CBO TESTIMONY

Statement of
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Mr. Chairman, I appreciate this opportunity to appear before your Committee to discuss the current and future condition of the thrift industry. I will specifically address the questions of whether the thrift crisis is in its final stages and what the future of the thrift industry might be. I will also share with you some concerns I have about the transition of responsibility from the Resolution Trust Corporation (RTC) to the Saving Association Insurance Fund (SAIF). In summary:

- The Congressional Budget Office (CBO) has not changed its basic view that when all is said and done the final bill for the thrift crisis will be about $215 billion (in 1990 dollars) and that as few as 1,400 of the nearly 4,000 thrifts that existed in 1980 will survive the crisis.

- If the RTC stops accepting institutions for resolution by October 1993, as scheduled, and hands over the remaining caseload to the SAIF, that fund will not be able to handle the task without additional federal resources. This situation has been worsened by the failure of the Administration and the Congress to agree on continued funding for the RTC and the premature scaleback of RTC resolution operations before completing its task.

HOW THE THRIFT INDUSTRY IS FARING TODAY

The thrift industry has been through a turbulent decade. But we are now beginning to see the benefits of the government's efforts to close failed institutions. The cost of this effort has been high, and the cleanup of the thrift crisis is not over. Data on the performance of the thrift industry during 1991 provide room for guarded optimism about its long-term viability--albeit as a much smaller player in the depository industry.

Condition of the Thrift Industry

The combined assets of the thrift industry steadily increased during most of the 1980s, peaking at $1.3 trillion in 1988. By the end of 1991, however, assets held by thrifts had declined to $876 billion, less than two-thirds of the nominal value of assets three years earlier.

Over the course of the last 12 years, the thrift industry endured considerable losses during two periods. The industry lost almost $9 billion in 1981 and 1982 as a result of high and volatile interest rates. During the four years from 1987 through 1991, the industry booked losses of about $24 billion, mostly because of problems with the quality of the assets in thrifts' portfolios.

The number of institutions in the thrift industry has shrunk by almost half since 1980, from nearly 4,000 institutions to under 2,100 at the end of 1991. Well over half of the 1,900 institutions that have left the industry have done so at a cost to the government--sustained by either the Federal Savings and Loan Insurance Corporation (FSLIC) or the Resolution Trust Corporation. Many thrifts were merged with other institutions at no cost to the government, but with the encouragement and supervision of thrift regulators. Some of those merged thrifts subsequently failed and left the industry at government expense.

Although recorded profits in the industry were better in 1991 than they were in 1990, thrifts are still not as profitable as they once were. For example, a comparison of after-tax profits at 2,000 thrifts that were operating both at the end of 1991 and in 1988 reveals that those thrifts earned over $3.1 billion in 1988, compared with less than $2.5 billion in 1991. Overall 1991 profits are equal to only 0.3 percent of assets, less than half of the average rate of about 0.7 percent for thrifts and 0.8 percent for banks in the 1970s.

In 1991, profitability in the industry was enhanced by lower (and more stable) interest rates and a wide spread of long-term over short-term rates. This condition was reflected in the net (pretax) operating income of $3.8

billion. Profits were also enhanced by realizing gains in asset values--net (pretax) nonoperating income was about $1 billion.

Measured on a book-value basis, the capitalization of the industry has improved. Counting only tangible capital--that is, excluding intangible "goodwill"--the industry reached its nadir in 1984 when it held only $3 billion in tangible capital against $978 billion in assets (0.3 percent). Tangible capital equaled 4.9 percent of assets at the end of 1991. On the basis of generally accepted accounting principles (GAAP), which include goodwill as part of an institution's capital, the industry held $34 billion in capital against $1,251 billion in assets (a capitalization ratio of 2.7 percent) in 1987. At the end of 1991, the industry had improved its GAAP capitalization ratio to slightly more than 6 percent.

The distribution of thrifts among various capitalization levels, as measured by book values of tangible capital and assets, has dramatically improved since 1988, as shown in Table 1. As of December 31, 1991, more than half of the thrift industry had a capitalization ratio greater than 6 percent, though these institutions held only about a quarter of the industry's assets. About 90 percent of the industry's assets were in institutions with tangible capital of more than 3 percent of assets. The number of institutions with less than 3 percent of capital had fallen to fewer than 200. These data

TABLE 1. DISTRIBUTION OF THRIFTS IN 1988 AND 1991

Capitalization[b]	1988 Thrifts Number	1988 Thrifts Percent	1988 Book Value of Assets[a] Billions of Dollars	1988 Book Value of Assets[a] Percent	1991 Thrifts Number	1991 Thrifts Percent	1991 Book Value of Assets[a] Billions of Dollars	1991 Book Value of Assets[a] Percent
Greater than 6 Percent	1,136	39	196	15	1,148	55	227	26
Greater than 3 Percent, Less than or Equal to 6 Percent	864	29	418	32	763	36	468	53
Greater than 1.5 Percent Less than or Equal to 3 Percent	281	10	244	18	105	5	104	12
Greater than Zero, Less than or Equal to 1.5 Percent	160	5	182	14	47	2	36	4
Less than or Equal to Zero	508	17	283	21	33	2	41	5
Total	2,949	100	1,323	100	2,096	100	876	100

SOURCE: Congressional Budget Office based on reported financial data as of December 1991.

NOTE: Numbers may not add to totals because of rounding.

a. Based on regulatory accounting practice.

b. Book value of tangible capital as a percentage of tangible assets.

suggest that the Office of Thrift Supervision (OTS) and the RTC have removed the most poorly capitalized institutions from the industry.

However, these data can be as misleading today as they were in the 1980s. Because they are based on reported book values, they fail to reflect accurately the current market value of assets held by thrifts. In addition, capitalization ratios do not provide information on income earned by thrifts or their profitability. The fact that the OTS has closed institutions that appeared to be highly capitalized and has left open some that are insolvent according to book values suggests that book values are an inadequate indicator of financial strength.

To overcome the shortcomings inherent in estimates based on book values, CBO employs a technique that is based on a rough estimate of the market values of resolved thrifts, as reported by the RTC (and FSLIC, before 1989). CBO uses this technique to estimate the cost of the thrift crisis and the number of institutions that will need to be resolved. The technique produces lower capitalization ratios for all institutions. It also suggests that many firms that appear solvent on a book-value basis may require resolution. Although we have greater confidence in the cost estimates than in the estimate of the number of institutions that will be resolved, both estimates are

consistent with analyses of academic experts and with other financial data on thrift income.

CBO estimates and other data show that the thrift industry appears to be splitting between one group of about 1,300 to 1,500 survivors that are reasonably healthy, profitable, and for the most part well capitalized, and another group of about 500 to 700 that are in financial difficulty. Many of these troubled institutions are inadequately capitalized--although most have book-value ratios of capitalization between 3 percent and 6 percent. Our analysis of these two groups shows that the healthy group has significantly improved its financial condition since 1988, and the unhealthy portion has substantially deteriorated in the past three years. This latter group is likely to leave the industry. Some may be merged or acquired by healthy thrifts and banks; others will require resolution at some expense to the government.

Projecting the Future of the Thrift Industry

CBO's view of the thrift industry could be significantly affected by several factors. Among these are macroeconomic conditions, conditions in real estate markets, the nature of competition with banks and other financial

institutions, the introduction of risk-based premiums for deposit insurance, and the behavior of government regulators.

Macroeconomic Conditions. The economic recovery that appears to be under way may offer both good news and bad news for thrifts. On the one hand, the recovery should increase loan demand, while reducing late payments and defaults. On the other hand, as short-term interest rates begin to rise, which they normally do in an expansion, thrifts may experience a narrowing of the spread between borrowing and lending rates. In addition to the obvious squeeze this would put on profits, the value of thrift assets may again be vulnerable to risk from rising interest rates. Over the last year, as long-term interest rates declined, many homeowners refinanced costly fixed- and variable-rate mortgages to lock in lower interest on fixed-rate mortgages. Although thrifts are in a far better position to hedge against rising interest rates than they were a decade ago, the industry's net operating income is still sensitive to both the level and volatility of interest rates. At the end of 1991, thrifts held 44 percent of their total loans as fixed-rate instruments.

If the economy follows a course similar to CBO's forecast, macroeconomic developments should not change the condition of the thrift industry by much. A stronger economic recovery that is not accompanied by inflationary pressures would benefit all thrifts. A weaker economy with some

fluctuations or weak shocks could probably be weathered by the well-capitalized portion of the industry.

Real Estate Markets. Thrifts are major holders of assets in real estate, primarily in the form of mortgages and mortgage-backed securities; in fact, nearly half of all thrift assets are in home mortgages. Most important, the composition of mortgage holdings has changed dramatically, reflecting a trend in the industry toward originating and selling mortgages rather than holding them. In addition, thrifts are retaining, selling, or purchasing the rights to service mortgages. Mortgage-backed securities have increased as a percentage of total assets from 4.4 percent in 1980 to more than 14 percent of the total in 1991.

Many experts believe that the thrift crisis will not truly be over until real estate markets recover from the speculative overbuilding that took place in the early and mid-1980s. Although no one can say with certainty that real estate markets have bottomed out, according to some indications residential markets are beginning to stabilize, particularly in those regions of the country where the bubble burst first--that is, the southwestern and northeastern regions. Although other regions, such as the far west, may yet experience similar real estate problems, the general economic recovery and lower interest rates may offset these problems.

Many analysts are concerned that the RTC's vast inventory of real estate assets is continuing to depress real estate markets and preventing healthy thrifts from realizing improved prices for the assets they hold that are related to real estate. As the RTC disposes of assets, it does so at prices that reflect how these properties and mortgages are now valued by the market. These prices often reflect steep markdowns from the values carried on the books of failed thrifts.

By themselves, neither the RTC's vast inventory nor RTC sales of these assets for prices less than the book value reported by failed thrifts would depress real estate prices. Those prices are depressed by the oversupply of existing properties, regardless of who holds them. As long as the RTC is able to receive the best price the market offers for these assets, it should not further depress real estate markets. Indeed, a large RTC-held inventory awaiting sale is harmful to real estate markets because it engenders uncertainty about when the other shoe will drop.

<u>Competition</u>. A key factor helping to determine the fate of the thrift industry is its relative competitiveness compared with other financial institutions, especially banks. For the most part, there are very few differences left that distinguish depositories chartered as thrifts from those chartered as banks. Nevertheless, differences remain. Some would tend to favor thrifts slightly--

most notably, the lack of restrictions on engaging in interstate branching. Other differences, most notably the Qualified Thrift Lender test, are viewed by many analysts as handicaps because they limit the diversification of a thrift's assets. In the near term, well-capitalized thrifts appear able to withstand competitive pressures from both other depository and nondepository financial institutions. Many of these thrifts are now thriving in their traditional role of providing community depository services and originating mortgages.

Risk-Based Premiums. The introduction of risk-based premiums could have a significant effect on the thrift industry. In the long run, the effect clearly will be to improve the performance of the deposit insurance system, as insured institutions react to the incentive to reduce risk in order to reduce their premium payments. In the short run, however, the direction of change is less certain. During the upcoming transition period, as the new premium structure is put into place, some thrifts may find themselves unable to maintain solvency because of the higher premiums they must pay. Although most of these firms may already be candidates for closure, the higher premium payments may accelerate their demise and temporarily increase deposit insurance outlays.

Regulation. Probably the most significant variable in determining both the long-run and short-run condition of the thrift industry is the intensity and type of regulation pursued by federal officials. The paradox of regulation may be that the stronger it is in the short run (that is, the more it accepts the pain of closing insolvent institutions), the stronger the industry will be in the long run; conversely, the more lenient regulators are now, the weaker the industry will be later.

Of all the variables that could affect the CBO estimate, this one is the hardest to predict and has the most impact on budget projections. CBO baseline projections are based on current law, so we are spared the impossible task of forecasting how laws might change. In the case of depository institutions, CBO assumes that the regulators will have sufficient resources to close failed thrifts and banks in an orderly process and that they will do so. The wide variation from year to year between CBO projections of RTC outlays and the actual reported amounts arises partly from differences between our assumptions about how regulators will act and how they do in fact act.

LONG-TERM PROSPECTS FOR THE THRIFT INDUSTRY

In recent months, the Administration has spoken with less than a clear voice on the subject of how much remains to be done to resolve the thrift crisis. To my knowledge, the official position of the Administration has not changed substantially since May 1990, when the Secretary of the Treasury, Nicholas Brady, testified that the RTC would need to resolve between 800 and 1,000 thrifts at a present-value cost in 1989 dollars of between $90 billion and $130 billion. The Administration's request earlier this year for additional RTC funding of $55 billion, plus the unused portion of the $25 billion provided in the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act--that is, $18 billion--was consistent with the high side of this estimated range.

Despite what appears to be a wide difference in the number of institutions that CBO and the Administration estimate will survive the thrift crisis, the present-value dollar estimates of the cost of the cleanup are reasonably close. The major difference between the figure of $130 billion (in 1989 dollars) cited by Secretary Brady and CBO's $155 billion in 1990 dollars is accounted for by calculating the cost of delays in closing insolvent thrifts. CBO applies this calculation to the outstanding caseload, but the Administration does not.

Recently, however, RTC Director Donald Casey and OTS Director Timothy Ryan have stated their view that the thrift industry is in much better shape than previously thought and that fewer resources need to be committed to the effort. OTS Director Ryan has been reported as saying: "We are now in the eighth inning of the cleanup." Others in the Administration have been silent on this question. Outside observers and academic experts, however, are skeptical that the condition of the weaker thrifts has changed significantly.

The question of what inning we are in, or whether we should expect a ball game with extra innings, is an important one because how one views the remainder of the thrift problem will have a strong influence on the strategies one employs to deal with that problem. For example, the RTC has begun the process of reducing the number of offices and employees in anticipation of closing shop in 1993. If the RTC and OTS are wrong in their assessment that the cleanup is nearly over, then the process of first stopping and then restarting operations will result in higher costs for the thrift cleanup. The Administration could shed more light on this question by providing more useful and timely data on the condition of the industry, as well as more detailed projections specifying the timing and amount of resources that the Administration believes will be necessary over the next five years.

Outlook for the Thrift Industry

What will the thrift industry look like in the year 2000? The answer depends primarily on what the Congress, the Administration, and the regulators do now. Certainly, it is essential to provide the RTC and the SAIF with sufficient funds to do the job of cleaning up what remains of the thrift crisis. If the market were unregulated, competition would already have weeded out weak firms, leaving the strongest ones to survive. But because the thrift industry is regulated, this necessary process will not take place without active government involvement. This job was given to the OTS and the RTC in 1989. The job is not over. If the agencies stop now, the same competitive forces and incentives that exacerbated the thrift crisis will continue to operate. That is, weak firms will undermine the competitiveness of stronger firms and rack up huge costs that will eventually fall due to the deposit insurance fund and the taxpayer. Alternatively, with good regulatory supervision and an effective policy of closing failed institutions, it is possible to see a strong and financially healthy group of thrift institutions continuing to survive and prosper beyond the year 2000.

What would the characteristics of that industry be? Barring further amendments to banking and deposit insurance legislation, I think it will look much like it does today.

Thrifts will still concentrate most of their business on real estate finance. The types of loans that they originate will continue to be more long-term in nature than the commercial and industrial loans in which commercial banks tend to specialize. Both commercial banks and thrifts will provide depository and lending services to households, but commercial banks will concentrate a substantial portion of their depository business on corporate accounts. Most thrifts are now viewed as being more like that portion of the commercial banking industry characterized as community banks. The very large thrifts are fairly similar to large regional commercial banks or mortgage investment banks. Those descriptions will in all likelihood continue to apply.

RTC, SAIF, AND THE FUTURE OF THE THRIFT INDUSTRY

For purposes of summarizing the costs of the savings and loan debacle, the single most useful measure is a present-value estimate of past, present, and future net costs of resolving failed thrifts. In January, CBO estimated that the present-value cost of resolving the savings and loan crisis would be $215 billion. This amount included the $60 billion that would be charged to the Federal Savings and Loan Insurance Fund and the FSLIC Resolution Fund for those institutions that the regulators had closed before the RTC was established. We estimate that the cleanup, expressed in terms of 1990 dollars,

will cost the RTC or its successor $155 billion. CBO derives this estimate from cash-flow projections through the year 2004.

In contrast, the federal budget does not reflect present-value estimates. Instead, it records the yearly net flows of cash in the deposit insurance accounts. On this basis, the Congress has provided the RTC with $105 billion to pay for losses incurred in resolving failed thrift institutions: $50 billion under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA); $30 billion under the RTC Funding Act of 1991; and $25 billion (available until April 1, 1992) under the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991. Of the funds provided, $84 billion has been obligated and $18 billion cannot be used because it was only available through March 31, 1992; the RTC has reserved the remaining $3 billion to pay for administrative costs, meet liquidity needs, adjust for accounting shortfalls, and complete a pending sale of an institution. Table 2 summarizes RTC's spending through the end of March 1992.

<u>Current and Future Funding for Thrift Failures</u>

CBO's estimates assume that the RTC will receive adequate funds on a timely basis. Funding delays, such as those that occurred in fiscal year 1991 and

TABLE 2. STATUS OF RESOLUTION TRUST CORPORATION FUNDING THROUGH MARCH 1992 (By fiscal year, in billions of dollars)

Source	Appropriated	Used	Expired	Remaining
FIRREA (August 1989)	50	50	0	0
RTC Funding Act (March 1991)	30	27	0	3
RTCRRIA (December 1991)	25	7	18	0
Total	105	84	18	3

SOURCE: Congressional Budget Office.

NOTE: FIRREA = Financial Institutions Reform, Recovery, and Enforcement Act of 1989; RTCRRIA = Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991.

again in 1992, affect the level of disbursements and receipts in any given time period, as well as the length of time needed to complete the resolution process and the final cost of the thrift crisis. The RTC needed funding late in fiscal year 1991 and again early in calendar year 1992 to maintain a steady pace of marketing and closing institutions. Instead, the agency had to wait until December to replenish its reserves; then, activity effectively halted again in April when the RTC's authority to use this new funding expired. Largely as a result of funding delays, CBO expects net outlays for the RTC in 1992 to be well below its earlier estimate of $40 billion, possibly as low as zero. One effect of this slowdown will be to push the caseload backward, thereby increasing 1995 spending.

That effect is particularly disappointing because the Budget Enforcement Act places no impediments in the way of RTC recapitalization. Legislation providing more funding to the deposit insurance agencies is specifically exempt from pay-as-you-go discipline as long as it merely honors the government's existing commitment. One reason this special treatment was afforded the depository insurance accounts was to ensure that the RTC had sufficient cash to close insolvent institutions to avoid a repetition of the thrift crisis.

Passage of the FDIC Improvement Act of 1991 requires regulators to close failed insured depositories on a more timely basis. Thus far, regulators have been reluctant, however, to carry out the new closure rules fully. At the end of 1991, 33 thrifts with $41 billion in assets were tangibly insolvent but still operating. Most of those had been tangibly insolvent for more than one year--a significant number had been insolvent since the early or mid-1980s. The OTS dealt with 24 of them in the first four months of this year and recently announced that 45 insolvent or inadequately capitalized thrifts were to be placed in conservatorship. But these actions, which do not depend on RTC funding, seem tardy.

In addition to finding that delaying closures increases the cost of resolution, CBO's analyses also suggest that delay in cleaning up insolvent thrifts hurts healthy ones. The faster that failed thrifts are removed from the industry, the better off are healthy institutions that no longer need to compete with poorly capitalized institutions. Although new rules should prevent poorly capitalized thrifts from relying on brokered deposits--a practice that bid up the costs of deposits to all institutions--these institutions can still cause financial damage to the healthy portion of the industry.

The Transition from the Resolution Trust Corporation to the Savings Association Insurance Fund

Current law authorizes the RTC to continue closing insolvent thrifts that are in receivership or conservatorship before October 1, 1993. Although the Savings Association Insurance Fund is scheduled to assume the job of protecting depositors in failed thrifts beginning in fiscal year 1994, the agency will face that responsibility with a modest balance of about $1 billion. The SAIF's potential liabilities are much greater, however. We expect losses in institutions that will need to be resolved by the SAIF to total about $48 billion over the 1994-1997 period. That figure does not include the cost of resolutions that were anticipated but not completed in the current year--that is, about $15 billion, which could be shifted to the 1994-1997 period. Whether the RTC or the SAIF performs these resolutions does not change the need for appropriated funds to carry out the job.

Beginning in 1993, thrifts will pay assessment premiums to the SAIF, net of the contributions to the Financing Corporation. These assessments will total about $0.9 billion during 1993, and will increase to $1.4 billion by 1997. FIRREA and subsequent legislation anticipated that the SAIF might need Treasury funding to build sufficient cash reserves and authorized two types of annual payments for this purpose. One authorization provides for a payment each year through the year 2000 equal to the difference between $2 billion

and the assessment income paid into the fund that year. The second authorization provides for payments to maintain the net worth of the SAIF according to a designated schedule starting at $1 billion for the beginning of fiscal year 1993 and increasing to $8.8 billion for the beginning of fiscal year 2000.

To date the Administration has not requested any appropriations for the SAIF. The Federal Deposit Insurance Corporation (FDIC) has authority to borrow up to $30 billion to allow the Bank Insurance Fund (BIF) and the SAIF to finance insurance loses. Without sufficient funding for the RTC, and if the SAIF assumes responsibility for thrift failures beginning in October 1993, the FDIC will probably need to tap that borrowing authority for use by the SAIF, thereby reducing the amount of funding available for the BIF. Under the assumptions of CBO's baseline projections, CBO estimates that the BIF might need up to $20 billion of the $30 billion authorized.

Current law requires that the SAIF reach a reserve ratio of 1.25 percent of insured deposits within a reasonable period of time. The FDIC board of directors recommended in May that the SAIF assessment rate be raised from the current 23 basis points to 28 basis points and that a risk-related premium system be adopted. We expect that these new rates will be effective beginning in January 1993. Although the adjustments to premium

rates will help to correct long-term imbalances in expenses and income, the FDIC also expects that to finance short-term losses the SAIF will need appropriated funds.

The statutory schedule of appropriations authorized for the SAIF and the risk-based premium rate schedules recently proposed by the FDIC (as required by the FDIC Improvement Act of 1991) are intended to achieve the policy objective of limiting *future* payments from the general fund to deposit insurance. Reforms in financial reporting, which focus on the funds' future long-term costs and income rather than the current GAAP target for reserves, would contribute significantly to the oversight of the insurance funds. Otherwise, the FDIC could report that the SAIF was on track toward achieving its GAAP reserves target, even if the fund's long-term costs were growing more rapidly than its long-term income. CBO is preparing a paper that will develop principles of effective control of losses and oversight of federal insurance programs.

CONCLUSION

The RTC needs additional funding to carry out its important task. Failure to provide sufficient funds will lead to a weaker industry in the long run and an

industry that is more likely to cost the government substantially more money. CBO's estimate has been and continues to be that a substantial portion of the cleanup of the thrift crisis remains to be completed. Under the best of circumstances, that job will not be done before the SAIF is scheduled to begin operations. Allowing the SAIF to start with a backlog of cases may be more costly than extending the life of the RTC by an additional two years. Moreover, failure to finish the job that the RTC was commissioned to do would leave the thrift industry weakened and diminish the chances that even those institutions that are now healthy will be able to survive into the next century.