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TESTIMONY OF

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FEDERAL DEPOSIT INSURANCE CORPORATION

ON

THE CONDITION OF THE SAIF AND RELATED ISSUES

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

11:00 A.M.
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ROOM 534, DIRKSEN SENATE OFFICE BUILDING

Mr. Chairman and members of the Committee: I am here today to describe the difficulties facing the Savings Association Insurance Fund (the SAIF), and to discuss recommendations for resolving those difficulties. These recommendations reflect discussions and analyses by the Department of the Treasury, the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC).

The FDIC has responsibility for two deposit insurance funds: the SAIF and the Bank Insurance Fund (the BIF). The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) created the SAIF to replace the defunct Federal Savings and Loan Insurance Corporation (FSLIC), which had become insolvent as the result of the savings and loan failures of the 1980s. The law provided the SAIF with no funds at its inception. For a variety of reasons, the mechanisms established to fund, or capitalize, the SAIF have not enabled it to reach the target minimum reserve ratio of 1.25 percent of insured deposits set by Congress in FIRREA.

A number of other factors compound the problem of the SAIF's inadequate capitalization. This testimony describes each of the SAIF's difficulties, shows how they are interrelated, and argues that they require Congressional action. The difficulties facing the SAIF are real and substantial. They can only be addressed comprehensively through Congressional action.

This testimony is divided into four parts. The first summarizes the SAIF's difficulties. The second discusses the possible consequence of these difficulties -- an insolvent SAIF. The third presents an overview of funding sources for dealing with the SAIF's difficulties. The fourth and final portion of the testimony describes recommendations for resolving the difficulties.

THE SAIF'S DIFFICULTIES

Three problems are at the heart of the SAIF's difficulties. First, the SAIF is grossly undercapitalized. Second, a sizable portion of the SAIF's ongoing assessments is diverted to meet interest payments on obligations of the Financing Corporation (FICO). Third, on July 1 the SAIF assumed responsibility from the Resolution Trust Corporation (RTC) for paying the costs arising from any new failures of thrift institutions. These three problems are exacerbated by several additional factors: the shrinkage since the SAIF was created in 1989 in both the SAIF assessment base and the portion available to provide assessment income for the FICO obligation; the incentives that the forthcoming BIF-SAIF premium disparity will provide for further shrinkage in the SAIF assessment base, primarily through the migration of deposits; and the difficulty of obtaining access to funds Congress provided as emergency backup for the SAIF.

Undercapitalization

The foremost problem confronting the SAIF is that it is grossly undercapitalized, a particular concern to the FDIC, which oversees the deposit insurance funds. At the end of the first quarter of 1995, the SAIF had a balance of $2.2 billion, or only 0.31 percent of insured deposits. The balance was less than seven percent of the assets of SAIF-insured "problem" institutions. At the current pace, and under reasonably optimistic assumptions, the SAIF is unlikely to reach the minimum reserve ratio of 1.25 percent until the year 2002.

In contrast, the $23.2 billion BIF balance at the end of the first quarter was 1.22 percent of BIF-insured deposits and 70 percent of the assets of BIF-insured "problem" institutions. The BIF probably reached the 1.25 minimum reserve ratio during the second quarter of this year, although the FDIC cannot confirm this fact until the Call Reports for the second quarter have been received and analyzed.

The FICO and Other Diversions

A principal reason the SAIF is undercapitalized is that SAIF assessments have been diverted to purposes other than building the fund. This problem was described in detail in a recent General Accounting Office report. In short, since 1989, $7.4

billion -- approximately three-quarters of SAIF assessments -- have been diverted from the SAIF to pay off obligations arising from the government's efforts to handle the thrift failures of the 1980s. The Resolution Funding Corporation (REFCORP) received $1.1 billion. The Federal Savings and Loan Insurance Corporation Resolution Fund (FRF) received $2 billion. The FICO has received $4.3 billion. Without these diversions, the SAIF would have reached its designated reserve ratio of 1.25 percent last year, prior to the BIF.

Only the FICO obligation remains, but under current law it has an annual call of up to the first $793 million in SAIF assessments until the year 2017, with decreasing calls for two additional years thereafter. In 1995, the FICO draw is expected to amount to approximately 45 percent of all SAIF assessments.

Congress established the FICO in the Competitive Equality Banking Act of 1987 (CEBA) in a vain attempt to recapitalize the FSLIC. Using $680 million in capital from the Federal Home Loan Banks, the FICO purchased 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 $8.2 billion in bonds. When these bonds 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 obligation of SAIF-insured institutions to the FICO involves the interest on the FICO bonds. Congress in CEBA made FSLIC-insured institutions responsible for the annual interest payments on the FICO bonds. When the FSLIC was abolished, following its failure, and replaced with the SAIF in FIRREA, SAIF-insured savings associations were given the obligation of FSLIC-insured institutions for the FICO interest payments. Attempts to capitalize the SAIF against the drain of the FICO interest payments can be likened to trying to fill a bucket with a hole in it.

Assumption of Responsibility for Thrift Failures

On July 1, 1995, the SAIF's undercapitalized condition became a matter of significant, continuing concern. On that date, the SAIF assumed responsibility from the RTC for resolving all new failures of SAIF-insured thrifts. One large or several sizable thrift failures could quickly deplete the $2.2 billion balance in the fund. While the FDIC is not currently predicting such failures, they are possible. The possibility is enhanced by the portfolio concentration of SAIF-member institutions in housing-related assets and the concentration of overall exposure in California, a state that has experienced significant volatility in real estate values.

The SAIF's Shrinkage

The assumption at the time of the SAIF's creation in 1989 by FIRREA was that the SAIF assessment base -- primarily SAIF-insured deposits -- would grow. The estimate by the Administration and the Congressional Budget Office was that thrift deposit growth would be six to seven percent annually. That growth has not occurred. Instead, SAIF deposits have declined every full year since the fund's creation. At year-end 1989, SAIF deposits were $950 billion. On March 31, 1995, SAIF deposits were $733 billion. At the current average assessment rate, a SAIF assessment base of $328 billion is necessary to generate sufficient assessment income to meet the FICO interest obligation.

Although SAIF deposits grew slightly in the last quarter of 1994 and the first quarter of 1995, by 0.6 percent and 1.6 percent respectively, there is no indication that the growth constitutes a permanent reversal of the long-term downward trend. The growth can very likely be traced to efforts by thrifts to seek lower-cost funding sources. For thrifts, insured deposits during the period were a low-cost source of funds because higher return options for depositors were limited. A shift in the interest-rate environment could quickly result in the evaporation of the growth SAIF-insured deposits experienced over the last two quarters. In addition, some SAIF members may have decided to leave insured deposits in the SAIF while waiting to see whether legislative solutions to the problems of the SAIF were possible. If no solutions are found, a return to a shrinking SAIF assessment base could come quickly.

A further problem concerning a shrinking SAIF is that under current law a portion of SAIF assessments are not available for the FICO interest payments. The SAIF assessments unavailable for the FICO interest payments are those from so-called Oakar and Sasser banks. An Oakar bank is a BIF-member bank that has acquired SAIF-insured deposits and pays deposit insurance premiums to both the BIF and the SAIF. A Sasser institution is a commercial bank or state savings bank that has changed its charter from a savings association to a bank but remains a SAIF member. SAIF assessments from Oakar and Sasser institutions are unavailable for the FICO obligation because under the law only assessments from insured institutions that are both savings associations and SAIF members may be used for the FICO interest payments.

The portion of SAIF assessments from Oakar and Sasser institutions, and consequently the portion of SAIF assessments unavailable for the FICO obligation, has been growing. At year-end 1992, Oakar and Sasser institutions held 14 percent of SAIF-assessable deposits; at year-end 1993, the proportion was 25 percent; and on March 31 of this year, it was 34 percent.

As of the end of March, the portion of the SAIF assessment base available for the FICO payments -- that is, the portion of the base remaining after the SAIF deposits of Oakar and Sasser institutions are subtracted -- totalled $478 billion. This leaves a "cushion" of $150 billion above the assessment base of $328 billion that is needed at the current average assessment rate to generate sufficient assessment income to meet the FICO interest obligation. The cushion is only half of what it was at year-end 1992. Continued shrinkage in the cushion -- because of continued shrinkage in the overall SAIF assessment base, continued growth in the Oakar and Sasser portions of the base, or some combination of the two -- could result in a shortfall in assessment revenues to meet the FICO interest obligation well before the year 2000.

BIF-SAIF Premium Disparity

A key additional factor complicating the SAIF's predicament is the forthcoming assessment disparity between SAIF-insured and BIF-insured institutions, and the market responses. The disparity stems from current statutory requirements. Insurance premiums for the BIF and the SAIF must be set independently. When an insurance fund reaches its designated reserve ratio of

1.25 percent of insured deposits, the FDIC's mandate, absent a factual basis for a higher designated reserve ratio, is to set assessments to maintain the fund at that target ratio. Therefore, the arrival of the BIF at the designated reserve ratio requires that BIF assessment rates be substantially reduced.

In January of this year, the FDIC issued a proposal to lower assessment rates for all but the riskiest BIF members when the fund attains the designated reserve ratio. Because the SAIF is significantly undercapitalized, the FDIC proposed that assessment rates for SAIF members remain at current levels. The proposals would result in SAIF members paying an average assessment rate approximately 20 basis points higher than BIF members. The average assessment rate for SAIF members would be 24 basis points, or 24 cents per $100 of assessable deposits; the average assessment rate for BIF members would be 4.5 basis points, or 4.5 cents per $100 of assessable deposits. When it takes final action in the near future, the FDIC may not adopt this exact proposal, but if it does not, under current law something similar would be required because of the expected recapitalization of the BIF.

Given the current size of the SAIF's assessment base, the FICO obligation would constitute approximately 11 basis points of the proposed premium differential. If the assessment base of the SAIF were to shrink, the size of the differential attributable to the FICO obligation would increase. Even when the SAIF reaches the capitalization level, the responsibility for the FICO interest payment would result in a BIF-SAIF premium disparity until the year 2019.

The potential premium differential between BIF members and SAIF members could adversely affect SAIF members in a number of ways, including increasing the cost of remaining competitive, impairing the ability to generate capital internally or externally, and leading to higher rates of failure for thrift institutions that compensate for the differential in unsafe or unsound ways. Most important from the standpoint of the SAIF, however, a premium differential would create a powerful incentive for SAIF members to minimize exposure to the higher SAIF rates. A sufficiently heavy response to this incentive could reduce the SAIF assessment base below the level necessary to provide adequate assessment revenue to meet the FICO obligation. Thus, the forthcoming BIF-SAIF premium disparity poses the real possibility of a default on the FICO interest payments.

Deposit Migration

There are two general ways SAIF members can act in response to the incentive to reduce their exposure to higher SAIF assessment rates. First, SAIF members can increase their reliance on nonassessable funding sources, such as Federal Home

Loan Bank advances and reverse repurchase agreements. The securitization of real estate lending portfolios can also decrease the need for assessable deposits.

Second -- and constituting probably the bigger threat to the SAIF -- members of the SAIF can pursue a deposit migration strategy. An FDIC analysis of the immediacy of the problems confronting the SAIF is attached as Attachment A. The analysis includes a discussion of the potential for and impediments to deposit migration from the SAIF. Since March 1, a number of holding companies with SAIF members have applied for de novo bank charters and federal deposit insurance in the BIF. Generally, the proposals seek to establish branch offices of the new BIF member in existing branch offices of the SAIF-member subsidiary. Customers could then be encouraged through various incentives to shift deposits from the SAIF-member subsidiary to the newly chartered BIF-member.

Another deposit migration strategy is open to holding companies that already have both BIF-member and SAIF-member subsidiaries. One such organization has applied for shared branch locations. Similarly, a thrift holding company could acquire an existing BIF-member. Finally, transfers of deposits could be accomplished through agency relationships, as permitted under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Under the provisions of that Act, shared branching arrangements between BIF and SAIF affiliates would not be necessary because offices of SAIF-member thrifts could accept deposits "as agent" for BIF-member affiliates.

To date, the applications for bank charters, deposit insurance, and shared branch arrangements remain under consideration by the chartering authorities and the FDIC. Together, the thrifts involved have SAIF deposits that represent more than 75 percent of the remaining FICO cushion against default. Even if all of these applications are approved, some obstacles exist to a massive migration of deposits. Still, deposit migration due to the incentive provided by a BIF-SAIF premium disparity is a significant threat to the existing balance of the SAIF.

Deposit migration would also exacerbate potential structural problems in the SAIF. The institutions most likely to migrate would be the stronger ones. This would leave the SAIF to be supported by, and to insure the deposits of, members that are currently considered higher-risk institutions. The effectiveness of the SAIF as a loss-spreading mechanism -- an effectiveness already less than optimal because of the large exposure of the thrift industry to the volatile housing industry -- would be reduced. In this regard, it is worth noting that the eight largest SAIF-insured institutions operate predominantly in California and hold 18.5 percent of all SAIF-insured deposits.

Any deposit migration that increased the SAIF's exposure to a particular geographic region or accentuated the extent of concentration among the SAIF's members would not be good for the fund's financial health.

Banks also might be affected by deposit migration. For example, banks might be forced to pay later if the SAIF fails because the stronger institutions have left it. Moreover, a migration of deposits from the SAIF to the BIF could lead to a dilution of the BIF's reserve ratio and the need for higher BIF premiums to compensate.

Therefore, for a variety of reasons, deposit migration poses a number of problems for the SAIF and could ultimately threaten its soundness. For members of the SAIF, the specter of years of high assessment rates attributable to the FICO interest obligation may well produce a rush to a less expensive insurance fund.

Backup Funds

When it replaced the FSLIC with the SAIF in 1989, Congress recognized that the draws on the SAIF by the FRF, the REFCORP, and the FICO would substantially delay the capitalization of the fund. Consequently, FIRREA authorized appropriations of up to $32 billion to capitalize the SAIF. An amount not to exceed $16 billion was to be in the form of payments of $2 billion annually through 1999. The purpose of the annual payments was to supplement assessment revenue. An additional $16 billion was authorized to maintain a statutory minimum net worth through 1999. Subsequent legislation extended the date for the receipt of the Treasury payments to 2000. Despite requests by the FDIC for the funds authorized to capitalize the SAIF, the SAIF never received any of the authorized funds.[1]

The RTC Completion Act of 1993 eliminated the authorized funds for the SAIF.[2] Instead, the Completion Act established a procedure giving the FDIC possible access to two backup funding sources for the SAIF: (1) for fiscal years 1994 through 1998, an

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[1]The 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 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. 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.

[2]In his letter dated September 23, 1993, to the House and Senate Banking Committee Chairmen and Ranking Minority Members, Acting FDIC Chairman Andrew C. Hove, Jr., cautioned that the legislation being considered to replace the SAIF funding authorizations of FIRREA, and that subsequently was approved as the RTC Completion Act, left significant problems: "[b]oth bills leave unresolved issues regarding the viability and the future of the thrift industry and the SAIF."

authorization for payments from the Treasury of up to $8 billion; and (2) during the two years following the RTC's termination on December 31, 1995, money authorized for the RTC to complete its work but unspent by that agency. In order to obtain funds from either of these sources, however, the FDIC must certify to Congress that an increase in SAIF premiums could 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.

Such a certification essentially requires a finding that there are foreseeable losses to the SAIF that will fully deplete the fund. Moreover, unlike the funds authorized for the SAIF under FIRREA but never appropriated, the sources of funds for the SAIF under the RTC Completion Act cannot be used to capitalize the SAIF -- that is, to build an insurance reserve. They are available only to replenish SAIF losses, leaving to SAIF members the continuing obligation to pay premiums at a level sufficient to capitalize the SAIF in the face of losses and debt service on the FICO bonds.

<u>Summary</u>

In summary, the SAIF is in a troubled state. It is significantly undercapitalized and since July 1 has had responsibility for paying the costs of thrift failures. The forthcoming insurance premium disparity with the BIF, which is required by law, is very likely to exacerbate the situation. A comprehensive solution to the SAIF's problems is beyond the authority of the FDIC, and Congressional action is necessary. If there is no Congressional action, the continued undercapitalization of the SAIF is virtually ensured, a default on FICO interest payments is likely, and the insolvency of the SAIF is a possibility. The next section of this testimony explores the ramifications of an insolvent SAIF and a FICO interest payment default.

AN INSOLVENT SAIF?

Deposit insurance is a fundamental part of the financial industry safety net. As part of the larger safety net, the deposit insurance system not only protects individual depositors but serves to buttress the banking and thrift industries during times of stress by substantially eliminating the incentives for depositors to engage in runs on banks and thrifts. Deposit insurance and the safety net provide security for customers, and stability for the financial system as a whole.

In 1933, the year the FDIC was created, there were 4,000 bank failures. In 1934, the first year the FDIC was in operation, there were nine bank failures. Deposit insurance provided the stability the banking industry needed to begin the long road back from the brink of collapse. In the 1980s and early 1990s, deposit insurance helped prevent the troubles encountered by the bank and thrift industries from escalating into an economy-wide disaster. Despite failures of a large number of institutions, the harm was contained. At one point, the FDIC borrowed funds for working capital purposes from the Federal Financing Bank, but the money was repaid with interest. The balance in the BIF declined, and as a result of an extremely large reserve for possible bank failures, fell below zero, but the fund was completely rebuilt. The rebuilding was due to insurance premiums paid by banks and to the greatly improved health of the banking industry, which permitted the reserve for losses to be reduced. No taxpayer money was needed for the BIF's recapitalization. The banking system not only survived but emerged renewed and revitalized. Deposit insurance and the safety net worked.

If the SAIF were allowed to become insolvent, the confidence Americans have in FDIC insurance as a source of stability for financial institutions could well be undermined, and the government's commitment to the safety net for the financial system could be called into question. The deposit insurance system and the other components of the financial industry safety net rest ultimately on confidence -- on the belief that the full faith and credit of the U.S. Government support the safety net.

Public confidence was a major reason that the troubles of the 1980s and early 1990s did not lead to widespread panic and economic disarray. That confidence could be damaged if government is perceived as no longer willing to support one or more components of the safety net.

Indeed, that confidence could be damaged if government is perceived as once again pushing a financial problem into the future in hopes that it will go away. The government's early, limited efforts in addressing the savings and loan crisis -- such efforts as the inadequate $10 billion authorized in 1987 to recapitalize the FSLIC through the issuance of FICO bonds -- ended up costing much more than a timely solution would have cost. Confidence in the government's backing of deposit insurance and the safety net is reduced if difficult issues are not fully addressed, and solutions are incomplete.

Experience with underfunded state deposit insurance funds in Maryland, Ohio, and Rhode Island, and with the underfunded FSLIC, shows that permitting an insurance fund to continue in an undercapitalized position is an invitation to much greater difficulties. At times in the past, regulators and legislators have failed, for various reasons, to take prompt action when large or visible institutions insured by a grossly weakened fund began to falter. Fear of runs on deposits inhibited action. Failed institutions were handled in a manner that minimized or deferred cash outlays but ultimately increased costs. In short, the failure to take adequate corrective action allowed the problems to become worse.

Related to the possible insolvency of the SAIF is the question of what would happen if the FICO bonds go into default. This is a subject of more direct concern to the Department of the Treasury, but the effects could be widespread. Among those effects could be downward pressure on the prices -- and upward pressure on the interest rates -- of securities issued by government-sponsored enterprises such as Fannie Mae, Freddie Mac, Farmer Mac, and Sallie Mae, which like the FICO are not backed by the full faith and credit of the United States. A fall in the prices of these types of securities would harm the balance sheets of investors holding them. Banks, of course, have large quantities of these securities in their portfolios.

A final but important point concerning the danger of contagion inherent in the SAIF problem is that only a small segment of the population distinguishes the SAIF, the BIF, and the FDIC. To most, only one acronym, "FDIC," matters. Indeed, Congress mandated in 1989 that the SAIF become "FDIC insured" precisely to ensure confidence in its future. Insolvency of the SAIF could be viewed by the public as a problem with FDIC insurance and with the federal safety net. In a public hearing the FDIC held in March, several bankers stated that "FDIC insured" is like a prized brand name to customers, and that the integrity of the name must be preserved.

SOURCES OF FUNDS

As with many public policy problems, the solution to the problems of the SAIF begins with money. Approximately $6.6 billion are needed to capitalize the SAIF -- to raise its balance to the point where the designated reserve ratio is $1.25 for every $100 in insured deposits. Capitalizing the SAIF, however, would resolve only part of its difficulties. The forthcoming BIF-SAIF premium disparity, the incentive this will give to institutions to abandon the SAIF, and the resultant specter of default on the FICO interest payments also must be addressed.

This section of the testimony examines the sources of money to resolve the SAIF's difficulties from a broad perspective. The discussion shows that no single source of money is adequate to alleviate all of the problems. A combination approach is required. Such an approach is described in the succeeding section.

Before the sources of money are examined, several considerations are worthy of note. One involves the appropriate use of insurance funds. The use of deposit insurance funds for purposes other than the protection of deposits can create future problems, as the diversion of SAIF funds from 1989 to the present should attest. That diversion led to the current undercapitalization of the SAIF and the present dilemma.

Another consideration is fairness. All parties touched by the SAIF's difficulties can make compelling cases about fairness. BIF members contend that the banking industry was not responsible for the savings and loan crisis, and consequently should not have to contribute financially to the resolution of a problem arising from the crisis. SAIF members argue that they should not be held responsible for costs incurred years ago by thrift institutions that failed. Many members of Congress and other protectors of the public purse argue that public funds should not be tapped again for the savings and loan clean-up, particularly given the strong need to balance the federal budget. Banks and thrift institutions point to others in the financial system who will benefit from a resolution of the SAIF's problems. Credit unions would benefit from assuring a sound safety net, and government-sponsored agencies would benefit from preventing a FICO default.

While each of these positions has merit, the fact remains that solving the SAIF's difficulties requires a financial sacrifice. In the final analysis everyone in the financial system has an interest in ensuring the system's stability.

In discussions with members of Congress, certain sources of possible funding to resolve the SAIF's problems have been identified more frequently than others, although the choice of funding alternatives would of course ultimately be at the discretion of Congress. These sources of funds for resolving the SAIF's difficulties are: (1) a special assessment on members of the SAIF; (2) investment income from the insurance funds; (3) FDIC insurance assessments themselves; and (4) funds appropriated for the RTC that may remain unspent at the end of the year when the RTC sunsets.

A one-time up-front special cash assessment on members of the SAIF could raise the $6.6 billion needed as of the end of the first quarter 1995 to capitalize the SAIF. A full one-time capitalization would require an assessment of approximately 85 to 90 cents per $100 of assessable deposits in SAIF-insured institutions. A possible downside of such a large one-time assessment could be an increased potential for thrift failures. Based on year-end 1994 financial reports, a 90-basis-point assessment would move a very small number of SAIF members with total assets of $500 million into the critically undercapitalized capital category. Another 103 SAIF members would be downgraded one notch from current capital categories. An approach that excludes the weaker SAIF members from a one-time up-front cash assessment could help alleviate that difficulty. A special assessment to capitalize the SAIF would by itself, however, leave the problem of the FICO interest payment and the resultant long-term BIF-SAIF premium disparity unresolved.

Investment income of one or both of the insurance funds is a second possible source of funding. Various proposals have been advanced to use investment income of the BIF and the SAIF for the FICO interest payment. The SAIF, of course, would have to be near the level of full capitalization before it would be able to generate a significant amount of investment income.

The use of investment income from the funds to meet the interest obligation on the FICO bonds has the advantage of limiting the precedent for applying insurance money to purposes other than meeting insurance losses or adding to fund balances. Nevertheless, because the investment income of a deposit insurance fund adds to the fund's balance and offsets the need for future insurance assessments, the difference between investment income and assessment income as a source of funding is more one of timing than result. Over time, the financial impact on individual institutions would be the same. In any event, the use of investment income of the insurance funds for the FICO interest payment alone would leave the problem of the SAIF's capitalization unresolved.

A third source of funding is insurance assessments themselves. If SAIF assessments were to be the main source of funding for the FICO obligation, a long-term premium disparity between the BIF and the SAIF would continue until the year 2019. If there were a fifty-fifty sharing between the funds, the disparity would be reduced to approximately 4 basis points in the near term. The disparity would increase if the shrinkage of the SAIF continued. Whether a 4-basis-point or more differential over 24 years is sufficiently small to forestall deposit migration from SAIF-insured institutions to BIF-insured institutions is a matter of uncertainty.

Like the use of investment income of the insurance funds to meet the FICO obligation, the use of assessment income goes against, to an extent, the principle of limiting insurance funds to insurance purposes. In a broader sense, however, the FICO obligation, arising as it did from efforts to recapitalize the FSLIC, is an "insurance purpose." Moreover, the precedent of using assessment income for the FICO payment has, unfortunately, already been established. Therefore, broadening the sources of assessment income for the FICO interest payment when the end result is to ensure the safety of an FDIC-insured fund and the stability that FDIC deposit protection provides to the financial system would be more a matter of spreading the burden to all FDIC-insured institutions than of opening new doors. Using the assessment income of the insurance funds for the FICO payment by itself without complementary action, however, would not address the problem of the SAIF's capitalization.

Another source to be considered is the estimated $10 billion in appropriated RTC funds that may remain unspent when the RTC completes its work at the end of this year. These funds could be used to address the undercapitalization of the SAIF, or to defease the FICO bonds by providing a source of funding for interest payments until 2019, or some combination of the two. Depending on how much of these funds were so applied, there might also have to be other funding to cover the remaining FICO burden in order to prevent deposit migration.

The major problem with use of the unspent RTC funds, or use of any taxpayer funds, to deal with the SAIF problem is the impact of public funding on the federal deficit. Use of unspent funds authorized for the RTC would not be "revenue neutral." Reducing the federal budget deficit is a major priority of both the legislative and executive branches of the government. The balancing of fiscal considerations against the need to address the SAIF's problems overhangs all possible solutions to these problems.

RECOMMENDATIONS

After extensive analysis of the relevant issues, the FDIC strongly supports the proposal developed on an interagency basis for resolving the problems of the SAIF. The proposal has three components to address the immediate, pressing financial problems of the SAIF: (1) the SAIF would be capitalized through a special up-front cash assessment on SAIF deposits; (2) the responsibility for the FICO payments would be spread proportionally over all FDIC-insured institutions; and (3) the BIF and the SAIF would be merged as soon as practicable, after a number of additional issues related to the merger are resolved. In addition to the three components of the proposal, the FDIC and the OTS also recommend making unspent RTC funds available as a kind of reinsurance policy against extraordinary, unanticipated SAIF losses to limit the potential future costs to taxpayers from the existing full faith and credit guarantee of the U.S. Government that the SAIF enjoys. An outline of the proposal is attached as Attachment B.

SAIF Capitalization

A special assessment on SAIF deposits would be used to capitalize the SAIF immediately. Institutions with SAIF-assessable deposits would be required to pay a special assessment in an amount sufficient to increase the SAIF's reserve ratio to 1.25 percent. The special assessment would amount to approximately 85 to 90 basis points, or 85 to 90 cents for every $100 of assessable deposits. A special assessment of this magnitude would produce approximately $6.6 billion, increasing the SAIF's balance to $8.8 billion and the reserve ratio to 1.25

percent. The special assessment would be based on SAIF-assessable deposits held as of March 31, 1995, and would be due on January 1, 1996.

After the SAIF is capitalized, its risk-related assessment schedule would be similar to the final schedule adopted for the BIF. Thereafter, as required by current law, assessments for the two funds would be set independently and would take account of losses to each fund separately, except that SAIF premiums would not be allowed to be lower than BIF premiums until the funds are merged. For purposes of setting risk-related assessments for calendar year 1996, the FDIC would calculate a SAIF-insured institution's capital before payment of the special assessment while at the same time taking into account fluctuations to capital from other causes.

Under the proposal, the FDIC's Board of Directors could protect the SAIF from losses that could result from imposition of the special assessment by exempting a weak institution from the up-front special assessment if the Board determined that the exemption would reduce risk to the SAIF. Any institution exempted from the special assessment would be required to continue to pay regular assessments under the current SAIF risk-related assessment schedule for the next four calendar years (1996 to 1999). As weaker institutions pay premiums of 29 to 31 basis points under the current risk-related premium schedules, this would constitute a total payment of up to 124 basis points per $100 of assessable deposits for the exempted institutions. That total payment would recognize the cost to the SAIF of the financial benefit given to the recipients of the deferral from the special assessment.

FICO Payments

The assessment base for interest payments on the FICO bonds would be expanded to cover all FDIC-insured institutions, both members of the SAIF and members of the BIF. The expansion would not only add all members of the BIF to the assessment base for the FICO payments but would also end the current exclusion of Oakar and Sasser institutions from that base. The effective date for the expansion would be January 1, 1996. The result of the expansion would be to spread the FICO obligation *pro rata* over all FDIC-insured institutions. At current insured deposit levels, the costs of this sharing would be 2.5 basis points, or 2.5 cents for every $100 in assessable deposits. A sharing of the FICO burden on a *pro rata* basis among all FDIC-insured institutions would focus the solution on those institutions that benefit directly from federal deposit insurance.

An alternative would be to look to other participants in the financial system to share the FICO burden. While the proposal is based in large part on numerous discussions with members of the

Congress on viable approaches to solving the SAIF's problems, the FDIC recognizes that it is ultimately Congress' judgment about whether to enlist in a solution other participants in the financial system who will benefit from stabilization of the SAIF and assurance that the FICO obligation will be repaid.

As a corollary, the FDIC would be authorized to rebate assessment income to BIF members if circumstances permit. That is, if the BIF had reserves exceeding its designated reserve ratio target, BIF assessment income could be rebated to BIF members.

From 1950 to 1989, the FDIC had the statutory authority to make rebates from assessment income, and did so for every year until 1985. The rebate authority from 1950 to 1989 only covered assessment income. The authority did not extend to the investment income of the insurance fund. Because of losses to the insurance fund, no rebates were made from 1985 to 1989. The rebate authority was substantially altered in 1989 in FIRREA, altered again in 1990 in the Assessment Rate Act, and eliminated entirely in 1991 in the Federal Deposit Insurance Corporation Improvement Act. The elimination occurred because Congress evidently considered rebate authority obsolete in view of the FDIC's power to set risk-related premiums to maintain the designated reserve ratio. A reduction in assessment rates was considered sufficient to accomplish the same result as rebates.

Experience is showing, however, that the power to reduce assessment rates is not equivalent in all respects to the power to make rebates. The FDIC Board of Directors generally considers three factors in setting deposit insurance assessments: (1) the designated reserve ratio; (2) expected operating expenses, projections of losses to the insurance fund from the failures of member institutions, and the effect of assessments on members' earnings and capital; and (3) the obligation to maintain a risk-related deposit insurance system. Taking these factors into account may lead to a significant buildup in an insurance fund. To avoid such a buildup, the FDIC Board should have reasonable discretion to rebate collected assessments, when circumstances permit.

To promote assessment rate stability and to ensure the soundness of an insurance fund, the FDIC's authority to set assessment rates should be clarified to allow explicitly the balance in the BIF to vary within a reasonable range from the target designated reserve ratio. The FDIC could be required under the current provisions of the law to make frequent relatively large adjustments in assessment rate schedules, including at times when insured institutions may be least able to sustain higher rates. In an environment of frequent adjustments in assessment rate schedules, depository institutions would have difficulty making reliable projections about their costs, and the

FDIC during serious economic downturns could be constrained from charging higher premiums.

Also to promote assessment rate stability, the minimum average premium required under Section 7(b)(2)(E) of the Federal Deposit Insurance Act when a deposit insurance fund is undercapitalized or when the FDIC has borrowings outstanding for the fund from the Treasury or the Federal Financing Bank should be reduced from 23 basis points to 8 basis points. The smaller minimum would give the FDIC greater flexibility to smooth out or phase in assessment rate changes, thereby making costs for the industry less erratic.

Merger of the Funds

The two elements of the proposal discussed thus far would provide immediate financial stability for the SAIF. The third element of the proposal, a merger of the BIF and the SAIF, is a necessary component of a solution to long-term structural problems facing the thrift industry, and consequently the industry's deposit insurance fund.

A sound deposit insurance system requires viable and sound banking and thrift industries. The thrift industry would seem to fall short of that characterization in the longer term. Encouraged or required by law, the industry concentrates on one sector of the economy, the housing sector, that is particularly volatile. The concentration hinders the ability of institutions to diversify risks and income sources. Moreover, as noted earlier in this testimony, the industry is concentrated geographically: the eight largest SAIF-insured institutions operate predominantly in California and hold 18.5 percent of all SAIF-insured deposits.

The FDIC strongly agrees that a merger of the BIF and the SAIF as soon as practicable is an important component of a long-term solution to the structural problems of the SAIF and the thrift industry. With respect to the immediate financial problems facing the SAIF, the FDIC believes that while a merger should be part of a solution, it should not be viewed as a substitute approach to capitalizing the SAIF. To avoid unfairness to BIF-insured institutions and to avoid dropping the BIF below the full recapitalization level, the task of recapitalizing the SAIF should be a responsibility of the current members of the SAIF.

A broader concern of the FDIC about a merger of the insurance funds is that the additional issues raised could take substantial time and effort to resolve. The charter question is the first issue encountered, although it could be addressed with thrifts accepting a bank charter, which could include a provision allowing the mutual form of organization. Other issues are also relevant and all, we believe, can be resolved. The FDIC favors an approach that addresses these questions sooner rather than later -- indeed as soon as practicable. The Treasury Department is working on a comprehensive approach to deal with the additional issues, and the FDIC expects to be a part of the effort. While these issues are being addressed, the SAIF would be fully capitalized and its immediate financial problems resolved.

The other elements of the proposal -- the special assessment to capitalize SAIF, the spreading of the FICO burden, no rebate authority for SAIF, and the provision that SAIF premiums could not go below BIF premiums -- could, under favorable economic conditions, result in a SAIF balance in excess of the designated reserve ratio. If this were to occur, any such excess funds in the SAIF at the time of the merger should not be rebated but remain in the merged fund as further protection from future losses.

In summary, sound policy reasons mandate a merger of the BIF and the SAIF. The marketplace has made many of the charter restrictions that govern the financial industry obsolete, even economically harmful. The longer-term structural problems of the thrift industry lead the FDIC to support strongly a merger of the BIF and the SAIF as soon as practicable.

Unspent RTC Funds

In addition to the three elements of the joint proposal, the FDIC and the OTS believe a fourth component is necessary. We recommend that the unspent RTC funds be made available as a backstop, or reinsurance policy, for extraordinary, unanticipated SAIF losses until the BIF and the SAIF are merged. Asking for taxpayer money, even in a backup role, is not done lightly, but the need to ensure a comprehensive resolution of the SAIF's difficulties is imperative. In 1989 in FIRREA, Congress authorized appropriations of up to $32 billion in taxpayer funds to capitalize the SAIF. Also, those authorizations were eliminated in the RTC Completion Act. Currently, the FDIC has access to taxpayer funds to replenish losses in the SAIF, provided the FDIC finds that foreseeable losses will fully deplete the fund.

Most of the savings and loan clean-up has been accomplished. The undercapitalized SAIF, however, is unfinished business from the savings and loan crisis in need of immediate attention. Providing unspent RTC funds in a backup role would be in keeping with Congress' original intention of providing funds to ensure a sound SAIF. It would be only a small step beyond current law, which provides access to unspent RTC funds and other taxpayer funds to pay for losses to the government from failed thrifts.

Moreover, the SAIF enjoys the full faith and credit guarantee of the U.S. Government. If the SAIF became insolvent, taxpayer money would be required to compensate insured depositors. Authorizing access to unspent RTC money to cover losses before an insolvency of the SAIF occurs is sound public policy and could ultimately save taxpayer money.

The recommendation of the FDIC and the OTS for the unspent RTC funds covers extraordinary losses above those currently projected. Under our recommendation, if SAIF losses were to exceed $500 million in any calendar year during the period beginning on July 1, 1995 -- when the SAIF took over the RTC's responsibility for resolving failed institutions -- and ending with the merger of the BIF and the SAIF, unspent RTC funds would be used to cover the excess. Thus, the SAIF would cover the first $500 million in losses during any year, and unspent RTC funds would cover only any additional losses.

Neither the Congressional Budget Office (CBO) nor the FDIC currently projects that SAIF losses will reach $500 million in any year. The CBO projects losses of $450 million per year. The FDIC projects losses of $270 million per year. It is, of course, difficult to predict losses more than six months to a year ahead. Unspent RTC funds would serve as a reinsurance policy against losses more severe than those now anticipated. The backup funds would assure SAIF members that for the near term they would not be asked to pay yet another special assessment to capitalize the fund. This assurance would further minimize the economic incentive for thrift institutions to shift deposits from the SAIF to the BIF.

CONCLUSION

Congressional action to resolve the difficulties facing the SAIF is very much needed. With a balance amounting to only 0.31 percent of insured deposits, the SAIF is grossly undercapitalized. This undercapitalized condition is directly attributable to the fact that since the SAIF's establishment in 1989, approximately 77 percent of assessment revenues from SAIF members has been statutorily diverted to pay for past losses related to the savings and loan crisis. Of the diversions, only the FICO interest obligation remains, but it has been the principal diversion -- and will consume 45 percent of the SAIF's assessment revenue this year. It will continue to be a drain on the SAIF until the year 2019. The SAIF's undercapitalized condition became more pressing on July 1, 1995, when the fund assumed the responsibility for paying the costs of thrift failures. One large or several sizable thrift failures could quickly deplete the SAIF's balance.

Additional matters add to the SAIF's difficulties. Contrary to expectations when the SAIF was created in 1989, the SAIF assessment base has decreased significantly. The portion of the base available to provide assessment income for the FICO obligation has also been shrinking. The forthcoming BIF-SAIF premium disparity will likely cause further shrinkage in the SAIF assessment base, primarily through the migration of deposits from SAIF-insured accounts to BIF-insured accounts. The possibility of thrift failures and losses to the SAIF is enhanced by the asset and geographic concentration of SAIF-member institutions. These concentrations also constitute longer term structural problems facing the industry. Finally, revenue and net worth supplements totalling $32 billion that Congress had authorized for the SAIF were never appropriated, and funds authorized under current law to replenish SAIF losses can be made available essentially only if the FDIC concludes that the insolvency of the SAIF is likely.

The FDIC believes that the interagency proposal and the recommendations discussed in this testimony would resolve the difficulties facing the SAIF. The approach suggested would prevent those difficulties from escalating to the point where the deposit insurance system and the federal government safety net for the financial industry are threatened. The recommendations would result in full capitalization for the SAIF. They would provide for that capitalization quickly. They would ensure that the FICO interest obligation is met. They would avoid a crushing burden to one small sector of the economy. They would obviate the necessity under current law of an ongoing significant disparity in insurance premiums between BIF-member and SAIF-member institutions, and avoid the strong economic incentive for SAIF members to shift deposits from the SAIF to the BIF, further weakening the SAIF. They would provide for a merger of the BIF and the SAIF and an encompassing solution to significant long-term issues facing the thrift industry.

The FDIC and the OTS would also recommend that Congress provide access to leftover RTC funds to cover only losses to the SAIF that significantly exceed those we currently project. This reinsurance policy for extraordinary losses would assure the stability of the SAIF in the near term until the funds are merged.

In short, the recommendations would resolve the serious problems facing the SAIF and depository institutions. Continued confidence in the deposit insurance system would be assured -- confidence that is necessary for the government safety net to accomplish its purposes.

THE IMMEDIACY OF THE SAVINGS ASSOCIATION INSURANCE FUND PROBLEM

PROBLEMS CONFRONTING THE SAVINGS ASSOCIATION INSURANCE FUND

Despite the general good health of the thrift industry, the Savings Association Insurance Fund (SAIF) is not in good condition and its prospects are not favorable. The SAIF faces the following immediate problems.

The SAIF is significantly undercapitalized.

On March 31, 1995, the SAIF had a balance of $2.2 billion, or about 31 cents in reserves for every $100 in insured deposits. An additional $6.6 billion would have been required on that date to fully capitalize the SAIF to its designated reserve ratio (DRR) of 1.25 percent of insured deposits. At the current pace, and under reasonably optimistic assumptions, the SAIF would not reach the DRR until at least the year 2002. However, even a fully capitalized SAIF would be subject to risks stemming from its size and certain structural weaknesses in the thrift industry. Relative to the Bank Insurance Fund (BIF), the SAIF has fewer members and faces greater risk with the failure of any one member. The exposure of the fund to insured deposits is higher for the SAIF than the BIF; that is, each dollar of SAIF-insured deposits is backed by $1.34 in member assets, whereas the comparable figure for the BIF is $2.20.

The SAIF also faces risks from geographic and product concentrations of the thrift industry. In terms of SAIF-insured deposits, the eight largest institutions operate predominantly in California and hold 18.5 percent of all SAIF-insured deposits.[1] While economic conditions and real-estate markets are beginning to improve in California, the SAIF would have significant loss exposure in the event of a regional economic downturn on the West Coast. Product concentration stems from the Qualified Thrift Lender (QTL) test that must be met to realize the benefits available under a thrift charter. The QTL test requires thrifts generally to maintain 65 percent or more of their assets primarily in loans or investments related to domestic real estate. Consequently, 49 percent of the assets of SAIF members are concentrated in 1-to-4 family mortgage loans, with another 13 percent in mortgage pass-through securities issued or guaranteed by government-sponsored enterprises. While these loans and securities generally involve relatively low credit risk, they can expose institutions to significant interest-rate risk.

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[1]By contrast, the eight largest holders of BIF-insured deposits are located in five different states and hold 10 percent of all BIF-insured deposits.

The SAIF assumed responsibility for resolving failed thrifts as of July 1, 1995.

On July 1st, the SAIF assumed resolution responsibility for failed thrifts from the Resolution Trust Corporation. Because the SAIF is undercapitalized, the failure of one large thrift or several medium-size thrifts could render the SAIF insolvent and put the taxpayer at risk.

SAIF assessments continue to be diverted to meet FICO interest payments.

Since its inception in 1989, the majority of SAIF-member assessment revenue was diverted 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). These diversions totaled $7.4 billion through March of 1995: $4.3 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 in 1994. Importantly, a significant portion of SAIF assessment revenue continues to be diverted to pay the interest on bonds issued by the FICO.

From 1987 to 1989, the FICO issued approximately $8.2 billion in 30-year bonds. The FICO has an ongoing first claim on up to $793 million of SAIF assessment revenues to meet interest payments on these bonds through 2019. In 1995, the FICO claim is expected to amount to approximately 45 percent of current SAIF assessment revenues (11 basis points of the current 23.7 basis point average SAIF assessment rate). The FICO draw on SAIF assessment revenue will remain as an impediment to the SAIF for 24 years to come.

SAIF assessments that can be used for FICO payments are limited by law to assessments on insured institutions that are both savings associations and SAIF members; these institutions currently account for just two-thirds of the SAIF assessment base. At current assessment rates, an assessment base of $328 billion is required to generate revenue sufficient to service the FICO interest payments. On March 31, 1995, the FICO-available base stood at $478 billion. The difference of $150 billion can be thought of as a cushion which protects against a default on the FICO bonds. Shrinkage in the FICO-available assessment base will cause this cushion to dissipate, and it is now less than half of what it was at year-end 1992.

The remaining third of the SAIF assessment base consists of deposits held by so-called Oakar and Sasser institutions.[2] A change in the law concerning the availability of Oakar and

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[2]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. 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. (continued)

Sasser assessments for FICO interest payments would postpone a FICO problem, but in all likelihood would not prevent a FICO default. If there were minimal shrinkage in the SAIF assessment base and current assessment rates were not lowered, the SAIF assessment base might be sufficient to meet the FICO draw through maturity. However, an ongoing rate differential between the BIF and the SAIF would make the prospect of minimal shrinkage of the SAIF assessment base unlikely. Such a rate differential is required under current law once the FDIC confirms the BIF has recapitalized at the DRR of 1.25 percent of insured deposits. More rapid shrinkage of the SAIF assessment base, as would occur in the scenarios below, increases the likelihood of a near-term FICO shortfall.

IMMEDIACY OF THE SAIF PROBLEM

Incentives to reduce reliance on SAIF-insured deposits.

The factors described above have created a situation that provides powerful economic incentives for those institutions that have SAIF-insured deposits to devise means to minimize their exposure to the higher assessment rates of the SAIF. SAIF assessments can be avoided in a variety of ways, including shifting funding to nonassessable liabilities, changing business strategies to reduce the volume of portfolio investments, and structuring affiliate relationships to accommodate migration of deposits from the SAIF to the BIF.

As to the incentives that would precipitate such a change in behavior, there are at least three considerations. First, SAIF assessment rates likely will be about 20 basis points above BIF rates for the next seven years, until, it is projected, the SAIF may be capitalized, and at least 11 basis points higher thereafter, until the FICO bonds mature in 2017 to 2019. To place these numbers in perspective, consider the impact that such a rate differential would have had on 1994 thrift financial returns. SAIF members had a return on assets (ROA) of 0.56 percent in 1994 and a return on equity (ROE) of 7.17 percent. A 20-basis point differential could have reduced net income by as much as 17 percent, dropping the ROA to 0.46 percent and the ROE to 5.93 percent for the year.[3] A long-term differential of this magnitude likely would make many thrifts less competitive in the pricing of loans and deposits, erode earnings and capital and hamper access to new capital.

(footnote 2 continued) A 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.

[3]This assumes that banks would pass their entire assessment savings to borrowers or depositors, forcing thrifts to set prices accordingly in order to compete. Alternatively, some thrifts may be able to lessen the impact of a premium differential by reducing other expenses or raising other revenues.

Second, the perceived fragility of the SAIF may mean that the remaining SAIF-insured institutions not only will have to bear an increasing share of the FICO debt-service burden, but also fund a larger share of failure costs if national or regional economic conditions deteriorate. Moreover, to the extent it is the healthiest SAIF-insured institutions that are successful in reducing their exposure to SAIF, the increased deposit insurance burden could increase failures materially.

Finally, the recent announcements by several large thrifts of their intention to migrate SAIF deposits to BIF-insured affiliates call into question the reasonableness of assuming a stable or increasing SAIF assessment base and raise the specter of the fixed FICO obligation being serviced by a decreasing number of institutions and a diminishing assessment base.[4] This situation gives rise to the same incentives that are present in a bank run -- if you are first in the teller line, you redeem your deposits in full; on the other hand, if you are last in line, you may get nothing. Moreover, if the SAIF assessment base shrinks, the SAIF will become a less effective loss-spreading mechanism for insurance purposes, raising more significant structural issues.

In summary, there is little question that the strong economic incentives created by the present system and the reduction in BIF rates are likely to reduce reliance by thrift institutions on SAIF-insured deposits. The real questions are how fast this will occur and how much the SAIF assessment base will be reduced. While legislation could reduce or eliminate some methods by which this could be accomplished, the financial markets are likely to create alternative means. In addition to being ineffective, such legislative hurdles may be costly and disruptive to the marketplace. Moreover, the structural weaknesses of the thrift industry would be exacerbated by any acceleration in the shrinkage of the industry, leaving fewer thrifts and deposits across which to spread risk.

Methods to reduce reliance on SAIF-insured deposits.

The following discussion examines several methods that thrifts can pursue to reduce their reliance on SAIF-insured deposits. While the methods may be illustrative of business decisions to reduce costs and uncertainty, the consequences of shrinkage in the SAIF assessment base are

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[4]The funding mechanisms for the SAIF were based in part on assumptions that proved to be overly optimistic about the level of the SAIF assessment base. At the time of FIRREA, projected annual thrift deposit growth rates of 6 to 7 percent may have seemed conservative relative to the higher growth rates of the early 1980s. However, for several years following FIRREA, SAIF deposits actually declined annually 6 to 7 percent. This deposit shrinkage can be explained by several factors including the runoff in deposits from RTC conservatorships and other weakened thrifts, a decreased reliance on brokered deposits, and depositor flight from declining or low interest rates. Higher capital requirements also may have encouraged downsizing.

serious, both for purposes of meeting FICO debt service obligations and minimizing fundamental risks to the SAIF.

Increased reliance on nonassessable funding sources.

As part of their efforts to minimize the impact of a rate differential, thrifts could reduce premium costs by shrinking their SAIF-assessable deposits. Nonassessable liabilities, such as Federal Home Loan Bank (FHLB) advances and reverse repurchase agreements, could be substituted for assessable deposits. The concentration of thrift portfolios in loans and investments related to domestic real estate, which serve as eligible collateral for these products, is an indicator of the capacity of thrifts to switch from domestic deposits to alternative nonassessable funding sources. While there is no limit on the amount of FHLB advances a well-capitalized thrift can receive, some level of deposits must be maintained in order to realize certain federal income tax benefits. (This is discussed in a later section on the thrift tax bad-debt reserve.)

Changing business strategies to reduce the volume of portfolio investments.

Funding needs also could be reduced through securitization. Thrifts could reduce their exposure to SAIF assessments by shrinking their portfolio investments through the securitization or sale of assets. Under certain economic conditions, the thrift could choose to become a mortgage bank, eliminating the exposure to SAIF altogether. The costs of such a strategy may include recapture of the tax bad-debt reserves, which is discussed below.

Structuring affiliate relationships to accommodate deposit migration from SAIF- to BIF-insured institutions.

It is possible for thrifts to structure these affiliate relationships in three ways: the chartering of a de novo BIF member; employing an existing BIF affiliate; and acquiring an existing BIF member. First, affiliate relationships could be established through the chartering of a de novo BIF member. Thrifts could apply for charters and deposit insurance to establish a national bank, a state-chartered commercial bank or, where available, a state-chartered savings bank. Second, the migration of deposits from the SAIF to the BIF could occur readily if both a BIF member and a SAIF member already are held within the same holding company. Finally, thrift holding companies could purchase existing BIF members. Under the latter two options, chartering and deposit insurance applications would not be necessary, although regulatory approval would be necessary for an acquisition.[5]

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[5]In cases where a BIF-member savings bank is acquired by a thrift holding company, the approval of the Office of Thrift Supervision (OTS) is required; acquisition of a BIF-member commercial bank would require approval from the Federal Reserve. Issues involving various applications related to new charters are discussed below.

Generally, these affiliate operations would function in the following manner. With the cost advantage accorded by the premium differential, the BIF affiliate could offer higher interest rates on deposits, thereby enticing customers to shift deposits from the SAIF affiliate to the BIF affiliate. To the extent that it is cost effective to do so, the SAIF affiliate would maintain the necessary qualifying assets and would fund these with nonassessable liabilities such as advances from the BIF affiliate or a FHLB. The BIF affiliate would hold the advances to the SAIF affiliate as its assets; its liabilities would consist primarily of the deposits that had migrated from the SAIF to the BIF. As an alternative to using the BIF affiliate primarily as a funding source, the holding company could choose to shift its thrift lending activities to the BIF affiliate.[6]

The migration of SAIF deposits can be accomplished through transfers between branch offices, through the use of shared branch offices or through the use of agency relationships. Shared or tandem operations are created when the BIF-affiliate branch offices are established in the existing branches of the SAIF affiliate. Transfers of deposits from the SAIF to the BIF also could be accomplished through agency relationships, as permitted under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Under the provisions of this Act, shared branching arrangements between BIF and SAIF affiliates would not be necessary, as offices of SAIF-member thrifts could accept deposits "as agent" for BIF-member affiliates.

The potential magnitude of deposit migration.

The potential deposit insurance premium differential between the BIF and the SAIF triggered a response on the part of a number of SAIF members. A number of SAIF-member thrift organizations have applied for de novo state or national bank charters and federal deposit insurance. Generally, the proposals seek to establish branch offices of the de novo BIF member in existing branch offices of the SAIF-member subsidiary. The parent holding company would be in a position to create incentives for customers to shift deposits from the SAIF-member subsidiary to the newly chartered BIF member. In addition, one thrift holding company has filed applications for shared branches between its existing SAIF and BIF affiliates. There are more than 100 bank or thrift holding companies that own both SAIF and BIF affiliates that could establish shared BIF/SAIF office locations, subject to applicable branching restrictions, without having to apply for de novo charters and deposit insurance.

To date, these applications for bank charters, deposit insurance and shared-branch arrangements remain under consideration by the chartering authorities and the FDIC. The applicants have SAIF-assessable deposits that represent more than 75 percent of the remaining FICO cushion against default. Should all these deposits successfully migrate from the SAIF to the BIF, the potential cost to the BIF would be approximately $1.4 billion, that is, the BIF would require an additional $1.4 billion to maintain a reserve ratio of 1.25 percent. While there

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[6]With the exception of restrictions on subquality assets, "sister" affiliates, that is, banks or thrifts held within a single bank holding company structure, are not subject to the interaffiliate transaction restrictions of Section 23A of the Federal Reserve Act.

are considerations discussed below that make it unlikely that a shift of this magnitude in these institutions would be realized, the shift could be greater if other thrifts seek to shift deposits from the SAIF to the BIF.

The migration of SAIF deposits has not occurred yet. That is not surprising because affiliate relationships can be expensive to establish and, given current interest rates, SAIF deposits are cheaper than some alternative funding sources. During the first three months of 1995, SAIF deposits increased $11 billion (1.6 percent), the second consecutive quarterly increase after steadily declining for six years. As a result, at the end of the first quarter SAIF members were more reliant on deposit funding (78.2 percent of total liabilities) than at year-end 1994 (77.2 percent). The first quarter's deposit growth was at least partially attributable to aggressive campaigns by some California thrifts to attract deposits, particularly lower-cost demand deposits. In the event there is a significant premium disparity, SAIF members can readily shift funding from demand deposits to other sources discussed above.

Impediments to reducing the reliance on SAIF-insured deposits.

Should conditions prevail that continue to provide incentives to migrate deposits or otherwise reduce SAIF exposure, institutions will encounter certain impediments. While these impediments would not eliminate any of the methods, in some instances they could result in added costs.

Thrift tax bad-debt reserves. The loss of the tax benefits inherent in the thrift charter may limit the extent to which thrifts that have been profitable over the years are willing to cause SAIF deposits to migrate to BIF affiliates. Since 1952, when thrifts first were subject to federal taxation, thrifts that have met certain standards have been allowed to take tax deductions for bad debts based on a percentage of their taxable income. The deduction essentially provided a subsidy for the industry for many years, allowing thrifts to accumulate substantial tax bad-debt reserves on a pre-tax basis. Changes in the tax laws slowly reduced the allowable deduction until the 1986 tax legislation substantially lowered the deduction to its current level of 8 percent of taxable income.[7]

Thrifts are required to recapture their reserves into taxable income if they fail to meet a three-part test related to supervisory considerations, operations and assets. For supervisory purposes they must have a thrift charter and thrift regulator; their operation must derive 75 percent of its income from loans and deposits; and, similar to the QTL test, they must maintain

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[7]Data on the aggregate level of thrift tax bad-debt reserves is unavailable, although America's Community Bankers has indicated that they are in the process of conducting a survey to estimate both the aggregate amount of reserves as well as the distribution of reserves across the industry. Data on the reserves of individual thrifts, while not reported to bank or thrift regulators, generally is noted in their annual financial reports.

60 percent of unconsolidated assets in mortgages and government- or mortgage-backed securities. Failure to meet these tests for tax purposes can trigger the recapture of all or a portion of a thrift's reserves. There is considerable variability between institutions as to the size of these reserves and the impediment they would pose to deposit migration. Thrifts that were profitable for many years may have substantial reserves, and the recapture of these reserves could be costly. On the other hand, thrifts that suffered long-term losses may face minimal recapture costs. Of the SAIF-insured institutions that have converted to commercial bank charters (Sasser institutions) and consequently were required to recapture some or all of their tax bad-debt reserves, most incurred minimal tax liability.

Considerations related to the tax bad-debt reserves may have an impact on the decisions of thrift institutions to cause SAIF deposits to migrate to the BIF or otherwise to reduce SAIF deposits. If an institution shrinks its qualifying assets, it must also reduce its reserve by a proportional amount. This can result in higher tax liability by causing the amount by which the reserve was reduced to be recaptured into earnings (over some number of years, depending on the method selected) and by limiting deductions going forward.

Under the three-part test for tax bad-debt reserves, the standards for assets are clearly defined, but there are no clear quantitative standards on the required proportion of deposits to total liabilities. The operations test mentioned above requires that thrifts demonstrate that they are in the business of making loans and taking deposits. Therefore, a thrift could not avoid SAIF assessments by shifting entirely to nondeposit liabilities without encountering tax consequences. Some thrift industry tax experts suggest that the Internal Revenue Service would not challenge institutions whose deposits represent only 20 percent or more of their total liabilities.

Impediments affecting affiliate relationships. Impediments stem from factors such as the costs associated with added regulation, the costs of establishing and maintaining affiliate relationships, and the impact on customer relations.

In addition to application costs, the establishment of new affiliates could subject holding companies to new layers of federal or state regulation. For example, the purchase of a BIF-member commercial bank by a thrift would cause the thrift to become a bank holding company subject to supervision by the Federal Reserve. Bank holding company status would restrict the activities and affiliations at the holding company level. Similarly, acquisition by a thrift holding company of a second thrift charter would result in the loss of unitary thrift holding company status, narrowing the list of permissible activities and affiliations. As such, it may deter some thrift holding companies from pursuing a migration strategy.

To the extent SAIF deposits are held in a BIF-member Oakar institution, it may be less cost effective to cause these deposits to migrate. The SAIF portion of each deposit dollar that migrates to the BIF would be determined by the institution's overall mix of SAIF and BIF deposits, which generally remains constant. As a result, an Oakar institution cannot reduce its SAIF exposure as rapidly as a non-Oakar, or pure, SAIF institution.

In addition, there may be costs associated with establishing and maintaining separate affiliates. These include costs associated with corporate separateness, such as maintaining distinct sets of books, boards of directors and management. For institutions establishing shared offices, the potential confusion could adversely affect customer relations.

CONCLUSIONS

The SAIF is significantly undercapitalized and is further threatened by the structural weaknesses of the thrift industry. Beginning July 1, 1995, losses from thrift failures must be paid by the SAIF. The obligation to pay interest on FICO bonds through 2019 requires an ongoing differential between the BIF and the SAIF. In combination, the problems facing the SAIF create overwhelming incentives for SAIF members to minimize their exposure to higher assessment rates. This can be accomplished through a variety of means. In addition to shifting funding to nonassessable liabilities, a number of SAIF members have in place or are pursuing the affiliate relationships that will enable the migration of SAIF-insured deposits to the BIF. Depending on the response of SAIF members to the perceived benefits, this migration could rapidly undermine the stability of the SAIF and threaten its viability. Moreover, this migration likely would exacerbate the structural weaknesses of the thrift industry, leaving a smaller insured pool against which to spread risks and costs.

RESOLVING THE PROBLEMS OF THE SAVINGS ASSOCIATION INSURANCE FUND

July 27, 1995

BACKGROUND: THE NEED FOR ACTION

SAIF Is in Poor Condition, and Its Prospects Are Bleak.

- ***SAIF is significantly undercapitalized.***

  As of March 31, 1995, SAIF held reserves of $2.2 billion to cover $704 billion in insured deposits -- only 31 cents in reserves per $100 of insured deposits.

- ***SAIF assessments have been -- and continue to be -- diverted to other uses.***

  From SAIF's inception in 1989 through March 1995, $7.4 billion in SAIF assessments were diverted to cover past thrift losses. If those funds had gone into SAIF, the fund would have been fully capitalized last year.

  Payments on bonds issued to prop up a prior deposit insurance fund (FICO bonds) currently consume 45 percent of SAIF assessments -- and that percentage will increase if SAIF deposits continue to shrink.

- ***SAIF's assessment base has declined sharply.***

  SAIF deposits shrank by 23 percent from year-end 1989 through March 1995, or an average of 5 percent annually, rather than growing over 40 percent (as projected at the time of SAIF's creation in 1989).

- ***SAIF is now responsible for resolving failed thrifts.***

  On July 1, 1995, SAIF became responsible for handling thrift failures. Given SAIF's meager reserves, the failure of one or two large thrifts could render SAIF insolvent and put the taxpayer at risk.

Consequences of Inaction: Prospects for SAIF, the FICO Bonds, and the Thrift Industry Will Worsen.

- ***Erosion of the SAIF assessment base would accelerate.***

  The healthiest SAIF members will have strong economic incentives to avoid paying almost 6 times as much as the healthiest BIF members for the same insurance coverage. Because of SAIF's obligation to make payments on the FICO bonds, a large differential between BIF and SAIF premiums would persist until the year 2019 even if SAIF were fully capitalized. Thus institutions would continue to have incentives to shrink their SAIF deposits.

  Healthy institutions have a wide variety of ways in which to shrink their SAIF deposits, despite the current moratorium on converting from BIF to SAIF. For example, they can sell off loans instead of holding them in portfolio. They can replace deposits with nondeposit funding sources. They can also seek to switch deposits from SAIF to BIF by forming or acquiring affiliated BIF-insured banks offering higher interest rates than thrifts.

- ***SAIF's weaknesses could lead to a default on FICO interest payments.***

  If the portion of SAIF's assessment base available for FICO payments declines 10 percent annually, FICO will default on its interest payments in a few years.

- ***Failure to resolve SAIF's problems could weaken the thrift industry, and thus further weaken SAIF.***

  Uncertainties about SAIF -- and high SAIF premiums -- could make it more difficult for SAIF members to attract and retain capital, thus reducing the thrift industry's ability to help solve its problems and respond to any adverse economic changes.

- ***Structural issues make SAIF more vulnerable to economic downturns and financial market instability.***

  SAIF faces increased risks because it insures institutions with similar asset portfolios, and because SAIF-insured deposits are concentrated in large West Coast thrifts.

PROPOSAL

1. Capitalize SAIF Through Assessments on SAIF Deposits

- Require institutions with SAIF-assessable deposits to pay a special assessment in an amount sufficient to capitalize SAIF (i.e., increase the Fund's reserve ratio to 1.25 percent). Base the special assessment on SAIF-assessable deposits held as of March 31, 1995. Make the special assessment due on January 1, 1996.

  The special assessment would probably amount to 85 to 90 basis points. The rate would depend on (1) the extent to which SAIF is undercapitalized at the end of this year; and (2) the total deposits subject to the special assessment (i.e., total SAIF-assessable deposits, minus deposits at weak institutions exempted by the FDIC from the special assessment, as discussed below).

  The risk-based assessment schedule for the newly capitalized SAIF would be similar to the schedule for BIF (the current FDIC Board proposal has rates ranging from 4 to 31 basis points).

  For purposes only of setting risk-based assessments for coverage during the calendar year 1996, the FDIC would calculate a SAIF-insured institution's capital before payment of the special assessment but taking into account other capital fluctuations.

- Permit the FDIC's Board of Directors (acting pursuant to published guidelines) to exempt weak institutions from the special assessment if the Board determines that the exemption would reduce risk to the Fund.

  - Require institutions exempted from the special assessment to continue to pay regular assessments under the current SAIF risk-based assessment schedule, with rates ranging from 23 to 31 basis points, for the next four calendar years (1996-1999).

Thus weak institutions would still, over time, generally pay more than healthy institutions. A healthy institution would pay approximately 101 basis points from 1996 through 1999 (an 85 basis point special assessment, plus a risk based assessment of 4 basis points for each of four years as proposed by the FDIC Board). A weak institution would pay annual assessments of 29-31 basis points (under the current schedule weak institutions pay assessments of 29-31 basis points) for a total of 116-124 basis points (29-31 basis points for each of four years).

- To encourage weak institutions to resolve capital and other deficiencies, give institutions exempted from the special assessment the option -- during the 1996-1999 period -- of paying a pro-rated portion of the special assessment and then paying assessments under the new risk-based schedule for the remainder of the period.

- Require that rates under the risk-based assessment schedule for SAIF be no lower than the rates for comparable institutions under the risk-based assessment schedule for BIF until the Funds are merged.

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2. Spread FICO Payments Over All FDIC-Insured Institutions

- Effective January 1, 1996, expand the assessment base for payments on FICO bonds to include the entire assessment base of all FDIC-insured institutions -- both BIF members and SAIF members (thus spreading the FICO obligation pro rata over all FDIC-insured institutions).

  As under current law, the cash to pay FICO bond interest would come from assessment payments remitted by insured depository institutions, rather than by withdrawing money from the deposit insurance funds.

  Spreading FICO payments would still allow healthy institutions' BIF premiums to decline dramatically from current rates.

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3. **Merge the Deposit Insurance Funds**

- Effective as soon as practicable -- preferably no later than the beginning of 1998 -- merge the BIF and SAIF.

  A merger of the funds would resolve the long-term weaknesses of SAIF by providing the requisite asset and geographic diversification, which in turn should protect taxpayers from the possibility of another deposit insurance crisis.

  We recognize that any discussion of a merger of the funds raises a host of ancillary issues, such as the future of the thrift charter -- and other distinctions between banks and thrifts. The Treasury is developing a comprehensive proposal to deal with these issues.

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4. **Authorize Rebates of BIF Excess Premiums**

- Authorize the FDIC to rebate assessments paid by BIF members to the extent that BIF reserves exceed the designated reserve ratio.

  Rebate authority would not extend to BIF's investment income, which has never been rebated in the FDIC's history.

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5. **Adjust Rules to Promote Assessment-Rate Stability**

- Direct the FDIC's Board of Directors to maintain a deposit insurance fund's reserve ratio so that it approximates the designated reserve ratio. Give the Board flexibility to reduce the size and frequency of assessment rate changes by permitting the reserve ratio to fluctuate temporarily within a range of not more than 0.1 percentage point above or below the designated reserve ratio. This would provide flexibility to smooth out premium rate fluctuations but would not change the 1.25 percent designated reserve ratio.

The FDIC would seek to maintain the fund at approximately the designated reserve ratio, but could permit it to fluctuate temporarily within a narrow band. This flexibility would in no way impair such other rules as (1) the FDIC's duty to base assessments on risk; or (2) the requirement that SAIF assessments be no lower than BIF assessments. Nor would it authorize rebating BIF's investment income.

- Lower from 23 basis points to 8 basis points the minimum average assessment required under section 7(b)(2)(E) of the Federal Deposit Insurance Act when a deposit insurance fund is undercapitalized or when the FDIC has borrowings outstanding for the fund from the Treasury or the Federal Financing Bank.

FDIC and OTS:

Make Unspent RTC Funds Available as a Backstop for Extraordinary, Unanticipated SAIF Losses Until the BIF and SAIF are Merged

- If SAIF losses were to exceed $500 million in any calendar year during the period beginning on July 1, 1995 (when SAIF takes over the RTC's responsibility for resolving failed institutions), and ending when the Funds are merged, make unspent RTC funds available to cover the amount by which the losses in that year exceed $500 million.

  Thus SAIF would cover the first $500 million in losses during any such year, and unspent RTC funds would cover any additional losses.

  Neither the CBO nor the FDIC currently projects that SAIF losses will reach $500 million in any year. (The FDIC projects losses of $270 million per year; the CBO projects losses of $450 million per year.) Thus unspent RTC funds would serve only as a reinsurance policy against losses more severe than those now anticipated.

  The Treasury does not support use of RTC funds.