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Observations on The Financial Institutions Reform, Recovery and Enforcement Act of 1989

Statement of
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Committee on Banking, Finance and Urban Affairs
House of Representatives

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss H.R. 1278, the Financial Institutions Reform, Recovery and Enforcement Act of 1989. My testimony will cover four areas--the urgency of enacting this legislation, the budgetary treatment of the financing to resolve the thrift crisis, the cost of resolving the crisis, and the structure of the proposed Resolution Trust Corporation (RTC), the entity tasked with handling thrift resolutions. First, I would like to briefly discuss GAO's major beliefs regarding the resolution of the thrift industry crisis.

As we have previously reported to and testified on before this Committee, the administration and the Congress are faced with two problems which, in our view, are of equal concern. First, they need to contain and resolve the immediate financial crisis of the Federal Savings and Loan Insurance Corporation (FSLIC) and the thrift industry, and second, they need to take action to prevent this crisis from recurring. In enacting the solution to this crisis, several major premises need to be considered:

-- The solution must be acted upon quickly to (1) avert a widespread loss of confidence in the U.S. financial institutions industry, (2) stem the operating losses of insolvent thrifts that continue to occur and will be added to the cost of resolving this crisis, and (3) reduce the incentives to pay excessive interest rates which are adversely affecting the entire system.

-- Federal assistance should be properly recorded and disclosed in the budget, even if it means revising Gramm-Rudman-Hollings deficit reduction targets.

-- To the extent practical, future industry earnings should first be used to establish a new fund; any additional contributions should be sought in a way that does not jeopardize the viability of healthy thrifts.

-- The solution should not disrupt other mechanisms, such as the banks' deposit insurance system, that are working reasonably well; and should not rely on fundamental changes in government policy relating to using funds provided for one purpose for another purpose, such as using the Federal Deposit Insurance Corporation's (FDIC) funds to help pay for the thrift crisis.

-- Reforms, such as stringent tangible capital requirements and enhanced, independent supervision and enforcement, must serve as the foundation for any legislation to resolve the thrift crisis.

With these major premises in mind, we have consistently recommended that certain steps be taken to resolve the crisis and prevent it from recurring.

-- Take control of and isolate the troubled segment of the thrift industry until an informed decision can be made whether to liquidate or merge those thrifts based upon a careful assessment of their asset portfolios and management capability and the comparative cost of each approach.

-- Immediately make the funds available to cover any potential run-off of insured deposits in these thrifts and to permit dealing with each of these institutions effectively, rather than deferring resolution through the use of forbearance.

-- Provide a separate mechanism to control and oversee this process, using staff from FSLIC, the Federal Home Loan Bank Board, and the banking regulators.

-- Establish a new thrift insurance fund independent from the Bank Board for the healthier segment of the industry, capitalizing it with future industry contributions. The new agency should be provided the authority and the resources to protect its insurance fund.

-- Enact strong regulatory reform actions to prevent a recurrence of the crisis. Such reforms would include, but not be limited to, increased tangible capital requirements for thrifts, increased management accountability for operating thrifts in a safe and sound manner, mandatory independent financial and compliance audits, and adequate authority for the insurer to deny or cancel deposit insurance, when necessary, and to limit state-allowed activities beyond those allowed for federally chartered thrifts. In particular, increased capital requirements are critical to the success of any plan to resolve this crisis and prevent it from recurring.

We continue to believe that these are the key issues to be dealt with in this legislation.

I would now like to turn to the four areas you asked me to discuss.

First, we continue to be concerned about delays in enacting this legislation. In view of the deposit run-off the industry is currently facing and the liquidity problems some thrifts are experiencing, as well as the potential for the continued loss of investor confidence and the diminishment of the franchise value of thrifts, it is imperative that legislation be enacted quickly. In addition, we need to get the funds to begin taking action on the thrifts FDIC has already taken over. Until such action is taken, insolvent thrifts will continue to incur operating losses that will add to the resolution costs; and all depository institutions will continue to be faced with paying high interest costs on deposits.

Second, in regard to our views on whether the financing to resolve the current thrift crisis should be on or off-budget, we have testified on several occasions that we believe that the financing should be on-budget even if that requires raising Gramm-Rudman-Hollings deficit reduction targets. As recently as May 19, 1989, the Comptroller General testified on this issue. Therefore, I would just like to reiterate what he said about the off-budget approach the administration proposed.

Specifically, we have two concerns about the off-budget approach. We and others have pointed out that using an off-budget entity, such as the Resolution Funding Corporation (REFCORP), has the longer term consequence of increasing interest costs over what Treasury would pay if it borrowed the funds and made them available for resolution actions. REFCORP's borrowings will carry higher interest rates than Treasury's. According to the administration, REFCORP would have to pay about 25 basis points more than Treasury would have to pay on debt with the same maturity, adding almost $4 billion to interest costs over the 30-year life of the bonds REFCORP issues. In addition, as others have pointed out, locking into a fixed 30-year interest rate at this time could be more expensive than having Treasury borrow the funds using a blend of maturities that minimizes the overall interest rate.

Our second concern relates to the need to maintain budget discipline. If budget discipline is to be maintained, care needs to be taken to avoiding new off-budget entities that, in reality, are more like federal agencies performing governmental functions. Off-budget approaches should not be used loosely to make it appear that the government is staying within deficit targets.

Turning specifically to whether REFCORP meets the criteria for the off-budget treatment the administration envisioned, when we consider the balance of the various features of REFCORP, we are led to believe that REFCORP more closely resembles a federal agency than an off-budget government-sponsored enterprise. Therefore, it should be on-budget.

We recognize that an on-budget approach would increase the reported outlays beyond fiscal year 1989, for any resolution actions that could not be completed in 1989, and add to other difficulties of reaching deficit targets. Actions would be needed to either raise the Gramm-Rudman-Hollings deficit targets, or to exempt the resolution outlays from the deficit calculations. As we have previously stated, we think that the targets should be raised to accommodate any extra governmental spending to resolve the thrift crisis.

Ultimately, the question of whether Treasury or REFCORP borrowings are used will be a policy choice of the Congress and the President. I would just suggest that in making that choice, our elected officials consider carefully the added costs and the implications for budget discipline of establishing an off-budget entity to finance the resolution of the thrift industry crisis.

Now, I would like to turn to the cost of resolving the thrift crisis. Recently, questions have been raised about whether the proposal provides adequate funds to cover the costs involved. The proposal provides funds for three major program elements:

-- about $60 billion for FSLIC's past actions,

-- $50 billion for currently insolvent thrifts and thrifts which become insolvent during the first 3 years after the legislation is enacted, and

-- $33 billion during the fourth through eleventh years of the plan for future insolvencies and to establish a new thrift insurance fund.

These costs total about $143 billion; with interest on the 30-year bonds and other miscellaneous items added in, the funding needs double to at least $285 billion. Of the $285 billion, about $157 billion, or 55 percent, will be paid by the taxpayers. To put that number into perspective, it amounts to about $600 for every man, woman, and child in this country.

While we can argue over some of the elements that went into the calculation of the overall funding needs for case resolutions, we have not seen anything that causes us to believe that the overall number is significantly under- or overstated. Nonetheless, on the financing side, we have expressed concern about two items in particular--deposit growth rate assumptions and interest rate assumptions. To the extent that the assumptions about deposit growth and/or interest rates are overly optimistic, the amount the taxpayers will have to contribute will increase.

I would now like to turn to the Resolution Trust Corporation. We believe that RTC is ultimately the most complex and risk-prone element of the plan. We have seen problems in the deals FSLIC made, particularly in December 1988, to resolve the problems of thrifts and in asset liquidation (the Federal Asset Disposition Association), and have testified on these issues on several occasions. Without proper oversight and controls, the potential for the same problems exists at RTC, only magnified many times.

We therefore believe that it is vitally important the we learn from past mistakes. Specifically, we believe that:

-- the structure of RTC needs to be abundantly clear in regard to who has the authority, responsibility, and accountability for its actions;

-- appropriate GAO and congressional oversight needs to be provided for; and

-- up-front congressional guidance needs to be provided on how RTC is to conduct its activities, especially those related to merger/liquidation decisions and asset disposition decisions. Since the RTC Oversight Board is tasked with day-to-day decision making responsibility, we question the adequacy of the oversight it can provide over its own decisions.

In conclusion, Mr. Chairman, I would like to reiterate our belief that, regardless of some of the concerns we have regarding the legislation, fast action is needed to put this crisis behind us. Insolvent thrifts are continuing to incur operating losses and are driving up the cost of funds for the entire depository institutions industry. Every day of delay increases the costs to the industry and the taxpayers.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or the members of the Committee may have.