

GAO

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**The Federal Savings and Loan Insurance
Corporation's Use of Notes and Assistance
Guarantees**

Statement of
Frederick D. Wolf, Director
Accounting and Financial Management Division

Before the
Committee on Banking, Finance and Urban Affairs
House of Representatives



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Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss issues related to the Federal Savings and Loan Insurance Corporation's (FSLIC) use of notes payable and other commitments to help resolve its caseload of hopelessly insolvent thrifts. In considering these issues, two points stand out. First, thus far in 1988, the costs incurred in the form of cash, notes, and other commitments required to act on FSLIC's problem cases have far exceeded those projected. Second, no binding restraints currently exist to ensure that FSLIC does not incur financial obligations that it is unable to meet. Before discussing these and the other issues the Committee asked us to address, I would like to briefly discuss the financial condition of the savings and loan industry and its insurer, FSLIC, to provide some perspective on why FSLIC relies on the use of notes and other obligations in its resolution actions.

THE SAVINGS AND LOAN INDUSTRY'S
FINANCIAL CONDITION

Over the last decade, the financial condition of many savings and loans, especially those in the Southwest, has suffered as a result of several factors including diversification into risky activities, high cost of funds, insufficient supervision, and severe economic downturn in certain sectors of the economy. Although almost two-thirds of the savings and loan industry was profitable in 1987, earning \$6.6 billion, those

profits were far outweighed by the \$13.4 billion loss experienced by the remaining one-third of the 3,147 FSLIC-insured institutions. Thrifts in the Southwest, which account for only 15 percent of the industry, were responsible for 67 percent of the losses. At the end of 1987, over 500 insolvent institutions, including 124 in Texas alone, with negative net worth of \$18 billion as measured by generally accepted accounting principles, were still operating.

Based upon first quarter results, the thrift industry experienced an overall net loss of \$3.8 billion during the first 3 months of 1988. While solvent institutions had net income of \$0.8 billion, insolvent institutions incurred losses of \$4.6 billion. As of March 31, 1988, 504 institutions were insolvent with negative net worth of \$17.3 billion.

Bank Board press releases indicate that substantial losses continued into the second quarter, with the industry reporting a \$2.3 billion decline in capital. Until more data are released, we are unable to determine whether this decline is due to operating losses or asset writedowns. Nonetheless, these continuing losses indicate a further decline in the industry's financial condition and, accordingly, the costs of resolving its problems are likely to escalate beyond those previously estimated.

FSLIC'S FINANCIAL CONDITION

As disclosed in our recent report to the Congress on FSLIC's 1987 financial statements (GAO/AFMD-88-58, July 5, 1988), during 1987, FSLIC incurred a net operating loss of \$8.6 billion, resulting in a \$14 billion deficit--more than double its 1986 deficit. This operating loss was primarily attributable to the \$7 billion increase in FSLIC's liability for failed but still operating savings and loan institutions, as well as \$3.5 billion in losses related to institutions that had received financial assistance or had already closed. During 1988, FSLIC's operating losses have continued. FSLIC's records indicate that it has experienced losses of \$16.2 billion related to the 101 resolution actions carried out through August 31st of this year.

In the last few years, FSLIC did not act promptly to resolve the industry's problems due in part to its precarious financial condition and limited financial resources. Responding to FSLIC's need for additional funds, in 1987, the Congress authorized FSLIC to receive the proceeds of a \$10.8 billion sale of bonds over a minimum 3-year period. In its first year, FSLIC received the maximum amount allowable from the sale of \$3.75 billion in bonds which were issued at interest rates of between 9.4 and 10.7 percent. While these additional funds have helped, FSLIC's cash resources have remained low. At the end of 1987, FSLIC had cash and Treasury investments of only \$2.9 billion; at August 31, 1988, it had cash and Treasury

investments of only \$2.5 billion. Nonetheless, recognizing that the longer insolvent institutions are allowed to continue to operate and incur additional losses, the higher its costs will be, FSLIC has been attempting to quickly deal with many of these insolvent institutions over the past several months. However, because its cash resources are limited, FSLIC has been forced to rely upon the use of large promissory notes and other financial commitments in its efforts to act on the industry's most troubled thrifts.

Questionable Assumptions In FSLIC's Financial Forecasts

Despite continuing industry losses and FSLIC's own insolvency, Bank Board officials maintain that FSLIC will have sufficient financial resources to deal with the industry's problems. As you know, the Bank Board has produced various projections of the funds it expects to have available and the corresponding outlays it expects to incur. These cash flow projections indicate that FSLIC will be able to generate sufficient income over the next 10 years to meet all of its obligations. However, we believe that these projections are based upon extremely optimistic assumptions regarding both expected revenues and resolution costs.

In projecting its cash receipts, FSLIC 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 average 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 1989 of the moratorium on exits from the system. This assumption also 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 one-eighth of 1 percent of insured deposits throughout the next 10 years, which may provide in fact incentive for institutions to seek deposit insurance elsewhere.

-- Recapitalization bonds will continue to be marketed at interest rates of approximately 10 percent.

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

-- It can minimize its resolution costs by selling or merging substantially all institutions rather than liquidating them since FSLIC liquidation estimates are

almost invariably more expensive than mergers. However, in the last 8 months, nearly one-fifth of all resolution actions were liquidations.

- New institutions created through the merger process will be economically viable and will not require FSLIC to incur additional assistance or resolution costs beyond those anticipated at the merger date.

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

- Interest rates will remain favorable and will not increase to any significant extent. Any significant increase in the cost 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 significant resolution costs will be incurred beyond those currently identified. In addition, FSLIC's cash flow projections show virtually no reserve for future losses at the end of the 10-year period.

We believe that these assumptions are highly optimistic and that there is a strong likelihood that they will prove incorrect. Moreover, we have already seen costs being incurred at a rate suggesting that FSLIC's projected resources, even under the most favorable assumptions, will not be adequate to cover them. An adverse change in any of these assumptions will reduce the Corporation's available funds and lessen its ability to resolve the industry's problems. In addition, while the Congress initially contemplated, both in originally establishing FSLIC 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 its ability to do so.

FSLIC'S USE OF NOTES
AND FINANCIAL ASSISTANCE GUARANTEES

As of August 31, 1988, FSLIC's total outstanding notes payable to thrift institutions amounted to approximately

\$10.0 billion. This represents a sharp increase in FSLIC's use of notes over the past year and a decided shift in the purpose for which the notes are issued. In the past, FSLIC has issued notes payable primarily for two reasons: to assist open institutions in meeting minimum regulatory capital requirements under the net worth certificate and income capital certificate programs, and to compensate the acquirer of a defaulted institution for the institution's negative net worth at the time of acquisition.

The balance of FSLIC notes payable issued in exchange for capital certificates rose from approximately \$100 million at December 31, 1981, to a high of \$2.2 billion at the end of 1985. Since then, the balance has steadily declined and totaled only \$1.1 billion as of August 31, 1988. In contrast, FSLIC's use of notes in merger-type resolution actions has been increasing dramatically. Between December 31, 1983, and August 31, 1988, its outstanding balance of notes payable to acquirers of failed institutions increased from less than \$100 million to almost \$9.0 billion.

FSLIC's Current Resolution Strategy Depends
Upon Notes To Finance Merger-Type Transactions

As previously discussed, FSLIC has been insolvent for the past 2 years and continues to conduct its operations at a loss. Consequently, FSLIC's ability to deal with insolvent savings and

loan institutions has been severely constrained. FSLIC is authorized by 12 U.S.C. 1729 and other provisions, at its sole discretion and upon terms and conditions it prescribes, to use loans, deposits, purchases, assumptions, and contributions to resolve cases and reduce the threat to the insurance fund. However, FSLIC is required to employ the resolution method which is the least costly to the fund.

FSLIC has essentially two options for resolving the problems of troubled institutions--liquidations or merger/acquisition transactions. While both options may involve substantial costs, FSLIC estimates have indicated that liquidation is more expensive and, therefore, the option of last resort. Over the last 2 years, liquidation costs have averaged 69 percent of assets while merger/acquisition cost estimates have averaged about 50 percent.

In a merger or acquisition action, a troubled institution is acquired by another, presumably healthier, savings and loan, or by investors wanting to enter or expand their presence in the industry. The cost of this resolution action is the result of negotiations between FSLIC and the acquirer, and the action usually requires FSLIC to provide assistance in the form of cash, notes, and various guarantees to help shield the acquirer from the risk of future losses on the institution's assets or from litigation.

FSLIC's strategy for maximizing its limited financial ability to act on seriously troubled institutions, particularly those in the Southwest, emphasizes using acquisitions or mergers rather than liquidations, and, to the extent possible, providing assistance in the form of notes and guarantees rather than cash. Between January 1st and August 31st of this year, FSLIC acted on the problems of 101 savings and loan institutions:

83 institutions were merged with and/or acquired by other institutions in 37 transactions, and 18 institutions were liquidated. In carrying out these transactions, FSLIC issued a total of 22 notes, with combined principal amounts of \$6.8 billion. The terms of the notes varied, ranging from 6 months to 15 years, and, for the most part, carrying variable interest rates. In addition, FSLIC made substantial long-term financial guarantees in carrying out these transactions, to compensate the acquirers for future losses.

FSLIC officials have expressed a preference for using notes in its merger transactions rather than cash raised from recapitalization bonds. FSLIC's cost of funds for the bonds has averaged 10 percent. To the extent FSLIC could reduce its need for funding through bond sales by issuing notes at a lower interest rate, it would achieve a savings in its interest costs. However, this issue appears moot; FSLIC has needed the full amount of funding authorized in the first year of its bond

program and its current cash projections indicate its intention to use the full \$10.8 billion of recapitalization authorized. Moreover, the use of variable rates on the notes leaves FSLIC vulnerable to any upward shifts in the cost of funds. Thus, there may be no opportunity for savings.

Impediments to Continuing
Acceptability of Notes

Using FSLIC notes remains a viable option in the resolution process only to the extent that acquirers are willing to accept them. According to Bank Board officials, in recent merger negotiations, potential acquirers have begun to express reluctance over accepting notes. We believe several factors tend to diminish the attractiveness of notes.

First, FSLIC's insolvency raises questions about the ultimate collectibility of notes. Generally, the value of a note to its holder depends upon the perceived ability of the note's issuer to meet its repayment terms. FSLIC's precarious financial condition would raise doubts about its ability to do so.

Second, FSLIC has not publicly set a dollar limit on the amount of notes it intends to issue. Clearly, its ability to meet financial obligations is not limitless, and potential noteholders would be concerned that FSLIC not dilute the value of its notes by issuing amounts clearly beyond its ability to repay.

We recently issued a report (GAO/AFMD-88-57, May 20, 1988) to the Chairman of the Federal Home Loan Bank Board in which we recommended that he publicly announce the total amount of notes and guarantees FSLIC intends to provide in connection with resolution actions. The Bank Board responded that it has given public assurances that its projected revenues would limit the amount of notes to be issued, and that FSLIC's cash flow projection, as provided to this Committee on July 7, 1988, showed it would be able to meet its commitments for both notes and guarantees.

We believe a more certain limitation on notes and other commitments needs to be established rather than simply linking them to FSLIC's cash forecasts. As discussed previously, these projections are based upon extremely optimistic assumptions, and are subject to change solely at FSLIC's discretion. Furthermore, FSLIC has already exceeded the amounts of notes to be issued and total notes outstanding for fiscal year 1988 as specified in the cash projection the Bank Board provided to this Committee on July 7, 1988. Accordingly, we believe a specific dollar limit should be established on the total of notes and other commitments which FSLIC may issue.

Finally, uncertainty has arisen about whether FSLIC notes are backed by the federal government. Because FSLIC is an instrumentality of the federal government, it has been assumed

that its obligations, such as notes, enjoy implicit government support, a factor which has mitigated concerns about FSLIC's financial condition in the past. However, with FSLIC's continuing losses and the sharp increase in the amount of notes it issues, there appears to be increasing uncertainty regarding the notes' worth.

Accounting Profession's View

A further concern to potential noteholders is how their auditors would view FSLIC notes. In November 1987, the American Institute of Certified Public Accountants (AICPA) issued Practice Bulletin 3, "Prepayments Into the Secondary Reserve of the FSLIC and Contingencies Related to Other Obligations of the FSLIC", which provides guidance on accounting by thrift institutions for FSLIC obligations. This practice bulletin states that notes receivable from FSLIC and other assets involving obligations of FSLIC to institutions under assistance agreements should be evaluated for the likelihood of loss in accordance with generally accepted accounting principles. The practice bulletin further states that, while FSLIC is current in meeting its obligations, "the uncertainties about its financial condition lead to the conclusion that a loss is at least reasonably possible." Accordingly, under Financial Accounting Standards Board Statement No. 5, "Accounting for Contingencies," if no loss is accrued on FSLIC obligations, the possibility of loss on FSLIC obligations

must be disclosed in the financial statements if the amounts are material.

Under current auditing standards, in addition to determining whether the financial statements are presented fairly, the auditor must also determine whether a paragraph disclosing information about FSLIC obligations should be included in the opinion on the financial statements. In making this determination, the auditor is required to consider the magnitude of the possible loss and the likelihood that it will occur.

Given the fact that FSLIC is an instrumentality of the federal government and that the Congress has explicitly stated that it stands behind the FSLIC fund to fully protect depositors (up to the \$100,000 limit), in our view, it is unlikely--although still remotely possible--that losses on these notes could occur. We believe that information on these obligations should be disclosed to financial statement users. The entity should disclose in its financial statements, information about the FSLIC obligations and the auditor should consider whether an explanatory paragraph is needed in the opinion. We wish to emphasize that any such explanatory paragraph does not constitute a qualification in the auditor's opinion on the financial statements.

FSLIC Is Also Expanding Use
Of Assistance Guarantees

In addition to cash and notes to compensate for net worth deficiencies, merger-type transactions often require FSLIC to agree to compensate acquirers for future losses of failed institutions. Assistance agreement provisions usually include some or all of the following guarantees:

- coverage of net capital losses due to writedowns or sale of problem assets;
- yield subsidies on non-performing assets to ensure a specified rate of return on assets;
- indemnification against undisclosed liabilities or litigation; and
- purchase of certain impaired assets from the failed thrift.

In providing guarantees against future losses, FSLIC is gambling that the thrift's performance will improve either through better management or changed economic conditions. Favorable changes in interest rates or in real estate markets in certain currently depressed areas could result in FSLIC payments on guarantees being substantially lower than the amount an acquirer would

demand at the time a merger agreement is ratified. However, the downside risk of such guarantees is that future conditions may be unfavorable, thereby increasing the payouts required to meet FSLIC's obligations under the agreements. For the acquirer, FSLIC guarantees remove many of the risks inherent in merging with a thrift with demonstrated asset problems and undisclosed liabilities.

Ultimately, guarantees represent a potential claim on FSLIC's future cash resources. Unlike notes, however, the ultimate cost of guarantees can only be estimated when the agreement is signed. Even the best estimates may substantially differ from the eventual costs. In addition, FSLIC does not have much control over the timing of cash outlays under the guarantee provisions.

GAO's Assessment

The issue of government backing of FSLIC's notes has been brought to a head by the recent proposal for the Congress to attach the full faith and credit of the United States to the notes. How the Congress acts upon this issue could significantly affect FSLIC's ability to use notes in future resolution actions.

In this regard, we would offer the following observations.

- First, given FSLIC's precarious financial condition, it has little choice but to use notes and other assurances if it is to act timely on the industry's problems; it simply does not have the resources to do otherwise.

- Second, if the Congress neither provides FSLIC with additional funds, nor explicitly states in legislation that the notes are backed by the full faith and credit of the United States, FSLIC's ability to act on problem cases is likely to be further constrained.

- Third, a specific dollar limitation needs to be placed upon the amount of notes and assistance guarantees FSLIC may issue. The absence of such a limit not only diminishes the acceptability of notes, but also presents the potential for FSLIC to incur future obligations which it may not be able to honor. While we understand FSLIC's need to issue notes and other commitments, we do not believe it should have a virtual blank check in this regard.

FSLIC'S RECENT RESOLUTION ACTIONS

The costs of 1988 resolution actions continue to exceed the

amounts FSLIC estimated in conjunction with its 1987 financial statements. These statements indicated its total resolution costs could amount to \$22.7 billion for the institutions that were insolvent according to generally accepted accounting principles as of December 31, 1987. However, in our report on FSLIC's financial statements, we estimated that the total resolution cost could range from \$26 to \$36 billion. Our estimate was comprised of 2 parts--the \$17.4 billion FSLIC accrued for approximately 200 insolvent institutions for which FSLIC had formally accepted responsibility for incurring the resolution costs, and our calculation of \$9 to \$19 billion for the 300 additional insolvent institutions. FSLIC had reported a much lower estimate of \$5.3 billion for the additional 300 insolvent institutions with which we did not agree.

We have found that FSLIC's resolution costs during 1988 have exceeded its December 31, 1987 estimates. FSLIC has acted on 101 problem institutions in 1988 at a reported cost of \$16.2 billion. Eighty-three institutions were merged or acquired and 18 were liquidated. For liquidations, the actual cost of \$2.3 billion exceeded FSLIC's estimate of \$1.7 billion by 35 percent. For mergers, the actual cost of \$13.9 billion exceeded the estimate of \$6.5 billion by 114 percent. Bank Board and FSLIC officials have attributed the differences to:

- losses experienced between the time of the estimate and the time of closing,

- the decision to liquidate certain high-paying thrifts, rather than continue to search for merger partners, in order to reduce the cost of funds for the industry, and

- additional guarantees being demanded by acquirers due to the seriously impaired nature of assets held by failed thrifts.

We have included details of FSLIC's 1988 actions in Attachment I to this statement.

Actions Under the Southwest Plan

Included in the actions discussed above were 31 thrifts merged in 6 separate transactions between May 13, 1988, and August 31, 1988, under the Bank Board's Southwest Plan. The total estimated cost to FSLIC of these transactions is \$10.3 billion, consisting of \$3.6 billion in cash outlays, \$3.6 billion in notes payable (principal and interest), and \$6.7 billion under various assistance and guarantee agreements. According to Bank Board officials, the combined net worth of the individual institutions before merger was negative \$7.0 billion. The officials estimated the capital ratios of the new

institutions created through the mergers at between 0 and 3.6 percent as calculated using regulatory accounting principles. Attachments II and III provide more data on the individual transactions.

To date, we have not analyzed the Southwest Plan strategy or its individual transactions in detail. However, GAO is beginning a comprehensive review of the plan which will include consideration of the viability of the new institutions being created through mergers, the amounts of future costs FSLIC is committing to under various guarantee and indemnity provisions, and the fairness of the potential return to FSLIC for its costs in these transactions. However, based upon the limited information we have, we can offer the following two observations.

First, authoritative information on the net worth of the newly merged institutions, as calculated according to generally accepted accounting principles, will not be available until the new entity is audited as required in the merger agreement. However, based on the reported regulatory capital ratios, these institutions appear to be thinly capitalized. Merging several insolvent institutions into a larger entity which remains thinly capitalized does not necessarily represent a final problem resolution. In our view, the term "resolution" would only be appropriate when the new entity has recognized all losses on problem assets, meets established capital requirements, and is

otherwise economically viable. Consolidations that fall short of this criteria may result in reduced losses to some extent through such factors as economies of scale, reduced competition for deposits, and enhanced supervisory oversight. However, whether or not such institutions can become viable entities without further assistance remains to be seen.

In this regard, the Bank Board's own March 3, 1988, report to the Congress, as required by the Competitive Equality Banking Act of 1987, addresses the importance of a sound capital position.

"A strong capital position is an important deterrent to insolvency. The presence of an adequate capital position indicates that the owners of a thrift institution have money at risk in case of insolvency. This provides a strong incentive for management to avoid high-risk ventures and keep the institution operating in a safe and sound manner.

Strong capital provides an important cushion to the institution; a cushion to help endure cyclical trends and seasonal changes. Capital also provides a cushion to the insurance fund to absorb losses before claims for insurance are made."

Second, the cost of implementing the Southwest Plan is significantly greater than FSLIC anticipated. FSLIC's estimate prepared in conjunction with its December 31, 1987, financial statements amounted to about \$7 billion but the cost of actions taken under the Southwest Plan have already amounted to over \$10 billion by August 31, 1988. Final costs may be even higher once the auditors determine the final net worth and asset valuation for the newly formed institutions and FSLIC adjusts the note or guarantee estimate to reflect these audited figures, as provided for in the merger agreements. In his testimony before this Committee on July 7, 1988, the Bank Board Chairman revised the cost estimate for the Southwest Plan upward to \$15.2 billion. We understand this estimate is not based upon individual, detailed analyses of the condition of institutions covered under the plan. Accordingly, we believe that the \$15.2 billion estimate should be regarded as tentative.

In summary, FSLIC actions taken under the Southwest Plan, cannot be considered final solutions until the newly created institutions prove viable. In addition, the higher than expected cost of actions taken under the Plan calls into question FSLIC's ability to marshal the financial resources necessary to pursue this strategy without additional funding. The likelihood is therefore increasing that the Congress will be faced with the difficult task of determining where necessary, additional funds may be obtained.

BUDGETARY IMPACT OF FSLIC
NOTES AND GUARANTEES

In regard to your question on the budgetary treatment of FSLIC notes, we believe that the administration's and Congressional Budget Office's (CBO) current budget scorekeeping of FSLIC notes is correct. Specifically, when FSLIC issues notes, the principal amounts of the notes are recorded as outlays, and budget authority and obligations for making the outlays are also recorded at the same time. The recorded outlay, as with other budget outlays, increases the reported budget deficit.

We understand that FSLIC did not follow these scorekeeping policies prior to the issuance in February 1988 of the President's budget for fiscal year 1989. Consequently, prior budgets did not show outlays for the FSLIC notes when they were issued, but only for the cash payments later made on the notes. Because of the payment terms on the notes, this practice had the effect of reducing their impact on the deficit for the years in which they were issued.

For the fiscal year 1989 budget and beyond, the Office of Management and Budget (OMB) has required FSLIC to follow the practice of recording as outlays the face value of the notes in the fiscal year in which they are issued, on the theory--a

correct one, we think--that the notes are cash-equivalent transactions intended to satisfy an obligation of government entities. For Treasury reporting purposes, this practice was adopted for fiscal year 1988.

Including outlays in the budget for FSLIC notes provides more timely budget disclosure to the Congress and the public of FSLIC's financial activities. This is a step forward.

However, we emphasize that such improved disclosure does not, in itself, reflect a legal constraint on the amount of notes FSLIC may actually issue. Thus, for the current fiscal year (1988), FSLIC has already issued notes in amounts exceeding those estimated for the year in the OMB budget materials. As of August 31, 1988, FSLIC had issued about \$8.3 billion in notes for fiscal year 1988 and the Bank Board has announced its intention to incur costs of about \$2 billion in further resolution actions before the end of fiscal year 1988. The President's budget released in February 1988, estimated that note issuances for 1988 would total only \$4 billion. Subsequently, OMB's July 1988 mid-session adjustments to the estimate for the 1988 budget only raised this amount to \$5.8 billion.

As for the implications of this 1988 pattern of underestimates for the Gramm-Rudman-Hollings deficit reduction law and procedures, two points should be made. First, the

issuance of FSLIC notes in fiscal year 1988 above earlier projections will not trigger any 1988 sequestrations in other parts of the budget to meet overall deficit reduction targets. (FSLIC itself is exempt from sequestration.) The fiscal year is drawing to a close, and there are no provisions in the deficit reduction statute requiring any 1988 spending reductions to offset FSLIC note issuances in 1988 that exceed earlier administration projections.

However, the administration's underestimates for fiscal year 1988 raise a question about what to expect for fiscal year 1989. While FSLIC itself is exempt from sequestration, OMB is required by law to include its estimates of FSLIC outlays for 1989 in its projection of the 1989 budget deficit. As part of these outlays, OMB has estimated that FSLIC will issue \$4.6 billion in notes in 1989. This projection was important in OMB's determination that a government wide sequestration would not be required in 1989. Meaningful deficit reduction requires accurate OMB estimates, and we can only hope that OMB's estimates for 1989 FSLIC notes will be accurate forecasts.

We agree with OMB's position that requires these notes to be reflected as outlays when issued. We also believe that legislatively placing limits on the amount of notes and guarantees FSLIC can issue would provide an important control mechanism that is not included in the federal budget process.

PROPOSALS TO LIMIT GROWTH
OF INSOLVENT INSTITUTIONS

You also asked that we comment on the merits of a provision that would require the Bank Board to limit any new loans or investments on the part of insolvent thrift institutions whose deposits are insured by FSLIC, as well as limiting the asset growth of insolvent institutions. We support the concept that these insolvent institutions should not be allowed to expose the insurance fund to further risks through unchecked asset growth. However, we believe that an absolute prohibition on any new loans or investments would be counterproductive.

By the time an institution reaches insolvency, it has usually accumulated significant amounts of troubled loans and real estate. Methods of reducing potential losses on such troubled assets include restructuring borrowers' existing lending arrangements or entering into new arrangements to reduce the potential for defaults and foreclosures. An absolute prohibition on new lending agreements could preclude needed flexibility in this regard. In addition, opportunities for sale of an institution's real estate portfolio would be hampered by the inability to finance any portion of the sale.

Similarly, prohibiting any new investments could impair an institution's ability to earn interest income from even the most

benign sources, such as overnight deposits and Treasury securities, once existing investments matured. Thus, liquid assets required for the daily operations of the institution would have to be retained in noninterest bearing cash accounts, reducing the institution's ability to offset losses with relatively risk-free income.

According to Bank system personnel, virtually all insolvent institutions are currently operating under supervisory arrangements which substantially restrict their lending and investment activities. These arrangements generally permit only minimal growth without supervisory approval. In addition, supervisory approval is generally required for investments in risky areas such as aquisition, development and construction (ADC) lending; junk bonds; and service corporations. We also understand that the Office of Regulatory Affairs has drafted new policies to further restrict insolvent institutions' investment and lending activities, and to impose reporting requirements on any supervisory exceptions granted. These policies could restrict undesirable lending and investment activities while permitting sufficient flexibility to enter into prudent transactions, but only if they are properly implemented, monitored, and enforced.

While we support restricting the growth of insolvent institutions to protect the insurance fund, we believe any

legislation to restrict these activities should provide the regulator with sufficient flexibility to permit limited and prudent lending and investment activities. However, we would encourage the Congress, in its oversight activities, to address the effectiveness of the regulator's policies in preventing growth of insolvent institutions through unwise lending and investment activities.

SUMMARY

In summary, we would reiterate the following points.

-- FSLIC's financial condition is such that it cannot undertake substantial actions on the industry's problems without resorting to making future commitments. Absent further action to provide additional resources to FSLIC, an explicit pledge of full faith and credit for FSLIC notes would assist FSLIC in continuing its strategy for dealing with the industry's worst problem cases. While we do have reservations about FSLIC's strategies including the Southwest Plan, experience has shown that taking no action is certain to sharply increase losses and eventual resolution costs. Accordingly, we would support legislation explicitly stating that FSLIC notes are backed by the full faith and credit of the United States.

- Any action to support the notes should be accompanied by a specific limitation on the commitments FSLIC would be permitted to incur. We believe such a limit should apply to total commitments, regardless of whether they are in the form of notes, guarantees, or any other form of obligation. As it stands now, FSLIC could incur resolution costs, through future commitments, on a virtually unlimited basis. These commitments are growing rapidly and will have to be dealt with in the future.

- A limitation would enhance congressional oversight of FSLIC's operations and ensure that FSLIC does not incur obligations beyond those deemed appropriate by the Congress. While FSLIC's current cash projection may be a logical starting point for determining the amounts to be established under such a limitation, the limit should be in terms of specific dollar amounts covering new issues and balances outstanding. Should it become necessary for FSLIC to incur higher resolution costs, it could seek to justify the need for the limitation to be raised. This would help ensure that the Congress remains fully informed of FSLIC's resolution actions and plans.

- Regardless of what decision the Congress makes concerning the FSLIC notes, we wish to emphasize that there is still

a significant imbalance between the thrift industry's problems and FSLIC's financial capabilities. The Congress has already provided FSLIC the means to obtain additional resources, but the costs of FSLIC's 1988 actions to deal with insolvent thrifts strongly suggests that the size of the problem continues to grow. More importantly, the long-term effectiveness of FSLIC resources already used to prop up the industry remains to be seen.

-- Our sense is that the Congress will be asked to devote additional resources to resolving the thrift industry's problems. I would like to emphasize that, if this comes to pass, we would strongly recommend swift action. The longer hopelessly sick savings institutions are allowed to operate, the higher the potential resolution cost to taxpayers becomes.

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

FSLIC ASSISTED TRANSACTIONS TO MERGE OR CLOSE PROBLEM INSTITUTIONS
 FROM JANUARY 1, 1988 THROUGH AUGUST 31, 1988
 (Unaudited)
 (All figures in thousands)

<u>TRANS #</u>	<u>FAILED ASSOCIATION</u>	<u>TYPE OF ACTION</u>	<u>TOTAL ASSETS AT DATE OF FSLIC ACTION</u>	<u>REPORTED COST TO FSLIC</u>	<u>PROJECTED COST AT 12/31/87 ##</u>	<u>INCREASE/ (DECREASE) OVER PROJECTED COST</u>
MERGERS/ACQUISITIONS						
1	FIRST FS&LA	ACQUISITION	\$31,100	\$14,000	\$13,150	\$850
2	MAGNET BANK, FSB TRADERS FS&LA MOUNTAIN STATE FS&LA	ACQUISITION	710,000	81,500	81,470	30
3	FIRST FS&LA	ACQUISITION	30,900	3,805	3,810	(5)
4	FIRST FEDERATED SB PERPETUAL S&LA FIRST FSB PEOPLES FS&LA	ACQUISITION	566,400	157,000	158,180	(1,180)
5	TRI-CITIES S&LA	ACQUISITION	54,500	15,800	16,610	(810)
6	CITIZENS S&LA	ACQUISITION	39,020	6,100	6,780	(680)
7	VALLEY FS&LA	ACQUISITION	87,500	7,080	7,420	(340)
8	ALLIANCE S&LA COLORADO COUNTY FS&LA SECURITY S&LA CAMERON COUNTY S&LA	ACQUISITION	455,800	146,226	48,009	98,217
9	LAMAR SA CITY S&LA STOCKTON SA BRIERCROFT SA	ACQUISITION	3,998,400	1,980,323	984,620	995,703
10	FIRST FS&LA	ACQUISITION	245,500	72,100	66,290	5,810
11	EUREKA FS&LA	ACQUISITION	1,740,000	304,000	285,050	18,950

FSLIC ASSISTED TRANSACTIONS TO MERGE OR CLOSE PROBLEM INSTITUTIONS
FROM JANUARY 1, 1988 THROUGH AUGUST 31, 1988

(Unaudited)

(All figures in thousands)

<u>TRANS #</u>	<u>FAILED ASSOCIATION</u>	<u>TYPE OF ACTION</u>	<u>TOTAL ASSETS AT DATE OF FSLIC ACTION</u>	<u>REPORTED COST TO FSLIC</u>	<u>PROJECTED COST AT 12/31/87 ##</u>	<u>INCREASE/ (DECREASE) OVER PROJECTED COST</u>
12	FRONTIER FSB	ACQUISITION	\$48,050	\$11,000	\$10,640	\$360
13	BLUEBONNET SA	ACQUISITION	24,100	9,900	8,520	1,380
14	FIRST FINANCIAL SA BROWNFIELD FS&LA	ACQUISITION	370,000	87,368	27,997	59,371
15	STANFORD SA	ACQUISITION	76,500	8,400	5,840	2,560
16	LYNNWOOD S&LA	ACQUISITION	24,600	6,100	4,620	1,480
17	MUSKEGON FS&LA	ACQUISITION	202,000	4,000	4,200	(200)
18	GALVA FS&LA MUTUAL S&LA HOME FS&LA	ACQUISITION	172,980	33,800	42,000	(8,200)
19	REPUBLIC SVGS. FS&LA	ACQUISITION	36,500	17,800	17,800	0
20	FIRST FS&LA	ACQUISITION	84,900	13,300	19,850	(6,550)
21	FIRST FS&LA	ACQUISITION	36,400	2,700	2,260	440
22	IRVING SA LONGVIEW S&LA GLADEWATER FS&LA RICHARDSON S&LA MAJESTIC SA COMMERCE FS&LA PARIS S&LA AMERICAN BANC SA SKYLINE SA BEN MILAM S&LA MERCURY SA SOUTHLAND SA	ACQUISITION	2,217,200	1,313,780	540,128	773,652
23	FIRST FEDERAL BANK FSB WESTERN FS&LA	ACQUISITION	49,600	13,000	12,210	790
24	CAPITOL FS OF AM	ACQUISITION	242,600	16,100	51,060	(34,960)

FSLIC ASSISTED TRANSACTIONS TO MERGE OR CLOSE PROBLEM INSTITUTIONS
FROM JANUARY 1, 1988 THROUGH AUGUST 31, 1988

(Unaudited)

(All figures in thousands)

<u>TRANS #</u>	<u>FAILED ASSOCIATION</u>	<u>TYPE OF ACTION</u>	<u>TOTAL ASSETS AT DATE OF FSLIC ACTION</u>	<u>REPORTED COST TO FSLIC</u>	<u>PROJECTED COST AT 12/31/87 ##</u>	<u>INCREASE/ (DECREASE) OVER PROJECTED COST</u>
25	FIRST FS&LA FIRST FS&LA FIRST FS&LA WASHINGTON FSB PEOPLES S&LA PIONEER FS&LA	ACQUISITION	\$1,088,900	\$299,000	\$251,535	\$47,465
26	STATE FS&LA	ACQUISITION	454,000	581,787	418,140	163,647
27	COMMERCE FSB	ACQUISITION	40,200	17,400	17,850	(450)
28	NORTHWEST FS&LA	ACQUISITION	26,700	2,390	170	2,220
29	HOMESTATE S&LA	ACQUISITION	190,000	44,700	41,460	3,240
30	BELL FS&LA	ACQUISITION	953,500	565,000	600,050	(35,050)
31	SUNBELT SA INDEPENDENT AMERICAN SA WESTERN FS&LA SUMMIT SA TEXANA S&LA FEDERATED S&LA FIRST CITY SA MULTIBANK SA	MERGER	4,826,300	6,166,657	2,488,359	3,678,298
32	CAPITAL FSB MUTUAL FS&LA	MERGER	3,559,000	1,898,200	282,528	1,615,672
33	FIRST OK SB MID AMERICA FS&LA					
34	KINGFISHER FS&LA SUNBELT SAV FS&LA					
35	FRONTIER FS&LA HOME S&LA					
36	PHOENIX FS&LA CIMARRON FS&LA					
37	FIRST FS&LA HERITAGE S&LA HOME SB, FA PEOPLES FS&LA					

FSLIC ASSISTED TRANSACTIONS TO MERGE OR CLOSE PROBLEM INSTITUTIONS
FROM JANUARY 1, 1988 THROUGH AUGUST 31, 1988
(Unaudited)
(All figures in thousands)

<u>TRANS #</u>	<u>FAILED ASSOCIATION</u>	<u>TYPE OF ACTION</u>	<u>TOTAL ASSETS AT DATE OF FSLIC ACTION</u>	<u>REPORTED COST TO FSLIC</u>	<u>PROJECTED COST AT 12/31/87 ##</u>	<u>INCREASE/ (DECREASE) OVER PROJECTED COST</u>
LIQUIDATIONS						
38	FIRST SA OF EAST TX	LIQUIDATION	\$62,900	\$86,700	\$87,990	(\$1,290)
39	TERRITORY S&LA	LIQUIDATION	37,800	52,000	46,190	5,810
40	CITIZENS S&LA	LIQUIDATION	150,000	135,000	141,270	(6,270)
41	MT. WHITNEY S&LA	LIQUIDATION	34,000	46,400	46,380	20
42	RAMONA FS&LA	LIQUIDATION	45,000	76,300	76,340	(40)
43	FIRST FS&LA	LIQUIDATION	130,000	52,300	52,340	(40)
44	INVESTORS S&LA UNITED S&LA	LIQUIDATION	167,600	76,300	84,850	(8,550)
45	FIRST FS&LA	LIQUIDATION	128,780	138,200	29,880	108,320
46	AMERICAN FS&LA	LIQUIDATION	164,400	67,200	32,630	34,570
47	CARDINAL SB	LIQUIDATION	93,800	34,400	25,622	8,778
48	LARUE FS&LA	LIQUIDATION	13,100	6,600	5,110	1,490
49	VICTOR S&LA	LIQUIDATION	230,000	241,000	124,850	116,150
50	THE AMERICAN FS&LA	LIQUIDATION	70,400	106,900	71,690	35,210
51	UNIVERSAL SA	LIQUIDATION	54,800	10,800	29,780	(18,980)
52	NORTH AMERICAN S&LA	LIQUIDATION	98,200	133,000	66,170	66,830
53	AMER. DIVERSIFIED SB	LIQUIDATION	509,000	798,000	631,170	166,830
54	FARMERS FS&LA	LIQUIDATION	<u>181,500</u>	<u>198,900</u>	<u>119,940</u>	<u>78,960</u>
			<u>\$24,854,430</u>	<u>\$16,160,316</u>	<u>\$8,190,808</u>	<u>\$7,969,508</u>
			*****	*****	*****	*****

Represents either amount accrued or negative tangible net worth at 12/31/87

Source: FSLIC records

ESTIMATED COSTS OF
SOUTHWEST PLAN RESOLUTIONS ACTIONS
THROUGH AUGUST 31, 1988
(Unaudited)

ACQUIRER	ESTIMATED COST OF ASSISTANCE AGREEMENTS (PRESENT VALUE)	PRESENT VALUE BASIS @					
		CASH	NOTES (PRINCIPAL)	NOTES (INTEREST)	CAPITAL LOSS COVERAGE	YIELD SUBSIDY	OTHER **
COASTAL BANC SA	\$146,226	\$3,627	\$12,584	\$22,569	\$52,001	\$52,888	\$2,557
SOUTHWEST SA	1,980,323		219,637	290,136	817,137	653,413	
MERABANK FSB	83,868		14,093	18,565	29,954	24,692	(3,436)
GIBSON GROUP, INC.	1,313,780		197,393	297,739	317,319	481,404	19,925
SUNBELT SA	6,166,637		918,691	1,492,472	1,721,533	2,033,941	
MERABANK FSB	<u>581,787</u>		<u>55,029</u>	<u>77,612</u>	<u>261,323</u>	<u>190,634</u>	<u>(2,811)</u>
TOTAL	\$10,272,621 =====	\$3,627 =====	\$1,417,427 =====	\$2,199,093 =====	\$3,199,267 =====	\$3,436,972 =====	\$16,235 =====

ACQUIRER	ESTIMATED COSTS OF ASSISTANCE AGREEMENTS (CASH BASIS)	CASH BASIS @					
		CASH	NOTES (PRINCIPAL)	NOTES (INTEREST)	CAPITAL LOSS COVERAGE	YIELD SUBSIDY	OTHER **
COASTAL BANC SA	\$237,225	\$3,627	\$32,639	\$35,041	\$112,752	\$61,870	(\$8,704)
SOUTHWEST SA	3,521,024		569,682	450,050	1,738,990	762,302	
MERABANK FSB	156,582		38,249	29,720	68,504	29,296	(9,187)
GIBSON GROUP, INC.	2,379,171		535,743	472,633	752,155	617,277	1,363
SUNBELT SA	11,509,284		2,459,761	2,383,834	4,061,931	2,603,758	
MERABANK FSB	<u>1,084,645</u>		<u>149,353</u>	<u>123,938</u>	<u>593,702</u>	<u>227,718</u>	<u>(10,066)</u>
TOTAL	\$18,887,931 =====	\$3,627 =====	\$3,785,427 =====	\$3,495,216 =====	\$7,328,034 =====	\$4,302,221 =====	\$(26,594) =====

** "Other" column includes mark to market adjustments, prepayment penalties on FHLB advances and projected future income from FSLIC ownership interests.

@ All figures in thousands.

Source: FSLIC records

CAPITAL CONTRIBUTIONS AND COSTS OF ACTIONS UNDER THE SOUTHWEST PLAN THROUGH AUGUST 31, 1988
(UNAUDITED)
(all figures in thousands)

<u>ACQUIRER</u>	<u>THRIFTS ACQUIRED</u>	<u>ACQUIRER CONTRIBUTION</u>	<u>FSLIC ASSISTANCE</u>	<u>TOTAL ASSETS OF ACQUIRED ASSOCIATIONS</u>	<u>FSLIC COST AS A PERCENT OF ASSETS</u>
COASTAL BANC SA	ALLIANCE S&LA COLORADO COUNTY FS&LA SECURITY S&LA CAMERON COUNTY SA	\$3,500	\$146,226	\$455,800	32.08%
SOUTHWEST SA	LAMAR SA CITY S&LA STOCKTON SA BRIERCROFT SA	25,000	1,980,323	3,998,400	49.53%
MERABANK FSB	BROWNFIELD FS&LA FIRST FINANCIAL	8,800	83,868	370,000	22.67%
GIBSON GROUP, INC.	IRVING SA LONGVIEW S&LA GLADEWATER FS&LA RICHARDSON S&LA MAJESTIC SA COMMERCE FS&LA PARIS S&LA AMERICAN BANC SA SKYLINE SA BEN MILAM S&LA MERCURY SA SOUTHLAND SA	48,000	1,313,780	2,217,200	59.25%
SUNBELT SA	SUNBELT SA INDEPENDENT AMERICAN SA SUMMIT SA WESTERN FS&LA TEXANA S&LA FEDERATED S&LA FIRST CITY SA MULTIBANC SA	0	6,166,637	4,826,300	127.77%
MERABANK FSB	STATE FS&LA OF LUBBOCK	<u>20,000</u>	<u>581,787</u>	<u>454,000</u>	<u>128.15%</u>
		\$105,300	\$10,272,621	\$12,321,700	83.37%
		=====	=====	=====	=====
		1.01%	98.99%		
		=====	=====		

Source: FSLIC records