Speeches
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TESTIMONY OF

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ON

FSLIC RESOLUTION FUND APPROPRIATIONS
FOR FISCAL YEAR 1991

BEFORE THE

SUBCOMMITTEE ON HUD, VA AND INDEPENDENT AGENCIES
COMMITTEE ON APPROPRIATIONS
UNITED STATES SENATE

1:30 PM
MAY 23, 1990
Room 138, Dirksen Senate Office Building

I. Introduction

Madame Chairman and members of the Subcommittee, it is a pleasure to appear before you today to present the FY 1991 budget estimates of the FSLIC Resolution Fund (FRF). As an integral part of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the FRF is the vehicle for liquidating the remaining obligations of the former Federal Savings and Loan Insurance Corporation (FSLIC). This principally involves payments on FSLIC contractual commitments made in prior years to financially assist acquirers of failed thrift institutions.

Following passage of FIRREA, the Administration proposed and the Congress enacted a FY 1990 FRF appropriation that was current, indefinite in nature. We support continuation of this type of appropriation because of the variable components of the assistance agreements funded in part by this appropriation. Estimating budgets for this program is an imprecise science at best.

In FY 1991, the Administration is seeking a current, indefinite appropriation to pay for the shortfall between FRF funding sources and the estimated uses of those funds. Under FIRREA, the Congress in Public Law 101-73 authorized "such sums as may be necessary" whenever FRF funding from other sources is insufficient to meet obligations outlined for the fund in that legislation. For FY 1991, the Federal Deposit Insurance Corporation (FDIC) now estimates the shortfall to be around $4 billion. However, material uncertainties exist principally in the area of quantifying payments for assistance agreement obligations, due primarily to the variables of interest rates and real estate values. For this reason, the current, indefinite appropriation is essential to avoid the possibility of a default on FRF obligations later in the fiscal year.

We will discuss the nature of the FRF, the sources and uses of funding estimated for the current year and the budget year under review. Some of the management issues, techniques, and problems that we and the Congress face until all FRF assets and liabilities are disposed of will also be addressed. We ask your support in obtaining the appropriation requested in a current, indefinite form.

II. Background

The assistance agreements that are obligations of the FRF were entered into by the former Federal Home Loan Bank Board (FHLBB) as the operating head of the FSLIC. Assistance transactions were used to facilitate the acquisition of failed thrifts. Transactions were executed pursuant to Section 406(f) of the National Housing Act, which provided that assistance could be provided to the extent that it was determined to be a less expensive means of resolution than liquidation. In providing assistance, the FHLBB attempted to introduce new capital and competent management, as well as attain objectives such as consolidating the industry and reducing the cost of funds. Another significant consideration was conserving the FSLIC's limited cash.

In sum, an assistance agreement is a contract between the FRF and an acquirer which specifies procedures and actions the acquirer must take prior to incurring major expenses or losses that are to be reimbursed by the FRF. Typically, these agreements would include some, but not all, of the following provisions:

o Payment in cash, or with a note, to cover all or a negotiated amount of the negative net worth of the failed institution(s);

o Capital loss coverage which provides payment for the difference between book value and net sales proceeds on "covered assets." The amount and nature of covered assets is negotiated in each agreement;

o Yield subsidies, which ensure a defined level of return on covered assets;

o Indemnifications to the acquirer for legal expenses in connection with lawsuits against the failed institution or other contingencies;

o Loss-sharing arrangements in which the acquirer bears a percentage of loss upon disposition of covered assets;

o Gain-sharing arrangements, in which a percentage of gain realized on the sale of covered assets above some benchmark, is provided as an incentive to the acquirer to obtain the maximum price for covered assets;

o Tax benefit sharing provisions that arise from the acquirers' use of preacquisition net operating losses (NOLs) as well as other tax features of the agreements.

o Buy out options under which the FDIC may elect to purchase covered assets;

o Warrants which entitle the FRF to share in any increase in value in the assisted thrift. In some instances, this also may include sharing in earnings;

o Mark-to-market coverage which may reimburse the acquirer for the difference between book and fair market value of remaining covered assets when the agreement terminates or for goodwill established for assets that are not covered.

III. Basis of FRF Authority

Section 215 of FIRREA amends section 11 of the Federal Deposit Insurance Act to establish the FRF and provide for its management and separate maintenance by the FDIC. Generally, all assets and liabilities of the former FSLIC were transferred to the FRF. This includes all liabilities arising under the financial assistance agreements and all FSLIC-related litigation.

FRF funds are to be obtained from the following sources in the listed priority: income earned on FRF assets; liquidating dividends and cash flows from receiverships; borrowing by the Financing Corporation (FICO); excess SAIF premiums through December 31, 1991; and direct payments from the Treasury. The FDIC has been informed, however, that no new FICO borrowing should be expected. The FRF is to be dissolved upon satisfaction of all liabilities and sale of all assets.

IV. Description of FRF Tasks and Responsibilities

The FDIC has a very substantial job in managing the liabilities of the FRF. As of December 31, 1989, the FRF represented a liability of $64.9 billion. This includes promissory notes of $19.4 billion; asset loss coverage of $29 billion; estimated future interest payments on promissory notes of $16.1 billion; and $0.4 billion in miscellaneous other liabilities.

There are 202 assistance agreements. Each has unique contractual features which must be taken into account in managing the acquirers' efforts. There is a large volume of complex litigation associated with these cases. In addition, there are many interrelationships, primarily as a result of participation loans, between assets covered by these agreements and other financial institutions. Exhibit 1 shows the location of assisted institutions by state.

V. Management Strategy for Program Execution

An initial strategic plan and specific goals have been established to provide direction in managing this liability at the least cost to U.S. taxpayers. These are included in Exhibit 2. This process will involve setting specific asset disposition targets for each assisted institution. Mechanisms for monitoring progress toward meeting these targets are in place and will be refined as needed. On a portfolio basis, this plan envisions a $15 billion decline in covered assets by December 31, 1992.

A key element in gaining control and quantifying costs is completion of opening "inventory" audits for all assisted transactions. These audits determine the actual negative net worth of the failed institutions and define the inventory of assets covered under the assistance agreements. At the time the FDIC assumed responsibility for the FRF, 191 audits were outstanding with a few not even started.

We are pleased to report that this task is nearing completion. Six remaining audits, which involve massive records reconstruction, will not be completed until the end of the summer. As a result of this effort, we estimate that FRF costs will be further adjusted upward for additional loss by approximately $500 million. Additional cost of $1.9 billion were already reserved for in December 31, 1989, and adjustments were made to FRF reserves.

In addition, the Division of FSLIC Operations (DFO) is working diligently to respond to inquiries and requests from the teams conducting the Resolution Trust Corporation's (RTC) review of 1988 assisted transactions. The findings from this Congressionally mandated review are to be presented to Congress in August. Recommendations could suggest very substantial, near-term funding increases to reduce long-term costs. For example, if cash was available to the FRF, the large note portfolio might be paid off early with tremendous interest savings.

DFO recently has been enhanced with the addition of 70 positions. The Division now has a personnel ceiling of 278. A current organizational chart is attached as Exhibit 3. This additional staffing will provide resources for more in-depth, on-site monitoring of institutions receiving assistance and will result in reduction of costly contractor support that has been utilized in monitoring these transactions. We expect a reduction of one-third in our contracting costs with associated cost savings of approximately $7 million. In addition, more emphasis is being placed on liaison with supervision staff, both within the FDIC and with the Office of Thrift Supervision (OTS).

VI. Funding

There are major uncertainties that could substantially impact on actual funding needs. The estimates of cost and the timing of outlays could vary substantially due to a number of factors, most notably:

o Interest rates -- yield payments on the $35.8 billion covered asset portfolio and on the $19.1 billion note portfolio are variable and tied to regional cost of funds indices. For example, a one percent increase in rates results in a $200 million additional cost on the note portfolio alone;

o Markets for real estate and loan portfolios. As you are well aware, the portfolio of real estate assets covered by assistance agreements tends to concentrate in depressed areas, especially the Southwest;

o The viability of the assisted thrifts is another issue that will affect cost, not only of the FRF, but also of the RTC. Discussions with the OTS indicate that 40 assisted institutions have either been taken into conservatorship or may be candidates for RTC's conservatorship program this year. A wide range of other issues such as the actual extent of negative net worth of the institutions that failed, undisclosed liabilities, the outcome of thousands of lawsuits against the failed institutions, the recommendations of the RTC upon completion of its required review of the 1988 deals, as well as toxic waste and environmental problems with some assets, also will factor into the final cost.

Another source of uncertainty is FICO, which is an alternative source of funding to the FRF. As you know, FICO was chartered as a mixed ownership Government corporation pursuant to the Competitive Equality Banking Act of 1987 (CEBA). FICO is managed by a three-member Directorate, comprised of the Director of the Federal Home Loan Bank Systems' Office of Finance, a permanent member, and two Federal Home Loan Bank Presidents, who are appointed for 1-year terms.

FICO's sole purpose was to function as a financing vehicle to recapitalize the FSLIC. FICO issued 30-year bonds to the investing public and transferred the bond sale proceeds to FSLIC in exchange for FSLIC capital stock. FIRREA contains provisions which eliminate the possibility that the FSLIC capital stock issued to FICO will ever be redeemed. A total of $8.17 billion of FICO bonds was issued between October 1987 and September 1989.

With the authority provided through the appropriation mechanism, the Treasury Department has preferred direct Treasury financing as an alternative to FICO as the yield on past FICO issues has been priced at 55 to 109 basis points above comparable term U.S. Treasury bonds. The more costly financing reduces the net amount of insurance assessments otherwise available to FDIC from thrift institutions.

In FY 1990, the FRF will require an estimated $5.2 billion from Treasury. In FY 1991, the FRF will require an estimated $4 billion. Exhibit 4 includes schedules on sources and uses of funds for 1990 and 1991. Projections through 1996 are presented in Exhibit 5. These longer term projections will be subject to very substantial revision as a result of the factors we have just reviewed for you.

In summary, we are working hard to effectively manage the assistance agreement liabilities that create the need for this appropriation. We very much appreciate your understanding of this program and your continued support for the "current, indefinite" flexible funding that is essential to minimizing overall costs.

This concludes my prepared statement. I would be happy to respond to any questions that you may have.