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STATEMENT ON THE EFFECTS OF THE DEFICIT REDUCTION ACT OF 1985 (GRAMM-RUDMAN-HOLLINGS ACT) ON THE FEDERAL DEPOSIT INSURANCE CORPORATION

PRESENTED TO The

SUBCOMMITTEE ON GENERAL OVERSIGHT
AND INVESTIGATIONS of the
House COMMITTEE ON BANKING, FINANCE
AND URBAN AFFAIRS,
~~HOUSE OF REPRESENTATIVES~~

BY

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I. INTRODUCTION

Mr. Chairman, I appreciate the opportunity to be here today to testify on the impact of the Gramm-Rudman-Hollings Act ("GRH") and the Antideficiency Act upon the FDIC.

We are greatly concerned about the adverse effects the imposition of GRH would have on FDIC operations. If applicable, GRH would impose major budget cuts upon our agency. Those reductions would hamper effective bank supervision and thereby result in increased exposure of the deposit insurance fund.

Last year, 120 banks failed or needed FDIC assistance, and we expect 140 to 160 more this year. The number of banks on the FDIC's problem list currently stands at more than 1,300 and continues to grow. Our need for flexibility and adequate resources, particularly in our supervisory and enforcement programs, is greater now than ever before.

First, I will address the sources of FDIC funding. After discussing GRH, I will comment briefly on the proposed applicability to the FDIC of the Antideficiency Act's apportionment provisions. Like GRH, the Antideficiency Act poses a real threat to the FDIC's ability to carry out its mission.

II. DISCUSSION

A. FDIC's Funding

The FDIC receives no appropriations from Congress. Insurance assessments from insured banks and investment income are, and always have been, the agency's exclusive sources of funds. The Federal Deposit Insurance Act ("FDI Act") authorizes an annual assessment on insured banks of one-twelfth of one percent of a bank's assessable deposits. It also provides that, with certain exceptions, the FDIC must annually rebate 60 percent of its net assessment income (assessment income less operating and insurance expenses and insurance losses) to those insured banks. The remaining forty percent of net assessment income, plus the investment income earned by the FDIC, is added to the FDIC trust fund, which is available to meet the insurance obligations of the FDIC. The FDIC is required by section 13(a) of the FDI Act to invest its funds in United States securities or obligations guaranteed by the United States Government.

Given the nature of the FDIC's funding, any reduction in our expenditures will have no real effect on federal expenditure levels, though for reporting purposes the additions to our reserve for insurance losses will be treated as a reduction of the deficit.[1] Such expense reductions will,

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[1] The fact that OMB uses the annual change in the FDIC's unobligated balances (cash flows) as a line item to reduce the overall deficit is an accounting artifact that has no practical significance. As a matter of law, FDIC funds are not available for use by other government agencies.

however, undercut our supervisory efforts and thus contribute to an increased incidence of bank failures.[2] More failures mean our total costs will increase, not decrease.

B. <u>FDIC's Statutory Exemption from GRH</u>

Despite the compelling legal and policy reasons for exempting the FDIC from GRH, the Office of Management and Budget ("OMB") and the General Accounting Office have concluded that GRH is applicable to "administrative expenses" of the FDIC. OMB reached that conclusion despite the fact that the statutory language and legislative history clearly support excluding the FDIC from GRH. Senator Packwood, Chairman of the Senate Finance Committee and head of the GRH Senate conferees, stated that "[w]e also exempted numerous other programs on which there was no argument, such as the Federal Deposit Insurance Corporation."[3]

The activities that OMB considers to be subject to sequestration include classifying supervisory expenditures as administrative expenses subject to reduction. Supervisory costs alone, without these support activities, amount to over two-thirds of the total expenses OMB deems "sequestrable" as administrative.

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[2] In addition to undermining safety and soundness examinations, supervisory cutbacks would hinder our ability to determine compliance with consumer laws, including the Truth-in-Lending Act, the Fair Credit Reporting Act, the Fair Housing Act, the Community Reinvestment Act, the Home Mortgage Disclosure Act, the Fair Debt Collection Practices Act, the Electronic Funds Transfer Act, and the Equal Credit Opportunity Act.

[3] 131 Cong. Rec. S. 14782 (Dec. 11, 1985).

The language of GRH belies OMB's interpretation of what constitutes "sequestrable" expenses. That statute lists the FDIC among those entities whose "legal obligations" are exempt from sequester orders. The FDIC's "legal obligation" is to provide deposit insurance and operate the deposit insurance system, including liquidating failed banks' assets, handling failing and troubled banks, and supervising banks to protect the insurance fund. Accordingly, OMB should not be able to sequester these activities as "administrative expenses."

Impact of GRH on the FDIC

In keeping with the spirit of GRH, we have voluntarily reduced our expenditures by 4.3 percent or $8.5 million. As shown on Table I, this required making cutbacks in a number of important areas. We curtailed hiring and training of personnel, reduced travel, postponed building improvements, and deferred a number of important projects. These projects included developing better management information systems and other computer programs that would faciliate bank supervisory activities and other insurance-related functions.

We are most concerned about the potential impact of GRH on our supervisory capabilities including the examination and oversight of troubled and failing banks. To appreciate the extent of our concerns, let me explain where our supervisory program stands now.

The FDIC has a force of about 1,670 field examiners. These are the individuals who actually go out to examine banks, and they account for 85% of

the professional staff of our Division of Bank Supervision. The size of the field force is almost exactly where it was five years ago, but a lot has happened since then. In 1981, commercial banks earned a return on assets of 81 basis points, 27 percent more than the 64 basis points earned in 1985. Three times more banks lost money in 1985 than in 1981. Today we have about 1,300 problem banks -- six times what we had back then. In 1981, ten banks failed; we average more than that in a month now.

This increase in problem and failing banks has put a major strain on our field examiners, a force which, because of self-imposed restrictions, was allowed to shrink in recent years. As Table II shows, our field force was down to only 1389 by the end of 1984. Moreover, during the last three years, we have had to detail 10 to 15 percent of our examiners to assist in the liquidation of failed banks.

The combination of increasing work demands and a shrinking work force caused major cutbacks in examinations. We have relied much more on brief visitations, which are much less comprehensive than exams. A number of specialty examinations (consumer compliance, trust departments, and data processing facilities) were cut back as well (see Table II). Still, we continued to fall behind while the banking problems grew. No longer were we able to meet our minimum policy guidelines, which call for examinations of marginal and problem banks (CAMEL ratings 3, 4, and 5) at least once a year with visitations in between. In some of our regions, we're averaging 20 months between exams. As for satisfactory banks (CAMEL ratings 1 and 2), our visitation period was extended to three years. We're not always able to do even that, and we are not comfortable with three year intervals. Experience has shown us that examinations two to three years old quickly lose their value.

Beginning in 1985, the FDIC started to rebuild its examination force. Our target is to reach 1,800 examiners by year's end. Since our field examiner turnover rate has been running about 11-12%, we have had to hire about 450 examiners over the last year to get where we are now. Currently, about one-third of our field force has less than one and one-half year's experience. This imbalance impacts our productivity. Training these people, most of which is done on the job, takes a substantial amount of time away from our seasoned examiners -- time needed to examine. It's taking longer to complete examinations, particularly in marginal and problem institutions where we've had to utilize many of these people. In 1985, for example, the examinations of such banks averaged 24% longer than in 1984.

In today's increasingly competitive deregulated environment, strong supervision is needed more than ever. We must continue our efforts to strengthen our examiner force if we are to stay on top of our supervisory problems. We are still evaluating our total examiner needs but preliminary figures indicate we should have over 2,000 field examiners by the end of 1987. This would allow us to meet our goal of shortening the interval for examining banks. It would also allow us to increase our involvement in the examination of all problem banks we insure. Finally, we would be able to resume a more reasonable schedule for conducting examinations specializing in consumer compliance, trust departments, and data processing facilities.

The more drastic cutbacks anticipated under GRH for 1987 and beyond would undo any progress we have made thus far in rebuilding our examiner force. As we have done this year, we would attempt to minimize the impact on our field force; but assuming GRH cuts in the order of 10-20%, major examiner reductions would be unavoidable. For every 100 examiner reduction, we would lose the capability to conduct about 225 examinations a year. We estimate that examiner cutbacks in the order of 15% would eliminate over 600 of the nearly 4,000 safety and soundness examinations budgeted for the year. Longer range goals of upgrading examination efforts would have to be abandoned.

Stretching out examination intervals any further in this banking environment would be counterproductive. A reduction in bank examination activity will diminish our ability to detect unsound banking practices and fraud, and take timely corrective measures. The net effect of these "savings" will be higher insurance costs and less stability in the financial system.

Vital automated services supporting bank supervision also would suffer as well. Even extremely modest cuts in the order of 10% would indefinitely delay integrating bank performance data sources into our offsite surveillance system. This would also prevent the maintenance and upgrading of data bank software relied on by the FDIC, the Comptroller of the Currency, and the Federal Reserve. Such cutbacks would seriously undermine our ability to perform cost-effective off-site monitoring.

III. THE ANTIDEFICIENCY ACT

On several previous occasions OMB has attempted to assert control over our budget, but has been repeatedly rebuffed by Congress. Now OMB is raising for

the first time the novel claim that a 36 year-old law -- the 1950 Antifeficiency Act -- authorizes it to apportion our budget. With this authority they intend to deal with substantive issues facing the FDIC. We are convinced that their claim is without legal merit (see our legal opinion, attached). Nevertheless, if OMB is allowed to go forward, the FDIC Board and the Congress would lose control of our budget. Control of the budget will inevitably permit the policy control OMB seeks (see letter from OMB Director Miller to Chairman St Germain of the House Banking Committee, attached). The application of the Antideficiency Act would change the historic position of the FDIC as a bipartisan independent agency, and would do so not by any current expression of congressional will but by applying a 36 year-old statute to give OMB powers the Congress has repeatedly denied to the agency in the past. The unfortunate experience of the Home Loan Bank Board when OMB controlled its supervisory budget indicates that loss of budget control by the FDIC Board could lead to even more serious problems than those created by GRH. In fact, the Bank Board has sought to put its supervision beyond the reach of OMB by placing its examiners in the regional Federal Home Loan Banks in order to achieve an effective supervisory force. This alternative is not available to the FDIC.

Congress has on several occasions reviewed the FDIC's budgetary process and has always concluded that our budget should remain outside Executive Branch review and the appropriations process. Congress has concluded that the FDIC's functional independence is tied to its budgetary independence. We recognize that independence carries with it the responsibility to meet the highest standards of accountability and financial reporting. We acknowledge that the

FDIC is a creature of the Congress and, through the Congress, ultimately accountable to the banking industry and the American public. At the same time, the legitimate objectives of disclosure and accountability can best be achieved within a framework of independent budgetary treatment.

Experience with thrifts in states such as Ohio and Maryland -- and with OMB's control over the Federal Home Loan Bank Board's budget -- clearly demonstrates that the lack of adequate supervision can lead to massive failures with excessive costs to all concerned. We cannot project for you what the costs of inadequate bank supervision would be. But you have seen from past experience what can occur. Past problems are dwarfed by the size of the problems we might face if our supervisory functions were to lose flexibility and the ability to act speedily. Imposing new OMB budget controls on the FDIC constitutes a false economy that the nation can ill afford. In these days of great strains in the financial system of the country, fundamental changes should be attempted only if a major problem can be identified, and none has been. The risk of such a change in regulatory operations simply is not justified, and we believe the Congress should act to insure that none is mandated.

Mr. Chairman, that concludes my prepared remarks. I would be pleased to answer any questions you may have.

Attachment