution size and location. For example, average loss rates on multifamily residential real-estate loans (1.30 percent of average loans) are greater than loss rates on 1-to-4 family loans (0.25 percent), and the use of these more detailed loss rates could yield somewhat different results than the average loss rate (0.50 percent) used in the model.

The model was intended to focus attention on the incremental failures attributable to a premium differential. The numbers and assets of projected total failures in Tables 6, 9 and 11 are probably less accurate in successive years because of the model's relatively simple design and limited focus. A comprehensive thrift performance model would take a more dynamic approach to future performance. This approach would require making numerous assumptions as to how the industry would react to the differential and to other regulatory, competitive and economic factors.

IV. Sensitivity Analysis

Although the preceding analysis concludes that the SAIF differential by itself does not create significant failures, the differential will create incentives for thrift institutions to shrink their assessable base. Although the FDIC's baseline projection calls for the SAIF to capitalize in the year 2002, changes in the underlying assumptions could alter the projected date. Similarly, the ability to fund FICO could be affected. This section examines the circumstances under which problems for SAIF capitalization and the SAIF's ability to support FICO assessments could arise. In each case the current assessment-rate structure for the SAIF is assumed to remain in place.

SAIF Capitalization. Factors including the growth or shrinkage of thrift deposits and the assessment base, and the amount of failed assets going forward will affect the SAIF's fund balance. Of these, the primary factor affecting SAIF capitalization is the failed-asset rate, that is, the amount of failed-thrift assets in a given year as a percent of total thrift assets. As discussed in Section II above, the baseline failed-asset rate is assumed to be 22 basis points of SAIF assets, or approximately \$2 billion per year. This rate is reflective of the industry's current sound condition. Of interest to this analysis, then, is the extent to which SAIF capitalization could be affected by alternative assumptions for the failed-asset rate.

Deposit or assessment-base shrinkage does not have a large impact on the year in which the SAIF is expected to capitalize, as long as failed-asset rates are reasonably low. As illustrated in Table 12, given the baseline assumption for failed assets of 22 basis points, the projected SAIF capitalization in year 2002 generally is not affected by changes in the deposit shrinkage rate. This primarily is due to the fact that changes in the base are "mirrored" in the reserve ratio; increases or decreases in the base lead, respectively, to decreases or increases in the ratio.²⁰

Table 12 presents the results of an analysis in which the sensitivity of SAIF capitalization to failed-asset rates and deposit-growth rates was examined. The year in which the SAIF was projected to capitalize is shown under varying combinations of failed-asset rates and deposit-growth rates. The FDIC's baseline projection, discussed above in Section II, projected SAIF capitalization in year 2002. This is denoted by superscript "a" in Table 12. The example noted above can be found by comparing the projected capitalization dates when the failed-asset rate is assumed to be 22 basis points. Even with a shrinkage rate of 15 percent, which could result from the proposals by Great Western and others to migrate deposits from SAIF to BIF, capitalization of the SAIF would actually occur one year earlier, in the year 2001, provided

²⁰The reserve ratio is defined as the ratio of the SAIF fund balance to SAIF-insured deposits. For a given fund balance, decreases in SAIF-insured deposits cause the SAIF reserve ratio to increase. When deposit-shrinkage rates are sufficiently high, 10 percent to 20 percent in this example, the reserve ratio increases lead to an earlier projected SAIF capitalization date.

failed-asset rates remain moderate. The impact of such a high rate of shrinkage on the ability to fund FICO is discussed later.

Table 12
Sensitivity of SAIF Capitalization to
Failure Rates and Deposit Growth Rates
(SAIF Capitalization Dates)

FICO-Eligible SAIF Deposit- Growth Rate	Failed-Asset Rate (Basis Points of SAIF Assets)				
	11	22	44	66	110
+ 2 %	2001	2002	2005	2010	(2004)
- 2 %	2001	2002 ^a	2007 ^b	*	(2001)
- 4 %	2001	2002	2007 ^c	*	(2000)
- 6 %	2001	2002	2006	*	(2000)
- 8 %	2001	2002	2006	*	(2000)
- 10 %	2000	2001	2005	*	(2000)
- 15 %	2000	2001	2004	*	(1999)
- 20 %	1999	2000	2003	(2011) ^d	(1999)

* The SAIF does not capitalize by 2019.

Figures in parentheses represent the year of SAIF insolvency.

The following scenarios illustrate the sensitivity of the projected SAIF capitalization year to alternate assumptions for the failed-asset rate and the deposit-growth rate. The first example, denoted by superscript "b" in Table 12, combines the baseline assumption of 2 percent SAIF deposit shrinkage²¹ with a failed-asset rate of 44 basis points of SAIF assets, or approximately \$4 billion per year. This rate approximates the BIF historical average failed-asset rate from 1974 to 1994 of 45 basis points. Under this higher failed-asset rate, SAIF capitalization would be delayed until year 2007. A second example, denoted "c," shows that if the baseline

²¹The 2 percent deposit-shrinkage rate applies only to the non-Oakar or FICO-eligible portion of the SAIF assessment base. The assumptions regarding Oakar deposit-growth and purchase rates were discussed in Section II.

assumption of 2 percent deposit shrinkage is doubled to 4 percent, and a failed-asset rate of 44 basis points is assumed again, the expected SAIF capitalization date is unchanged at year 2007.

When the failed-asset rate is sufficiently high the SAIF may not be able to capitalize at all. If the failed-asset rate is tripled to 66 basis points, or approximately \$6 billion in failed assets per year, which is about one and one-half times the BIF average failed-asset rate from 1974 to 1994, the SAIF generally does not capitalize by 2019. As denoted by "d," when combined with a deposit-shrinkage rate of 20 percent, the SAIF becomes insolvent in 2011. Under an even more pessimistic failed-asset rate of 110 basis points, the SAIF becomes insolvent by the turn of the century.

The FICO Assessment. The primary factors that affect the SAIF's ability to fund FICO are the growth or shrinkage rates for FICO-eligible SAIF deposits and the percentage of the SAIF assessment base that is held by Oakar and Sasser institutions. This analysis explores the conditions under which FICO payment problems could arise.²² In particular, the analysis examines the extent to which changes in these factors could affect the ability of the SAIF to fund FICO.

Unlike the baseline projection discussed in Section II, this analysis is based on simplified assumptions about the size of the FICO-eligible SAIF assessment base and the rate at which FICO-eligible SAIF deposits shrink. While the baseline projection assumes moderate growth in Oakar institutions going forward, this analysis holds the proportion of the assessment base constant while the deposit-shrinkage rate is varied. The impact of alternate deposit-shrinkage rates on the ability of the SAIF fund FICO under these simplified assumptions is shown in Table 13.

Currently, the percentage of the SAIF assessment base that is held by Oakar and Sasser institutions is approximately 33 percent, leaving 67 percent of the SAIF assessment base available for FICO payment purposes. In addition to the current FICO-eligible SAIF assessment base of 67 percent, smaller FICO-eligible assessment bases of 60 and 50 percent are examined. These reflect the growth of Oakar and Sasser institutions to 40 and 50 percent of the total SAIF assessment base, respectively. For each of these FICO-eligible assessment bases, the deposit-shrinkage rate for FICO-eligible SAIF deposits is varied from 2 percent to 20 percent. The following examples are illustrative of the results.

²²The Board has the discretion to consider FICO's debt-service needs in setting assessments for SAIF members.

Table 13
Ability to Fund FICO from the
FICO-Eligible SAIF Assessment Base
(FICO Problem Dates)

FICO-Eligible SAIF Deposit-Growth Rate	FICO-Eligible SAIF Assessment Base As a Percent of the Total SAIF Base*		
	67 %	60 %	50%
- 2 %	2014 ^a	2008 ^c	1999 ^f
- 4 %	2004	2001	1997
- 6 %	2001 ^b	1999	1996 ^e
- 8 %	1999	1998	1996
- 10 %	1998 ^c	1997	1995
-15 %	1997 ^d	1996	1995
- 20 %	1996	1996	1995

* This analysis holds the proportion of the assessment base constant while the deposit-shrinkage rate is varied.

In the first example, denoted by superscript "a" in Table 13, the percentage of the SAIF assessment base that is available for FICO payment purposes is maintained at the current level of 67 percent. If FICO-eligible SAIF deposits are assumed to shrink at a rate of 2 percent, which, again, is the deposit-shrinkage assumption used in the FDIC's baseline projection, full FICO payments likely would be made only through the year 2013. In other words, a "FICO-shortfall" could occur in year 2014.

FICO problems will be encountered earlier if the deposit-shrinkage rate for FICO-eligible SAIF deposits increases. For the next example, denoted by "b," assume that the percentage of the SAIF assessment base available for FICO payment purposes remains at 67 percent. Assume that FICO-eligible SAIF deposits shrink at a rate of 6 percent, a rate that is slightly higher than the rate experienced, on average, since 1989 and is reflective of a period that included numerous thrift failures. This combination would result in a FICO shortfall in year 2001; that is, full FICO payments would be expected to be made only through year 2000. If a higher deposit-shrinkage rate of 10 percent is assumed, again keeping the FICO-eligible SAIF assessment base at 67 percent, the increased rate would be expected to lead to a FICO shortfall in the year 1998. This example is denoted by "c" in Table 13.

Without further shifting of SAIF deposits into Oakar and Sasser institutions, severe shrinkage of FICO-eligible SAIF deposits, such as that suggested by the Great Western proposal, would lead to an imminent FICO shortfall. Denoted by "d" in Table 13, severe deposit-shrinkage -- 15 percent per year -- against the current FICO-eligible SAIF assessment base yields an expected FICO shortfall in year 1997.

The ability of SAIF to fund FICO also will be affected if the percentage of the assessment base held by Oakar and Sasser institutions continues to increase, thereby shrinking the available FICO-eligible SAIF assessment base. These examples are denoted by superscripts "e" and "f," respectively, in Table 13. First, given a deposit-shrinkage rate of 2 percent, a decrease in the FICO-eligible SAIF assessment base from 67 percent to 60 percent leads to an expected FICO problem in 2008. Next, a decline of the FICO-eligible SAIF assessment base to 50 percent leads to an expected FICO problem in the year 1999.

In combination, changes in the deposit-shrinkage rate for FICO-eligible SAIF deposits and the percentage of the SAIF assessment base available for FICO payments can be expected to lead to the earlier onset of FICO problems. For example, as denoted by "g," if FICO-eligible SAIF deposits shrink at a rate of 6 percent, while the percentage of the SAIF assessment base available for FICO payment purposes shrinks to 50 percent, the expected year in which FICO payments cannot be made from available assessment revenue is 1996.

V. Competitive Issues

There is likely to be a negative impact on the competitiveness of SAIF-insured institutions from a significant premium differential with BIF members. This effect is difficult to quantify. It is probable that SAIF members will experience more difficulty raising capital in external markets and increasing capital internally. However, as discussed below, there are other factors that must be considered in evaluating the competitiveness of the industry.

Earnings Impact of a Premium Differential. Twenty-five percent of SAIF members had a return on assets (ROA) of 1.13 percent or higher for the year 1994. Under the rather pessimistic assumption that pretax earnings are reduced by the full amount of the differential, for this group of institutions with high ROAs, a premium differential of 20 basis points would reduce pretax operating earnings by 6.8 percent. For institutions with ROAs at the median value of 0.86 percent, the differential represents about 12 percent of pretax earnings. However, the actual impact on earnings is likely to be less than these figures indicate because BIF members, in aggregate, are likely to pass along less than the full amount of their assessment savings to customers, and the impact of any related cost increase for SAIF members can be mitigated to the extent they can raise revenues or reduce other expenses.

Historical Evidence on Differentials. Savings associations historically have paid somewhat higher deposit insurance premium rates than banks. From 1935 through 1980, the effective premium rates (net of credits and other reductions) paid by savings associations were 4 to 5 basis points higher than bank rates. Since 1980, the average premium differential has varied from zero (1992) to 12.5 basis points (1984 through 1989). Since 1992, when risk-related assessment rate schedules went into effect for BIF and SAIF members, SAIF members have paid, on average, 1 to 2 basis points more than BIF members. However, both banks and thrift institutions in the highest rate category (31 basis points) have paid a differential of 8 basis points as compared with their healthiest competitors.

Another form of differential relates to the different interest-rate ceilings that were applied to banks and thrifts. Beginning in 1966, savings associations and savings banks were allowed to pay higher interest rates on deposits than were commercial banks, creating a differential which remained in effect until 1984. The interest-rate differential, which was as high as 100 basis points but most frequently was set at 25 to 50 basis points, was intended to assure a flow of funds to thrifts to finance the nation's housing needs. This interest-rate differential was further justified by the advantage commercial banks had by being able to accept demand deposits (checking accounts) and engage in commercial lending. However, to the extent this advantage existed, it was eroded during the 1970s and early 1980s by innovation, market forces and, finally, legislation.

While it is important to note that there have been differences in the treatment of the two industries historically, it is difficult to draw any conclusions based on this information regarding the competitive effects of a premium differential over the next few years. First, the likely magnitude of the future premium differential is larger than the premium differential that existed

in the past. Second, the effects of the differing price ceilings such as those in effect from 1966 through 1983 are conceptually different than the effect of differing tax rates that will result from a premium differential. Finally, the economic, competitive and regulatory environment is much different today.

Longer-Term Implications. The thrift industry also may face longer-term structural problems. The industry may not be able to earn long-run competitive returns, in part, because the business of mortgage lending has become more competitive. The growth of the secondary mortgage market and government-sponsored enterprises such as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation have reduced the profitability of holding mortgage loans to maturity. In addition, there are asset restrictions stemming from the Qualified Thrift Lender test that must be met to realize the tax benefits available under a thrift charter.²³

²³Under the Qualified Thrift Lender test, first enacted in FIRREA and subsequently amended, savings associations must maintain 65 percent or more of their tangible assets in "qualified thrift investments," which are predominantly loans and investments related to domestic real estate. Failure to meet the test can result in, among other things, having to recapture the bad debt reserve into taxable earnings.

VI. Conclusions

The SAIF began 1995 with a balance of \$1.9 billion, barely one-fifth of its statutorily required level. The primary current obstacle to capitalizing the SAIF is the FICO assessment. If SAIF assessment revenues had not been diverted to FICO, the SAIF would have been expected to capitalize in 1996; if other diversions of SAIF assessments totaling \$7 billion to date had not occurred, the fund would have capitalized in 1994. Similarly, if the FICO assessment were removed from the SAIF today, the SAIF would be expected to capitalize in 1998. While the thrift industry is in relatively healthy condition and failures projected for the near term appear manageable, the fund remains vulnerable to a single large-institution failure or several mid-sized failures that could result from adverse economic conditions or from management or other problems affecting the asset quality or earnings of individual institutions. The SAIF has little or no cushion for such adversities as it assumes responsibility for losses from failed institutions beginning July 1, 1995.

A premium differential between BIF- and SAIF-insured institutions could create a competitive disadvantage for SAIF members that would result in an increase in failures of SAIF-insured institutions. The fund should be able to absorb the expected losses such failures would cause in the next five years, assuming other larger losses do not threaten the fund's solvency. Indeed, other factors -- reduced net interest margins and asset-quality problems -- could result in a greater increase in failures of SAIF-insured institutions than are likely to result from the proposed premium differential, according to our analysis.

Under certain baseline assumptions, the SAIF is projected to capitalize in 2002. The capitalization date is sensitive to increases in failed-asset rates, from whatever cause. The baseline projection also indicates that there would be sufficient assessment revenue to cover the FICO interest payment through 2004, leaving a shortfall in subsequent years. However, this date is sensitive to increases in the rate of assessment-base shrinkage or in the proportion of Oakar or Sasser assessments. Efforts by SAIF-insured institutions to lessen or avoid a premium differential could significantly accelerate assessment-base shrinkage and hasten the date at which there is a FICO shortfall.

The overall conclusion is that SAIF is assuming the full responsibility for resolving thrift failures in a severely undercapitalized condition. Moreover, the impending premium differential undoubtedly will spark sufficient entrepreneurial efforts to avoid the differential, thus all but ensuring that FICO interest payments will not be met absent a significant and potentially counterproductive increase in SAIF premium rates.

Attachment 1
Proposed Assessment Rate Schedules
Second Semiannual 1995 Assessment Period
FDIC-Insured Institutions

Proposed BIF Rate*

Capital Category	Supervisory Risk Group		
	Group A	Group B	Group C
1. Well	4	7	21
2. Adequate	7	14	28
3. Under	14	28	31

Estimated Annual Assessment Revenue: \$1.1 Billion
Average Annual Assessment Rate: 4.5 bp
Rate Spread: 27 bp

Proposed SAIF Rate*

Capital Category	Supervisory Risk Subgroup		
	Group A	Group B	Group C
1. Well	23	26	29
2. Adequate	26	29	30
3. Under	29	30	31

Estimated Annual Assessment Revenue: \$1.7 Billion
Average Annual Assessment Rate: 24 bp
Rate Spread: 8 bp

*Rates are in basis points

Reading file P.02

Attachment 2



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

cc: R. Cherry
Kirchman

January 10, 1992

Honorable Richard Darman
Director
Office of Management and Budget
Washington, D.C. 20503

Dear Director Darman:

We have been advised by your staff that FDIC's appropriation request for the Savings Association Insurance Fund will not be submitted in the President's budget for fiscal year 1993. Our submission included a request for \$1.285 billion in Treasury funding as provided for by FIRREA to bring the SAIF's revenue to the designated level of \$2 billion.

We strongly urge you to reconsider FDIC's appropriation request for SAIF. The Congress and Administration outlined in FIRREA an extensive funding plan from a combination of S&L industry and taxpayer resources to put the SAIF on a sound financial footing. According to legislation, modified slightly by the recent Recap Bill, Treasury is to pay SAIF sufficient funds to maintain its income at \$2 billion during fiscal years 1993 through 2000. The FY93 Treasury payments for revenues, if skipped, would not be available to the SAIF in the future.

The General Accounting Office in its 1990 financial audit of the SAIF, expressed concern regarding the adequacy of funding sources for SAIF to meet future resolution demands and achieve net worth goals set by FIRREA. Clearly, not funding SAIF at this point will not allow the fund to build the resources, as envisioned by Congress, to meet its future obligations.

Sincerely,

William Taylor

FDICFederal Deposit Insurance Corporation
Washington, DC 20426Office of the Director
Division of Accounting and Corporate Services

February 20, 1992

Mr. Jerome H. Powell
Assistant Secretary, Domestic Finance
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Powell:

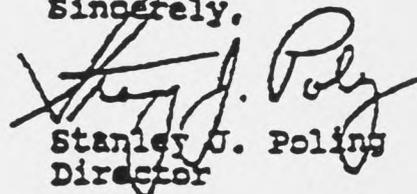
As of December 31, 1991, the Savings Association Insurance Fund (SAIF) is reporting a negative net worth of \$20,713,000 due to losses recognized from the failure of a financial institution for which the SAIF had a share of financial responsibility.

Section 11(a)(6)(F) of the Federal Deposit Insurance Act (12 U.S.C. 1821 (a)(6)(F)) states that the "Secretary of the Treasury shall pay to the Savings Association Insurance Fund, for each fiscal year ... [beginning October 1 of 1991 through 1999], any additional amount which may be necessary, as determined by the Corporation and the Secretary of the Treasury to ensure that such Fund has the minimum net worth referred to in [the table included as part of this provision] throughout each ... fiscal year [noted above]...." The minimum net worth prescribed in this section of the FDI Act for the fiscal year beginning October 1, 1991 (i.e., fiscal year 1992) is zero.

Section 11(a)(6)(J) of the FDI Act (12 U.S.C. 1821 (a)(6)(J)) states that "[t]here are authorized to be appropriated to the Secretary of the Treasury such sums as may be necessary to carry out the provisions of this paragraph [subject to certain limitations]...."

Accordingly, we request that the Treasury acknowledge its obligation to fund the aforementioned SAIF net worth deficiency by signing the concurrence line below and returning this letter to us as soon as possible. Based on your concurrence, we will establish a receivable from the U.S. Treasury for \$20,713,000, which will bring the SAIF's fund balance to zero as required by law.

Sincerely,



Stanley J. Poling
Director

Concur:

Jerome H. Powell
Assistant Secretary, Domestic Finance



OFFICE OF THE CHAIRMAN

September 23, 1993

Honorable Jim Leach
Ranking Minority Member
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Congressman Leach:

I would like to express my appreciation for your leadership with respect to the RTC/SAIF funding legislation. As the House and Senate begin to resolve their differences in the legislation, I would like to take this opportunity to raise a concern regarding the Savings Association Insurance Fund. Although the current versions of RTC funding legislation are an improvement over the status quo, both bills leave unresolved issues regarding the viability and the future of the thrift industry and the SAIF.

The House adopted a provision providing the Resolution Trust Corporation with an additional 18 months (until April 1, 1995) to resolve failing SAIF-insured institutions. I would support the Conferees in adopting the 18-month extension.

Prior to the SAIF accepting failed institutions for resolution, it is my hope that the Congress will examine what the viability and future is for the thrift industry and the SAIF. The SAIF has three major obligations: to fund insurance losses associated with failures of SAIF members, to recapitalize the insurance fund to an amount equal to 1.25 percent of insured deposits, and to provide approximately \$800 million per year of FICO bond interest payments through the year 2019. In 1989, FIRREA authorized the Treasury, under certain conditions, to provide appropriated funds to SAIF. These funds could have been used to meet these obligations through the year 2000. Thus, while Congress envisioned a healthy, growing thrift industry, FIRREA was crafted so that a backstop would be available in the event that unfavorable industry conditions persisted.

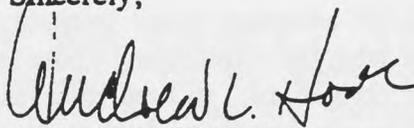
The proposed legislation focuses on the obligation to fund insurance losses over the next several years. This is accomplished in the House bill by extending the RTC's responsibility for failed institutions by eighteen months, thus providing an opportunity for the SAIF to capture the net premium income during this time without incurring any insurance losses. In both the House and Senate proposals, Treasury funds are available to SAIF only to cover losses subject to certain certifications.

By focusing on insurance losses, the proposed legislation leaves recapitalization and the FICO obligation as the responsibilities of SAIF members. While Treasury funding for recapitalization was contemplated by FIRREA, Congress subsequently has determined it is more appropriate to hold SAIF members responsible for recapitalizing their insurance fund. This means that, with respect to recapitalization, SAIF members will be held to the same standard as BIF members. However, the FICO obligation creates a troubling disparity between BIF and SAIF members. Given the current assessment base, FICO interest payments add 10 basis points to SAIF premiums. Even if the insurance losses of the two funds are comparable in the future, a differential premium rate will exist for most of the next 25 years as a result of the FICO obligation.

The specter of a continuing premium differential creates a powerful incentive for SAIF-insured institutions to minimize premium costs by shrinking the base against which assessments are levied (currently domestic deposits). This can be accomplished in a variety of ways even if Congress enacts a moratorium on conversions of SAIF- to BIF-insured institutions and if the definition of the assessment base is expanded to include other direct funding sources. Furthermore, shrinkage may be hastened by the thrifts' awareness that their share of the FICO burden will increase as the assessment base dwindles. The net result could be a dramatic shrinkage of the assessment base, and therefore assessment revenue, that outpaces any increase in premium rates. This could ultimately frustrate any attempt to recapitalize the SAIF and could threaten the ability of the industry to fund FICO payments.

If you or your staff wish to discuss this further, please do not hesitate to contact me.

Sincerely,



Andrew C. Hove, Jr.
Acting Chairman

Oral Statement
Ricki Helfer
Chairman
Federal Deposit Insurance Corporation

on
The Conditions of the Bank and the Savings Association Insurance Funds
and Related Issues

Before the
Subcommittee on Financial Institutions
and Consumer Credit
Committee on Banking and Financial Services
U.S. House of Representatives

March 23, 1995

Madam Chairwoman and Members of the Subcommittee, I am here today to present the views and analyses of the Federal Deposit Insurance Corporation (FDIC) concerning the condition of the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF).

We face a compelling problem -- and one that has grown more compelling this year. As my written statement discusses in detail, the BIF is in good condition and its prospects appear favorable.

In contrast -- despite the general good health of the thrift industry -- the SAIF is not in good condition and its prospects are not favorable.

Any solution to the SAIF problem requires action by the Congress -- and, in fact, the need for Congressional action is more urgent today than ever before.

Beginning later this year, Madam Chairwoman, a substantial disparity between the deposit insurance premiums paid by BIF members and SAIF members is likely to occur. The disparity is mandated by current statutory provisions. The FDIC cannot avoid bringing the disparity into being. Only Congress can change the laws that will soon require the FDIC to promulgate significantly

different assessments for the two deposit insurance funds. Like the tip of an iceberg, the premium disparity is only the visible manifestation of a larger difficulty, most of which lies beneath the surface.

This difficulty -- which most recently has been described in depth in a report by the General Accounting Office -- has three dimensions.

One, the SAIF is significantly underfunded. At year-end 1994, the SAIF had a balance of \$1.9 billion -- or 28 cents in reserves for every \$100 in insured deposits. This amounts to six percent of the assets of SAIF-insured "problem" institutions. The \$21.8 billion BIF, in contrast, amounts to 52 percent of the assets of BIF-insured problem institutions.

Two, an ongoing fixed draw of \$779 million on SAIF revenue arises from an obligation to pay interest on bonds issued by the Financing Corporation (FICO) in the 1980s. If you have ever tried to fill a bucket with a hole in it, you understand what I mean. This draw alone creates a premium differential between BIF members and SAIF members that likely will persist for 24 years until the bonds are repaid. This differential, at least 11 basis points, could provoke further shrinkage in the SAIF assessment base and a shortfall of assessment revenue to pay the FICO obligation, which would lead to default on the bonds. Although FICO bonds are not obligations of the FDIC, interest on the bonds is a significant drain on the SAIF.

Three, for the first time, the SAIF will assume responsibility for resolving failed thrifts after June 30 of this year. Given the underfunding of the SAIF, significant insurance losses in the near-term could render the SAIF insolvent and put the taxpayer at risk.

To establish parity between the BIF and the SAIF today would require about \$15.1 billion, or about 25 percent of the total equity capital of SAIF members. Of this total, \$6.7 billion would be needed to increase the SAIF from its year-end 1994 balance of approximately \$1.9 billion to \$8.7 billion, the amount that currently would achieve the designated reserve ratio required by Congress of 1.25. The remaining \$8.4 billion of the \$15.1 billion is the amount that would be necessary at current interest rates to defease the FICO obligation. That is to say, it is the amount that would have to be invested today to generate an income stream sufficient to service the FICO bonds until maturity between the years 2017 and 2019 because the bonds are not callable.

Requiring these amounts to be collected entirely through SAIF insurance premiums raises difficult questions. What will be the effect on the ability of SAIF members to raise new capital, to prosper, and to compete effectively? Will erosion of the SAIF assessment base and changes in its composition jeopardize the

ability of the FICO to meet its obligations? Should some of the burden be shared? And by whom?

There is no magic answer to these questions. No matter how the \$15.1 billion cost is borne, there will be an outcry by at least one constituency that a great injustice is being done. There is no way for the FDIC to resolve this issue through the exercise of its regulatory authority.

For two reasons the need to find solutions to the problems grows more urgent. One, as mentioned earlier, starting July 1, 1995, the cost of all new thrift failures must be paid out of the SAIF. Two, recently announced efforts by some SAIF-insured institutions to transfer deposits into BIF-insured institutions raises the specter that the insured deposit base of the SAIF could shrink so rapidly that, under current assessment rates, debt service on the FICO bonds would quickly run into trouble. Six institutions have declared their intent to be "born again" as BIF institutions. Together, they total about \$80 billion in SAIF-insured deposits.

Although the need for immediate Congressional action concerning the SAIF is evident, there is considerable disagreement over precisely what action should be taken and whether it should be taken this year or later. The most frequently mentioned sources of money to address SAIF's needs include the thrift industry, the banking industry, and the U.S. Treasury. Others have been mentioned, too, as having an interest in resolving the problems. None of the possible sources of funding is happy about the prospect of footing the bill for capitalizing the SAIF and funding the FICO interest payments.

As I noted earlier, the SAIF is significantly undercapitalized -- it is constantly being drained to meet obligations from savings-and-loan failures in the 1980s -- and it must begin paying for thrift failures that occur after mid-1995. I will discuss each of these three issues in turn.

First -- as chart number one shows -- the SAIF is significantly undercapitalized. As noted earlier, the SAIF had a balance of \$1.9 billion, or only 0.28 percent of insured deposits at year-end 1994. At the current pace, and under reasonably optimistic assumptions, the SAIF would not reach the minimum reserve ratio of 1.25 percent until at least the year 2002. Consequently, it would be impossible to lower SAIF premiums to the proposed levels for the BIF for at least seven years, and because of the continuing need to fund interest payments on the FICO bonds, probably much longer.

Second, SAIF assessments have been -- and continue to be -- diverted to purposes other than the fund. This problem was described in detail in the recent General Accounting Office

report. In short -- as chart number two shows -- from 1989 to 1994, \$7 billion -- approximately 95 percent of SAIF assessments during that time -- was diverted from the SAIF to pay off obligations from thrift failures in the 1980s through the Resolution Funding Corporation (REFCORP), the Federal Savings and Loan Insurance Resolution Fund (FRF), and the Financing Corporation (FICO). Of the \$9.3 billion in SAIF assessment revenue received from 1989 to 1994, a total of \$7 billion was diverted: \$1.1 billion was diverted to REFCORP; \$2 billion was diverted to FRF, and \$3.9 billion was diverted to FICO. By far the largest of the drains on SAIF assessment income, the FICO was established by Congress in 1987 in an attempt to recapitalize the defunct Federal Savings and Loan Insurance Corporation. From 1987 to 1989, the FICO issued approximately \$8.1 billion in bonds. SAIF assessment revenue currently amounts to just over \$1.7 billion a year and FICO interest payments run \$779 million a year, or about 45 percent of all SAIF assessments. Without these diversions, the SAIF would have reached its designated reserve ratio -- and would have been fully capitalized -- in 1994. The REFCORP and FRF no longer have claims on SAIF assessments, but -- as things now stand -- the FICO claim will remain as an impediment to SAIF funding for 24 years to come.

Third, the SAIF will be under stress beginning on July 1, 1995, when it takes over responsibility for resolving the failures of SAIF-insured savings associations from the Resolution Trust Corporation (RTC). One large or several sizable thrift failures could bankrupt the fund.

The outlook for the SAIF is further complicated by the fact that the law limits SAIF assessments that can be used for FICO payments to assessments on insured institutions that are both savings associations and SAIF members. As chart number three shows, because assessment revenue from these institutions cannot be used to meet debt service on FICO bonds, over 32 percent of SAIF-insured deposits were unavailable to meet FICO payments in 1994. This portion was up from 25 percent at the end of 1993. This shift contributed significantly to a 7.9 percent decline in 1994 in the SAIF assessment base available to service FICO, even though the overall insured deposit base of the SAIF declined by only 1.1 percent in 1994. At current assessment rates, an assessment base of \$325 billion is required to generate revenue sufficient to service the FICO interest payments.

As chart number four shows, the FICO-available base at year-end 1994 stood at \$486 billion. The difference of \$161 billion can be thought of as a cushion which protects against a default on the FICO bonds. If there is minimal shrinkage in the FICO assessment base -- 2 percent -- a FICO shortfall occurs in 2005.

Chart number five shows, however, that -- if shrinkage increases -- for whatever reason -- the shortfall occurs earlier -- as early as 1997 or even 1996 under some assumptions. On March 1, 1995, Great Western Financial Corporation, the parent company of a SAIF-member federal savings bank with offices in California and Florida, announced that it had submitted applications for two national bank charters. Under the applications these commercial banks would share Great Western's existing branch locations. As I noted before, by mid-March, five other SAIF-insured institutions announced that they were considering similar actions to shift deposits from the SAIF to the BIF.

If these efforts in converting SAIF-insured deposits to BIF-insured deposits are successful, others are likely to follow. These six institutions have approximately \$80 billion in SAIF deposits -- and that represents 50 percent of the FICO-cushion mentioned earlier. There are also other methods that do not require applications or approvals to shift deposits from SAIF to BIF. For these reasons, the SAIF assessment base could shrink significantly -- and quickly. Removal of substantial deposits from the SAIF would result in a significantly smaller base from which to generate the fixed FICO assessment.

On Friday, March 17, the FDIC Board of Directors held an unprecedented public hearing on the agency's proposals to reduce deposit insurance premiums for most banks while keeping insurance rates unchanged for savings associations. Although written comments are not due until April 17, we have received almost 800 comment letters -- more than 100 in the 24 hours since we completed our written testimony.

One message came through loud and clear from the majority of the witnesses at the hearing: In weighing proposals to address the SAIF problem -- and many proposals have been made -- we must seek a real and permanent solution, not one that simply defers the issue to a later time while leaving in place the conditions that are the source of the problem.

In that regard, any solution should be judged by how well it accomplishes three goals.

First, it should reduce the premium disparity between BIF and SAIF member institutions, and eliminate to the extent possible the portion of the SAIF premium attributable to the FICO assessments. This disparity encourages SAIF members to engage in legal and regulatory maneuvering to avoid SAIF assessments and in my view renders infeasible the existing mechanism to fund the FICO. This standard leaves open the question of what level of premium disparity between BIF and SAIF members would be small enough to eliminate the incentive for SAIF members to flee the SAIF.

Second, it should result in the SAIF being capitalized relatively quickly, perhaps no later than 1998. The longer we allow the SAIF to be undercapitalized, the greater the possibility that unanticipated losses will deplete the fund. As chart number six shows, under moderate failure assumptions, the SAIF capitalizes in 2002. Chart number seven, however, shows that, if failures climb dramatically, they can prevent SAIF capitalization altogether, and even threaten that insurance fund's solvency.

Third, a solution should address the immediate problem that on July 1, the SAIF will take over from the RTC the responsibility of handling thrift failures. Unfortunately, the SAIF will assume this responsibility in a vulnerable and grossly undercapitalized condition.

The progress towards capitalization, in other words, should be "front-loaded," with a substantial chunk of the capital coming quickly.

In addition, we need to be concerned about the means to achieve these ends. In that regard, we must consider the precedent that is being set for the use of deposit insurance funds. To ensure sufficient insurance reserves to meet future losses and to protect the FDIC's independence, deposit insurance funds should be used for deposit insurance purposes. Ideally, the converse should also be true that deposit insurance expenses should not be paid out of public funds, although the savings and loan crisis is evidence of an unfortunate breach of the latter principle, and the diversions from the SAIF for other purposes prove the rule about the former. We also must carefully consider the fairness of the solution to all concerned. Finally, to the extent that Congress may wish to consider options involving the use of RTC money to address the problems outlined here, there may be budgetary issues outside the purview of the FDIC.

My written statement analyzes a number of options for addressing these issues.

Madam Chairwoman, I take to heart Yogi Berra's observation that "All predictions are dangerous, especially ones about the future." I do not try to foretell the future. As a bank regulator and a deposit insurer, however, it is a part of my job to think about what could happen.

The resources of the SAIF are insufficient to absorb the cost of the failure of one large or a few medium-sized thrifts, or other substantial unanticipated losses.

If there are no major unanticipated losses, the SAIF balance would inch up to its target over the next seven years. Over this

length of time, however, it is difficult to take comfort that losses will not prevent the SAIF from reaching its target. The longer the time before the SAIF capitalizes, the greater the chance the SAIF might fail to capitalize. The margin of comfort is too thin.

Therefore, there is a compelling need for legislative action to reduce the disparity in the financial condition of the BIF and the SAIF.

Again, I want to stress that any solution to the SAIF problem should eliminate the long-term premium differential caused by the FICO assessments. It should greatly reduce the time needed to capitalize the SAIF. It should include an immediate injection of funds into the SAIF or a ready source of backup funding for SAIF losses.

Madam Chairwoman, the FDIC is committed to finding solutions that address these three concerns in a manner that is consistent with good public policy. We stand ready to assist the Subcommittee in this effort in the weeks ahead. I commend your farsightedness in holding this hearing and I look forward to your questions and to questions from members of the Subcommittee.

Thank you.
