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GAO

Report to the Congress

May 1987

FINANCIAL AUDIT

Federal Savings and Loan Insurance Corporation's 1986 and 1985 Financial Statements

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GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-114893

May 27, 1987

To the President of the Senate and the
Speaker of the House of Representatives

This report presents our qualified opinion on the Federal Savings and Loan Insurance Corporation's consolidated financial statements for the years ended December 31, 1986 and 1985, and our reports on the Corporation's system of internal accounting controls and on its compliance with laws and regulations. The accompanying financial statements reflect a loss of almost $11 billion for 1986 and a deficit of more than $6 billion at the end of 1986.

Our opinion on the 1986 financial statements is qualified subject to the uncertainty as to whether the Corporation can continue to fulfill its mission and meet its financial obligations. Troubled sectors of the savings and loan industry have placed a severe strain on the Corporation. The average size of savings and loan institutions that have failed and the number of institutions receiving financial assistance or special supervisory attention from the Corporation have steadily increased during the last several years. The Corporation currently estimates the ultimate cost of providing assistance to about 380 troubled institutions may reach $25 billion.

Currently, the Congress is considering legislation to recapitalize the insurance fund. The amounts of capital to be provided under the legislative proposals range from $5 billion to $7.5 billion over 2 years. Given the severity of the situation, it appears that the amounts under consideration would not provide the monetary resources necessary for the Corporation to address the problems in this troubled industry.

The Federal Savings and Loan Insurance Corporation, a wholly owned government corporation governed by the Federal Home Loan Bank Board, is responsible for insuring deposits in savings institutions. The Comptroller General audits the financial transactions of wholly owned government corporations under 31 U.S.C. 9105. We conducted our examinations in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Director of the Office of Management and Budget, the Secretary of the Treasury, and the Chairman of the Federal Home Loan Bank Board.

Charles A. Bowsher

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Comptroller General
of the United States

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To the Chairman
Federal Home Loan Bank Board

We have examined the consolidated statements of financial condition of the Federal Savings and Loan Insurance Corporation as of December 31, 1986 and 1985, the related consolidated statements of income and expense and reserves, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The accompanying financial statements reflect a net loss of almost $11 billion for 1986 and a deficit of more than $6 billion at the end of 1986. Troubled sectors of the savings and loan industry have placed a severe strain on the Corporation. The average size of savings and loan institutions that have failed and the number of institutions receiving financial assistance or special supervisory attention from the Corporation have steadily increased during the last several years. From December 31, 1985, to December 31, 1986, the Corporation's caseload of institutions in serious financial trouble virtually doubled—from 93 to 183.

The Corporation's 1986 net loss was primarily due to the provision for losses of almost $9 billion for troubled institutions in the Corporation's current caseload that will require new or increased financial assistance. The provision increased to $9 billion in 1986, from $1.6 billion in 1985, because of the increasing number of troubled institutions needing regulatory action. These institutions all have large deficits and continue to incur substantial operating losses, which will increase the Corporation's costs to resolve industry problems.

The 1986 loss provision is not a projection of the cost of resolving all future problems in the industry. The Corporation estimates that more than 380 institutions, including the 183 institutions in its current caseload, will ultimately require assistance. The Corporation believes the cost of providing assistance to about 280 currently insolvent institutions may range up to $21 billion. Assistance to another 100 institutions that currently appear to have little chance of recovery could add another $4 billion to the Corporation's losses. Future losses cannot be precisely estimated because of various uncertainties, such as the quality of each troubled institution's assets, future levels of interest rates, and the economic outlook for sectors of the economy in which a large portion of the troubled institutions operate.

Currently, the Congress is considering legislation to recapitalize the insurance fund. The amounts of capital to be infused under the legislative proposals range from $5 billion to $7.5 billion over 2 years. Given the severity of the situation, it appears that the amounts under consideration would not provide the monetary resources necessary for the Corporation to address the problems in this troubled industry. The previous Congress considered similar legislation but did not enact it into law.

Since the end of 1986, the Corporation's condition has continued to deteriorate. Its cash and investment securities, which declined from $6.1 billion to $4.0 billion during 1986, have further declined, and at May 1, 1987, stood at $913 million. This decrease was caused in part by the Corporation honoring its guarantee of $947.4 million in Dallas Federal Home Loan Bank's advances to insured institutions. As described in note 2, as of December 31, 1986, the Corporation had guaranteed Federal Home Loan Bank advances outstanding of $3.6 billion, including the $947.4 million subsequently paid to the Dallas Bank. Because of the Corporation's impaired liquidity, should other Federal Home Loan Banks request the Corporation to honor their guaranteed advances, the Corporation may be unable to do so.

These factors indicate that the Corporation may be unable to continue to fulfill its mission and meet its financial obligations. The 1986 consolidated financial statements presented herein do not reflect any adjustments that might be necessary should the Corporation be unable to continue in its present form.

As a result of its losses, the Corporation has exercised its authority under sections 404 (e) and (h) of the National Housing Act, as amended (12 U.S.C. 1727 (e), (h)), to use its secondary reserve to help absorb operating losses. Accordingly, the secondary reserve declined from $774 million at December 31, 1985, to zero at December 31, 1986. The remainder of the losses were charged to the primary reserve. The secondary reserve comprised the equity of certain savings and loan institutions in the Corporation based on premium prepayments and related interest not yet paid to those institutions.

In our opinion, subject to the Corporation obtaining sufficient funds to continue operating and to meet its obligations, the financial statements referred to above present fairly the financial position of the Federal Savings and Loan Insurance Corporation as of December 31, 1986 and 1985, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

May 1, 1987

Report on Internal Accounting Controls

We have examined the consolidated financial statements of the Federal Savings and Loan Insurance Corporation for the years ended December 31, 1986 and 1985, and have issued our opinion thereon. This report pertains only to our study and evaluation of the system of internal accounting controls for the year ended December 31, 1986. (Our report on the study and evaluation of internal accounting controls for the year ended December 31, 1985, is presented in GAO/AFMD-86-65, dated July 2, 1986.)

As part of our examination, we made a study and evaluation of the system of internal accounting controls to the extent we considered necessary to evaluate the system as required by generally accepted government auditing standards. The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the Corporation's consolidated financial statements. For purposes of this report, we have classified the significant internal accounting controls in the following categories:

- assistance to problem savings and loan institutions, including supervisory and liquidation activities;
- expenditure;
- financial reporting;
- revenue; and
- treasury.

Our study and evaluation included all of the control categories listed above except for treasury. For that activity, we found it more efficient to rely solely on substantive audit tests. In addition, we reviewed the Corporation's report for the year ending September 30, 1986, issued pursuant to section 2 of the Federal Managers' Financial Integrity Act of 1982 to determine the existence and status of any internal control weaknesses relevant to financial matters which the Corporation had identified.

The Corporation's management is responsible for establishing and maintaining an effective system of internal controls. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system of internal controls are to provide management with reasonable assurance that (1) obligations and costs are in compliance with applicable laws, (2) funds, property, and assets are safeguarded against waste, loss, and unauthorized use or misappropriation, and (3) assets, liabilities, revenues, and expenditures applicable to operations are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over the Corporation's assets. Because of inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study and evaluation, made for the limited purpose described in the second paragraph, would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the Corporation's system of internal accounting controls taken as a whole or on the categories of controls identified in the second paragraph. Our study and evaluation did not disclose any internal accounting control weaknesses which we considered to be material in relation to the consolidated financial statements taken as a whole. However, concerns resulting from the Corporation's losses, from studies we performed, and from a review of staffing levels all indicate to us a need for additional reviews of the liquidation and supervisory activities and related internal controls, which we plan to do.

During the course of our examination, we also identified several weaknesses in internal accounting controls and procedures that we did not consider to be material to the consolidated financial statements. Nonetheless, they merit corrective action to strengthen the Corporation's internal accounting controls, and we are reporting them separately to the Corporation.

Report on Compliance With Laws and Regulations

We have examined the consolidated financial statements of the Federal Savings and Loan Insurance Corporation for the years ended December 31, 1986 and 1985, and have issued our opinion thereon. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of compliance with laws and regulations as we considered necessary in the circumstances. This report pertains only to our review of compliance with laws and regulations for the year ended December 31, 1986. (Our report on the review of compliance with laws and regulations for the year ended December 31, 1985, is presented in GAO/AFMD-86-65, dated July 2, 1986.)

In our opinion, the Corporation complied with the terms and provisions of laws and regulations for the transactions tested that could have materially affected its consolidated financial statements. In connection with our examination, nothing came to our attention that caused us to believe that the Corporation was not in compliance with the terms and provisions of laws and regulations for those transactions not tested.

Consolidated Statement of Financial Condition

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
CONSOLIDATED STATEMENT OF FINANCIAL CONDITION
DECEMBER 31, 1986 AND 1985
(in thousands)

	1986	1985
Assets		
Cash	$ 42,209	$ 9,443
Investments (Note 3)	3,986,515	6,127,968
Interest receivable on investments	19,035	46,871
Insurance premiums and accounts receivables	913	7,271
Contributions subject to repayment	27,423	29,090
Subrogated accounts from receivers (Note 4)	2,827,489	836,157
Collateralized advances from receivers (Note 4)	824,484	282,555
Loans to receivers	117,274	86,276
Interest receivable on loans to receivers	2,016	-0-
Collateralized loans to insured institutions (Note 5)	900,000	900,000
Other loans to insured institutions (Note 5)	113,502	133,305
Interest receivable on other loans to insured institutions	2,778	1,659
Real estate, mortgage loans and other assets in process of liquidation (Note 6)	293,056	227,145
Income capital certificates (Notes 7 and 9)	1,436,781	1,534,759
Net worth certificates (Notes 8 and 9)	272,650	274,500
Other assets (Note 1)	6,885	2,002
Total assets	10,873,010	10,499,001
Liabilities		
Accounts payable and other liabilities	61,138	49,316
Notes payable and other liabilities to insured institutions (Note 9)	4,872,750	2,600,880
Accrued interest on notes payable to insured institutions	97,941	61,399
Notes payable to Federal Home Loan Banks (Note 5)	900,000	900,000
Possible losses under existing assistance agreements (Note 10)	774,072	774,004
Estimated contingent liability (Note 13)	10,500,000	1,556,000
Total liabilities	17,205,901	5,941,599
Insurance Fund Reserves		
Primary reserve	(6,332,891)	3,783,169
Secondary reserve	-0-	774,233
Total insurance fund reserves (Note 12)	(6,332,891)	4,557,402
Total liabilities and reserves	$10,873,010	$10,499,001

The accompanying notes are an integral part of these financial statements.

Consolidated Statement of Income and Exenses and Reserves

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
CONSOLIDATED STATEMENT OF INCOME AND EXPENSE AND RESERVES
FOR THE YEARS ENDED DECEMBER 31, 1986 AND 1985
(in thousands)

	1986	1985
Income		
Insurance premiums (Note 1)	$ 750,678	$ 703,913
Special assessment premiums (Note 1)	1,078,774	1,010,691
Interest on investments	368,005	489,774
Interest on collateralized advances	2,807	424
Interest on other loans to insured institutions	35,333	20,898
Interest on collateralized loans to insured institutions	48,572	61,562
Interest on mortgage loans and other assets in process of liquidation	13,236	25,678
Gain on transfer of insured accounts	64,871	69,289
Other income	45,320	5,932
Total income	2,407,596	2,388,161
Expenses		
Insurance settlement and administrative expenses for FSLIC	63,504	31,157
Services rendered to FSLIC by the Federal Home Loan Bank Board (Note 2)	24,820	20,960
Interest applied to the secondary reserve (Note 12)	52,793	54,737
Interest on notes payable to Federal Home Loan Banks	45,653	59,099
Interest on notes payable to insured institutions	217,979	101,747
Provision for possible future losses on:		
Subrogated accounts from receivers (Note 4)	3,195,274	1,063,641
Collateralized advances from receivers (Note 4)	(254,174)	229,739
Real estate, mortgage loans and other assets in process of liquidation (Note 6)	40,509	11,235
Loans to insured institutions (Note 5)	-0-	5,650
Income capital certificates (Notes 7 and 9)	127,599	653,306
Net worth certificates (Notes 8 and 9)	-0-	13,500
Assistance agreements (Note 10)	889,404	(310,742)
Estimated contingency (Note 13)	8,944,000	1,556,000
Total expenses	13,347,361	3,490,029
Net income (loss) from operations	(10,939,765)	(1,101,868)
Transfer of secondary reserve to primary	823,705	774,233
Primary reserve at beginning of year	3,783,169	4,885,037
Reserves at end of year (Note 12)	$ (6,332,891)	$ 4,557,402

The accompanying notes are an integral part of these financial statements.

Consolidated Statement of Changes in Financial Position

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
FOR THE YEARS ENDED DECEMBER 31, 1986 AND 1985
(in thousands)

	1986	1985
Source of Funds:		
Net income (loss)	$(10,939,765)	$ (1,101,868)
Add (deduct) items not requiring, or generating cash:		
Depreciation of FF&E	332	99
Accretion and amortization of investments	6,224	(13,122)
Interest applied to the secondary reserve	52,793	54,737
Transfer from the secondary reserve	(91)	(129)
Writeoff of other receivables	-0-	250
Provision for possible losses on:		
Subrogated accounts (Note 4)	3,195,274	1,063,641
Collateralized advances from receiver (Note 4)	(254,174)	229,739
Real estate, mortgage loans and other assets (Note 6)	40,509	11,235
Income capital certificates (Notes 7 and 9)	127,599	653,306
Assistance agreements (Note 10)	889,404	(310,742)
Estimated contingency (Note 13)	8,944,000	1,556,000
Net worth certificates (Notes 8 and 9)	-0-	13,500
Loans to insured institutions (Note 5)	-0-	5,400
Funds provided from operations	2,062,105	2,162,046
Increase in:		
Notes payable and other liabilities to insured institutions (Note 9)	2,271,870	1,766,045
Accrued interest on notes payable to insured institutions	36,542	26,354
Accounts payable and other liabilities	11,822	(6,364)
Notes payable to FHLBanks (Note 5)	-0-	200,000
Decrease in:		
Investments and interest receivable	2,162,790	(242,408)
Insurance premiums and accounts receivable	6,358	30,809
Contributions subject to repayment	1,667	(29,090)
Loans to insured institutions and interest receivable	18,684	(113,857)
Net worth certificates	1,850	(147,450)
Total funds provided	6,573,688	3,646,085
Application of Funds:		
Amount paid under assistance agreements	889,336	621,515
Secondary reserve refund (Note 12)	3,230	1,105
Increase in:		
Subrogated accounts	5,186,607	1,385,893
Income capital certificates	29,621	1,610,309
Collateralized advances from receiver	287,755	(70,388)
Loans to receivers and interest receivable	33,014	86,276
Real estate, mortgage loans & other assets in process of liquidation	106,144	3,167
Other assets	5,215	1,530
Total funds applied	6,540,922	3,639,407
Increase in cash	$ 32,766	$ 6,678

The accompanying notes are an integral part of these financial statements.

Notes to Financial Statements

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1986 AND 1985

1. Summary of Significant Accounting Policies:

   a) General - These statements do not include accountability for assets and liabilities of closed insured institutions for which the Corporation acts as receiver or liquidating agent. Periodic and final accountability reports of its activities as receiver or liquidating agent are furnished by the Corporation to courts, supervisory authorities, and others as required.

   b) Premium Income Recognition - Insurance premium income is recognized as earned when member institutions are assessed. This assessment is at the rate of 1/12 of 1 percent of the insured institution's total savings capital. In addition to the normal insurance premium, the Bank Board has authorized the Corporation to assess each member an additional premium in an amount equal to 1/32 of 1 percent of their total savings capital each quarter. Because the additional insurance premium has no fixed term, a determination to assess insured institutions is made by the Bank Board on a quarterly basis.

   c) Provision for Loss Contingencies - Prior to 1985, the Corporation considered it impracticable to estimate its contingent liability for those troubled institutions which would likely require new or increased financial assistance. The Corporation established an estimated provision for loss only when the Bank Board approved assistance to an insured institution. The provision for loss represented the difference between the assistance provided and the expected amount of recovery, or the purchase price of the assets of a failed institution less the estimated recovery value, including all liquidation costs. These provisions were reviewed every quarter and adjusted to reflect projected interest rates, recent appraisals, and historical experience. As of December 31, 1985, the Corporation began estimating a contingent liability for troubled institutions that it believed would require new or increased financial assistance. The loss estimate is based on the Corporation's historical loss experience and an evaluation of the past and present financial condition of such institutions. This methodology is not a projection of the cost of resolving all future problems in the savings and loan industry which present projections indicate could amount to $21 billion. The contingent liability is revised as institutions are accepted into the FSLIC financial assistance caseload or as financial institution cases are solved. The Corporation believes that with its present borrowing authority and assuming proper recapitalization of its reserves, via legislation, there will be sufficient funds to provide needed assistance to troubled or failed institutions (Note 16).

d) Furniture, Fixtures, and Equipment - These assets are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method based on an 11-year useful life. Beginning on October 1, 1986 all FSLIC FF&E purchases below $250,000 will be expensed and only those purchases exceeding that limit will be capitalized and depreciated. The net balance of this account is insignificant and is included in Other Assets.

e) Principles of Consolidation - Effective December 31, 1986, FSLIC began accounting for its investment in the Federal Asset Disposition Association (FADA), a wholly owned subsidiary, through consolidation (Note 14). Prior to 1986, FSLIC's investment in FADA was only $1 million. Prior year's financial statements do not require restatement, nor does the change affect previously reported earnings.

f) Reclassifications - Reclassifications have been made in the 1985 Financial Statements to conform to the presentation used in 1986.

2. Related Party Transactions - The Federal Savings and Loan Insurance Corporation, a government agency created by the National Housing Act of 1934, is governed by the Federal Home Loan Bank Board. Bank Board expenses are met through assessments to the FSLIC and the FHLBanks. The FSLIC's share of the Bank Board assessment is charged to operating expenses during the year in which the assessment is levied.

In addition to Bank Board related transactions, the FSLIC, as part of its default prevention activities, may guarantee repayment of FHLBank advances that have been made to certain insured institutions. These guarantees generally cover advances that are secured. The amount of these advances as of December 31, 1986 and 1985 totaled $3,595 million and $2,064 million, respectively. In the event that FSLIC is called upon to honor these guarantees, they are recorded as an asset. The FSLIC also has a claim against any assets pledged as collateral to secure such advances. Subsequent to December 31, 1986, the FSLIC was called upon by the FHLBank of Dallas to honor $947.4 million in guaranteed FHLBank advances. Payment was made on March 18, 1987.

The FHLBanks are also authorized, as directed by the Bank Board, to make loans to the FSLIC. All such loans must be in accordance with the provisions of section 402(d) of the National Housing Act. Loans from

FHLBanks at December 31, 1986 and 1985 were $900 million and have been passed through to member institutions as Collateralized Loans (Note 5).

3. Investments - Investment securities are stated at cost, adjusted for amortization of premiums and accretion of discounts. Such amortization and accretion are computed by the interest method at rates based upon the maturity dates of the related securities. Both amortization and accretion are recognized as an adjustment to Interest on Investments.

All cash received by the Corporation which is not used to defray operating expenses or for outlays related to assistance to insured institutions and liquidation activities, is invested in U.S. Treasury securities. Other Securities are mostly S&L stock and GNMAs issued by Federal Government Agencies other than the U.S. Treasury which were obtained through the Corporation's default prevention activities.

As of December 31, 1986 and 1985, the Corporation's investment portfolio consisted of the following:

	1986		1985	
	Book Value (in thousands)	Market Value	Book Value (in thousands)	Market Value
U.S. Treasury Securities:				
Overnight Funds	$ 3,154,595	$ 3,154,595	$ 1,217,419	$ 1,217,419
Maturities up to One Year	$ 446,695	$ 447,976	$ 3,614,358	$ 3,614,033
Maturities Over One Year	$ 242,952	$ 246,659	$ 1,229,501	$ 1,162,927
Subtotal:	$ 3,844,242	$ 3,849,230	$ 6,061,278	$ 5,994,379
Other Securities:				
Maturities Up to One Year	$ 2,500	$ 2,497	$ -0-	$ -0-
Maturities Over One Year	$ 139,773	$ 139,380	$ 66,690	$ 63,584
Subtotal:	$ 142,273	$ 141,877	$ 66,690	$ 63,584
Total:	$ 3,986,515	$ 3,991,107	$ 6,127,968	$ 6,057,963

4. Subrogated Accounts and Collateralized Advances - As required by Statute, an institution is closed only when there is no default prevention measure that would be less costly than liquidation. In these cases, FSLIC settles insurance claims either by cash payout of insured accounts or by transferring insured accounts to another insured institution. The FSLIC's claims on the Receivership of the liquidated institution are equal to the amount of the insured accounts transferred and/or the Collateralized Advances paid.

In most cases a Receivership does not have sufficient assets to pay all of its claims; therefore, FSLIC must estimate how much of each claim will be recovered over the life of the Receivership and record the difference as an allowance for loss against the claim.

The changes in Subrogated Accounts and Collateralized Advances for the years ended December 31, 1986 and 1985 are:

	Subrogated Accounts		Collateralized Advances	
	1986	1985	1986	1985
	(In thousands)		(In thousands)	
Balance, Beginning of Year	$ 2,525,370	$ 1,156,502	$ 569,293	$ 642,809
Add: Increase (Decrease) During Year	5,186,606	1,368,868	287,755	(70,388)
Less: Actual Losses Incurred	-0-	-0-	1,097	3,128
Balance, End of Year	7,711,976	2,525,370	855,951	569,293
Less: Allowance for Possible Losses (Cumulative)	4,884,487	1,689,213	31,467	286,738
Net, End of Year	$ 2,827,489	$ 836,157	$ 824,484	$ 282,555

5. Loans to Insured Institutions - The FSLIC makes both collateralized and other types of loans in assistance cases. The collateralized loans have been funded by pass-through loans from FHLBanks. In these transactions, FSLIC issues a Note Payable to the FHLBank and loans the proceeds to an insured institution. The FSLIC has two loans of this type, totaling $900 million. Interest rates on the $200 million loan to an insured institution and the corresponding note to the FHLBank are the same and averaged 6.9% in 1986. Interest rates on the remaining $700 million loan to an insured institution is based on the monthly weighted-average cost of funds charged to members of the FHLBank in which the insured institution is located and ranged from 7.7% to 5.7% in 1986. Interest on the corresponding Note to the FHLBank is based on the cost of FHLBank funds

plus 20 basis points which varied between 8.9% and 7.6% during 1986. Annual principal payments on the collateralized loans begin in 1988 and end in 1995.

The $113.5 million in Other Loans to Insured Institutions is shown net of a $5.4 million allowance which was established in 1985. The interest rate on these loans varies with each note.

6. Real Estate, Mortgage Loans and Other Assets - The FSLIC makes direct acquisitions of troubled assets from problem associations in its attempt to merge a failing institution. The vast majority of these assets consists of real estate and mortgage loans. An allowance for possible loss has been established to reduce these assets to their net realizable value.

The changes in Real Estate, Mortgage Loans and Other Assets in Process of Liquidation for the years ended December 31, 1986 and 1985 are:

	1986	1985
	(in thousands)	
Balance, Beginning of Year	$ 257,749	$ 296,677
Add: Increase (Decrease) During Year	79,730	(38,928)
Balance, End of Year	337,479	257,749
Less: Allowance for Possible Losses (Cumulative)	44,423	30,604
Net, End of Year	$ 293,056	$ 227,145

7. Income Capital Certificates - Since 1981 the FSLIC has purchased Income Capital Certificates (ICCs) from insured institutions as part of its default prevention activities. The FSLIC usually purchases an ICC by issuing a note payable and records the ICC at cost (Note 9). The ICCs earn annual income payments based on the United States Treasury Bill rates. The annual income payments and principal are redeemable upon the issuing institution having profitable operations and attaining a specified net worth level.

The changes in the ICCs for the years ended December 31, 1986 and 1985 are:

	1986	1985
	(in thousands)	
Balance, Beginning of Year	$ 2,330,923	$ 720,614
Add: Net Purchases (Cancellations) During Year	(111,379)	1,610,309
Balance, End of Year	2,219,544	2,330,923
Less: Allowance for Possible Losses (Cumulative)	782,763	796,164
Net, End of Year	$ 1,436,781	$ 1,534,759

8. Net Worth Certificates - Since 1982 the FSLIC has purchased Net Worth Certificates (NWCs) from insured institutions as part of its default prevention activities. The FSLIC purchases an NWC by issuing a note payable and records the NWC at cost (Note 9). NWCs earn annual income payments based on the cost of Federal Home Loan Bank System Obligations plus 1/4 of one percent. Annual income and principal payments are due upon the issuing institution having profitable operations and attaining a specified net worth level. The legislation authorizing the issuance of net worth certificates expired in October 1986.

   The changes in the NWCs for the years ended December 31, 1986 and 1985 are:

	1986	1985
	(in thousands)	
Balance, Beginning of Year	$ 292,000	$ 144,550
Add: Net Purchases (Cancellations) During Year	(19,350)	147,450
Balance, End of Year	272,650	292,000
Less: Allowance for Possible Losses (Cumulative)	-0-	17,500
Net, End of Year	$ 272,650	$ 274,500

9. Notes Payable and Other Liabilities to Insured Institutions - The FSLIC has outstanding negotiable notes to purchase ICCs and promissory notes to purchase ICCs and NWCs. Variable interest is paid semiannually based on the cost of Federal Home Loan Bank System Obligations or the average auction yield for United States Treasury Notes with maturities from 5-10 years. In addition to issuing notes to purchase ICCs and NWCs, the FSLIC has also issued notes to insured institutions who have acquired the deposits of defaulted S&Ls. The principal on these notes may be paid through the transfer of cash and/or assets to the acquirer. The interest

on these notes is paid semiannually based on an average auction yield of U.S. Treasury bills with maturities from 13-26 weeks plus 15 basis points. In addition to the notes to acquirers, FSLIC has other liabilities to acquiring institutions of $648,488,000.

The aggregate amount of the Notes Payable to Insured Institutions and their maturity dates as of December 31, 1986 is as follows:

	(in thousands)				
	ICCs	NWCs	Acquirers	Other	Total
1987	$ -0-	$ 5,000	$ -0-	$ 3,622	$ 8,622
1988	-0-	-0-	-0-	22,074	22,074
1989	-0-	-0-	-0-	-0-	-0-
1990	1,355,412	-0-	30,139	-0-	1,385,551
1991	78,919	-0-	2,398,446	-0-	2,477,365
Later	27,000	267,650	-0-	36,000	330,650
Total	$ 1,461,331	$ 272,650	$2,428,585	$61,696	$4,224,262

10. Assistance Agreements - The FSLIC enters into assistance agreements, which are usually associated with mergers, to prevent the default of an insured institution. Under these agreements the Corporation agrees to give financial assistance over time. All future cash outlays are discounted to their present value. The changes in Possible Losses Under Existing Assistance Agreements for the years ended December 31, 1986 and 1985 are:

	1986	1985
	(in thousands)	
Balance, Beginning of Year	$ 774,004	$ 1,706,261
Provision Charged (Credited) to Expense	889,404	(310,742)
Less: Assistance Paid	889,336	621,515
Balance, End of Year	$ 774,072	$ 774,004

11. Retirement Plan - Substantially all of the FSLIC employees are covered by the Civil Service Retirement System, which is currently two-tiered. For employees hired prior to January 1, 1984, the FSLIC withholds approximately 7 percent of their gross earnings. Their contribution is then matched by the FSLIC and the sum is transferred to the Civil Service Retirement Fund, from which this employee group will receive retirement benefits. For employees hired on or after January 1, 1984, the FSLIC withholds, in addition to social security withholdings, approximately 1.3

percent of their gross earnings, but matches such withholdings with a 7 percent contribution, as above. This second employee group will receive retirement benefits from the Civil Service Retirement System along with the Social Security System, to which they concurrently contribute. The retirement plan expenses incurred for calendar years 1986 and 1985 were $733,715 and $346,838 respectively.

Although the FSLIC funds a portion of pension benefits under the Civil Service Retirement System relating to its employees and makes the necessary payroll withholdings from them, the FSLIC does not account for the assets of the Civil Service Retirement System nor does it have actuarial data with respect to accumulated plan benefits or the unfunded pension liability relative to its employees. These amounts are reported by the Office of Personnel Management for the Retirement System and are not allocated to the individual employers. The Office of Personnel Management also accounts for all health and life insurance programs for retired federal employees.

12. Reserves - The FSLIC's total reserves available for losses did consist of a Primary and Secondary Reserve. The Primary Reserve was the cumulative net income (loss) of the FSLIC since its inception. The Secondary Reserve was the equity of certain institutions in FSLIC based on premium prepayments and related interest not yet paid to these institutions.

Because the FSLIC suffered losses during calendar year 1986 in excess of all of its reserves, the secondary reserve was eliminated in order to further reduce losses in the primary reserve.

As of December 31, 1986 and 1985, the Corporation's reserves consisted of the following:

	1986	1985
	(in thousands)	
Primary Reserve		
Balance, Beginning of Year	$ 3,783,169	$ 4,885,037
Net Income (Loss)	(10,939,765)	(1,101,868)
Transfer from secondary reserve	823,705	-0-
Balance, End of Year	(6,332,891)	3,783,169

Secondary Reserve		
Balance, Beginning of Year	774,233	720,730
Interest Applied	52,793	54,737
Transfers and Refunds	(3,321)	(1,234)
Transfer to primary reserve	(823,705)	-0-
Balance, End of Year	-0-	774,233
Total Reserves at End of Year	$ (6,332,891)	$ 4,557,402

13. Estimated Contingent Liability - The 1986 liability includes only those institutions on the FSLIC case list as of December 31, 1986. This liability represents the present value of the estimated total cost to provide the most probable form of assistance in each case less any costs already recognized because of some currently provided FSLIC assistance.

14. Federal Asset Disposition Association - In November 1985, the Bank Board approved the formation of the Federal Asset Disposition Association, or FADA, formerly termed the "406 Corporation". The FADA, which is a wholly owned subsidiary of the FSLIC, manages and disposes of certain assets received by the FSLIC in case resolution actions. As of December 31, 1986, the FSLIC had purchased 25,000 shares of FADA common stock for $25 million. For the period November 1985 through December, 1986, FADA has reported assets of $23.6 million, liabilities of $2.2 million, and a net loss of $3.6 million.

    Under a contract with the Federal Home Loan Bank of Topeka, the FSLIC has guaranteed repayment of up to $50 million in Bank advances to the FADA. As of December 31, 1986, the FADA has borrowed $800,000 against a $2 million open line of credit with the Bank.

15. Lease Commitments - Prior to 1986, the FSLIC did not lease any office space. However, due to increased staffing levels, a lease was signed in 1986 for rental of additional office space at 1735 Eye Street N.W. Washington, D.C. Rent for this office premise charged to administrative expenses was $410,230 during CY 1986. Yearly minimum rentals are as follows:

1986	1987	1988
$410,230	$670,332	$279,305

16. Subsequent Event - The Congress is currently considering legislation (S.790; H.R.27) to strengthen FSLIC's insurance fund reserves through the infusion of funds from both the savings and loan industry and the private

sector. Because the Congressional bills are in the early stages of the legislative process, the amount of funds the FSLIC is authorized to raise is not readily determinable.

17. Litigation - At the end of 1986, FSLIC was named in 34 legal or administrative actions, while its receiverships were involved in 215 cases. Currently, it is not possible to predict the eventual outcome of the various actions. However, it is management's opinion that these claims will not result in liabilities to such an extent that they will materially affect the FSLIC's financial position.

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