BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Net Worth Certificate Assistance Programs: Their Design, Major Differences, And Early Implementation

The Garn-St Germain Depository Institutions Act of 1982 authorized capital assistance programs to savings and loan associations and savings banks--commonly called thrifts. These programs are intended to increase the net worth of weakened thrifts so that they can restructure and return to profitability.

The act requires GAO to audit the programs, as administered by the Federal Home Loan Bank Board and the Federal Deposit Insurance Corporation, and report to the Congress. GAO's review showed that the Bank Board, using discretion given by the act, developed a program that differs from FDIC's. The Bank Board developed a restrictive program which reduces the number of thrifts eligible for assistance and, until recently, reduced assistance amounts thrifts could receive.

The report discloses that the capital assistance provided by the agencies, while increasing thrifts' net worth for regulatory purposes, does not conform to accepted public accounting standards. GAO recommends that the agencies qualify regulatory financial reports on thrifts and other institutions provided to the public that differ from those standards because the reports could be misleading.

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

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

In the past several years, there has been national concern about the ability of the thrift industry (savings and loan associations and savings banks) to operate in a high interest rate economy. Congress addressed the industry's problems in the Garn-St Germain Depository Institutions Act of 1982 (Public Law 97-320). Since passage of the act, the industry returned to profitability primarily due to lower interest rates in 1983. However, despite overall improved performance, the thrift industry remains vulnerable to rising interest rates.

The Garn-St Germain Act authorized programs to provide capital assistance to weakened thrifts and required the General Accounting Office to conduct audits of the programs and report to the Congress. This report, the first of several we plan to issue, discusses the condition of the thrift industry since passage of the act and the capital assistance programs it authorized.

Copies of this report are being sent to the Director, Office of Management and Budget; the Chairman, Federal Home Loan Bank Board; the Chairman, Federal Deposit Insurance Corporation; and interested members and committees of the Congress.

Charles A. Bowsher
Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

NET WORTH CERTIFICATE ASSISTANCE PROGRAMS: THEIR DESIGN, MAJOR DIFFERENCES, AND EARLY IMPLEMENTATION

DIGEST

In 1981 and 1982, the thrift industry (savings and loan associations and savings banks) experienced extensive losses. Responding to the difficulties faced by the industry, the Congress passed the Garn-St Germain Depository Institutions Act of 1982. The act was designed to aid thrift institutions in two ways: first, by expanding investment and lending powers so that thrifts could restructure and return to profitability; and second, by authorizing capital assistance to increase the net worth (defined as an institution's assets less liabilities) of weakened thrifts that might not otherwise survive long enough to restructure.

This report addresses the net worth assistance authorized by Title II of the Garn-St Germain Act. That title, called the Net Worth Certificate Act, authorizes the Federal Deposit Insurance Corporation (FDIC) and the Federal Home Loan Bank Board (the Bank Board) to establish programs to increase the net worth of qualified institutions. The act expires in October 1985.

Section 205 of the act requires GAO to audit the programs and to report on each audit to the Congress. This report discusses the condition of the thrift industry, the design of the programs, and their early implementation, as well as analyzes differences between the programs.

THOUGH THE THRIFT INDUSTRY IMPROVED EARNINGS IN 1983, THE OUTLOOK IS STILL UNCERTAIN

During 1981 and 1982, savings and loan associations insured by the Federal Savings and Loan Insurance Corporation (FSLIC), a subsidiary of the Bank Board, experienced losses totaling $8.9 billion; similarly, FDIC-insured savings banks experienced losses totaling $2.7 billion.

Following these losses, federally insured savings and loan associations and savings banks collectively returned to profitability in 1983. FSLIC-insured institutions generated a profit and FDIC-insured savings banks significantly reduced their losses. This rebound can be attributed primarily to the sharp decline in interest rates that started in the latter part of 1982 and continued through May of 1983. However, moderate increases in interest rates in the second half of 1983 slowed the recovery. Data on the condition of the thrift industry in 1984 were not available at the time of GAO's review.

Despite improved overall performance, 35 percent of the 3,183 FSLIC-insured institutions and 23 percent of the 294 FDIC-insured savings banks reported losses for 1983. According to the FDIC, the Bank Board, and industry representatives, the thrift industry remains vulnerable to interest rate fluctuations. (See pp. 7 to 10.)

THE ACT GIVES DISCRETION TO AGENCIES IN DESIGNING PROGRAMS

The assistance authorized by the act partially offsets an institution's losses and entails an exchange of paper between an institution and its insurer. The institution gives the insuring agency a capital instrument, called a "net worth certificate." In return, the agency gives the thrift institution a promissory note for the same amount. The exchange of a promissory note and certificate--similar to raising new capital through the sale of stock--is intended to increase the institution's net worth. This transaction is designed to forestall liquidation or forced merger procedures, creating time for the thrift to restructure its financial portfolio and return to profitability. If, however, the institution fails and is liquidated, the promissory note provided by the federal agency is available as an asset to satisfy the claims of general creditors.

The act provides for assistance to a wide range of institutions whose net worth is too low to serve as an adequate cushion against losses, but precludes assistance to those institutions that do not have reasonable prospects for long-term viability. The act specifies an eligibility ceiling and an eligibility floor. To receive assistance, an institution must have net worth no greater than 3 percent of its assets--the eligibility ceiling. However, an institution must also have net worth of not less than one-half of 1 percent of assets after considering the effect of assistance--the eligibility floor. Simply stated, if an institution's net worth after adding in the assistance amount does not rise to at least 0.5 percent of assets, then the institution is not eligible to receive the assistance. Those institutions failing to meet the eligibility floor might have little chance for survival and ultimately might be merged or liquidated.

The act provides for assistance to partially cover operating losses at amounts determined by applying suggested percentage rates to an institution's losses for two quarters. However, the act gives FDIC and the Bank Board discretion to design their own programs. It specifically allows them to depart from the assistance formula provided in the act. (See pp. 1 to 4.)

FDIC'S PROGRAM ADHERES CLOSELY TO THE ACT

In December 1982, when FDIC was designing its capital assistance program, it estimated that 40 to 60 of its 315 savings banks would qualify for net worth assistance. The assistance was to be backed by FDIC's insurance fund of $13.8 billion as of December 31, 1982. Without issuing formal regulations, FDIC announced the establishment of an "FDIC Capital Assistance Plan," effective December 7, 1982. By December 31, 1983, FDIC had exchanged promissory notes for net worth certificates totaling $378,706,657 from 25 savings banks. Since none of the 25 savings banks participating in the program has failed, FDIC has not been required to make any cash payments on its promissory notes. (See pp. 15 to 18.)

FDIC designed its program to provide assistance to offset losses at the percentage rates suggested by the act and developed strict operating terms and conditions that savings banks must agree to in order to obtain assistance. It also encourages institutions eligible for or receiving net worth certificate assistance to voluntarily seek mergers with healthier institutions. (The act is intended to forestall only forced, not voluntary, mergers.) As of December 31, 1983, three institutions, after receiving net worth certificate assistance, subsequently merged with other institutions under FDIC's voluntary merger plan.

THE BANK BOARD USES ITS DISCRETION TO PROTECT INSURANCE FUND

In contrast to the FDIC, the Bank Board estimated in May 1983 that about 500 of its approximately 3,000 institutions could qualify for assistance, backed by an insurance fund of only $6.3 billion as of December 31, 1982. Accordingly, the Bank Board designed a program that would generally provide less assistance to an institution than FDIC's program would and reduces the total number of eligible institutions. Like FDIC, the Bank Board provides assistance through an exchange of a promissory note for a net worth certificate and also developed strict operating controls that institutions must agree to. However, the Bank Board has developed some features in its program that differ from FDIC's.

A key feature of the Bank Board's program is its definition of "net worth." Unlike FDIC, the Bank Board defines net worth to include an item called "appraised equity capital." Appraised equity capital is essentially the difference between the appraised fair market value and the net book value (cost at acquisition less depreciation, where applicable) of an institution's office land, buildings, and improvements. Through the use of appraised equity capital, an institution can take credit for the unrealized equity (market value less net book value) in its office land, buildings, and improvements without selling these assets. Because of rising property values, recognizing this unrealized equity tends to increase an institution's net worth. This requirement is important because an increase in net worth can cause some institutions, depending upon their net worth level, to become eligible for assistance, while causing others to become ineligible. Using appraised equity capital is a prerequisite for institutions seeking net worth certificate assistance. (See pp. 24 to 26.)

In the first year and a half of its program, the Bank Board used two assistance formulas. One was used when an institution first applied for assistance (called initial assistance); the other was used for subsequent assistance. The Bank Board's initial assistance formula provided for assistance at one-half of the percentage rates suggested in the act. The Bank Board imposed the one-half limit because operating controls which it required of institutions as a condition for assistance were not in effect when institutions first entered the program. Once operating controls were agreed to, the Bank Board provided all subsequent assistance at the full percentage rates allowed under the act. Recently, however, the Bank Board recognized the need to provide greater assistance to troubled thrifts, and eliminated, effective September 4, 1984, the initial assistance formula with its one-half limitation on assistance. For all assistance thereafter, Bank Board regulations provide for assistance at the maximum percentage rate suggested by the act. (See pp. 22 and 23.)

Although the Bank Board experienced initial program start-up problems, the program is now operating more smoothly. As of December 31, 1983, the Bank Board had exchanged promissory notes for net worth certificates totaling $88,875,000 from 64 institutions. Since none of these institutions has failed, the Bank Board has not been required to make any cash payments on its promissory notes as part of the liquidation process. However, two of the institutions merged and a third was acquired by another thrift institution. The net worth certificate assistance was retained by the three surviving institutions. (See pp. 27 to 30.)

FDIC AND THE BANK BOARD TREAT FINANCIALLY SIMILAR INSTITUTIONS DIFFERENTLY

Because of differences between FDIC's and the Bank Board's programs, two financially similar institutions--one insured by FDIC, and the other by FSLIC--are treated differently. The differences affect eligibility and, until recently, amounts of assistance provided to qualified thrifts. GAO analyzed the differences to demonstrate their effect on institutions, and therefore the effect of agency discretion allowed under the act. However, the effects identified do not necessarily indicate that one agency's program is better than the other's. While institutions can only receive assistance from one of the two insurers, for theoretical purposes GAO analyzed the extent of assistance that Bank Board thrifts would receive under FDIC's program, since FDIC's program adheres more closely to the act.

Because of the importance of these programs to weak thrifts, GAO conducted a separate analysis to compare the effects of the two programs on weak institutions. GAO identified 71 financially weak savings and loan associations that had (1) a net worth-to-asset ratio of less than 0.5 percent or (2) a net worth-to-asset ratio under 3 percent, but with less than 6 months to insolvency, as projected by the Bank Board. According to GAO's analysis of these weak savings and loan associations, the Bank Board would qualify a greater number of these institutions for assistance than FDIC. This result occurred because including the unrealized equity in office land, buildings, and improvements sufficiently raised the institutions' net worth to meet the act's eligibility floor. (See pp. 33 to 35.)

While unrealized equity in office land, buildings, and improvements helps weaker institutions meet the act's eligibility floor, the Bank Board estimates that it causes a greater number of stronger institutions to exceed the act's eligibility ceiling. (See pp. 25 and 26.) Overall, FDIC's program would qualify more Bank Board institutions and prior to September 4, 1984, would provide greater amounts of assistance than the Bank Board's program would.

THE BANK BOARD AND FDIC SHOULD DISCLOSE LIMITATIONS ON FINANCIAL DATA RELEASED TO THE PUBLIC

The Bank Board and FDIC are releasing financial reports containing information on thrifts' net worth that could mislead or confuse the general public. Thrifts submit these reports for regulatory and supervisory purposes to the FDIC and the Bank Board. However, financial information is reported in a manner that is not recognized under generally accepted accounting principles (GAAP), the standard for consistent financial reporting to the public.

The Bank Board's appraised equity capital, its net worth certificate, and FDIC's net worth certificates are not recognized components of an institution's net worth under GAAP. Concerning appraised equity capital, GAAP does not permit the reporting of unrealized equity in office land and buildings as part of net worth, requiring instead that office land and buildings be reported on an historical cost basis--cost at acquisition less applicable depreciation. Because net worth certificates are new, the accounting profession's views on them are emerging; currently, however, these certificates are not recognized by authoritative accounting organizations. The Financial Accounting Standards Board--the recognized organization for establishing financial reporting standards--tentatively concluded that the Bank Board's promissory note does not meet the profession's definition of an asset and that the Bank Board's net worth certificate should therefore not increase an institution's net worth. Similarly, the American Institute of Certified Public Accountants (AICPA) concluded that the FDIC's promissory note did not meet the definition of an asset. The AICPA concluded that the exchange of FDIC's promissory note for a bank's net worth certificate under FDIC's program does not involve the payment of any consideration and that the note is realizable only if the bank is liquidated. (See pp. 37 to 41.)

Although both agencies release financial reports to the public containing these items that do not conform to GAAP, neither discloses that fact. Without proper disclosure, the public could rely upon such reports to make business and investment decisions. (See pp. 41 to 43.)

GAO RECOMMENDATION

GAO recommends that the Chairmen of the Bank Board and the FDIC qualify financial reports and information that are based on regulatory requirements that differ from GAAP. This qualification should notify the public that the financial reports and data depart from and are not intended to be presented in conformity with GAAP. (See p. 44.)

AGENCY COMMENTS

The Bank Board, commenting on the report, said that it was making arrangements to qualify its financial reports and information given to the public, as GAO recommended (see app. II). In its comments, FDIC stated that its initial reaction was that GAO's recommendation was unnecessary (see app. III). However, FDIC said that it would consider implementing the recommendation after consulting with other affected federal regulators.

FDIC stated that the users of the financial reports it disseminated were generally a fairly sophisticated group well aware of the limitations of the reports. GAO recognizes that many users of FDIC-disseminated financial reports may be aware of the reports' limitations. However, according to GAO's review, a significant number of requests for information came from individuals and other sources that may not be aware of the limitations of these reports. (See pp. 44 and 45.)

FDIC also stated that GAO offers no empirical evidence of people actually being misled. But GAO's recommendation stems from the concern that releasing non-GAAP based financial reports has the potential to mislead the public. GAAP is the standard for consistent financial reporting to the public. One of its purposes is to enhance financial comparability among enterprises that might otherwise use different accounting treatments. GAO believes that its recommendation would be relatively easy and inexpensive to implement, and the Bank Board has indicated it would do so.

The Bank Board also commented that it was re-evaluating its net worth certificate program and studying ways in which participation could be made more readily available to distressed thrifts. As a result of its study, the Bank Board amended its regulations, as described earlier, to provide more assistance. GAO plans to review these regulatory changes and report on them in a future report. (See p. 48.)

Contents

ABBREVIATIONS

AICPA	American Institute of Certified Public Accountants
AEC	Appraised Equity Capital
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	Generally Accepted Accounting Principles
GAO	General Accounting Office
S&L	Savings and Loan Association
The Bank Board	Federal Home Loan Bank Board

Page

Tables and Charts

CHAPTER 1

INTRODUCTION

Responding to the unprecedented difficulties faced by institutions specializing in home mortgage lending, the Congress passed the Garn-St Germain Depository Institutions Act of 1982 (P.L. 97-320). This act contained several provisions designed to aid these institutions, primarily savings and loan associations and savings banks. Title II, the Net Worth Certificate Act, provides direct assistance to the troubled institutions (collectively known as "thrifts").

Section 205 of the act requires the General Accounting Office (GAO) to conduct audits of the net worth certificate programs as designed and implemented by two federal insurers of financial institutions: the Federal Deposit Insurance Corporation (FDIC) and the Federal Home Loan Bank Board (the Bank Board), with its subsidiary the Federal Savings and Loan Insurance Corporation (FSLIC). The first of several reports that GAO will publish on the programs, this report discusses the condition of the thrift industry, the design of the programs, and their early implementation; it also analyzes the differences between the programs to demonstrate their effect on thrifts.

GARN-ST GERMAIN ACT DESIGNED TO HELP AILING THRIFT INDUSTRY

The Garn-St Germain Act was designed to help the thrift industry in two major ways. First, it authorized expanded investment and lending powers for thrifts so that they could restructure and improve the profitability of their operations. Second, it provided "net worth assistance" to give weakened institutions time to use these new powers and improve their financial condition.

Perceiving that many of the thrift industry's problems were caused by legislated restrictions on its business, the Congress, in the Garn-St Germain Act, eliminated or modified several restrictions. These changes included, among others,

--giving thrifts new authority to make commercial, corporate, business, or agricultural loans (secured or unsecured);

--eliminating all interest rate differentials on savings accounts offered by banks and thrifts;

--allowing thrifts to offer demand deposit accounts for persons and organizations that develop a business or commercial loan relationship with them;

--creating a new money market deposit account; and

--repealing limitations on conversions of federal/state charters.

The Congress also recognized, however, that it would take time for these changes to yield their desired effects. The Net Worth Certificate Act therefore was designed to provide interim assistance to troubled thrifts that might not otherwise survive long enough to benefit from the new opportunities given them.

Simply stated, "net worth" is the difference between the assets and the liabilities of an institution. Net worth provides a cushion against losses and is considered by regulators and others to be an important measure of the long-term viability of an institution. Regulators often measure net worth as a percentage of assets, which is mathematically expressed as a net worth-to-asset ratio. In this report, unless otherwise stated, any reference to net worth as a percent means a net worth-to-asset ratio.

The type of assistance provided for in the act involves an exchange of paper between an institution and its insurer. The institution gives the insuring agency a capital instrument, called the "net worth certificate." In return, the agency gives back a promissory note of like amount. The certificate can be compared to a stock certificate, with the promissory note substituting for a cash payment for the stock. The promissory note and certificate are intended to increase the institution's assets and net worth respectively. By increasing the net worth of qualified institutions, regulatory procedures to liquidate or merge participants are forestalled, creating time for restructuring and returning to profitability. The act expires on October 15, 1985, and the assistance it authorizes is not permanent. FDIC and the Bank Board provide for their promissory notes and net worth certificates to be redeemed as institutions return to profitability or to be retired at maturity.

The concept of net worth assistance is not new. FSLIC in mid-1981 started providing capital assistance to failing savings and loan associations through an effort which was subsequently used in developing the Net Worth Certificate Act. Prior to the act, however, FSLIC could only provide assistance when an institution was in danger of default. Similarly, prior to the act, FDIC had limited authority to help prevent a troubled institution from closing: FDIC could only assist the institution if it were considered essential to the community. The new act gives FDIC and FSLIC broader authority to offer assistance.

Institutions must meet eligibility requirements

The act is primarily designed to assist depository institutions that specialize in home mortgage lending. To meet the statutory criteria for a "qualified institution," an institution must be insured and must:

--have, before assistance, net worth equal to no more than 3 percent of its assets (the eligibility ceiling), but not less than one-half of 1 percent of assets after considering the effect of assistance (the eligibility floor);[1]

--have incurred losses during the two previous quarters;

--have not incurred such losses as a result of transactions involving speculation in futures or forward contracts, management actions designed solely to obtain assistance, or excessive operating expenses;

--agree to comply with all the terms and conditions established by FDIC or FSLIC for receiving assistance; and

--have investments in residential mortgages or securities backed by such mortgages totaling at least 20 percent of its loans.

State-insured depository institutions that meet the above qualifications are eligible for assistance, provided the state insurance fund agrees to indemnify the appropriate federal insurance fund for any losses incurred by the latter as a result of providing assistance, and provided the state insurance fund maintains a specified level of assessments on its members.

The act provides a formula for determining assistance levels

The amount of net worth assistance that a qualified institution may receive is provided by a formula contained in the act. In general, the amount of assistance available is determined by a sliding scale which takes into account both the level of net worth and the actual losses of an institution. Assistance is available semiannually based on a percentage of an

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[1]Those institutions failing the eligibility floor might have little chance for survival and ultimately might be merged or liquidated.

institution's losses for two previous quarters. The act provides that FDIC and FSLIC may purchase net worth certificates in the following amounts:

If an Institution Has a Net Worth of:	Level of Assistance Is Limited to:
greater than 2 percent but no more than 3 percent,	50 percent of operating losses;
greater than 1 percent but no more than 2 percent,	60 percent of operating losses;
less than or equal to 1 percent.	70 percent of operating losses.

However, the act provides FDIC and FSLIC with discretion to depart from the assistance formula, provided that such assistance does not exceed 100 percent of the institution's operating losses.

Sunset provision

FDIC and FSLIC may purchase new net worth certificates from qualified institutions through October 15, 1985, at which time the Net Worth Certificate Act expires. Institutions with outstanding net worth certificates as of October 15, 1985, will continue participating in FDIC's or the Bank Board's program until the certificates are redeemed or cancelled.

Legislation gives agencies considerable flexibility

Although the Net Worth Certificate Act contains many specific provisions addressing its intent, the act provides FDIC and the Bank Board with nearly complete discretion to design their respective programs. Under the act the agencies can depart from the assistance formula as well as prescribe additional eligibility requirements.

OBJECTIVES, SCOPE, AND METHODOLOGY

GAO is required by section 205 of the Garn-St Germain Act to audit the net worth certificate programs on a semiannual basis and to report on each audit to each House of the Congress. This is our first written report.

The objectives of this report are to

--describe the condition of the industry that led up to the act and the developments since its passage,

--describe the design and early implementation of FDIC's and the Bank Board's programs, and

--analyze the differences in the programs and their implications.

Future reports will discuss the administration of the two programs, the degree of thrifts' participation, and the restructuring efforts in the thrift industry.

Our work was performed at the FDIC and the Bank Board in Washington, D.C. We interviewed officials from these two agencies to obtain information regarding program design and administration. We also reviewed procedures, policies, and regulations pertaining to the net worth certificate programs. To obtain some insight into the impact of net worth certificates on thrift institutions, we contacted three nationally recognized trade associations representing thrifts: the U.S. League of Savings Institutions, the National Association of Mutual Savings Banks, and the National Savings and Loan League.[2] We also contacted the National Association of State Savings and Loan Supervisors, an alliance of the 51 state and territorial savings and loan association regulators.

Certain issues related to accounting matters and their relationship to generally accepted accounting principles were discussed with officials of the American Institute of Certified Public Accountants and of the Financial Accounting Standards Board.

Because the Bank Board used two assistance formulas designed to limit assistance otherwise suggested by the act, we determined the effect of these formulas by analyzing potential assistance for 71 of the weakest savings and loan associations. From Bank Board listings containing information on 76 percent of the approximately 3,300 FSLIC-insured institutions, we identified institutions that, before considering assistance, had (1) net worth of less than 0.5 percent or (2) net worth under 3

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[2]The National Association of Mutual Savings Banks and the National Savings and Loan League in November 1983 merged into one new association, the National Council of Savings Institutions, representing thrifts.

percent, but with less than 6 months to insolvency, as projected by the Bank Board.[3]

On the basis of these criteria, we identified 71 institutions that we classified as "weak." We estimated the eligibility for and level of assistance these institutions would receive under the Bank Board's assistance formulas and, for analytical purposes, compared it to assistance levels the institutions would receive under FDIC's formula, which is similar to the act's formula. Details of the test and the results are contained in chapter 5.

Unless otherwise noted, the data on the condition of the thrift industry are current as of December 31, 1983; the program data are current as of December 31, 1983. Data on the condition of the thrift industry for the first half of 1984 were not available at the time of our review.

Our review was conducted in accordance with generally accepted government auditing standards.

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[3]Current information on 24 percent of the 3,343 total FSLIC-insured institutions as of December 31, 1982, was not available at the time of our review.

CHAPTER 2

THE THRIFT INDUSTRY BEGINS

UNCERTAIN RECOVERY

In early 1982 the condition and future prospects for the thrift industry were bleak. Since then the conditions have improved. After 2 years of large losses, the industry showed improved earnings in 1983. The decline in interest rates, which began in late 1982, has provided relief for the thrift industry. The industry, however, continues to remain vulnerable to interest rate fluctuations.

THRIFTS EXPERIENCED SUBSTANTIAL LOSSES IN 1981 AND 1982

Thrifts in 1981 and 1982 experienced their worst difficulties since the 1930's Depression. During these 2 years, FSLIC-insured savings and loan associations and FDIC-insured savings banks experienced losses totaling $11.6 billion, and their net worth declined by $9.1 billion, a 22-percent decrease. In addition, during 1981 and 1982, 730 savings and loan associations--1 out of every 6--were either merged or liquidated. By comparison, in 1980 only 105 institutions were merged or liquidated.

The crisis in 1981 and 1982 occurred because thrifts had assets consisting primarily of long-term, fixed-rate mortgages, which yielded lower rates of return than the interest the institutions had to pay to attract deposits. Many thrift institutions that were borrowing short and had for years loaned long at fixed rates found their net worth declining rapidly and consistently, primarily because of two factors. First, the high and volatile interest rates in 1980 and 1981 caused thrifts' costs of funds (the liability side of their balance sheet) to exceed the return on their fixed rate mortgage loans (the asset side of their balance sheet), many of which had been originated in a lower interest rate environment. Second, the competition for deposits heightened, due in large part to the rapid flow of thrifts' pass-book deposits into the money market mutual funds. In passing the Garn-St Germain Act the Congress addressed the need for thrifts to broaden their asset powers and become more competitive in attracting deposits. (See pp. 1 and 2.)

The prosperity that thrifts enjoyed in the 1970s, the severity of the ensuing crisis starting in 1980, and the improved earnings in 1983 are shown in the following table:

Net Income/Loss & Net Worth Ratio
For Insured
Thrift Institutions
From 1977 Through 1983

	FDIC-insured savings banks			FSLIC-insured institutions[a]		
Year	Number of institutions	Net income (millions)	Net worth to assets (percent)	Number of institutions	Net income (millions)	Net worth to assets (percent)
1977	323	$ 682	6.40	4,065	$3,198	5.45
1978	325	809	6.53	4,053	3,918	5.51
1979	324	649	6.69	4,039	3,620	5.58
1980	323	-249	6.25	4,002	784	5.26
1981	331	-1,448	5.36	3,779	-4,632	4.27
1982	315	-1,229	4.79	3,343	-4,271	3.66
1983	294[b]	-127[b]	4.83[b,c]	3,183	2,005	4.03[c]

[a]Prior to 1983, substantially all FSLIC-insured institutions were savings and loan associations. At the end of 1983, FSLIC-insured institutions included 3,040 savings and loan associations and 143 savings banks.

[b]Preliminary data as of August 31, 1984

[c]The net worth ratios in 1983 include net worth certificates and, for FSLIC-insured institutions, other regulatory items that were not included in prior years. The addition of net worth certificates and other regulatory items in 1983 complicates comparison to previous years.

THRIFTS SHOWED SIGNS OF IMPROVEMENT IN 1983

After 2 years of heavy losses, FSLIC-insured institutions returned to profitability in 1983, reporting $2.005 billion net income. The improved earnings are primarily attributable to interest rates that sharply declined starting in the second half of 1982 from their previously high levels. Rates on 6-month Treasury bills on average were more than 2 percentage points lower in 1983 than in 1982. However, despite increased earnings, the Chairman of the Bank Board cautioned that the industry remains vulnerable to interest rate fluctuations.

During the first half of 1983, FDIC-insured savings banks reported a net income of $31.7 million and appeared to be on the road to profitability because of lower interest rates. However, due in part to a moderate upswing in interest rates in the latter half of 1983, which contributed to a higher cost of funds, FDIC-insured savings banks were unable to sustain profitability for the year. Rates on 6-month Treasury bills rose from an average of 8.32 percent for the first half of the year to an average of 9.14 percent for the second half of the year. Although FDIC-insured savings banks reported a $127 million net loss for the year as a whole, the loss was significantly less than those in 1981 and 1982.

OUTLOOK FOR THRIFTS IS UNCERTAIN

While FDIC- and FSLIC-insured thrifts collectively returned to profitability in 1983, federal regulators and industry representatives caution that the outlook for the thrift industry is uncertain. Despite the improved overall performance, 35 percent of the 3,183 FSLIC-insured institutions and 23 percent of the 294 FDIC-insured savings banks were still reporting losses during 1983. The thrift industry remains vulnerable to rising interest rates.

In December 1982, when FDIC announced its net worth certificate program, the Chairman of FDIC was optimistic about earnings prospects for the savings bank industry. The Chairman stated that if interest rates remained at the levels existing in December 1982, the savings bank industry as a whole would return to profitability by March 1983, and institutions receiving net worth certificates would be profitable during the 3-year life of the program.

Although interest rates remained relatively stable in early 1983, they began to rise in June and rose moderately in the second half of the year. While this increase was not as sharp as in 1980 and 1981, regulators and industry representatives began voicing concerns.

In an August 1983 speech, the President of the National Association of Mutual Savings Banks called rising interest rates

> "disturbing, raising concerns that thrift institutions and housing markets will again come under increasing pressures. . . . thrift institutions are increasingly vulnerable to a future rise in interest rates."

What mutual savings banks must do in the future, he said, is

> "to bring the asset side of the balance sheet into balance with the liabilities side, by restructuring portfolios in the direction of shorter-term, more interest-sensitive loans and investments. For those [savings banks] who do not use the present window of opportunity, the next wave of high interest rates could be the last."[1]

CONCLUSION

Although financial data for 1983 show some improvements in thrift industry earnings, the future is uncertain. As discussed in the next two chapters, the net worth certificate programs of FDIC and the Bank Board are designed to provide time for weakened thrifts to restructure their operations for survival in a changing, deregulated environment. The extent to which thrifts can restructure their operations and achieve long-term survival will need to be continually evaluated.

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[1]Remarks by the President of the National Association of Mutual Savings Banks at the 1983 Conference of the Society of Real Estate Appraisers, Honolulu, Hawaii, August 1, 1983.

CHAPTER 3

FDIC PROGRAM ADHERES CLOSELY TO LEGISLATED PARAMETERS

FDIC's net worth certificate program generally follows the parameters for assistance set forth in the act. FDIC designed its program to maximize the amount of assistance available to a qualified institution, although it does have strict operating terms and conditions that thrifts must comply with. In addition, in conjunction with its program, FDIC actively encourages institutions eligible for or receiving its capital assistance to seek mergers with healthier institutions.

FDIC IMPLEMENTED ITS PROGRAM QUICKLY

Without issuing formal regulations, FDIC announced the establishment of an "FDIC Capital Assistance Plan," effective December 7, 1982. By the end of the month, FDIC had granted assistance to 15 savings banks. At the time, FDIC's insurance fund totaled $13.8 billion.

The principal features of FDIC's program are as follows:

--The net worth certificate as defined by FDIC will be subordinated and considered part of an institution's capital account.

--FDIC will purchase certificates from qualified institutions every 6 months for the 3-year life of the program.

--Net worth certificates will be retired on the basis of an institution's future earnings.

--FDIC will not purchase certificates when it believes mismanagement or unsafe activities exist.

--FDIC assistance generally conforms with the assistance formula provided in the act and is available to any qualified institution whose net worth ratio is 3 percent or less before providing assistance and not less than 0.5 percent of assets after considering the effect of assistance.

FDIC PROVIDES ASSISTANCE SUGGESTED BY THE ACT

FDIC uses the assistance formula provided in the Net Worth Certificate Act but, in addition, caps assistance so that an institution's net worth after assistance cannot exceed 3 percent of assets. The assistance formula in the act provides for maximum assistance at 70 percent of an institution's losses. However, the act gives the agencies "sole discretion" to depart from the formula, as long as the assistance does not exceed 100 percent of an institution's losses.

The assistance authorized under the act could allow an institution's net worth ratio, after including assistance, to rise above 3 percent, the upper limit for eligibility. Neither FDIC nor the Bank Board, however, will permit this situation to occur. If applying the assistance formula would increase an institution's net worth to above 3 percent, FDIC will reduce the assistance and limit it to an amount that brings the institution's net worth to 3 percent. In addition, neither FDIC nor the Bank Board will, as a general rule, provide assistance beyond the 70-percent maximum provided for in the act's formula.

FDIC and the Bank Board imposed the cap on assistance to assure that participants would not have an unfair advantage over nonparticipants. The agencies did not want to give participants the opportunity to increase their net worth to a level higher than their competitors, whose net worth may have been just over 3 percent and who were therefore ineligible for assistance.

FDIC'S ASSISTANCE ENTAILS CASHLESS TRANSACTIONS

The Net Worth Certificate Act did not specify the exact nature of either the promissory note to be issued by FDIC and the Bank Board, or the capital instrument, referred to as a "net worth certificate," to be issued by a qualified institution. The act provides FDIC and FSLIC with the discretion to design their own net worth certificates as well as the consideration[1] used to purchase the certificates.

FDIC designed a net worth certificate that acts as an equity instrument. The certificate is treated as net worth for regulatory purposes by the issuing institution, is issued in a specific principal amount, and is redeemable when an institution returns to profitability. However, if the certificate is not redeemed and remains outstanding 7 years after issuance, FDIC can demand that it be retired.

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[1]In law, consideration is the benefit that a contracting party derives when the party enters into a contract. Consideration must be present for a contract to be valid.

As consideration for the net worth certificate, FDIC designed an FDIC promissory note. The note is treated by the institution receiving it from FDIC as an asset for regulatory purposes. The note is nonnegotiable and nonassignable; it is only redeemable when the certificate principal is redeemed. If an institution fails, the note becomes payable in cash and is available to general creditors as part of the liquidation process. Both the FDIC promissory note and the institution's net worth certificate provide for the payment of interest quarterly at an equivalent rate.[2]

By design, as long as an institution remains viable, FDIC's assistance is cashless. The exchange of the note and certificate is a paper exchange which raises an institution's regulatory net worth without providing cash. The quarterly payment of interest on the note by FDIC and on the certificate by the institution is also cashless. Both the FDIC and the institution earn interest income and incur interest expense in equal amounts which offset each other on the income statement.

Similarly, when an institution becomes profitable and must make a required principal payment on its net worth certificate, it triggers a corresponding principal payment by FDIC on its note. The principal payment is cashless and is handled through accounting transactions. Both FDIC and the institution reduce the net worth certificate and promissory note on their respective books by the amount of the required principal payment.

When reporting to FDIC for regulatory purposes, an institution participating in the net worth certificate program treats the FDIC note as an asset and its net worth certificate as equity. (However, as we explain in ch. 6, this accounting treatment for the note and certificate is not recognized under generally accepted accounting principles for general purpose financial reporting to the public.)

FDIC IMPOSES STRICT OPERATING TERMS AND CONDITIONS

One way in which FDIC used its discretion under the legislation was to establish operating terms and conditions that an institution must meet to participate in FDIC's program. To qualify for assistance under FDIC's program, an institution must have met or agreed to various operating terms and conditions, including:

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[2]As defined by FDIC, interest on both the promissory note and net worth certificate accrues quarterly, at a rate tied to the average equivalent coupon issue yield on the U.S. Treasury's 52-week bill auction held immediately prior to the beginning of a calendar quarter, plus 1/2 of 1 percent.

--submitting a comprehensive business plan outlining strategies and operating plans;

--not acquiring more than 5 percent interest in any corporation, partnership, or any other type of operating entity without the prior approval of FDIC;[3]

--cancelling senior management employment contracts over 12 months in duration;

--cancelling severance pay contracts for amounts in excess of 6 months' salary;

--agreeing to change in charter or ownership form when requested by FDIC; and

--considering all reasonable merger opportunities.

The purpose of requiring the business plan is to have institutions develop broad strategies and detailed plans for returning to profitability. The plan must address both income generation and cost reduction. In addition, FDIC requires institutions to routinely report and explain subsequent performance that significantly deviates from the business plans' projections. The Bank Board, as discussed in the next chapter, also requires institutions to develop a business plan as a condition for net worth certificate assistance.

The requirement limiting employment contracts and severance pay is intended to prevent savings bank managers from developing expensive contracts to assure their own security. Costly employment contracts and severance pay arrangements of long duration can be an impediment to a potential merger partner that may have to assume the costs.

FDIC ENCOURAGES VOLUNTARY MERGERS

While one intention of the Net Worth Certificate Act is to forestall forced mergers, FDIC believes that additional mergers would enhance the viability of some institutions as well as the

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[3]In December 1983, FDIC revised this condition to require that an institution must obtain prior approval of FDIC to: (1) acquire more than 1 percent ownership interest in any depository institution; and (2) invest more than 5 percent of its net worth in any corporation, partnership, or other type of operating entity.

overall strength of the savings bank industry. Accordingly, to supplement its net worth certificate program, FDIC developed a "voluntary merger plan" to encourage, but not force, mergers between financially sound institutions and institutions eligible for or receiving net worth certificate assistance. As an incentive to facilitate voluntary mergers, FDIC offers to provide financial assistance. This assistance may include interest bearing notes, cash, "or any other form agreed to by FDIC."

If an institution submits a merger proposal to acquire another institution eligible for or receiving net worth certificate assistance, and the proposal involves tangible FDIC assistance, FDIC will attempt to determine whether other institutions can accomplish the merger at lower cost to FDIC. If FDIC obtains a less costly merger offer, the institution to be dissolved is not required to accept the less costly merger proposal: it can reject the proposal and still be eligible for net worth certificate assistance, and can then proceed with the original merger offer.

FDIC prefers that institutions eligible for or receiving net worth certificate assistance merge with stronger institutions <u>not</u> receiving it. However, FDIC will give additional assistance under its voluntary merger plan to two merging institutions, both eligible for or receiving net worth certificate assistance, if the merger will result in a stronger institution. As of December 31, 1983, three institutions, after receiving net worth certificate assistance, subsequently merged with other institutions under the voluntary merger plan.

<u>NET WORTH CERTIFICATE ASSISTANCE PROVIDED AS OF DECEMBER 31, 1983</u>

When FDIC announced its program on December 7, 1982, it estimated that 35 institutions would be eligible for assistance during the program's first year, and a total of 40 to 60 institutions during the program's 3-year life. As of December 31, 1983, FDIC had exchanged its promissory notes for net worth certificates from 25 savings banks, totaling $378,706,657.

FDIC Promissory Notes Exchanged for Net Worth Certificates Through December 31, 1983

Promissory notes and net worth certificates exchanged in:	Number of exchanges	Amount of notes and certificates exchanged
Dec. 1982--for losses incurred 2nd and 3rd quarters 1982	15	$174,529,065
March 1983--for losses incurred 3rd and 4th quarters 1982	6	20,956,192
June 1983--for losses incurred 4th quarter 1982 and 1st quarter 1983	18[a]	110,643,853
Sept. 1983--for losses incurred 1st and 2nd quarters 1983	5[b]	9,273,101
Dec. 1983--for losses incurred 2nd and 3rd quarters 1983	16[c]	$ 63,304,446
Total	60[d]	$378,706,657

[a]Includes 3 savings banks receiving net worth certificate assistance for the first time and 15 savings banks receiving a second round of assistance.

[b]Represents five savings banks receiving a second round of assistance.

[c]Includes 1 savings bank receiving net worth certificate assistance for the first time, 2 savings banks receiving a second round of assistance, and 13 savings banks receiving a third round of assistance.

[d]Represents 25 individual savings banks receiving net worth certificate assistance.

The amount of promissory notes and certificates outstanding as of December 31, 1983, is less than the total amount exchanged. Two savings banks retired certificates amounting to $1,840,900 because the banks were merged with other depository institutions. After deducting the retired certificates, FDIC had net worth certificates of $376,865,757 outstanding from 23 savings banks. The outstanding net worth certificates ranged from a low of $364,899 to a high of $111,700,000, and the median amount was $5,709,000. Since none of the institutions participating in the program has failed, FDIC has not been required to make any cash payments on its promissory notes.

Geographically, FDIC holds certificates from institutions located in New York, New Jersey, and Pennsylvania, as shown in the following table.

FDIC Promissory Notes And
Net Worth Certificates Outstanding
By State
Through December 31, 1983

Location	Number of savings banks	Amount of notes/ certificates outstanding
New York City	11	$339,013,921
Other New York State	8	12,263,531
All New York State	19	$351,277,452
Pennsylvania	3	21,891,105
New Jersey	1	3,697,200
All locations	23	$376,865,757

The relatively high number of savings banks in New York State with outstanding net worth certificates can be attributed to two factors. First, approximately 59 percent of the savings banks potentially eligible for assistance under FDIC's program as of December 31, 1982, were located in New York. Second, the act exempts qualified institutions from state and local taxes (determined on the basis of deposits held or the interest paid on such deposits) as long as they have net worth certificates outstanding. New York State and New York City have such taxes, and FDIC officials told us that the tax exemption provision was an incentive that increased program participation in New York.

As of December 31, 1983, FDIC had denied assistance to one institution, and three institutions had withdrawn their applications. FDIC denied assistance in the one instance because the institution's net worth-to-asset ratio was greater than 3 percent after FDIC had disallowed operating losses attributable to mismanagement.

CHAPTER 4

THE BANK BOARD USES ITS DISCRETION

TO PROTECT INSURANCE FUND

Faced with a relatively greater potential threat to a smaller insurance fund than FDIC's, the Bank Board designed a somewhat conservative net worth certificate program. The Bank Board's operating terms and conditions for thrifts are strict and its assistance formulas were designed to provide smaller amounts to institutions than FDIC's formula.

THE BANK BOARD TRIES TO PROVIDE ASSISTANCE WHILE PROTECTING ITS INSURANCE FUND

As we pointed out in our recent report on the FSLIC insurance fund, FSLIC has thus far successfully weathered a significant challenge to the financial condition of the fund.[1] The severe potential strain on the fund was one of the most important factors that the Bank Board had to consider when it designed its net worth certificate program. On the other hand, the industry that it supervised--the savings and loan industry--was suffering a $7 billion decline in net worth in 1981 and 1982.

The Bank Board, when designing its program, faced a greater threat to its insurance fund than FDIC. At the inception of its program in December 1982, FDIC stated that 40 to 60 savings banks would be eligible for net worth certificates during the program's 3-year life. In contrast, the Bank Board estimated much higher numbers of institutions that might be eligible for assistance under its program. When the financial condition of the thrift industry was at a low point, the Bank Board in May 1982 estimated that more than 1,430 of its institutions would be eligible for assistance. Subsequently, as interest rates dropped, the Bank Board revised its estimates downward. In March 1983, the Bank Board estimate of eligible institutions dropped to about 800, and in May 1983, to about 500.

Not only did the Bank Board have to plan for a larger number of eligible institutions, but it also had a smaller insurance fund to protect. As of December 31, 1982, FDIC's insurance fund totaled $13.8 billion, whereas the Bank Board's FSLIC insurance fund was $6.3 billion.

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[1] The FSLIC Insurance Fund--Recent Management and Outlook for the Future (GAO/GGD-84-3, Oct. 14, 1983).

Consequently, some of the premises underlying the Bank Board program, according to a former Bank Board General Counsel, are as follows:

--"There should be every incentive for institutions not to participate in the program, or if they do . . . to graduate from it as quickly as possible. Therefore, participants should expect a certain degree of increased regulatory restraints and general operating discomforts;

--"Participants in the program should not be permitted to use their assistance to undercut the competitive position of institutions not receiving assistance through excessive advertising, unjustifiable expansion, predatory pricing, and excessive operating expenses;

--"To the extent possible, institutions must remain susceptible to natural market forces. Thus, assistance will be based upon an institution's current, not past, financial condition; and, finally,

--"Net worth certificates are not a solution, but a means to a solution. They will simply provide time for institutions to restructure and adopt business plans that seek to mitigate interest rate risk through gap management. An institution's ability to develop a successful business plan and stick to it will be the basic regulatory action. For the good of the industry, institutions that are not viable should not be artificially sustained."[2]

In accordance with these premises, the specific Bank Board administrative requirements and assistance formulas outlined below significantly augmented the basic provisions of the Net Worth Certificate Act.

THE BANK BOARD'S OPERATING TERMS AND CONDITIONS, LIKE FDIC'S, ARE STRICT

To be eligible for net worth certificate assistance, an institution must meet both the requirements set out in the act and additional administrative requirements established by the Bank Board in accordance with its discretionary authority. To receive assistance from the Bank Board, an institution must

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[2]Remarks by the General Counsel of the Federal Home Loan Bank Board, at the Ninetieth Annual Convention of the United States League of Savings Associations, New Orleans, Louisiana, November 16, 1982.

--be able to remain solvent for at least 6 months (after considering the effect of net worth certificate assistance);

--recognize and include in its net worth an item called "appraised equity capital" (AEC), essentially the difference between the appraised fair market value and the net book value (cost at acquisition less depreciation where applicable) of office land, buildings, and improvements;

--agree to comply with certain operating terms and conditions while receiving net worth certificate assistance; and

--certify that it does not have available a merger that would reduce or eliminate the need for net worth certificate assistance.

Although the operating terms and conditions that an institution must comply with are stringent, they are intended to help institutions return to profitability. An institution must

--submit a business plan that includes operating and financial plans and asset-liability management plans;

--agree in writing to comply with all supervisory requests while on assistance, including outstanding supervisory directives;

--agree not to open new branches;

--agree not to relocate existing branches without approval;

--agree not to pay cash dividends as long as certificates are outstanding;

--agree to a limitation on capital expenditures;

--agree not to enter into new service contracts with parent holding companies and not to revise existing service contracts without approval; and

--agree in writing to the Bank Board's method of calculating insolvency.

After meeting all statutory and administrative requirements, an institution is considered "qualified" and may receive net worth certificate assistance in accordance with the Bank Board criteria for determining assistance amounts.

THE BANK BOARD ESTABLISHED TWO FORMULAS FOR ASSISTANCE

For the first year and a half of its program, the Bank Board used two assistance formulas--one for an institution's first application for assistance (called "initial assistance") and one for subsequent assistance. The Bank Board's assistance formulas differed from the one provided in the act in three ways. First, for both initial and subsequent assistance, the Bank Board, like FDIC, capped assistance so that an institution's net worth could never exceed 3 percent after including assistance. Second, for both initial and subsequent assistance, the Bank Board used a tiered calculation (as explained below) and rounded assistance amounts to the nearest $25,000. Third, for initial assistance only, the Bank Board used percentage rates equal to one-half of those specified in the act's formula, a significant departure. To understand the impact of this departure, it is helpful to first understand how the subsequent assistance formula functioned.

The subsequent formula used a tiered calculation and capped assistance

The amount of net worth certificate assistance that the Bank Board would provide to a qualified institution was based on the institution's (1) operating loss for a semiannual period[3] and (2) its ratio of net worth to assets at the end of the semiannual period. For subsequent assistance, the Bank Board used the full assistance percentages allowed by the act's formula but used a tiered calculation and capped assistance at 3 percent.

As depicted on page 4, the act suggests, through an assistance formula, that the agencies cover 70, 60, or 50 percent of an institution's applicable losses, depending on whether its net worth is less than or equal to 1 percent, greater than 1 percent but no more than 2 percent, or greater than 2 percent but no more than 3 percent, respectively. But the Bank Board used the percentages as illustrated in the following example.

Suppose a qualified institution has a net worth before assistance of less than 1 percent. For subsequent assistance, the Bank Board first would cover 70 percent of the losses up to the point at which it would bring the net worth after assistance to 1 percent. Then it would cover 60 percent of any remaining losses until the net worth reached 2 percent. Finally, if any

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[3]The act requires that an institution must have "incurred losses during the two previous quarters" to qualify for assistance. The Bank Board has interpreted this requirement to mean a loss for a semiannual period rather than two losses for two quarters.

losses still remained, 50 percent would be covered only up to the point at which the institution's net worth reached 3 percent. Similarly, if an institution applying for assistance has a net worth greater than 1 percent, the tiering calculation would start at 60 or 50 percent, whichever is appropriate.

The Bank Board's subsequent assistance formula, compared to the assistance allowed by the act's formula and available under FDIC's program, tended to decrease the amount of assistance available to qualified institutions. The act does not provide for the tiering calculation, nor for capping assistance at 3 percent net worth. FDIC, while capping assistance at a 3 percent net worth level, does not use a tiering calculation when determining assistance amounts.

The initial formula provided assistance at one-half the level suggested by the act

The assistance formula discussed above applied to institutions applying for subsequent assistance. When an institution first applied for assistance, the Bank Board provided it at one-half the rates allowed by the act's formula.

In calculating the amount of assistance to be provided, the Bank Board divided the assistance percentages in half to 35, 30, and 25; it then applied these percentages using the tiered calculation and the capping of assistance at a 3 percent net worth ratio. According to the Bank Board, it imposed the one-half limit because operating controls it requires of institutions as a condition for net worth certificate assistance were not in effect when institutions first entered the program. Accordingly, the Bank Board decided to cover losses at a one-half rate. Once operating controls were agreed to, the Bank Board provided all subsequent assistance at the full rates allowed under the act's formula using the Bank Board's tiered calculation.

The Bank Board's initial assistance formula departed significantly from the assistance formula provided in the Net Worth Certificate Act, but was within the Bank Board's discretionary authority. The initial assistance formula reduced the amount of assistance provided to qualified institutions.

Recently, the Bank Board recognized the need to provide greater amounts of assistance to troubled thrifts. By regulations effective September 4, 1984, the Bank Board eliminated the initial assistance formula and the tiering calculation. For all assistance after that date, the Bank Board regulations provide for assistance at the maximum 70 percent suggested by the act, with a capping of assistance at a net worth level of 3 percent.

APPRAISED EQUITY CAPITAL COUNTS AS NET WORTH UNDER THE BANK BOARD'S PROGRAM

The Net Worth Certificate Act does not define net worth, leaving it to the discretion of FDIC and FSLIC. The Bank Board has defined net worth for its net worth certificate program to include a significant item--appraised equity capital (AEC).[4] The inclusion of AEC in net worth is a prerequisite for institutions seeking net worth certificate assistance. For any other Bank Board institution not participating in the net worth certificate program, the inclusion of AEC in net worth is optional. The Bank Board views AEC as a capital assistance program which is used in conjunction with or in lieu of its net worth certificate program. AEC, for regulatory purposes, increases the net worth of an institution: that is, it raises the value of an institution's total assets by the amount of the unrealized equity of an institution's office land, buildings, and improvements. (Equity refers to market value less net book value.) The resulting increase in net worth might forestall regulatory actions in the same way as net worth certificate assistance. While used for regulatory purposes, AEC is not recognized as part of net worth under generally accepted accounting principles and is also not recognized by FDIC under its program. (See ch. 6.)

AEC causes some institutions that might otherwise be under the qualifying ceiling--3 percent or less net worth before assistance--to exceed it, and it also causes a smaller number which fall short of the qualifying floor--0.5 percent net worth after considering the effect of assistance--to rise above it. The net effect of AEC is to reduce the total number of eligible institutions.

The Bank Board requires an institution to include AEC in its net worth as a prerequisite to net worth certificate assistance. In the Bank Board's view, the built-up equity that an institution has in its office land and buildings provides additional information on the financial condition of an institution. With AEC included in net worth, and defined as "regulatory net worth," the Bank Board states that it can better judge the amount of assistance it should provide to an institution.

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[4]The Bank Board defines AEC as (1) the unrealized and unrecorded equity in office land, buildings, and improvements (including leasehold improvements) owned by the insured institution or a subsidiary thereof, (2) the unamortized deferred profits originating from the sale and leaseback of office properties formerly owned by the insured institutions or the subsidiary thereof, and (3) the value of leasehold interests.

AEC reduces the number of projected eligible institutions and total amounts of assistance

According to the Bank Board projections as of May 1983, including AEC in institutions' net worth reduces both the projected number of institutions eligible for net worth certificate assistance and the projected amount of assistance. The following table shows the Bank Board projections with and without AEC included:

Bank Board Projections of Eligible Institutions and Total Amounts of Assistance With and Without AEC

	Projected assistance by year end 1983		Projected assistance by year end 1985	
	Number of eligible institutions	Amount of assistance (millions)	Number of eligible institutions	Total amount of assistance (millions)
Without AEC	427	$293	624	$1,041
With AEC (as required under under the Bank Board's program)	302[a]	234	528[a]	1,036
Difference (Impact of AEC)	125	$ 59	96	$ 5

[a]This represents the number of institutions estimated as of May 1983, to be eligible for assistance. However, the actual number applying has been considerably smaller than the number projected to be eligible. (See pp. 28 and 29.)

While the above projections cannot be readily updated, they can still be significant in demonstrating the extent to which AEC reduces the number of eligible institutions. The Bank Board's projection that AEC will reduce the number of eligible institutions in 1983 by 125, as shown in the above table, results from a combination of two of the act's requirements. The act precludes providing assistance to institutions with a net worth ratio over 3 percent. If an institution, before assistance, has a net worth ratio of 3 percent or less without AEC, and the inclusion of AEC raises the net worth to above 3 percent, the institution becomes ineligible for assistance. However, AEC has the opposite effect of making exceptionally weak institutions eligible. The act provides that institutions, after considering assistance, must have at least a 0.5 percent net worth ratio to receive assistance. By increasing their net worth, AEC can help institutions with low net worth pass the 0.5 percent eligibility test. The net effect of AEC in making some institutions ineligible and others eligible is a net reduction of 125 potentially eligible institutions for 1983, according to the Bank Board. (Ch. 5 further demonstrates how AEC provides eligibility to exceptionally weak institutions.)

THE BANK BOARD GIVES ASSISTANCE WITH SOME CASH TRANSACTIONS

The Bank Board has designed a net worth certificate and promissory note similar to the instruments used in its former income capital certificate program. Like the FDIC program, the Bank Board program treats an institution's certificate as an equity instrument on the institution's books. According to the Bank Board, the certificate is similar in function to preferred stock. In exchange for the certificate, the institution receives a FSLIC nonnegotiable promissory note that it treats as an asset. Both the note and the certificate provide for the payment of interest and dividends at the same rate,[5] and the note is payable in cash at maturity, generally 10 years after issuance. If the institution fails, the note becomes payable to general creditors as part of the liquidation process.

Unlike FDIC's promissory note and certificate, the Bank Board's provide for cash interest, dividend, and principal payments. Because the cash payments on the FSLIC note and the payments on the certificate do not offset each other, and because of other requirements, discussed below, there is an infusion of cash to unprofitable institutions and an outflow of cash as institutions return to profitability.

The FSLIC promissory note unconditionally provides semi-annual cash interest payments to institutions. However, the net worth certificate issued by a thrift does not require cash dividend and principal payments to the Bank Board until the institution has earned net income. Thus, for institutions that have no net income, the FSLIC note provides a net infusion of cash.

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[5]Interest on the promissory note and dividends on the net worth certificate are based on the Bank Board's own standardized financing costs, a variable 6-month yield on its obligations.

As of January 31, 1984, the Bank Board made cash interest payments totaling $6,699,403 to 58 institutions for interest earned during 1983. Some institutions received multiple interest payments while others received a single payment, depending upon the number of FSLIC promissory notes purchased and the effective dates of the notes. The payments ranged from a low of $2,256 to a high of $1,998,023, with a median payment of $26,185. Two institutions received 53 percent of the interest payments because they had large amounts of net worth certificates outstanding.

Once institutions return to profitability and increase their net worth to certain levels, they are required to redeem their net worth certificates by making annual principal and dividend payments. In contrast, the Bank Board, while required to make semiannual interest payments to institutions, is not required to make periodic principal payments to redeem its FSLIC notes. Rather, the notes can remain outstanding until maturity, generally 10 years after issuance, and may be redeemed by the Bank Board in a lump sum payment. Accordingly, as institutions return to profitability, their annual payments to FSLIC can, when profits become large enough, start to exceed the periodic interest payments they receive from the Bank Board.

When reporting to the Bank Board for regulatory purposes, an institution participating in the net worth certificate program treats the FSLIC promissory note as an asset and its net worth certificate as equity. (However, as we explain in ch. 6, the promissory note and net worth certificate as designed by the Bank Board have tentatively been determined not to be an asset and equity under generally accepted accounting principles for general purpose financial reporting to the public.)

THE BANK BOARD EXPERIENCED PROGRAM START-UP PROBLEMS

Following passage of the act on October 15, 1982, the Bank Board quickly issued comprehensive regulations, effective December 31, 1982, governing its program, and in January 1983 made available a comprehensive booklet for institutions to use in applying for net worth certificate assistance. After designing its program, the Bank Board experienced some problems which delayed processing of applications.

The Bank Board in the early months of the program approved relatively few applications and issued few notes. From January through April 1983, the Bank Board received 95 applications from institutions requesting net worth certificate assistance, with 56 of the applications received in February. During that 4-month period, the Bank Board acted upon 13 of the 95 applications--4 were approved for assistance and 9 were withdrawn or denied. The remaining 86 applications were in process. In May

1983, the Bank Board issued its first promissory notes to five institutions and in June began to provide net worth certificate assistance at a faster rate.[6]

The processing delays resulted from two of the Bank Board's administrative requirements--approval of institutions' AEC and submission of business plans as conditions of assistance. When institutions first began submitting required property appraisals in support of AEC as part of their applications for assistance, Federal Home Loan banks began rejecting appraisals for technical reasons. Some appraisals were rejected because they did not reflect highest market value according to Bank Board criteria; some applications were delayed because of confusion about when business plans were required--before or after assistance was granted--and about their content. In June 1983, the Bank Board took steps to eliminate the bottleneck of pending applications. The Bank Board issued new guidelines for approving AEC and the program administrator issued new guidance for approving business plans.

In addition, Bank Board officials told us that a large turnover of senior management in the first half of 1983 was also a factor in delaying implementation of the program.

NET WORTH CERTIFICATE ASSISTANCE PROVIDED AS OF DECEMBER 31, 1983

While the Bank Board projected a large number of thrift institutions eligible for net worth certificate assistance, the actual number choosing to participate in the first year of the program has been significantly lower. The Bank Board made several estimates of the number of institutions eligible for assistance when the act was being considered and when the program was being designed. In May 1983, the Bank Board estimated that about 300 institutions would be eligible for assistance during the first year, and a total of about 500 during the

[6]In December 1982 the Bank Board uniquely provided net worth certificate assistance to two institutions. These institutions had outstanding certificates under a previous capital assistance program and were under FSLIC control. Outside the application process, the Bank Board provided assistance of $37.5 million by (1) substituting the outstanding certificates of $13 million issued under the prior program for equivalent net worth certificates and (2) purchasing new net worth certificates of $24.5 million. The primary reason for the quick action for these two institutions was to allow exemption from state tax on deposits, as authorized by the act.

program's 3-year life. However, through December 31, 1983, 64 institutions have chosen to participate in the Bank Board's net worth certificate program.

While a future report will address the reasons for the low level of program participation, preliminary data, based on questionnaires sent to eligible institutions, indicate that both economic and program factors have tended to significantly limit program participation. The Bank Board informed us that it was reevaluating its program to identify ways in which participation in it could be made more readily available to troubled thrifts.

The 64 institutions participating in the Bank Board's program exchanged their net worth certificates for Bank Board promissory notes totaling $88,875,000 as of December 31, 1983. Since none of these institutions failed, the Bank Board has not been required to make any cash payments on its promissory notes as part of the liquidation process. However, two institutions merged and a third was acquired by another thrift institution. The net worth certificate assistance for these institutions was retained by the surviving institutions.

The promissory notes and net worth certificates exchanged between the Bank Board and the 64 institutions ranged from a low of $25,000 to a high of $20 million, with a median purchase of $450,000. The 64 institutions were located in 23 states, as shown in the following table.

The Bank Board's Promissory Notes and Net Worth Certificates Outstanding By State Through December 31, 1983

State	Number of institutions	Amount of notes and certificates outstanding
California	1	$ 450,000
Georgia	2	1,825,000
Illinois	10	7,775,000
Indiana	3	650,000
Iowa	2	850,000
Kansas	2	500,000
Kentucky	1	425,000
Louisiana	3	500,000
Maryland	1	75,000
Massachusetts	1	150,000
Michigan	2	1,075,000
Mississippi	1	175,000
Missouri	3	925,000
Montana	1	175,000
Nebraska	3	7,050,000
New Jersey	8	5,500,000
New York	14	53,650,000
North Carolina	1	675,000
Ohio	1	2,225,000
Rhode Island	1	825,000
Texas	1	600,000
Virginia	1	1,275,000
Wisconsin	1	1,525,000
Total	64	$88,875,000

As of December 31, 1983, the Bank Board had denied assistance to 20 institutions. Among the reasons given most often by the Bank Board for denying assistance were:

--the thrift's failure to have at least a 0.5 percent net worth-to-asset ratio after considering the effect of net worth certificate assistance;

--the thrift's failure to submit an application within the filing deadline; and

--the existence of a pending merger offer, which would reduce or eliminate the need for net worth certificate assistance.

CONCLUSIONS

The Bank Board designed a relatively conservative net worth certificate program that was intended to provide assistance while protecting the FSLIC insurance fund. Given the condition of the savings and loan industry at the time the program was designed, the Bank Board's intentions were understandable. However, the large gap between the number of institutions the Bank Board projected as eligible and the much smaller number of institutions actually participating suggests that the Bank Board's program should be evaluated as the program progresses to assess its effectiveness in helping troubled thrift institutions.

AGENCY COMMENTS

In commenting on a draft of this report (see app. II), the Bank Board stated that it was reevaluating its net worth certificate program to make it more readily available to distressed thrifts. Specifically, the Bank Board stated that it was studying

> "the possibility of providing full assistance in the initial cycle; relaxing appraised equity capital requirements and the stockholder approval requirement; reducing operating restrictions; eliminating the 'three tier' method of calculating assistance amounts; and modifying the repayment provisions."

Following its study, the Bank Board issued regulations, effective September 4, 1984, revising its net worth certificate program to provide greater net worth certificate assistance to troubled thrifts and to promote a more efficient program. We changed our report on page 23 to reflect the new Bank Board regulations. We plan to discuss the Bank Board's changes more fully in a future report.

On another matter, the Bank Board pointed out that it has provided assistance beyond 70 percent of losses on an exception basis to help minority institutions qualify for assistance, and in other exceptional cases. In addition, the Bank Board stated that its rounding of assistance to the nearest $25,000 may result in assistance percentages greater than 70 percent.

CHAPTER 5

DIFFERENCES BETWEEN FDIC'S AND THE BANK BOARD'S PROGRAMS CAN RESULT IN LIKE INSTITUTIONS BEING TREATED DIFFERENTLY

Using broad discretionary authority contained in the act, FDIC and the Bank Board developed significantly different net worth certificate programs. As a result, two financially similar institutions--one, a savings bank insured by FDIC and the other a savings and loan association insured by FSLIC--are treated differently. These differences affect eligibility and, until recently, significantly affected assistance amounts provided to qualified thrifts. We analyzed the differences to demonstrate the extent of their effect on institutions and therefore the effect of the discretion allowed to agencies under the act. Our review showed that, overall, more Bank Board institutions would qualify for assistance and, prior to recent changes, would have received greater amounts of assistance under FDIC's program than under the Bank Board's program. However, our separate analysis of very weak Bank Board institutions showed that the Bank Board's program would qualify more of them than FDIC's program would.

THE BANK BOARD'S PROGRAM GENERALLY PROVIDES LESS TOTAL ASSISTANCE THAN FDIC'S

There are three areas of difference between FDIC's and the Bank Board's net worth certificate programs, as originally designed:

--The Bank Board requires institutions to include appraised equity capital (AEC) in their net worth;[1] FDIC does not.

--The Bank Board provided initial assistance during the first year and a half of its program at one-half the percentage rates allowed by the act's formula and limited assistance through a tiering calculation;[2] FDIC provides initial and subsequent assistance at the full percentages allowed by the act's formula.

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[1]See chapter 4, page 24.

[2]See chapter 4, page 23.

--The Bank Board provides some cash assistance to institutions receiving net worth certificate assistance; FDIC does not.

The Bank Board's AEC provision reduces the number of institutions that would otherwise qualify for assistance under FDIC's program; the Bank Board's original assistance formulas reduced the amount of assistance institutions would receive. (However, effective September 4, 1984, the Bank Board's assistance formula--which was changed subsequent to our analysis--eliminates the effect of reduced assistance for future qualifying institutions.)

While the Bank Board liberalized its assistance formula, it did not eliminate its AEC provision. Fewer Bank Board institutions would qualify for assistance under the Bank Board's program than FDIC's because AEC reduces the number of institutions eligible for assistance. In short, AEC causes some weaker institutions to meet the eligibility floor, but according to the Bank Board, causes a greater number of stronger institutions to exceed the eligibility ceiling.[3] Consequently, the weaker institutions would qualify for assistance under the Bank Board's program, but stronger ones would not.

THE BANK BOARD'S PROGRAM ALLOWS MORE WEAK INSTITUTIONS TO QUALIFY FOR ASSISTANCE

While, in general, FDIC's program would qualify more thrifts and provided until recently greater amounts of assistance than the Bank Board's, this is not true for weak institutions. Because net worth certificate assistance can be crucial to the survival of very weak institutions, we made a separate analysis of some of the weakest to determine how they would fare under both agencies' programs. Our analysis confirms that the Bank Board's AEC requirement helps weaker institutions gain eligibility that would otherwise be denied under FDIC's program.

From a Bank Board April 25, 1983, list containing financial information on 76 percent of the approximately 3,300 FSLIC-insured institutions, we identified institutions that, before considering assistance, had (1) net worth of less than 0.5 percent or (2) net worth under 3 percent, but with less than 6 months to insolvency, as projected by the Bank Board. Using

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[3]Chapter 4, pages 25 and 26, provide Bank Board projections which show the extent to which AEC reduces the number of eligible institutions and total amounts of assistance.

these criteria, we identified 71 institutions that were in very poor financial condition and which we defined as "weak." Our test group was not intended to be a sample of all potentially eligible institutions.

To measure the effect of the differences in the two agencies' programs, we determined eligibility and computed amounts of assistance for the 71 "weak" institutions using (1) the Bank Board's initial assistance formula, (2) the Bank Board's subsequent assistance formula, and (3) FDIC's assistance formula. To determine eligibility, we used for both FDIC and the Bank Board the statutory criterion that institutions must have 0.5 percent net worth or higher after considering assistance. For the Bank Board we also applied its requirement that an institution must have at least 6 months of projected solvency after taking assistance into account.

Because the institutions in our test group had not reported AEC, we applied estimates based on Bank Board information for 310 institutions reporting AEC as of April 30, 1983. (See app. I.) The AEC estimates were used in calculating Bank Board assistance to the 71 institutions.

The assets, net worth, and losses used to calculate assistance for each of the 71 institutions were actual amounts as reported to the Bank Board. The institutions in our test group were in poor financial condition. As a group their total net worth was a negative $193 million, with only 15 of the 71 reporting positive net worth.

AEC serves to qualify more weak institutions

Under Bank Board formulas, which use AEC, more of the "weak" institutions in our test group qualified for assistance than under FDIC's formula, which does not use AEC. As the following table shows, the Bank Board's initial formula, as originally designed, qualifies 7 institutions more than FDIC's; the Bank Board's subsequent formula, applied independently of the initial formula, qualifies 15 more.[4] AEC accounts for the additionally qualified institutions under both Bank Board formulas. The different results between the Bank Board's formulas, as explained below, reflect the effect of the one-half limit on

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[4]If an institution does not qualify initially for assistance, then the subsequent formula in actuality is never applied. However, for theoretical purposes, we analyzed both formulas to illustrate the potential effect of each formula and, in particular, the impact of AEC upon the Bank Board formulas.

initial assistance, which was in force until recently. The subsequent formula, when compared to FDIC's, therefore shows the full effects of AEC more accurately than the initial formula.

GAO Analysis of
Weak Savings and Loan Associations Qualifying
for Assistance Under the Bank Board's Formulas
With AEC Included and Under FDIC's Formula

	Number of institutions qualifying	Amount of calculated assistance: Total (millions)	Amount of calculated assistance: Average for institution
FDIC formula	22	$31.6	$1,435,906
Bank Board initial formula	29	$13.3	$ 458,707
Bank Board subsequent formula	37	$47.5	$1,284,282

The inclusion of AEC in the Bank Board's formulas is responsible for making more weak institutions eligible for assistance. The act requires that institutions have a net worth-to-asset ratio of at least 0.5 percent after considering assistance. When including AEC and calculating assistance under the subsequent formula, using the full assistance rates and the tiering calculation, the net worth of 15 additional qualified institutions is raised to above the act's eligibility floor. Even when assistance is reduced through the use of the one-half rates established in the Bank Board's initial formula, AEC will still raise seven institutions' net worth to above the act's eligibility floor. Without AEC, then, these institutions would not, under either formula, have passed the act's 0.5 percent net worth eligibility test.

While AEC helped qualify additional weak institutions under both of the Bank Board's original formulas, it was detrimental for two such institutions in our test group. For these two institutions, AEC raised their net worth above 3 percent, thus making them ineligible for assistance. The act prohibits assistance to institutions with net worth above 3 percent.

CONCLUSIONS

FDIC's program, which adheres closely to legislative parameters, would qualify more Bank Board institutions for assistance, and, prior to recent changes would have provided greater amounts of assistance than the Bank Board's program. There are two reasons for these differences. First, the Bank Board's AEC requirement, which FDIC does not impose, while qualifying weak institutions, disqualifies a greater number of stronger institutions. The net effect of AEC is that it reduces the total number of institutions eligible for assistance. Second, the Bank Board's recently eliminated, initial formula, with its one-half limitation, reduced the amount of assistance provided. However, because AEC helps weak institutions meet the act's eligibility floor, more weak institutions qualify under the Bank Board's program than under FDIC's.

These effects, as well as the differences we identified between the agencies' programs, do not necessarily indicate that one agency's program is better than the other's. What they do show is that FDIC and the Bank Board have chosen different methods in designing their programs that result in different eligibility requirements and amounts of assistance. These differences can significantly affect similarly situated institutions requesting assistance under each agency's program, though the degree of difference has been reduced by recent changes in the Bank Board's assistance formula.

CHAPTER 6

THE BANK BOARD AND FDIC RELEASE TO THE PUBLIC

POTENTIALLY MISLEADING INFORMATION

ON THRIFTS' NET WORTH

The Bank Board and FDIC release financial reports submitted by thrift institutions that could be misleading or confusing to the general public. These reports are required by FDIC and the Bank Board for regulatory and supervisory purposes. However, they contain financial information reported in a manner that is not recognized under generally accepted accounting principles (GAAP) for general purpose reporting to the public. The Bank Board's appraised equity capital (AEC), as well as the net worth certificates of both the Bank Board and the FDIC are not recognized components of net worth (equity) under GAAP. Furthermore, while FDIC and the Bank Board release financial reports containing information that departs from GAAP, neither agency discloses this departure. Without proper disclosure, the public could inadvertently rely upon such reports to make business and investment decisions.

WHILE RECOGNIZED FOR REGULATORY PURPOSES, NET WORTH CERTIFICATES AND AEC ARE NOT RECOGNIZED AS ASSETS AND NET WORTH UNDER GAAP

Although the Net Worth Certificate Act gives agencies the discretion to design the financial instruments for their net worth certificate programs, the act specifies that net worth certificates shall be considered a part of institutions' net worth for statutory and regulatory purposes. However, to be recognized for general purpose reporting under GAAP, the FDIC and the Bank Board certificates and the Bank Board's AEC, also established as a regulatory component of net worth, must meet GAAP criteria.

GAAP is the standard for general purpose reporting

General purpose financial reporting for private sector institutions in the United States is based on GAAP. The objective of general purpose financial reporting is to provide consistent information that is useful to present and potential investors, creditors, and other users in making rational investment, credit, and related decisions.

GAAP consists of principles and standards that are accepted and applied in practice primarily by private sector institutions. It is based on substantial, authoritative support from recognized professional boards, associations, and other organizations.

Although GAAP is the standard for general purpose reporting, it is not necessarily the standard for special purpose reporting. In regulated industries such as the thrift industry, regulators often ask for specialized reporting based on a different set of needs. The Bank Board's and FDIC's net worth certificates and the Bank Board's AEC fall into the category of net worth for regulatory purposes. As such, these components of net worth as defined by the two regulators are useful in special purpose reporting.

The Bank Board's promissory note and net worth certificate tentatively determined not an asset and net worth under GAAP

The Bank Board designed its net worth certificate instruments--the FSLIC promissory note and the net worth certificate --to comply with GAAP. According to the Bank Board, the net worth certificate it designed is, in many respects, similar to preferred stock.

Contrary to the Bank Board's attempts, the Financial Accounting Standards Board (FASB)[1] tentatively concluded at a November 16, 1983 Board meeting, that the note and certificate should not result in an increase in an institution's assets and net worth because the FSLIC note does not meet the definition of an asset under GAAP. FASB's conclusion was based on the definition of an asset under FASB concept statement No. 3[2] and was

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[1]The mission of the Financial Accounting Standards Board is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information. Since 1973, the Financial Accounting Standards Board has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards are, in effect, rules governing the preparation of financial reports. They are officially recognized as authoritative by the Securities and Exchange Commission (Financial Reporting Release No. 1, Section 101) and the American Institute of Certified Public Accountants (Rules of Conduct, as amended May 1973 and May 1979).

[2]FASB Statement of Financial Accounting Concepts No. 3, Elements of Financial Statements of Business Enterprises, December 1980.

disseminated to its constituents in a November 23, 1983, publication. FASB plans no further action on this matter, and accordingly the accounting profession should follow FASB's guidance.

FDIC's promissory note and net worth certificate not an asset and net worth under GAAP

While FASB has not formally expressed its views on FDIC's net worth certificate instruments, there is general agreement within the accounting profession that FDIC's promissory note and net worth certificate should not result in any increase in an institution's assets and net worth under GAAP. This agreement is based on discussions with officials of FASB, the American Institute of Certified Public Accountants (AICPA), and FDIC. In a June 1983 document considering the accounting treatment of net worth certificates, the Savings and Loan Associations Committee of the AICPA concluded that

> "participation in the FDIC net worth certificate program does not result in any recognition in financial statement [sic] prepared in accordance with Generally Accepted Accounting Principles."

According to AICPA officials, the FDIC promissory note does not meet the definition of an asset under FASB's concept statement No. 3. The AICPA concluded that the exchange of FDIC's promissory note for a bank's net worth certificate under FDIC's program does not involve the payment of any consideration and that the note is realizable only if the bank is liquidated. In addition, FDIC program officials told us that the agency's net worth certificate instruments were never intended to be accounted for as assets and equity in institutions' financial statements prepared in accordance with GAAP.

The Bank Board's AEC also not an asset and net worth under GAAP

In defining net worth for institutions participating in its net worth certificate program, the Bank Board includes AEC--essentially the difference between the appraised fair market value and the net book value (cost at acquisition less depreciation, where applicable) of an institution's office land, buildings, and improvements. AEC, which raises an institution's net worth, is considered a capital assistance program by the Bank Board. The use of AEC is a prerequisite for institutions seeking net worth certificate assistance, but optional for all other Bank Board institutions.

According to the Bank Board, the reporting of institutions' AEC is useful for regulatory purposes. For the net worth certificate program, the Bank Board stated that AEC is particularly appropriate because it provides additional information on the financial condition of an institution and would improve the reported net worth of most institutions. Further, AEC is significant to the Bank Board for supervisory purposes in determining the solvency of a troubled institution and the extent to which its assets would be available to protect the financial interests of its customers, FSLIC, and the general public.

While AEC may be useful for regulatory purposes, reporting it on financial statements as a component of an institution's assets and net worth is not in accordance with GAAP. For general purpose financial reporting to the public, GAAP requires financial institutions to report office land and buildings on the basis of acquisition cost less applicable depreciation. The development of and adherence to this "cost" principle is important because it provides investors, lenders, and the public with an objective measure of value and a standardized basis for interpreting financial statements. Thus, recognizing unrealized equity in office land and buildings is not in accordance with GAAP.

In our report The FSLIC Insurance Fund--Recent Management and Outlook for the Future (GAO/GGD-84-3, Oct. 14, 1983), we discuss AEC in context with the Bank Board's need for supplemental financial reporting to carry out its responsibilities. Although we recognize that in some cases, regulatory reporting can aid regulatory agencies' decisionmaking process, we expressed concern about the inclusion of supplemental financial reporting initiatives that do not follow GAAP. We stated that "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 (page 48)."

The Bank Board recognizes that AEC is not in accordance with GAAP and cautioned institutions

The Bank Board recognizes that reporting AEC in general purpose financial statements is not in accordance with GAAP and cautioned institutions about externally reporting AEC in certain circumstances. In a document issued in December 1982, to assist professional staff of the Office of Examinations and Supervision in answering inquiries on the AEC regulations, the Bank Board stated that:

> "Since AEC is not a recognized component of net worth under Generally Accepted Accounting Principles (GAAP), caution is advised in including AEC in published financial statements and counter statements. Consultation with legal and accounting counsel is recommended. . . . In any case where inclusion of AEC is deemed acceptable, the institution should make it clear, by footnote or otherwise, that the account of which AEC is a part is 'regulatory net worth' as that term is defined by the Board, as opposed to net worth defined according to GAAP."

This document was made available to insured institutions and other interested parties.

THE BANK BOARD AND FDIC ARE PUBLICLY RELEASING NON-GAAP BASED FINANCIAL INFORMATION

The Bank Board and FDIC require thrift institutions that they regulate and supervise to periodically submit financial reports on their condition and operations. While intended for internal use by the Bank Board and FDIC, these financial reports and the data extracted from them are routinely released to the public upon request. Some of the publicly-released financial information, as previously discussed, is not recognized for general purpose financial reporting under GAAP.

The Bank Board regulatory reports released

The Bank Board requires institutions to submit regulatory financial reports monthly and semiannually. Since December 1982, the Bank Board has required institutions participating in its net worth certificate and AEC programs to include amounts for net worth certificates and AEC in their reports. Participating institutions are therefore reporting asset and net worth amounts that have not been recognized for general purpose financial reporting under GAAP. These departures from GAAP can significantly change institutions' reported net worth: for example, the inclusion of AEC and net worth certificates materially improved the net worth of the 71 weak institutions we analyzed. To illustrate the impact of this issue: 602 institutions, representing 19 percent of FSLIC-insured institutions, were participating in either the Bank Board's AEC or net worth certificate programs as of December 31, 1983.

The financial reports of thrift institutions participating in the net worth certificate and AEC programs, as well as the reports of other institutions regulated and supervised by the Bank Board, are routinely released to the public upon request. The Bank Board receives requests for financial data from various public sources, such as law firms, newspapers, mortgage companies, consultants, banks, and savings and loan associations. Since August 1977, it has made available to the general public financial data on individual federally insured savings and loan associations.

According to a Bank Board official, the semiannual report of an institution is, by far, the document most often requested by the public. This report is available from the Bank Board in hard copy and on computer tape containing reports for over 3,000 institutions regulated by the Bank Board. For 1983, the Bank Board filled 1,257 requests from the public for hard copies and 206 requests for computer tapes containing semiannual reports. For the 19 percent of FSLIC-insured institutions participating in the programs, the computer tapes, in particular, would convey to requesters net worth and asset amounts that are not recognized under GAAP.

FDIC regulatory data released

FDIC requires its insured commercial and savings banks to submit regulatory financial reports quarterly. FDIC requires that such institutions generally follow GAAP when presenting financial data in regulatory reports, but recognizes that some deviations from GAAP may be necessary for regulatory and supervisory purposes. Since December 1982, savings banks participating in FDIC's net worth certificate program were required to include net worth certificate amounts in reporting their assets and net worth to FDIC. As such, the assets and net worth amounts of these institutions would not be recognized for general purpose financial reporting under GAAP.

The regulatory reporting of net worth certificate amounts can significantly affect the net worth of an institution. For example, of the 23 savings banks participating in FDIC's net worth certificate program, 4 reported net worth consisting solely of net worth certificates, as of December 31, 1983.

Like the Bank Board, FDIC routinely releases to the public financial information reported by insured institutions. The financial information is extracted from quarterly financial reports submitted to FDIC and released in hard copy listings and on computer tapes to various requesters; these include financial institutions and banking trade associations, universities, research organizations, newspapers, and individuals. Because some financial data in institutions' regulatory reports submitted to FDIC is confidential, FDIC extracts the nonconfidential information in preparing its hard copy listings and computer tapes.

FDIC provides a computer tape containing financial information on all of its approximately 300 insured savings banks.

Accordingly, for institutions participating in the net worth certificate program, the computer tapes convey to the requesters net worth and asset amounts that are not recognized for general purpose financial reporting under GAAP. In 1983, FDIC provided 106 computer tapes on its savings banks to 72 requesters.

INSTITUTIONS' FINANCIAL REPORTS AND DATA ARE NOT QUALIFIED WHEN PUBLICLY RELEASED BY THE BANK BOARD AND FDIC

Neither the Bank Board nor FDIC discloses that financial reports and data released to the public are not entirely based upon GAAP, nor that certain financial data are presented in accordance with regulatory accounting standards. Both agencies, however, do attach a statement disclaiming responsibility for the data in reports released to the public. For example, the Bank Board disclaimer states that:

> "The Federal Home Loan Bank Board does not accept responsibility for the completeness, accuracy, or adequacy, of either the original information submitted to it or of the information it provides. The latter may differ from the original submission of the association due to amendments, rounding, editing by FHLBank editors, etc."

FDIC has a similar disclaimer. Both agencies' disclaimers, while generally cautioning the public, do not specifically alert the public about potentially misleading information contained in the financial reports and data released. Furthermore, although it provides a disclaimer when releasing hard copy reports, the Bank Board does not issue a disclaimer for its computer tapes.

CONCLUSION

In financial statements and data released to the public, the Bank Board and FDIC do not disclose the differences between net worth based on regulatory requirements and net worth based on GAAP. Without such disclosures, users may inadvertently rely on financial statements prepared for regulatory purposes to make investment and other business decisions. Distributing such financial statements publicly may seriously undermine public confidence not only in GAAP-based financial statements but also in the regulated institutions.

General purpose financial reporting to the public (investors, creditors, and other nonregulators) should provide consistent information that is useful in making business and economic decisions. Financial reporting best achieves this objective when it is based on GAAP. Accordingly, the Bank Board and FDIC should emphasize the purpose and uses of its regulatory reports so that the public does not use regulatory data unwittingly in making investment and other business decisions.

RECOMMENDATION TO THE CHAIRMEN OF THE FEDERAL HOME LOAN BANK BOARD AND THE FEDERAL DEPOSIT INSURANCE CORPORATION

We recommend that the Chairman of the Bank Board and the Chairman of the FDIC qualify financial reports and information that are based on regulatory requirements that differ from GAAP. This qualification should notify the public that the financial reports and data depart from and are not intended to be presented in conformity with GAAP.

AGENCY COMMENTS AND OUR EVALUATION

In commenting on a draft on this report, the Bank Board stated that it is making the arrangements to qualify its financial reports and information given to the public, as we recommended (see app. II). The Bank Board stated that such financial reports in the future will disclose that they are prepared in accordance with regulatory accounting procedures and may differ from generally accepted accounting principles.

In its comments, FDIC stated that its initial reaction was that our recommendation was unnecessary, but that it would consider implementing it after consultation with other affected regulatory agencies (see app. III). FDIC stated that:

> "the users of the financial information, e.g., analysts, other financial institutions, etc., are generally a fairly sophisticated group well aware of what they are getting and the usefulness and limitations of the data."

Further, FDIC stated that our report offered no empirical evidence that our recommendation was needed nor that anyone had ever been misled because the financial reports they received from FDIC had not been prepared in accordance with GAAP.

We recognize that many requesters of financial reports of FDIC-insured institutions could be considered "sophisticated, informed users." However, our review disclosed that some of the requesters cannot be presumed to know the limitations of those financial reports. As we note in the report, FDIC releases financial reports to a variety of requesters, including financial institutions, universities, research organizations, and individuals. According to FDIC's records, a sizeable number of the requests come from individuals and other sources that, without additional information, should not be expected to know the reports' limitations. Our review of 770 requests for hard copies of bank financial reports filled by FDIC during the first 4 months of 1984 showed that

--46.5 percent were from financial institutions,

--29.7 percent were from attorneys and research organizations,

--2.7 percent were from government agencies,

--8.3 percent were from newspapers, and

--10.9 percent were from individuals.

While it might be reasonable for FDIC to assume that financial institutions are "sophisticated, informed" requesters, we do not believe that this same assumption can necessarily be made about other requesters, especially individuals. In this regard, our review of the requests for financial reports showed that little could be concluded about the requesters' knowledge of financial statements or the purpose for which the requested reports were to be used.

FDIC states that the report offers no empirical evidence of people being misled. However, our recommendation is based on the concern that FDIC releases financial reports that depart from GAAP and therefore have the potential to mislead the public. As we state in the report, GAAP is the standard for consistent financial reporting to the public. GAAP is based on substantial, authoritative support from recognized professional boards, associations, and other organizations. A prime objective of GAAP is to enhance financial comparability among enterprises that might otherwise use different accounting treatments. In contrast, regulatory accounting principles, initiated by regulators such as FDIC, generally allow greater latitude in accounting and financial reporting than GAAP and consequently affect the comparability and consistency of financial reports. Accordingly, financial reports based on regulatory requirements that differ from GAAP have the potential to mislead the public.

We believe that our recommendation would be relatively easy and inexpensive to implement; the Bank Board has already indicated it would implement our recommendation. We believe that FDIC has a responsibility to inform the public of the limitations on the financial reports it is releasing.

U.S. GENERAL ACCOUNTING OFFICE

METHODOLOGY FOR DEVELOPING APPRAISED EQUITY CAPITAL

APPRECIATION FACTORS

For our analysis of weak institutions (discussed in ch. 5, pp. 33 to 35), we estimated AEC for each of the 71 institutions on the basis of information furnished by the Bank Board. The 71 institutions selected for analysis did not include AEC in the net worth they reported to the Bank Board. AEC is a requirement under the Bank Board's program and thus necessary for determining eligibility and amounts of net worth certificate assistance.

To estimate AEC for the weak institutions in our test, we asked the Bank Board to provide us with the percentage by which AEC increased the office land and building amounts of 310 institutions reporting AEC as of April 30, 1983. Specifically, we requested the median[1] percentage increase for each Federal Home Loan Bank (FHLB) district, which was furnished as follows:

Appraised Equity Capital Appreciation Factors

FHLB district	District number	AEC median percentage increase
Boston	1	66.4
New York	2	58.9
Pittsburgh	3	51.3
Atlanta	4	55.3
Cincinnati	5	36.4
Indianapolis	6	32.4
Chicago	7	49.2
Des Moines	8	38.2
Little Rock	9	78.9
Topeka	10	22.8
San Francisco	11	67.1
Seattle	12	33.1

[1]The median is the amount at which one-half of the values in the group are higher and one-half are lower. Medians are more stable than means (averages) because they are not influenced by very large or very small values.

We applied the appropriate AEC percentage increase to each of the 71 institutions' office land and building amounts as shown on their semiannual financial reports as of December 31, 1982.

Federal Home Loan Bank Board

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

EDWIN J. GRAY
CHAIRMAN

April 25, 1984

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

Dear Mr. Anderson:

Thank you for the opportunity to review the draft of your report entitled "Net Worth Certificate Assistance Programs--Their Design, Major Differences, and Early Implementation." As you know the Net Worth Certificate Program was instituted during a low point in the outlook for the thrift industry. Since that time the picture has brightened to some extent with the industry generating after-tax profits of $2.1 billion in 1983. The state of the industry, generally, remained very fragile and thrifts face a long and arduous road to recovery. Approximately 35% of FSLIC-insured institutions were still operating in the red at the end of 1983 and most of last year's profits represented unusual non-operating income. A significant upward change in rates could again submerge the majority of thrifts in a sea of red ink.

In light of this, the Board is currently reevaluating its Net Worth Certificate Program and is studying ways in which participation in the program could be made more readily available to distressed thrifts. We are studying the possibility of providing full assistance in the initial cycle; relaxing the appraised equity capital requirement and the stockholder approval requirement; reducing operating restrictions; eliminating the "three tier" method of calculating assistance amounts; and modifying the repayment provisions.

In regard to your report's recommendation, I am happy to report that the Bank Board is currently making the necessary arrangements to qualify its financial reports and information given to the public, as your report recommended. In the future, such reports will disclose that they are prepared in accordance with regulatory accounting procedures and may differ from generally accepted accounting principles.

I would also like to take this opportunity to point out a small misstatement contained in the draft report. In the last sentence of the first full paragraph on page 12 of the report the following statement is made: "In addition, neither FDIC nor the Bank Board will provide assistance beyond the 70 percent maximum provided for in the act's formula." This is not strictly true in that the Board has provided for exceptions to this general rule in the case of minority institutions which may need a higher percentage to meet the eligibility requirement and in other extreme cases. Also, the Board's rounding of assistance amounts to the nearest $25,000 may result in assistance percentages greater than 70%.

Sincerely,

Edwin J. Gray
Chairman

FDIC
Federal Deposit Insurance Corporation
Washington DC 20429
Division of Bank Supervision

Years of Confidence
1933 – 1983

April 23, 1984

Mr. William J. Anderson
Director
General Government Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

This is in response to your letter of March 21 submitting for our review and comment a draft GAO report entitled "Net Worth Certificate Assistance Programs -- Their Design, Major Differences, and Early Implementation." The report recommends that the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board qualify, through a statement, financial reports and information the agencies give to the public which is based on regulatory requirements that differ from generally accepted accounting principles ("GAAP").

The call reports of condition and income in question have traditionally been prepared and submitted by insured depository institutions to the supervisory agencies for regulatory purposes in accordance with principles and standards established by the agencies. The reports and the information derived from them have been made available to the public on an "as is" basis; that is, as received from the affected institutions with no representations as to the accuracy or completeness of the information or that it was prepared in accordance with GAAP. The instructions used to prepare the information are also publicly available. The users of the information, e.g., analysts, other financial institutions, etc., are generally a fairly sophisticated group well aware of what they are getting and the usefulness and limitations of the data. Thus far, we have had no evidence or indication that anyone has ever been misled, in business decisionmaking or otherwise, because the information they received from call reports was not prepared in accordance with GAAP. It should be noted that in some respects (e.g., the treatment of "goodwill") the call report information is more restrictive than the treatment under GAAP.

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