United States General Accounting Office

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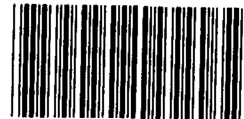
Report to Congressional Requesters

August 1991

FINANCIAL ANALYSIS

Short-Term Funding Needs of the Bank Insurance Fund and the Resolution Trust Corporation



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

Comptroller General
of the United States

B-245305

August 22, 1991

The Honorable Henry B. Gonzalez
Chairman
Committee on Banking, Finance,
and Urban Affairs
House of Representatives

The Honorable Chalmers P. Wylie
Ranking Minority Member
Committee on Banking, Finance,
and Urban Affairs
House of Representatives

The Honorable Frank Annunzio
Chairman, Subcommittee on
Financial Institutions
Supervision, Regulation and
Insurance
Committee on Banking, Finance,
and Urban Affairs
House of Representatives

This report responds to your July 24, 1991, request for information about the financial condition of the Bank Insurance Fund and the Resolution Trust Corporation (RTC). You also asked whether we had any evidence that the Federal Deposit Insurance Corporation (FDIC), due to a lack of cash, was forbearing from closing institutions or approving forms of transactions that are more costly in the long-run but conserve cash now.

The information and estimates presented in this report are based largely on the results to date of our ongoing audits of the Fund's and RTC's financial statements for the year ended December 31, 1990. Some of the information available to us is not current or complete. Also, economic uncertainties, particularly related to the real estate market, make judgments about future cash flows and cash needs difficult and subject to significant change.

Subject to these limitations, it is our best judgment that

-- The Fund will likely be insolvent by the end of 1991--the exact date depends on the rate at which insolvent banks are identified and losses recognized. The Fund should have sufficient cash resources and borrowing authority available to cover its cash needs through December 31, 1991. However, if the Fund is insolvent at December 31, 1991, its borrowing authority under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) would be limited to $5 billion available from the U.S. Treasury. Therefore, having new borrowing authority in place by the end of 1991 would help ensure that the Fund has resources available to resolve problem banks.

-- If RTC adheres to its June 17, 1991, resolution schedule, it will use $79 billion of the $80 billion loss funds already provided by September 30, 1991, and will exceed the total funds provided by $8 billion at December 31, 1991. Although RTC should have sufficient borrowing authority for working capital to carry it through the end of 1991, some new financial arrangements will probably be required by September 30, 1991, to cover the shortfall in loss funds.

We have not specifically reviewed whether forbearance is being used to conserve cash. However, our financial audits of the Fund and RTC have identified a number of insolvent banks and thrifts that have not been closed. We have asked the regulators to provide an explanation and will consider their views and report to you at a later date.

STATUS AND FUNDING NEEDS OF THE BANK INSURANCE FUND

You requested that we provide our best estimate of the financial condition of the Bank Insurance Fund as of September 30, 1991, and as of December 31, 1991. Estimating the financial condition of the Fund at these dates requires that we estimate both the cost and timing of future bank failures as well as determine the status of the Fund at December 31, 1990.

Based on current generally accepted accounting principles, we have concluded that the Fund balance at December 31, 1990, previously reported as $8.2 billion by the FDIC was overstated by a minimum of $4.2 billion--leaving a balance of $4.0 billion. FDIC has agreed that this adjustment

represents needed additional reserves for losses associated with banks that, at December 31, 1990, either (1) reported that they were insolvent or (2) reported that they were solvent but, in fact, were insolvent.

We are withholding our opinion on the financial statements until certain matters are resolved. However, resolution of these matters will have no impact on the Fund's balance at December 31, 1990. For example, there is an unresolved issue that affects the classification of $3.6 billion on the Fund's 1990 balance sheet related to escrowed funds from certain purchase and assumption bank assistance transactions. Resolution of this matter could significantly affect the Fund's borrowing authority.

A new methodology adopted by FDIC this month to identify and recognize losses associated with insolvent institutions, while in need of some refinements, should produce more accurate information in the future on the status and condition of the Fund. However, existing deficiencies in accounting principles for both loss recognition and measurement will continue to hinder the ability of FDIC and other financial institution regulators to identify all institutions that are insolvent. We have made recommendations[1] to the Financial Accounting Standards Board (FASB) but to date it has not taken decisive action to address our concerns.

Looking to the future, the Fund faces exposure in 1991 and future years from a substantial number of additional problem banks that we believe have the potential to fail. Our analysis leads us to conclude that an additional 34 large banks (those with assets over $100 million) with minimal levels of equity capital are more likely than not to fail in 1991 unless they receive some form of capital infusion. If these banks fail, we estimate their cost to the Fund to be approximately $5.0 billion based on FDIC's historic loss rates made available to us. Application of accounting principles as we have recommended to FASB would cause these losses and additional losses associated with small institutions to be recognized at December 31, 1990, and result in the Fund declining to a negative balance of $1.4 billion at that date.

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[1] Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991).

We have identified another 64 large institutions whose financial condition is such that continued financial deterioration may result in their failure over the next 1 to 3 years. If these 64 banks all failed, we estimate that they would cost the Fund $22.5 billion over the next 3 years. Finally, we believe that the Fund will continue to incur losses of approximately $1.0 billion a year over the next 3 years from the failure of small institutions. However, because of continuing problems in commercial real estate markets and other economic factors affecting bank loan portfolios, these estimates may understate the problem. Therefore, we are reluctant to attempt to look forward beyond December 31, 1991.

Also, the exact timing of bank failures is difficult to forecast. In addition to the accounting deficiencies previously mentioned and changing economic and operating conditions, other factors limit our ability to determine when a problem institution will fail. For example, a problem bank may receive an infusion of capital from its parent holding company or from some outside source which may delay regulator action with regard to closing the institution. The actual closing of an institution could occur prior to depletion of a bank's equity (i.e., the bank's chartering authority may close the institution for unsafe and unsound practices) or, as is more commonly the case, the closing may occur sometime after the bank becomes insolvent. Bank regulators take into account a number of other factors in addition to insolvency in determining whether and when to close an institution. For example, if a bank is determined to be vital to its community or if its closure would significantly disrupt banking services, regulators may consider other alternatives to closing the bank, such as merging the bank with another institution or providing some form of open bank assistance.

Notwithstanding these uncertainties, we believe that it is prudent to recognize at least one third of the costs associated with those banks we believe have the potential to fail over the next 1 to 3 years in estimating the financial condition of the Fund at December 31, 1991. This would result in the Fund recognizing approximately $8.5 billion in costs associated with these institutions. On this basis, we estimate that the Fund will have a negative balance of approximately $5 billion at December 31, 1991. However, we cannot determine precisely when between now and the end of 1991 the Fund will likely

become insolvent due to continuing deficiencies in financial reporting by banks and the inherent uncertainties associated with regulatory decisions on when and in what manner to resolve problem institutions. In evaluating this information, it should be recognized that the Fund's cash reserves are not affected until action is taken to resolve problem banks.

In addition to the prospect of experiencing a significant capital deficiency by December 31, 1991, the Fund also is facing a possible shortage of working capital. Assuming no disbursements are required for any banks other than those now reserved for by FDIC as of December 30, 1990, the Fund would need approximately $20 billion in cash resources for working capital to fund bank resolutions through December 31, 1991. The Fund had available cash and investments totaling about $7 billion on January 1, 1991. Additionally, FDIC projects that the Fund will collect approximately $10 billion in calendar year 1991 from investments, assessment revenues, and recoveries on sales of failed bank assets. Through July 31, 1991, FDIC's projections appear to be substantially accurate in the aggregate. Assuming FDIC's projections of cash collections hold true and assuming FDIC uses all funds held in investments, the Fund will need to borrow $3 billion for working capital purposes through December 31, 1991.[2] Under FIRREA, the Fund has authority to borrow as long as the Fund's net worth to total assets ratio remains no less than 10 percent. Assuming an adjusted Fund balance of $4.0 billion as of December 31, 1990, the Fund could borrow up to $24 billion from FFB. Additionally, the Fund has $5 billion in borrowing authority available to it from the U.S. Treasury in excess of the borrowing under the net worth limitation established by FIRREA.

If, in addition to the insolvent banks reserved for in arriving at a $4.0 billion fund balance at December 31,

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[2]Through July 31, 1991, the Fund had already borrowed approximately $7 billion from the Federal Financing Bank (FFB), despite having cash and investments totaling about $6 billion. Because the majority of its investments are in 1- to 3-year U.S. Treasury notes and bonds, we believe FDIC is attempting to avoid redeeming these investments prior to their maturity in order to maximize the Fund's return on these investments.

1990, the other 34 minimally capitalized banks we have identified as likely to fail do, in fact, fail in 1991, the Fund will need a total of approximately $14 billion in FFB borrowings through December 31, 1991. We believe that this is the more likely estimate of the Fund's working capital needs for 1991. As previously discussed, we believe that it would be prudent to anticipate that one third of the costs associated with the 64 potential large bank failures as well as with failures of small institutions will need to be recognized in 1991. In the unlikely event that the institutions associated with these costs were to require assistance in 1991, the Fund would require an additional $21 billion from FFB. This would bring total FFB borrowings needed in 1991 to $35 billion, $11 billion more than the total borrowing authority currently available under the net worth limitation in FIRREA. The Fund still would have available an additional $5 billion in borrowing authority from the U.S. Treasury.

Although the Fund should survive 1991 with existing borrowing authority, it in all likelihood will be insolvent at December 31, 1991. Once the Fund's net worth falls below the threshold level in FIRREA of 10 percent of assets, the Fund will no longer have authority to borrow from FFB. Unless the Fund is recapitalized, this could effectively paralyze the Fund's resolution activity beyond 1991. The banking bills (H.R. 6 and S. 543) contain provisions for funding the Fund. If funding legislation is not enacted within the next few months, we suggest obtaining revised estimates of funding needs from FDIC, given the uncertainties clouding the magnitude of the banking industry problem.

FUNDING NEEDS OF THE RESOLUTION TRUST CORPORATION

Your letter also requested that we provide you with our best estimate of when additional loss funds and/or borrowing authority would be needed for the continued operation of the Resolution Trust Corporation. In June 1991, RTC's Oversight Board requested that the Congress appropriate $80 billion in loss funds to RTC in addition to the $80 billion already provided by the Congress and approve working capital borrowings of up to $160 billion so that RTC could complete its required resolution activity.

Precisely when and how much additional funding RTC will require depends on a number of factors, including the number, timing, and type of planned resolutions. RTC

produces a financial operating plan for its Oversight Board on a quarterly basis covering the remaining quarters of its fiscal year. As part of this plan, RTC includes a summary of resolution activity to date and projections of activity through the end of the year. According to the activity summary included in RTC's revised operating plan of June 17, 1991, it plans to close 268 thrift institutions with assets totaling $148 billion in calendar year 1991. RTC has estimated the cost of these resolutions to be $44 billion. If RTC adheres to this resolution schedule, it will have used a total of $79 billion of the $80 billion already provided in loss funds through September 30, 1991, and will exceed the total loss funds provided by $8 billion at December 31, 1991. This resolution schedule would require that new funding legislation be in place by September 30, 1991, to avoid additional costs resulting from delays in closing troubled thrifts.

To accomplish the resolutions planned for the period July through December 1991, RTC has projected working capital needs of $50 billion, of which $12 billion is expected to come from repayments of loans made to institutions in conservatorship and proceeds from sales of assets in RTC receiverships. The remaining $38 billion is to be borrowed from FFB. RTC is currently operating under an agreement with FFB which allows working capital borrowings of up to $100 billion through December 31, 1991. On July 1, 1991, RTC borrowings outstanding from FFB totaled $54 billion. If RTC projections prove accurate, $8 billion of borrowing authority will remain under present FFB agreements, and a new working capital agreement with FFB to provide more funds will not be required until calendar year 1992. However, with the scale of resolution activity anticipated, financing arrangements for working capital should be in place by the beginning of 1992.

We have reviewed RTC's current operating plan and compared the numbers and costs of projected quarterly resolutions with results from past quarters. We found that RTC's schedule, although ambitious, is not impossible. In the 7 quarters since its inception, RTC has on average resolved 61 institutions with about $23 billion in assets each quarter. However, RTC has closed as many as 155 institutions (second quarter 1990) and as few as 15 institutions (first quarter 1990). From January through July 1991, RTC resolved 115 institutions, leaving 153 to be closed before year-end. Consequently, RTC faces a

significant amount of work in the next few months to meet its schedule.

RTC's operating plan also indicates that losses will be lower than average on the institutions remaining to be resolved through year-end. Through the first 7 quarters, RTC losses have averaged approximately 36 percent of the gross assets of failed institutions at resolution. For the remaining 2 quarters of 1991, RTC expects losses to average 26 percent of failed institutions' gross assets. Lower than average losses would imply that the institutions now being resolved have higher net worth and less troubled assets than those resolved in the past. We do not have sufficient information to be able to judge the reasonableness of the projected lower loss rates.

While RTC must make assumptions in order to project funding needs, the actual cost for all failed institutions will not be known until the last asset is sold from receivership. Final costs are subject to significant uncertainties, including the total number of failed thrifts requiring resolution and the state of the economy in general and real estate markets in particular.

As stated previously, our audit of RTC's financial statements for the year ended December 31, 1990, is not yet complete. We are currently evaluating information RTC recently provided us to support its estimated losses. However, there are major uncertainties related to the recovery value of RTC assets in receivership because of the government's large portfolio of troubled assets and RTC's need to sell in a soft market. Therefore, although the RTC financial statements may be adjusted for audit findings, it is likely that we will report that the values shown in the financial statements are uncertain and subject to significant reduction that cannot be reasonably estimated. As of May 31, 1991, RTC reported receivership assets of about $10 billion in real estate owned and $43 billion in real estate backed loans, of which about $15 billion was delinquent. Some of RTC's working capital may not be recovered from proceeds of the sales of such assets. If this occurs, RTC will be unable to repay some of its FFB borrowings. We cannot determine the impact of these potential losses on RTC's December 31, 1991, funding requirements. However, some funding arrangements should be made for this exposure. We suggest that you request that RTC management provide an estimate for funding purposes.

APPROPRIATENESS OF FDIC'S RESOLUTION OF TROUBLED BANKS AND THRIFTS

Your letter asked if we have any evidence that the lack of cash may be affecting the FDIC's decisions about when and what type of action to take regarding insolvent banks and, in its role as exclusive manager of RTC, thrifts. Specifically, you asked whether we have any evidence that FDIC is forbearing from closing institutions or is approving forms of transactions that are more costly in the long-run but that conserve cash resources in the short-term.

We have not specifically reviewed whether forbearance is being used to conserve cash. Our audit work on both the Bank Insurance Fund and RTC has identified a number of banks and thrifts that continue to remain open despite being equity insolvent. However, as we have already stated, there are a number of factors the regulators must consider in deciding when, and in what form, action will be taken to resolve a problem institution. Certainly cost and cash resource constraints delay resolutions, but we are not in a position to state whether and to what extent these considerations and constraints drive the decisions made by the regulators. As of July 26, 1991, we identified 15 banks that were reported equity insolvent at December 31, 1990, but had not failed. We have requested that FDIC provide us with information on why these banks were not closed or assisted. Also, as of May 13, 1991, we identified 25 thrifts that were reported equity insolvent at December 31, 1990, but were still operating in the private sector. We have requested that the Office of Thrift Supervision provide us with information on why these thrifts were not passed on to RTC and placed in conservatorship. When we have received and evaluated these responses, we can provide you with more complete information on this matter.

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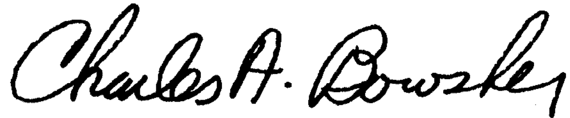
We are sending copies of this report to the Chairman of the Board of Directors, Federal Deposit Insurance Corporation; the Director of the Office of Management and Budget; the Secretary of the Treasury; the Chairman of the Board of Governors of the Federal Reserve System; the Comptroller of

the Currency; the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing and Urban Affairs; and other interested congressional committees.



Charles A. Bowsher
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