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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

The FSLIC Insurance Fund--Recent Management And Outlook For The Future

This report reviews the Federal Savings and Loan Insurance Corporation's (FSLIC's) management of the Federal deposit insurance fund during the last 2 years when 730 savings and loan associations merged or were liquidated and the industry's net worth declined by $7 billion or nearly one-fourth to about $25 billion. The report also evaluates the outlook for the fund in light of changing interest rates, recent legislation, and new competitive factors.

GAO's analysis shows that in the face of a significant financial challenge in 1981-82, FSLIC initiated a number of innovative techniques to deal with an increasing number of weakened institutions. FSLIC's management of the fund has maintained depositors' confidence in the industry and a fairly stable level of fund reserves.

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-211593

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

In 1981 and 1982, the Nation's savings and loan industry experienced well publicized, recordbreaking losses. Yet, through this difficult period, public confidence in the Nation's savings and loans never seriously weakened. In part, confidence was maintained because of the presence of the Federal Savings and Loan Insurance Corporation (FSLIC), the Federal insurance agency that protects deposits in savings and loan associations up to $100,000.

This report discusses FSLIC's management during this difficult period. It also addresses the agency's prospects for the future in light of different interest rate possibilities and the changing competitive environment in the financial marketplace. The report also discusses changes and proposed changes in financial reporting--an issue that has received considerable attention since interest rates rose in 1979 and savings and loan associations began reporting high losses.

We are also sending copies of this report to the Director, Office of Management and Budget; the Chairman, Federal Home Loan Bank Board; and interested members and committees of the Congress.

Charles A. Bowsher
Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

THE FSLIC INSURANCE FUND--RECENT MANAGEMENT AND OUTLOOK FOR THE FUTURE

DIGEST

In 1981 and 1982, the savings and loan (S&L) industry experienced its worst financial operating results since the 1930's depression. During those 2 years, the industry's net worth declined by about one-fourth ($7 billion) and 730 federally insured S&L's--one of every six--were merged or liquidated. (See pp. 11 to 14.)

Yet, through this difficult period, depositors' confidence in the industry as a whole never seriously weakened. There was some outflow of deposits, but it appears this outflow was generally related to more attractive investment opportunities. The Federal Savings and Loan Insurance Corporation (FSLIC) with the backing of the Congress succeeded in assuring S&L customers that their deposits, up to the $100,000 insurance limit, were safe.

This report reviews the actions of FSLIC, the Federal insurer of deposits in S&L's, during those 2 years. The report also assesses the outlook for the FSLIC fund in light of different interest rate scenarios, recent legislation, and new competitive factors facing the industry. Also, the report addresses recent changes affecting S&Ls' accounting and financial reporting.

FSLIC WAS EFFECTIVE BECAUSE IT CHANGED ITS METHODS FOR AIDING FAILING INSTITUTIONS

Like the Federal Deposit Insurance Corporation, the fund that insures deposits in commercial banks, FSLIC operates with reserves equal to about 1.25 percent of the deposits it insures. If fund reserves prove insufficient, FSLIC is authorized to increase industry insurance premiums, borrow an additional $750 million from the Treasury Department, and borrow from the Federal Home Loan banks.

In the difficult 1981-82 period, none of these extraordinary actions was needed. FSLIC was able to manage a record number of insolvencies and close out 1982 with fund reserves of $6.3 billion, 2 percent lower than 2 years earlier. When the reserves are discounted for inflation or compared to the total value of deposits, FSLIC's reserves declined about 12 to 15 percent during the 1981-1982 period. (See p. 36.)

FSLIC was able to weather the 1981-82 period with only a modest decrease in its reserves because it changed the way it handled financially troubled institutions. FSLIC reduced the cost of dealing with financially troubled institutions by developing new forms of assistance that avoided the liquidation of many institutions. The need for FSLIC assistance was also reduced by regulatory changes allowing institutions to operate on their own with less capital.

Prior to 1981 FSLIC simply liquidated institutions that were declared by state and Federal regulatory officials to be insolvent because the institutions' assets were valued at less than the institutions' liabilities. FSLIC liquidated these institutions either by (1) paying depositors directly and taking title to all assets or (2) transferring all liabilities (including insured deposits) and selected assets to another institution. Under this latter purchase and assumption approach, FSLIC's cash outlays were limited to the difference between the market value of the assets transferred to the institution and the value of the liabilities that the institution assumed.

Although the purchase and assumption approach involved less initial cash outlays, both liquidation approaches were expensive to FSLIC because the market value of the assets it acquired was typically considerably less than the value the assets had carried on the books of the failed institutions.

Beginning in the latter half of 1981 when the number of institutions facing insolvency began to increase sharply, FSLIC initiated a program of assisting troubled institutions before they became insolvent. This program involved much less cash outlay than a liquidation and also avoided the realization of the loss in asset values that FSLIC had to absorb when institutions were liquidated.

FSLIC was able to accomplish this objective by focusing on institutions' net cash flow (the difference between cash coming in and cash going out) in addition to net worth (difference between assets and liabilities). S&L's had strong cash flow because their largest expense--interest expense--is largely a noncash expense (because most depositors do not withdraw the interest as it is earned). So, by cash standards, most S&L's were able to meet all their financial commitments even though by net worth standards the institutions were approaching insolvency--that is, their liabilities were becoming greater than their assets.

Building on S&Ls' strong cash flow, FSLIC arranged mergers that limited initial cash outlays and spread costs over future periods. Using this technique, FSLIC avoided the much larger losses associated with traditional liquidations. FSLIC was also able to reduce its costs by arranging, for the first time, the sale or merger of financially troubled associations with out-of-state institutions and institutions outside the S&L industry. (See pp. 30 to 32.)

Also, in an effort to reduce costs and aid only the most severely troubled S&L's, the Federal Home Loan Bank Board (FHLBB), the board that controls FSLIC and regulates the savings and loan industry, lowered the reserve and net worth requirements for FSLIC-insured institutions in accordance with authority provided by the National Housing Act. This is significant because the net worth requirements have traditionally served as a barometer of institutions' soundness. The Garn-St Germain Depository Institutions Act of 1982 subsequently replaced the statutory net worth requirements with the instruction that FSLIC-insured institutions are to "provide adequate reserves in a form satisfactory to [FSLIC]."

As a result of these changes in approach, in late 1981 and all of 1982, FSLIC was able to aid 98 S&L's with $40.6 billion in assets at an initial cost of about $300 million and an estimated total present value cost of about $1.8 billion, including future payments from reserves, spread over a period of up to 12 years. By contrast, using previous methods, in the first 6 months of 1981, FSLIC aided nine S&L's with $1.6 billion in assets at an initial cost of about $930 million at the time assistance was provided, and an estimated total present value cost of about $350 million, after the sale of acquired assets. (See p. 30.)

DECLINING INTEREST RATES AND THE GARN-ST GERMAIN ACT PROVIDED RELIEF FOR THE S&L INDUSTRY AND FSLIC

The substantial decline in interest rates since August of 1982, from an average of about 13 percent to an average of about 8 percent and more recently almost 10 percent for 6-month Treasury bills, has provided relief for the industry and, therefore, also for FSLIC. At the time when interest rates fell, more than 400 institutions were in immediate danger of insolvency. (See p. 14.)

The declines in interest rates narrowed the unprofitable spread between S&Ls' cost of deposits and their return on assets (which is strengthened by a number of loans made when rates were higher). In the last 2 months of 1982, the industry showed a slight profit for the first time in more than 18 months. Declining interest rates also signal a break for FSLIC. To the extent that lower interest rates facilitate S&Ls' return to profitability, FSLIC's financial assistance requirement will decline.

While declining interest rates represent the most significant positive news for S&L's, the prospects for the industry also received a boost from the Garn-St Germain Act. In the short term the Net Worth Certificate Act, Title II of the Garn-St Germain Act, should help weakened institutions to continue to operate as they struggle to regain profitability. The net worth certificate, like FSLIC's income capital certificates, provides weakened institutions with a basis for increasing their net worth and avoiding technical insolvency. As long as the institution survives, the transaction (in which FSLIC issues a promissory note to the institution in exchange for the net worth certificate) is largely a bookkeeping transaction, although FSLIC does pay out some cash in interest payments. FSLIC pays interest to compensate for inflation and to keep the value of the note constant over time. Only if the institution is declared insolvent, which has not yet happened, would FSLIC have to make good on the promissory note.

For the long term the new asset and deposit-taking powers provided by that act, such as allowing S&L's to accept corporate demand deposits, commercial investment authority, and money market deposit accounts, will allow S&L's to diversify their asset and deposit holdings. Secondary market sales and purchases of mortgages and mortgage-backed securities, which were used extensively in 1982 as S&L's restructured their portfolios, also provide opportunities for diversifying assets. New powers and secondary market operations should allow S&L's to become less susceptible to problems associated with economic fluctuations and make them more competitive in the financial marketplace. For some associations, however, increased competition to obtain and maintain customers by offering new services and higher rates for deposits could lead to increased risk resulting in financial difficulties of a different nature.

The long-term impact of newly authorized powers and a changed financial environment on S&L's role in mortgage financing remains to be seen. During 1982, S&L's continued to originate a large share of the nation's home mortgages. However, the 37-percent share of the reduced net mortgage lending that occurred in 1982 was somewhat lower than the 43 to 55 percent market share experienced during the preceding decade. As S&L's concentrated on financial restructuring during 1982, they substantially increased their holdings of mortgage-backed securities and investments that improved their liquidity. But, they actually decreased their mortgage holdings.

Thus far in 1983 S&L's share of mortgage acquisitions is showing signs of increasing to former levels. The industry is once again providing a large share of the funds for the net increase in mortgages accompanying the economic recovery. A 1982 GAO study, however, concluded that today's diversified, efficient capital markets would be able to meet the market demand for mortgage financing even if S&L's and other thrifts ultimately became less important net suppliers of long-term financing.[1] (See p. 25.)

FSLIC'S OUTLOOK FOR THE FUTURE

The future condition of the FSLIC fund depends largely on interest rates and the effects of new competitive factors on industry profits. While there is some historical basis for gauging the effects of interest rates, there is little evidence as yet for projecting the effects of competition.

Assuming short term interest rates remain below 11 percent, FSLIC currently has more than sufficient reserves and annual cash receipts to fund existing commitments and new insolvencies that might occur over the next few years. If interest rates should rise above the 11-percent level for a sustained period of time, industry losses

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1/"Analysis of Options for Aiding the Homebuilding and Forest Products Industries" (GAO/CED-82-121, Aug. 31, 1982).

could mount again, resulting in substantial FSLIC financial commitments and outlays. (See pp. 37 to 40.)

FSLIC's options for providing assistance in the future will continue to be restricted to recently adopted low cost assistance techniques because of the limited size of the insurance fund and the potentially large number of insolvencies that could occur if interest rates rise. Also, if losses should increase, FSLIC will probably expand its low cost exchange of promissory notes for net worth certificates as provided for by the Garn-St Germain Act. Since a promissory note is a promise to pay the stated amount of the note, and at some point, FSLIC might have to fund the promissory notes used to purchase these certificates, it might want to limit assistance under this program to the amount of fund reserves--currently about $6.3 billion.

Lower interest rates, although signaling a return to improved conditions for the industry and reduced pressure on the FSLIC insurance fund, represent only the first step in what appears to be a long-term recovery and transition in the financial marketplace for the industry. In this context, industry and FSLIC activity will remain an issue of concern to the Congress throughout the 1980's.

ACCOUNTING AND FINANCIAL REPORTING CHANGES FOR THE S&L INDUSTRY

S&L's, like most other businesses, report their financial results in accordance with generally accepted accounting principles (GAAP). To improve its oversight of S&L's in light of the industry's recent financial difficulties, the FHLBB began in 1982 to require additional reporting by S&L's on their operations and financial conditions. These reports are intended for FHLBB internal use for monitoring S&Ls' conditions and are not intended to replace S&Ls' external reporting requirements in accordance with GAAP. (See pp. 45 to 46.)

This distinction is an important one because while supplemental reports to GAAP-based financial statements can provide additional information for the internal use of an industry regulator, such reports are not an acceptable substitute for general purpose financial reporting. Regulatory accounting practices often allow greater latitude in accounting treatment and financial reporting than GAAP, thus detracting from the comparability and consistency of financial reports.

At the same time the FHLBB was making regulatory changes, the Financial Accounting Standards Board (FASB)--the recognized organization for establishing standards for financial accounting and reporting--made a change in general purpose financial reporting by S&L's. On February 28, 1983, FASB announced a new statement on the reporting of income and expense when one S&L acquires another.

Prior to the ruling, an acquiring S&L could amortize income resulting from the acquisition over a shorter period than the expenses associated with the acquisition. FASB's new statement requires that income and expense resulting from an acquisition be reported over the same periods of time. This eliminates an acquiring S&L's opportunity to report inflated earnings early in the acquisition. This may have the effect of discouraging voluntary acquisitions because the transaction will no longer have an immediate favorable effect on reported earnings. This could place greater pressure on FSLIC to aid the merger of financially weakened S&L's. (See pp. 46 to 47.)

Regarding the Income Capital Certificate Program and the Net Worth Certificate Act, the FASB has not yet issued a formal statement on the acceptability of the promissory notes as assets and whether under GAAP the certificates are a liability or net worth.

AGENCY COMMENTS

The Federal Home Loan Bank Board, after reviewing a draft of this report, commented that "The report presents a generally accurate and fair picture of the conditions the Corporation faced at the end of 1982." The Board emphasized, however, that a sharp, sustained rise in short term interest rates could significantly increase pressure on fund reserves.

Contents

ABBREVIATIONS

CD	Certificate of Deposit
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHLBB	Federal Home Loan Bank Board
FHLBS	Federal Home Loan Bank System
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	Generally Accepted Accounting Principles
GAO	General Accounting Office
GNMA	Government National Mortgage Association
ICC	Income Capital Certificate
MMC	Money Market Certificate

MMDA	Money Market Deposit Account
NWC	Net Worth Certificate
S&L	Savings and Loan
T-Bill	Treasury Bill

Tables and Charts In This Report

Glossary

Appraised equity capital (AEC)	The difference between the market or current value and the book value of office land, buildings, and similar assets. Normally, this increases an institution's reported net worth. An S&L is permitted to use AEC as a component in the calculation of regulatory net worth on a one-time only basis.
Book value	The stated cost or value of assets, liabilities, and net worth as reported on an S&L's financial statement.
Financial futures markets	The market of supply and demand relating to speculation on the future course of interest rates.
Income capital certificate (ICC)	A certificate issued by an S&L to FSLIC in exchange for cash or a FSLIC promissory note. The certificate is recorded as capital or net worth on the financial statement of the S&L issuing the certificate. FSLIC's promissory note is a promise to fund the value of the note at some point if needed. The ICC was developed by FSLIC and the FHLBB in 1981 to temporarily strengthen S&Ls' net worth at little or no cost to FSLIC. The ICC was the prototype for the Net Worth Certificate, which was adopted as part of the Garn-St Germain Act in 1982 to assist failing institutions.
Level yield curve	A flat yield curve, in which the short-term yield on assets is equal to the long-term yield on assets.

Market value	The value that a buyer is willing to pay for a specific asset or liability at a specific point in time. The real value of the item.
Negative yield curve	Also called an "inverted yield curve." A downward sloping yield curve, in which the short-term yield on assets is greater than the long-term yield on assets.
Net worth	The sum of all reserve accounts, retained earnings, permanent stock, and any other nonwithdrawable accounts of an insured institution. In November 1982, the FHLBB changed the term "net worth" to "regulatory net worth" to include, in addition to the items previously mentioned, appraised equity capital, outstanding net worth certificates and amounts of net worth certificates FSLIC is committed to purchase. S&L's are permitted to include these items in their reports to the FHLBB.
Net worth certificate (NWC)	Based on the "Income Capital Certificate" form of financial assistance used by the FHLBB (See definition of ICC above). The Net Worth Certificate Program was incorporated as Title II into the Garn-St Germain Depository Institutions Act of 1982. To qualify for net worth certificates, S&L's must (1) have net worth equal or less than 3 percent; (2) have net worth equal to or greater than 1/2 percent of assets after issuance of net worth certificates; (3) have incurred

losses during the previous 2 quarters; (4) have not incurred losses due to speculative transactions in futures or other mismanagement; (5) have investments in residential mortgages aggregating 20 percent of their loans; and (6) agree to comply with all terms and conditions established by FSLIC.

The net worth certificate program expires 3 years from the date of enactment of the act.

Nominal and real rates	The nominal rate is the stated or book value presentation of rate or rate change. The real rate is the stated or book value rate adjusted for inflation.
Pass-through securities (another name for "Ginnie Maes")	Mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA) and insured by mortgage bankers, commercial banks, savings and loan associations, savings banks, and other institutions to provide new sources of funds into residential financing. Pass-throughs are backed by FHA, VA, or FHMA mortgages.
Positive yield curve	An upward sloping yield curve, in which the short-term yield on assets is less than the long-term yield on assets. (Yield is defined as the rate of return on an investment, expressed as a percentage of the investment).

CHAPTER 1

INTRODUCTION

The savings and loan (S&L) industry in 1981 and 1982 experienced its most severe financial difficulties since the 1930's Depression. From January 1981 through December 1982 the number of federally insured S&L's declined 18 percent from 4,002 to 3,286, the industry's net worth declined about 22 percent ($7 billion), and the industry's share of the nation's financial assets declined.1/ Also during this time, the Federal Savings and Loan Insurance Corporation (FSLIC), the industry's Federal insuring agent, disbursed or committed approximately $2.8 billion to liquidate or prevent the default of a record 109 federally insured institutions.2/ The Congress, in 1982, by concurrent resolution committed the full faith and credit of the U.S. Government to the payment of all insured deposits in savings and loans.

This report reviews FSLIC's management of the insurance fund during the last 2 years and the outlook for the future of the fund in light of different interest rate scenarios, competitive factors facing the industry, and new legislative requirements. The report assesses fund management and

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1/Although there has been a decline in the S&L industry's market share, the industry's market share is still above that which prevailed a decade earlier. During the 1970's, S&L assets as a percent of GNP grew from 19.4 percent in 1971 to a peak of 24.3 percent in 1978. Similarly, S&L's market share of financial assets increased from 13.8 percent to 17.5 percent. However, from 1978 through 1981, the industry's assets as a percent of GNP declined from 24.3 percent to 22.6 percent and S&L's market share of financial assets declined to 15.9 percent.

2/FSLIC was established in 1934 under Title IV of the National Housing Act to insure the accounts of savings and loan associations. It was established to protect depositors' savings and maintain public confidence in savings and loan associations. From FSLIC's inception until the end of 1980, insurance fund reserves grew to $6.4 billion while FSLIC managed a total of 135 settlement actions. See page 34 for a presentation of FSLIC's financial statement of condition. See page 55 for a detailed description of FSLIC and the Federal Home Loan Bank System.

finances at a time when interest rates have subsided but before many of the changes provided for in new legislation have really taken effect.

The report is organized around the relationship between industry net worth and FSLIC finances.3/ First, the report addresses the industry's condition in terms of both past experience and future prospects. Then, it examines FSLIC finances in recent years and the fund's outlook for the future. Finally, the report discusses a number of accounting issues affecting the reporting of industry operations and the implications of these issues for the FSLIC insurance fund.

OBJECTIVES, SCOPE, AND METHODOLOGY

In order to assist the Congress in its consideration of matters regarding the S&L industry and Federal deposit insurance and to inform the public of these matters, we addressed two questions:

--Does FSLIC have the resources to manage S&L insolvencies and income losses that could occur in the near future?

--How will the newly enacted Garn-St Germain Depository Institutions Act of 1982--especially its net worth certificate program, its establishment of insured money market rate depository accounts, and its establishment of new asset powers--affect FSLIC finances?4/

Utilizing records and studies of the Federal Home Loan Bank Board (FHLBB) and FSLIC,5/ we analyzed the current

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3/The term "net worth" means the sum of all reserve accounts, retained earnings, permanent stock, and any other nonwithdrawable accounts of an insured institution.

4/A summary of the provisions of the act is provided on page 58.

5/FSLIC, the Federal insuring agent for S&L's, is governed by the FHLBB, an independent Federal agency that supervises the savings and loan industry. The Board is governed by a Chairman and two board members, all three of whom serve in a fiduciary capacity for FSLIC. The Board establishes policies, issues regulations, supervises operations, and appoints officers of FSLIC.

condition of the S&L industry and the outlook for the future of the industry and FSLIC using different assumptions about interest rates and considering the implications of recent legislation and the more competitive environment that is evolving in the financial services industry.[6] We discussed our observations with FHLBB and FSLIC officials. Our analysis focused on a qualitative assessment of FSLIC's financial capability but not on precise forecasts of fund outlays. The data used in the report is as of December 31, 1982, in most cases.

The report does not try to pass judgment on the future of the industry or FSLIC's past or future role in structuring the industry.[7] Further, it does not address any changed authority or funding that may be desirable for FSLIC nor does it analyze issues relative to potential changes in the structure and management of deposit insurance.[8] Also, the report does not address the status of State-run deposit insurance funds for State insured S&L's nor what impact, if any, the actions of these funds might have on FSLIC.

To provide a more complete picture of S&L industry finances, the report describes briefly the role that S&L's play in the nation's system for financing housing and how that role was affected by the financial strains of the 1981-82 period. The discussion concerning the adequacy of the supply of mortgage funds as a result of changing conditions in the S&L industry draws on data compiled by the Department of Housing and Urban Development, FHLBB, and the Federal Reserve System. It also draws on the discussion of the nation's

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6/Unless otherwise stated, any mention of interest rates throughout this report refers to the 6-month Treasury bill rate.

7/Analysis of the extent to which the existence of deposit insurance may have encouraged institutions to undertake the risks that contributed to the problems these institutions experienced in the 1981-82 period is beyond the scope of this study.

8/The Garn-St Germain Depository Institutions Act of 1982 requires FSLIC to conduct a study and report to the Congress on deposit insurance issues including (1) consolidated funds, (2) risk-based insurance premiums, (3) 100-percent insurance, (4) private insurance, and (5) adequacy of the insurance fund.

system for financing housing contained in GAO's 1982 report analyzing the homebuilding and forest products industries.[9]

Our review was performed in accordance with generally accepted government auditing standards. It complements GAO's recent examinations of FHLBB's and FSLIC's financial condition ("Examination of Financial Statements of the Federal Home Loan Bank Board and Related Agencies For the Year Ended December 31, 1981", AFMD-82-58, April 29, 1982; and "Examination of the Federal Home Loan Bank Board and Related Agencies' Financial Statements For the Year Ended December 31, 1982" (GAO/AFMD-83-65, Apr. 1, 1983).

In trying to evaluate whether conditions in the savings and loan industry could present FSLIC with problems that would strain or exceed the fund's financial capacity, it is necessary to recognize that there are several different ways to evaluate FSLIC's ability to manage its financial assistance requirements. In addition, the Congress could at any time amend FSLIC's authority to provide assistance. Ultimately judgment factors must be brought to bear on the question of the margin of safety needed for dealing with possible contingencies.

In the analysis that follows, we have used two criteria which we believe are useful benchmarks for assessing FSLIC's continued effectiveness:

--FSLIC's ability to meet annual cash outlays from annual cash inflow from assessments and interest earnings.

--FSLIC's ability to maintain unencumbered reserves in excess of the present value of commitments for future outlays.

These criteria do not represent fully the limits of FSLIC's financial capacity; but they do represent significant points for congressional oversight of the soundness of the deposit insurance fund. For example, to the extent that FSLIC cannot meet its cash outlay requirements with current cash receipts, FSLIC would be required to sell assets, levy additional assessments on the industry, or borrow from the Treasury or

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9/"Analysis of Options for Aiding the Homebuilding and Forest Products Industries" (GAO/CED-82-121, Aug. 31, 1982).

the Federal Home Loan Bank System (FHLBS).10/ Similarly, without unencumbered reserves, FSLIC would be forced to operate the fund with negative net worth. While neither situation would be an impossible one, it would be a matter of concern to industry and Government officials from the standpoint of maintaining the public's confidence in FSLIC's ability to meet obligations as they occur.11/

AGENCY COMMENTS

The Federal Home Loan Bank Board, after reviewing a draft of this report, commented that "The report presents a generally accurate and fair picture of the conditions the Corporation faced at the end of 1982." The Board emphasized, however, that a sharp, sustained rise in short term interest rates could significantly increase pressure on fund reserves.

10/The Garn-St Germain Depository Institutions Act of 1982 provided FSLIC authority to borrow from the FHLBS. In addition, FSLIC is authorized to borrow up to $750 million from the Treasury.

11/In this regard, it is important to recognize that while the present value of future outlays are reported on FSLIC's balance sheet, the present value of future premiums is not reflected on the balance sheet.

CHAPTER 2

HAVING WEATHERED A VERY DIFFICULT PERIOD, THE SAVINGS AND LOAN INDUSTRY IS SHOWING SIGNS OF IMPROVEMENT

This chapter examines recent experience with industry net worth on a book value basis, in particular the factors which made net worth rise or fall.[1] Exclusive of accounting policies, the three most important factors for an institution are

--the margin or interest spread between cost of funds and earnings on assets;

--the amount of money generated as other income (principally fees); and

--the amount of expenses required to operate an institution.

From late 1979 to mid-1982, high and volatile interest rates caused substantial income and net worth losses for a major portion (80 percent) of the industry. Many S&L's closed; however, most institutions that survived actually increased their assets because of a favorable cash flow. Declines in interest rates, more flexible arrangements for financing housing, and new authority to compete in the financial marketplace have provided a more optimistic outlook for the industry. The ultimate effect of this new authority is still uncertain, however, because it also permits greater competition between S&L's which could reduce profit margins and slow S&L's recovery.

FROM 1979 THROUGH 1982, HIGH AND FLUCTUATING INTEREST RATES CREATED A NEGATIVE SPREAD BETWEEN COST OF FUNDS AND YIELD ON ASSETS

In 1979, the S&L industry appeared to be in generally sound financial condition. There was, however, as subsequent events proved, a substantial interest rate risk. This risk

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1/Book value measurement is the traditional measure of financial condition for going concerns. If the industry was measured on its market value, or the value that could be realized if assets had to be sold, it would be showing a negative net worth. For additional discussion of accounting issues, see page 42.

had been present in the industry for years as most S&L's accepted rate sensitive, short-term deposits and lent them out for fixed rate long-term mortgages. S&L's counted on the interest spread of a positive yield curve to provide funds to cover operating expenses not paid from other sources and to increase net worth. Typically, there was a spread of about 150 basis points.2/ During the period from 1975 to 1978, industry net worth rose steadily from $19.1 billion to $28.1 billion, an increase of $9 billion (47 percent) over the period. Although law and regulation restricted investment opportunities for S&L's, in recent years the development of secondary markets, pass-through securities, and financial futures markets provided associations with means to limit interest rate risk, but many chose not to use these new instruments.

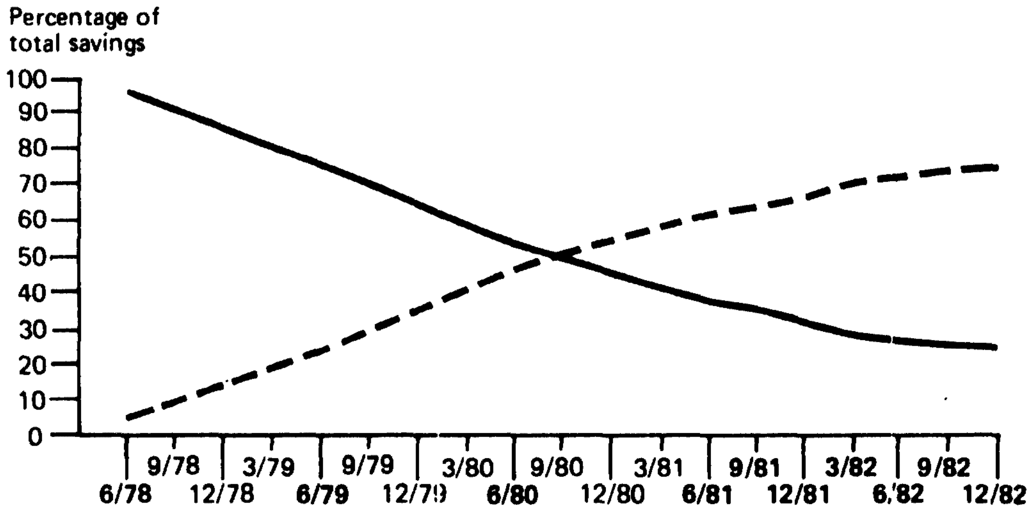
In 1979 short term interest rates began to increase dramatically, signaling the beginning of a period of financial difficulty much more severe and of longer duration than any experienced by the industry since the early years of the Great Depression of the 1930's.3/ Rates on 6-month Treasury bills rose from 7.6 percent in 1978 to 10.1 percent in 1979. Short-term rates continued to rise steadily until mid-1980 when rates plummeted. The rates began to increase again in late 1980 and remained high until the summer of 1982. For much of this period, short-term rates remained above long-term rates creating an inverted or negative yield curve. Although interest rates have fallen since then, the rate in both nominal and real terms in December 1982 was still higher than the average of 6-month T-bill rates during the period from 1972 to 1979. The rise in interest rates has fueled industry losses and resulted in an increasing number of insolvencies.

Higher interest rates in 1979 coupled with the introduction of new deposit instruments (the 6-month money market certificate (MMC) in 1978 and the 30-month certificate in 1980) changed the makeup and the cost of deposits held by S&L's. As shown by the chart below, deposits in S&L's, from 1978 to 1982, shifted from low rate passbook savings accounts and low rate long-term certificates (4 to 8 years) to more short-term, rate sensitive certificates (6 and 30 month).

2/One basis point equals .01 percent; therefore, 100 basis points equals 1 percent. A positive yield/cost spread of 150 basis points means that mortgage yield exceeded cost of funds by 1.5 percentage points.

3/The industry experienced liquidity and earnings problems in 1970 and 1973 when high interest rates caused a shift of funds out of most thrifts, but these problems were of a more temporary nature than those of the last couple of years.

Percent Distribution of Total
Deposit Balances of Savings and Loans:
June 1978 to December 1982



Deposits	6/78	6/79	6/80	6/81	9/81	12/81	3/82	6/82	9/82	12/82
	(Percent)									
—— Nonmarket-Sensitive Deposits										
Regular savings	36	29	23	20	20	19	19	19	19	17
Time deposits	59	47	30	19	16	13	10	9	7	8
– – – Market-Sensitive Deposits										
6-month MMC	2	20	35	40	40	36	35	34	32	29
Jumbo CD's	3	4	7	9	9	9	10	10	10	10
30 month CD's			5	12	15	19	21	22	25	24
Other deposit accounts (note a)						4	5	6	7	12

a/These deposit accounts include those newly authorized during September 1981 through December 1982: 1-year "all-Savers", 18- and 42-month no ceiling certificates, 7-to-31 day accounts, 91-day MMC's, and money market deposit accounts (MMDA's).

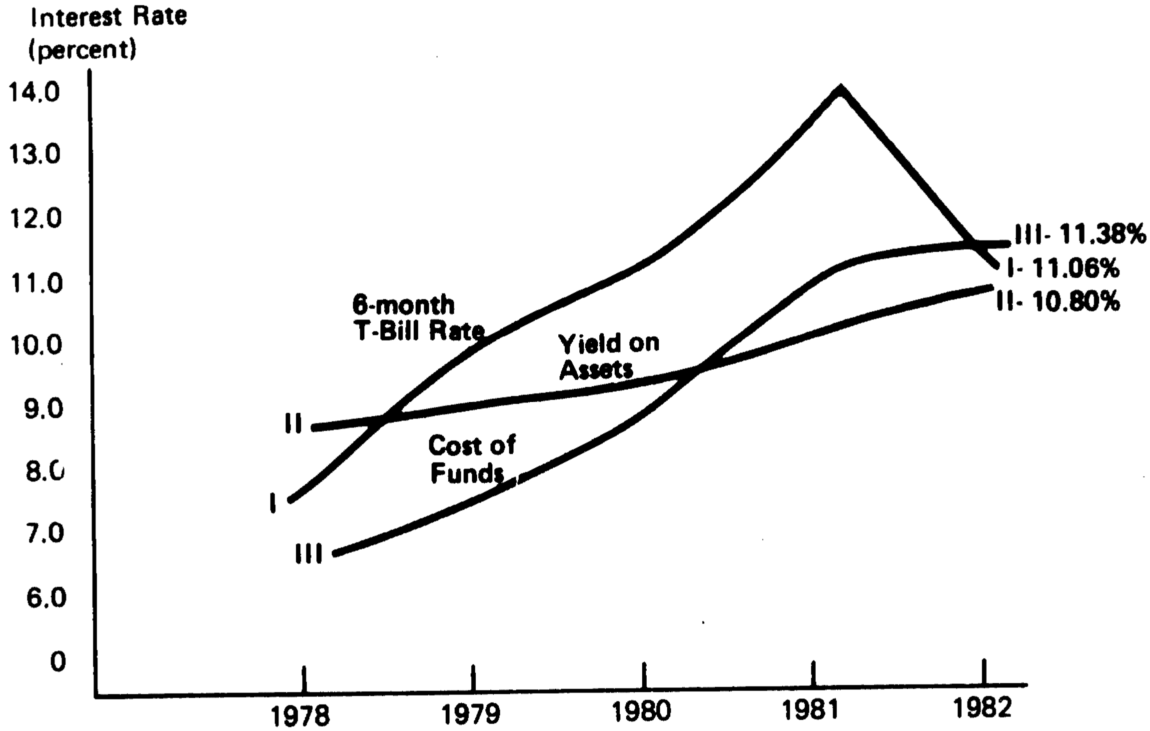
Regular passbook savings and traditional time deposits, which accounted for 95 percent of savings deposits in June 1978, represented only 25 percent of deposits in December 1982. Higher yielding 6-month, 30-month, Jumbo certificates, and newly authorized deposit instruments accounted for 75 percent of S&Ls' deposits as of December 1982.4/ A significant change in the last year is the decrease in 6-month MMC's and the increase in 30-month certificate savings deposits. For the average S&L this means that a decline in interest rates may not be reflected in about 24 percent of their deposits for another 1 to 2 years. Thus, a decline in interest rates will not quickly yield a comparable decline in cost of funds.

As interest rates began to climb in 1979 and depositors shifted their funds into higher return accounts, the margin between S&Ls' return on mortgages (which were fixed at low rates) and other investments and their cost of funds (deposits and borrowings) began to shrink. With higher rates, S&L's have increased their yields on assets substantially--from an average of 8.50 percent in 1978 to about 11 percent in 1982--but this lagged behind the sharper increase in cost of funds.5/ From 1979 to 1980, the margin of return fell from 1.56 percent to 0.56 percent. Since the beginning of 1981, the average S&L has been paying a higher rate of interest for its deposits and borrowed money than it has been earning from its outstanding mortgage loans and investments, resulting in a negative earnings spread and income losses. In 1982, the average S&L paid 11.38 percent for its deposits and borrowings while only earning approximately 10.80 percent on mortgages and other investments. The development of this negative earnings spread is reflected in the graph on the following page.

4/Newly authorized deposit accounts, except for the 1-year "All-Savers" Certificates, increased steadily during 1982. The introduction of the money market deposit account (MMDA) in December 1982 resulted in a large increase from the September figure. MMDA's represented 6 percent of all savings deposits at yearend.

5/The extent to which the yield on assets can change depends upon the availability of funds for investment in higher yielding assets (derived from reinvestment of maturing mortgages or assets and new funds from savings and borrowing) and from loan terms that might allow for variable rates. With higher rates, existing assets were turning over more slowly. (For additional discussion on cash flows, see page 21.)

Industry Asset Return and Funds Costs
for Calendar Years 1978 through 1982



I -Average annual 6-month T-Bill Rate
II -Average annual yield on Assets
III-Average annual cost of funds

Because of this negative earnings spread, industry profits turned into losses and net worth declined as shown in the following table. However, as the table on page 11 shows, while there was a direct correlation between after tax income gains or losses and net worth from 1978 through 1981, this relationship did not exist in 1982. Operating losses were greater than the net worth decline in 1982 primarily because of FHLBB regulatory changes in how S&L's account for net worth and FSLIC's purchase of income capital certificates (ICC's), see page 26.

Impact of Industry Gains and Losses on Net Worth for Calendar Years 1978 to 1982

	1978	1979	1980	1981	1982
	(billions)				
Industry after tax net gain or (loss)	$ 3.9	$3.5	$.8	($4.6)	($4.3)
Industry net worth	$28.1	$31.6	$32.4	$27.8	$25.4
Net worth as a percentage of assets	5.5%	5.6%	5.3%	4.3%	3.7%

The following table shows how industry losses began to mount in 1980 and continued to do so through mid-1982.

FSLIC-Insured Associations With Losses (Negative Net Income) For Calendar Years 1974 to June 30, 1982

Period	Total loss	Number of associations with losses	Percent of associations with losses
1974	$ 43,325,331	208	5.0
1975	55,008,554	300	7.4
1976	36,975,619	169	4.2
1977	21,221,124	122	3.0
1978	28,686,636	93	2.3
1979	52,223,876	174	4.3
1980	644,389,800	1,193	29.8
1981	4,907,885,000	2,981	79.5
1982-1st half	$3,469,928,000	2,943	82.4

As depicted by the table above, during the period from 1974 to 1979, the number of associations with losses averaged around 180 per year (4.4% of the industry). The total loss for that period averaged about $40 million per year. However, beginning in 1980 through mid-1982, the number of S&L's with losses increased. In 1981 and 1982, almost 3,000 S&L's (about 80 percent of the industry) reported operating losses. The total industry losses for the 18-month period ending June 30, 1982, were almost $8.5 billion.

INDUSTRY NET WORTH AND THE NUMBER OF S&L'S DECLINED AS A RESULT OF LARGE LOSSES

The effect of industry losses on individual institutions is reflected in both the declining number of institutions and the changes in institutions' net worth as a percent of assets. From the beginning of 1981 through December of 1982, 730 S&L's were merged or liquidated. By comparison, in 1980 only 105 institutions merged or liquidated.

Further, in 1981 and 1982, FHLBB and FSLIC assumed a much larger role in the merging of institutions. For example in 1980, FHLBB supervisory and FSLIC-assisted mergers accounted for only about 30 percent of all mergers.[6] In 1981 and 1982, FHLBB supervisory and FSLIC-assisted mergers represented about 44 percent of the much greater number of mergers that occurred during that period.

The table on the following page shows the number of S&L's reporting different levels of net worth as a percent of assets in January 1981 and December 1982. The table also shows the eroding of net worth for a large number of institutions during this period.

6/There are three general types of mergers: voluntary, FHLBB supervisory, and FSLIC-assisted. Voluntary mergers are developed and carried out by the involved institutions with FHLBB approval. Supervisory and assisted mergers are coordinated by the FHLBB examination staff and FSLIC insurance staff to correct a problem situation. Only an assisted merger involves a commitment of FSLIC resources.

Net Worth Comparison of
January 1981 and December 1982

Net Worth percent category	Number of associations in net worth category January 1, 1981	December 31, 1982
1.00 and less	65	179
1.01 to 2.00	83	266
2.01 to 3.00	199	500
3.01 to 4.00	493	636
4.01 to 5.00	801	494
5.01 to 6.00	713	362
6.01 and more	1641	849
Totals	3995	3286

A further analysis shows that in December 1982, the assets of institutions and their net worth holdings by net worth category looked as follows:

Industry Assets By Net Worth Category and Net Worth Holdings as of December 31, 1982

Net worth percent category	Number of associations	Assets	Net worth
		----(billions)---	
1.00 and less	179	$ 30.9	$ 0.15
1.01 to 2.00	266	61.5	0.93
2.01 to 3.00	500	136.7	3.43
3.01 to 4.00	636	235.2	8.25
4.01 to 5.00	494	111.9	5.04
5.01 to 6.00	362	47.2	2.60
6.01 and more	849	69.2	5.14
Total	3,286	$692.6	$25.5

Median Net Worth Based
on Industry Assets - 3.5%

The table above also shows that institutions accounting for about one-eighth of the industry assets have net worth of less than 2 percent. From FSLIC's perspective, this means that a net worth reserve of about $1.1 billion protects 445 S&L's with more than $90 billion in assets from technical insolvency. By past standards, these institutions would have been considered as already having capital impairments and would have been candidates for merger or liquidation.

Relating associations, assets, and net worth holdings as a percentage of industry totals shows that a large number of small, well-capitalized institutions (with about 17 percent of the industry's assets) hold approximately one third of the industry's net worth. Lower capitalized S&L's with 33 percent of the industry's assets hold only about 18 percent of the industry's net worth.

Industry Profile by Selected Net Worth Group as of December 31, 1982

Net worth percent category	Percent of associations in net worth category	Percent of assets in net worth category	Percent of industry net worth in category
2.00 and less	14%	13%	4%
2.01 to 3.00	15	20	14
3.01 to 5.00	34	50	52
5.01 and more	37	17	30

DECLINING INTEREST RATES SHOULD SPEED RECOVERY, BUT NEW COMPETITIVE FACTORS COULD SLOW THE PROCESS

The high interest rates that prevailed in 1981 and 1982 forced most S&L's into a race for survival that many lost--they were merged or liquidated before they were able to have their assets yield more than their costs of funds. Although the recent decline in interest rates coupled with the steady increase in asset yields has narrowed the earnings disparity for a number of S&L's and reduced industry losses, the change has not yet been sufficient to return many institutions to profitability. During the fourth quarter of 1982, short term interest rates averaged 8.26 percent as compared to an average annual rate of 13.8 percent in all of 1981. This decline in rates reduced the average S&L's cost of funds from an average of 11.5 percent for the period July 1981 through June 1982 to an average of 11.3 percent for the last 6 months of 1982 and reduced the spread between cost of funds and return on assets. In addition, buoyed by a large inflow of new cash for money market deposit accounts, the industry registered net income of $644 million for the last 2 months of 1982. This was the industry's first profitable period in more than 18 months. As of August 1983, rates were once again trending upward and approaching 10 percent.

Industry outlook is optimistic if interest rates are low

Given enough time, the yield on S&L assets would rise above the cost of funds even if interest rates remained high. This is because maturing loans and new deposits can be invested at higher market rates. Also, in time S&L's could protect themselves from future interest rate fluctuations by more closely matching the maturities of assets and liabilities. For many associations, however, the point of insolvency arrived before yields could be increased and portfolios restructured. Had interest rates not dropped, many more associations would also have become insolvent before the situation of mounting losses could be reversed.

Since the industry's profitability over the next few years depends in large part on the general level of interest rates, FHLBB has developed an industry model that uses different short term interest rate scenarios to project probable industry profits and losses. The FHLBB researchers have applied four different scenarios to the model: (1) a scenario which assumes a variable short-term rate averaging about 8.2 percent for 1983 and 1984; (2) a scenario which assumes a variable short-term rate averaging about 9.1 percent for 1983 and 9.8 percent for 1984; (3) a stable 9.5 percent scenario; and (4) a consistent 13.5 percent scenario. Model results show that if short term interest rates remain in the 8 to 9 percent range as they did during the last 3 months of 1982, most S&L's will be managing asset portfolios that yield more than their costs of funds by the end of the first quarter of 1983.[7/] The scenario which assumes short term interest rates averaging 9.1 percent in 1983 and 9.8 percent in 1984 shows industry profitability during the first three quarters of 1983 but a return to operating losses for the remainder of 1983 and most of 1984.[8/] The stable 9.5 percent scenario indicates that most S&L's will be managing asset portfolios that yield more than their costs of funds by the second quarter of 1984. If rates should rise to above 13 percent again, losses will mount and it will be at least 4 or 5 years before the industry as a whole returns to profitability.[9/]

7/This assumes a positive yield curve.

8/This is about a level yield curve.

9/The situation would be aggravated if the yield curve is inverted.

Projected Industry Net Profits/Losses for 1983 and 1984 Using Different Interest Rate Scenarios

Interest rate assumptions for 1983 and 1984	Industry net profit/loss 1983	1984	Total for 1983 and 1984	Remaining industry net worth end of 1984
	-----------(billions)------------			
Average 8.2 percent	$1.1	$2.3	$3.4	$26.1
Range from 9.10 to 9.80 percent	a/.2	b/-.5	-.3	22.7
9.50 percent	-1.2	.2	- 1.0	21.5
13.50 percent	-10.1	-17.5	-27.6	- 5.4

a/Includes gains for the first three quarters and a loss for the fourth quarter of 1983.

b/Includes losses for the first three quarters and a gain for the fourth quarter of 1984.

FHLBB projections show that if interest rates stabilize in the 8 to 8.5 percent range and stay there through the end of 1984, industry net worth will increase by approximately $2.8 billion. This scenario shows the industry becoming profitable during the first quarter of 1983.[10/]

One possible scenario, not yet modeled by FHLBB, is that interest rates remain low through most or all of 1983 and then rise sharply in 1984 as rising credit demands are restrained in order to reduce inflationary pressures in the economy. If this situation did occur, industry net worth could once again decline in 1984 if short-term rates increased to 12 percent or more.

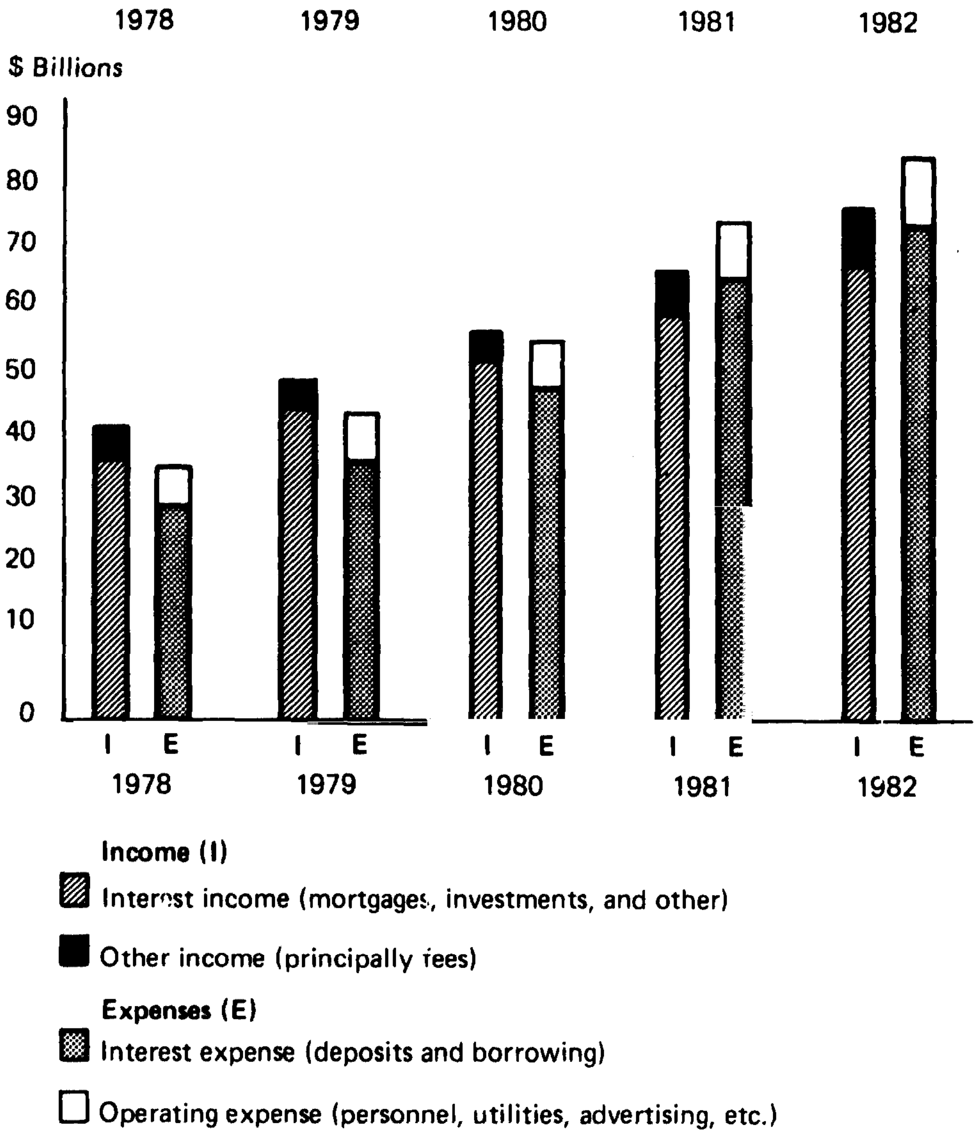
10/Because interest rates declined even further than projected in this scenario for the fourth quarter of 1982, the industry actually showed a profit of $644 million for the last 2 months of 1982.

Competitive factors could slow the process

The extent to which profitability returns as lower interest rates prevail depends on competitive factors in addition to general interest rate conditions. In the past when deposits, except for Jumbo CD's, were regulated by rate ceilings and competition was limited largely to nonprice areas such as advertising, personnel, and other administrative expenses, competitive factors affecting the profitability of individual associations were muted. The Garn-St Germain Act, by allowing money market rate depository accounts, set the stage for greater competition in the prices paid for deposits. Accordingly, general interest rate declines may not proportionately increase profits. Because of increased competition, S&L's may have to pay more for deposits, therefore, the yield/cost spread may not be reduced.

The projections in the table on page 17 are based on historical relationships associated with changes in interest rates and do not take into consideration the possible effects of increased competition as a result of deregulated deposit interest rates. The relationship between interest rates, return on assets, fee income, cost of funds, and other expenses for the past 4 years looks as follows:

Analysis of S&Ls' Income and Expenses
for Calendar Years 1978 to 1982



The graph shows that through 1979, S&L's generated enough income from interest income alone to pay for all interest and operating expenses. In that environment of regulated interest rates on deposits and relatively little competition in setting rates on assets, there was little incentive for institutions to focus critical attention on items such as other income and operating expense. As the margin between interest income and expense narrowed and inverted, income and expense items not related to interest rates took on a more important role. In a competitive environment, the setting of prices for deposits and services as well as the effective management of operating expenses will all take on increased importance for an S&L's profitability.

Implications of recent legislation

The Garn-St Germain Depository Institutions Act of 1982 provides for new lending, investment, and depository authority for federally chartered S&L's. It is not expected that this expanded lending and investment authority will have an immediate effect on the financial condition of the industry. However, the effect should be reflected in the long term as S&L's gradually diversify their assets and strengthen their portfolios by reducing asset-liability maturity mismatches. The Net Worth Certificate provisions of the act, which temporarily increase institutions' net worth, are designed to aid the survival of a number of institutions in the interim.

The new depository authority provided by the act, however, could have a significant effect in the short term depending on how S&L managers use the power. The new money market rate depository accounts provided for by the act enhance S&Ls' ability to compete for funds and thereby enhance the size and quality of association assets. However, such competition could ultimately increase cost of funds and other expenses and reduce profitability. To the extent that competition decreases profitability, the recovery of weaker institutions could be slowed and some institutions could fail, despite declines in general levels of interest rates.

Despite recent legislative actions, many institutions, because of an inability to quickly improve their net worth positions, are still expected to become insolvent and require FSLIC financial assistance. The number of S&L's that will be categorized as insolvent will depend on the economy and the way in which FSLIC/FHLBB implements the provisions of the Net Worth Certificate Act. But, even with favorable interest rates and liberal net worth assistance, FSLIC estimates that as many as 100 institutions with assets of $15 billion are too weak to qualify for the net worth certificates and could become technically insolvent requiring FSLIC aid by the end of 1984. As the table on page 14 shows, about 450 associations are currently operating with net worth of less than 2 percent.

DESPITE LOSSES, MOST S&L's HAVE ADEQUATE CASH FLOW TO SUSTAIN OPERATIONS

Although most of the S&L industry has reported operating losses and declining net worth, most associations have had sufficient cash to fund their operating requirements. This is largely a result of the nature of S&L operations and S&Ls' ready access to sources of liquidity. For example, S&L's receive cash for mortgage principal repayments.[11] However, this cash is not considered income and is not reported as such on institutions' income statements. At the same time, S&L's record income statement expense for interest credited to deposits for which no cash is actually disbursed. On an income statement basis most S&L's have reported income losses. But, on a cash basis they have showed a gain.

S&L's can also obtain cash on short notice from the Federal home loan banks and Federal Reserve banks located around the country and from other commercial lending sources. However, an institution's ability to obtain funds from these sources depends greatly on the institution's net worth level. In the case of minimal net worth, an association may only be able to borrow if it has a guarantee from FSLIC to repay the loan in the event that the institution cannot.

The significance of cash flow is reflected in statistics for 1981. While the industry recorded an operating loss of about $5 billion in that year, it actually had a positive net cash flow of about $73 billion which was available for lending or investment. The same general relationship existed for 1982. During 1982, the industry had an operating loss of about $4.3 billion; however, a positive net cash flow of $139.8 billion was recorded. This suggests that even though an association may exhaust its net worth--the traditional standard for assessing insolvency--it could, because of adequate cash, continue to operate and pay all debts as they come due.

This cash surplus, which allows investment in higher yielding assets, is one reason why S&L asset yields have risen during the recent period of operating losses. Total assets and liabilities increased by about $77 billion (13 percent) during the 1981-82 period. The principal explanation for the asset growth was interest credited on deposits that was not actually disbursed.

11/Since 1980 there has been a steady increase in delinquent mortgage loans. The delinquent loan ratio has increased from 0.9 percent in January 1980 to 2.2 percent in December 1982. However, at this level, delinquencies have not been a major problem for the industry as a whole.

SUMMARY OF S&Ls' CASH FLOW:

JANUARY 1980 THROUGH DECEMBER 1982

	1980 January-June	1980 July-December	1981 January-June	1981 July-December	1982 January-June	1982 July-December
	(billions)					
Net cash from operations (note a)	$20.6	$22.5	$23.7	$24.4	$25.0	$26.2
Net cash deposits/ (withdrawals) (note b)	2.3	8.3	(11.1)	(14.3)	(8.8)	2.4
Cash from mortgage repayments and mortgages sold	25.5	33.7	24.6	25.5	36.3	58.7
Cash available for lending or investment	48.4	64.5	37.2	35.6	52.5	87.3
Cash for new mortgages closed or purchased	-33.2	-57.6	-38.2	-28.6	-36.0	-55.1
Total cash after loans closed	$15.2	$ 6.9	$(1.0)	$ 7.0	$16.5	$32.2
Cash from borrowing	(0.3)	9.6	10.2	14.0	8.0	1.2
Cash after borrowing	$14.9	$16.5	$ 9.2	$21.0	$24.5	$33.4

a/Interest income and service fees less personnel and facility expenses and interest on borrowing.

b/Interest credited to depositors' accounts is not a cash reduction.

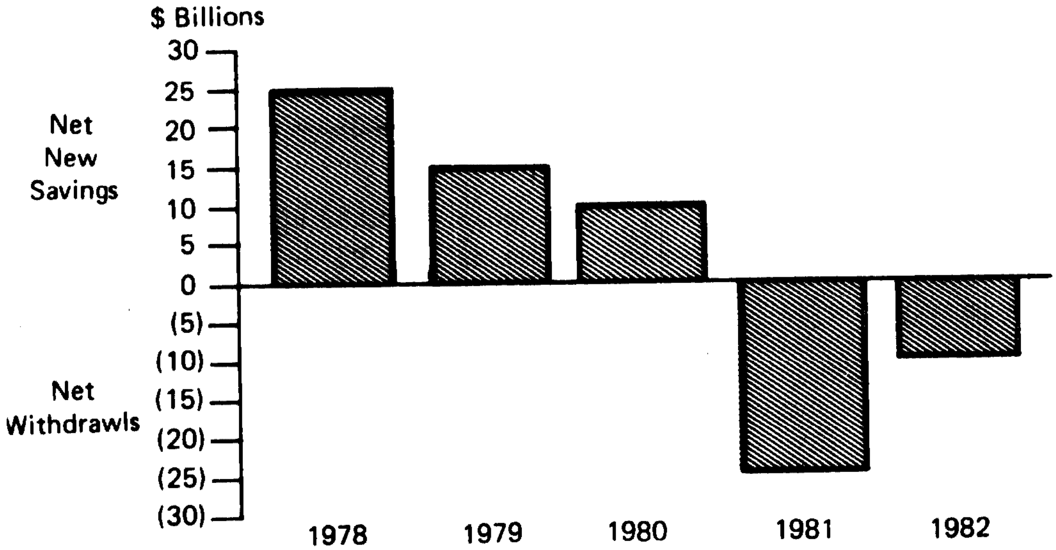
For the first 6 months of 1982, the industry received approximately $53 billion of discretionary cash, i.e., cash available for use, net of deposit withdrawals of $8.8 billion (an additional $4.4 billion was withdrawn through September 1982). Of this amount, $36 billion was used to fund or purchase mortgages. The 1982 deposit withdrawals represent a substantial slowing down of the trend recorded during most of 1981. As in 1981, the industry generally replaced deposit withdrawals with borrowings. At the end of June, S&L's had $24.5 billion, after borrowing, for investments and liquidity purposes.

Deposit withdrawals slowed substantially during the latter part of 1982--resulting in total withdrawals of $6.4 billion for the year. The introduction of the money market deposit account (MMDA) on December 14, 1982, as authorized by the Garn-St Germain Act, resulted in net new deposits of $10.4 billion for the S&L industry in December. This was in sharp contrast to the deposit outflows experienced in the prior months of 1982 and in 1981. Outstanding MMDA balances at S&L's were $33.6 billion at yearend 1982, representing 6 percent of all S&L deposits.

Net deposit inflows continued to be strong in 1983, as more than $28 billion in net new deposits were received in the first 3 months of the year. The rate of increase in deposits declined substantially, however, after the initial surge of MMDA deposits were received in December of 1982 and January and February of 1983.

The following chart shows the decrease in net new dollar savings from 1978 to 1980 and net deposit withdrawals for 1981 and 1982.

Analysis of Savings Activity for Calendar Years 1978 to 1982



While deposit withdrawals have not significantly affected most S&L's, there are indications that deposit withdrawals did play a key role in some institutions' insolvencies in 1981. For example, GAO reviewed FSLIC records on 10 associations that became insolvent in 1981, and found that 9 recorded significant cash withdrawals after their net worth dropped below 2 percent. Most of these associations reached insolvency prior to FSLIC's initiation of new assistance techniques, discussed below. More recent analysis by FHLBB researchers indicates that investors and depositors have not reacted similarly in 1982 to institutions approaching insolvency.

The Net Worth Certificate Act, Title II of the Garn-St Germain Depository Institutions Act of 1982, recognizes the unique nature of the industry's cash flow. Essentially, it allows FSLIC to strengthen the association's net worth with little cash expenditure, by providing a promissory note in exchange for the S&L's issuance of a net worth certificate, which is recorded as net worth on the S&L's financial statement.12/ Without sufficient cash flow, which is necessary

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12/While there is no initial cost associated with this type of transaction, FSLIC must make periodic cash interest payments to institutions under the terms of the promissory notes, generally to maintain the market value of the certificates.

for eventual profitability, an association could not survive even with the certificates.[13]

S&L'S CONTINUED TO PLAY A SIGNIFICANT BUT SOMEWHAT CHANGED ROLE IN FINANCING HOUSING

Coping with the financial difficulties that occurred in the 1981-82 period affected the traditional S&L roles of originating and financing mortgages. Although S&L's continued to originate a large portion of the mortgages that were being made in the depressed market conditions of that period, the share of home mortgages originated by S&L's in 1982--37 percent--was somewhat below the 43 to 55 percent share that S&L's originated during the previous decade.

The role of the S&L industry as net supplier of funds for long-term mortgages was affected even more significantly in 1982. Throughout the 1970's and through 1981 at least 70 percent (and often more than 85 or 90 percent) of the industry's increase in assets was accounted for by a net increase in holdings of mortgages or mortgage-backed securities. By the end of 1981 the S&L industry was financing in excess of 45 percent of the more than $1 trillion in home mortgages that were then outstanding. By far the largest share of this financing was directly held mortgages rather than mortgage-backed securities that had been purchased. In 1982, however, as the industry concentrated on liquidity-related investments, only 11 percent of the $55.3 billion of S&L's net increase in assets was associated with mortgage instruments. For the year as a whole, a $23.3 billion net decrease in mortgage holdings was offset by a $29.8 billion net increase in U.S. Government agency mortgage-backed securities. In the last half of 1982 the S&L industry actually reduced slightly its net financial stake in mortgage instruments.

In 1983 as housing and other sectors of the economy recovered, interest rates remained lower, and S&L's continued to receive deposit inflows, the S&L industry returned to a more active position in the housing finance market. The share

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13/In this respect, the Net Worth Certificate Program differs from other Federal loan and guarantee programs such as Lockheed and Chrysler, in which strengthening cash flow was the major objective.

of home mortgages originated by S&L's increased once again to the lower end of the range that had occurred in the previous decade. S&L's also acquired more mortgage instruments (particularly mortgage-backed securities) that allowed greater flexibility in portfolio management, but the percentage of the industry's net increase in assets invested in such instruments was about 60 percent compared with a minimum of 70 percent (and usually more than 80 percent) during the previous decade. However, looked at from the point of view of the mortgage market as a whole, S&L's market share returned to pre-1982 levels. In the first half of 1983 S&L's supplied the financing for about 40 percent of the net increase in all types of mortgages that occurred in the U.S. This share was well within the range that had occurred in the previous decade and significantly higher than the share that occurred in the inflationary 1977 through 1980 period when S&L's had trouble attracting deposits and mortgage pools and other financial intermediaries expanded their capability to meet the record high demand for mortgages.

The longer run impacts on the S&L's housing finance role as a result of efforts to diversify their asset holdings and of other features of the changing financial environment remains to be seen. The greater flexibility and competitiveness associated with recent changes in laws, regulations, and housing finance practices can be expected to lessen the fluctuations in the financial condition of the S&L industry. Even if the role of a restructured S&L industry as a net provider of long term mortgage financing should ultimately decline, however, a 1982 GAO study concluded that today's diversified and efficient U.S. capital markets should be capable of supplying all of the mortgage funds for which there was effective demand.14/

CONCLUSION

High and fluctuating interest rates from late 1979 through mid-1982 forced the average S&L to pay higher rates for its deposits and borrowing than it earned on its assets. This earnings disparity resulted in significant losses and net worth declines for about 80 percent of the industry. Because

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14/"Analysis of Options for Aiding the Homebuilding and Forest Products Industries" (GAO/CED-82-121, Aug. 31, 1982.) Chapter 6, pages 108-116 of that report provides an overview of the mortgage market.

of these losses during 1981 and 1982, 730 institutions (about 18 percent of all federally insured S&L's) merged or closed their doors. Despite large losses, however, those institutions that remained in business increased their assets and liabilities by about 13 percent ($77 billion) primarily because of favorable cash flow resulting from interest credited on deposits but not withdrawn by depositors.

Declines in interest rates after mid-1982 offered hope that the weakened industry could reverse its losses and regain profitability during 1983. But while declining interest rates and more flexible arrangements for financing housing have set the stage for the industry's recovery, new competitive factors stemming from provisions of the Garn-St Germain Act might possibly slow the process for many associations.

CHAPTER 3

FSLIC CONTINUES TO MAINTAIN SIZABLE RESERVES

BY THE USE OF INNOVATIVE ASSISTANCE TECHNIQUES

Although S&L industry losses have forced the FSLIC insurance fund to liquidate or extend assistance to a record number of potentially insolvent institutions, the fund, due to changes in policy adopted by FSLIC in 1981, has managed to maintain sizable reserves. From January 1981 through December 1982, FSLIC liquidated or assisted 109 associations while reporting only a modest decline in reserves. While the effects on the fund of the new Net Worth Certificate Program and increased competition are not yet fully clear, it seems reasonable to assume that if current assistance practices continue, the fund will have sizable levels of reserves in the foreseeable future. However, FSLIC has reduced its assistance costs for an insolvent institution to about as low as is feasible; thus FSLIC has limited additional flexibility for adopting cheaper alternatives in dealing with insolvencies. A sharp, sustained rise in interest rates or a broad loss of public confidence in the S&L industry could quickly alter the outlook for the fund.

HOW THE FUND WORKS

The FSLIC insurance fund reserves of $6.3 billion represent about 1 percent of the industry's $500 billion in insured deposits. 1/ In carrying out its insurance activities, FSLIC usually incurs liability only when the net worth of individual S&L's, on a book value basis, is exhausted or approaches that point.

FSLIC becomes involved when an institution approaches insolvency and cannot reverse its condition without aid. Net worth on a book value basis is the traditional measure of an institution's financial condition. As a general rule, when net worth drops to zero, the association is considered to be insolvent. The theory behind this rule is that when an institution's liabilities exceed its assets, it cannot meet all its legal debts.

FSLIC, as the insuring agency, is authorized by law to provide financial assistance to institutions in danger of becoming insolvent. FSLIC assistance consists of loans, asset

1/FDIC maintains a comparable reserves to deposits ratio for the commercial banks it insures.

purchases, contributions, guarantees, or any combination thereof, either to assist operating institutions or to facilitate mergers of failing institutions. Assistance actions are taken in order to prevent the closing of an association whenever the cost of such actions does not exceed the cost of liquidation. However, if continued operation of an association is essential to the community, FSLIC may undertake assistance actions without regard to cost comparisons. If none of the assistance actions are possible, the insolvent institution is generally placed into liquidation as a last resort.

In deciding which method of assistance to employ to prevent insolvency, FSLIC, in some cases, has used a loan or contribution coupled with a restructuring of the failing institution's management. The most common method used by FSLIC has been assisted mergers between a problem institution and a healthy institution. FSLIC can provide financial assistance in the form of contributions or loans to the institution merging with the problem institution or can guarantee against certain losses resulting from the merger. FSLIC may engage in a "purchase and assumption" transaction, whereby the savings deposits and generally a portion of the assets of a failing institution are transferred to another S&L, with the remaining assets being acquired by FSLIC. A purchase and assumption transaction can still be less costly than liquidation because FSLIC receives a premium on the accounts assumed by the acquiring S&L that helps offset the loss that otherwise would be absorbed entirely by FSLIC. 2/

FSLIC INITIATED NEW ASSISTANCE METHODS IN 1981 THAT PROTECTED THE FUND

Prior to mid-1981, liquidation/payouts and purchase and assumption transactions were the principal methods of dealing with institution insolvencies. During the first half of 1981, FSLIC provided about $930 million in cash to assist nine institutions with assets of $1.6 billion. 3/ In these cases, FSLIC was funding market value losses, and assistance equaled about 58 percent of assets. The ultimate cost of assistance in these cases could be as low as one-third of this amount, once acquired assets are sold. However, without a substantial infusion of resources, a continuation of assistance in this

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2/Also, there is less initial cash outlay in a purchase and assumption transaction because the acquiring institution pays FSLIC a premium.

3/Of the approximately $930 million in cash assistance, FSLIC purchased $560 million of assets and made loans and contributions of $190 million and $180 million, respectively.

manner would have allowed FSLIC to manage only about $12 to $15 billion of insolvencies. Consequently, FSLIC began to change its assistance strategies in mid-1981 by negotiating merger agreements with assistance payments to be made over time. Other new actions that reduced the cost of assistance included interstate mergers and acquisitions, and the development of the Income Capital Certificate (ICC).

Results of shift in FSLIC assistance methods

In June 1981, FSLIC changed its approach to assistance. The dramatic increase in insolvencies in 1981 and 1982 forced FSLIC to adopt cost-saving and cost deferral assistance techniques. Through the techniques of assisted merger and the purchase of income capital certificates (ICC's), FSLIC began funding only book value loss, rather than the full market value loss inherent in the liquidation approach. As a result, in the last 6 months of 1981 and during 1982 FSLIC provided about $300 million in cash to assist a total of 60 mergers involving 98 savings and loan associations with assets of $40.6 billion. Cash outlays for assistance for these cases averaged less than 1 percent of the institutions' assets, as compared to cash assistance of 58 percent of assets for nine insolvencies during the first half of 1981.

Inherent in FSLIC's strategy of reducing current cash outlays for assistance is the establishment of long term contingent liabilities for many cases. Thus, assistance agreements consummated in late 1981 and 1982 carry a significantly higher future commitment than agreements entered into prior to mid-1981. For example, prior to mid-1981, long term contingent liabilities established in 24 merger agreements totaled about $84.6 million. However, during the last half of 1981 and 1982, contingent liabilities established for 30 merger agreements totaled about $616 million. Even with the long-term contingencies, however, the estimated present value total cost of assistance for these agreements, as for all cases entered into during the last half of 1981 and 1982, is substantially less, as a percent of assets, than that experienced in earlier agreements.

FSLIC was able to reduce its assistance costs and defer cash outlays by using new assistance techniques, such as the ICC, primarily to aid failing institutions that FSLIC could not otherwise merge. The ICC concept was employed as a means to strengthen an S&L's net worth without expending a large

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4/FSLIC may have to provide additional funds to the S&L's depending on the extent of future losses.

amount of FSLIC's cash. 5/ A second technique developed by FSLIC as an incentive for one institution to acquire another one was an agreement to pay an acquiring S&L a portion of future losses incurred from the operations of the acquired association.

These techniques essentially focused on reimbursing institutions' reported net worth losses as opposed to paying for the losses that would be realized if the institutions' assets were sold in the marketplace. So in addition to allowing FSLIC to spread its expenditures over a longer period of time with little initial cash cost, these practices reduced FSLIC's overall assistance costs.

In September 1981 FHLBB approved, for the first time, the interstate acquisition of a failing S&L. Consideration of out-of-State institutions expanded FSLIC's base of competition and reduced costs of assistance because of premiums that out-of-State competitors were willing to pay to obtain a deposit market outside their home State. 6/ By December 31, 1982, the FHLBB had approved 18 interstate mergers. According to FSLIC officials, no intrastate merger partners could be found to acquire the weak institutions without substantially greater FSLIC financial assistance. The Garn-St Germain Act

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5/An ICC, the prototype for the Net Worth Certificate(NWC), is an instrument issued by an S&L in exchange for cash or a cash equivalent FSLIC promissory note. The ICC can be used as permanent equity capital for purposes of determining net worth. ICC's have been used primarily in "Phoenix" mergers, where two or more essentially insolvent institutions are combined, with FSLIC purchasing ICC's from the new institution. Thus far, FSLIC has purchased about $500 million of ICC's.

The use of ICC's are advantageous to FSLIC because of limited cash outlays in the form of interest payments. In addition, the ICC allows FSLIC to "buy time" for an S&L that has a reasonable chance of recovery in the long run. However, if interest rates rise or the institution fails, the ICC method of assistance could result in a higher ultimate cost of merger or liquidation compared to the cost of acting sooner.

6/In the case of a failing institution, FSLIC seeks bids to acquire the institution. Normally, a successfully operating institution wanting to expand will pay a premium for a failing institution because the institution has already established a facility and a market (which are expensive to establish). FSLIC's ability to get a higher bid is generally enhanced if it can increase the number of competitors bidding on the institution.

formalized this process by specifically providing for and detailing procedures for interstate mergers, as well as intrastate and interindustry mergers.

Another method used by FSLIC to reduce costs has been to encourage outside investors to inject capital into the industry. For example, in September 1981 as part of the first interstate merger, the National Steel Corporation of Pittsburgh provided $75 million in new capital to facilitate the acquisition of two failing S&L's by a subsidiary S&L holding company. In addition, in August 1982, Citicorp, a $120 billion New York bank holding company, acquired a California Federal savings and loan association and provided over $80 million in equity capital as part of another interstate merger.

In addition to initiating new assistance methods to conserve FSLIC funds, in 1980 and 1982 the FHLBB approved reductions in the net worth requirement which allowed more institutions to operate without being categorized as capitally impaired and operating in an unsafe or unsound manner. Also in 1980, FHLBB granted a temporary exemption from the net worth and reserve requirements for institutions that sold assets at a loss in order to more closely match the maturities of assets and liabilities. In addition, in October 1982, the Garn-St Germain Depository Institutions Act of 1982 replaced specific net worth requirements with the instruction that FSLIC-insured institutions are to "provide adequate reserves in a form satisfactory to the Corporation."

With the high level of interest rates in the last 3 years, the market value of S&Ls' long-term loans dropped below book value. However, institutions' book value, not market value, was the indicator of immediate concern for FSLIC. Since the industry had substantial book value net worth reserves, most S&L's were able to absorb the book value operating losses of the last 3 years. FSLIC's ability to fund industry assistance requirements would have been in question if it had had to absorb the full market value loss experienced by all of the institutions that, on a market value basis, fell below established capital standards.

CURRENT CONDITION OF THE FUND

During the 12 months ending December 1982 in which the industry experienced record losses, FSLIC's reserves increased slightly from $6.156 billion to $6.307 billion. 7/ The fund's cash inflow from assessments and earnings on investments was greater than cash outlays for expenses. FSLIC's balance sheet as of December 1982 appears on the following page.

7/Reserves increased as a result of net income from operations of $137 million and earnings on the secondary reserve (S&L's prepaid premiums) of approximately $14 million.

FSLIC's Balance Sheet as of December 1982

Assets		$ Billions
Cash and receivables		$ .023
Investments	a/	6.437
Loans		.445
Total mortgage loans and other assets	b/	.335
ICC's and net worth certificates (NWC's)		.272
		$7.512

Liabilities and Reserves		
Promissory notes payable (ICC and NWC offset)		$ .457
Other payables		.043
Allowance for loss	c/ d/	.705
Reserves		6.307
		$7.512

a/Market value of investments including acquired securities is $6.067 billion.

b/In December 1982, a new FSLIC accounting policy resulted in a change to the "Assets Acquired" category, which had previously been listed as a single line item. Acquired Federal agency securities, such as GNMA securities, of $1.064 billion were shifted to the "Investments" category. In addition, the "Acquired Assets" category was redesignated as "Mortgage Loans and Other Assets," taking into account allowances for possible future losses.

c/Estimated future disbursements are premised on only slight changes in interest rates. If interest rates should rise greatly above the level when the assistance agreements become effective, FSLIC's liabilities could be greater. If rates should fall below that level, FSLIC's financial liability would be less.

d/Does not include additional FSLIC contingent liabilities of $423 million which FSLIC does not expect to have to pay. The maximum contingency, according to FSLIC officials, is set higher than the actual estimated cost in order to provide a cushion for uncertainties concerning litigation and other undisclosed liabilities. FSLIC's experience indicates that the maximum contingent liability is rarely reached, and it is FSLIC's opinion that the total contingent obligations will not be incurred.

For the year ended December 1982, the insurance fund's gross income was $1.090 billion. The fund's principal income sources were insurance fee assessments of 1/12 of 1 percent of associations' deposits ($427 million) and interest earned on investments in Federal agency and U.S. Government securities ($604 million). General operating and other insurance-related expenses ($130 million) and provisions for losses ($823 million) totaled $953 million, and FSLIC posted a net gain of $137 million.

FSLIC's reserves increased slightly during 1982. The cash position of the fund also strengthened during this period. In 1980 and 1981, record cash outflows caused the fund to pay out more cash than it took in and the make-up of the fund's assets changed. Thus, from 1979 to 1981 the amount of the fund's cash and investments decreased, and loans to and assets acquired from insured institutions increased.

The innovative assistance methods initiated by FSLIC in 1981 minimized FSLIC's immediate cash outlays. These methods allowed FSLIC to spread its cash requirements over a number of years making it possible to sustain its current operations with cash received from assessments and earned on investments. 8/ FSLIC's account dealing with the provision for future losses under contribution agreements totaled more than $0.8 billion. If FSLIC had not adopted this approach, however, it is probable that during the difficult 1981-82 period FSLIC's reserves might have exhausted and that FSLIC's cash position would also have deteriorated rapidly.

8/As of December 31, 1982, FSLIC had about $200,000 in cash and a total investment portfolio, not including acquired securities, of $5.3 billion, consisting of $2.2 billion in short-term investments and $3.1 billion in long-term investments. The short-term investments totaled $1.5 billion in Treasury overnight securities and $0.7 billion in issues maturing within 18 months.

All of the investments are redeemable on demand, if FSLIC should require immediate cash. However, with the exception of Treasury overnight securities, losses would be incurred upon early redemption. Liquidation of the total $5.3 billion portfolio would result in about $275 million in losses (5.2 percent of the portfolio).

Summary of changes in FSLIC from 1980 to 1982

While FSLIC reserves declined only modestly in terms of their reported value, the reserves, when compared to deposits and assets and when adjusted for inflation, show a larger decline (or slower comparable growth). As shown below, the reserves declined by 14.8 percent from the end of 1980 to the end of 1982 when the dollar amount of reserves is adjusted for inflation using 1972 dollars. Similarly, when reserves are compared to assets and deposits, reserves lagged behind the growth of assets and deposits by 13.3 and 12.3 percent, respectively, from December 1980 to December 1982. Coupled with reduced capital at most S&L's during this period, the net effect is a reduced cushion against losses in the near future.

Change in Value of FSLIC Reserves: December 31, 1980 to December 31, 1982

	12/31/80	12/31/82	Percent change
FSLIC Reserves unadjusted for inflation ($ billion)	$6.462	$6.307	- 2.4
FSLIC Reserves adjusted for inflation ($ billion, 1972 dollars) (note a)	3.516	2.997	-14.8
FSLIC Reserves (unadjusted for inflation) as percent of total assets in insured savings and loan institutions	1.05	.91	-13.3
FSLIC Reserves (unadjusted for inflation) as percent of total deposits in savings and loan institutions	1.30	1.14	-12.3

a/GNP deflator was used to calculate 1972 dollars.

OUTLOOK FOR COMMITMENTS OF FSLIC RESOURCES

FSLIC's future well-being depends upon what happens to the large segment of the industry that currently has very little remaining net worth. The costs to FSLIC of this group of S&L's depends upon the future course of interest rates, extent of net worth losses from all sources, cash flow within the S&L industry, attractiveness of financially troubled S&L's to investors both inside and outside the S&L industry, and policies adopted by FSLIC, FHLBB, and other Federal regulators. Although we have not attempted to undertake precise projections for each area of FSLIC activity, recent experience does provide a basis for estimating approximate demands for FSLIC resources over the next several years.

The demands on FSLIC for both near term cash outlays and total contingent liabilities can be grouped into three areas

--costs associated with carrying out agreements already entered into,

--costs associated with the newly authorized Net Worth Certificate (NWC) program, and

--costs associated with failures and assistance agreements other than those under the NWC program.

In the coming months the profits or losses of S&L's hinge principally on two factors: the general level of interest rates and the effects of competition. Our assessment at this time is based principally on interest rate levels as the effects of competitive factors are not yet clear. 9/ Another recent trend in the S&L industry, that is hard to place a value on but which should bolster industry net worth and provide an additional cushion to the FSLIC fund, is the conversion of mutual S&L's to stock ownership. The stock form of ownership provides S&L's with: (1) additional capital through stock offerings to the public; (2) an opportunity for expansion and diversification in the consumer and commercial loan areas; and (3) holding company status, which allows acquisition of other institutions and new activities.

9/On the assumption that competitive factors would tend to increase the cost of funds, increase expenses, and lower yield on assets, we would assume that the outlook for FSLIC based on general level of interest rates probably tends to underestimate to some extent the demands that may be placed upon FSLIC. On the other hand, a significant inflow of new funds as a result of attractive new deposit instruments will permit S&L's to purchase more assets at current market rates, thereby contributing to higher earnings.

Cash outlays for existing agreements

FSLIC's ability to meet annual cash outlays from annual cash inflow from assessments and interest earnings is a function of existing commitments and future agreements. Currently, FSLIC annually receives about $1 billion in cash income. It pays out about 5 percent of this amount or about $50 million annually for general operating expenses. Through 1986, FSLIC estimates that it will pay an additional $100 to $200 million annually to fulfill existing contingent liability commitments. This leaves $750 million or more annually of uncommitted cash.

Net worth certificate program

As a result of the Garn-St Germain Act, FSLIC's principal assistance activity over the next 3 years is expected to involve the purchase of NWC's from institutions with less than 3 percent net worth in order to maintain or increase those institutions' net worth. Although essentially a bookkeeping transaction, FSLIC purchases the NWC's with a promissory note--a commitment to provide cash in an amount equal to the note should it be necessary in the future. This would occur if the S&L were liquidated but could also occur for other reasons. To date, however, FSLIC has not yet had to pay off a promissory note. Because the promissory note is backed by FSLIC reserves, it has value and is entered on the S&L's financial statement as an asset. The NWC is recorded in the S&L's financial statement as net worth or reserves. To conform with accounting principles, FSLIC makes market rate interest payments, semiannually, on the promissory notes to maintain their issue value.

As of October 1982, institutions accounting for about 40 percent of the assets of the S&L industry had less than 3 percent net worth and probably sustained about 50 percent of the industry's annual losses. Under the provisions of Title II of the Garn-St Germain Act, FSLIC could purchase net worth certificates equal in value for up to about 60 percent of these losses. The act also provides for periodic cash interest payments to institutions issuing NWC's. If industry losses increase, the percentage of losses funded by FSLIC could increase because more institutions would have net worth below 3 percent. [10]

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[10] The percentage of losses to be covered by FSLIC under the program increases as institutions' net worth declines. For example, the act provides for the purchase of certificates equal to 50 percent of losses for institutions with net worth between 2 and 3 percent. Coverage increases to 70 percent if net worth falls below 1 percent.

FSLIC is not constrained in its ability to exchange promissory notes for net worth certificates since the exchange represents offsetting entries on FSLIC's balance sheet. However, in our opinion, as a practical matter, FSLIC might want to limit assistance under the program to the amount of fund reserves--currently about $6.3 billion. 11/

On the basis of industry losses associated with the interest rate scenarios described on page 15, which indicate that losses would be $1.2 billion in 1983 if rates were 9.5 percent and $14 billion if rates were 11.5 to 12 percent, our judgment at this time is that FSLIC's assistance requirements under the Net Worth Certificate Act would vary from about $400 million if the interest rate was 9.5 percent to about $4 to $5 billion if interest rates were between 11.5 and 12 percent. 12/ As long as interest rates remain below 12 percent, FSLIC's unencumbered reserves should remain positive through 1984.

Using the estimated requirements for NWC's above, FSLIC's cash requirements for interest to maintain the value of the certificates on an annual basis would range from about $40 million to as much as $600 million. 13/ Thus,

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11/On a market value basis, FSLIC's reserves are about $6 billion. It is not clear what market value will be accorded the NWC's that FSLIC purchases.

12/This assumes the following: (1) The passage of the Net Worth Certificate Act will not have the effect of increasing realized S&L losses. (Under the Net Worth Certificate Act, FSLIC is to ensure that institutions do not artificially inflate losses.) (2) FSLIC could purchase certificates in an amount equal to about 60 percent of half of the industry losses or about 30 percent of industry losses. Also, these estimates do not take into consideration the effects of FSLIC's Appraised Equity Capital policy as a prerequisite for receiving the certificates. This policy should have the effect of increasing the net worth of individual S&L's and could reduce FSLIC's requirements for purchasing certificates by as much as 50 percent. For additional discussion of this policy, see pages 45 to 46.

13/Calculated as follows: 9.5 percent of $400 million equals $38 million; 12 percent of $5 billion equals $600 million.

even if interest rates rise to 12 percent during a particular year, FSLIC should have sufficient annual cash inflow to meet annual cash outlay requirements.

Liquidations and assisted mergers

Despite the Net Worth Certificate Act and the recent drop in interest rates, as noted above, some institutions are expected to become insolvent and require FSLIC financial assistance. The number of institutions that will be categorized as insolvent will depend on the economy and on the manner in which FSLIC implements the provisions of the act. However, even if interest rates average about 9.5 percent and net worth assistance is provided liberally, FSLIC estimates that as many as 100 institutions (with assets of about $15 billion) could become technically insolvent by the end of 1984. At the current cost of assisted merger arrangements, this number of insolvencies would reduce FSLIC's reserves by about $300 million, but these losses should correspondingly reduce the magnitude of the net worth certificate program.

The above estimate for insolvencies and assisted mergers assumes that FSLIC will continue to follow the lower cost pattern established in the latter part of 1981. These lower cost approaches, although they protect the insurance fund, also result in limiting, somewhat, FSLIC's flexibility for dealing with insolvency situations. In other words, FSLIC is using the least expensive options available, which assumes the only other options would be more expensive. These lower cost approaches also require that FSLIC take an active role in arranging mergers that can have a considerable impact on the evolving nature of the S&L industry.

CONCLUSION

In summary, FSLIC, through innovative assistance techniques, has been able to maintain a generally stable fund reserve even though the deteriorating condition of the industry is the worst since the establishment of the fund in 1934. The outlook for the future of the fund depends primarily on interest rates and on how FSLIC implements the new Net Worth Certificate Act. Under the provisions of the act, FSLIC could absorb up to about 60 percent of the losses in net worth experienced by S&L's with less than 3 percent net worth. These S&L's account for about one-half of the losses in the industry.

With interest rates at levels experienced as of August 1983, it appears that FSLIC is in no immediate danger of reaching either its cash flow or net worth limits and that the insurance fund would only face renewed difficulty if short term interest rates rise and remain above 11.5 to 12 percent.

However, competitive factors associated with the new money market certificates and the resolution of related accounting issues (see ch. 4) could impact upon the industry's condition and FSLIC's requirements to aid the industry. At the same time, recent actions to convert mutually owned S&L's to a stock form of ownership should inject more capital into the industry increasing the amount of reserves that protect an S&L from insolvency and FSLIC assistance. Barring some unforeseen factors that could trigger a run on the industry, it seems reasonable that FSLIC could experience difficulty in 1983 only if short term interest rates rise on a sustained basis to at least 13.5 percent.

CHAPTER 4

ACCOUNTING AND FINANCIAL REPORTING CHANGES

FOR THE S&L INDUSTRY

The recent large operating losses and net worth declines experienced by the S&L industry and the related increase in S&L insolvencies and mergers have prompted regulatory officials to require additional financial reporting on the operations and condition of S&L's. Thus far, the principal change in this respect is FHLBB's recent requirement that institutions report on the market value of their buildings and land.

At the same time that regulatory changes in financial reporting are being made, the Financial Accounting Standards Board (FASB)--the recognized organization for establishing standards for financial accounting and reporting--has made a change in general purpose financial reporting by S&L's. On February 28, 1983, FASB announced a new statement on the reporting of banking and thrift acquisitions.

These changes in financial reporting could have significant effects on the regulation of and reporting by the S&L industry. This chapter discusses changes in accounting and financial reporting and the implications of these changes for the FSLIC insurance fund. Actions taken by the Congress and FHLBB to (1) improve S&Ls' net worth with net worth certificates and income capital certificates and (2) avoid insolvencies by lowering the insolvency threshold, based on reporting in accordance with established accounting standards, have slowed pressure from groups wanting to change accounting rules. These actions have helped to preserve the existing financial reporting system.

SETTING STANDARDS FOR FINANCIAL REPORTING

General purpose financial reporting in the United States is based on generally accepted accounting principles (GAAP). The objectives of general purpose financial reporting are to provide information that is useful to present and potential investors and creditors and other users of such information in making rational investment, credit, and related decisions.

Accounting principles and/or standards in the strictest sense are the rules for reporting financial position, results of operations, and changes in financial position of an entity. Principles and standards refer to the rules for recognizing and valuing transactions for reporting and report format, presentation, and disclosure. However, in a more general sense, principles and standards also include underlying concepts and theories which provide the basis for standards.

Generally accepted accounting principles or standards are essentially principles or standards that are accepted and applied in practice. They are based on substantial authoritative support from recognized professional boards, associations, or other organizations. One of the primary reasons for the development of these standards was to enhance the comparability of financial reporting among enterprises that might otherwise use different accounting treatments.

Although GAAP is the standard for general purpose financial reporting, this type of reporting is only one source of information needed by those individuals who make decisions about business enterprises. In regulated industries such as the S&L industry, regulators often ask for specialized supplementary reporting on the basis of a different set of needs. For the S&L industry, the FHLBB is authorized to require S&L's to submit supplementary reporting.

FINANCIAL REPORTING REQUIREMENTS BY THE FHLBB

The FHLBB has historically relied to a large extent on the type of general purpose financial reporting followed by businesses in the United States. As required by GAAP, S&L's report most assets, liabilities, and net worth on an historical cost basis--cost at acquisition. While this practice causes little difficulty in a stable economic environment for S&L's which traditionally have made long term mortgage loans, it raises questions about asset values in periods of volatile or sustained interest rates higher or lower than the rates prevailing at the time of asset acquisition. The situation is analagous to the problem of inflation accounting for businesses and accounting for variations in foreign exchange.

The FHLBB recently decided it needed specialized supplemental financial information in order to deal with the unique problems of the S&L industry. Because of financial difficulties experienced by the S&L industry over the past several years, the FHLBB has reconsidered the usefulness of some of the industry GAAP-based financial reporting. From a regulatory perspective, reporting has a practical impact beyond informing current and potential investors about the nature of a particular enterprise. If regulators limited themselves to GAAP-based financial reporting only, then they might not have sufficient information to make the type of decisions they are required to make.

Financial reporting, among other things, is used by Federal and State regulators in defining and enforcing capital adequacy standards. Some State laws require the liquidation of any financial institution whose net worth falls below zero, irrespective of whether the institution is able to meet obligations as they mature. Furthermore, FSLIC has used its regulatory power essentially to take over the management and/or force the merger of associations whose net worth has fallen below 2 percent of assets. As conditions in the S&L industry worsened in 1981 and 1982, more S&L's, using GAAP-based reporting, were falling below established criteria for solvency.

Changes in the decision criteria and assistance relieved some of the pressure to change reporting standards

Practical difficulties resulting from the application of financial reporting standards need not, of course, require changes in the reporting standards. To the extent that difficulties exist, they can be handled instead by changes in the decision criteria based on established reporting standards. If accounting rules were changed at the first sign of trouble, the integrity of financial reporting would be seriously undermined.

In this regard, FHLBB did change its decisionmaking processes, prior to modifying reporting standards, in order to accommodate the changing conditions in the industry. Whereas, at the beginning of 1981 the FHLBB gauged severe financial difficulty for an S&L at 2 percent net worth, by early 1982 it had modified its measurement criteria to gauge severe difficulty at different levels depending on the institution. The Congress, in enacting the Garn-St Germain Act, furthered this line of reasoning by eliminating specific net worth requirements as a basis for judging an S&L's viability. The modification of the decisionmaking process alleviated the pressure for changing reporting to make it easier to maintain established net worth standards.

In addition to changing the criteria for deciding when an institution reaches insolvency, FHLBB and the Congress established programs to bolster weakened institutions' net worth. In 1981, FHLBB established its ICC program which was used selectively to improve the net worth of weak institutions. Under the program, FSLIC provided weakened institutions with promissory notes to provide cash, if needed, in exchange for capital certificates issued by the institution and recorded on the institutions' financial statement as capital or net worth. In 1982, the Congress expanded this program as part of the Garn-St Germain Act, under the name of the Net Worth Certificate Program, to include all S&L's with less than 3 percent net worth that were incurring operating losses.

These programs, by improving S&Ls' reported net worth, further reduced the likelihood of the institutions being declared insolvent on the basis of low net worth and bolstered the public's confidence in the industry. GAO, in August 1982, in a letter to the Chairman of the House Banking Committee, discussed the factors affecting the accounting treatment of ICC's (B-208603, Aug. 13, 1982). To date, the FASB has issued no formal statements on the acceptability of the certificates.

FHLBB decided it needed supplemental financial reporting to carry out its responsibilities

To fulfill its regulatory responsibilities, however, FHLBB has determined it also needs additional financial reporting. Part of the supplemental financial information FHLBB has decided it needs, concerns the market value of assets and liabilities. The feasibility and the implementation of this type of a system for financial reporting continues to be studied by the FHLBB and the Federal Financial Institution Examination Council which represents the five Federal financial depository institution regulatory agencies. FASB has not formally taken the matter under consideration.

A change to market accounting would require S&L's annually to take losses and gains associated with changing interest rates as they occur. While such a change would not be acceptable under GAAP, it is acceptable to the extent that it provides supplementary information for regulatory purposes, including management of the insurance fund.

The concept of assigning market values to assets and liabilities, however, is not without technical problems. It assumes a continually accessible market place and the capability for an orderly disposition of assets and liabilities. If too many institutions tried to market assets simultaneously as might occur in a period of perceived crisis, the value for the assets would be adversely affected.

Thus far, FHLBB's principal change regarding market or current value accounting is its November 4, 1982, regulation allowing institutions, for regulatory reporting purposes, to include as part of their reserves a newly recognized item called "Appraised Equity Capital." Essentially this regulatory change provides for institutions to take credit for the appreciation (market value less purchase price or book value) of their buildings and land. The Board argues that this is a more realistic approach for reflecting equity items in institutions' reports to the Board. This change is significant because, in most cases, it would improve the reported net worth (equity) of most S&L's and reduce FSLIC's requirements to provide net worth certificates or other assistance.1/ (See p. 34.)

While supplemental reports to GAAP-based financial statements can provide information for the internal use of an industry regulator, such reports often are not an acceptable substitute for general purpose financial reporting. As illustrated by the example above, regulatory accounting practices sometimes allow greater latitude in accounting treatment and financial reporting than GAAP which affects the comparability and consistency of financial reports. Since one of the primary reasons for the development of accounting standards by a single recognized professional board was to enhance the comparability of financial reporting among enterprises, the distribution to the public of financial statements which might be designed to accomplish objectives other than the fair presentation of operating results in accordance with GAAP may seriously undermine public confidence in not only GAAP-based financial statements but the regulated institutions as well. Accordingly, any time supplementary information is disclosed to the public, adequate disclosures should be provided to call attention to the departure from GAAP and give the dollar effect of such departure.

FINANCIAL REPORTING CHANGES BY THE FASB

FASB has promulgated changes in general purpose financial reporting by S&L's. FASB's new rule expects to provide more reliable and informative reporting while correcting certain reporting by some S&L's that was misleading and inconsistent. The rule modifies the accounting policy for S&L acquisitions that assisted FSLIC in its efforts to arrange low cost assistance and, in some cases, to avoid assistance because of voluntary merger.

Under the rules of purchase accounting for thrift acquisition prior to the recent change, an S&L that acquired another S&L, with or without assistance, was required to (1) mark down the assets and liabilities of the acquired institution from book value to market value and (2) mark the

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1/On November 4, 1982, the FHLBB also changed the term "net worth" to "regulatory net worth" to allow appraised equity capital and other equity items to be included by S&L's in their reports to the FHLBB.

acquired institution's net worth to zero. The resulting imbalance between assets and liabilities (normally fewer assets than liabilities) was designated as goodwill (intangible benefit stemming from the association's established clientele and service base) and entered on the acquired association's books as an asset. The value of goodwill equaled the excess of liabilities over assets.

In subsequent years (up to 40 years), the acquiring institution expensed the goodwill on its income and expense statements. The rationale for this amortization of goodwill to expense was that the acquired institution brought to the merger certain intangible value which was lost as time went by.

At the same time that goodwill was expensed, the acquiring institution recorded additional income in an amount equal to the difference between what it paid for the purchased loans (market value) and the higher principal amount (book value) that borrowers eventually repaid. This difference was normally amortized over a period shorter than 25 years. (See app. V for an example of how this was recorded.)

On February 28, 1983, the FASB, in response to requests for interpretation, issued a final statement amending thrifts' treatment of the amortization of goodwill when accounting for acquisitions after September 30, 1982. The statement was enacted as a result of concerns that existing accounting principles on the matter did not adequately address the conditions present in some recent business combinations involving those institutions which, some believed, produced unrealistic post combination operating results.

The increased frequency of such combinations as a result of the economic climate prompted the request for review. The thrust of FASB's statement is to provide a more consistent matching of amortized income and expense resulting from the transaction so that they are accounted for in the same manner and over the same period, precluding the benefit of otherwise unearned income in the early years of the combined institution.

FASB's ruling on purchase accounting should result in discouraging many voluntary S&L acquisitions because it eliminates an acquiring S&L's opportunity to realize inflated earnings in the early years of the acquisition. This could place greater pressure on FSLIC to aid the merger of financially weakened S&L's.

CONCLUSION

As a result of financial difficulties experienced by the S&L industry, the FHLBB has recently established supplementary reporting requirements for use in monitoring S&L activity. FHLBB and congressional actions to modify decisionmaking practices, when financial reporting indicated that an association was approaching technical insolvency, reduced pressure from groups wanting changes in reporting for S&L's.

FASB has modified GAAP-based reporting for thrift acquisitions to clarify reporting for such transactions. Such a change was made to clarify existing standards because of the increased frequency of such transactions.

While GAO does not disagree with changing accounting standards, we believe it should be done under the auspices of FASB. The objective of financial reporting is to provide information that is useful in making business and economic decisions. We believe financial reporting best achieves this objective when it is based on GAAP. These principles provide a standard by which to measure financial presentations. We are concerned about supplementary reporting initiatives that would not necessarily follow GAAP, although we understand that in some cases regulatory reporting can aid regulatory agencies' decisionmaking process. Thus far, FHLBB's requirement for supplemental information in the context of supplementary reporting does not conflict with GAAP. However, GAAP should not be changed or modified through regulatory requirements simply to improve the appearance of an industry's financial health or to amplify regulatory needs when there are nonregulatory users.

APPENDIX I

COMPARISON OF BALANCE SHEET DATA FOR INSURED SAVINGS AND LOANS FROM DECEMBER 1979 TO DECEMBER 1982

	Dec. 1979		Dec. 1980		Dec. 1981		Dec. 1982 (note a)	
	Amounts (billions)	Percent of total	Amounts (billions)	Percent of total	Amounts (billions)	Percent of total	Amounts (billions)	Percent of total
Assets								
Mortgages	$466.5	82.3	$492.7	80.1	$509.4	78.2	$473.1	68.3
Cash & inv. sec.	50.7	8.9	60.7	9.9	66.4	10.2	82.3	11.9
Other loans	15.8	2.8	18.7	3.0	18.6	2.9	16.0	2.3
Mortg. bkd. sec.	19.9	3.6	26.8	4.3	32.8	5.0	61.8	8.9
Other assets	13.8	2.4	16.4	2.7	23.8	3.7	59.5	8.6
Total assets	$566.7	100	$615.3	100	$651.0	100	$692.7	100
Liabilities								
Savings dep.	$459.5	81.0	$498.6	81.0	$512.3	78.7	$554.6	80.1
Borrowed funds	54.7	9.7	63.4	10.3	88.8	13.6	97.5	14.1
Other liab.	20.9	3.7	20.9	3.4	22.1	3.4	15.2	2.1
Total liabilities	$535.1	94.4	$582.9	94.7	$623.2	95.7	$667.3	96.3
Net worth	31.6	5.6	32.4	5.3	27.8	4.3	25.4	3.7
Total liabilities & net worth	$566.7	100	$615.3	100	$651.0	100	$692.7	100

a/Because of an FHLBB regulatory accounting change implemented in September 1982, certain balances that had earlier been reported as liabilities are now reported as "Contra-assets" (i.e., as deductions from asset accounts). Balance sheet data for 1979-81 conforms to previous definitions.

COMPARISON OF OPERATIONS DATA FOR FEDERALLY INSURED S&L's

FROM DECEMBER 1978 TO DECEMBER 1982

	1978		1979		1980		1981		1982	
	Amount (billions)	Percent of total	Amount (billions)	Percent of total	Amount (billions)	Percent of total	Amount (billions)	Percent of total	Amount (billions)	Percent of total
Gross operating income										
Interest on Mortgages	$32.7	80.6	$38.3	78.8	$43.3	77.2	$48.8	75.0	$ 58.5	79.4
Interest on Investments	3.0	7.4	4.4	9.1	5.6	10.0	7.5	11.5	8.5	11.5
Interest-Other	0.9	2.2	1.3	2.7	1.8	3.2	2.3	3.5		
Fees and Discounts on Loans	1.8	4.4	1.8	3.7	1.8	3.2	1.8	2.8		
Other Operating Income	2.2	5.4	2.8	5.7	3.6	6.4	4.7	7.2	b/ 6.7	9.1
Total Gross Operating Income	$40.6	100	$48.6	100	$56.1	100	$65.1	100	$73.7	100
Operating Expense	$ 6.2	15.3	$ 7.1	14.6	$ 7.9	14.1	$ 9.0	13.8	$10.5	14.2
Cost of Funds										
Interest/Dividends on Savings	$26.0	64.0	$32.1	66.1	$41.6	74.2	$54.1	83.1	$60.2	81.7
Interest on Borrowed Money	2.7	6.7	4.3	8.8	5.8	10.3	9.2	14.1	12.0	16.3
Total	$28.7	70.7	$36.4	74.9	$47.4	84.5	$63.3	97.2	$72.2	98.0
Net Income Before Taxes (note a)	5.7	14.0	5.2	10.7	1.2	2.1	(6.1)	-9.4	$(5.9)	- 8.0
Income Taxes	1.8	4.4	1.6	3.3	.4	.7	(1.5)	-2.3	$(1.6)	- 2.2
Net Income	$ 3.9	9.6	$ 3.6	7.4	$ .8	1.4	(4.6)	-7.1	$(4.3)	- 5.8

a/Reflects nonoperating items not shown on schedule.

b/"Other Operating Income" for 1982 includes "Interest-other" and "Fees and Discounts on Loans."

Analysis

This chart highlights the problems high interest rates have created for the S&L industry. From 1978 through 1982, S&Ls' cost of funds increased from 71 percent to 98 percent of gross operating income, virtually eliminating any opportunity for profit. Operating expenses, as a percent of gross operating income remained relatively stable. Operating income has continued to grow ($73.7 billion) and is higher than the amount as of December 1981 ($65.1 billion).

APPENDIX II

SAVINGS ACTIVITY OF INSURED SAVINGS AND LOANS

FOR CALENDAR YEARS 1978 TO 1981 AND MONTHLY IN 1982

	New savings received	Savings withdrawal	Net new savings	Interest credit	Net inflow
	(billions)				
1978	$246	$222	$24	$21	$45
1979	331	316	15	24	39
1980	424	414	11	30	41
1981	482	507	(25)	39	14
1982					
January	45.7	45.8	(0.1)	2.1	2
February	40.8	40.0	0.8	1.9	2.7
March	43.9	45.2	(1.3)	6.5	5.2
April	45.6	50.2	(4.6)	2.0	(2.6)
May	40.1	40.4	(0.3)	1.9	1.6
June	42.2	45.5	(3.3)	6.7	3.4
July	48.2	49.2	(0.9)	2.1	1.2
August	45.8	47.5	(1.7)	2.1	0.4
September	45.1	46.9	(1.8)	6.7	4.9
October	59.3	62.2	(3.0)	2.6	(0.4)
November	55.6	56.2	(0.6)	2.0	1.4
December	78.5	68.1	10.4	7.1	17.5
Total-1982	$590.8	$597.2	$(6.4)	$43.7	$37.3

Analysis

This table shows the trend in savings activity since 1978. It shows that from 1978 through 1980 new savings and interest credited combined for a reasonably consistent net inflow of savings. However, from 1979 to the present, interest credited has accounted for most of the increase. Net new dollar savings showed a steady decrease from 1978, and in 1981 there was a net withdrawal of $25 billion from S&L's. Net inflow in 1981 remained positive only because interest credited exceeded savings withdrawals.

The table also shows increased savings deposits/withdrawal activity at S&L's. From 1978 to 1981, the level of activity (savings received and savings withdrawn) almost doubled. In 1982, there was a net withdrawal of about $6.4 billion. However, this amount represents a substantial slowing down of the withdrawal trend recorded during most of 1981. During most of 1982, monthly net inflow was positive only because interest credited exceeded savings withdrawals. However, in December the introduction of the Money Market Deposit Account (MMDA) resulted in a substantial increase in net new savings which, when combined with interest credited to accounts, amounted to a record monthly net inflow.

ANALYSIS OF LIQUIDATED OR MERGED FSLIC-INSURED SAVINGS AND LOAN ASSOCIATIONS FROM JANUARY 1980 TO DECEMBER 1982

	1980	1981	1982	Total
Number of associations disappearing as a result of:				
Voluntary merger	73	174	197	444
FHLBB supervisory merger	21	61	189	271
FSLIC-assisted merger	11	30	77	118
Liquidation and payout	0	1	1	2
Total	105	266	464	835
Percentage of associations disappearing as a result of:				
FSLIC-assisted merger	10.5%	11.3%	16.6%	14.1%
FHLBB supervisory merger and FSLIC-assisted merger	30.5	34.2	57.3	46.6

Analysis

This table shows that from January 1980 through December 1982, 835 associations were merged or liquidated. From 1980 to December 1982, the percentage of FSLIC-assisted mergers increased from 10.5 percent to 16.6 percent. During the same time period, the percentage of associations merged with FSLIC supervision or assistance increased from 30.5 percent to 57.3 percent, while the percentage of associations which voluntarily merged decreased significantly (from 69.5 percent in 1980 to 42.5 percent in 1982).

ANALYSIS OF HYPOTHETICAL PURCHASE ACCOUNTING TRANSACTION FOR AN ACQUIRED INSTITUTION

	Book value	Purchase adjustments	Value added to acquired books	Amortizable amount (note b)
	(millions)			
Assets	$250	($50)	$200	$50
Goodwill	0	a/ 40	40	$40
Total	$250	($10)	$240	
Liabilities	$240	0	$240	
Net worth	10	($10)	0	
Total	$250	($10)	$240	

a/Calculated to balance adjustments.

b/Period for amortization established by acquiring institution.

Subsequent Years

Income Statements for Merged Institution

Asset Discount Income ($50 million at 25 years or less)	$2 million
Expense Goodwill ($40 million at 40 years or less)	$1 million

THE FEDERAL HOME LOAN BANK SYSTEM

The Federal Home Loan Bank System was created by Congress in 1932 to provide a nationwide structure to regulate and service local home financing institutions. The system provides mortgage lending institutions access to major capital markets by issuing consolidated obligations and discount notes in large denominations. The funds thus raised are distributed through the regional banks to local lending institutions. The funds supplement local savings in making home loans and providing other financial services. The system also serves as a source of secondary liquidity to its members allowing them to obtain cash advances to meet heavy or unusual withdrawal demands.

All federally-insured savings and loan associations are required by law to belong to the FHLB System. Membership is open on a voluntary basis to State-chartered savings associations, mutual savings banks and life insurance companies.

The FHLB System is organized in a manner similar to the Federal Reserve System for commercial banks. It is composed of the Federal Home Loan Bank Board in Washington, the 12 regional banks, and member savings associations serving their local communities.

There are approximately 3,500 savings and loan associations insured by the Federal Savings and Loan Insurance Corporation (FSLIC). These associations hold more than $530 billion of the public's funds in the form of deposits of savers holding more than 100 million accounts, and provide nearly half of all home mortgages.

THE FHLB BOARD

The Board has three members appointed for 4-year terms by the President with the consent of the Senate. No more than two members may belong to any one political party. The Board governs and regulates the Bank System. It is the chartering and regulatory authority for Federal savings and loan associations. It also governs the Federal Savings and Loan Insurance Corporation and the Federal Home Loan Mortgage Corporation. The Board is an independent agency in the executive branch of the government and submits an annual report to Congress. All its expenses are met through assessments on the regional banks, the FSLIC and examinations fees. None of the Board's expenses are paid out of public tax dollars.

THE REGIONAL FHLB BANKS

The Regional Banks carry out the functions of the System in its dealings with individual savings and loan associations. Although the banks are instrumentalities of the Federal Government, they are wholly owned by their member associations. Each bank has its own staff and board of directors. Each Board is composed of six public interest members appointed by the FHLBB for 4-year terms, plus an additional number of directors elected by member asociations for 2-year terms. The regional Federal Home Loan Banks serve as central credit banks for member associations and have no direct contact with the public except through the sale of consolidated obligations.

The regional banks are not autonomous. The FHLBB reviews their annual budgets, approves appointments of top personnel, and governs and sets System-wide operating policy.

The regional banks provide a variety of services to their member savings associations. Besides maintaining deposit facilities and making cash advances, the district banks offer safekeeping, purchase and sale of securities, and operation of statistical and research programs relevant to their geographical area. The district banks' capital stock is all owned by their member associations. Member associations are required to own stock equal to one percent of their total loan portfolios. Also, borrowing members must hold stock at least equal to one-twelfth of the total amount advanced them from their regional bank.

THE FHLMC

The Federal Home Loan Mortgage Corporation (FHLMC) was created by an act of Congress in 1970 to promote the flow of capital into the housing market by establishing an active secondary (resale) market in home mortgages. The corporation is under the direction of the Federal Home Loan Bank Board, and may by law deal only with government-supervised lenders. (This means depository institutions and those mortgage bankers that meet FHLBB specified criteria).

In time of tight credit or regional imbalances in the money supply, FHLMC provides additional funds to mortgage lenders by purchasing existing mortgages from their portfolios. FHLMC's programs cover conventional mortgage loans of various types. It obtains funds to finance its purchases mainly from the sale of bond-type and pass-through mortgage certificates.

FSLIC

The Federal Savings and Loan Insurance Corporation (FSLIC) is an instrumentality of the Federal Government, created by Congress to insure savings accounts at savings and loan associations. FSLIC is governed by the Federal Home Loan Bank Board. It was established in 1934, the year in which deposits at commercial banks and mutual savings banks first were insured by the Federal Deposit Insurance Corporation. FSLIC and FDIC are both permanent corporations similar in structure and purpose. Both insure accounts up to $100,000.

In protecting the funds of savers FSLIC has a wide choice of approaches to aid member associations that find themselves in financial difficulties. FSLIC can make loans, grants, or special contributions, can purchase assets or use any combination of these methods. Such actions help put member associations back on a sound fiscal operating basis or allow time for an orderly merger to be arranged. The merger of a problem association into one that is financially and mangerially strong is the most frequently used FSLIC aid method.

Because of such default prevention methods, the FSLIC has had to close and pay off the insured accounts of only 17 associations in its nearly half century of existence. For those situations where no default prevention methods can be found, the FSLIC has developed a method for reimbursing insured depositors almost immediately. Through these methods, the FSLIC has protected millions of savers over the years, with no loss of insured savings.

Source: Federal Home Loan Bank Board

SUMMARY OF THRIFT POWERS AND CAPITAL ASSISTANCE

(As Contained in the Conference Report on H.R. 6267
"The Garn-St Germain Depository Institutions Act"
As Approved by Conferees, Sept. 29, 1982)

I. Broader Powers for Federally-chartered S&Ls:

--New authority to make commercial, corporate, business or agricultural loans (secured or unsecured), subject to the same loan-to-one-borrower limits as national banks, to 5 percent of assets until Jan. 1, 1984 and 10 percent of assets thereafter. The Conference did not create separate "baskets" for originations and purchases. (Note: Senate Banking Committee Report language states that these aggregate ceilings include any commercial investments made under service corporation and overdraft authorities.)

--Repeal the law establishing the statutory differential, and phase-out the differential for all accounts "on or before" Jan. 1, 1984. For all categories already scheduled for phase-out at earlier dates, such as the 30-month Small Savers Certificate, the differential will disappear as soon as "practicable," but not later than already scheduled. For accounts on which ceilings remain when the differential is phased out, banks will be allowed to pay the current thrift ceiling.

--Demand accounts are authorized, without percentage limitation, for persons or organizations that have a business or commercial "loan relationship" with an S&L; also deposit-taking-only, non-interest-bearing accounts are permitted for commercial, corporate, business and agriculture entities. Statutory 30-day notice-of-withdrawal period is eliminated for savings accounts (including NOWs).

--Existing loan-to-value restrictions and first-lien requirements on real property loans are deleted. Percentage-of-assets restriction on non-residential real estate lending is increased to 40 percent from 20 percent.

--New authority to invest (to 10 percent of assets) in tangible personal property and engage, thereby, in equipment leasing (consumer and corporate).

--New authority to invest (for liquidity purposes) in deposits of other FSLIC-insured S&Ls (not just FDIC-insured banks).

--Removal of asset limitations on investments in municipal and State securities (subject to per-issuer restrictions).

--Clarification that "floor plan" financing is permitted and an increase (to 30 percent-of-assets) in limit applicable to consumer lending.

--Education loans of all types (not just for college) are permitted under existing 5 percent authority.

--Out-of-State branches acquired by a Federal [1] must meet 60 percent tax law test or be discontinued; present branches are "grandfathered."

--S&L subsidiary of unitary S&L holding company must meet 60 percent tax law test or holding company becomes subject to activities list of multiple S&L holding companies.

--Federal thrifts are made subject to "anti-tying" (between granting of credit and use of other S&L services) restrictions comparable to those applicable to bank holding companies.

II. <u>Money Market Deposit Account</u>

--DIDC [2] is instructed to develop a new account with no interest rate ceiling, to "be directly equivalent to and competitive with money market mutual funds." (The Conference Report, but not the statute, suggests a minimum of no more than $5,000.)

--This new account is to be effective not later than 60 days after date of enactment of this legislation.

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[1] A federally chartered savings and loan.

[2] Depository Institutions Deregulation Committee.

--The new account may have up to three preauthorized or automatic transfers and three third-party transfers per month and be reserved at the "nonpersonal" time deposit level (currently 3 percent); if limits are exceeded, such account will presumably be subject to the reserve level for transaction accounts (currently 12 percent.)

III. Restructuring Provisions:

--Permits conversion to Federal S&L or Federal savings bank (repealing existing limitations), or, back to State-chartered. As part of the process, converting institution could change from mutual to stock (or the reverse) and elect to use the label "Federal S&L" or "Federal Savings Bank."

--Grants authority for de novo Federal stock chartering (S&L or savings bank).

IV. Capital Assistance:

--FSLIC and FDIC-insured institutions may issue net worth certificates for purchase by their agencies to bolster net worth.

--To qualify, institutions must (1) have net worth of less than 3 percent; (2) have incurred losses for previous two quarters; (3) comply with terms prescribed by agencies; (4) have not engaged in speculative activities or incurred losses just to qualify for the program; (5) have a net worth of not less than 1/2 of 1 percent after FSLIC purchase of net worth certificates; and (6) have at least 20 percent of loans in residential mortgages (or mortgage-backed securities).

--The FSLIC may not require management changes if applicant for assistance demonstrates (through a business plan) positive net worth for 9 months, nor can FSLIC require an agreement to merge if applicant can project positive net worth for 6 months. (Rejected business plans can be appealed to full FHLBB.)

--Initial assistance formula will be:

Net Worth	Level of Assistance
3 percent or less	50 percent of period loss
2 percent or less	60 percent of period loss
1 percent or less	70 percent of period loss

--Federal law overrides State provisions: (1) to ensure that assisted State-chartered S&L can continue to operate and pay dividends; and, (2) State franchise taxes are suspended during period of assistance.

--Assistance program is open to non-federally-insured S&L's (provided their deposit insurance funds indemnify FSLIC/FDIC for losses and charge equivalent premiums).

--Present 3 percent-to-6 percent and 20-to-30-year stretch-out statutory net worth language is replaced by instruction that FSLIC-insured institutions are to "provide adequate reserves in a form satisfactory to the Corporation."

V. Due-On-Sale

--Banks, savings and loans, and other lenders will be permitted to enforce due-on-sale clauses in real property contracts notwithstanding State law, except for loans originated or assumed during a window period (affected States have 3 years to override).

--FHLMC prevented from proceeding with July 2, 1981 rules until July 1, 1983.

VI. Miscellaneous

--Federal law preempts State laws preventing utilization by State-chartered S&Ls of full range of alternative mortgage instruments available under Federal regulation for Federally-chartered institutions.

--All depositories may offer NOW accounts to government unit depositors of all types (public funds).

--FHLBanks may lend to FSLIC.

--Statutory collateralization-of-advances requirements are simplified.

--FHLBB may permit payment of FHLBanks dividends out of undivided profits and suspend set-aside of FHLBank earnings to reserves when "severe financial conditions exist threatening the stability of member institutions."

--Drop-outs from FHLBank system may not rejoin for 5 years, and will be assessed a prepayment penalty on advance.

--FSLIC can suspend pay-out from its Secondary Reserve when "extraordinary financial conditions exist increaseing the risk to the Corporation."

--Full FSLIC coverage will continue for 6 months for depositors with accounts in two or more merging institutions.

--FSLIC and other Federal deposit insurers are directed to study: optional coverage above the $100,000 limit; feasibility of combining the Federal insurance funds; basing premiums on risk, etc.

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

Federal Home Loan Bank Board

EDWIN J. GRAY
BOARD MEMBER

MAY 3 1983

Mr. William J. Anderson
Director
General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

We have received your draft report "The FSLIC Insurance Fund - Recent Management and Outlook for the Future". The report presents a generally accurate and fair picture of the conditions the Corporation faced at the end of 1982. We feel no substantive changes are necessary.

We would like to reiterate our belief that the outlook for the Insurance Fund over the next few years will depend largely on interest rates. Should there be a sharp and sustained rise in short-term interest rates, pressures on the Insurance Fund reserves could be expected to increase dramatically.

Sincerely,

E J Gray

Edwin J. Gray

(233096)

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