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United States General Accounting Office

GAO

Report to the Congress

July 1988

FINANCIAL AUDIT

Federal Savings and Loan Insurance Corporation's 1987 and 1986 Financial Statements

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United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-114893

July 5, 1988

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

This report presents our opinion on the Federal Savings and Loan Insurance Corporation's (FSLIC) financial statements for the years ended December 31, 1987 and 1986, and our reports on the Corporation's system of internal accounting controls and on its compliance with laws and regulations. Our opinion discusses the potential need for further congressional action to enable the Corporation to resolve the savings and loan industry's problems and meet its obligations.

The deterioration of the industry's financial condition has overwhelmed the resources the Corporation had accumulated to protect depositors. The Corporation's 1987 financial statements reflect a loss of more than $8 billion and a deficit of almost $14 billion. Our May 19, 1988, testimony before the Senate Committee on Banking, Housing, and Urban Affairs, includes additional information about the Corporation's current financial condition and outlook. (See GAO/T-AFMD-88-12.)

The Federal Savings and Loan Insurance Corporation is a wholly owned government corporation governed by the Federal Home Loan Bank Board. We conducted our examinations pursuant to the provisions of 31 U.S.C. 9105 and in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Director of the Office of Management and Budget, the Secretary of the Treasury, and the Chairman of the Federal Home Loan Bank Board.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

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Abbreviation

FSLIC Federal Savings and Loan Insurance Corporation

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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 interest rates on deposits 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 industrywide 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 activities, 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 remained 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 under 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.

These institutions, which have been incurring losses and which the Corporation probably will not act on for several years, will likely 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 has cost the Corporation more than 20 percent of an institution's assets and has 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 insurance premiums the Corporation would otherwise receive over the next 30 years.

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 from the sale of assets from existing receiverships available for resolutions and other operating expenses. 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 resolutions, the Corporation has assumed the following.

- 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 will not be able to take away any substantial portion of the thrift industry's current business.
- It will continue the special assessment of one-eighth of one percent of insured deposits throughout the next 10 years, and will not phase it out in accordance with section 306(c) of the Competitive Equality Banking Act of 1987 or as contemplated by its April 12, 1988, proposed regulation, under which the special assessment would be phased out for thrifts meeting certain capital requirements.
- Recapitalization bonds will continue to be marketed at interest rates of slightly less than 10 percent.

In determining the costs related to its caseload, the Corporation has assumed the following.

- 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, almost 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 incurring 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.

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 or increase its resolution costs, thus affecting its ability to resolve the industry's problems.

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.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

May 17, 1988

Report on Internal Accounting Controls

We have examined the financial statements of the Federal Savings and Loan Insurance Corporation for the years ended December 31, 1987 and 1986, and have issued our opinion thereon. As part of our examinations, we made a study and evaluation of the system of internal accounting controls to the extent we considered necessary to evaluate the system as required by generally accepted government auditing standards. This report pertains only to our study and evaluation of the system of internal accounting controls for the year ended December 31, 1987. Our report on the study and evaluation of internal accounting controls for the year ended December 31, 1986, is presented in GAO/AFMD-87-41, dated May 27, 1987.

The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the Corporation's financial statements. For purposes of this report, we have classified the significant internal accounting controls into the following categories:

- assistance to problem savings and loan institutions,
- expenditures,
- financial reporting,
- revenue, and
- treasury.

Our study and evaluation included all of the control categories listed above except for the treasury category. For that category, we found it more efficient to rely solely on substantive audit tests. In addition, we reviewed the Corporation's report for the year ending September 30, 1987, issued pursuant to section 2 of the Federal Managers' Financial Integrity Act of 1982, to determine the existence and status of any internal control weaknesses relevant to financial matters which the Corporation had identified.

The Corporation's management is responsible for establishing and maintaining an effective system of internal accounting controls. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system of internal accounting controls are to provide management with reasonable assurance that (1) obligations and costs are in compliance with applicable laws, (2) funds, property, and assets are safeguarded against waste, loss, and unauthorized use or misappropriation, and (3) assets, liabilities, revenues, and expenditures applicable to operations are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over the Corporation's assets. Because of inherent limitations in any system of internal accounting controls, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with procedures may deteriorate.

Our study and evaluation, made for the limited purpose described in the second paragraph, would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the Corporation's system of internal accounting controls taken as a whole or on the categories of controls identified in the second paragraph.

During our examination, we identified and reported to the Federal Home Loan Bank Board matters related to the Corporation's operations which we believe warranted attention (GAO/AFMD-88-57, dated May 20, 1988). Specifically, we recommended that the Bank Board issue a public policy statement regarding the total amount of notes to acquirers the Corporation intends to issue, as well as the total amount of yield and other guarantees the Corporation intends to provide in connection with resolution actions. As discussed in our report, this recommendation is intended to help the Bank Board and the Corporation maintain the credibility and acceptability of the notes and guarantees. Because of our concerns about the impact that new, creative financial instruments may have on insured institutions and the insurance fund, we also recommended that the Bank Board provide necessary guidance on new financial instruments and transactions to supervisory and examination staff, as well as to staff of FSLIC-insured savings and loan institutions.

During our examination, we also identified several internal accounting control matters which, although not material, nonetheless merit corrective action to strengthen the Corporation's internal accounting controls. These matters will be reported separately to the Corporation.

Report on Compliance With Laws and Regulations

We have examined the financial statements of the Federal Savings and Loan Insurance Corporation for the years ended December 31, 1987 and 1986, and have issued our opinion thereon. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of compliance with laws and regulations as we considered necessary in the circumstances. This report pertains only to our review of compliance with laws and regulations for the year ended December 31, 1987. Our report on the review of compliance with laws and regulations for the year ended December 31, 1986, is presented in GAO/AFMD-87-41, dated May 27, 1987.

In our opinion, the Corporation complied with the terms and provisions of laws and regulations for the transactions tested that could have materially affected its financial statements. In connection with our examination, nothing came to our attention that caused us to believe that the Corporation was not in compliance with the terms and provisions of laws and regulations for those transactions not tested.

Financial Statements

Consolidated Statement of Financial Condition

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
CONSOLIDATED STATEMENT OF FINANCIAL CONDITION
DECEMBER 31, 1987 AND 1986
(in thousands)

	1987	1986
Assets		
Cash	$ 12,415	$ 42,209
Investments (Note 3)	3,357,173	3,986,515
Interest receivable on investments	1,000	19,035
Insurance premiums and accounts receivable	506	913
Contributions subject to repayment	18,544	27,423
Subrogated accounts from receivers (Note 4)	3,988,495	2,827,489
Collateralized advances from receivers (Note 4)	814,047	824,484
Loans to receivers (Note 5)	113,573	117,274
Interest receivable on loans to receivers	3,767	2,016
Collateralized loans to insured institutions (Note 6)	900,000	900,000
Other loans to insured institutions (Note 6)	214,181	113,502
Interest receivable on other loans to insured institutions	10,533	2,778
Real estate, mortgage loans and other assets in process of liquidation (Note 7)	173,437	293,056
Income capital certificates (Notes 8 and 10)	656,742	1,436,781
Net worth certificates (Notes 9 and 10)	225,025	272,650
Other assets	19,009	6,885
Total assets	10,508,447	10,873,010
Liabilities		
Accounts payable and other liabilities	102,230	61,138
Notes payable and other liabilities to insured institutions (Note 10)	4,947,463	4,872,750
Accrued interest on notes payable to insured institutions	99,905	97,941
Notes payable to Federal Home Loan Banks (Note 6)	900,000	900,000
Allowance for loss - assistance agreements (Note 11)	749,069	774,072
Allowance for loss - unresolved cases (Note 15)	17,400,000	10,500,000
Total liabilities	24,198,667	17,205,901
Insurance Fund Reserves		
Capital stock	129,500	0
Capital certificates	1,070,500	0
Reserves	(14,890,220)	(6,332,891)
Total primary reserve (Note 13)	(13,690,220)	(6,332,891)
Total liabilities and reserves	$10,508,447	$10,873,010

The accompanying notes are an integral part of these financial statements.

Consolidated Statement of Income and Expense and Reserves

FOR THE YEARS ENDED DECEMBER 31, 1987 AND 1986
(in thousands)

	1987	1986
Income		
Insurance premiums (Note 1)	$ 734,021	$ 750,678
Special assessment premiums (Note 1)	1,119,582	1,078,774
Interest on investments	112,552	368,005
Interest on collateralized advances	8,814	7,458
Interest on NWC's & ICC's	60,607	24,236
Interest on other loans to insured institutions	28,010	6,446
Interest on collateralized loans to insured institutions	101,240	48,572
Interest on advances to insured institutions.	47,051	0
Interest on mortgage loans and other assets in process of liquidation	17,159	13,236
Gain on sale of assets	32,299	620
Gain on transfer of insured accounts	31,710	64,871
Other income	102,084	44,700
Total income	2,395,129	2,407,596
Expenses		
Insurance settlement and administrative expenses for FSLIC	192,593	63,504
Services rendered to FSLIC by the Federal Home Loan Bank Board (Note 2)	25,604	24,820
Interest applied to the secondary reserve (Note 13)	0	52,793
Interest on notes payable to Federal Home Loan Banks	78,928	45,653
Interest on notes payable to insured institutions	237,789	217,979
Provision for loss on:		
Subrogated accounts from receivers (Note 4)	1,623,060	3,195,274
Collateralized advances from receivers (Note 4)	145,313	(254,174)
Real estate, mortgage loans and other assets in process of liquidation (Note 7)	106,943	40,509
Loans to receivers (Note 5)	24,225	0
Income capital certificates (Notes 8 and 10)	281,793	127,599
Assistance agreements (Note 11)	1,334,730	889,404
Unresolved cases (Note 15)	6,900,000	8,944,000
Total expenses	10,950,978	13,347,361
Net income (loss) from operations	(8,555,849)	(10,939,765)
Primary reserve at beginning of period	(6,332,891)	3,783,169
Net income (loss)	(8,555,849)	(10,939,765)
Add transfer of secondary reserve at 12/31/86	0	823,705
Secondary reserve adjustments after transfer	(1,480)	0
Capital stock	129,500	0
Capital certificates	1,070,500	0
Primary reserve at end of period (Note 13)	($13,690,220)	($6,332,891)

The accompanying notes are an integral part of these financial statements.

Consolidated Statement of Changes in Financial Position

FOR THE YEARS ENDED DECEMBER 31, 1987 AND 1986
(in thousands)

	1987	1986
Source of Funds:		
Net income (loss)	$(8,555,849)	$ (10,939,765)
Add (deduct) items not requiring, or generating cash:		
Depreciation of FF&E	3,227	332
Accretion and amortization of investments	1,972	6,224
Interest applied to the secondary reserve	0	52,793
Transfer from the secondary reserve	0	(91)
Gain on transfer of insured accounts	(31,710)	0
Provision for loss on:		
Subrogated accounts (Note 4)	1,623,060	3,195,274
Collateralized advances from receiver (Note 4)	145,313	(254,174)
Real estate, mortgage loans and other assets (Note 7)	106,943	40,509
Income capital certificates (Notes 8 and 10)	281,793	127,599
Assistance agreements (Note 11)	1,334,730	889,404
Unresolved cases (Note 15)	6,900,000	8,944,000
Loans to receivers	24,225	0
Funds provided from operations	1,833,704	2,062,105
Sale of capital stock	129,500	0
Sale of capital certificates	1,070,500	0
Increase in:		
Accounts payable and other liabilities	41,092	11,822
Notes payable and other liabilities to insured institutions (Note 10)	74,713	2,271,870
Accrued interest on notes payable to insured institutions	1,964	36,542
Decrease in:		
Insurance premiums and accounts receivable	407	6,358
Investments and interest receivable	644,945	2,162,790
Real estate, mortgage loans & other assets in process of liquidation	13,136	(106,144)
Contributions subject to repayment	8,879	1,667
Income capital certificates	498,247	(29,621)
Net worth certificates	47,625	1,850
Total funds provided	4,364,712	6,419,239
Application of Funds:		
Amount paid under assistance agreements	1,359,733	889,336
Secondary reserve refund	1,480	3,230
Increase in:		
Subrogated accounts	2,752,355	5,186,607
Loans to insured institutions and interest receivable	108,434	(18,684)
Collateralized advances from receiver	134,876	287,755
Loans to receivers and interest receivable	22,275	33,014
Other assets	15,353	5,215
Total funds applied	4,394,506	6,386,473
Increase (Decrease) in cash	$ (29,794)	$ 32,766

The accompanying notes are an integral part of these financial statements.

Notes to Financial Statements

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1987 AND 1986

1. Summary of Significant Accounting Policies:

   a) Principles of Consolidation - The FSLIC began accounting for its investment in the Federal Asset Disposition Association (FADA), a wholly owned subsidiary, through consolidation effective December 31, 1986. However, these consolidated statements, do not include accountability for assets and liabilities of closed insured institutions for which the Corporation acts as receiver or liquidating agent. The Corporation furnishes periodic and final accountability reports of its Receivership or liquidating agent activities to courts, supervisory authorities, and other interested parties as requested.

   b) Premium Income Recognition - Insurance premium income is recognized as earned when member institutions are assessed. These premiums are assessed annually and semi-annually based on an institution's insured anniversary date. On August 10, 1987 the Congress passed the Competitive Equality Banking Act of 1987 (CEBA), PL 100-86. Title III, Section 305 of this act limits FSLIC's authority to collect premiums by reducing them by the amount the newly created Financing Corporation assesses. The rate of assessment may not exceed 1/12 of one percent of the insured institution's total savings capital, whether the premiums are paid to the FSLIC, the Financing Corporation, or a combination of both. As of result of CEBA, $32.1 million of insurance premiums were assessed and collected by the Financing Corporation during 1987.

   c) Special Assessment Recognition - In addition to the regular insurance premiums, the Corporation has the authority under Section 404(c) of the National Housing Act to assess each insured member a special assessment premium not to exceed 1/8 of one percent of their total savings capital. The special assessment is billed quarterly and income is recognized as earned when member institutions are billed. Title III, Section 306(c) of the Competitive Equality Banking Act of 1987 also placed limitations on the amount of special assessments for the years 1987 through 1991. The 1987 limitation was 5/48 of one percent. However, the Act allowed the Board to postpone the reduction in the special assessment until 1988 if the Board determined that such postponement would improve the financing environment for selling obligations of the Financing Corporation. The Board approved a postponement of the reduction on December 14, 1987.

d) Allowance for Loss - The Corporation's policy is to establish an estimated allowance for loss at the time the Bank Board approves financial assistance to an insured institution. The type of financial assistance provided may be in several forms (Notes 4 thru 11). The estimated allowance for the assistance given, represents the purchase price of the assets of a failed or troubled institution less the estimated recovery value, including all liquidation costs. These allowances are reviewed at least annually and are adjusted to reflect projected interest rates, recent appraisals, and historical experience, etc.

The allowance for loss on unresolved cases includes bid prices received by FSLIC and the estimable and probable resolution costs of the remaining thrifts in the FSLIC caseload; plus an additional allowance for institutions located in the Southwest that were not part of the FSLIC caseload as of December 31, 1987. The $17.4 billion allowance for loss on unresolved cases only includes future assistance that is probable and can be reasonably estimated and is not a projection of the cost of resolving all future problems in the savings and loan industry which present projections indicate could amount to $22.7 billion or more. The allowance for unresolved cases is reviewed at least annually and is adjusted to reflect changes in FSLIC's financial assistance caseload or as institutions are solved. The Corporation believes that adequate resources exist to provide needed assistance to troubled or failed thrifts.

e) Furniture Fixtures, and Equipment (FF&E) - The FF&E cost at December 31, 1987 was zero. The cost at December 31, 1986 was $2,769,864 less accumulated depreciation of $434,696. Depreciation was computed on the straight-line method based on an 11 year useful life. Beginning on October 1, 1986, the FSLIC changed its FF&E policy to expense all new FF&E purchases below $250,000 and to capitalize and depreciate only those purchases that exceeded this limit or were made in a prior year. The prior years capitalized purchases were depreciated through September 30, 1987 at which time a further review of the FF&E policy was made. It was determined that for the purpose of consistency all FF&E should be expensed. This new policy change resulted in a one time 1987 FF&E reduction of $2,128,626 and an increase to depreciation expense. The FF&E of FADA, however, is capitalized and stated at cost less accumulated depreciation, with depreciation computed on a straight line basis over the estimated useful lives of the assets. The net balance is insignificant and is included in other assets.

f) Reclassification - Reclassifications have been made in the 1986 Financial Statements to conform to the presentation used in 1987.

2. Related Parties - The Federal Savings and Loan Insurance Corporation, a government agency created by the National Housing Act of 1934, is governed by the Federal Home Loan Bank Board. Bank Board expenses are met through assessments to the FSLIC and the FHLBanks. The FSLIC's

share of the Bank Board assessment is charged to operating expenses during the year in which the assessment is levied. In addition to Bank Board, FSLIC interacts with FHLBanks, FADA and the Financing Corporation which are also under the Bank Board's direction.

FHLBanks - The FSLIC, as part of its default prevention activities, may guarantee repayment of FHLBank advances that have been made to certain insured institutions. These guarantees generally cover advances that are secured. As of December 31, 1987, the FSLIC had guaranteed commitments of $7.3 billion, of which $2.3 billion had been advanced to member associations. By comparison, as of December 31, 1986, guaranteed commitments totaled $8.7 billion, of which $3.6 billion had been advanced. In the event that FSLIC is called upon to honor these guarantees, they are recorded as an asset. The FSLIC also has a claim against any assets pledged as collateral to secure such advances.

The FHLBanks are also authorized, as directed by the Bank Board, to make loans to the FSLIC. All such loans must be in accordance with the provisions of section 402(d) of the National Housing Act. Loans from FHLBanks were $900 million as of December 31, 1987 and 1986 and have been passed through to member institutions as Collateralized Loans (Note 6).

FADA - In November 1985, the Bank Board approved the formation of the Federal Asset Disposition Association, or FADA. The FADA, which is a wholly owned subsidiary of the FSLIC, manages and disposes of certain assets received by the FSLIC in case resolution actions. As of December 31, 1986, the FSLIC had purchased 25,000 shares of FADA common stock for $25 million. At December 31, 1987 FADA reported assets of $26.8 million, liabilities of $12.4 million, and a retained deficit of $10.6 million.

Under a contract with the Federal Home Loan Bank of Topeka, the FSLIC has guaranteed repayment of up to $50 million in Bank advances to the FADA. As of December 31, 1987, and 1986, the FADA borrowed $7.0 million, and $800,000, respectively, against this open line of credit.

Financing Corporation - Title III, Section 302 of the Competitive Equality Banking Act of 1987 establishes a newly created Financing Corporation. The Financing Corporation (FICO) is funded by the FHLBanks investment and its issuance of public debt offerings which are limited to $10.8 billion. The net proceeds of obligations issued by the Financing Corporation are required to be used to purchase capital stock or capital certificates issued by the FSLIC (Note 13). Through December 31, 1987, the FICO has purchased $1.2 Billion in FSLIC capital stock and capital certificates.

3. Investments - Investment securities are stated at cost, adjusted for amortization of premiums and accretion of discounts. Such amortization and accretion are computed by the interest method at rates based upon the maturity dates of the related securities. Both amortization and accretion are recognized as an adjustment to Interest on Investments.

All cash received by the Corporation which is not used to defray operating expenses or for outlays related to assistance to insured institutions and liquidation activities, is invested in U.S. Treasury securities. Other Investments are mostly S&L stock and GNMAs issued by Federal Government Agencies other than the U.S. Treasury which were obtained through the Corporation's default prevention activities.

As of December 31, 1987 and 1986, the Corporation's investment portfolio consisted of the following:

	1987		1986	
	Book Value	Market Value	Book Value	Market Value
	(in thousands)		(in thousands)	
U.S. Treasury Securities:				
Overnight Funds	$ 2,910,410	$ 2,910,410	$ 3,154,595	$ 3,154,595
Maturities up to One Year	0	0	446,695	447,976
Maturities Over One Year	0	0	242,952	246,659
Subtotal:	2,910,410	2,910,410	3,844,242	3,849,230
Other Investments:				
Maturities Up to One Year	51,985	51,801	2,500	2,497
Maturities Over One Year	5,017	4,857	74,083	73,690
Total Securities	2,967,412	2,967,068	3,920,825	3,925,417
Preferred Stock	389,761	389,761	65,690	65,690
Total Investments:	$ 3,357,173	$ 3,356,829	$ 3,986,515	$ 3,991,107

4. Subrogated Accounts and Collateralized Advances - As required by Statute, an institution is closed only when there is no default prevention measure that would be less costly than liquidation. In these cases, FSLIC settles insurance claims either by cash payout of insured accounts or by transferring insured accounts to another insured institution. The FSLIC's claims on the receivership of the liquidated institution are equal to the amount of the insured accounts transferred and/or the collateralized advances paid.

   In most cases, a receivership does not have sufficient assets to pay all of its claims; therefore, FSLIC must estimate how much of each claim will be recovered over the life of the receivership and record the difference as an allowance for loss against the claim.

The changes in Subrogated Accounts and Collateralized Advances for the years ended December 31, 1987 and 1986 are:

		Subrogated Accounts		Collateralized Advances	
		1987	1986	1987	1986
		(in thousands)		(in thousands)	
Balance:	Beginning of Year	$ 7,711,976	$ 2,525,370	$ 855,951	$ 569,293
Add:	Increase	2,784,065	5,186,606	134,876	287,755
Less:	Actual Losses Incurred	(767)	0	0	(1,097)
Balance:	End of Year	10,495,274	7,711,976	990,827	855,951
Less:	Allowance for Loss (Cumulative)	(6,506,779)	(4,884,487)	(176,780)	(31,467)
Net:	End of Year	$ 3,988,495	$ 2,827,489	$ 814,047	$ 824,484

5. Loans to Receivers - The FSLIC makes loans available to meet the administrative and operating expense requirements of certain receiverships. These loans are to be repaid from the liquidation of unencumbered assets of the receivership.

The changes in Loans to Receivers for the years ended December 31, 1987 and 1986 are:

		1987	1986
		(in thousands)	
Balance:	Beginning of Year	$117,274	$ 86,276
Add:	Increase (Decrease)	20,524	30,998
Balance:	End of Year	137,798	117,274
Less:	Allowance for Loss (Cumulative)	(24,225)	0
Net:	End of Year	$113,573	$117,274

6. Loans to Insured Institutions - The FSLIC makes both collateralized and other types of loans in assistance cases. The collateralized loans have been funded by pass-through loans from FHLBanks. In these transactions, FSLIC issues a note payable to the FHLBank and loans the proceeds to an insured institution. The FSLIC has two loans of this type, one for $200 million and one for $700 million, totaling $900 million. Interest rates on the $200 million loan and the corresponding note to the FHLBank are the same and averaged 6.6% in 1987. The interest rate on the remaining $700 million loan receivable is based on the monthly weighted-average cost of funds charged to members of the FHLBank in which the institution is located and ranged from 7.2% to 7.6% in 1987. Interest on the corresponding note payable to the FHLBank is based on the cost of FHLBank funds plus 20 basis points. This rate varied between 6.0% and 7.5% during 1987. Annual principal payments on the collateralized loans begin in 1988 and end in 1995.

The $214.2 million in Other Loans to Insured Institutions is shown net of a $5.4 million allowance which was established in 1985. The interest rate on these loans varies with each note.

7. Real Estate, Mortgage Loans, and Other Assets - The FSLIC makes direct acquisitions of troubled assets from problem associations in its attempt to merge a failing institution. The vast majority of these assets consists of real estate and mortgage loans. An allowance for loss has been established to reduce these assets to their net realizable value.

The changes in Real Estate, Mortgage Loans and Other Assets in Process of Liquidation for the years ended December 31, 1987 and 1986 are:

		1987	1986
		(in thousands)	
Balance:	Beginning of Year	$ 337,479	$ 257,749
Add:	Increase (Decrease)	(49,560)	79,730
Balance:	End of Year	287,919	337,479
Less:	Allowance for Loss (Cumulative)	(114,482)	(44,423)
Net:	End of Year	$ 173,437	$ 293,056

8. Income Capital Certificates - Since 1981 the FSLIC has purchased Income Capital Certificates (ICCs) from insured institutions as part of its default prevention activities. The FSLIC usually purchases an ICC by issuing a note payable and records the ICC at cost (Note 10). The ICCs earn annual income payments based on the United States Treasury Bill rates. The annual income payments and principal are redeemable upon the issuing institution having profitable operations and attaining a specified net worth level.

The changes in the ICCs for the years ended December 31, 1987 and 1986 are:

		1987	1986
		(in thousands)	
Balance:	Beginning of Year	$ 2,219,544	$ 2,330,923
Add:	Net Purchases or (Cancellations)	(573,661)	(111,379)
Balance:	End of Year	1,645,883	2,219,544
Less:	Allowance for Loss (Cumulative)	(989,141)	(782,763)
Net:	End of Year	$ 656,742	$ 1,436,781

9. Net Worth Certificates - Since 1982 the FSLIC has purchased Net Worth Certificates (NWCs) from insured institutions as part of its default prevention activities. The FSLIC purchases an NWC by issuing a note payable and records the NWC at cost (Note 10). NWCs earn annual income

payments based on the cost of Federal Home Loan Bank System Obligations plus 1/4 of one percent. Annual income and principal payments are due upon the issuing institution having profitable operations and attaining a specified net worth level. The legislation authorizing the issuance of net worth certificates expired in October 1986 and was reinstated with the passage of the Competitive Equality Banking Act of 1987 on August 10, 1987.

The changes in the NWCs for the years ended December 31, 1987 and 1986 are:

		1987	1986
		(in thousands)	
Balance:	Beginning of Year	$ 272,650	$ 292,000
Add:	Net Purchases or (Cancellations)	(47,625)	(19,350)
Balance:	End of Year	225,025	272,650
Less:	Allowance for Loss (Cumulative)	0	0
Net:	End of Year	$ 225,025	$ 272,650

10. Notes Payable and Other Liabilities to Insured Institutions - The FSLIC has outstanding negotiable notes to purchase ICCs and promissory notes to purchase ICCs and NWCs. Variable interest is paid semiannually based on the cost of Federal Home Loan Bank System Obligations or the average auction yield for United States Treasury Notes with maturities from 5-10 years. In addition to issuing notes to purchase ICCs and NWCs, the FSLIC has also issued notes to insured institutions who have acquired the deposits of defaulted S&Ls. The principal on these notes may be paid through the transfer of cash and/or assets to the acquirer. The interest on these notes is paid semiannually based on an average auction yield of U.S. Treasury bills with maturities from 13-26 weeks plus 15 basis points. In addition to these notes, FSLIC has other liabilities to acquiring institutions of $302 million.

The aggregate amount of the Notes Payable to Insured Institutions and their maturity dates as of December 31, 1987 are as follows:

	ICCs	NWCs	Acquirers	Other	Total
		(in thousands)			
1988	$ 0	$ 0	$1,161,128	$ 21,894	$1,183,022
1989	0	0	0	0	0
1990	839,587	0	809,544	0	1,649,131
1991	160,919	0	939,487	0	1,100,406
1992	0	26,825	0	15,000	41,825
Later	27,000	178,200	0	465,578	670,778
Total	$ 1,027,506	$ 205,025	$2,910,159	$502,472	$4,645,162

11. Allowance for Loss - Assistance Agreements - The FSLIC enters into assistance agreements, which are usually associated with mergers, to prevent the default of an insured institution. Under these agreements the Corporation agrees to give financial assistance over time. All future cash outlays are discounted to their present value. The changes in the allowance for loss on Assistance Agreements for the years ended December 31, 1987 and 1986 are:

	1987 (in thousands)	1986
Balance: Beginning of Year	$ 774,072	$ 774,004
Add: Provisions	1,334,730	889,404
Less: Assistance Paid	(1,359,733)	(889,336)
Balance: End of Year	$ 749,069	$ 774,072

12. Retirement Plan - Approximately 36% of the FSLIC's employees are covered by the Civil Service Retirement System (CSRS), which is currently two-tiered. For employees hired prior to January 1, 1984, the FSLIC withholds approximately 7 percent of their gross earnings. This contribution is then matched by the FSLIC and the sum is transferred to the Civil Service Retirement Fund, from which this group will receive retirement benefits. For employees hired on or after January 1, 1984, with more than five years of service (not necessarily continuous), the FSLIC withholds, in addition to Social Security withholdings, approximately 1.3 percent of their gross earnings, but matches such withholdings with a 7 percent contribution. At the point such earnings exceed the FICA maximum wages of $43,800 for 1987, employees covered under this tier of CSRS are required to have 7 percent of their earnings withheld while the agency expense remains a 7 percent contribution. This second employee group will receive retirement benefits from the CSRS along with the Social Security System, to which they concurrently contribute. Beginning in January 1987, all employees hired since January 1, 1984, either as new employees or as having less than 5 years of accumulated service (with a break in service over one year) are included in the new Federal Employee Retirement System (FERS). For such employees the FSLIC withholds 1.3% of their gross earnings and matches those withholdings with a 14.8 percent contribution (through 10/10/87) and a 12.5% contribution effective 10/11/87. This group of employees will receive benefits from the FERS as well as the Social Security System to which they concurrently contribute. The retirement expenses incurred for all plans during calendar years 1987 and 1986 were $1,353,587 and $733,715 respectively.

Although the FSLIC funds a portion of pension benefits under both of the above Retirement Systems relating to its employees and makes the necessary payroll withholdings from them, the FSLIC does not account for the assets of either retirement plan nor does it have actuarial data with respect to accumulated plan benefits or the unfunded pension liability relative to its employees. These amounts are reported by the Office of Personnel Management for both Retirement Systems and are not allocated to the individual employers. The Office of Personnel Management accounts for all health and life insurance programs for retired federal employees.

13. Reserves - The FSLIC's total reserves available for losses in 1986 consisted of a Primary and Secondary Reserve. The Primary Reserve was the cumulative net income (loss) of the FSLIC since its inception. The Secondary Reserve was the equity of certain institutions in FSLIC based on premium prepayments and related interest not yet paid to these institutions.

Because the FSLIC suffered losses during calendar year 1986 in excess of all of its reserves, the secondary reserve was eliminated in order to further reduce losses in the primary reserve. However, Title III, Section 307 of the Competitive Equality Banking Act of 1987 (CEBA) authorizes insured institutions to offset against future special assessment premiums the amounts that were previously part of the "secondary reserve". This amount is currently $818.7 million but will decrease each year, beginning in 1988, by 20 percent of the declining balance.

Title III, Section 304 of CEBA also authorizes the FSLIC to issue equity in the form of redeemable non-voting capital stock and non-redeemable capital certificates. The non-voting capital stock is issued in an amount equal to the aggregate investment by the FHLBanks in the Financing Corporation. The Financing Corporation is the sole purchaser of both the capital stock and capital certificates and proceeds paid to the FSLIC from that purchase are included as part of its primary reserve. The FSLIC is prohibited from paying any dividends to the Financing Corporation on the capital stock or certificates.

As of December 31, 1987 and 1986, the Corporation's primary reserve consisted of the following:

	1987	1986
	(in thousands)	
Primary Reserve		
Balance: Beginning of year	$ (6,332,891)	$ 3,783,169
Transfer of Secondary Reserve	0	823,705
Adjusted Beginning Balance	(6,332,891)	4,606,874
Net Income (loss)	(8,555,849)	(10,939,765)
Secondary Reserve Adjustments after transfer	(1,480)	0
Capital Stock	129,500	0
Capital Certificates	1,070,500	0
Balance: End of Year	$(13,690,220)	$(6,332,891)

14. Lease Commitments - The FSLIC is currently leasing office space in three Washington D.C. locations in order to accommodate its increased staffing levels. The minimum yearly rental expenses for each location are as follows:

	1735 Eye St. N.W.	801 17th St. N.W.	1776 G St. N.W.
1986	$410,230	$ -	$ -
1987	670,332	1,979,112	348,898
1988	279,305	5,937,336	380,554
1989	-	5,937,336	380,554
1990	-	5,937,336	380,554
1991	-	5,937,336	380,554
1992	-	6,088,336	380,554
Later	-	$65,170,748	$634,250

15. Allowance for Loss - Unresolved Cases - The Corporation has established a contingent liability for future assistance to troubled (unresolved) institutions that is probable and estimable. The liability includes bid prices received by FSLIC and the estimable and probable resolution costs of the remaining thrifts in the FSLIC caseload; plus an additional allowance for institutions located in the Southwest that were not part of the FSLIC caseload as of December 31, 1987. Changes in the Allowance for Loss on Unresolved Cases for the years ended December 31, 1987 and 1986 are:

	1987 (in thousands)	1986
Balance: Beginning of Year	$10,500,000	$ 1,556,000
Add: Provisions	6,900,000	8,944,000
Balance: End of Year	$17,400,000	$10,500,000

16. Litigation - At the end of 1987, FSLIC was named in 45 legal or administrative actions, while its receiverships were involved in 481 cases. FSLIC in its capacity as conservator was also involved in 35 cases. Currently, it is not possible to predict the eventual outcome of the various actions. However, it is management's opinion that these claims will not result in liabilities to such an extent that they will materially affect the FSLIC's financial position.

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