

Analysis of Issues Confronting the Savings Association Insurance Fund



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

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Executive Summary

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

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

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

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

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

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

An Analysis of the Issues Confronting the Savings Association Insurance Fund

I. The Problems Facing the SAIF

The SAIF Is Undercapitalized

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

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

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

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

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

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

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

Why the SAIF Is Undercapitalized

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

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

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

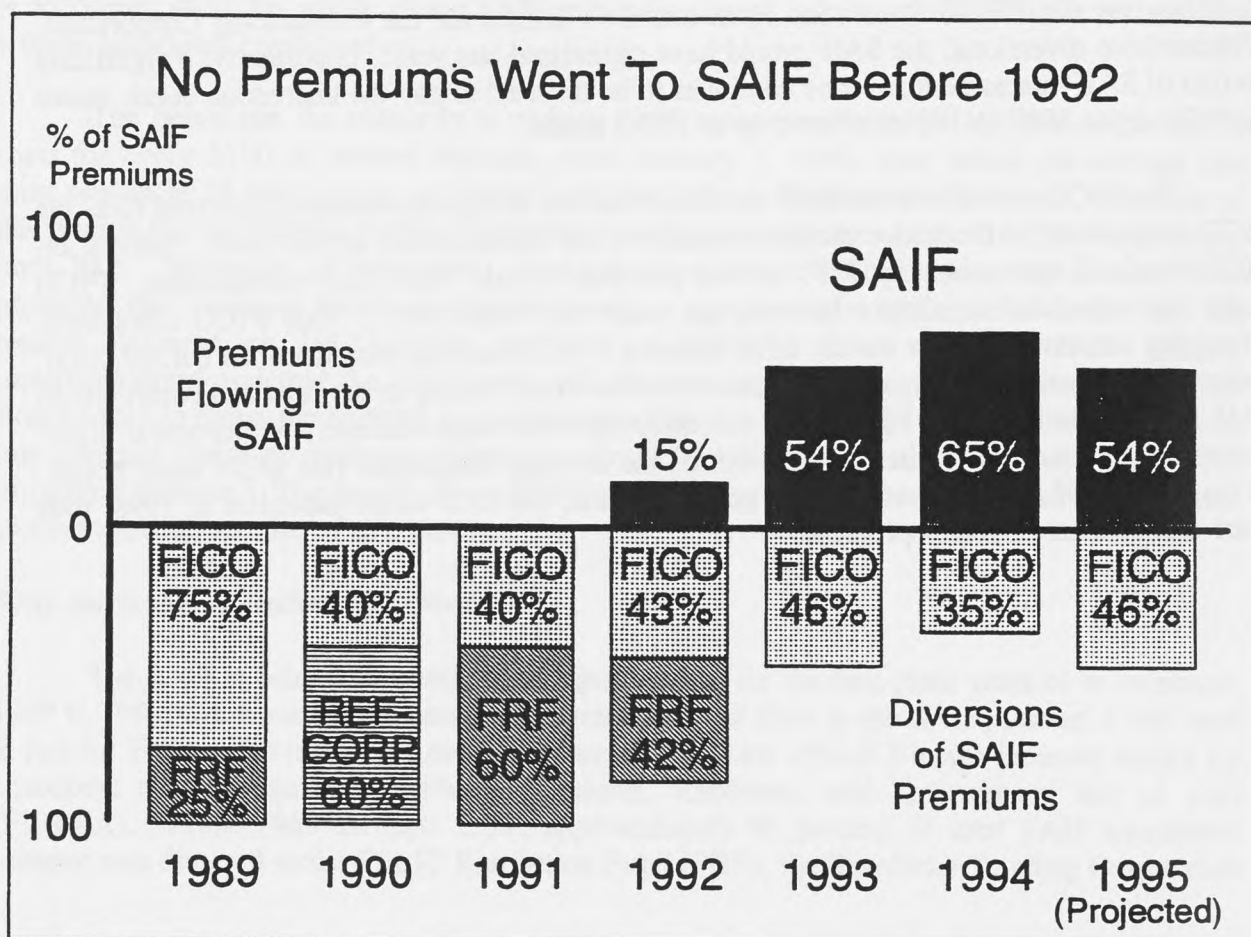
⁵The proposed SAIF assessment rate schedule is shown in Attachment 1. See Federal Register, 60 (February 16, 1995): 9266-70.

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

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

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

FIGURE 1



Dollars in Millions)

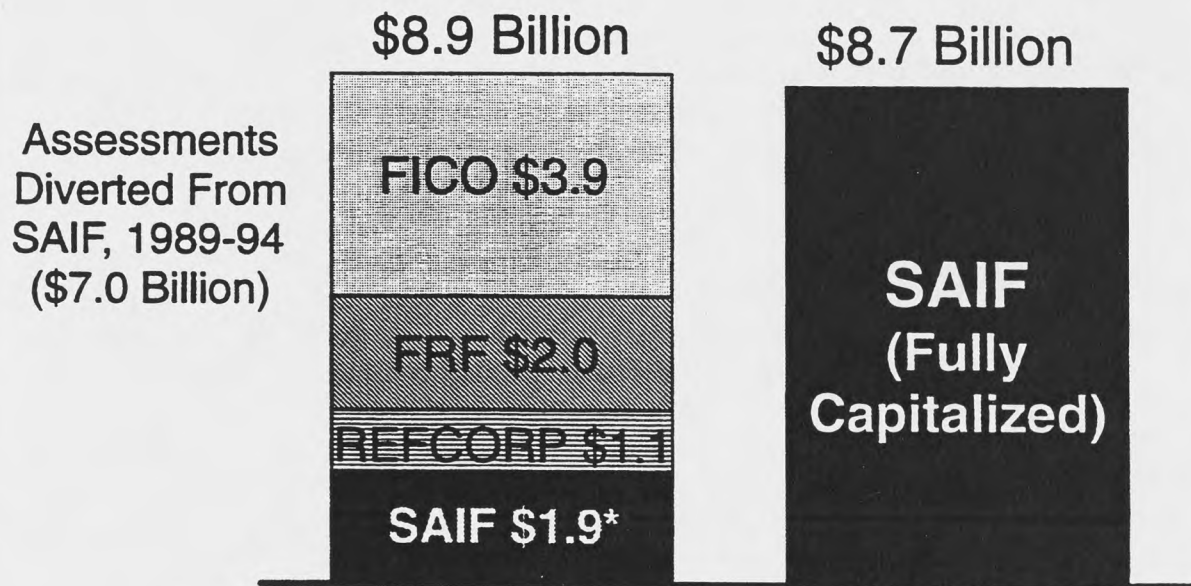
Diversion of SAIF

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

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

FIGURE 2

SAIF Is Undercapitalized



* Unaudited balance, net of reserves, 12/31/94.

The Ability of the SAIF to Fund FICO

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

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

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

The SAIF Differential

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

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

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

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

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

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

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

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

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

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

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

Conclusions

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

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

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

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

FIGURE 3

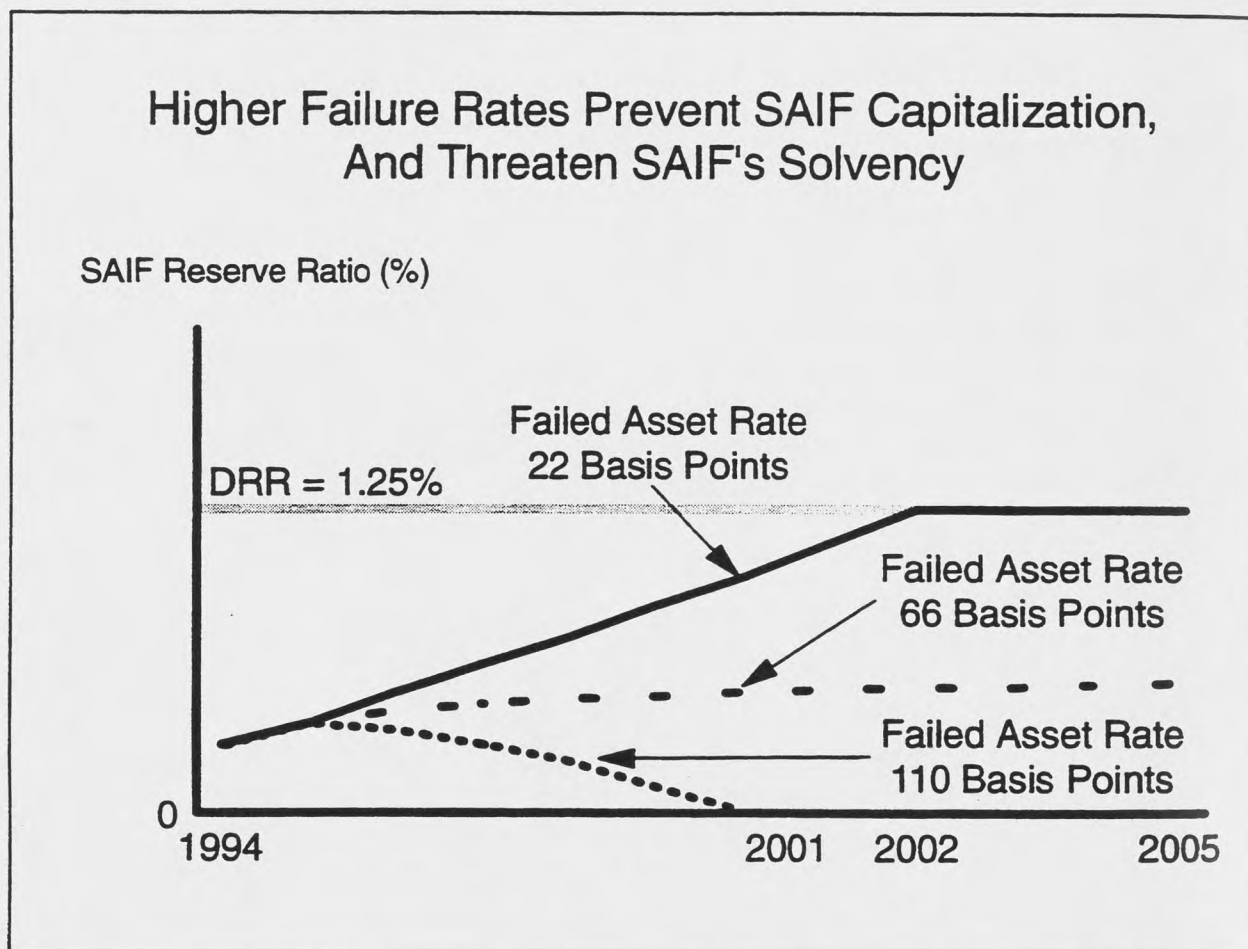
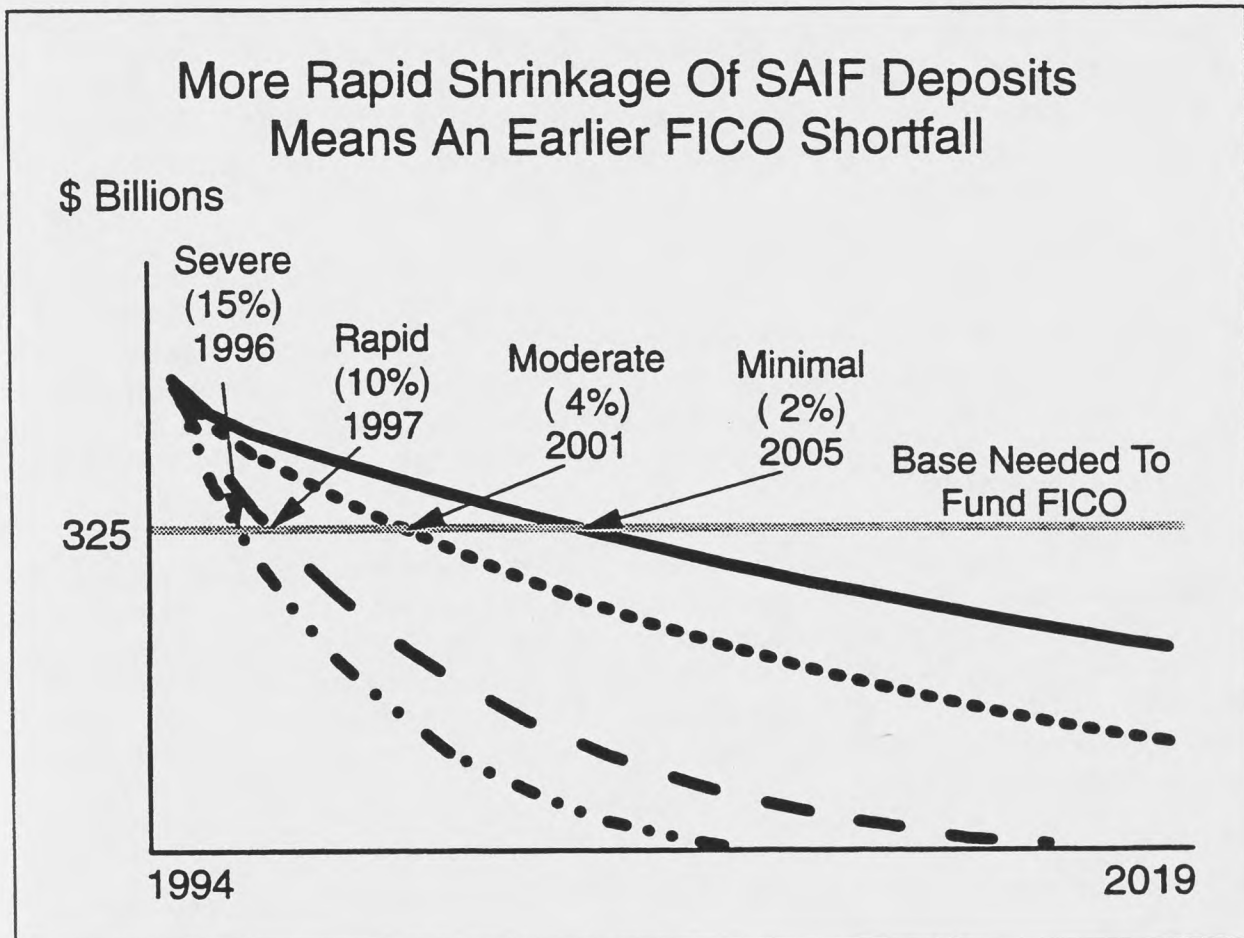


FIGURE 4



II. FDIC "Baseline" Projections for the SAIF

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

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

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

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

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

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

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

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

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

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

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

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

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

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

FIGURE 5

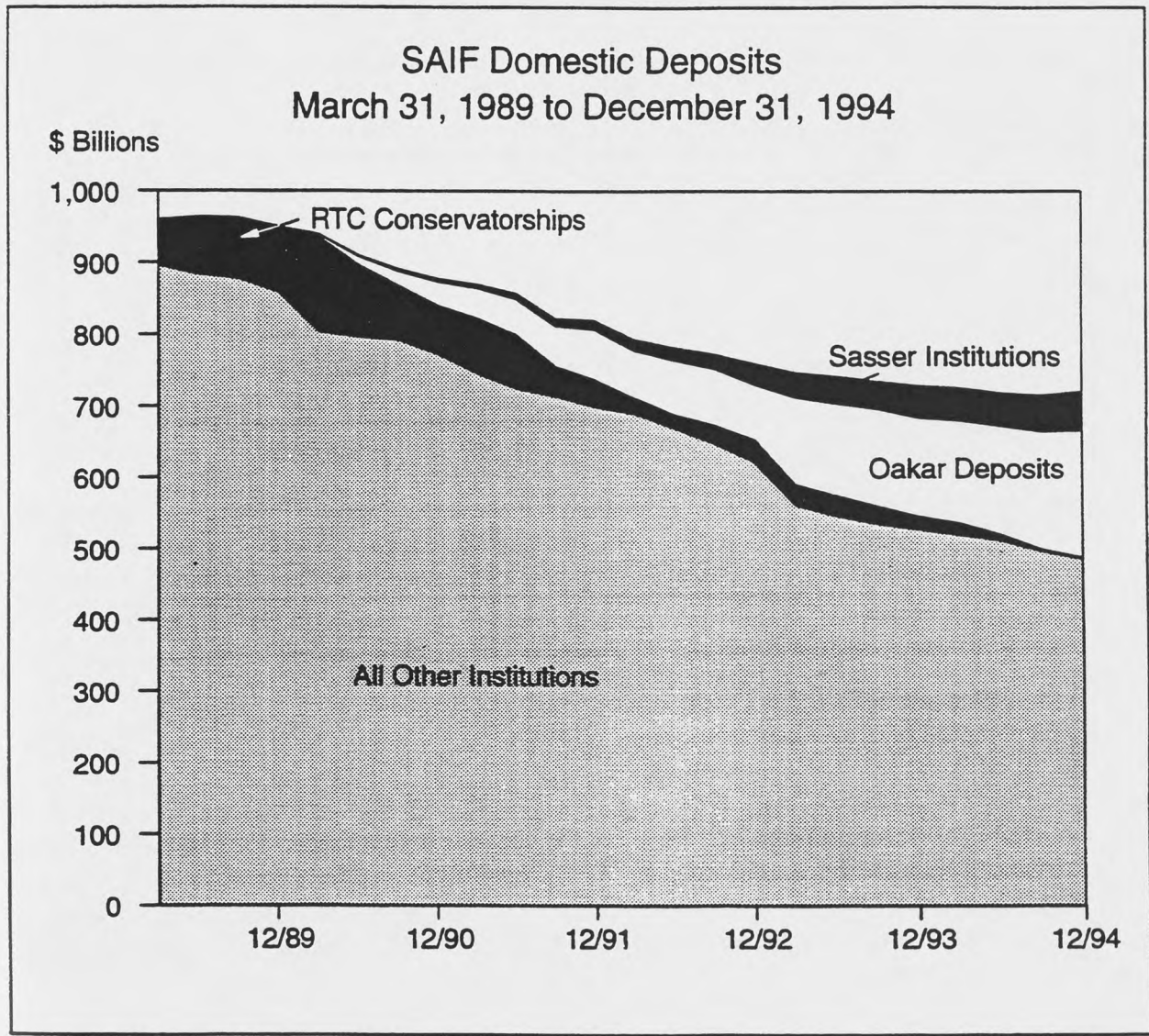


Table 2
SAIF Assessment Base: Domestic Deposits (\$ Millions) and
Percentage Change from Prior Year-End

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

* Not available for FICO assessment

** Available for FICO assessment

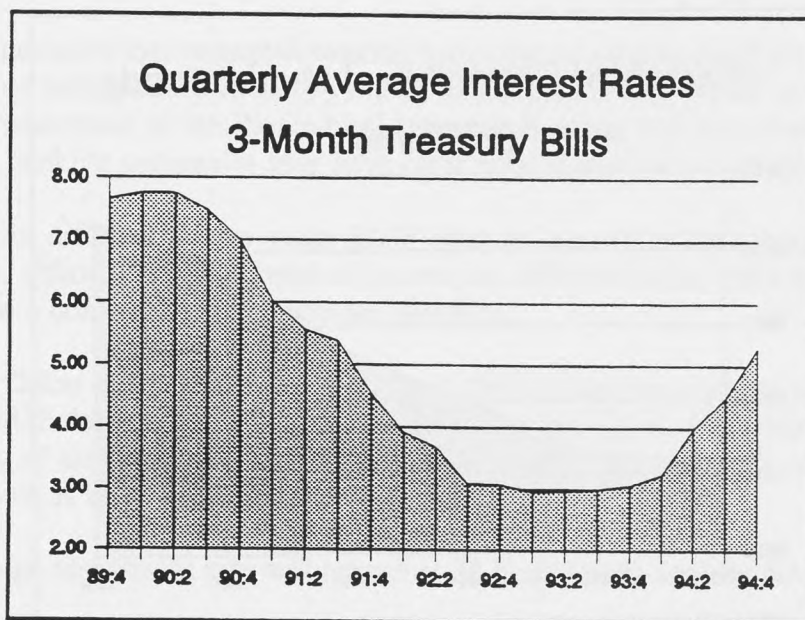
healthy SAIF-insured institutions, the shrinkage is characteristic of weakened and failed institutions, and because the number of such institutions has been greatly reduced, related shrinkage can be expected to slow. Other evidence indicates that shrinkage was more prevalent at weaker thrifts during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

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

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

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

Figure 6

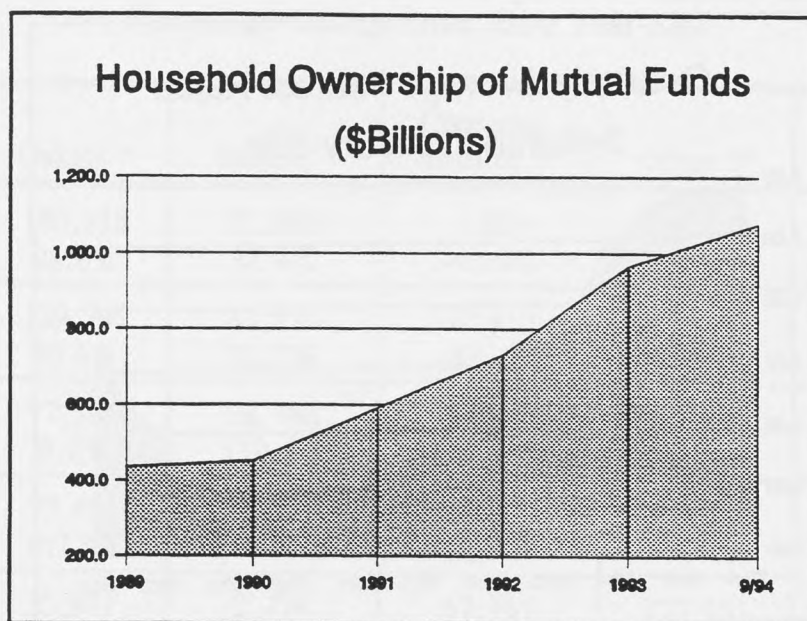


Source: Derived from monthly average rates in the Federal Reserve's H.15 Statistical Release.

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

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

Figure 7



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

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

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

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

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

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

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

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

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

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

III. The Impact of a SAIF Differential on Troubled Institutions

The SAIF Differential

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

Summary of Methodology

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

Summary of Results

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

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

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

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

Methodology and Assumptions

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

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

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

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

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

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

The Scenarios

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

Interest-Rate Scenarios

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

More detailed results are presented on the following page.

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

Base Case: No SAIF Differential

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

SAIF Differential of 5 Basis Points

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

SAIF Differential of 20 Basis Points

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

Asset-Quality Scenarios

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

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

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

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

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

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

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

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

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

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

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

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

Base Case: No SAIF Differential

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

SAIF Differential of 5 Basis Points

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

SAIF Differential of 20 Basis Points

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

Combination Scenarios

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

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

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

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

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

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

Base Case: No SAIF Differential

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

SAIF Differential of 5 Basis Points

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

SAIF Differential of 20 Basis Points

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

Conclusions

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

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

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

Caveats with Respect to the Methodology and Assumptions

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

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

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

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

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

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

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

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

IV. Sensitivity Analysis

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

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

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

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

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

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

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

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

* The SAIF does not capitalize by 2019.

Figures in parentheses represent the year of SAIF insolvency.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

V. Competitive Issues

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

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

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

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

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

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

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

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

VI. Conclusions

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

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

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

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