United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
10:00 a.m.
Wednesday,
February 22, 1989

Resolving the Savings and Loan Crisis

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

Before the
Committee on Ways and Means
United States House of Representatives

044700/138030

GAO/T-GGD-89-7

RESOLVING THE SAVINGS AND LOAN CRISIS

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

Changed Structure and Management of the Deposit Insurance System: Without changes to the structure and management of the deposit insurance system, the federal government faces potentially even larger losses in insuring deposits. This potential is most evident in FSLIC. To protect the integrity of the deposit insurance system, FSLIC needs to be made independent of the Federal Home Loan Bank Board. The Government should take control of insolvent thrifts. Healthy and unhealthy thrifts should be put into separate funds.

Provide Funding: If reforms are adopted, then Congress should make funds available to meet FSLIC's financing shortfall. The funding plan should (1) provide enough money to finance resolutions of insolvent thrifts over the next three years, (2) require thrift industry capital contributions to create an adequate insurance fund reserve, (3) assure adequate controls over spending to protect the taxpayers' interests, and (4) use an on-budget approach that fully discloses the funding and outlays involved.

Changed Approach to Resolving Insolvent Thrifts: The FHLBB's approach to resolving insolvent thrifts has depended too heavily on complex assistance agreements that minimize FSLIC's need for cash by using notes and guarantees, subsidies for up to 10 years, and special tax provisions. GAO believes that the full costs of resolving insolvent thrifts should be recognized and that it is far preferable to pay for this fully from adequately funded deposit insurance funds rather than through special tax provisions.

Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss problems in the thrift industry. My testimony is based principally on a report we prepared for the House Banking Committee. I will also draw on work we have underway for the Senate Banking Committee examining aspects of the complex assisted merger agreements the Federal Home Loan Bank Board (FHLBB) used to resolve insolvent thrifts in 1988.

I hope we are finally reaching a point where a comprehensive approach can be taken to dealing with the issues associated with the insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC). We estimate that to fully pay for insurance losses and to put FSLIC back on a solid financial footing it will cost at least $85 billion more than FSLIC currently anticipates receiving in revenue over the next 10 years. Delay will only increase this cost and damage the nation's financial system. If interest rates go up, a recession occurs, or thinly capitalized thrifts become insolvent, costs will increase further.

Without question, federal financing is needed to resolve the thrift industry situation. However, to be as certain as possible that a FSLIC situation is not repeated, we must also change the deposit insurance system. It would be a mistake to commit federal funds without adopting key reforms.

Structural changes

The 1980s have been a turbulent period for our nation's depository institutions. Changes in the financial landscape resulting from market developments and legislated deregulation have drastically altered the way that depository institutions operate. These changes have many positive aspects, but combined with changes in the economy and a breakdown in the regulatory system they have also resulted in new risks and a rash of thrift failures.

In light of these developments, we need to look critically at the deposit insurance system. Our current system provides many benefits to the public that should be preserved, but the risks to the government inherent in insuring about $2.5 trillion in bank and thrift deposits can be very great. The most immediate problems now are in the thrift industry.

To effectively manage deposit insurance risks it is necessary to (1) have sufficient funds to pay for losses, otherwise the credibility of the insurer is damaged; (2) ensure that capital in insured institutions is sufficient to absorb reasonably anticipated losses; and (3) have a system of oversight and supervision that can effectively and quickly identify problems, require the institutions to remedy them if possible, and close institutions at the point of insolvency.

To accomplish these goals two key issues involving FSLIC must be addressed--FSLIC's lack of independence and the structure for oversight and supervision of thrifts. Presently, FSLIC operates under the direction of the Federal Home Loan Bank Board, which both promotes and regulates the industry. The industry itself is overseen and supervised by the Federal Home Loan Banks, which, in turn, are owned by each district bank's constituent institutions. In our view, the Federal Home Loan Bank System's role as an industry promoter has been accorded more importance than FSLIC's risk management and insurance function.

To deal with these and other issues, we recommend:

-- FSLIC should be made independent of the Federal Home Loan Bank Board and provided with adequate examination capability and supervisory authority over both state and federally chartered thrifts. Two separate insurance funds are needed--one fund for healthy thrift institutions and another fund for insolvent and thinly capitalized thrifts. The latter would be severely curtailed in their ability to compete with the rest of the depository institution industry.

-- More flexibility should be given to both FDIC and FSLIC to adjust premiums to reflect actual or reasonably anticipated losses.

-- More authority should be given to both Federal Deposit Insurance Corporation (FDIC) and FSLIC to place stringent controls on improperly operated and undercapitalized institutions.

-- Greater consistency between banks and thrifts should be established in matters pertaining to powers and operations that materially affect the deposit insurers' exposure to risk.

-- Capital adequacy requirements should be strengthened, and the quality of supervision and oversight must be improved.

These and more specific recommendations are detailed in our February 21, 1989, report to the House Banking Committee. The reforms and funding arrangements we recommend should remedy the problems that have occurred in FSLIC. They would also help accomplish a longer run goal of developing an appropriate regulatory structure for depository institutions.

Funding To Fully Resolve Problems Must Be Provided

Insolvent institutions cannot be effectively resolved unless enough money is available. Unfortunately, deciding precisely how much money will be needed and who should pay is difficult.

As I indicated at the outset, our best judgement at this time is that it will cost FSLIC at least $85 billion more than it currently anticipates receiving over the next 10 years to deal with the problem. Of this amount, $26 billion represents FSLIC's unfunded cost of paying for actions taken in 1988 and $34 billion represents the future cost of acting on the approximately 350 remaining insolvent cases. In addition, $5 billion represents the cost of resolving thrifts not presently known to have serious problems, and $20 billion is needed to establish adequate reserves. However, given the fluid nature of the situation and the fact that the final loss in the closed and insolvent thrifts is not yet known, I want to stress that these numbers are only estimates. Further near-term refinements of cost estimates, we think, should be developed in conjunction with an analysis of the Administration's plan.

While we believe the thrift industry should pay as much of the shortfall as possible, the industry is currently paying premium assessments that are more than twice as much as those paid by the banking industry. Many believe that indefinite continuation of the special assessment will weaken healthy thrifts and thereby prove self defeating. Although we think the healthy segment of the industry should be charged with recapitalizing its new insurance fund, the bulk of the money will have to be found elsewhere. Judgements as to who can pay how much must be made based on what is perceived to be fair. If contributions are not sought from other segments of the depository institutions industry, then the entire shortfall will have to be met by the federal government.

If needed changes to risk management and insolvent thrift resolution approaches are made, we recommend that a plan be adopted by Congress that:

-- provides for authority sufficient to resolve insolvent thrifts, which we believe can be completed over the next 3 years,

-- assures adequate controls over spending to protect the taxpayers' interests, such as by creating a control board to oversee the resolution of insolvent thrifts, and

-- provides flexibility to allow short-term liquidity borrowing to finance any deposit outflows that might occur while efforts are being made to determine the best resolution approaches.

If federal money is used, as we believe is necessary, we recommend an on-budget approach that fully discloses the funding and outlays that are involved, even if this requires raising the Gramm-Rudman-Hollings deficit reduction targets. We also think that a restructured federal budget along the lines we have proposed elsewhere would better highlight the financing of FSLIC and similar enterprises that are set up to operate on a business basis.[1]

A Different Approach To Resolving Insolvent Institutions Is Needed

At the beginning of 1988 there were roughly 500 insolvent savings and loans with assets of about $140 billion. During 1988, the Federal Home Loan Bank Board began acting on these cases. The Bank Board acted on about 220 institutions, with most of the activity concentrated in the latter part of the year.

The willingness of the Bank Board to act on insolvent thrifts represents a much needed break from the practices of the past. But, we have serious reservations about the way the Bank Board proceeded.

In recent years the federal government has been involved in several financial rescues. In 1984 we issued a report, based on the government's experience with the Chrysler Corporation, New York City, and several other situations, about how such efforts should be structured.[2] The guidelines developed in that report underscore the importance of developing an adequate plan for

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[1]See Financial Management Issues, (GAO/OCG-89-7TR, November 1988.)

[2]Guidelines for Rescuing Large Failing Firms and Municipalities (GAO/GGD-84-34, Mar. 29, 1984).

financing, implementing, and overseeing these types of situations.

The Bank Board's actions have not been consistent with these guidelines. Without first implementing reforms and securing adequate funding and staff resources, the Bank Board resolved cases principally by executing assisted merger agreements that extend for up to 10 years. The notes and guarantees in these agreements provided a mechanism for getting around FSLIC's lack of funds and its lack of information on the true financial condition of many insolvent thrifts. Chart I summarizes the generic components of these agreements.

As I noted earlier, at the request of the Senate Banking Committee we are studying FSLIC's 1988 assisted mergers. Although we have not completed our work, we do have concerns about the nature of these agreements. These are summarized in Chart II.

-- Ownership capital contributed by private investors has been minimal, and large, thinly capitalized institutions are being created. If history is prologue, inadequate capital creates incentives for highly leveraged institutions to engage in unsafe and unsound management practices. These new institutions may, therefore, pose risks to FSLIC in the future.

-- The institutions resulting from the assisted mergers are heavily subsidized by FSLIC and are competing with healthy nonassisted depository institutions at a cost advantage.

-- FSLIC provides capital loss coverage and an operating subsidy on assets that could make it profitable to simply hold them. We question the strength of the new institutions' incentives to actively manage and generate recoveries on those assets.

-- It is questionable whether many of these assisted transactions, especially when the tax consequences are taken into consideration, save the government money compared to other options that would be possible if FSLIC had had adequate funds and staff resources.

-- Finally, FSLIC faces a huge task in effectively administering these complex agreements.

In view of these concerns, we think a different approach should be used to resolve insolvent thrifts. We have recommended that the government take control of these institutions as soon as possible, restructuring their operations until resolution decisions can be made based on a careful assessment of their asset portfolios and the comparative merits of each resolution option. To carry this out, we recommended that the assistance of FDIC and of federal and state regulators be enlisted.

Tax Considerations

Special provisions in the Internal Revenue Code grant substantial tax benefits to acquirers of insolvent thrifts. One provision makes the sale of insolvent thrifts eligible for tax-free treatment as a reorganization without meeting all of the usual requirements. Qualification as a tax-free reorganization and other special provisions allow the acquired thrift's pre-agreement net operating losses (NOLs) to be deducted against the future income of the new thrift.

The rules also enable the new thrift to carry over the full value of assets from the acquired thrift. Because this value is generally higher than the fair market value, there is a loss when the assets are sold. This "built-in" loss is deductible against the new thrift's income and also may be used to offset income of a holding company which owns the new thrift.

Other special provisions provide that FSLIC assistance is excluded from taxable income and is not reflected in the tax basis of the new thrift's assets. The primary FSLIC payments are: guaranteed rate of return on assets; interest on FSLIC note(s); and, reimbursements for expenses and built-in losses.

Chart III outlines both the deductions and exclusions. The use of these benefits was recently extended, but reduced by 50 percent, through December 31, 1989.

FSLIC provided us with projections of the tax consequences of the 1988 deals on February 9, 1989. They show tax consequences of \$8.7 billion on a cash basis (as opposed to a present value basis.) We are in the process of analyzing the data and the assumptions used to compute the information.

I want to emphasize that determining accurately the tax consequences of these transactions is very difficult. The true market value of failed thrifts' assets, which affects the tax, is not known, nor is the timing of asset sales. The future profitability of the new thrift and any holding company are difficult to estimate. And, it is difficult to anticipate the future business decisions of the new owners in light of the tax benefits available.

The special tax benefits, which now apply to banks as well as thrifts, are used in the resolution of insolvent institutions. The need for the continuation of the special tax provisions depends on the extent to which FSLIC, and FDIC, are able to resolve failed institutions using insurance funds only. In this regard, we believe it would be far preferable to take the actions we have discussed to ensure the financial soundness of the insurance funds so that the insurers have the means to pay for, and thus fully recognize, resolution costs, rather than resorting to using special tax benefits. The insurance funds should be funded by the industries.

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This concludes my prepared statement. My colleagues and I will be pleased to answer questions.

GAO Typical December 1988 Deal

- Note for negative net worth
- Guaranteed return on assets
- Guaranteed book value of assets
- Reimbursed certain expenses
- Waived regulation compliance
- Tax benefits
- Equity position in S&L

GAO Concerns About Deals

Creates new thrifts that are:

- Thinly capitalized
- Have cost advantage over healthy S&L's
- Lack incentives to manage assets

May cost more than liquidation

Will require huge monitoring job because of complexity

GAO Tax Benefits

- Deductions
  - Losses on asset sales
  - Pre-agreement NOLs

- Exclusions
  - Interest on FSLIC notes
  - Guaranteed rate of return on assets
  - Payments for losses on asset sales
  - Payments for certain expenses