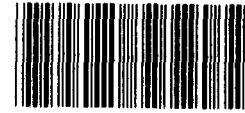


GAO

Testimony



143775

For Release
on Delivery
Expected at
10:00 a.m. EDT
April 26, 1991

Rebuilding the Bank Insurance Fund

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

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



Rebuilding the Bank Insurance Fund

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

GAO is testifying today on the preliminary results of its audit of the Bank Insurance Fund's 1990 financial statements and its views on how best to meet the Fund's financial needs.

BIF now stands at the most important crossroads in its history. Paying for the failure of about 600 banks in the past 3 years has almost exhausted the Fund's reserves. As of December 31, 1990, GAO's preliminary estimate is that BIF's reserves are no higher than \$5 billion--just .26 percent of insured deposits--but could go lower. We are discussing these preliminary estimates with FDIC before issuing our final audit. This level represents an all time low and the Fund is in a precarious state. While the Administration plan provides the Fund with cash, it does not rebuild BIF capital.

By next year, unless the fund is rebuilt, it will almost certainly be insolvent as more troubled banks fail. GAO expects BIF's reserves at the end of 1991 to range between \$1 billion and negative \$5 billion based on GAO's estimates of probable and possible 1991 bank failures. The specific outlook for the Fund beyond 1991 is more uncertain. However, based on GAO's estimates, BIF will remain weak, at least through 1993. Significant progress in building reserves appears very unlikely. Clearly, action must be taken right away to rebuild BIF and prevent its insolvency.

GAO believes that the banking industry--not the taxpayer--should fund the recapitalization and that maintenance of the Fund's reserves at acceptable levels should continue to be an industry responsibility. Thus, GAO recommends that BIF be rebuilt with special industry assessments to bring BIF's reserves up to the FIRREA minimum reserve standard of 1.25% of insured deposits by January 1, 1995.

There are a number of ways in which special assessments could be levied to meet the standard, but it would be beneficial to make substantial progress toward meeting it quickly. For this reason, one option would be an initial special assessment of 40 basis points on bank assets, which would add \$15 billion to BIF's reserves at the end of 1991. If that amount combined with BIF income is not adequate to bring reserves up to the 1.25% goal by 1995, FDIC should also be required to levy an assessment in 1993 to bring the Fund up to 1% of insured deposits by the close of that year, and in 1994 to fully capitalize the Fund at 1.25% as of January 1, 1995.

•Because this approach may represent a significant burden on the industry, an alternative would be to levy annual 20 basis point

special assessments in 1991 and 1992 and thereafter, as needed, until the FIRREA mandated standard is reached. This alternative might better enable the industry to adjust its income and expenses to meet its obligations to BIF than would a larger assessment.

If an industry financed rebuilding of the Fund proves infeasible it would be appropriate to consider a Treasury equity contribution to BIF's recapitalization.

A recapitalization of BIF through special assessments has several distinct advantages. It may receive a favorable reaction from the capital markets; it should encourage bank managers to confront the problems facing them; and it will provide an incentive to the industry to demand that regulators act on a timely basis to close insolvent institutions, thereby reducing the cost of resolution.

Equally as important as the losses BIF will likely incur over the next several years are the Fund's potential working capital needs. GAO estimates that the Fund may use as much as \$90 billion in working capital between 1991 and 1993 and that BIF resources available to fund working capital after a recapitalization would total about \$50 billion. Based on this estimate, GAO agrees that the \$45 billion requested by Treasury for working capital is adequate.

The principal difference between GAO's recommendations and those of the Administration is that the Administration seems to suggest that BIF's traditional reserve could be replaced by a line of credit financed by the industry but, in effect, co-signed by the U.S. taxpayer. This proposal is of great concern to GAO. Regulators might be tempted to postpone facing up to reducing the number and cost of bank failures if supplied with a large line of credit. Moral hazard in the industry might be heightened by the perception of a vulnerable Fund. The political ramifications of extended borrowing may discourage borrowing when necessary and postpone failed bank resolutions.

Recapitalizing BIF will not solve the Fund's long-term financial problems unless the deposit insurance system is reformed as well. GAO believes that reform must begin with earlier and more forceful intervention by regulators to correct problems in banks before capital deteriorates. Actions must also be taken to improve regulators' ability to obtain accurate information on a bank's value by strengthening reporting requirements for banks and their external auditors, requiring banks to value problem assets based on existing market conditions, strengthening the corporate governance mechanisms for banks, and requiring annual, full scope, on-site examinations of all banks. These actions will also help the industry to reduce its losses and speed its recovery.

Mr. Chairman and Members of the Committee:

We appreciate this opportunity to give you the preliminary results of our audit of the 1990 financial statements of the Bank Insurance Fund together with our views on how best to meet the Fund's financial needs. BIF is nearly insolvent and I cannot overemphasize the importance we place on rebuilding it as soon as possible. The Administration plan provides cash but it does not restore Fund capital. Furthermore, recapitalization must be tied to fundamental reform.

BIF now stands at the most important crossroads in its history. Paying for the failure of about 600 banks in the past 3 years has almost exhausted the Fund's reserves. As of December 31, 1990, our preliminary estimate is that BIF's reserves are no higher than \$5 billion--an all time low of just .26 percent of deposits--but could go lower.

By next year, unless the Fund is rebuilt, it will almost certainly be insolvent as more troubled banks fail. The longer recapitalization of BIF is delayed, the more expensive deposit insurance is likely to become for the industry, and the more likely that substantial taxpayer dollars will be needed to help the banking industry.

To keep BIF from running out of money for resolving bank failures, the Administration has proposed a plan that would

enable FDIC to borrow up to \$70 billion--\$25 billion from the Federal Reserve banks to finance net BIF losses from failed bank resolutions, and \$45 billion from other sources for working capital needs. Funds would be borrowed as needed and repaid by the banking industry over 15 years out of higher deposit insurance assessments plus, in the case of working capital, sales of failed bank assets. Insurance premiums would be used to repay borrowings, but would be capped at 30 basis points.

The thrust of the Administration plan, therefore, is a "borrow-as-you-go" financing of BIF. Unfortunately, the plan does not recapitalize BIF because it does not provide a mechanism for building up equity in the Fund. Instead it gives BIF a \$70 billion line of credit, backed by the full faith and credit of the U.S. government. This line of credit is to be financed by the industry but, in effect, co-signed by the U.S. taxpayer.

An increase in FDIC's ability to borrow for working capital is needed. But, we are concerned with allowing FDIC to fund losses strictly through borrowing. We believe that the banking industry should pay for the recapitalization of BIF and that maintenance of the fund's reserves at acceptable levels should continue to be an industry responsibility.

As part of the recapitalization, it is also essential that reforms we have already recommended to reduce the industry's

longer run cost of deposit insurance be adopted. These reforms include an early intervention--or tripwire--supervisory system that will lead to the timely closure of failing banks, and the accounting, financial reporting and auditing reforms that are necessary to make such a system effective and strengthen the corporate governance system.

THE OUTLOOK FOR BIF

No one can know exactly how much money BIF will require over the next several years to pay for its losses, meet its needs for working capital, and maintain an adequate reserve. First, no one can be sure about the actual condition of banks because their financial reports do not always present the banks' actual condition. Second, unpredictable variations in the number of large banks that fail can significantly change any assessment of BIF's needs. Third, while it is possible to predict fairly accurately the number of banks likely to fail in the next year or so, estimates beyond that period are much more uncertain and depend in part on interest rates, the state of the economy, and other factors that no one can forecast with confidence.

One thing is clear--the fund is in a precarious state. A sound plan for BIF's financial needs must be adopted.

We are now completing our audit of BIF's 1990 financial statements. Last year's audit revealed both a significant weakening of the Fund and many BIF-insured institutions under financial stress.¹ FDIC's unaudited end of year 1990 financial statements for BIF showed a fund balance of \$8.4 billion.

However, at this time we believe that the Fund balance is actually significantly lower than the level presented in the unaudited statements. We reached this tentative conclusion after reviewing the financial condition of 368 banks. Collectively, these banks have \$1.8 trillion in assets (about one-half of the industry total). These banks include, with some overlap, (1) all banks that FDIC lists as problem banks with assets over \$100 million and with no provision for loss yet booked by BIF, (2) the largest 100 banks in the U.S., and (3) banks that the Office of the Comptroller of the Currency and the Federal Reserve list as problem banks, excluding those already on the FDIC list.

We believe that about 71 of these banks, with total assets of about \$69 billion, are already insolvent or nearly so and will need to be resolved in 1991 unless recapitalized. When we apply historical FDIC rates of loss to these bank failures, we estimate that FDIC will lose between \$7 billion and \$11 billion in its 1991 resolutions.

¹Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund. September 1990 (GAO/AFMD-90-100).

Under generally accepted accounting principles, an entity must accrue an estimated loss if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Under generally accepted accounting principles as they are presently applied, it is probable that BIF has incurred a liability if a bank is equity insolvent (liabilities exceed assets). Also, the losses can be reasonably estimated using FDIC's historical loss experience in assisting failed banks. Applying these accounting rules, our preliminary estimates indicate that 40 of the 71 troubled banks are equity insolvent and should be reserved for in 1990. Reserving this amount raises BIF's total expenses for the year to about \$12 billion, and reduces the Fund balance to about \$5 billion.

The remaining 31 banks more likely than not will fail without recapitalization but do not meet the criteria of insolvency and, therefore, present accounting rules do not require the Fund to reserve for these banks. We believe that reflecting these additional losses at December 31, 1990 would be desirable and have suggested that accounting standard setters revise rules to require it.

We are now discussing our preliminary audit results with FDIC before issuing our final report. Our analysis of the financial condition of banks uses their call reports as a starting point to determine their condition and performance and analyze their

financial ratios over several years. We have already reported that the early warning system provided by bank call reports is seriously flawed. Because FDIC consistently found that the failed banks we reviewed overstated their asset values there is no doubt that some banks operating today have underreserved for nonperforming assets. Therefore, in analyzing the condition of troubled banks it is necessary to make adjustments for the inaccurate call reports to get the "water" out of the banks' balance sheets. Our reserve for the 40 equity insolvent banks represents a conservative estimate of the effect of these adjustments which we are discussing with FDIC. It will be several weeks before this process is finished. Based on what we know at this time, the adjustment could be as low as \$2 billion or as high as \$5 billion.

Considering a \$3 billion adjustment to FDIC's reported 1990 fund balance and premium revenues of about \$5 billion in 1991, we expect that the BIF fund balance at the end of 1991 will be somewhere between a high of \$1 billion and a low of a negative \$5 billion. It is highly probable therefore that the fund will be insolvent at the end of 1991.

We base this conclusion on our estimates of losses from the 31 banks not reserved for in 1990 that more likely than not will require assistance and on our review of another 66 of the 368 banks, with assets of \$137 billion, that could possibly fail in

the next few years assuming continued deterioration in earnings, problem loans, and other measures of financial performance. If all of these 66 institutions were to fail, we estimate losses of between \$11 and \$16 billion over the next few years. Further, BIF is also likely to lose another \$1 billion over each of the next several years resolving probable failures of smaller banks. Accordingly, for planning purposes, we think it is reasonable to expect total losses associated with bank failures to range between \$9 billion and \$15 billion in 1991, and between \$5 billion and \$7 billion in 1992 and 1993.

While past experience indicates that not all of these banks will fail, experience does suggest that other banks not yet identified based on today's information, will fail.

The specific outlook for the fund beyond 1991 is more uncertain. If BIF losses are at the lower end of our range of estimates, the level of fund revenues (assuming continuation of a 23 basis point premium) will exceed expenses by no more than \$2 billion or \$3 billion in 1992 and 1993. If, however, the Fund's losses on bank failures are at the upper range of our estimate, total expenses would absorb all of BIF's revenue. It is important to note that our estimates do not allow for further losses that might occur due to continued major deterioration in the economy or in regions of the country beyond that already evident in the Northeast and the Southwest.

In sum, based on what we know now, BIF will remain in a weak state, at least through 1993. Significant progress in building reserves appears very unlikely.

Clearly, action must be taken right away to prevent BIF from becoming insolvent.

GAO'S RECOMMENDED APPROACH TO
MEETING BIF'S FINANCIAL NEED

To provide BIF the money it needs to close insolvent banks promptly, the Administration recommends that Congress let the Fund borrow from various sources whenever it needs money to finance losses or working capital needs.

We support an increase in borrowing for working capital purposes. However, in our view, to the greatest extent possible, this increase in borrowing authority should be part of an industry-financed recapitalization of BIF.

We recommend that BIF be recapitalized with special assessments so that BIF's reserves are brought up to the FIRREA minimum designated reserve standard of 1.25 percent of insured deposits by January 1, 1995. Although even this standard may be low in relation to the risks faced by financial institutions, achieving this level of reserves would provide considerably more confidence

in BIF and protection for the taxpayer.

To initiate the process of recapitalizing BIF, we believe a special supplemental premium should be levied on all BIF-insured institutions, payable no later than December 31, 1991. This assessment would be added to the regular 23 basis point premium assessment of that year. The special assessment would be calculated as a percentage of total bank assets.

The assessment base we propose--total assets--differs from the regular assessment base of only total domestic deposits, including those over \$100,000. We believe this base distributes the burden of recapitalization as fairly as possible. Use of the current assessment base gives banks--especially larger banks--a greater incentive to seek funds through overseas deposits or non-deposit liabilities that are not part of the current premium base, but are frequently protected on a de facto basis when banks fail. Since the potential failure of larger banks places BIF in the most danger, we believe the fairest way to recapitalize BIF is with an assessment base that encompasses all activities on a bank's balance sheet.

There are a number of ways in which special assessments could be levied on the industry to meet the FIRREA standard. We believe it would be beneficial to make substantial progress toward meeting the standard quickly. For this reason, one option would

be to have a relatively high initial special assessment of 40 basis points, which would add \$15 billion to BIF's reserves at the end of 1991. Depending on whether BIF's expenses are at the high or low end of the range we have estimated, the 40 basis point assessment would immediately bring the Fund's reserves up to between .51% and .81% of insured deposits.

Under this option, if BIF losses are at the low end of the range we have estimated, it may be possible to reach the goal of bringing BIF reserves up to 1.25% of insured deposits without another special assessment. BIF reserves would be at about 1% by 1993, and the net income of the Fund for the years after that may be sufficient to attain the 1.25% goal.

However, if BIF losses are at the higher end of the range we have estimated, additional special assessments would be needed. FDIC would be required to levy an assessment in 1993 to bring the Fund up to 1% of insured deposits by the close of that year, and to levy a further assessment in 1994 so that the Fund would be capitalized at 1.25% of insured deposits as of January 1, 1995.

We recognize that the initial assessment of 40 basis points may represent a substantial drain on the industry's income. For this reason, another option would be to levy lower special assessments of 20 basis points each year if an immediate 40 basis point assessment is determined to be too much for banks to pay at one

time. This 20 basis point assessment could be levied in 1991 and 1992 and thereafter, as needed until the FIRREA mandated standard is reached. This alternative might better enable the industry to adjust its income and expenses to meet its obligations to BIF than would the immediate 40 basis point alternative.

To illustrate how these two recapitalization options would affect BIF's finances, we have included several tables at the end of the statement that show the effects of the different approaches to recapitalization under our lower and higher cost assumptions. These tables assume that industry assets and deposits grow at an annual rate of 4.5%, the assumption used by FDIC.²

The two approaches to BIF financing do not adequately capitalize the Fund immediately, but they represent our judgment of how best to balance the goal of BIF recapitalization with concerns about the industry's ability to pay and the degree of uncertainty that necessarily surrounds BIF's future losses. Once a major effort to recapitalize the Fund is launched, we believe it is reasonable to give FDIC the authority and mandate to complete the recapitalization in 1993 and 1994. At that time more will be known about the trends in BIF's losses. More will also be known

²These tables do not consider additional costs which would be incurred were BIF to require borrowing for working capital needs. Depending on the levels of cash reserves available, we believe the interest associated with the potential level of borrowings needed by BIF could be several billion dollars over the next few years.

about the effects of deposit insurance reforms which, if implemented promptly, may also reduce fund losses.

Working capital needs

Equally as important as the losses BIF will likely incur over the next several years are the Fund's potential working capital needs. In just two years, BIF's cash position has declined from \$16.2 billion in 1988 to just \$6.8 billion at year end 1990. Given the level of losses we estimate BIF could incur over the next several years, we believe the Fund may use as much as \$90 billion in working capital between 1991 and 1993. This use could occur if our high loss estimate of \$31 billion is borne out, and the relationship between working capital needs and losses is roughly three to one. While we have not yet received FDIC's final statement of cash flows for 1990, it is clear that BIF's working capital needs will still be substantially greater than its cash resources even if BIF is recapitalized. We estimate that BIF resources available to fund working capital from existing reserves, premium income, and funds from our BIF recapitalization proposal would total approximately \$40 billion. Recoveries on assets should also yield about \$12 billion.

Based on these estimates, we believe the \$45 billion requested by the Administration for working capital is reasonable. Such borrowing, if properly structured, would be repaid through the

sale of assets acquired as part of resolution actions. However, to assure this result, working capital borrowing should be fully collateralized with assets that have had their values adjusted to reflect the best estimate of their true worth. The value of these assets should also be discounted further to account for the uncertainty associated with any estimate.

WHY REBUILDING THE FUND IS IMPORTANT

The principal difference between our recommendations and those of the Administration is that we think it imperative that BIF's reserves be rebuilt. Under the Administration proposal, insurance premiums to pay off borrowings are to be no higher than 30 basis points, levied on the domestic deposits assessment base. For illustrative purposes I have included a third table that shows BIF finances if the 30 basis point premium were to be levied on July 1, 1991 and maintained through 1993. Under our low loss scenario, with a 30 basis point premium, progress toward recapitalizing the Fund is very slow; the Fund remains weak. Under our high loss scenario, the Fund remains insolvent through the period.

The Administration's suggestion that BIF's traditional reserve could be replaced by a "borrow-as-you-go" plan concerns us for several reasons.

- Funding losses from bank failures with a relatively open-ended line of credit may well create an unfortunate atmosphere of business as usual among bank regulators and FDIC. Simply charging the cost of bank failures to a line of credit payable for years into the future may seem attractive to regulators, compared to the expenditure of time and effort required to reduce the number and cost of bank failures. Until borrowing is almost at its ceiling, the motivation to reduce costs is likely to be weak. And, the larger the line of credit, the weaker the incentive to act.

- The incentives of bank owners are equally troublesome if efforts are not made to create an adequate BIF reserve. The Fund is likely to be perceived by banks as vulnerable. This perception may heighten moral hazard problems in weak banks, causing owners and managers to believe that bank closures will be postponed due to lack of funds.

As we know from the thrift industry experience, such perceptions can add significantly to the cost of resolutions. Creating such expectations concerning BIF could turn what we now believe is a manageable problem into one that could require significant tapping of proposed credit lines. If that were to occur, potentially high premiums to repay long-term loans could burden the banking industry for a generation or longer and could impair the industry's ability to rebound from

the financial difficulties it faces today.

-- Borrowing to cover insurance losses, with its attendant political ramifications, may discourage full and necessary funding which could postpone resolutions of failed banks. Such delays invariably increase costs. The recent debate over RTC funding shows how urgently needed funding can be delayed by public debate.

We recognize that recapitalizing BIF through a special assessment will be painful for the industry; at the same time, we believe that our plan has several distinct advantages. First, a recognition of BIF's financial needs and a recapitalization to meet those needs is more likely to receive a favorable reaction from the capital markets than the drawn out scenario proposed by the Administration in which the industry's financial exposure to meet BIF's needs is much less certain. This more favorable reaction should improve the ability of banks to raise capital in the future.

Second, recapitalization of BIF through assessments and increased premiums should encourage bank managers to confront the problems facing them. Managers will have to make decisions on cost cutting, pricing, improving internal controls, consolidation, shrinkage, and other matters affecting their costs of operations. Once BIF is recapitalized and reforms are adopted, insurance

premiums might be reduced--perhaps significantly--thus lowering banks' cost of doing business.

Third, having committed a large portion of its near-term earnings to BIF under our recapitalization plan, the industry will have a much greater incentive to demand that regulators act on a timely basis to close insolvent institutions, thereby significantly decreasing historical loss rates on bank resolutions. These demands could serve as a catalyst for adoption of reforms for more rigorous enforcement of safe and sound banking practices, as well as for improved internal controls and corporate governance.

In sum, every effort should be made to recapitalize BIF with industry funds, not taxpayer dollars.

INDUSTRY'S ABILITY TO PAY TO RECAPITALIZE BIF

We recognize that the current stress in the banking industry requires that policy makers carefully design a BIF recapitalization plan. The plan must not create a financial liability from which the industry may not be able to recover or cause the failure of banks that would otherwise not fail. It also must not significantly heighten current credit availability problems.

Obviously, the banking industry will find paying for a

recapitalization of BIF painful. But the industry has proven resilient in addressing problems of a similar magnitude.

For example, in the past 2 years the industry has written off \$67 billion of real estate and other loans, yet it has still maintained a relatively strong total capital position of \$235 billion. Despite low earnings, the banking industry paid out \$29 billion in dividends over the past two years--over 90% of its earnings. The amount raised under one of our options--a 40 basis point up-front special assessment--would be approximately equal to the amount of dividends paid in each of the last 2 years. We believe that recapitalization payments should certainly take precedence over a high rate of dividend payouts. In addition, bank managers have some flexibility in reducing expenses or increasing prices, so all recapitalization expense need not come, dollar for dollar, out of profits or bank capital.

We estimated how many banks would become insolvent or fail to meet the current 3 percent minimum leverage requirement in 1991 under our special assessment options. To make the estimate, we deducted both the special assessment and the increase in the regular premium over the rate that prevailed in 1990 from the amount of capital shown in the year end 1990 financial statements of the banking system. This is a worst case estimate because it allows for no offset from tax effects or from changes in revenues or other costs.

When we applied the 40 basis point assessment to the 3,400 solvent banks that had assets over \$100 million at the end of 1990, only one bank (with about \$2 billion in assets) became insolvent, and 21 (with total assets of \$16 billion) fell below the 3.0 percent minimum leverage requirement. Applying the 40 basis point assessment to the 9,336 solvent banks with less than \$100 million in assets resulted in 18 banks (with total assets of less than \$1 billion) becoming insolvent and 34 banks (with about \$1 billion in assets) falling below the leverage requirement. The banks most adversely affected are among those most likely to fail in any event.

Under the second, 20 basis point option, even fewer banks would fall into insolvency or fail to meet the minimum leverage requirement.

While few banks would become insolvent or fall below the minimum leverage requirement, a number of banks with a significant portion of industry assets would remain with capital just above the minimum. If, for this reason, it is felt that an industry contribution of the magnitude we have discussed is not feasible at this time, it would then be most appropriate to consider a Treasury contribution to BIF's recapitalization. This could involve a contribution to make up the difference between what the industry could pay and the full recapitalization amount needed to

bring the Fund up to 1.25% of insured deposits by 1995. We believe that such a payment, if necessary, should be in the form of a Treasury subscription to BIF capital stock to be paid back through insurance premium income after the Fund has stabilized.

DEPOSIT INSURANCE REFORMS

BIF recapitalization, while extremely important, is but one part of the solution to the problems that beset our insured depository institutions. Comprehensive reform of the deposit insurance system is the other. Neither is sufficient alone to protect U.S. taxpayers from loss and revitalize our banking industry.

We believe reform must begin with earlier and more forceful intervention by regulators to correct problems in banks. Because our work has demonstrated that capital is a lagging indicator of problems in banks, we have proposed an early intervention approach focused on management problems, asset quality, and related areas. Our reform proposal requires regulatory intervention before capital deteriorates as well as after a bank breaches certain threshold levels of capital sufficiency.

The success of any early intervention strategy depends, in turn, upon good information on the value of insured banking institutions. For this reason and others, we believe that a series of actions is necessary for regulators to obtain accurate information on a bank's value. To accomplish this result, it is

essential that Congress strengthen financial and management reporting requirements for banks and their external auditors, require banks to value problem assets based on existing market conditions, and strengthen the corporate governance mechanisms for banks. Regulators also need to perform annual, full scope on-site examinations of all banks. These actions will also, through their identification of internal control and corporate governance weaknesses, help reduce industry losses and foster its recovery.

The point of the various reforms is to enable the regulators to act decisively and promptly to close institutions before all of the economic value of these institutions has been lost. When this can be done, the cost of deposit insurance to healthy banks--and potentially to the taxpayers--should decline.

While we have not factored the beneficial effects of adoption of these deposit insurance reform recommendations into our loss estimates, the reforms, if implemented promptly, may reduce BIF's near-term losses thereby reducing the financial burden of BIF's recapitalization on the banking industry. If current estimates of BIF's needs prove to be too high because of the success of these reforms, the likelihood or magnitude of further industry contributions to recapitalization may be diminished and deposit insurance premiums might also be appropriately reduced.

ADDITIONAL COMMENTS THE ADMINISTRATION'S PROPOSAL
TO FUND BIF

As I indicated, the Administration has proposed financing BIF's losses and working capital needs with up to \$70 billion in borrowing--\$25 billion from the Federal Reserve banks to cover BIF's net losses and \$45 billion for working capital. Income from insurance premiums would be earmarked to repay the Federal Reserve loans over 15 years. Premium increases of about 3.5 basis points per \$10 billion in borrowing would be required, according to FDIC. Insurance premiums would be capped at 30 basis points.

Although the Administration's proposal provides enough money to pay BIF's bills for the foreseeable future, as I indicated we are very concerned that the plan does not provide for rebuilding BIF's reserves. In addition to this concern, we have several others.

First, the proposal to allow BIF to borrow from the Federal Reserve banks creates a potentially dangerous precedent, particularly at a time when the government has been unwilling to bring the budget deficit under control. It is worth questioning whether such an approach might be used to meet other fiscal needs in the future, given the seeming ease with which such borrowing can be accomplished. The approach also could undermine the Federal Reserve's independence because of new and potentially

competing demands when decisions need to be made about how and when to resolve failing banks, particularly large ones.

These concerns are particularly troublesome because borrowing from the Federal Reserve offers no benefit over borrowing directly from the Treasury. The arrangement does not reduce taxpayer exposure to FDIC losses, since FDIC borrowing from any source is backed by the full faith and credit of the federal government. Nor does it affect the amount of money that Treasury must ultimately borrow from the public to meet the government's fiscal needs. If BIF borrows from the Federal Reserve System, Federal Reserve banks would have to reduce their holdings of Treasury securities by the amount of their lending to BIF to avoid disruptions to achieving monetary aggregate targets. Thus, the amount of Treasury debt held by the public would be no different than if Treasury lent the funds directly to FDIC.

Second, Treasury has proposed counting FDIC's \$5 billion Treasury line of credit as equity thereby allowing FDIC to borrow working capital up to nine times the untapped line of credit. We think it preferable to simply increase FDIC's line of credit at the Treasury for working capital purposes to \$45 billion, subject to the conditions that I mentioned earlier.

Third, we believe that the Administration's 30 basis point cap on deposit insurance premiums is inappropriate. Imposing such a cap

reduces BIF's flexibility to address future problems in the least costly way.

CONCLUSION

Deposit insurance serves vital public policy objectives. Largely because of deposit insurance, our financial system has remained stable despite the energy price shocks, inflation, recessions, and stock market drops of the past two decades. Continued confidence in the system requires that BIF be recapitalized. Our proposal offers a way of accomplishing that.

But, it is not a panacea. BIF recapitalization will not succeed in stemming losses from bank failures unless the root causes of those failures are addressed through comprehensive deposit insurance reform. Our proposal does, however, raise the funds necessary to recapitalize BIF in a way that offers the best chance of protecting the taxpayer from losses. It also allows the banking industry to take responsibility for industry losses while minimizing the long-term costs to the industry. The industry will not raise these funds easily. But, in the long-term, our proposal will allow the nation to address BIF's financial problems as quickly and directly as possible and move on toward creating a healthy, stable, and competitive banking system. If an industry financed recapitalization is found to be too expensive at this time, some public funding of BIF's needs

might be considered, given the national benefits our deposit insurance system provides. But public funding should be a last resort and only instituted if a number of the deposit insurance reforms we have recommended accompany such funding. Every effort should be made to ensure that BIF's recapitalization is industry financed.

There could no doubt be a tendency by some to postpone full recognition of the problem and delay the pain as long as possible. This would be a mistake. Congress, the regulatory agencies, and the industry all have a stake in building confidence in BIF and the banking system. The experience with FSLIC has clearly demonstrated that a recapitalization plan that fails to deal clearly with the magnitude of the problem will simply postpone the inevitable, thereby producing both increased expenses and well-deserved skepticism.

Mr. Chairman, this concludes my prepared statement. My colleagues and I will be pleased to answer questions.

TABLE 1

PROJECTION OF BANK INSURANCE FUND
 GAO Low Estimates, with Recapitalization
 Billions of Dollars (40 Basis Point Special Assessment)

	1990	1991	1992	1993
BANK INSURANCE FUND				

Revenue Earned	4	5	7	8
Expenses & Losses	12	9	5	5
Net Income (Loss)	(8)	(4)	2	3
Fund Balance before Special Assessment	5	1	18	21
Special Assessments	0	15	0	0
Fund Balance	5	16	18	21
=====				
Ratio of BIF/ Insured Deposits	0.26%	0.81%	0.88%	0.98%
Special Assessment Rate		0.40%	0.00%	0.00%

PROJECTION OF BANK INSURANCE FUND
 GAO High Estimates, with Recapitalization
 Billions of Dollars (40 Basis Point Special Assessment)

	1990	1991	1992	1993
BANK INSURANCE FUND				

Revenue Earned	4	5	7	7
Expenses & Losses	12	15	7	7
Net Income (Loss)	(8)	(10)	0	0
Fund Balance before Special Assessment	5	(5)	10	10
Special Assessments	0	15	0	11
Fund Balance	5	10	10	21
=====				
Ratio of BIF/ Insured Deposits	0.26%	0.51%	0.49%	0.98%
Special Assessment Rate		0.40%	0.00%	0.28%

TABLE 2

PROJECTION OF BANK INSURANCE FUND
 GAO Low Estimates, with Steady Recapitalization
 Billions of Dollars (20 Basis Point Special Assessment)

	1990	1991	1992	1993
BANK INSURANCE FUND -----				
Revenue Earned	4	5	7	8
Expenses & Losses	12	9	5	5
Net Income (Loss)	(8)	(4)	2	3
Fund Balance before Special Assessment	5	1	10	21
Special Assessments	0	7	8	6
Fund Balance	5	8	18	27
=====				
Ratio of BIF/ Insured Deposits	0.26%	0.38%	0.89%	1.28%
Special Assessment Rate		0.20%	0.20%	0.15%

PROJECTION OF BANK INSURANCE FUND
 GAO High Estimates, with Steady Recapitalization
 Billions of Dollars (20 Basis Point Special Assessment)

	1990	1991	1992	1993
BANK INSURANCE FUND -----				
Revenue Earned	4	5	7	7
Expenses & Losses	12	15	7	7
Net Income (Loss)	(8)	(10)	0	0
Fund Balance before Special Assessment	5	(5)	2	10
Special Assessments	0	7	8	8
Fund Balance	5	2	10	18
=====				
Ratio of BIF/ Insured Deposits	0.26%	0.11%	0.49%	0.85%
Special Assessment Rate		0.20%	0.20%	0.20%

TABLE 3

PROJECTION OF BANK INSURANCE FUND
 GAO Low Estimates, No Recapitalization
 Billions of Dollars (Premium Raised to 30 Basis Points)

	1990	1991	1992	1993
BANK INSURANCE FUND				

Revenue Earned	4	7	8	9
Expenses & Losses	12	9	5	5
Net Income (Loss)	(8)	(2)	3	4
Fund Balance	5	3	6	10
=====				
Ratio of BIF/ Insured Deposits	0.26%	0.14%	0.29%	0.46%

PROJECTION OF BANK INSURANCE FUND
 GAO High Estimates, No Recapitalization
 Billions of Dollars (Premium Raised to 30 Basis Points)

	1990	1991	1992	1993
BANK INSURANCE FUND				

Revenue Earned	4	7	8	8
Expenses & Losses	12	15	7	7
Net Income (Loss)	(8)	(8)	1	1
Fund Balance	5	(3)	(2)	(1)
=====				
Ratio of BIF/ Insured Deposits	0.26%	-0.17%	-0.11%	-0.03%

Totals may not add due to rounding

Tables 1, 2 and 3 do not reflect additional costs which would be incurred were BIF to require borrowing for working capital needs. Depending on the levels of cash reserves available, we believe the interest associated with the potential level of borrowing could be several billion dollars over the next few years.