TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

ON

PROBLEMS FACING THE SAVINGS AND LOAN INDUSTRY AND
THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

BEFORE THE

HOUSE BUDGET COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

9:30 a.m.
January 26, 1989
Room 210, Cannon House Office Building

Good morning, Mr. Chairman and members of the Committee. I appreciate this opportunity to testify today concerning the costs facing our nation resulting from the problems of the savings and loan ("S&L") industry and the Federal Savings and Loan Insurance Corporation ("FSLIC"). We believe this matter is a critical issue that requires action by the Congress and the Administration.

It is important for the Federal Deposit Insurance Corporation ("FDIC"), as insurer of bank deposits, to address this issue because the thrift industry problems threaten the profitability -- and potentially even the stability -- of many banks. Moreover, some have suggested that the FDIC should be involved in dealing with the S&L insurance problems.

During the past year, the FDIC has examined ways to improve the current federal deposit insurance system. Our recommendations for legislative and regulatory reform that resulted from that examination are contained in our recently released study, Deposit Insurance for the Nineties: Meeting the Challenge. The appendix to this testimony is the executive summary from the new FDIC study. I also would like to submit the full study for the record.

As part of our review of the deposit insurance system, we discussed the extent of the S&L problem and estimates of the cost of resolving it, and analyzed alternative sources of funding. These areas will be the primary focus of my remarks today.

Before addressing the S&L and FSLIC problem specifically, I would like to make a few comments on our present federal deposit insurance system. It is the FDIC's view that changes must be made to the deposit insurance system to ensure that it is cost-effective. Any legislated resolution of the FSLIC problem, in addition to providing appropriate funding, should change the system to protect against a recurrence of this type of problem. Detailed recommendations for improvements to the system are contained in our study. However, I would like to summarize some of the most important concepts.

NEEDED CHANGES IN THE DEPOSIT INSURANCE SYSTEM

The Federal deposit insurance system has provided many benefits by eliminating bank runs, stabilizing the banking system and providing a safe place for people's money. However, the system requires some fundamental changes if it is to continue to serve the purposes for which it was created by Congress over 55 years ago, and function in a cost-effective manner. Generally, our efforts must be aimed at managing the system better.

One of the fundamental changes recommended in our study is that the federal insurer should be allowed to operate as much as possible like a private insurer. This principle is central to improving the system. To maintain adequate resources, the insurer must have additional controls over revenues, including the ability to adjust insurance premiums paid by insured institutions and to require an entrance fee from those newly obtaining insurance. The insurer also must be able to control costs. This necessitates the ability to set standards for insurability for all institutions and to promptly terminate insurance privileges when an institution is operating in an unsafe manner.

To accomplish private insurer status, the FSLIC and FDIC should be made as financially, operationally and organizationally independent as possible. To ensure political independence, the insurer should continue to be self-funded. It should have a budget separate from the general federal budget and should not be allowed to obligate general federal revenues. The insurer also should be independent from the Congressional appropriations process. The insurer should remain accountable to Congress on an annual basis, but should remain free from annual budgetary controls.

One of the most important concepts contained in the study, within the jurisdiction of this Committee, is that the FSLIC and FDIC trust funds should be separately budgeted and should not be part of the general operational federal budget. In essence, the basic purpose and mandate of the trust funds is to save for emergencies. For decades the insurance funds have been depositing their unspent premium income into the U.S. Treasury. While the insurance trust funds receive no taxpayer dollars, these deposits to the Treasury nonetheless are counted as income to the government rather than savings reserved for future problems in the industry. When funds are withdrawn from the Treasury to deal with a problem institution, that action is treated as a government expenditure. Instead, it should be treated as a payback of money on deposit.

As the present system is designed, it creates a disincentive for saving for future problems. Moreover, because of the immediate negative impact on the general budget, the insurer may be hesitant to draw upon funds to deal with industry problems at an early stage.

For these reasons, we urge the Committee to give strong consideration to setting up a separate budget for the deposit insurance funds. The FSLIC and

FDIC trust funds should be treated as a separate budget and not part of the general federal budget. For macroeconomic purposes, however, analysts could combine the new separate budget with the general federal budget.

I would now like to turn to the FSLIC situation.

SCOPE OF THE FSLIC PROBLEM

Cost Estimate. We estimate the costs associated with handling insolvent S&Ls and recapitalizing the FSLIC to range between $80 and $105 billion. That range is arrived at by totaling three components. First, the FSLIC estimates that the 217 cases involved in FSLIC-supported transactions in 1988 will cost approximately $39 billion. Secondly, based on available data, we estimate that an additional $30 billion to $50 billion may be needed to deal with the remaining troubled S&Ls. And third, we estimate that about $10 billion to $15 billion will be needed to maintain an ongoing S&L insurance fund to deal with future problems that we can foresee.

Calculation of the Cost Estimate. We must emphasize that our estimates are not precise. A more definite estimate of the cost of handling insolvent S&Ls can be made only after the completion of detailed on-site examinations. Even then, uncertainties would remain based on regional and local economic developments, interest-rate trends, and other factors that could influence the future value of S&L franchises.

In the absence of information generated by on-site examinations, we have based our estimates on the formula we have developed from past experience to estimate the cost of bank failures. While no formula can be completely accurate for each individual institution, we have found this method of estimating the costs of bank failures reliable, yielding results that, on average, approximate our actual costs.

Essentially, the formula applies a loss rate to various classes of "risk assets." For banks, these include virtually all assets except cash, marketable securities and other highly liquid short-term assets. A loss rate of 20 percent is applied to all risk assets not adversely classified by examiners. Increasingly severe loss rates are applied to classified assets depending upon the level of examiner criticism. In addition, losses may be adjusted up or down depending upon the geographic location or size of the failing institution.

In applying our formula to S&Ls, we considered intangible assets, such as deferred losses and goodwill, to be worthless. Also, we adjusted our formula to exclude any loss rate on residential mortgages and mortgage pass-through securities -- categories that accounted for about 43 percent of the holdings of unprofitable and insolvent thrifts as of mid-year 1988. While credit losses on such mortgages and securities should be relatively low, because there will be some losses in that category, this adjustment provides a significantly conservative bias to our loss estimates. Thus, the ultimate costs of resolving the S&L problem may be even greater than our estimates.

However, it should be noted that the FDIC cost formula is based on our experience in liquidating banks. Any bias in our formula toward under-estimating losses in insolvent S&Ls could be reduced somewhat to the extent that assisted mergers with healthy institutions can be arranged at costs below liquidation values. Moreover, the formula applies to small banks -- those below $500 million in total assets. Our liquidation experience with large-bank failures evidences lower costs per dollar of assets, although most problem S&Ls are under $500 million in total assets.

Growth of the Problem. The costs of resolving existing S&L insolvencies are growing rapidly. We estimate that insolvent, unprofitable S&Ls lost about $15 billion during the fifteen months ending March 31, 1988, or about $1 billion per month. We estimate that about half those losses are in insolvent S&Ls that were not handled by the FSLIC in 1988. Such losses can be divided into two categories: loan losses and operating losses.

Loan losses do not necessarily reflect the current growth of costs to the insurer. Instead, they reflect our acquired knowledge of costs that already have been incurred, but may not have been apparent earlier. When an insolvent institution is closed, the insurer may discover loan losses that had not yet been recognized. Additional costs resulting from unrecognized loan losses are impossible to estimate without detailed on-site examinations.

Operating losses, on the other hand, are losses incurred solely from current operations. As these losses mount, the S&L's net worth deficit and, hence, the FSLIC's cost increase. The operating losses at insolvent and unprofitable S&Ls that the FSLIC has not yet handled were about $1.7 billion in the first nine months of 1988.

The FDIC believes that insolvent S&Ls incurring the greatest operating losses should be identified and dealt with first. These institutions have the highest rates of growth in estimated present value cost, thus compounding the problem the longer they remain in business. Excluding the cases resolved by the FSLIC in 1988, we estimate that it would cost about $20 to $25 billion to resolve the "worst 100" of these institutions.

Other factors that cannot easily be measured also serve to increase the cost of closing or merging insolvent S&Ls the longer they remain open. These include the incentive for managers to look for risky investments (or "bet the S&L") in an attempt to return to solvency, and the deterioration in franchise value of the S&L the longer it remains open for business. The deterioration in value usually results from attempts to "economize" on expenses -- such as maintenance of property or legal actions to strengthen creditor positions.

RESOLVING THE FSLIC PROBLEM

There are a number of decisions that must be made to meet the problems confronting the S&L industry and the FSLIC. One threshold issue is how to allocate the costs among several sources that may include the S&L industry, the Federal Home Loan Banks ("FHLBs"), the FDIC, the Federal Reserve, the commercial and savings bank industries (or other financial-service industries), and the Treasury, i.e., the American taxpayers. Another fundamental issue is the appropriate budget treatment for the financing.

Sources of Funds. We believe the S&L industry, including the FHLBs, should bear as much of the cost as is prudent to assign to it. Our analysis indicates, however, that there are severe constraints on the industry's ability to finance the FSLIC shortfall. First, the tangible net worth of all solvent S&Ls is only about $40 billion. Even if that entire net worth could be used to deal with the problem, it would not be adequate. Second, insurance premiums for S&Ls are now 150 percent higher than for banks, and accounted for about 67 percent of the average annualized return on assets for GAAP-solvent S&Ls as of midyear 1988. That means a significant proportion of the industry's earnings already are being devoted to this problem. This can continue for only a few years. Any prolonged continuance would jeopardize industry viability.

The remaining source of funds from within the S&L industry is the Federal Home Loan Bank System. The total retained earnings are about $2 billion and profits of the FHLBs are about $1.4 billion per year. Some of this amount should be available. However, using too large a portion of these resources to refinance the FSLIC entails the risk of permanently damaging the Banks' financing capabilities.

We do not believe that the FDIC insurance fund should be a source of payment for the FSLIC shortfall. For 1988 the FDIC will show a 15 to 20 percent reduction in its fund -- its first operating loss ever. The FDIC fund has fallen below one percent of insured deposits, the level which we believe should be maintained as a base for the fund. The FDIC's current and anticipated financial resources are just sufficient to meet its own insurance needs. In addition, use of the FDIC's available reserves for the FSLIC resolution would not provide any federal budgetary benefits because the projected deficit would rise dollar-for-dollar with any FDIC outlay.

We also believe that it would be unwise to target banks to pay the cost of rescuing their competitors, the S&L industry. Banks already have incurred substantial costs in attempting to match inflated deposit rates paid by insolvent S&Ls. Banks also have not enjoyed the same permissive capital regulation, broad geographic expansion and product authorities, or tax subsidies that have been granted FSLIC-insured S&Ls.

Another financing option is the use of Federal Reserve funds. The Federal Reserve has annual earnings of $17 billion. Alternatively, the Federal Reserve could begin paying interest on banks' required reserves -- currently about $3 to $4 billion per year -- and transfer the proceeds to the agency responsible for closing the insolvent S&Ls. This would be of no benefit to the budget deficit since the Federal Reserve's earnings, which are passed to the Treasury each year, would be reduced correspondingly. Further, we believe that interest on reserves, if any is paid, should be paid to those who own them, and not to an insurance fund.

Finally, some have advocated levying a tax on depositors or imposing a fee on new mortgages or deposits. This we call the "reverse toaster plan": Come in and open an account and instead of getting a toaster as a premium the depositor gives one to the government. We do not favor this approach. A flat-rate system of user fees would impose a form of tax, handicap depository institutions competitively and be expensive to administer.

Unfortunately, we believe the Treasury Department will have to provide some of the funding to resolve the FSLIC problem. We have discussed this issue with the Treasury and anticipate that a Treasury proposal will be presented to President Bush in the near future.

Financing Mechanisms. After deciding who is to pay for the FSLIC shortfall, an appropriate financing mechanism must be found. This may involve substantial borrowing by some governmental or quasi-governmental agency. Any borrowing by the FSLIC or the FDIC against future insurance premiums, or borrowing by the Federal Reserve or the Treasury, under current law and procedures, would be part of the general federal budget. This would have the effect of increasing the federal budget deficit and rendering the Gramm-Rudman deficit reduction targets unattainable in the absence of offsetting cuts in other programs or increased tax revenues.

Through a separate-budget-financing approach, power to borrow to resolve S&L insolvencies could be entrusted to the already existing Financing Corporation ("FICO"), or to some other new limited-life, quasi-governmental agency.

Alternatively, the FDIC or the FSLIC -- or a merged version of the two -- could be given sufficient borrowing authority and made subject to a separate budget. Responsibility for interest and principal on the borrowings could be apportioned among the S&L industry, the FHLBs and the Treasury. For example, interest on borrowings of the Farm Credit System Financial Assistance Corporation will be paid by the Treasury for at least the first five years, and half the interest for the next five years. Treasury also guarantees the principal of these borrowings. A similar arrangement could be made to fund the FSLIC shortfall.

The FDIC favors a separate-budget-financing approach under which the insurer borrows the necessary funds directly. First, it would be less costly to generate funds if the insurer were able to borrow directly, rather than through a FICO-type entity. However, as with a FICO-type agency, any such direct borrowing would not be treated as an outlay of general federal revenues. Second, as indicated at the beginning of this statement, we believe that the deposit insurance trust funds should never have been included as part of the general federal budget in the first instance. Combining these funds with the general federal budget discourages the prudent management of the deposit insurance system. And third, a separate budget will still leave the cost of this problem fully apparent -- it is not a vehicle to hide that cost -- but it will facilitate a more efficient and effective solution.

ECONOMIC IMPLICATIONS

From a general economic standpoint, we do not believe that finding a solution to the FSLIC insolvency will adversely affect the U.S. economy. The FSLIC insolvency represents money that has been borrowed and spent, but that has not been repaid. Presently, those borrowings are financed by insured deposits. The proposed solutions do not involve raising additional funds, but instead entail substituting some other form of financing mechanism for insured deposits.

In other words, if the U.S. Treasury or some other government agency has to raise, say, $50 billion, that is $50 billion less that has to be raised in insured deposits. Because aggregate borrowing does not increase, there is no reason for a change in interest rates -- except to the extent that the U.S. government or a government agency can raise funds at a lower cost than can insolvent S&Ls. In that connection, there may be some downward pressure on rates. Also, because aggregate spending does not change under the proposed financing mechanisms, there is no reason for a change in price or employment levels. Overall, we are substituting one form of financing for another, with little real effect on the U.S. economy.

CONCLUSION

In summary, the FSLIC insolvency is substantial, with current estimates ranging up to $105 billion. We have outlined the options available for financing the insolvency.

In conjunction with any resolution of the FSLIC problem, we again emphasize that some important changes in the structure of deposit insurance and regulation are necessary. Relative to this Committee's jurisdiction, the most important change would be to remove the FSLIC and the FDIC trust funds from the overall federal budget, and place them in a separate budget. Moreover, if the insurers were removed from the federal budget, any borrowings to resolve the FSLIC problem would have no impact on the general federal budget and would be less costly than borrowing through a FICO-type mechanism.

Thank you, Mr. Chairman. I will be pleased to answer any questions the Committee may have.

Appendix