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The Federal Savings and Loan Insurance Corporation--Current Financial Condition and Outlook

Statement of
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Accounting and Financial Management Division

Before the
Committee on Banking, Housing and Urban Affairs

United States Senate

042191

GAO Form 160 (12/87)

Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss the results of our audit of the Federal Savings and Loan Insurance Corporation's (FSLIC) 1987 financial statements, the insurance fund's precarious financial condition, and FSLIC's and the Federal Home Loan Bank Board's ability to resolve the growing threat to the insurance fund and savings and loan (S&L) industry presented by the increasing number of insolvent and inadequately capitalized institutions. I would first like to provide some background on how a large segment of the industry got into this critically deteriorated financial condition, which will serve to underscore the seriousness and magnitude of the problems the troubled sector of the S&L industry faces and provide perspective on the resources FSLIC needs to deal with problem institutions.

THE SAVINGS AND LOAN INDUSTRY'S TRANSFORMATION

For over 40 years, the thrift industry operated in a relatively simple and safe environment in which deposits generated from the local economy at regulated interest rates were invested in traditional home mortgages. However, during the last decade, that simple environment has disappeared as the industry has struggled to remain competitive and profitable. During this time,

- -- restrictions on interest rates that could be paid on deposits were progressively lifted,
- -- competition for deposits escalated,
- -- S&Ls had to pay increasingly higher interest rates to preserve their core deposits at the same time that they were encumbered with low-yielding loan portfolios,
- -- S&Ls were permitted to expand their operations into assets traditionally reserved for banks, such as commercial and consumer lending, and
- -- various states dramatically expanded the types and extent of investment activities in which state-chartered S&Ls could participate.

Diversification Into Non-traditional Assets

The expansion of asset and investment activities is particularly noteworthy. Many thrifts began to diversify their asset portfolios away from traditional residential mortgage loans and into other potentially more profitable but possibly riskier activities, many of which were predicated upon continued increases in real estate values to make them economically viable. Such activities included:

-- acquisition, development, and construction loans, with S&Ls often providing 100 percent financing, and on which payment depends upon a project being completed and achieving profitability;

-- direct investment in real estate and equity securities, profit on which generally depends upon economic factors beyond the thrifts' control;

-- land speculation; and

-- participation loans on which S&Ls often used lax underwriting standards, with the participating S&Ls relying on the loan originator to adequately evaluate the soundness of the loans.

While such activities are potentially more lucrative than traditional home mortgage loans, they require expertise that many S&Ls did not have. Moreover, returns from these ventures are more volatile than traditional home mortgages and such activities are among the first affected by economic downturns.

Non-traditional Funding Sources

To fund these potentially more lucrative, but possibly riskier activities and to fund rapid growth--which was often erroneously assumed to equate to higher profits--many S&Ls began to rely to a greater extent on non-traditional sources of funds. Specifically, many S&Ls began selling their traditional home mortgage loans, thus eliminating a stable source of income. Accepting brokered deposits also became a widespread means of obtaining funds, especially by troubled thrifts willing to pay a premium to get funds needed to continue operating. Such funds are not only costly but also are usually very volatile, shifting from one institution to another to obtain a higher rate of return. Thus, if such funds are withdrawn, as brokered deposits often are, an already troubled S&L's financial condition could be critically affected.

Imprudent and Dishonest Operators Enter Market

Compounding the problems resulting from rapid asset diversification and from the high cost of rapid growth was the entry of some imprudent and dishonest operators into the S&L industry. Many of these "high fliers" used their S&Ls as private piggy banks to finance lavish lifestyles and to engage in speculative business activities. Failing to follow Bank Board regulations, including those pertaining to insider loans and loans to a single borrower were evident in many of the largest S&L failures.

Impact on the Supervisory Process

As a result of the industry's rapid transformation, supervisory and examination personnel became responsible for monitoring a diversified and complex industry engaged in sophisticated and often unprecedented financial activities. At the same time, the Bank Board's supervisory and examination activities suffered from high employee turnover and staff inexperienced in the new, complex activities of thrifts. Moreover, until 1985, due in large part to hiring and salary limitations, the Bank Board was unable to increase the size of its staff to deal with the newly deregulated and rapidly expanding industry. This combination of factors served to exacerbate an already troubled situation in the industry by potentially delaying recognition of problems at an early stage when they possibly could have been contained.

Economic Downturn in Certain Sectors of the Economy

Perhaps the most damaging blow to the savings and loan industry was the economic downturn in the agricultural and, more importantly, the oil and gas sectors of the economy. The dramatic increase in energy prices in the early-1980s fueled tremendous growth and rapid inflation of real estate values in the Southwest. However, the equally dramatic and rapid decline in energy prices in the mid-1980s caused the bottom to fall out of the real estate industry in that area of the country. This drastic decline in real estate values substantially altered the savings and loan industry's financial condition and accelerated its downward slide.

THE S&L INDUSTRY'S FINANCIAL CONDITION

Diversification into riskier activities, high cost of funds, and insufficient supervision, coupled with severe economic downturn in certain sectors of the economy, have left many thrifts with little except enormous losses from their poor quality assets. While rapidly declining interest rates began to correct the interest rate spread problems of the late-1970s and early-1980s, S&Ls began having to absorb substantial losses on their loans and investments. The outcome has been an alarming number of S&L failures, and a large segment of the industry saddled with asset quality problems. Although almost two-thirds of the industry was profitable in 1987, earning $6.6 billion, these profits were far outweighed by the $13.4 billion loss experienced by the remaining one-third of the 3,147 FSLIC-insured institutions, located primarily in the Southwest. In addition, although 211 S&Ls were closed or merged between 1983 and 1987, at the end of 1987, over 500 insolvent institutions with negative net worth of $18 billion, as measured by generally accepted accounting principles, were still operating. An additional 435 institutions with assets of $255 billion were barely solvent, with net worth ratios between

0 and 3 percent. For your information, we are providing two tables that show in detail the condition of the thrift industry. (See attachments I and II.)

Over the past 2 years, the Federal Home Loan Bank Board has acted to limit S&Ls' and FSLIC's exposure to certain investments and loans. Specifically, the Bank Board has increased the supervisory and examination staff and has adopted regulations to limit direct investments and certain highly risky loans, increase capital requirements, and require S&Ls to begin reporting in accordance with generally accepted accounting principles. While we support the Bank Board's actions, and believe they may minimize future losses related to such activities, these actions were too late to reduce the enormous problems the industry and FSLIC face.

In addition, it now appears that S&Ls are entering into newer and more complex financial transactions that potentially expose FSLIC to additional significant risks. These transactions include risk controlled arbitrage, in which some institutions fund rapid growth by using short-term liabilities to add long-term assets. While such arrangements offer potentially higher returns, they also carry commensurate risk and require a high level of expertise to manage. Also, recently, an investment firm attempted to create new financial instruments--Real Estate Mortgage Investment Conduit certificates created from "underwater mortgages." This transaction was intended to enable financial institutions with below market yield mortgage-backed securities or mortgages to "sell" these assets and, surprisingly, record a gain on the sale. While it appears this scheme never got off the ground, the potential for developing other "creative" transactions exists. Any new activities, especially complicated financial instruments and arbitrage schemes, require a great deal of expertise, and are not, by any stretch of the imagination, risk-free. Nor are they a quick and easy solution to the industry's financial woes. Instead, if not adequately monitored and controlled, they may do much more harm than good.

FSLIC'S CURRENT FINANCIAL CONDITION

We have just completed our audit of FSLIC's 1987 financial statements and will be issuing our report on that audit shortly. A copy of our opinion, which will be delivered to the Corporation, and a summary of FSLIC's financial statements are attached to this statement. (See attachments III and IV.) These statements indicate continuing deterioration of FSLIC's financial condition, and raise serious questions about its ability to deal with the industry's still growing problems.

During 1987, FSLIC had a net operating loss of $8.6 billion, resulting in a $13.7 billion deficit--more than double its 1986 deficit. FSLIC's operating loss was primarily attributable to the $6.9 billion increase in its liability for failed but still operating thrift institutions, as well as $3.5 billion in losses for institutions that have received financial assistance or have already closed.

1987 Loss Provision for Unresolved Cases

The attached summary financial statements reflect a liability of more than $17 billion for resolving the problems of the more than 200 insolvent institutions for which FSLIC has assumed responsibility and for several others FSLIC expects to deal with in 1988. This liability increased by $6.9 billion in 1987 due to the growing number of critically distressed open thrifts and to the increasing cost related to resolving their problems. During 1987, FSLIC's caseload of seriously troubled thrifts increased from 183 to 205 and included 138 thrifts that were in its 1986 caseload. These thrifts continued to incur large operating losses, thus further increasing FSLIC's eventual resolution costs.

While some have suggested that these losses are not "real" but only contingent in nature, we would dispel that myth. The term "contingent" in no way applies to the loss estimates developed for FSLIC's caseload. The institutions involved have incurred actual losses, as evidenced by their negative tangible net worth, and FSLIC's costs to resolve institutions' problems have historically exceeded negative tangible net worth. The fact that FSLIC cannot resolve all cases for several years does not diminish its liability. Instead, experience clearly shows that delaying resolution will increase FSLIC's ultimate costs by allowing these institutions to continue incurring losses. In this regard, the industry reported further capital losses of $3.3 billion in the first quarter of 1988.

The $17 billion liability at December 31, 1987, is not a projection of the cost to resolve all known problems in the industry. Instead, as previously noted, it is primarily the estimated cost to resolve the problems of those insolvent institutions for which FSLIC had assumed responsibility. At December 31, 1987, almost 300 additional institutions with assets of about $88 billion were insolvent, exposing FSLIC to further risk. A precise estimate of the eventual cost to resolve problems of those additional institutions cannot presently be made because the cost depends upon various uncertainties, such as the quality of each institution's assets, future interest rates, and the economic outlook for certain sectors of the economy in which many of the troubled institutions operate. FSLIC believes that the negative tangible net worth of those institutions indicates that the cost will be at least $5.3 billion. We believe that this estimate may substantially understate the magnitude of financial assistance the S&Ls will need for two reasons--probable future operating losses and historical experience. We expect these S&Ls, which have been incurring losses and which FSLIC will not act on for several years, to incur future losses, thus increasing the eventual costs FSLIC must absorb. In addition, the historical costs of resolving S&Ls' problems have consistently exceeded the reported negative tangible net worth of those institutions. Over the last 3 years, liquidating and merging S&Ls cost FSLIC, on average, more than 20 percent of an institution's assets and generally exceeded negative tangible net worth by almost 70 percent. Estimates of FSLIC's ultimate cost to deal with these additional S&Ls, using historical factors, would indicate a potential cost for the 300 additional institutions substantially in excess of the currently reported $5.3 billion negative tangible net worth, and range from $9 to $19 billion.

1987 Loss Provision for Resolved Cases

During 1987, FSLIC paid off or transferred insured depositors' accounts in 17 insurance actions. As a result, FSLIC made claims of $2.8 billion against the closed institutions' assets, which were transferred to receiverships for liquidation at the time the S&Ls were closed. However, because the loans and real estate of the failed thrifts are of extremely poor quality, FSLIC only expects to recover 39 percent of its claims from the sale of assets of institutions liquidated in 1987. In total, at December 31, 1987, FSLIC had $11.6 billion in claims against all receiverships, of which it expects to recover only $4.9 billion, or 42 percent of its claims.

In addition, in 1987, FSLIC losses related to assistance agreements for the merger or acquisition of failed thrifts increased by more than 150 percent over the previous year. FSLIC's 1987 loss provision of $1.7 billion includes the estimated cost of the 31 institutions merged or sold in 1987, as well as adjustments to estimated costs of prior years' mergers and acquisitions. Between 1981 and 1987, FSLIC spent a total of $4.6 billion to provide such assistance. However, this expenditure may not reflect final resolution costs for those institutions. Some mergers have resulted in institutions so poorly capitalized that further costly action may be necessary. For example, four institutions that acquired failed thrifts with FSLIC assistance during 1987 had negative tangible net worth at the end of the year.

OUTLOOK FOR RESOLVING THE INDUSTRY'S PROBLEMS

As previously noted, a significant number of S&LS are insolvent and continue to incur sizable losses. The problems of these institutions are of such magnitude they clearly cannot be resolved without substantial financial assistance. At the same time, FSLIC's financial condition and, thus, its ability to provide such assistance, is severely distressed. Nonetheless, FSLIC believes that it will have the resources available to effectively resolve the industry's problems, and has provided us with a 10-year projection of funds it expects to have available, and the corresponding outlays it expects to incur.

Over the next 10 years, FSLIC expects to have about $28 billion in net new funds from regular and special assessments and from the sale of bonds authorized by the Competitive Equality Banking Act of 1987 (CEBA), as well as from the sale of assets from existing receiverships available for resolutions. However, in developing its projection, FSLIC has made several assumptions that are relatively optimistic and, as with any projection, may prove incorrect. We have carefully reviewed the projection and its underlying assumptions and have concluded that, while FSLIC has the resources to continue operating in the near future, it may not have sufficient resources to effectively deal with the industry's current and future problems.

Ability to Merge Rather Than Liquidate

Implicit in FSLIC's forecast is the expectation that almost all of the problem institutions can be dealt with by merging them with other, presumably healthier, thrifts, rather than liquidating them. Using these assumptions results in a lower cost than if more liquidations were expected because, historically, it has been significantly less costly for FSLIC to arrange for a troubled institution's assets and liabilities to be assumed by another, financially strong institution rather than close an institution and pay off its insured depositors. Specifically, between 1985 and 1987, merger costs were 16 percent of the merged institutions' assets, while liquidation costs were 49 percent of the institutions' assets.

Unfortunately, the premise that almost all of the industry's problem cases can be resolved through mergers is inconsistent with resolution actions over the past 5 years. Of 179 transactions FSLIC completed during that period, 66, or 37 percent, were liquidation-type transactions, while 113 were mergers or acquisitions. Recent activity does not indicate a trend toward mergers. Between January 1, 1988 and April 30, 1988, FSLIC accomplished 22 transactions--10, or 45 percent, were liquidations, and 12 were mergers or acquisitions. While FSLIC and the Bank Board may hope to accomplish more mergers in the future, we do not believe that in prior years they would have chosen liquidation--the more costly form of resolution--if a merger would have been cheaper and equally effective.

The Bank Board has stated that a large number of potential investors have expressed interest in acquiring thrifts with FSLIC assistance. However, the availability of suitable merger partners willing to absorb large numbers of insolvent institutions at favorable terms is still unproven. S&Ls in the region of the country where most of the troubled thrifts are located are in significantly worse shape than those in the rest of the country.

To illustrate, the 479 thrifts in the Dallas Federal Home Loan Bank district, the district with the most insolvent thrifts, had negative net worth of $6.7 billion at December 31, 1987.

Additionally, FSLIC assumes that investors will be willing to accept FSLIC notes, rather than cash, as an acceptable form of assistance. In view of FSLIC's precarious financial condition, we believe the degree to which FSLIC notes will be accepted as substitutes for cash remains an open question.

We want to emphasize that simply merging two or more weak institutions into a larger one does not necessarily represent a problem resolution. For such a consolidation to offer promise of stability, the resulting entity must normally be well capitalized, which usually requires a substantial infusion of high quality assets.

Lower Resolution Costs

FSLIC also assumes that future resolutions will be less expensive than in the past and that resolutions will occur rapidly, minimizing additional losses to insolvent thrifts and FSLIC's costs, with virtually no new problem cases beyond those already identified. For the currently insolvent institutions not included in its $17.4 billion liability, FSLIC projects resolution costs equal to the institutions' negative tangible net worth--about $5.3 billion. However, based on experience, this estimate is optimistic. As previously discussed, using historical resolution costs as a percentage of assets to estimate the costs for these institutions indicates that resolution costs could reach $19 billion.

FSLIC also forecasts incurring over $14 billion in resolution costs during fiscal years 1988 and 1989, and assumes that virtually no new resolutions will be required after fiscal year 1992. Neither 1987's performance (52 resolutions) nor resolutions accomplished thus far in 1988 (22 through April 1988) indicate that FSLIC can act on cases this rapidly. Moreover, FSLIC's assumption that no new problem cases will develop appears extremely optimistic in view of the industry's current condition and most recent operating results. In particular, if interest rates should significantly increase, S&Ls could be faced with the interest rate spread problems that occurred 10 years ago.

Revenue Projections

FSLIC's revenue projections are based on several relatively optimistic assumptions regarding interest rates and future conditions in the savings and loan industry and in the U.S. financial markets. The effects of these assumptions are interrelated--should future conditions vary significantly, both FSLIC's projected revenues and outlays could be adversely affected.

-- Growth in Deposits at Insured Institutions - FSLIC assumes that insured deposits will grow about 7 percent annually, roughly doubling insured deposits over 10 years. Because FSLIC's premium income (both regular and special assessments) is based upon fixed percentages of insured deposits, its revenues increase significantly under this scenario. While this growth rate is consistent with the overall growth experienced over the past decade, we believe it may be overly optimistic. While deposits grew dramatically in 1983 and 1984, the growth rate declined in 1985, 1986, and 1987. Moreover, CEBA imposed a moratorium on thrifts leaving the FSLIC system which expires in August 1988--any significant departures of thrifts would result in corresponding decreases in deposit growth. This assumption further implies that other financial institutions are not able to take away any substantial portion of the thrift industry's current business.

-- Special Assessment Income - FSLIC's forecast assumes FSLIC will continue the special assessment of 1/8 of 1 percent of insured deposits throughout the next 10 years. However, under CEBA the special assessment was to be phased out by 1991. Although CEBA contains provisions permitting the Bank Board to continue the special assessment under certain circumstances, the Bank Board has not officially indicated what it plans to do. Moreover, continuation of the special assessment could encourage healthy thrifts to transfer to the Federal Deposit Insurance Corporation, thus eroding the deposit base from which FSLIC's premium income is generated. Conversely, without continuing the special assessment, there is no shred of hope of resolving FSLIC's financial plight without turning to the taxpayer.

-- Recapitalization Bonds and Related Interest Expenses - FSLIC's revenue forecast projects that recapitalization bonds will be marketed at interest rates of slightly less than 10 percent, which has been the case thus far. While FSLIC receives the proceeds from the bond sales, it must also bear the interest costs on the bonds. The interest costs will be paid from FSLIC's assessment income over the 30-year life of the bonds. Thus, significant increases in overall interest rates would reduce FSLIC's funds. Such a reduction would be compounded if higher interest rates were accompanied by slower deposit growth than FSLIC anticipates.

Other Sources of Funds

In addition to funds from recapitalization proceeds, insurance premiums, investment income, and liquidating assets, FSLIC and the Bank Board have access to funds from other sources.

However, each of these sources has drawbacks, and most do not add to FSLIC's reserves because the money must be repaid.[1]

-- Borrowing From the Treasury - FSLIC has a $750 million line of credit available if the Bank Board determines funds are needed for insurance purposes.

-- Borrowing From the Federal Reserve System - FSLIC can borrow directly from the Federal Reserve System under two different authorities and indirectly under one other authority. The amount available under each authority depends upon the amount of suitable collateral at FSLIC's disposal.

-- Borrowing From the Federal Home Loan Banks - FSLIC is authorized to borrow from the Bank system under certain limitations.[2] In addition, if the Secretary of the Treasury and the Chairman of the Bank Board certify to the Congress that alternative means of raising funds cannot be used and the ability to supply such funds is impaired, the Treasury can purchase up to $4 billion of Federal Home Loan Bank obligations, which could then be used to assist the thrift industry.

-- Mandatory Infusion of Up To 1 Percent of Withdrawable Deposits Into FSLIC - The Bank Board is authorized to require insured S&Ls to make such deposits into FSLIC. According to Bank Board officials, FSLIC could raise over $9 billion in this manner; however, its liabilities would increase by an equal amount.

FSLIC has not included funds from these sources in its projection and we agree with that decision. In our view, these sources are accompanied by serious disadvantages, and their use should only be considered in an extreme emergency.

GAO'S VIEW ON FSLIC'S ABILITY TO DEAL WITH THE INDUSTRY'S PROBLEMS

As previously discussed, we view FSLIC's projections with significant reservations. It is understandable that FSLIC faces its challenges with a high degree of optimism. While we believe FSLIC's projections and their underlying assumptions are relatively

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[1]For more detailed information on these sources of funds, see Thrift Industry: The Treasury/Federal Home Loan Bank Board Plan for FSLIC Recapitalization (GAO/GGD-87-46BR, March 3, 1987).

[2]FSLIC has used this authority twice to fund pass-through loans to insured institutions.

optimistic, we do not question either the sincerity or the ability of those who developed them. Nonetheless, depending upon the outcome of the various uncertainties underlying FSLIC's projections, we conclude that the eventual costs of restoring the thrift industry's financial health are likely to exceed the funds that FSLIC will have available. In addition, because of the distressed financial condition of a large segment of the industry, it also appears unlikely that the industry would have the resources to provide such funding. Consequently, further congressional action may well be needed to obtain adequate funding.

However, as we said earlier, FSLIC does have sufficient resources to continue operating and resolve cases in the near term. FSLIC has established an ambitious plan for rapidly resolving cases. Whether or not FSLIC can effectively accomplish this plan should become readily apparent in the near future.

In closing, we would like to emphasize our view that if congressional action becomes necessary, it should be taken swiftly. Any delays in acting on insolvent thrifts inevitably result in increased resolution costs and undermine the stability of all financial institutions. Such has been the bitter lesson of the current thrift industry crisis.

Mr. Chairman, this concludes my formal statement. At this time, I would be pleased to answer any questions you may have.

ATTACHMENT I

SELECTED FINANCIAL INFORMATION FOR SAVINGS AND LOAN INSTITUTIONS AS OF DECEMBER 31, 1987
($ in billions)

GAAP Net Worth (%)	Number of S&Ls	Percent of Total	Total Assets	Total Deposits	GAAP Net Worth
Less than -12%	182	5.8	$ 43.2	$ 49.3	$(14.2)
From -12 to -9%	33	1.1	5.5	4.7	(0.6)
From -9 to -6%	61	1.9	23.0	19.6	(1.7)
From -6 to -3%	75	2.4	17.5	14.8	(0.7)
From -3 to 0%	154	4.9	51.1	40.4	(0.7)
From 0 to 3%	435	13.8	255.2	175.7	4.0
From 3 to 6%	1,014	32.2	555.9	398.7	25.0
From 6 to 9%	743	23.6	231.0	177.1	15.9
From 9 to 12%	290	9.2	38.6	31.6	3.9
More than 12%	160	5.1	30.7	20.9	6.0
Total	3,147	100.0	$1,251.7	$932.8	$36.9

ATTACHMENT II

SELECTED FINANCIAL INFORMATION FOR SAVINGS AND LOAN INSTITUTIONS IN THE DALLAS FEDERAL HOME LOAN BANK DISTRICT AS OF DECEMBER 31, 1987
($ in billions)

GAAP Net Worth (%)	Number of S&Ls	Percent of Total	Total Assets	Total Deposits	1987 Net Income	GAAP Net Worth
Less than 0 %	181	37.8	$ 59.4	$ 57.1	$(6.51)	$(10.16)
From 0 to 3%	91	19.0	35.4	26.1	(0.44)	0.59
From 3 to 6%	118	24.6	25.7	19.6	(0.12)	1.12
More than 6%	89	18.6	13.2	9.9	0.04	1.79
Total	479	100.0	$133.7	$112.7	$(7.03)	$(6.66)

TO BE DELIVERED

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To the Chairman
Federal Home Loan Bank Board

We have examined the consolidated statements of financial condition of the Federal Savings and Loan Insurance Corporation as of December 31, 1987 and 1986, and the related consolidated statements of income and expense and reserves, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. In addition to this report on our examination of the Corporation's 1987 and 1986 consolidated financial statements, we are also reporting on our study and evaluation of internal accounting controls and compliance with laws and regulations.

SAVINGS AND LOAN INDUSTRY'S FINANCIAL CONDITION

Over the past decade, the savings and loan industry has experienced severe financial difficulties. During this time, as restrictions on deposit rates were progressively lifted and competition for deposits escalated, savings and loan associations had to pay increasingly higher interest rates to preserve their core deposits at the same time they were encumbered with low-yielding loan portfolios. The resulting negative interest rate spread led to large industry-wide operating losses and capital depletion in 1981 and 1982. With the liberalization in the early-1980s of the types of activities in which thrifts could participate, many institutions began to diversify their asset portfolios away from traditional home mortgage loans and into other activities. These activities included transactions such as acquisition, development, and construction loans, and various direct investments, which offer potentially higher rates of return, but carry commensurate risk. Moreover, the profitability of many of these activities was predicated upon continued increases in real estate values to make them economically viable.

Although interest rates declined sharply beginning in late 1982, reducing or eliminating the negative interest rate spread problem, many institutions have been adversely affected by substantial losses on their loans and investments. These losses have been further compounded by the severe economic downturn in the Southwest. Between the end of 1982 and 1986, the number of insolvent thrifts as measured by generally accepted accounting principles more than doubled from about 220 to 460.

In 1987, the industry's financial condition continued to deteriorate. The 3,147 FSLIC-insured savings and loan institutions reported an overall net loss of $6.8 billion. Although nearly two-thirds of these institutions operated profitably, earning $6.6 billion during the year, those profits were far outweighed by the $13.4 billion in losses incurred by the remaining one-third of the institutions, located primarily in the Southwest. In 1987, the number of insolvent institutions further increased to 505, with reported negative net worth of $18 billion.

THE CORPORATION'S FINANCIAL CONDITION

The deterioration of the industry's financial condition has overwhelmed the resources the Corporation had accumulated to protect depositors. At the end of 1980, the Corporation had reserves of $6.5 billion, representing 1.35 percent of total insured deposits; at December 31, 1987, it had a deficit of $13.7 billion. Due to increasing costs related to insurance actions, the Corporation began incurring losses in 1984. The Corporation's 1987 loss of $8.6 billion was primarily due to the $3.5 billion in costs related to institutions that have closed or received assistance and to the $6.9 billion increase in its liability for failed but still operating institutions.

The accompanying financial statements reflect a $17.4 billion liability for the expected costs of resolving the problems of the more than 200 hopelessly insolvent institutions for which the Corporation had assumed responsibility as of December 31, 1987, as well as several other institutions whose problems the Corporation expects to resolve in 1988. Because of the thrift industry's continuing difficulties, the Corporation has had to accept responsibility for increasing numbers of savings and loan institutions needing financial assistance. At the same time, its own weakened financial condition has prevented it from taking prompt action to liquidate or assist troubled institutions. As a result, a significant number of the failed but still operating institutions that were in the

Corporation's 1986 caseload were still in its 1987 caseload. In 1986, the Corporation's caseload increased from 93 institutions to 183. During 1987, its caseload further increased to 205. These 205 institutions reported total assets of $52.1 billion and negative tangible net worth of $14.6 billion at the end of 1987. In contrast, the 183 institutions in the Corporation's 1986 caseload reported total assets of $55.1 billion and negative tangible net worth of $8.2 billion.

The $17.4 billion liability at December 31, 1987, is not a projection of the cost to resolve all known problems in the industry. Instead, as previously noted, it is primarily the estimated cost to resolve the problems of those insolvent institutions for which the Corporation had assumed responsibility. At December 31, 1987, almost 300 additional institutions with assets of about $88 billion were insolvent using generally accepted accounting principles, exposing the Corporation to further risk.

A precise estimate of the eventual cost to resolve the problems of the 300 additional institutions cannot presently be made because the cost depends upon various uncertainties, such as the quality of each institution's assets, future interest rates, and the economic outlook for certain sectors of the economy in which many of the troubled institutions operate. The Corporation believes that the negative tangible net worth of those institutions indicates that the cost to resolve the problems of the additional 300 institutions will be at least $5.3 billion. We believe that this estimate may substantially understate the magnitude of financial assistance the institutions will need.

We expect these institutions, which have been incurring losses and which the Corporation probably will not act on for several years, to incur future operating losses, thus increasing the eventual costs the Corporation must absorb. In addition, the historical costs of resolving institutions' problems have consistently exceeded the reported negative tangible net worth of those institutions. Over the last 3 years, liquidating and merging institutions cost the Corporation more than 20 percent of an institution's assets and generally exceeded negative tangible net worth by almost 70 percent. Our estimates of the Corporation's ultimate cost to deal with these additional institutions, using historical factors, would indicate that the potential cost for the 300 additional institutions could be substantially in excess of the currently reported $5.3 billion negative tangible net worth, and range from $9 to $19 billion.

OUTLOOK FOR THE CORPORATION

Our opinion on the Corporation's 1986 financial statements, dated May 1, 1987, was qualified as subject to the Corporation "obtaining sufficient funds to continue operating and to meet its obligations." On August 10, 1987, the Congress passed the Competitive Equality Banking Act of 1987 which provides for recapitalizing the Corporation through the sale of a maximum of $10.8 billion in bonds over a 3 to 10 year period. The bonds will be repaid by the proceeds from zero coupon securities purchased with Federal Home Loan Bank funds, while the interest will be paid using a substantial portion of the next 30 years' insurance premiums the Corporation would otherwise receive.

Over the next 10 years, the Corporation expects to have about $28 billion in net new funds from regular assessments, special assessments, and the sale of bonds authorized by the Competitive Equality Banking Act of 1987, as well as the sale of assets from existing receiverships available for resolutions. Although this amount covers the current estimated cost related to the Corporation's 1987 caseload, depending upon the outcome of various uncertainties, it probably will not be adequate to resolve the problems of the additional 300 troubled institutions or to address any future problems in the industry.

In estimating its funds available for resolution, the Corporation has assumed that:

-- The amount of FSLIC-insured deposits will grow by more than 7 percent each year. While this assumption is consistent with overall growth during the last 10 years, it exceeds the growth rate over the last 3 years. Further, this assumption implies that no significant number of institutions will leave the FSLIC system in spite of the planned expiration in August 1988 of the moratorium on exits from the system. This assumption further implies that other financial institutions are not able to take away any substantial portion of the thrift industry's current business.

-- It will continue the special assessment of 1/8 of 1 percent of insured deposits throughout the next 10 years.

-- Recapitalization bonds will continue to be marketed at interest rates of slightly less than 10 percent.

We believe that these assumptions are relatively optimistic and, as with any projection, may prove incorrect. An adverse change in any of these assumptions will reduce the Corporation's available funds and affect its ability to resolve the industry's problems.

In determining the costs related to its caseload, the Corporation has assumed that:

-- It can minimize its resolution costs by selling or merging substantially all institutions rather than liquidating them since liquidations are almost invariably more expensive than mergers. However, over the last 5 years, more than one-third of the Corporation's resolutions were liquidations.

-- It can act on most of the problem institutions in the next 2 years, thus, minimizing those institutions' additional losses and the cost to the Corporation. Since assistance agreements usually contain provisions requiring the Corporation to, as a minimum, compensate the acquirer for the negative net worth of the troubled institutions, allowing institutions to continue operating and incur additional losses would increase the Corporation's resolution costs.

-- Interest rates will remain favorable and will not increase to any significant extent. Any significant increase in costs of funds to the thrift industry could again exacerbate the financial pressures on the industry and cause additional deterioration in capital and profitability.

-- Virtually no new problem cases will develop in the industry over the next 10 years and no further resolution costs will be incurred beyond those currently identified.

Finally, while it was initially contemplated, both in originally establishing the Corporation and in recapitalizing it in 1987, that the industry would be able to provide the funds needed to resolve its problems, the deteriorated capital position and poor operating results of a large segment of the industry seriously impair the industry's ability to do so. In this regard, the deterioration has continued up to the present--in the first quarter of 1988, the industry reported further capital losses of $3.3 billion.

GAO OPINION

As a result of the above conditions, namely,

-- the magnitude of the resolution costs for currently insolvent institutions,

-- the uncertainties about the Corporation's future revenue streams,

-- the Corporation's current $13.7 billion deficit, and

-- the industry's deteriorated financial condition,

we believe that further congressional action, beyond that already taken under the Competitive Equality Banking Act of 1987 to recapitalize the Corporation, may well be needed to enable the Corporation to continue to meet its obligations and provide the deposit insurance it is mandated to provide.

In our opinion, subject to the potential need for further congressional action to enable the Corporation to resolve the industry's problems and meet its obligations, the financial statements referred to above present fairly the financial position of the Federal Savings and Loan Insurance Corporation as of December 31, 1987 and 1986, and the results of its operations and changes in financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

ATTACHMENT IV

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
SUMMARY CONSOLIDATED STATEMENT OF FINANCIAL CONDITION

	1987	1986
ASSETS		
Cash and investments	$ 3,400,000,000	$ 4,100,000,000
Claims against assets of closed institutions (net)	4,900,000,000	3,800,000,000
Loans and assistance to insured institutions	2,200,000,000	3,000,000,000
TOTAL ASSETS	$ 10,500,000,000	$ 10,900,000,000
LIABILITIES		
Accounts payable and other liabilities	$ 100,000,000	$ -0-
Notes and interest payable to insured institutions	5,100,000,000	5,000,000,000
Notes payable to Federal Home Loan Banks	900,000,000	900,000,000
Estimated losses under existing agreements with acquirors	700,000,000	800,000,000
Liability for losses on unresolved cases	17,400,000,000	10,500,000,000
TOTAL LIABILITIES	24,200,000,000	17,200,000,000
INSURANCE FUND RESERVE (DEFICIT)		
Recapitalization funds	1,200,000,000	-0-
Primary reserve	(14,900,000,000)	$(6,300,000,000)
TOTAL RESERVE (DEFICIT)	$(13,700,000,000)	$(6,300,000,000)

ATTACHMENT IV

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
SUMMARY CONSOLIDATED STATEMENT OF INCOME AND EXPENSES

	1987	1986
INCOME		
Insurance premiums	$ 700,000,000	$ 700,000,000
Special assessment premiums	1,100,000,000	1,100,000,000
Interest income	400,000,000	500,000,000
Other income	200,000,000	100,000,000
TOTAL INCOME	2,400,000,000	2,400,000,000
EXPENSES		
Administrative and related expenses	300,000,000	100,000,000
Interest expense	300,000,000	300,000,000
Provision for losses related to claims against assets of closed institutions	1,800,000,000	2,900,000,000
Provision for losses related to acquisitions and mergers	1,700,000,000	1,100,000,000
Provision for losses related to unresolved cases	6,900,000,000	8,900,000,000
TOTAL EXPENSES	11,000,000,000	13,300,000,000
NET LOSS FROM OPERATIONS	$(8,600,000,000)	$(10,900,000,000)