Testimony by
Rikki
Chairman
Federal Deposit Insurance Corporation
Before the U.S. Representatives
Washington, D.C.
March 24, 1995

INTRODUCTION

Madam Chairman and Members of the Subcommittee, I am here today to present the views and analyses of the Federal Deposit Insurance Corporation (FDIC) concerning the condition of the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). We face a compelling problem -- and one that has grown more compelling this year. The BIF is in good condition and its prospects appear favorable. Despite the general good health of the thrift industry, however, the SAIF is troubled. Any solution to the SAIF problem requires action by the Congress. Indeed, the need for Congressional action is more urgent today than ever before.

Beginning later this year, a substantial disparity between the deposit insurance premiums paid by BIF members and SAIF members is likely to occur. The disparity is mandated by current statutory provisions. The FDIC cannot avoid bringing the disparity into being. Only Congress can change the laws that will soon require the FDIC to promulgate significantly different assessments for the two deposit insurance funds. Like the tip of an iceberg, the premium disparity is only the visible manifestation of a larger difficulty, most of which lies beneath the surface.

This difficulty -- which most recently has been described in depth in a report by the General Accounting Office -- has three dimensions.

One, as Chart 1 shows, the SAIF is significantly underfunded. At year-end 1994, the SAIF had a balance of $1.9 billion -- or 28 cents in reserves for every $100 in insured deposits. This amounts to six percent of the assets of SAIF- insured "problem" institutions. The $21.8 billion BIF, in contrast, amounts to 52 percent of the assets of BIF-insured problem institutions. Assuming that loss experience from failed thrifts does not increase significantly from today's levels, the SAIF is not expected to be fully capitalized at $1.25 in reserves for every $100 in insured deposits until at least 2002.

Two, an ongoing fixed draw of $779 million on SAIF revenue arises from the obligation to pay interest on bonds issued by the Financing Corporation (FICO) in the 1980s. This draw alone creates a premium differential between BIF members and SAIF members that likely would persist for 24 years until the bonds are repaid. This differential, at least 11 basis points, could provoke further shrinkage in the SAIF assessment base and a shortfall of assessment revenue to pay the FICO obligation, which would lead to default on the bonds. If you have ever tried to fill a bucket with a hole in it, you understand what I mean.

Three, for the first time, the SAIF will assume responsibility for resolving failed thrifts after June 30 of this year. Given the underfunding of the SAIF, significant insurance losses in the near-term could render the SAIF insolvent and put the taxpayer at risk. This risk stems from the fact that deposit insurance carries with it an implicit U.S. Government guarantee.

THE SEARCH FOR A SOLUTION

To establish parity between the BIF and the SAIF today would require about $15.1 billion, or about 25 percent of the total equity capital of SAIF members. Of this total, $6.7 billion would be needed to increase the SAIF from its unaudited year-end 1994 balance of approximately $1.94 billion to $8.66 billion, the amount that currently would achieve the designated reserve ratio required by Congress of 1.25. The remaining $8.4 billion of the $15.1 billion is the amount that would be necessary at current interest rates to defease the FICO obligation. That is to say, it is the amount that would have to be invested today to generate an income stream sufficient to service the FICO bonds until maturity between the years 2017 and 2019.

Requiring these amounts to be collected entirely through SAIF insurance premiums raises difficult questions. What will be the effect on the ability of SAIF members to raise new capital, to prosper, and to compete effectively? Will erosion of the SAIF assessment base and changes in its composition jeopardize the ability of the FICO to meet its obligations? Should some of the burden be shared? And by whom?

There is no magic answer to these questions. No matter how the $15.1 billion cost is borne, there will be an outcry by at least one constituency that a great injustice is being done. There is no way for the FDIC to resolve this issue through the exercise of its regulatory authority.

For two reasons, the need to find solutions to the problems grows more urgent. One, as mentioned earlier, starting July 1, 1995, the cost of all new thrift failures must be paid out of the SAIF. Two, recently announced efforts by some SAIF-insured institutions to transfer deposits into BIF-insured institutions raises the specter that the insured deposit base of the SAIF could shrink so rapidly that, under current assessment rates, debt service on the FICO bonds would quickly run into trouble.

Although the need for immediate Congressional action concerning the SAIF is evident, there is considerable disagreement over precisely what action should be taken and whether it should be taken this year or later. The most frequently mentioned sources of money to address SAIF's needs include the thrift industry, the banking industry, and the U.S. Treasury. Others have been mentioned, too, as having an interest in resolving the problems. None of the possible sources of funding is happy about the prospect of footing the bill for capitalizing the SAIF and funding the FICO interest payments.

The first section of this testimony describes the conditions of the BIF and the SAIF and the reasons for the coming disparity in their assessment rates. The second section of the testimony summarizes the statutory constraints that prevent a regulatory solution to the problems. The third section of the testimony discusses the unprecedented public hearing on this subject held on March 17 before the Board of Directors of the FDIC. This is followed by an analysis of the various proposals for addressing the SAIF problem, measured against three standards set out in the testimony.

THE CONDITION OF THE BIF AND THE SAIF

Bank Insurance Fund

The good news in this testimony is about the Bank Insurance Fund. The fund balance is rapidly approaching the recapitalization level specified in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and confirmed in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). As noted before, that level -- the designated reserve ratio -- is 1.25 percent of insured deposits -- or $1.25 for every $100 insured deposits. At year- end 1994, the BIF had a balance of $21.8 billion, which was 1.15 percent of insured deposits.

The BIF has made a remarkable recovery. Three years ago, at year-end 1991, the BIF had a negative balance of $7.0 billion. From this nadir, the lowest level in the bank fund's six decades of existence, the balance improved to a negative $100 million at year-end 1992 and a positive $13.1 billion at year-end 1993. In other words, since year-end 1991, the BIF has grown by almost $29 billion. Two factors contributed to the restoration of the BIF. One, fewer banks failed than had been anticipated. While the number and assets of failed banks reached record levels in the late 1980s and early 1990s, both fell sharply in the last two years. As a result, declining insurance losses enabled the FDIC to recapture reserves that had been set aside before 1992. In fact, over the last three years (1992 through 1994) reversing provisions for insurance losses increased BIF net income by $12.8 billion.

Second, banks have paid significantly higher premiums to the BIF than they paid previously. Beginning in 1990, assessment rates were increased sharply. Rates are now almost three times higher than the rate paid in 1989. In the last three years, insured institutions have paid nearly $17 billion in assessments to the BIF.

The recovery of the BIF reflects the recovery of the banking industry from the problems of the late 1980s and early 1990s. Since 1990, the earnings of the industry have been on an impressive upward trend: $16.1 billion for 1990, $18.6 billion for 1991, $32.2 billion for 1992, $43.1 billion for 1993, and $44.7 billion for 1994. The results for 1992, 1993, and 1994 were successive earnings records.

Ninety-one percent -- more than nine of every ten -- BIF- member institutions are currently in the lowest risk category and pay the lowest assessment rates. These institutions hold 88 percent of all BIF-member assets. They meet the highest regulatory capital standards and have the strongest examiner ratings. These institutions are not expected to cause losses to the BIF in the near-term.

As bank earnings have improved, bank failures have declined dramatically. The number of BIF-insured failures in 1994 was 13, the lowest total since 1981. These 13 failures marked the continuation of a seven-year downward trend: 221 in 1988, 207 in 1989, 169 in 1990, 127 in 1991, 122 in 1992, and 41 in 1993. The estimated costs for these 13 failures last year is $139 million, all of which had been reserved in prior years. Consequently, no additional expenses for failures were incurred by the BIF in 1994.

As a result of the recovery of both the banking industry and its insurance fund, the BIF is projected to reach the 1.25 statutory designated reserve ratio between May and July of this year. Thereafter, absent a factual basis for a higher reserve ratio, the FDIC has a statutory mandate to set deposit insurance assessments to maintain the balance of the fund at the 1.25 ratio, at the same time retaining a risk-related system of premiums and assessing each BIF member at least $1,000 semiannually. Therefore, when the designated reserve ratio for the BIF is reached -- an event that appears imminent -- the law requires the FDIC to reduce assessments for BIF members.

In January of this year, the FDIC Board of Directors issued a proposal to lower assessment rates for all but the riskiest BIF members once the fund attains the designated reserve ratio. Because the SAIF is significantly undercapitalized, the FDIC Board proposed maintaining assessment rates for SAIF members at current levels. If the two proposals are adopted, a significant disparity will exist between the assessment rate schedule for BIF-insured institutions and the assessment rate schedule for SAIF-insured institutions, regardless of whether the Board retains the current SAIF rate schedule or reduces SAIF assessments to the statutory minimum weighted average of 18 basis points. The FDIC has asked for public comments on the assessment rate proposals, and the 60-day comment period extends until April 17. The FDIC also held an unprecedented public hearing on issues related to the BIF and SAIF assessment rate proposals, as discussed in the next section.

Savings Association Insurance Fund

There is also good news about the health of the savings and loan industry. Eighty-seven percent of all SAIF-member institutions with 71 percent of SAIF-member assets are in the lowest risk category and pay the lowest assessment rates.

Despite the good news in the savings and loan industry, the SAIF -- as noted earlier -- is troubled. It is significantly underfunded. Assessment revenue is constantly being diverted to meet obligations from savings and loan failures in the 1980s. The SAIF must begin paying for thrift failures that occur after mid-year. This testimony discusses each of these three issues in turn.

First, the SAIF is undercapitalized. As noted earlier, the SAIF had a balance of $1.9 billion, or only 0.28 percent of insured deposits at year-end 1994. Thus, the current insurance reserve amounts to only six percent of the assets of SAIF-insured "problem" institutions. The $21.8 billion BIF balance, in contrast, amounts to 52 percent of the assets of BIF-insured problem institutions. At the current pace, and under reasonably optimistic assumptions, the SAIF would not reach the minimum reserve ratio of 1.25 percent until at least the year 2002. Consequently, it would be impossible to lower SAIF premiums to the proposed levels for the BIF for at least seven years, and because of the continuing need to fund interest payments on the FICO bonds, probably much longer.

Second, SAIF assessments have been diverted to purposes other than the fund. This problem was described in detail in the recent General Accounting Office report. In short, from 1989 to 1994, $7 billion -- approximately 95 percent of SAIF assessments -- was diverted from the SAIF to pay off obligations from thrift failures in the 1980s through the Resolution Funding Corporation (REFCORP), the Federal Savings and Loan Insurance Corporation Resolution Fund (FRF), and the Financing Corporation (FICO) (see Attachment B). Of the $9.3 billion in SAIF assessment revenue received from 1989 to 1994, a total of $7 billion was diverted: $1.1 billion was diverted to REFCORP; $2 billion was diverted to FRF, and $3.9 billion to date, was diverted to FICO. SAIF assessment revenue currently amounts to just over $1.7 billion a year, while FICO interest payments run $779 million a year, or about 45 percent of all SAIF assessments. Without these diversions, the SAIF would have reached its designated reserve ratio in 1994. The REFCORP and FRF no longer have claims on SAIF assessments, but the FICO claim will remain as an impediment to capitalizing SAIF for 24 years.

Third, the SAIF will be under stress beginning on July 1, 1995, when it takes over responsibility for resolving all new failures of SAIF-insured savings associations. One large or several sizable thrift failures could bankrupt the fund. Two funding sources may be available to pay for losses: (1) an authorization for payments from the U.S. Treasury of up to $8 billion for losses incurred by the SAIF in fiscal years 1994 through 1998; and (2) unspent RTC money during the two years following the RTC's termination on December 31, 1995. To obtain funds from either of these sources, the FDIC must certify to Congress that an increase in SAIF premiums would reasonably be expected to result in greater losses to the Government, and that SAIF members are unable to pay assessments to cover losses without adversely affecting their ability to raise and maintain capital or maintain the assessment base. Congress required these certifications in an effort to ensure that SAIF members pay the highest rates possible before taxpayer funds are used to cover losses. Of course, this would have the effect of exacerbating the impending premium differential. It may require extremely grave conditions in the thrift industry in order for the FDIC to certify that raising SAIF assessments would result in increased losses to the Government. Moreover, these sources of funds cannot be used to capitalize the fund -- that is, to provide an insurance reserve, which was the original purpose of requiring a 1.25 reserve ratio. A detailed discussion of the legislative history of the SAIF funding scheme is contained in Attachment A.

By far the largest of the drains on SAIF assessment income, the FICO was established by Congress in 1987 in an attempt to recapitalize the defunct Federal Savings and Loan Insurance Corporation (FSLIC). The FICO was provided with approximately $3.0 billion in capital by the Federal Home Loan Banks. The capital was used by the FICO to purchase zero-coupon U.S. Treasury securities. These securities in turn served as collateral for the issuance of 30-year interest-bearing debt obligations by the FICO. The proceeds from these obligations were channeled by the FICO to the FSLIC. From 1987 to 1989, the FICO issued approximately $8.1 billion in bonds. When they mature, the principal values, or face amounts, will be paid with the proceeds of the simultaneously maturing zero-coupon Treasury securities. No FICO bonds were issued after 1989, and the FICO's issuing authority was terminated in 1991.

The Competitive Equality Banking Act of 1987 made FSLIC- insured institutions responsible for the annual interest payments. FIRREA abolished the FSLIC, created the SAIF, and reaffirmed the FICO's first priority to assess SAIF members. The FICO bonds do not mature until 2017 to 2019 and are not callable.

In enacting FIRREA, Congress in 1989 recognized that draws on the SAIF by the FRF, REFCORP, and FICO would delay the capitalization of the insurance fund. At that time, the GAO notes, the Administration projected annual thrift deposit growth of six to seven percent. Since SAIF's inception, however, total SAIF deposits have declined an average of five percent annually.

FIRREA authorized the appropriation of funds to the SAIF in an aggregate amount of up to $32 billion to supplement assessment revenue by ensuring an income stream of $2 billion each year through 1999 (not to exceed $16 billion in the aggregate) and to maintain a statutory minimum net worth through 1999 (not to exceed $16 billion in the aggregate). Subsequent legislation extended the date for receipt of Treasury payments to 2000. Despite requests by the FDIC to the Department of the Treasury and the Office of Management and Budget, the Treasury never requested any appropriations for these purposes, and the SAIF never received any of the authorized funds. The issue of the SAIF's need for appropriated funds to reach mandated reserve levels has been recognized by the FDIC since the creation of the SAIF. It was raised on January 10, 1992, in a letter from William Taylor, Chairman of the FDIC, to Richard Darman, Director, U.S. Office of Management and Budget, and it was raised again in a letter, dated February 20, 1992, from Stanley J. Poling, Director, FDIC Division of Accounting and Corporate Services, to Jerome H. Powell, Assistant Secretary for Domestic Finance, U.S. Treasury. More recently, the issue was addressed at the time Congress was considering the RTC Completion Act in a letter dated September 23, 1993, from Andrew C. Hove, Jr., Acting Chairman, to the House and Senate Banking Committee Chairmen and Ranking Minority Members. (Copies of this correspondence are appended in Attachment C.) See also the Testimony of Andrew C. Hove, Jr., on "The Condition of the Banking and Thrift Industries," before the United States Senate Committee on Banking, Housing and Urban Affairs, September 22, 1994.

The outlook for the SAIF is further complicated by the fact that the law limits SAIF assessments that can be used for FICO payments to assessments on insured institutions that are both savings associations and SAIF members. Two types of institutions that pay assessments to the SAIF, Oakar and Sasser institutions, are not savings associations that are SAIF members. An Oakar is a BIF member that has acquired SAIF-insured deposits and therefore pays deposit insurance premiums to the BIF and the SAIF. Between late 1989 and year-end 1994, 715 banks had purchased $180 billion of thrift deposits -- or 25 percent of year-end 1994 SAIF domestic deposits.

A Sasser institution is a commercial bank or a state savings bank that has changed its charter from a savings association to a bank but remains a SAIF member. There are 319 "Sasser" banks holding deposits of $53 billion -- or 7.4 percent of SAIF domestic deposits.

Because assessment revenue from Oakar banks and from Sasser banks cannot be used to meet debt service on FICO bonds, almost 33 percent of SAIF-insured deposits were unavailable to meet FICO payments in 1994 (see Chart 1).See Notice of FDIC General Counsel's Opinion No. 7, 60 FR 7055 (February 6, 1995), confirming a 1992 opinion of the FDIC Legal Division that assessments paid by banks on deposits acquired from SAIF members should remain in the SAIF and not be allocated among the FICO, REFCORP, or FRF. In a letter to the FDIC Board of Directors, dated May 11, 1992, the Comptroller General described this conclusion and treatment of Oakar assessments as "reasonable." See letter from Charles A. Bowsher, Comptroller General of the United States, to the FDIC Board of Directors, dated May 11, 1992. In addition, the FDIC General Counsel's opinion states the FDIC Legal Division's position that assessments paid by any former savings association that has converted to a bank and remains a SAIF member are not available to the FICO. See GAO Report 95-84, Deposit Insurance Funds, March 1995, p. 15. This portion was up from 25 percent at the end of 1993. This shift contributed significantly to a 7.9 percent decline in 1994 in the SAIF assessment base available to service FICO, even though the overall insured deposit base of the SAIF declined by only 1.1 percent in 1994. At current assessment rates, an assessment base of $325 billion is required to generate revenue sufficient to service the FICO interest payments. The FICO-available base at year-end 1994 stood at $486 billion. The difference of $161 billion can be thought of as a cushion which protects against a default on the FICO bonds. If the 7.9 percent rate of shrinkage in the SAIF assessment base available to FICO were to continue, this FICO- cushion would be eliminated within five years.

The disparity that would arise from the FDIC's premium proposals would further complicate the outlook for SAIF. The proposed assessment rate schedules for BIF and SAIF members are shown in Table 1. The proposals would result in SAIF members paying an average assessment rate of 24 basis points, 19.5 basis points higher than the average rate of 4.5 basis points for BIF members. This premium differential could adversely affect SAIF members in a number of ways, including increasing the cost of remaining competitive, impairing their ability to generate capital internally or externally, and causing marginally higher rates of failure.

Historically, savings associations have paid somewhat higher deposit insurance premiums than have banks. From 1935 to 1980, this differential was 4 to 5 basis points, and from 1980 to 1991 the differential ranged as high as 12.5 basis points. In 1992, the differential was zero. Since 1992, under risk-related assessments, SAIF members have paid an average rate about 1 to 2 basis points above the average rate for BIF members. It is not clear that these historical differentials are instructive when evaluating the impact of the differential that would result from the current assessment-rate proposals. Previous premium differentials were smaller and the marketplace is widely considered to be more competitive today.

By way of background, from 1966 until 1984, thrifts were allowed to pay slightly higher rates of interest on deposits under Regulation Q. This interest rate differential was most frequently set at 25 to 50 basis points and was justified by the advantage that banks had in accepting interest-free demand deposits and engaging in commercial lending. The Regulation Q advantage may have lessened the burden of higher insurance premiums for thrifts. All these advantages were eventually dissipated by innovation, market forces and legislation.

We have considered the effect of a differential on pricing, on capital and on failures.

Pricing. If BIF-members pass all or some of their assessment reductions to their depositors by paying higher interest rates or to their borrowers by charging lower rates, SAIF members would be forced to incur higher costs in order to remain competitive. It is difficult to predict the eventual size of the effective differential because this will be determined by BIF- and SAIF-member management. In the extreme case where SAIF members absorb all of the differential, pretax earnings in the aggregate would be reduced by $1.4 billion. For the 25 percent of SAIF members earning a return on assets of 1.13 percent or higher in 1994, a differential of 20 basis points would reduce pretax earnings by 6.8 percent. For SAIF members with the median ROA of 0.86 percent in 1994, pretax earnings would be reduced about 12 percent. Earnings reductions this large would be significant. The likely impact, however, promises to be less dramatic. BIF members are likely to use some portion of their assessment savings to increase dividends or otherwise enhance shareholder value, and SAIF members can offset some portion of the differential by increasing revenues or reducing other expenses.

Capital. To the extent SAIF members' earnings are reduced by a premium differential, their ability to generate or raise capital could be impaired. Thrifts' average returns on assets and equity already lag significantly below those of banks, and the industry faces longer-term structural problems that will be difficult to overcome. This is primarily due to the fact that the business of mortgage lending has become increasingly competitive, reducing the profitability of holding mortgage loans to maturity. However, current tax laws require thrifts to maintain a certain percentage of their tangible assets in "qualified thrift investments" in order to realize the tax benefits available under a thrift charter. In recent years, we have seen some thrifts successfully raise new capital, even in some instances where the institutions were unprofitable, and we must conclude that the potential for a future premium differential was known at the time of issue. However, investors cannot be expected to suffer low returns indefinitely.

Failures. We are particularly concerned about the possible effects a premium differential could have on weaker institutions and whether a differential would cause any increase in failures. We analyzed the group of SAIF-insured institutions with FDIC supervisory ratings of 3 or higher and projected their performance for a five-year period, incorporating a 20-basis point differential and a variety of interest-rate and asset-quality assumptions. The results showed a slight increase in failures attributable to the differential, but we feel these additional failures should be manageable by the SAIF provided there is no unforeseen spiking of losses attributable to other factors, such as an economic downturn. In fact, in our projections the factors relating to interest rates and asset quality had a greater effect on failure rates than did a premium differential. The potential cumulative effect of all three factors could be substantial. Our analysis is included as Attachment C.

Most recently, the outlook for the SAIF has been further clouded by dramatic new developments. On March 1, 1995, Great Western Financial Corporation, the parent company of a SAIF- member federal savings bank with offices in California and Florida, announced that it had submitted applications for two national bank charters. Under the applications these commercial banks would share Great Western's existing branch locations. In its press release of March 1, 1995, Great Western noted the proposed premium differential and said the company's plan would "ensure its ability to offer deposit products at rates which will be competitive with commercial banks." By mid-March, five other SAIF-insured institutions announced that they were considering similar actions.

If these or other efforts in converting SAIF-insured deposits to BIF-insured deposits are successful, others are likely to follow. That would mean the SAIF assessment base could shrink significantly -- and quickly. These six institutions have approximately $80 billion in SAIF deposits, which represent 50 percent of the FICO-cushion mentioned earlier. Removal of those deposits from the SAIF would result in a significantly smaller base from which to generate the fixed FICO assessment.

Such a large shift in deposits would also have ramifications for the BIF. An additional $80 billion in BIF-insured deposits would require an additional $1 billion in BIF reserves -- 1.25 percent of $80 billion. While these announcements are unlikely to result in a large enough shift in insured deposits from the SAIF to the BIF by midyear to delay recapitalization of the BIF, such a shift could ultimately push the reserve ratio below 1.25 percent. If this were to occur, premiums paid by banks would have to be increased in order to again reach and maintain the 1.25 target ratio. The six new BIF members would begin contributing assessments to the BIF, but other BIF members would pay the preponderance of the needed $1 billion addition to reserves.

It is estimated that many more thrift institutions are considering ways of shifting deposits to the BIF. The announced proposals require various approvals associated with chartering new institutions, but there are other means to achieve the same ends that do not require such approvals, and are likely to lead to a further shrinkage in the SAIF assessment base. For example, existing affiliations between BIF and SAIF members enable deposit-shifting without the need for new charters or approvals by regulators. In general, we can expect the market to respond to cost differences, and those who suggest that regulators can prevent the movement of deposits out of the SAIF appear to underestimate the market's ability to innovate around constraints. If the rate of shrinkage in the SAIF assessment base increases 4 percent per year as a result of all available techniques, debt service on the FICO bonds is threatened as early as 2001. If the rate of shrinkage in the SAIF assessment base increases to 10 percent per year, debt service on the FICO bonds is threatened as early as 1977 (see figure 4 of Attachment C).

CONSTRAINTS

A number of legal constraints prevent a regulatory solution to the SAIF problem and, therefore, require Congressional action if the problem is to be addressed. Among the constraints:

- The law requires that the FDIC Board set assessments to maintain each deposit insurance fund's reserve ratio at the minimum designated reserve ratio (DRR) of 1.25 percent of estimated insured deposits once that ratio has been achieved.
- The FDIC Board may increase the DRR above 1.25 percent for any year only if the Board determines that circumstances exist raising a significant risk of substantial future losses to the fund for the year.
- Assessment rates and the DRR of the BIF and SAIF must be set independently.
- The BIF and the SAIF must be maintained separately, with no commingling of assets, liabilities, revenues or expenses.
- The FDIC Board must maintain a risk-based assessment system and assess each fund member at least $1,000 semiannually after a fund is capitalized.
- Until January 1, 1998, the FDIC Board is required to set SAIF assessments to increase the reserve ratio to the designated reserve ratio. Beginning January 1, 1998, the FDIC is required to promulgate a SAIF recapitalization schedule that achieves the DRR.
- As long as the SAIF remains undercapitalized, until January 1, 1998, SAIF assessments must average at least 18 basis points; thereafter, SAIF assessments must average at least 23 basis points.
- Assessment revenue from SAIF deposits that have been purchased by BIF members (Oakar banks) and from savings associations that have converted to bank charters (Sasser banks) is deposited in the SAIF and is not available to the FICO.
- FICO bonds are not an obligation of the FDIC, but of the FICO. Although the FICO is a mixed-ownership U.S. government agency, FICO bonds do not carry the full, faith and credit of the United States.
- Until 2019, the last maturity date of FICO's bonds, with the approval of the FDIC Board, the FICO has first priority to assess savings associations that are SAIF members to cover FICO's debt service needs.
- In setting SAIF assessments, the FDIC Board is required to consider the fund's expected operating expenses, case resolution expenditures and income, the effect of assessments on members' earnings and capital, and any other factors the Board determines to be appropriate.

FICO assessments is a relevant "other factor" that the FDIC Board may consider in setting SAIF assessments.

GOING FORWARD

Public Hearing

On Friday, March 17, the FDIC Board of Directors held an unprecedented public hearing on the agency's proposals to reduce deposit insurance premiums for most banks while keeping insurance rates unchanged for savings associations. These proposals were issued for public comment on January 31, and although written comments are not due until April 17, more than 600 comment letters already have been received.

The FDIC Board decided that a public hearing would provide a unique opportunity to explore all of the issues relevant to its consideration of the proposed assessment rates, the problems facing the SAIF, and the need for Congressional action. The format consisted of an open dialogue with representatives of both BIF-insured and SAIF-insured institutions and other interested parties. We heard not only from the major financial institution trade associations, but also from private citizens and individual bank and thrift executives from both large and small institutions.

I think I speak for the entire FDIC Board, as well as our witnesses and many observers, when I characterize these discussions as enlightening, thought-provoking, and extremely beneficial. In general there was agreement that while there is no easy solution, there is a very real problem. A problem that needs to be addressed sooner, rather than later.

There was not unanimous agreement on the timing of problems for the SAIF and the FICO bonds. The majority of the participants, however, conceded that a very real crisis looms on the horizon. One of our witnesses characterized himself as an historian and urged us not to repeat mistakes of the past "where policymakers have avoided decisions and waited for crises to occur." In a similar vein, others cautioned against temporizing.

I will not attempt to summarize the positions of all parties who spoke at the hearing.The FDIC has a transcript of the hearing available to distribute to all who are interested. A variety of alternatives were presented and discussed. These ranged from the purchase of FDIC-issued interest-bearing obligations by SAIF-member institutions to recapitalize the SAIF, to a one-time special assessment on SAIF-member institutions, to use of interest on RTC funds remaining at year-end to pay interest on the FICO bonds, to using the excess RTC funds in some form to meet future losses to the SAIF, to merging the two insurance funds. We intend to consider the views of all of the witnesses, as well as the many comment letters received, as we continue our analysis of the proposed assessment rates.

One area in which I would like to believe that a consensus was reached is a willingness by bank and thrift executives alike "to come to the table and talk." To be sure, there was a hesitancy on the part of many commercial bankers about bringing their wallets with them, and also a suggestion that the table be enlarged to include a broader range of financial institutions. In fact, I think our witnesses were quite candid in expressing that competitive inter-industry rivalries continue to exist, that there is a strong feeling among many banks that the SAIF "is not our problem," and that this is a very emotionally charged issue. It was even suggested that finding a solution that everyone can live with may be akin to resolving the baseball strike. We at the FDIC certainly hope that is not the case!

Of particular interest was the testimony of individual bankers about surviving the savings and loan crisis, the agricultural bank crisis, and the demise of the Ohio Deposit Guarantee Fund, to name a few. There were lessons learned that will not be soon forgotten. The common thread was the effect on financial institutions and their depositors when there is a crisis of confidence. Therefore, when queried as to whether they would be concerned if the SAIF failed, several bankers commented that "FDIC insured" is like a prized brand name to customers -- the logo on the door of a financial institution represents confidence -- and the integrity of that name must be preserved.

Clearly, there are no easy solutions to the problems of capitalizing the SAIF and meeting the FICO debt obligation, but I am encouraged by the willingness expressed by so many of our witnesses "to do the right thing" and to work together to find a constructive resolution. Several witnesses expressed their belief that the FDIC has a "moral obligation" to bring these problems to your attention and "the responsibility to articulate a comprehensive solution to the Congress." I now would like to turn to a discussion of possible legislative options.

A large number of proposals to address the SAIF problem have been made. In weighing the options, we must seek a real and permanent solution, not one that simply defers the issue to a later time while leaving in place the conditions that are the source of the problem.

Standards

In that regard, any solution should be judged by how well it accomplishes three goals. First, it should reduce the premium disparity between BIF- and SAIF-member institutions, and eliminate to the extent possible the portion of the SAIF premium attributable to the FICO assessments. This disparity encourages SAIF members to engage in legal and regulatory maneuvering to avoid SAIF assessments and in my view renders infeasible the existing mechanism to fund the FICO. This standard leaves open the question of what level of premium disparity between BIF and SAIF members would be small enough to eliminate the incentive for SAIF members to flee the SAIF. Second, it should result in the SAIF being capitalized relatively quickly, perhaps no later than 1998. The longer we allow the SAIF to be undercapitalized, the greater the possibility that unanticipated losses will deplete the fund. Third, a solution should address the immediate problem that on July 1, the SAIF will take over from the RTC the responsibility of handling thrift failures. Unfortunately, the SAIF will assume this responsibility in a vulnerable and grossly undercapitalized condition.

The progress towards capitalization, in other words, should be "front-loaded," with a substantial chunk of the capital coming quickly.

We must also be concerned with the means used to achieve these ends. In that regard, we must consider the precedent that is being set for the use of the deposit insurance funds. To ensure sufficient insurance reserves to meet future losses and to protect the FDIC's independence, the deposit insurance funds should be used only for deposit insurance purposes. Ideally, the converse should also be true that deposit insurance expenses should not be paid out of public funds, although the savings and loan crisis is evidence of an unfortunate breach of the latter principle, and the diversions from the SAIF for other purposes proves the rule about the former. We also must carefully consider the fairness of the solution to all concerned. Finally, to the extent that Congress may wish to consider options involving the use of RTC money to address the problems outlined here, there may be budgetary issues outside the purview of the FDIC.

Options

A number of options for addressing these issues are described below. The options are grouped as follows: one, no action; two, options using public funds; three, options involving a special assessment on the SAIF assessment base; four, options that would use investment income of the insurance funds to pay the FICO assessments; five, options using no public funds, including merging the funds and sharing the FICO assessments between BIF members and SAIF members; and six, options that combine the above approaches. Each option is described and evaluated in terms of how well it achieves the three goals just described. Other relevant advantages and disadvantages also are discussed. Information about each option is presented in Table 2.

No Action

Without any legislative action, SAIF members would bear the entire $15.1 billion cost of bringing the BIF and the SAIF into parity (option 1 of Table 2). Under a scenario that assumes no major unanticipated losses, a gradual shrinkage of the SAIF assessment base and a gradual increase in the portion of the base ineligible for the FICO assessment, the SAIF would not reach the designated reserve ratio until 2002. The premium disparity would be on the order of 19 basis points until the SAIF capitalizes. After capitalization, and assuming equal expenses for the two funds, the disparity would simply equal the basis-point equivalent of the fixed $779-million-per-year FICO obligation. Under the assumptions used regarding the shrinkage of the SAIF assessment base, this would amount to 12 basis points at the time of capitalization and would increase gradually until the FICO bonds mature.The analysis in Table 2 assumes that the FDIC would set assessments at the rate necessary to fund FICO interest payments after the SAIF achieves its designated reserve ratio. The law leaves the decision to the discretion of the FDIC Board.

Taking no action does not satisfy any of the three standards stated above. One, a premium disparity would continue to exist for 24 years and would almost certainly render the existing FICO funding mechanism obsolete. Two, the SAIF would not capitalize for at least seven years even assuming no major unanticipated losses. Three, there is no early injection of capital into the SAIF to alleviate the immediate problem of significant undercapitalization in the face of the requirement that the SAIF take over from the RTC the responsibility of handling failures of thrift institutions beginning July 1.

Approaches Using Excess RTC Funds

It has been estimated that there will be between $10 billion and $14 billion in RTC funds that have been appropriated but not spent -- the so-called excess RTC funds. It has been suggested that these funds be used either to pay the FICO assessments or to capitalize the SAIF, or some or all of both. Two such approaches are discussed below.

Use of Unspent RTC Funds to Pay the FICO Obligation. Under this approach, the FICO obligation would be paid out of excess RTC funds. This approach is presented in Table 2 as option 2. The approximate cost to the Treasury of this option is $8.4 billion.

Under our proposed standards, one, there would be no premium disparity arising from the FICO obligation and no chance of a FICO shortfall. Two, under this approach SAIF capitalization would occur in 1998 assuming no large unanticipated losses, significantly more quickly than currently expected. Three, this approach, however, would not address the immediate vulnerability of the SAIF beginning July 1.

There are several other public-policy issues related to this approach. The Congress recognized in FIRREA that statutory draws on the SAIF fund to support the FICO, the REFCORP, and the FRF could result in an undercapitalized SAIF for an extended time. Consequently the Congress authorized up to $32 billion in income and net worth supplements for the SAIF -- monies that never were appropriated. In light of this legislative intent, it may be appropriate for excess RTC funds to be used to pay the FICO obligation.

Another issue with this approach would relate to budgetary scoring. Under current law, deposit insurance outlays do not trigger offsetting reductions in other federal spending or require increased revenue; FICO assessments, however, are counted as interest outlays rather than deposit insurance outlays. In this regard it should be noted that resolutions of failing banks can often give rise to obligations that require the insurer to make periodic payments. Such periodic payments have been scored as insurance outlays for budgetary purposes. Congress may wish to consider similarly classifying FICO assessments as insurance outlays for budgetary purposes.

Use of Excess RTC Funds to Capitalize the SAIF. Under this approach, the excess RTC funds described above would be contributed to the SAIF in the amount needed to allow the fund to achieve its designated ratio of 1.25 percent of insured deposits (option 3). This would amount to $6.7 billion at year-end 1994.

Under our three proposed standards, one, this approach by itself would do nothing to alleviate the 24-year premium differential arising from the FICO assessments. Without some means to alleviate this differential, we could not rule out further shrinkage in the SAIF assessment base, a resulting increase in the premium disparity, and a deficiency in premium income to service the FICO assessment base. Two, the SAIF would capitalize much much more quickly than under the status quo. Three, the short-term vulnerability of the SAIF would be eliminated.

As noted earlier, excess RTC funds are available to cover insurance losses of the SAIF provided the FDIC certifies that an increase in SAIF premiums would reasonably be expected to result in greater loss to the Government, and that SAIF members are unable to pay assessments to cover losses without adversely affecting their ability to raise and maintain capital or maintain the assessment base. Congress required those certifications in an effort to ensure that SAIF members pay the highest rates possible before taxpayer funds are used to cover SAIF losses. Of course, this would have the effect of exacerbating the impending premium differential. In addition, it may be difficult for the FDIC to certify that increasing SAIF assessments would result in increased losses to the government prior to the SAIF being at or near depletion. Consequently, making RTC funds immediately available to capitalize the SAIF would require modifying or removing the existing certification requirements.

A closely-related alternative to providing excess RTC funds to capitalize the SAIF would be to make such funds available to cover insurance losses from thrift failures if they occur over a specified time period. As discussed above, this would have to be accompanied by modification or removal of the certification requirements to provide meaningful relief from the possibility of the SAIF being depleted. This option for capitalizing the SAIF is fundamentally different from others described in this testimony in that it would involve contingent assistance rather than upfront funded amounts.

There are substantial public-policy concerns with the precedent set by using public funds to capitalize the SAIF. Independence is vital to the effective functioning of the deposit insurance system. This does not mean freedom from accountability but independence to constrain undue risk-taking and to protect the insurance funds. The exercise of safety-and-soundness powers, pricing risk for insurance purposes, and closing and disposing of insolvent institutions all are accomplished most effectively when they are insulated from the political process. Capitalization of the SAIF with appropriated money could create a climate in which the FDIC's exercise of its insurance responsibilities would be influenced by policy concerns outside the scope of the FDIC's mission.

Approaches Involving a Special Assessment on the SAIF Base

Under this approach (option 4 of Table 2), a special one- time assessment that contributes to the capitalization of the SAIF would be levied against the SAIF assessment base. This special assessment could amount to some or all of the $6.7 billion needed as of year-end 1994 to capitalize the SAIF. In order to collect the full $6.7 billion, a special assessment of about 70 basis points would have to be levied over and above the current average assessment of about 24 basis points. The question of how many additional thrift failures would be triggered by such a special assessment is discussed below.

One, a special assessment would not eliminate the premium disparity -- even if large enough to recapitalize the SAIF -- because of the continuing FICO obligation. Two, it would substantially reduce, or eliminate, the time needed to reach the designated reserve ratio. Three, it would inject funds quickly, addressing the short-term vulnerability of the SAIF. A special assessment on SAIF members could act to short-circuit the types of legal and regulatory assessment-avoidance tactics described earlier. To put it bluntly, a special assessment could tax SAIF deposits before they can escape the fund. In this regard, Congress may wish to consider a cut-off date for a special assessment that would ensure that institutions attempting to avoid the assessment pay their fair share. A special assessment also would reduce to some extent the need for SAIF members to engage in assessment-avoidance tactics by reducing the capitalization component of the premium disparity.

If the full $6.7 billion were not collected at once, the SAIF would fall short of the 1.25 minimum reserve ratio. Under current law this would mean that SAIF premiums would have to average at least 18 basis points until 1998, and at least 23 basis points thereafter, until the required reserve ratio is achieved. Thus, there would continue to be a premium disparity on the order of 14 to 19 basis points until the SAIF is capitalized, and possibly thereafter if FICO bonds remain a SAIF obligation.

For a variety of reasons, however, if a special assessment were levied against the SAIF assessment base, it may be reasonable to eliminate the 18 basis-point statutory minimum average assessment rate required under current law. Assuming that the FICO-related premium disparity were eliminated by one of the options described above, a premium disparity would exist because of the need to complete the capitalization of the SAIF. The greater the special assessment, the less would be the need for additional assessment revenues to complete the capitalization of the SAIF. Table 3 shows how the size of the special assessment (treated as an addition to the existing premiums) and the time allowed to achieve capitalization affect the premium necessary for the SAIF to capitalize in the desired time.

For example, under a special assessment of 30 basis points, and assuming we wish the SAIF to reach the 1.25 reserve ratio in 1998, we would have to charge a SAIF premium of 15.5 basis points and the resulting premium disparity would be approximately 11 basis points under the current proposal. Alternatively, if we were willing to impose a 40-basis point special assessment and extend the deadline to capitalization to 1999, the necessary SAIF premium would be about 9 basis points and the disparity would be about 5 basis points. These numbers assume that the minimum assessment rate for

BIF members would be 4 basis points, and that there are no major unanticipated losses for either fund. They also assume that the FICO assessment and the current statutory minimum assessment rates for SAIF could be eliminated. If the FICO assessment were shared pro rata, both BIF and SAIF premiums would be about 2.4 basis points higher than indicated here.

Depending on the size of the special assessment, a disadvantage would be that there could be additional failures of SAIF members as a result. Under a one-time assessment on the SAIF assessment base of 94 basis points, the full amount needed to bring the SAIF to its designated ratio (70 basis point special plus 24 basis point current assessment), three SAIF members with total assets of $500 million would become critically undercapitalized, based on year-end 1994 financial reports, and another 103 SAIF members would be downgraded one notch from current capital categories.

Approaches Using Investment Income of the Insurance Funds to Pay the FICO

There have been a number of proposals to use investment income of the insurance funds to pay the FICO assessments. Two such proposals are considered here as option 5 of Table 2. One proposal would inject RTC funds into the SAIF in the amount needed to achieve the 1.25 reserve ratio. The interest on the SAIF's investment portfolio would then be used to pay a portion of the FICO assessments. With a fully invested fund at today's interest rates, this would yield approximately $600 million annually as compared with the $779 million required to meet FICO debt service obligations.

Another option that has recently been proposed would allow investment income equal to two basis points of the BIF assessment base to be used to pay the FICO assessments. Based on the current BIF assessment base, about $500 million of the $779 million annual FICO assessment would be paid by the BIF under this approach.

The first option does not constitute a complete solution to the problems posed by the difference in the condition of the two funds, but simply changes the form in which the FICO assessment would be paid by the SAIF industry. Instead of being paid by the SAIF members through assessments, the FICO would be serviced by garnishing the SAIF's income. If the BIF and the SAIF started at the same reserve ratio, had the same loss experience going forward, and maintained their respective 1.25 ratios, SAIF premiums would have to be higher than BIF premiums by a sufficient amount to offset the drain in the SAIF's income caused by the FICO service. Otherwise, if there were no premium differential, the BIF reserve ratio would increase continuously relative to the SAIF reserve ratio during the full 24-year period in which the FICO bonds are outstanding, and SAIF members would have to be assessed higher premiums to make up the difference if losses to the SAIF dropped the balance below the 1.25 ratio.

The advantage of the approach is delaying the SAIF premium increase until justified by losses. On the other hand, over the long term, this approach does not address the first standard set out above, address the premium disparity arising from the FICO assessment, as well as the incentive of SAIF members to avoid these assessments, and the resulting difficulties in funding the FICO debt. Our proposed standards two and three are met, because the SAIF would be capitalized immediately.

Looking at the approach involving BIF investment income, first, a premium differential arising from FICO assessments would still exist to the extent the SAIF's share of the remaining portion of the FICO assessment is greater than the investment income of the SAIF. Based on the current assessment bases of the two funds, the SAIF would pay about two basis points more than the BIF for its share of the FICO assessment. This differential could change over time if the BIF and SAIF assessment bases grew at different rates. The differential is not likely to be substantial, but could increase somewhat over time. Two, this option would capitalize the SAIF in 1999 under current conditions. Three, it would do nothing to address the short-term vulnerability of the SAIF.

Using investment income of the BIF to pay FICO assessments would set a precedent for using BIF funds to pay expenses not related to the BIF, although use of only investment income would be a more limited precedent. In addition, diverting investment income of the BIF would increase the likelihood that assessment rates for BIF members would have to be increased at some future time to replace the contribution investment income would have made to covering losses to the BIF from failed banks.

Use of No Public Funds

Options 6 and 7 in Table 2 present two approaches that rely solely on FDIC-insured institutions to raise some or all of the $15.1 billion needed to bring the SAIF into parity with the BIF. These are sharing the FICO assessments between the BIF and the SAIF without merging the funds (option 6) and merging the BIF and the SAIF (option 7).

The BIF Share of the FICO Obligation Without a Merger. Under this option, the BIF members would be assessed for a portion of the FICO assessments. For example, a pro rata sharing of the FICO assessments between the BIF and the SAIF, based on insured deposit levels in the two funds, would cost BIF members about $6.5 billion in present-value terms. The BIF's share of the annual $780 million obligation would be about $600 million, or 2.4 basis points per year because 77 percent of the total domestic deposits of FDIC-insured institutions are held by BIF members, and 23 percent by SAIF members.

Under our proposed standards, this approach would, one, eliminate any premium disparity arising from the FICO obligation, currently about 11 basis points of the proposed 19 basis point differential. By making the entire assessment base of both funds available to service the FICO debt, it would virtually rule out a deficiency of premium income to service the FICO assessment. Two, this approach would enable the SAIF to capitalize significantly more quickly than currently anticipated by eliminating most of the FICO drain on SAIF assessment revenue. Assuming no large unanticipated losses, capitalization would occur in 1999, three years earlier than currently projected.

Three, this approach would do nothing to address the concern that the SAIF will begin resolving thrift failures on July 1 in a significantly undercapitalized position and remain there for several years. This makes the SAIF very vulnerable to unanticipated losses. It thus leaves open the possibility that the SAIF could be bankrupted and that both SAIF- and BIF-insured institutions would suffer from the resulting negative publicity. The other concern with this approach has already been discussed. By using BIF funds for purposes other than paying for deposit insurance costs, this approach sets a precedent that could erode the effectiveness and independence of the deposit insurance system.

Another alternative for this approach would be for the BIF to contribute 50 percent of the cost of servicing the FICO obligation (option 6(b) of Table 2). This currently would amount to approximately 1.5 basis points annually for BIF members, or about a $4.2 billion present-value cost.

Under our proposed standards, this approach, one, would not eliminate the premium disparity. Unlike the pro rata sharing approach, this approach retains a 24-year premium disparity, although at lower levels than some other options. To illustrate, with the 50 percent sharing described here, equal shares of the annual FICO cost by the BIF and the SAIF of $390 billion would amount to about 1.5 basis points for BIF members and 5.5 basis points for SAIF members. Thus, after the SAIF is capitalized, there would remain a premium disparity of about four basis points that could grow larger if the SAIF assessment base were to shrink.

Two, this approach would not achieve SAIF capitalization as quickly as the alternative in which the BIF shares the FICO assessments on a pro rata basis -- 2000 rather than 1999 --, thus leaving the SAIF undercapitalized for one more year. Three, this option also does not address the short-term vulnerability of the SAIF.

In addition, this approach sets a precedent by using BIF resources for other purposes. BIF members probably would argue, however, that equal dollar sharing is less unfair than proportional sharing because it entails less use of BIF resources.

Merging the BIF and the SAIF. Under this option, the two funds would be combined and the existing premium rates maintained until the combined fund meets the designated reserve ratio. FICO assessments would continue to be paid by the thrifts. The designated reserve ratio for the combined fund could be expected to be achieved in 1996.

The cost to the BIF of this approach is estimated at $5.5 billion, or the equivalent of a one-time charge of 22 basis points on the BIF assessment base. By our proposed standards, one, there would be no premium disparity until capitalization of the combined fund occurred. At capitalization the disparity would equal the size of the fixed $779 million FICO charge relative to the SAIF assessment base. This would be about 11 basis points in 1996, assuming no drastic change in the SAIF assessment base during the next year.

This option meets standard two and three because there is an immediate and substantial capital injection into the SAIF and the combined fund recapitalizes quickly. The resulting 11-basis point disparity, based on the current SAIF assessment base, would nevertheless appear large enough to provide an incentive for further legal and regulatory maneuvering by SAIF members to avoid assessments. If successful, SAIF assessment revenue would prove insufficient to fund the FICO earlier than otherwise.

Merging the funds would set an unfortunate precedent for the use of the resources of the deposit insurance funds -- in this case the BIF. Existing law requires that BIF resources be used to cover only BIF expenses; merging the funds would violate that principle. There is a danger in overriding the law governing the use of insurance fund resources solely for the sake of expediency. If an insurance fund's resources can be used for purposes other than protecting the depositors of that fund, where should we draw the line about what charges to deposit insurance reserves are appropriate? Such "other uses" of deposit insurance funds weaken the distinction between those funds and general federal monies and pose a danger to the independence of the deposit insurance system. Moreover, there is a significant question of fairness to BIF member banks, who have paid $22 billion during the last four years to recapitalize the BIF at the level mandated by the Congress. Finally, the current problem of capitalizing the SAIF as a result of the diversions of SAIF assessment revenue for other purposes illustrate the effect of using deposit insurance funds for other purposes.

Combination Options

This section presents some options that involve combinations of the approaches outlined above. These are grouped under option 8 in Table 2. All of these options share a common theme: they are designed to enhance some of the approaches above that did not address the long-term premium disparity arising from the FICO assessments.

The first such option involves merging the funds and having BIF and SAIF share the FICO assessments proportionately. The most important shortcoming of merging the funds would be that, taken by itself, it would do nothing to resolve the 24-year premium disparity. By providing that the FICO burden be shared proportionately between current BIF and SAIF members this problem could be mitigated. The cost to the BIF would be $11.7 billion, or the equivalent of a one-time charge of 47 basis points on the BIF assessment base. This option would entail proportional sharing between the BIF and the SAIF of the total $15.1 billion cost of bringing the two funds into parity.

Under this approach, there would be no premium disparity, and, because the SAIF would be capitalized quickly, there would be an up-front substantial injection of funds. It would, therefore, meet our three standards. On the other hand, as emphasized above, there would be an unfortunate precedent set in using the BIF for purposes other than BIF insurance costs.

The second option would be to combine RTC capitalization of the SAIF with a pro rata sharing of the FICO assessments between BIF and SAIF. The drawback in using the excess RTC funds to capitalize the SAIF is that such an approach by itself would not alleviate the long-term premium disparity arising from the FICO assessments. This problem could be alleviated by combining this approach with a pro rata sharing of the FICO assessments between the BIF and the SAIF. This approach would eliminate the premium disparity and would result in an immediate capitalization of the SAIF, thus meeting our proposed standards. As emphasized above, however, these advantages come at a cost: the use of public funds and all that entails for the independence of the deposit insurance system.

A special assessment on the SAIF assessment base, either in combination with a BIF and SAIF sharing of the FICO or with excess RTC funds being used to pay the FICO assessment constitutes the third and fourth options. A special assessment by itself does nothing to resolve the premium disparity arising from the FICO assessments. Either two approaches could correct this problem. Either of these two approaches are presented in Table 2 under the assumption that the entire $6.7 billion needed for the SAIF to achieve the reserve ratio is collected at once through a special assessment. Approaches involving smaller special assessments were discussed above (see Table 3 and the accompanying discussion). Both approaches have advantages. One, there would be no long-term premium disparity; two and three, the SAIF is capitalized immediately.

CONCLUSIONS

There is an urgent need for legislative action to reduce the disparity in the financial condition of the BIF and the SAIF. This immediate need arises from three sources. First, on July 1 the SAIF will assume the responsibility for handling failures of thrift institutions. It will not assume this responsibility in a position of strength, because it is grossly undercapitalized. This condition is directly attributable to the fact that until 1993, most assessment revenues from SAIF members were statutorily diverted from the SAIF to pay for past losses related to the thrift crisis. In addition, revenue and net worth supplements totalling $32 billion that Congress had authorized for the SAIF never were appropriated. As a result of this history, the existing SAIF balance simply does not provide an adequate margin of comfort. The resources of the SAIF are insufficient to absorb the cost of the failure of one large or a few medium-sized thrifts, or other substantial unanticipated losses.

Second, as a result of the SAIF's significant undercapitalization, there can be no assurance that the Congress will not again have to address these issues. If there are no major unanticipated losses, the SAIF balance should inch up to its target over the next seven years. Over this length of time, it is difficult to take comfort that unanticipated losses will not prevent the SAIF from reaching its target. The longer the time before the SAIF capitalizes, the greater the chance the SAIF might fail to capitalize.

Third, the current structure for funding the FICO obligation is not viable. Requiring this fixed cost to be paid from deposit insurance assessments on the SAIF creates enormous economic incentives for the targeted group to engage in legal and regulatory maneuvering to reduce their potential costs. We are already seeing such maneuvering in the current interest expressed by some large thrifts in opening new banks and by applications from thrifts to operate branches that would share bank and thrift operations. As stated earlier, the question is not whether there will be insufficient premium income to service the FICO obligations, but when the deficiency will occur.

Any solution to these problems should address all three concerns. It should eliminate the long-term premium differential caused by the FICO assessments. It should greatly reduce the time needed to capitalize the SAIF. The longer the SAIF is allowed to remain undercapitalized, the greater the chance that unanticipated losses will prevent us from reaching the target or will force Congress to consider these issues again. Finally, the solution should include an immediate injection of funds into the SAIF or a ready source of backup funding for SAIF losses. As matters stand now, the SAIF will begin its responsibilities for handling thrift failures after June 30 in a dangerously vulnerable condition.

Madam Chairwoman, the FDIC is committed to finding solutions that address these three concerns in a manner that is consistent with good public policy. We stand ready to assist the Subcommittee in this effort in the weeks ahead. I commend your forsightedness in holding this hearing, and I look forward to your questions and to questions from members of the Subcommittee.

Last Updated 12/6/2011