# THE IMMEDIACY OF THE SAVINGS ASSOCIATION INSURANCE FUND PROBLEM

## PROBLEMS CONFRONTING THE SAVINGS ASSOCIATION INSURANCE FUND

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

*The SAIF is significantly undercapitalized.*

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

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

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

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

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

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

Since its inception in 1989, the majority of SAIF-member assessment revenue was diverted to pay for Federal Savings and Loan Insurance Corporation (FSLIC) losses incurred before the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). These diversions totaled $7.4 billion through March of 1995: $4.3 billion for the Financing Corporation (FICO), $2 billion for the FSLIC Resolution Fund and $1.1 billion for the Refinancing Corporation. Without these diversions, the SAIF would have capitalized in 1994. Importantly, a significant portion of SAIF assessment revenue continues to be diverted to pay the interest on bonds issued by the FICO.

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

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

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

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[2]Oakar institutions, which are created from the purchase of SAIF-insured deposits by a BIF member, pay assessments to both the BIF and the SAIF based on the proportion of BIF- and SAIF-insured deposits held by the institution at the time of purchase. They are BIF members. Sasser institutions are SAIF members that have switched charter type and primary federal supervisor without changing insurance fund membership; that is, they are either commercial banks (state- or federally chartered) or FDIC-supervised state savings banks. They are not savings associations. (continued)

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

## IMMEDIACY OF THE SAIF PROBLEM

### *Incentives to reduce reliance on SAIF-insured deposits.*

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

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

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(footnote 2 continued) A 1992 FDIC legal opinion determined that FICO assessments can be made only on savings associations that are SAIF members. This opinion was described as "reasonable" by the Comptroller General in a letter to the FDIC Board of Directors, dated May 11, 1992 and recently reconfirmed by the FDIC. See Federal Register 60 (February 6, 1995): 7055-58.

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

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

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

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

*Methods to reduce reliance on SAIF-insured deposits.*

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

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

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

**Increased reliance on nonassessable funding sources.**

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

**Changing business strategies to reduce the volume of portfolio investments.**

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

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

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

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

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

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

***The potential magnitude of deposit migration.***

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

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

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

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

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

***Impediments to reducing the reliance on SAIF-insured deposits.***

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

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

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

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

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

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

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

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

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

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

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

## CONCLUSIONS

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