TESTIMONY OF

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ON

THE "THRIFT CHARTER CONVERGENCE ACT OF 1995"

BEFORE THE

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

10:00 A.M.
SEPTEMBER 21, 1995
ROOM 2128, RAYBURN HOUSE OFFICE BUILDING

Madam Chairwoman and members of the Subcommittee, thank you for the opportunity to testify on proposed legislation to resolve the difficulties facing the Savings Association Insurance Fund (SAIF). As you know from my prior testimony, these difficulties pose a significant threat to the viability of the federal deposit insurance system and the stability of the nation's financial industry. Madam Chairwoman and Congressman Vento, you and other members of the Subcommittee are to be strongly commended for your efforts to address the SAIF's problems.

The Federal Deposit Insurance Corporation (FDIC), the Department of the Treasury, the Federal Reserve Board, the Office of Thrift Supervision (OTS), and the Office of the Comptroller of the Currency, have all testified before Congress this year on the scope of the SAIF's difficulties and the need for timely Congressional action. I have appeared before this Subcommittee twice on the matter, on March 23 and August 2. The extent of the SAIF's difficulties have been thoroughly aired. Therefore, I will limit my remarks this morning to summarizing what was said on earlier occasions about why Congressional action is needed and on the proposed legislation, the Thrift Charter Convergence Act of 1995.

To summarize the FDIC's position on the proposed legislation, the agency supports with just a few concerns the portions of the bill aimed directly at resolving the SAIF's difficulties. The FDIC also supports in principle the portions

of the bill designed to bring about a merger of the bank and thrift industries. The FDIC, however, is concerned that examination of the many issues inherent in a merger of the bank and thrift charters could delay prompt action on the pressing need to shore up the financial position of the SAIF. Thus, if the measures designed to bring about a merger of the bank and thrift industries begin to impede efforts to resolve the serious financial difficulties of the SAIF, we recommend that the resolution of the SAIF's financial difficulties be separated for more expeditious action. A specific time frame for addressing the remaining issues could be adopted at the same time.

Finally, the FDIC is concerned about changes the bill would make in the agency's authority to set, collect, and retain deposit insurance assessments. The proposal could be interpreted as permitting the FDIC to set premiums <u>only</u> to the extent necessary to maintain the reserve ratio at the designated reserve ratio or 1.25 percent of insured deposits. Thus, in good economic times when the reserve ratio is at 1.25, the bill might force the FDIC to set premiums at zero for all insured institutions. The proposal would also require the FDIC to rebate all assessment income in excess of the amount necessary to meet the fund's designated reserve ratio.

These changes would strike at the underpinnings of the principle of spreading risk over time and of the concept of risk-

based deposit insurance. All insured depository institutions -- even those in unsafe or unsound condition or involved in strategies likely to lead to losses to the insurance fund -- would be relieved of the requirement to pay insurance premiums if the insurance fund were at or above its designated reserve ratio. The FDIC believes that the purpose of the risk-based deposit insurance system -- to discourage reckless uses of funds obtained from deposits backed by the full faith and credit of the government -- is sufficiently important to warrant a less absolute trade-off between risk-based deposit insurance and the designated reserve ratio.

In addition, the limitations in the bill on the FDIC's authority to make assessments above 1.25 percent could prevent the FDIC from collecting assessment income to meet debt service obligations on the bonds issued by the Financing Corporation (FICO).

THE SAIF'S DIFFICULTIES

As I have testified before, the SAIF faces three main problems. First, the fund is grossly undercapitalized. As of June 30, it had a balance of $2.6 billion, or only 0.37 percent of insured deposits -- $6.27 billion below that amount necessary to reach the 1.25 ratio. In contrast, the balance in the Bank Insurance Fund (BIF) on June 30 was $24.7 billion, or 1.288

percent of insured deposits. At the current pace, the SAIF will likely not reach the minimum reserve ratio of 1.25 percent of insured deposits until the year 2002.

Second, On July 1, 1995, the SAIF assumed the responsibility from the Resolution Trust Corporation (RTC) for paying the costs arising from any new failures of thrift institutions. Although the thrift industry currently appears to be in good health, one large or several sizeable thrift failures could quickly deplete the $2.6 billion balance in the fund. The SAIF's vulnerability to economic downturns and financial market instability is increased because of asset and geographic concentrations in the thrift industry. As a result, the SAIF insures institutions with similar asset portfolios, with large West Coast thrifts accounting for nearly 20 percent of SAIF-insured deposits.

Third, almost half of current SAIF assessment revenue is diverted from building the fund's balance to paying the interest on the FICO bonds. Congress established the FICO in the Competitive Equality Banking Act of 1987 in an unsuccessful effort to recapitalize the now defunct Federal Savings and Loan Insurance Corporation (FSLIC). Under current law, the FICO interest obligation 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.

Moreover, the differential between BIF assessment rates and SAIF assessment rates that became effective June 1, 1995, will give an incentive for thrift institutions to shift deposits from the SAIF to the BIF. As required by law, the FDIC has reduced the average assessment rate for BIF-insured institutions to approximately 4.4 cents per $100 of assessable deposits. The assessment rates for SAIF-insured institutions remain in the range of 23 cents to 31 cents per $100 of assessable deposits.[1] Because the SAIF's reserve ratio of 0.37 percent is well below the designated reserve ratio of 1.25 percent, the FDIC is required -- by law and by considerations of financial prudence -- to maintain a substantially higher assessment rate schedule for the SAIF.[2]

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[1]The vote by the FDIC Board of Directors to reduce the deposit insurance premiums paid by most BIF members but to keep the existing assessment rate schedule for SAIF members occurred on August 8, 1995 (60 Fed. Reg. 42680, 42741, August 16, 1995). The decisions closely resemble proposals that had been issued for public comment earlier in the year. The new BIF assessment rates were to be effective the first day of the month after the BIF recapitalized. An analysis of the June 30, 1995, Call Report data was completed in early September and showed that the BIF was recapitalized at May 31. Accordingly, the new BIF assessment rates were effective as of June 1. The BIF's recapitalization was announced on September 5, 1995.

[2]Until January 1, 1998, if the SAIF remains below the designated reserve ratio of 1.25 percent of insured deposits, the FDIC Board of Directors has the authority to reduce SAIF assessment rates to a minimum average of no less than 18 cents per $100 of assessable deposits. Beginning January 1, 1998, the minimum average rate must be 23 cents per $100 of insured deposits until the SAIF achieves the designated reserve ratio. Because of the SAIF's difficulties, including its extremely undercapitalized condition, the Board at the August 8, 1995, meeting noted in footnote 1 decided not to make any changes in the SAIF assessment rate schedule. If the FDIC had reduced SAIF assessment rates to a minimum average of 18 basis points, a

The premium differential of approximately 20 basis points between BIF-insured and SAIF-insured institutions is a strong incentive for SAIF members to reduce their exposure to the higher SAIF rates. A number of strategies -- such as shifting deposits from SAIF-insured to BIF-insured institutions in the same holding company structure -- are available to SAIF members inclined to act on this incentive. One effect of efforts to reduce exposure to the SAIF rates could well be a reduction in the SAIF assessment base to a level below what is necessary to support the FICO interest payments. That may occur as early as the next two years.

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 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.

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substantial premium differential between the BIF and the SAIF would still have existed and debt service on the FICO bonds would still be threatened.

PROPOSED LEGISLATION

Title I of the Thrift Charter Convergence Act of 1995 contains the measures that the FDIC believes are necessary to resolve the SAIF's difficulties and which we recommended to the Subcommittee in August. Title I would also make certain changes in the FDIC's authority concerning the making and collecting of assessments. Section 105 could prohibit the FDIC from setting assessments in excess of the amount needed to maintain the reserve ratio. Section 104 would require the FDIC to rebate assessment income in excess of the amount needed to meet a fund's designated reserve ratio.

Title II is designed to bring about a common charter for the bank and thrift industries. No later than January 1, 1998, federal savings associations would be required to convert to bank charters, either national or state. Federal associations that do not voluntarily convert, or that go into liquidation, would be automatically converted to national banks. State savings associations would not be required to convert but would be treated as banks for the purpose of federal banking law.

Concerning savings and loan holding companies, Title II would grandfather the activities of such existing companies. The insured depository institution subsidiary of a grandfathered savings and loan holding company, however, would in effect have

to confine itself to its existing thrift business. In addition, the grandfathered privileges would be lost if there were a change in ownership of the holding company. Concerning the activities of savings associations themselves, such activities not permissible for banks could not be conducted after a two-year transition period. The appropriate supervising federal banking agency could grant an institution up to two one-year extensions beyond the initial transition period.

Title II would also permit existing mutual savings associations converting to national banks to remain in mutual form after the conversions. Federal savings associations that are currently members of the Federal Home Loan Bank system would have to remain FHLB members. The interstate branches of existing savings associations that would not be permissible for banking organizations would be grandfathered.

FDIC CONCERNS

The legislative proposal before the Subcommittee contains many provisions that the FDIC supports. Broadly, the proposal would resolve the difficulties of the SAIF, a task that the FDIC believes is imperative. The proposal, however, contains several issues about which the FDIC has concerns.

Curtailment of Assessment Authority

Section 105 of the proposed legislation could be interpreted as explicitly limiting the FDIC's authority to make and collect assessments. The FDIC's Board of Directors could not set semi-annual assessments in excess of the amount needed either to maintain the reserve ratio of the insurance fund at the designated reserve ratio or, if the reserve ratio is less than the designated reserve ratio, to increase the reserve ratio to the designated reserve ratio. This provision also may prevent the FDIC from collecting assessment income to meet the FICO interest payments. Moreover, such a limitation would conflict both with the requirement for the FDIC to maintain a risk-based assessment system and with the risk-spreading function of deposit insurance.

The FDIC believes that the risk-based assessment system, which was mandated by Congress in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) under your leadership, Madam Chairwoman, was an important advance in bank supervision techniques and is an important tool for ensuring the maintenance of a healthy and stable banking industry. If the risk-based assessment system became inoperative when an insurance fund reached the designated reserve ratio, the discipline the system is designed to foster would be lost.

Eliminating the FDIC's authority to allow the insurance fund to fluctuate above the designated reserve ratio would also substantially reduce the agency's ability to spread risk over time and across injured parties. The deposit insurance system could be moved in the direction of a pay-as-you-go approach in which expenses and revenues of the insurance fund may have to be equated over a relatively short time horizon. High insurance premiums in times of economic difficulties could be required to maintain the deposit insurance fund, but that would be precisely at a time when financial institutions can ill afford high premiums.

Consequently, the FDIC urges the Subcommittee to retain current law with respect to its premium setting authority. The bill's limitations on the FDIC's authority to collect assessments above the designated reserve ratio could also prevent the FDIC from collecting assessments to meet debt service obligations on the FICO bonds, one of the purposes of this legislation. We will be happy to work with the Subcommittee to resolve this issue, which may have been an inadvertent drafting error.

Rebate Authority

Section 104 would require the FDIC to rebate to insured institutions amounts by which the actual reserves in a fund exceed the balance required to meet the designated reserve ratio

at the end of a calendar year. Each institution's rebate could not exceed the total amount of assessments that the institution paid in a year.

The FDIC believes that it should have discretionary authority to rebate assessment revenue as a tool for managing the fund at the target designated reserve ratio. Rather than providing discretionary rebate authority, however, Section 104 requires the FDIC to make rebates of assessment income in excess of that needed to meet the designated reserve ratio. Thus Section 104 raises the same issues as the proposed curtailment of assessment authority in Section 105.

Therefore, the FDIC requests that the discretionary rebate authority it possessed for much of its history be restored. Discretionary rebate authority would give the FDIC greater flexibility in maintaining the balance in the insurance fund in accordance with (1) the principle of spreading risks over time and (2) the concept of risk-based insurance assessments.

Bank and Thrift Charter Merger Questions

A major concern of the FDIC is that consideration of the many issues involved in eliminating the distinctions between bank and thrift charters could delay action on the immediate problem of the SAIF's financing. The SAIF's difficulties could be dealt

with in a narrow piece of legislation devoted to the financial issues affecting the SAIF, and the issues concerning the elimination of distinctions between bank and thrift charters could be examined with more deliberation than the current needs of the SAIF permit. A two-step process would meet the goals of assuring a sound SAIF as soon as possible and providing sufficient time to assure that other issues relating to the thrift institutions are resolved thoughtfully, fully and finally.

The FDIC is not opposed to eliminating the distinctions between bank and thrift charters -- far from it. The FDIC believes that the current charter distinctions no longer match economic reality. Moreover, forcibly concentrating a class of institutions -- thrifts in this instance -- into a limited range of activities with low profit margins is a prescription for trouble, as the savings and loan crisis of the 1980s and early 1990s amply demonstrated.

Nevertheless, the elimination of bank and thrift charter distinctions involves some difficult questions that may take a fair amount of time to resolve. The dual banking system is an extremely important component of the nation's financial structure. State legislatures should have ample opportunity to examine federal legislation that would change the nature of state-chartered institutions. The need to provide a speedy resolution of the SAIF's difficulties should neither force

premature action on these questions nor be sidetracked by their consideration.

The FDIC fully understands the competitiveness concerns banks have in relation to thrift institutions and the unfairness of requiring banks to share in the FICO obligations while competing with thrifts that enjoy competitive advantages. For that reason, the FDIC supports resolution of the non-financial issues in the legislation and the merger of the BIF and SAIF as soon as possible commensurate with a thoughtful, fair, and complete solution.

Unspent RTC Funds as Backup

As we testified in August, the FDIC continues to believe that unspent RTC funds should be available as a backstop, or reinsurance policy, for extraordinary, unanticipated losses until the BIF and the SAIF are merged. Projections by both the FDIC and the Congressional Budget Office indicate that the need for these funds is unlikely, and therefore the budgetary impact is unlikely to be great. Nevertheless, the prediction of losses to the insurance funds, within a specified near-term time horizon, is very difficult. Unspent RTC funds would serve as protection against losses more severe than those now anticipated. The backup funds would also assure SAIF members that they would not be asked to pay yet another special assessment to capitalize the

fund before its merger with the BIF. Finally, the backup funds would assure banks that at the time of merger, the SAIF balance will not be diluted by SAIF losses, necessitating higher premium rates to make up the difference.

SUMMARY

The FDIC believes that Congressional action to resolve the problems of the SAIF is imperative. I applaud you, Madam Chairwoman, Congressman Vento, and other members of the Subcommittee for the considerable attention you have given this very important issue. Accordingly, the agency urges expeditious passage of the bill with the changes outlined in our testimony.

One of the changes the FDIC requests is the elimination of the provision that can be interpreted as restricting the FDIC's authority to set deposit insurance premiums to maintain the target designated reserve ratio on average over a reasonable planning horizon. A "pay-as-you-go" insurance system in which the cost of the insurance event is borne entirely at the time the event occurs does not accomplish the spreading of risk over time. In addition, the provision could render the risk-based deposit insurance system ineffective when the insurance fund reaches the designated reserve ratio. Charging all institutions the same premium regardless of the risk each institution poses to the fund penalizes well-managed and well-capitalized institutions.

Finally, the provision could prevent the FDIC from collecting assessments to meet the debt service obligations of the FICO bonds.

A second change requested by the FDIC is the alteration of the provision giving the FDIC rebate authority. The provision would make exercise of the authority mandatory when assessment income exceeds the amount necessary to meet the designated reserve ratio. To avoid making the deposit insurance system a pay-as-you-go system and to preserve the incentives of risk-based deposit insurance, the rebate authority should be discretionary.

The FDIC also supports the measures in the proposed legislation designed to bring about a merger of the bank and thrift charters. The FDIC is concerned, however, that consideration of the many issues involved in a merger of the charters might delay action on the difficulties of the SAIF. Moreover, states should be given an opportunity to examine and amend laws related to chartering issues. If a delay in enacting the comprehensive legislative package appears likely, the FDIC suggests that the matters be dealt with separately, with the SAIF's difficulties being addressed as soon as possible and the charter merger being examined at a pace that allows thorough and complete resolution of all relevant issues, but within a specified, reasonable time frame.

Thank you for the opportunity to testify on this critical subject. I would be please to answer any questions.