Oral Statement
Ricki Helfer
Chairman
Federal Deposit Insurance Corporation

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

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

March 23, 1995

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Thank you.

******