RESOLVING THE PROBLEMS OF THE SAVINGS ASSOCIATION INSURANCE FUND

July 27, 1995

BACKGROUND: THE NEED FOR ACTION

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

PROPOSAL

1. Capitalize SAIF Through Assessments on SAIF Deposits

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

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

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

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

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

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

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

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

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

---

2. Spread FICO Payments Over All FDIC-Insured Institutions

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

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

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

---

3. **Merge the Deposit Insurance Funds**

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

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

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

---

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

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

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

---

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

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

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

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

FDIC and OTS:

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

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

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

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

  The Treasury does not support use of RTC funds.