United States General Accounting Office

GAO Testimony

For Release
on Delivery
Expected at
10:00 a.m.
Thursday
February 2, 1989

Resolving the Savings and Loan Crisis

Statement of
Charles A. Bowsher
Comptroller General
of the United States

Before the
Committee on Banking, Housing and Urban Affairs
United States Senate

044493/137835

RESOLVING THE SAVINGS AND LOAN CRISIS

SUMMARY OF STATEMENT BY
CHARLES A. BOWSHER
COMPTROLLER GENERAL OF THE
UNITED STATES

In response to a recent request from the Honorable Donald W. Riegle, Chairman of the Senate Committee on Banking, Housing and Urban Affairs, GAO provided its views on how to resolve problems in the thrift industry.

In Summary: GAO recommended providing sufficient funding to resolve what has become at least an $85 billion problem in FSLIC, the insurance fund that insures thrift industry deposits. However, to be sure that this situation is not repeated, GAO recommended that the system be reformed as a condition for committing federal funds.

Changed Structure and Management of the Deposit Insurance System: Without changes to the structure and management of the deposit insurance system, the federal government faces potentially large losses in insuring deposits. This potential for loss is most evident in FSLIC. To protect the integrity of the deposit insurance system, FSLIC needs to be made independent of the Federal Home Loan Bank Board. Healthy and unhealthy thrifts should be put into separate funds so that tougher deposit insurance rules can fairly and equitably be applied to healthy thrifts right away.

Provide Funding: If reforms are adopted, then a plan should be adopted by the Congress that makes funds available to meet the financing shortfall which we estimate at around $85 billion. This plan should (1) provide for budget authority sufficient to finance case resolutions over the next three years, (2) require a thrift industry capital contribution to create an adequate insurance fund reserve, (3) provide FSLIC with the flexibility to undertake short term liquidity borrowing to meet any deposit outflows that might occur, (4) assure adequate controls over spending to protect the taxpayers' interests, and (5) use an on-budget approach that fully discloses the funding and outlays that are involved.

Changed Approach to Resolving Problem Institutions: FSLIC's approach to resolving cases depends too heavily on assistance agreements that minimize FSLIC's need for cash but require subsidies for up to 10 years. FSLIC needs money to achieve more flexibility in its approach. Using personnel resources from other federal agencies, FSLIC should take control of all insolvent institutions over the next year thereby curtailing the ability of these institutions to adversely affect healthy thrifts. FSLIC should then seek to resolve cases at the lowest cost to the government while minimizing adverse competitive impacts on healthy thrifts.

Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss problems in the thrift industry. My testimony is based principally on a report we are preparing for the House Banking Committee. I will also discuss work we have begun on your request to examine aspects of transactions entered into by the Federal Home Loan Bank Board (FHLBB) in December 1988.

I hope we are finally reaching a point where a comprehensive approach can be taken to dealing with the issues associated with the insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC). We estimate that to fully pay for insurance losses and to put FSLIC back on a solid financial footing it will cost at least $85 billion more than FSLIC currently anticipates receiving in revenue over the next 10 years. Delay will only increase this cost. Delay will also

-- perpetuate the tendency of weakly capitalized and insolvent institutions to squander our nation's wealth on questionable economic endeavors at no significant risk to their owners,

-- weaken our financial system because healthy depository institutions must match the high rates of interest on deposits paid by weak and insolvent thrifts,

-- weaken the regulatory process by creating pressure for lower regulatory standards across the depository institutions industry, and

-- perpetuate the situation in which the actions FSLIC does take will likely be merger agreements that avoid short run cash needs rather than minimize the federal government's costs in resolving cases.

Without question, federal financing will be needed to resolve the thrift industry situation. However, if we want to be as certain as we can that a FSLIC situation is not repeated, we must be concerned as well with changing the structure of the deposit insurance system. It would be a mistake to commit federal funds without adopting key reforms.

The remaining parts of my testimony discuss structural reforms, funding requirements, and the need for changes in the way problem cases are resolved.

Structural changes

The 1980s have been a turbulent period for our nation's depository institutions. Changes in the financial landscape resulting from market developments and legislated deregulation have drastically altered the way that depository institutions operate. These changes have many positive aspects, but combined with changes in the economy and a breakdown in the regulatory system they have also resulted in new risks and a rash of thrift failures.

In light of these developments, we need to look critically at how the deposit insurance system functions. Our current system provides many benefits to the public that should be preserved. However, the risks to the government inherent in insuring about $2.5 trillion in bank and thrift deposits can be very great. By far, the most serious insurance problems now are in the thrift industry.

To effectively manage deposit insurance risks it is necessary to (1) have sufficient funds to pay for losses, otherwise the credibility of the insurer taking appropriate action is damaged; (2) ensure that levels of capital in institutions are sufficient to absorb reasonably anticipated losses; and (3) have an effective system of oversight and supervision to quickly identify problems, remedy them if possible, and close institutions at the point of their insolvency.

To accomplish these goals two key issues involving FSLIC must be addressed. First, is the problem of FSLIC's lack of independence. Presently, FSLIC operates under the direction of the Federal Home Loan Bank Board which both promotes and regulates the industry. The industry itself is overseen and supervised by the Federal Home Loan District Banks, which, in turn, are owned by each District Bank's constituent institutions. In our view, the Federal Home Loan Bank System's role as an industry promoter has been accorded more importance than FSLIC's risk management and insurance function.

The second issue is how to best reorganize thrift industry oversight and supervision. This will be exceedingly difficult as long as insolvent and thinly capitalized institutions are allowed to compete with healthy institutions. An equitable way must be found to isolate problem cases so that we can "turn the corner" toward more effective oversight, supervision and enforcement of more rigorous rules for the rest of the industry.

To deal with these two issues, we recommend the following:

-- FSLIC should be made independent of the Federal Home Loan Bank Board, and established with a separate board of directors and adequate supervisory capability over both state and federally chartered thrifts. An independent FSLIC should oversee two separate insurance funds--one fund for healthy thrift institutions ("good companies") and another fund for insolvent or thinly capitalized thrifts that would be severely curtailed in their ability to compete with the rest of the depository institutions industry.

-- More flexibility should be given to both FDIC and FSLIC to adjust premiums to reflect actual or reasonably anticipated losses.

-- More authority should be given to both FDIC and FSLIC to place stringent controls on improperly operated and undercapitalized institutions.

-- Greater consistency between banks and thrifts should be established in matters pertaining to powers and operations that materially affect the deposit insurers' exposure to risk.

-- Capital adequacy requirements should be strengthened, and the quality of supervision and oversight must be improved through an increase in the personnel and other resources of the deposit insurance funds.

These and more specific recommendations will be detailed in our final report to be issued later this month to the House Banking Committee. The reforms and funding arrangements we recommend should help accomplish the goal of developing an appropriate regulatory structure for depository institutions. FSLIC's financial problems have to be solved. The deposit insurance agencies need to have greater powers over the terms and conditions for insuring both federal and state chartered institutions. A higher degree of comparability is needed between banks and thrifts in matters that materially affect deposit insurance risk. After these reforms are enacted, it will be easier to consider what other changes need to be made to the federal regulatory structure.

For example, as part of the reform package, we recommend allowing qualified thrifts to choose between remaining in a reorganized FSLIC or switching to FDIC which should help Congress in making future regulatory decisions. Business decisions made by individual healthy thrifts will provide useful information about the value of thrift charters and the need for a separately identified thrift industry.

Funding To Fully Resolve Problems Must Be Provided

Insolvent institutions cannot be effectively resolved unless enough money is available. Unfortunately, deciding precisely how much money will be needed and who should pay will be difficult.

As I indicated at the outset, our best judgement at this time is that it will cost FSLIC at least $85 billion more than it currently anticipates receiving over the next 10 years to deal with the problem. Of this amount, $26 billion represents FSLIC's unfunded cost of paying for actions taken in 1988 and $34 billion represents the future cost of acting on the approximately 350 remaining insolvent cases. In addition, $5 billion represents the cost of resolving cases not presently identified as problems, and $20 billion is needed to establish adequate reserves. However, given the fluid nature of the situation and the fact that we haven't analyzed all of the actions taken in 1988, I want to stress that these numbers are only estimates.

We believe the thrift industry should pay as much of the shortfall as possible. However, the industry is currently paying premium assessments that are more than two times higher than those paid by the banking industry. Many believe that indefinite continuation of the special assessment will weaken healthy thrifts and thereby prove self defeating.

Under the best of circumstances, it is not likely that the thrift industry can contribute much more to the funding shortfall. Although we think the healthy segment of the industry should be charged with recapitalizing the insurance arrangements that apply to them, the bulk of the money will have to be found elsewhere. Judgements as to who can pay how much must be made based on what is perceived to be fair. If contributions are not sought from other segments of the depository institutions industry, then the shortfall will have to be met by the federal government.

If the changes to risk management and case resolution approaches that I have described are made, then we recommend that a plan be adopted by Congress that makes available the funds needed to meet the shortfall. This plan should:

-- provide for budget authority sufficient to finance case resolutions, which we believe can be completed over the next 3 years,

-- assure adequate controls over spending to protect the taxpayers' interests, such as by creating a control board, and

-- provide FSLIC with flexibility to undertake short-term liquidity borrowing to finance any deposit outflows that might occur while efforts are being made to determine resolution approaches for institutions placed in receivership.

To the extent that federal money is used, we recommend an on-budget approach that fully discloses the funding and outlays that are involved, even if this requires raising the Gramm-Rudman-Hollings deficit reduction targets. We also think that a restructured federal budget along the lines we have proposed elsewhere would better highlight the financing of FSLIC and similar enterprises that are set up to operate a business type cycle of operations.

A Different Approach To Resolving Insolvent Institutions Is Needed

At the beginning of 1988 there were roughly 500 insolvent savings and loans with assets of about $140 billion. During 1988, the Federal Home Loan Bank Board began resolving these cases. The Bank Board acted on some 222 institutions, with most of the activity concentrated in the latter part of the year.

The willingness of the Bank Board to begin reducing its problem thrift caseload represents a much needed break from the practices of the past. But, we have serious reservations about the way the Bank Board proceeded.

In recent years the Federal government has been involved in several financial rescues. In 1984 we issued a report, based on the government's experience with Chrysler, New York City, and several other situations, about how such efforts should be structured.[1] This past experience underscores the importance of developing an adequate plan for financing, implementing, and overseeing these types of situations.

The Bank Board's actions have not been consistent with such an approach. The Bank Board has relied extensively on FSLIC assisted merger agreements that extend for up to 10 years. The

---

[1]Guidelines for Rescuing Large Failing Firms and Municipalities (GAO/GGD-84-34, dated March 29, 1984).

notes and guarantees in these agreements provide a mechanism for coping with FSLIC's lack of funds and its lack of information on the financial condition of many of its insolvent institutions. Chart I summarizes the generic components of the deals.

As I noted earlier, at your request we are studying FSLIC's December 1988 transactions. We have not yet obtained all of the information we need and therefore are not in a position to comment in detail. However, we do have concerns about the nature of these agreements. These are summarized in Chart II.

-- Ownership capital contributed by private investors has been minimal, and large and thinly capitalized institutions are being created. If history is prologue, inadequate capital creates incentives for highly leveraged institutions to engage in unsafe and unsound management practices. These new institutions may, therefore, pose risks to FSLIC in the future. Should they become insolvent, FSLIC may find it even more difficult to fully resolve their situations because of their larger size.

-- The institutions resulting from the assisted mergers are heavily subsidized by FSLIC, and are competing with healthy nonassisted depository institutions at a cost advantage.

-- FSLIC provides capital loss indemnification and an operating subsidy on assets that appear to make it profitable to simply hold them. We therefore question the strength of the new institutions' incentives to actively manage and generate recoveries on those assets.

-- FSLIC faces a huge task in effectively administering these complex agreements.

-- Finally, it is questionable whether many of these mergers really save the government money compared to other options that would be possible if FSLIC had the money to resolve cases.

Another approach is needed that fully resolves insolvent institutions with no lingering adverse competitive effects on healthy thrifts or threats to FSLIC's finances. We recommend that:

-- FSLIC promptly take control of all insolvent institutions. These institutions should be placed in receivership whenever necessary until a decision can be made to liquidate or merge them based on a careful assessment of their asset portfolios, and the comparative cost of each resolution option. Of fundamental importance, these institutions must be effectively isolated from the rest of the depository institutions industry to prevent them from competing with healthy institutions. Their operations must be limited to investing in high grade securities, managing bad assets on their books, and accepting deposits at prevailing market rates.

-- To accomplish this action, the assistance of state and federal regulators and insurance officials should be enlisted to quickly help assess the quality of assets in these institutions and make the necessary resolution decisions.

-- Arrangements should be made with FDIC for asset management and liquidation services until FSLIC can develop the requisite capability. FSLIC does not possess the infrastructure needed to manage the timely, cost effective resolution of all insolvent thrifts.

It is imperative that Congress reach an agreement about the FSLIC strategy as soon as possible. As things now stand, more of these merger agreements can be expected unless Congress acts to change FSLIC's strategy, reform the system, and provide the needed funds.

- - - - - - - - - -

I recognize that within the outlines of the actions I have suggested, there are many specific arrangements that need to be worked out. We are prepared to provide whatever assistance this

Committee and others deem necessary in developing the detailed plans for putting the thrift industry crisis behind us.

That concludes my prepared statement. My colleagues and I will be pleased to answer questions.

CHART I

GAO

Typical December 1988 Deal

- Note for negative net worth
- Guaranteed return on assets
- Guaranteed book value of assets
- Reimbursed certain expenses
- Waived regulation compliance
- Tax benefits
- Equity position in S&L

CHART II

GAO

Concerns About Deals

Creates new thrifts that are:

- Thinly capitalized
- Have cost advantage over healthy S&L's
- Lack incentives to manage assets

May cost more than liquidation

Will require huge monitoring job because of complexity