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DEPOSIT INSURANCE FUNDS

Analysis of Insurance Premium Disparity Between Banks and Thrifts

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The Honorable Alfonse M. D'Amato
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate

The Honorable John J. LaFalce
Ranking Minority Member
Committee on Small Business
House of Representatives

This report responds to your June 10, 1994, request that we (1) analyze issues related to a possible premium rate disparity that could occur between banks and thrifts if the Federal Deposit Insurance Corporation (FDIC) reduces premiums for banks when their insurance fund recapitalizes before the insurance fund for thrifts is capitalized, and (2) present various policy options to avoid or mitigate problems that a premium rate differential may create.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies of this report to the Chairman of the Federal Deposit Insurance Corporation; the Acting Director of the Office of Thrift Supervision; the Secretary of the Treasury; the Director of the Office of Management and Budget; the Chairman and Ranking Minority Member of the House Committee on Banking and Financial Services; the Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs; the Chairman of the House Committee on Small Business; and other interested parties. We will also make copies available to others on request.

Please call me at (202) 512-9406 if you or your staffs have any questions concerning the report. Other major contributors to this report are listed in appendix IV.

Robert W. Gramling
Director, Corporate Financial
Audits

Executive Summary

Purpose

The Congress, administration, regulators, thrift industry, and other interested parties have expressed concern that a significant insurance premium disparity between banks and thrifts could develop when the Federal Deposit Insurance Corporation (FDIC) lowers bank premiums once the Bank Insurance Fund (BIF) is fully recapitalized. It is expected that thrift premiums could be as much as 5 times greater than bank premiums because thrift premiums would need to remain at higher levels to fully capitalize the Savings Association Insurance Fund (SAIF). Also, the higher thrift premiums would be needed to pay interest on bonds issued specifically to help pay for resolving the thrift crisis that developed in the 1980s. Such a premium disparity has raised concern that thrifts would be at a significant competitive disadvantage with banks. This could adversely affect the viability of the thrift industry and its insurance fund, ultimately resulting in the need for appropriated funds.

Pursuant to a June 10, 1994, congressional request, GAO's principal objectives were to (1) determine the likelihood, potential size, and timing of a premium rate differential between banks and thrifts, (2) analyze possible effects of the premium rate differential on the two industries, (3) assess potential adverse effects on SAIF's viability, and (4) identify policy options to avoid or mitigate problems the premium rate differential may create.

Background

The thrift crisis of the 1980s overwhelmed the industry's insurance fund, resulting in hundreds of billions of dollars in taxpayer assistance and industry costs to protect insured depositors. Legislative action in response to the crisis included establishing the Financing Corporation (FICO) in 1987 to recapitalize the thrift insurance fund. FICO issued $8.2 billion in bonds and was given authority to assess thrifts for the annual bond interest expense. Other legislation (1) established the Resolution Trust Corporation (RTC) to resolve troubled thrifts, (2) created SAIF as a new insurance fund for thrifts and retitled the insurance fund for banks—BIF, (3) designated FDIC as the insurer and administrator of the two funds, (4) set a designated ratio of reserves to insured deposits of 1.25 percent ($1.25 for each $100 of deposits) for the insurance funds, and provided for the designated reserve ratio to be reached within certain time frames, and (5) gave FDIC authority to set premiums for the funds to reach the designated reserve ratio.

As of December 31, 1994, BIF had unaudited reserves of $21.8 billion, or about 1.16 percent of insured deposits, and SAIF had unaudited reserves of

$1.9 billion, or about 0.27 percent of insured deposits. Current average premium rates are 23 cents for every $100 in insured deposits for banks, and 24 cents for thrifts.

SAIF originated in 1989 without any initial capital, and funds authorized for SAIF were not appropriated. More recent legislation (1) authorized $8 billion for SAIF for insurance losses, (2) made available, also for insurance losses, any remaining RTC funding (RTC is to terminate by year-end 1995) for 2 years under certain conditions, and (3) increased borrowing authority from the Treasury.

SAIF's capitalization has been slowed by its members' premiums being used to pay for certain obligations created in financing the resolution of the thrift crisis. From 1989 through 1993, about $6.4 billion, or 84 percent of SAIF's premiums were used for other obligations created in response to the thrift crisis, including FICO. Since 1993, only the FICO obligation has remained. However, the thrift industry's assessable base has been shrinking. Since SAIF's inception, deposits have declined an average of 5 percent annually, from $948 billion in 1989 to $711 billion in 1994. In 1993, the FICO payments totaled $779 million, or about 46 percent of SAIF's total insurance premiums.

Results in Brief

Given BIF's current condition and short-term outlook, it is fairly certain that it will achieve the designated reserve ratio in 1995. FDIC has proposed adjusting bank premium rates as early as the September 1995 payment to reflect the Fund's capitalization date. In contrast, current FDIC projections show that SAIF will not be fully capitalized for another 7 years. Although the estimation process has inherent uncertainties, FDIC projects BIF's reduced premiums will average 4 to 5 basis points, while SAIF's will average 24 basis points until SAIF is fully capitalized.

A significant portion of assessments paid by SAIF-insured thrifts is used to pay FICO's bond interest. GAO assumed that FDIC would continue to set SAIF premium rates at a level sufficient to service the FICO bond interest. If SAIF-insured thrifts are not assessed for FICO bond interest, FICO will be unable to pay the interest expense unless other funding mechanisms are made available. FDIC officials advised GAO that they will be examining this matter. In setting SAIF premium rates, FDIC stated it has the discretion to consider the effects on the ability of FICO to meet its obligations.

SAIF's total deposit base has declined by 25 percent since 1989. Further, premiums paid on thrift deposits acquired by banks and deposits held by former thrifts that converted to bank charters cannot be used to pay FICO bond interest. The portion of the base available to pay FICO has declined by 48 percent. If the deposit base continues to decline and if premium levels are set to pay the FICO bond interest, the premium differential could be significantly affected.

Reliable statistical estimates are not available to predict banks' and thrifts' responses to a premium rate differential. However, banks could pass on savings resulting from reduced premiums by increasing deposit interest rates and improving customer services to compete more aggressively for deposits. Thrifts would likely incur additional costs trying to match bank actions to remain competitive.

This report discusses a range of options for the Congress and the administration to consider in dealing with the concerns raised by a premium differential, including an option of taking no action.

GAO's Analysis

Significant Uncertainties Affect Timing of SAIF's Capitalization and Ability to Pay FICO Interest

Long-range estimates of future thrift failures and losses associated with those failures are very uncertain. Given the unprecedented size of the thrift industry crisis, recent thrift failure and loss experience does not provide a sound basis for estimating future losses. In projecting that SAIF would be capitalized in 2002, FDIC considered historical bank failure rates and current conditions in the thrift industry and assumed an annual 2 percent shrinkage of SAIF's deposit base available to pay FICO bond interest.

FDIC projected that insured institutions holding 0.22 percent of total thrift industry assets will fail each year and that losses associated with such failures will average 13 percent of their assets. However, if greater annual failure rates of 0.35 percent, 0.53 percent, or 0.70 percent were experienced, SAIF's capitalization would be delayed until 2004, 2007, or 2010, respectively.

SAIF's total deposit base has declined by an annual average of 5 percent since 1989, and the portion of the base available to pay FICO has declined

by an annual average of nearly 10 percent. Although these declines reflect RTC's resolution of problem thrifts, the deposit base continues to decline, although at a decreasing rate, and the portion of the base available to pay FICO interest continues to decline. If this experience continues, the premium differential is likely to increase and the sufficiency of SAIF premiums to pay the FICO bond interest is threatened.

At December 31, 1994, SAIF's assessment base available to pay FICO bond interest was about $500 billion. Given the current assessment rate of 24 basis points, that base could shrink to about $325 billion before premium rates would need to be raised to meet the FICO obligation. If shrinkage in the portion of SAIF's assessment base available to pay FICO were to continue at the average rate experienced since the Fund's inception, FDIC would need to increase SAIF's premium rates in the year 2000 to meet the FICO obligation.

Currently, SAIF does not have a large capital cushion to absorb the cost of thrift failures. Thus, SAIF will be vulnerable to the potential cost of a large thrift failure when it assumes full resolution responsibility from RTC this year. While FDIC projections indicate that SAIF could manage the projected rate of failures, any delays in SAIF's capitalization will extend the period of risk associated with a thinly capitalized insurance fund.

Potential Effects of Premium Differential on Industry Costs and Capital

Banks and thrifts compete in a wide market, including nondepository financial institutions, which contributes to uncertainties in predicting banks' responses to a decline in premium rates. Although reliable statistical evidence is not available to predict these responses, in one illustration GAO assumed banks would pass 50 percent of the savings from reduced premiums to customers and that thrifts, to remain competitive, would fully match bank actions. Using the median thrift return on assets of 1 percent (100 basis points) and assets financed with 60 to 90 percent of assessable deposits, the estimated cost increase for these thrifts would be about 3.9 percent to 5.8 percent of annual after-tax earnings. A return on assets of only 0.5 percent (50 basis points) would double the cost as a share of earnings.

The duration of a premium rate differential is a significant factor in determining its impact. FDIC's projections show a premium rate differential of 19.5 basis points existing during the years 1996 through 2002. However, because FICO's bonds will not be fully liquidated until 2019, a substantial differential could continue an additional 17 years beyond 2002. Regardless

of its duration, the impact of the premium differential will be more severe for thrifts with low earnings and low capital.

Policy Options

There are several policy options for decisionmakers to consider to prevent a premium rate differential between BIF and SAIF members from occurring or to reduce the size and duration of a differential. Taking no action is also an option, but poses significant risk in terms of SAIF's exposure to thrift failures and the ability to pay FICO bond interest.

Most of the options to avoid or mitigate the potential impact of the premium differential involve shifting some of the costs of capitalization or future FICO interest payments to either BIF members or to the taxpayer. Opponents of any option that involves shifting all or a portion of the FICO obligation to the banking industry contend it is unfair to require banks to assist in paying for the thrift industry's obligation. Others contend that the institutions that comprise today's thrift industry were no more responsible for the thrift crisis of the 1980s than banks.

The options GAO presents do not attempt to judge the merits of either side, but rather present the impact of such options on banks and thrifts, and on eliminating or reducing the risks associated with the premium differential. These options include

- taking no action at this time, but monitoring the effects of the premium differential on the thrift industry and SAIF;
- merging BIF and SAIF, and several possible scenarios within that option, such as (1) including no initial funding to capitalize SAIF and using both BIF- and SAIF-member premiums to pay FICO bond interest, (2) assessing SAIF members to capitalize SAIF and using BIF- and SAIF-member premiums to pay FICO, and (3) including no initial capitalization of SAIF and using only SAIF-member premiums to pay FICO;
- requiring BIF and SAIF members to share FICO bond interest costs proportionally;
- using BIF premiums to pay FICO bond interest; and
- using appropriated funds to capitalize SAIF or to fund FICO bond interest.

As of December 31, 1995, GAO estimates that the present value cost to increase SAIF's reserves to the designated ratio and to fund the FICO bond interest would be \$13.8 billion or \$14.4 billion, depending on the source of funding. GAO has costed out the various policy options, including the

option of taking no action, using these estimates. GAO presents the risks to the thrift industry, SAIF, and the taxpayers under these policy options.

Agency Comments

FDIC, the Office of Thrift Supervision (OTS), and the Department of the Treasury provided written comments on a draft of this report. These comments are included as appendixes I, II, and III. They were incorporated as appropriate, throughout the report. FDIC, OTS, and Treasury generally agreed with the broad analysis presented in the report. FDIC, OTS, and Treasury agreed that assumptions used in FDIC's projections are subject to significant uncertainties, and any changes in assumed thrift failures and deposit shrinkage could affect SAIF's ability to attain its target capitalization and its ability to service the FICO obligation.

FDIC noted that SAIF's premium income has thus far been sufficient to pay the annual FICO bond interest and gradually build SAIF's reserves. However, at some future date, servicing the FICO obligation could become an issue if SAIF experiences a dramatic increase in the portion of its assessment base whose premiums are not available to pay FICO, or if FDIC reduces premium rates once SAIF achieves its designated reserve ratio. FDIC pointed out that, in setting SAIF's premiums, FDIC has the discretion to consider the effects of the premium rates on the ability of FICO to meet its obligations.

Both OTS and Treasury expressed concern over the risks concerning taking no action. OTS emphasized its concerns regarding SAIF's current capital position, the funding mechanism for FICO bond interest, and the potential adverse effects of a significant premium rate disparity. Treasury emphasized the lack of the thrift industry's risk diversification, the long-term effect of a premium differential on the industry, and the limited assessment base for paying FICO bond interest.

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Abbreviations

BIF	Bank Insurance Fund
FDIC	Federal Deposit Insurance Corporation
FDICIA	FDIC Improvement Act of 1991
FDI	Federal Deposit Insurance
FICO	Financing Corporation
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FRF	FSLIC Resolution Fund
FSLIC	Federal Savings and Loan Insurance Corporation
GAO	General Accounting Office
OTS	Office of Thrift Supervision
REFCORP	Refinancing Corporation
RTC	Resolution Trust Corporation
SAIF	Savings Association Insurance Fund

Introduction

The Bank Insurance Fund (BIF) has substantially rebuilt its reserves over the last 3 years from a deficit position at the end of calendar year 1991. The Savings Association Insurance Fund (SAIF), while also building its reserves, is doing so at a significantly slower rate.

The Congress, administration, savings association trade groups, regulators, and other interested parties have expressed concern that a significant disparity in premium rates between BIF and SAIF could develop when BIF is fully recapitalized if the Federal Deposit Insurance Corporation (FDIC) lowers BIF's premium rates. They are concerned that a significant insurance premium rate differential could put SAIF-insured institutions at a competitive disadvantage with their BIF-insured counterparts. They believe that this, in turn, could have serious implications for the long-term viability of the industry and its insurance fund.

Pursuant to the June 10, 1994, request of the now Chairman of the Senate Committee on Banking, Housing, and Urban Affairs and the now Ranking Minority Member of the House Committee on Small Business, we undertook a review of the issues related to the likelihood that an insurance premium rate differential would develop between bank and thrift institutions and the potential impact of such a differential on the banking and thrift industries and their respective insurance funds.

Background

During the 1980s, the savings and loan industry experienced severe financial difficulties, and the deterioration of the industry's financial condition overwhelmed the resources of its deposit insurance fund, the Federal Savings and Loan Insurance Corporation (FSLIC). By 1988, the condition of the industry and its insurance fund had reached crisis proportions. At December 31, 1988, FSLIC reported a deficit of $75 billion.

The Financing Corporation (FICO) was established in 1987 to recapitalize FSLIC. FICO was funded mainly through the issuance of public debt offerings, which were limited to $10.8 billion.[1] The net proceeds of FICO's debt offerings were used to purchase capital stock and capital certificates issued by FSLIC—in effect, providing capital to FSLIC. FICO was authorized to assess FSLIC-insured institutions for the annual interest expense on the obligations issued, as well as for bond issuance and custodial costs. The

[1]The Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 later terminated FICO's bond issuance authority, effectively capping it at $8.2 billion.

industry's problems, however, required far more funding than that provided through FICO.[2]

In response to the thrift crisis, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) was enacted. FIRREA abolished FSLIC and created the Resolution Trust Corporation (RTC) to manage and resolve all troubled savings institutions that were previously insured by FSLIC and for which a conservator or receiver was appointed during the period January 1, 1989, through August 8, 1992.[3]

FIRREA also provided RTC with an initial $50 billion for the cost of resolving these institutions. FIRREA created a new insurance fund for thrifts—the Savings Association Insurance Fund, retitled the insurance fund for banks—the Bank Insurance Fund, and designated FDIC as sole insurer of all banks and savings associations and administrator of the insurance funds.[4]

FIRREA Established Assessment Authority and Capitalization Levels for BIF and SAIF

FIRREA authorized FICO, with the approval of the FDIC Board of Directors, to assess SAIF-member savings associations to cover its interest payments, issuance costs, and custodial fees. Subsequently, the RTC Refinancing, Restructuring, and Improvement Act terminated FICO's authority to issue bonds, but it did not modify FICO's authority to assess SAIF members to cover its annual interest expense, which will continue until the 30-year recapitalization bonds mature in the years 2017 through 2019.[5] FIRREA provided that the amount of FICO's assessment was not to exceed the amount authorized to be assessed SAIF members by FDIC for insurance

[2]The thrift crisis resulted in hundreds of billions of dollars in appropriated funds and industry costs to protect insured depositors.

[3]The RTC Refinancing, Restructuring, and Improvement Act of 1991 extended RTC's resolution authority through September 30, 1993. This date was subsequently extended to a date not earlier than January 1, 1995, nor later than July 1, 1995, by the RTC Completion Act. The act stated that the final date would be determined by the Chairperson of the Thrift Depositor Protection Oversight Board. On December 5, 1994, the Chairperson made the determination that RTC will continue to resolve failed thrift institutions through June 30, 1995.

[4]FDIC was created by the Banking Act of 1933 to provide insurance coverage for bank depositories and to foster sound banking practices. FDIC was authorized to promulgate and enforce rules and regulations relating to the supervision of insured banks and to perform other regulatory and supervisory duties consistent with its responsibilities as insurer. Prior to enactment of FIRREA, FDIC insurance authority extended only to bank depositories.

[5]Fifteen percent of the outstanding bond principal matures in the year 2017, 57 percent matures in 2018, and the remaining 28 percent matures in 2019. FICO's bond principal will be paid using the proceeds of its investments, which have a face value sufficient to repay the principal amount upon maturity.

premiums, and that FICO's assessment was to be deducted from the amount FDIC was authorized to assess SAIF members.

FIRREA and subsequent legislation also amended the Federal Deposit Insurance Act (FDI Act), particularly with respect to insurance assessments. Under the FDI Act, as amended, the FDIC Board of Directors is to set semiannual insurance premium rates for SAIF and BIF independently. Further, the Board is to set such rates for SAIF to increase SAIF's reserve ratio to the designated reserve ratio and, once SAIF attains the designated reserve ratio, to maintain SAIF's reserve ratio at the designated reserve ratio. In setting insurance premium rates, the Board of Directors is required to consider the Fund's expected operating expenses, case resolution expenditures and income, the effect of assessments on members' earnings and capital, and any other factors that the Board of Directors may deem appropriate.

The FDI Act, as amended, establishes a designated reserve ratio of 1.25 percent for both BIF and SAIF so that both funds build reserves sufficient to withstand the pressures of any substantial financial institution failures in the future. FDIC's Board of Directors must set insurance premium rates at a level that will enable each fund to build its reserves to reach this ratio. The fund capitalization provisions added to the FDI Act by the FDIC Improvement Act of 1991 (FDICIA) required FDIC to establish a recapitalization schedule for BIF to achieve the designated reserve ratio not later than 15 years after implementation and to set insurance assessments in accordance with this schedule.

Until January 1, 1998, FDIC must set SAIF's insurance premium rates at a level that will enable SAIF to achieve the designated reserve ratio within a reasonable period of time. FDIC's Board of Directors has the authority to lower SAIF premiums to an average annual rate of 18 basis points until January 1, 1998. After January 1, 1998, FDIC must set premium rates for SAIF to meet the designated reserve ratio according to a 15-year schedule. FDIC may extend the date specified in the schedule to a later date that it determines will, over time, maximize the amount of insurance premiums received by SAIF, net of insurance losses incurred.

FDIC currently projects that BIF will reach the 1.25 percent designated reserve ratio during 1995, and SAIF is projected to attain its ratio in 2002. As of December 31, 1994, BIF had unaudited reserves of $21.8 billion, representing approximately 1.16 percent of insured deposits. As of the same date, SAIF had unaudited reserves of $1.9 billion, representing

approximately 0.27 percent of insured deposits. Currently, BIF-insured institutions are assessed insurance premiums at a rate averaging 23 cents for every $100 in deposits subject to assessments (23 basis points), while SAIF-insured institutions are assessed at premium rates averaging 24 cents for every $100 of assessable deposits (24 basis points).[6]

Original Authorized Funding for SAIF Was Not Appropriated

SAIF was created without any initial capital, and from SAIF's inception through December 31, 1992, FICO, the Resolution Funding Corporation (REFCORP),[7] and the FSLIC Resolution Fund (FRF)[8] had prior claim on a substantial portion of SAIF members' insurance premiums. During the period 1989 through 1993, approximately $6.4 billion, or 84 percent of SAIF's insurance premiums, were used to fund the priority claims of FICO, REFCORP, and FRF. Beginning in 1993, only FICO continued to have prior claim on SAIF members' insurance premiums, with SAIF receiving the remaining amount. In 1993, FICO received $779 million, which represented approximately 46 percent of SAIF's total insurance premiums for that year.

To address the problem of SAIF's capitalization in light of the other claims on its insurance premiums, the FDI Act, as amended by FIRREA, provided for two types of supplemental funding from the Treasury—backup funding for SAIF insurance premiums and payments to maintain a minimum fund balance. As subsequently amended by the RTC Refinancing, Restructuring, and Improvement Act of 1991, these provisions required the Treasury to provide funding to SAIF each fiscal year from 1993 to 2000 to the extent that the SAIF-member insurance premiums deposited in the Fund did not total $2 billion a year. This would have assured SAIF of at least $16 billion in either premium income or Treasury payments. In addition, Treasury was authorized to make annual payments necessary to ensure that SAIF had a specific net worth, ranging from zero during fiscal year 1992 to $8.8 billion during fiscal year 2000. The cumulative amounts of these payments were also not to exceed $16 billion. The FDI Act, as amended, also authorized funds to be appropriated to the Secretary of the Treasury for purposes of

[6]As required by the FDI Act, as amended, FDIC has implemented a risk-based assessment system that charges higher rates to those institutions that pose greater risks to the insurance funds. Banks and thrifts currently pay an assessment rate of between 23 cents and 31 cents per $100 of assessable deposits, depending on their risk classifications.

[7]REFCORP was established by FIRREA to provide funding for RTC. REFCORP was entitled to SAIF insurance premiums in order to purchase zero-coupon bonds to finance its activities. REFCORP ceased its bond issuance activities in 1991 and, therefore, has no further claim to SAIF insurance premiums.

[8]FRF was established by FIRREA to liquidate the assets and liabilities of the former FSLIC and was entitled, through December 31, 1992, to the SAIF-member premiums not taken by FICO or REFCORP.

these payments. However, none of the funds authorized were actually appropriated.

Current Funding Provisions for SAIF Contain Significant Restrictions

The funding provisions contained in the FDI Act were again amended in December 1993 by the RTC Completion Act. The amendments authorize Treasury payments of up to $8 billion to SAIF for insurance losses incurred in fiscal years 1994 through 1998. Additionally, before any funds can be made available to SAIF for this purpose, FDIC must certify to the Congress, among other things, that (1) SAIF-insured institutions are unable to pay premiums sufficient to cover insurance losses and to meet a repayment schedule for any amount borrowed from the Treasury for insurance purposes under the FDI Act, as amended, without adversely affecting their ability to raise and maintain capital or to maintain the assessment base and (2) an increase in premiums could reasonably be expected to result in greater losses to the government.

The RTC Completion Act also makes available to SAIF any of the RTC's unused loss funding to cover insurance losses during the 2-year period beginning on the date of RTC's termination. However, SAIF's use of this funding is subject to restrictions similar to those of the Treasury funding authorized under the act.

Additionally, FDICIA provided SAIF a mechanism for funding insurance losses. Specifically, FDICIA authorized FDIC to borrow up to $30 billion from the Treasury, on behalf of SAIF or BIF, for insurance purposes. No borrowing has yet occurred, however, BIF or SAIF would have to repay any amounts borrowed from the Treasury with premium revenues. Also, FDIC would have to provide the Treasury with a repayment schedule demonstrating that future premium revenue would be adequate to repay any amounts borrowed plus interest. Additionally, the amount of such borrowings is further restricted by a formula limiting each fund's total obligations.

FICO Obligation Requires Greater Portion of Assessments Than Originally Assumed

At the time FIRREA was enacted, the administration projected annual thrift deposit growth of 6 to 7 percent. Under this assumption, the annual FICO interest obligation would have accounted for 7 basis points (29 percent) of the 24 basis points charged annually for SAIF premiums. Since SAIF's inception, however, total SAIF deposits have declined an average of 5 percent annually, from $948 billion in 1989 to $711 billion in 1994. As a result, the annual FICO interest obligation is being spread over a smaller

than anticipated assessment base. Thus, the FICO interest obligation represents a significantly higher proportion of the assessment rate and the premiums paid by SAIF members than originally assumed.

Growing Segment of SAIF Assessment Base Is Not Available to Service FICO Obligation

Another factor which exacerbates the problem of shrinkage in SAIF's assessment base is the growth of a segment of the SAIF assessment base whose premiums may not be used to fund the FICO interest obligation. This segment of SAIF's assessment base includes deposits which have been acquired by BIF members from SAIF members, and former savings associations that have converted to bank charters while retaining SAIF membership.

Thrift deposits acquired by BIF members, referred to as "Oakar" deposits, retain SAIF insurance coverage, and the acquiring institution pays insurance premiums to SAIF for these deposits at SAIF's premium rates. However, because the institution acquiring these deposits is not a savings association and remains a BIF member as opposed to a SAIF member, the insurance premiums it pays to SAIF, while available to capitalize the Fund, are not available to service the FICO interest obligation. When the acquisition occurs, FDIC establishes a ratio of BIF-insured deposits to SAIF-insured deposits for the BIF member acquiring institution. This ratio remains constant for the institution in the event of subsequent deposit growth or shrinkage. Similarly, premiums paid by SAIF-member savings associations that have converted to bank charters, referred to as "Sasser" institutions, are unavailable to fund the FICO interest obligation since the institutions are banks as opposed to savings associations.

Institution Conversions From SAIF to BIF Membership Are Restricted Until SAIF Is Capitalized

Currently, SAIF-insured institutions cannot voluntarily change or convert their membership from SAIF to BIF. The FDI Act, as amended, contains a moratorium on conversions from SAIF to BIF except in limited cases where (1) the conversion transaction affects an insubstantial portion of the total deposits of the institution as determined by FDIC and (2) the conversion occurs in connection with the acquisition of a SAIF member in default or in danger of default and FDIC determines that the benefits to SAIF or RTC equal or exceed FDIC's estimate of the loss of insurance premium income over the remaining balance of the moratorium period and RTC concurs with FDIC's determination. Once SAIF is fully capitalized, the moratorium on conversions will be lifted. However, institutions converting their membership will be subject to substantial entrance and exit fees.

Objectives, Scope, and Methodology

As directed by the requesters' June 10, 1994, letter, our objectives were to (1) determine the likelihood, potential size, and timing of a differential in premium rates between BIF- and SAIF-insured institutions, (2) analyze possible effects of the premium rate differential on the thrift and banking industries, (3) assess potential threats to SAIF's viability, and (4) present various policy options to avoid or mitigate problems which a premium rate differential may create. As agreed with the requesters, we did not analyze the potential effects of the premium rate differential on the availability of housing finance.

To address the above questions, we obtained background information and data from officials at FDIC, the Office of Thrift Supervision (OTS), the Board of Governors of the Federal Reserve System, the Federal Housing Finance Board, and the Department of the Treasury. We also met with officials at the Savings and Community Bankers Association, the California League of Savings Institutions, the Savings Association Insurance Fund Industry Advisory Committee (SAIFIAC), the American Bankers Association, and other knowledgeable parties who provided us with information and their perspectives.

For our analyses, we relied on FDIC's projected capitalization schedules for BIF and SAIF, and detailed financial data for SAIF-member institutions. We also relied on information reported by FDIC regarding troubled thrifts and potential future failures. We verified that key beginning figures in FDIC's capitalization schedules were reasonable in relation to BIF's and SAIF's financial statements; however, we did not audit the data presented in the schedules. Also, we did not audit the detailed financial data for SAIF members provided by FDIC, nor did we audit the information regarding troubled thrifts and potential future failures reported by FDIC.

In order to determine the likelihood, potential size, and timing of a differential in premium rates between BIF- and SAIF-insured institutions and to assess the future outlook for SAIF, we identified the major assumptions underlying FDIC's projected capitalization schedules for BIF and SAIF. We considered the potential effects of major uncertainties associated with these assumptions as well as other uncertainties affecting the duration of a differential in premium rates. We also analyzed the effects of various institution failure rates on SAIF's ability to attain its designated reserve ratio. Additionally, we analyzed the effects of shrinkage in the portion of SAIF's assessment base available to pay FICO on SAIF's ability to finance the annual interest obligation to FICO's bondholders.

In order to analyze the possible effects of the premium rate differential on the thrift and banking industries, we developed economic scenarios as a framework to forecast the potential magnitude of the impact of FDIC's projected premium differential. We used this approach due to the lack of reliable statistical estimates of the likely behavioral responses of banks and thrifts resulting from a differential in premium rates. Using detailed financial data for SAIF members on a national level, we converted the premium differential into a cost increase for SAIF members. We also analyzed data for SAIF-member institutions in California, a state with a significant level of thrift assets. In our calculations, we used FDIC's projected premium rate differential between BIF and SAIF.

We used information gained throughout the assignment to present various options available for mitigating or avoiding the potential problems associated with a premium differential between BIF and SAIF. We altered assumptions in FDIC's BIF and SAIF projection schedules to correspond with some of the options presented.

We conducted our work in Washington, D.C., from August 1994 through February 1995 in accordance with generally accepted government auditing standards.

FDIC, OTS, and the Department of the Treasury provided written comments on a draft of this report. These comments have been incorporated, as appropriate, throughout this report, and are reprinted in appendixes I through III.

Premium Rate Differential Could Occur and SAIF's Future Outlook Is Uncertain

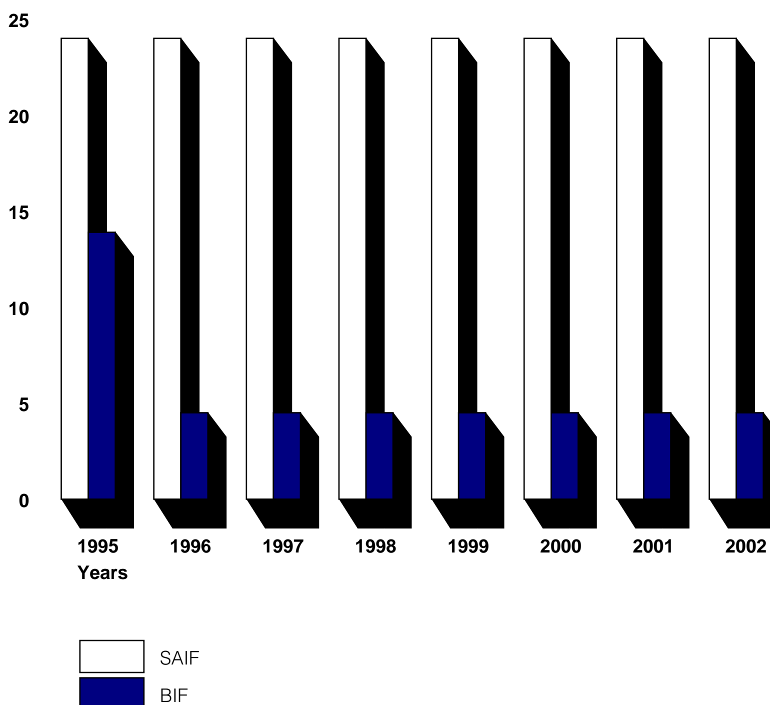
A significant differential in premium rates charged by BIF and SAIF will develop in 1995, if FDIC lowers rates for BIF members immediately after BIF reaches its designated reserve ratio in 1995. FDIC projections indicate that, beginning in 1996, SAIF's premium rates will be more than five times the rate of BIF premiums until SAIF's projected capitalization in the year 2002. The premium rate differential could continue for the duration of the FICO interest obligation if SAIF-insured thrifts continue to be assessed at rates sufficient to pay the interest on the FICO bonds. Significant uncertainties exist with respect to key assumptions in FDIC's projection schedules, including institution failure and loss assumptions, and future shrinkage in the portion of SAIF's deposit base available to fund the FICO interest obligation. These factors could affect SAIF's capitalization date and future premium rates.

A Significant Premium Rate Differential Could Develop in 1995

FDIC's current projections for BIF indicate that BIF will attain its designated ratio of reserves to insured deposits of 1.25 percent in 1995. Given the Fund's current condition and short-term outlook, it is fairly certain that BIF will achieve the designated reserve ratio in 1995. In response to the Fund's rapid improvement and its current outlook, on January 31, 1995, FDIC's Board of Directors issued for public comment a proposal that would significantly reduce the average annual premium rates charged to BIF-insured institutions. FDIC's Board of Directors could adjust BIF-member premium rates as early as the September 30, 1995, payment date to reflect the date in which the Fund achieves the designated reserve ratio. FDIC's projections for SAIF indicate that SAIF will attain its designated reserve ratio in the year 2002, 7 years later than BIF.

FDIC projects that BIF insurance premium rates will average 4 to 5 basis points (4 to 5 cents per $100 of deposits) after BIF reaches its designated reserve ratio. FDIC estimates that this rate will be sufficient to cover future insurance losses and maintain the Fund's reserve ratio. In contrast, FDIC projects that SAIF's premium rates will remain at an average of 24 basis points, more than five times the rate for BIF-insured institutions, until SAIF reaches its designated reserve ratio. (See figure 2.1.)

Figure 2.1: SAIF and BIF Premium Rates Projected by FDIC



Because of the potential magnitude of the differential in premium rates between BIF and SAIF that could develop under the Board's proposal and the potential effects such a differential could have on thrifts and their insurance fund, the Director of OTS, at the January 31, 1995, FDIC Board meeting requested that the Board hold public hearings to discuss the issues and concerns raised by the Board's proposal. We concur with the OTS Director's request and believe such hearings would be a useful forum for examining the implications associated with the premium rate disparity that would develop under the Board's proposal.

Uncertainties inherent in the estimation process could result in the actual premium rate differential being significantly different from the projected differential in any given year. However, it is fairly certain that a period of high premium rate differentials will exist between BIF and SAIF until SAIF reaches its designated reserve ratio.

Future Payment of FICO Bond Interest

Since FICO bonds were first issued in 1987, the thrift industry has paid assessments for the annual interest expense on FICO's bonds. FDIC projections are that SAIF will achieve its designated reserve ratio in 2002 and that SAIF-insured thrifts will be assessed for FICO bond interest through that time. For purpose of our analyses, we assume that assessments of SAIF-insured thrifts for FICO bond interest will continue until the bonds mature in 2017 through 2019.

If FICO assesses[1] SAIF members to pay the annual FICO interest, using the assumptions underlying FDIC's projections, annual assessment rates could be lowered to approximately 19 basis points after SAIF attains its designated reserve ratio. However, these rates would need to be gradually increased as the portion of SAIF's assessment base available to pay FICO decreases. This would result in a substantial premium rate differential continuing through the liquidation of FICO bonds, while at the same time increasing the Fund's reserve ratio to a level significantly higher than the designated reserve ratio.[2] The premium rates for SAIF and the resulting differential could be even higher under scenarios where the portion of the SAIF assessment base available to pay FICO interest experiences significant shrinkage.

FDIC official projections on assessments for SAIF-insured thrifts do not go beyond the year 2002 or otherwise address to what extent SAIF-insured thrifts may be assessed for FICO bond interest after SAIF achieves its designated reserve ratio.[3] If SAIF-insured thrifts are not assessed for the FICO bond interest, FICO will be unable to pay the interest expense unless other funding mechanisms are made available. FDIC officials advised us that they will be examining this issue. In its comments on a draft of this report, FDIC stated that in setting SAIF premiums, it may consider FICO assessments and the effects of SAIF premiums on the ability of FICO to meet its obligations. However, FDIC's comments also reflected the tension that FDIC may face at some future time between its duty to protect SAIF and FICO's debt service requirements.

[1]As previously discussed, the approval of FDIC's Board of Directors is required for FICO assessments of SAIF members.

[2]This assumes that Oakar and Sasser institutions continue to be charged premiums at a rate FDIC determines is sufficient to maintain the Fund's designated reserve ratio and service the FICO bond interest. Because Oakar and Sasser premiums cannot be used for this latter purpose, their premiums would serve to further increase the Fund's reserves.

[3]Although FDIC published projections showing SAIF's balance and designated reserve ratio through the year 2012 in the Federal Register on February 16, 1995, these projections do not indicate the assessment rates to be charged insured institutions.

Uncertainties Regarding Failure Rates and Loss Assumptions Affect Timing of SAIF's Capitalization

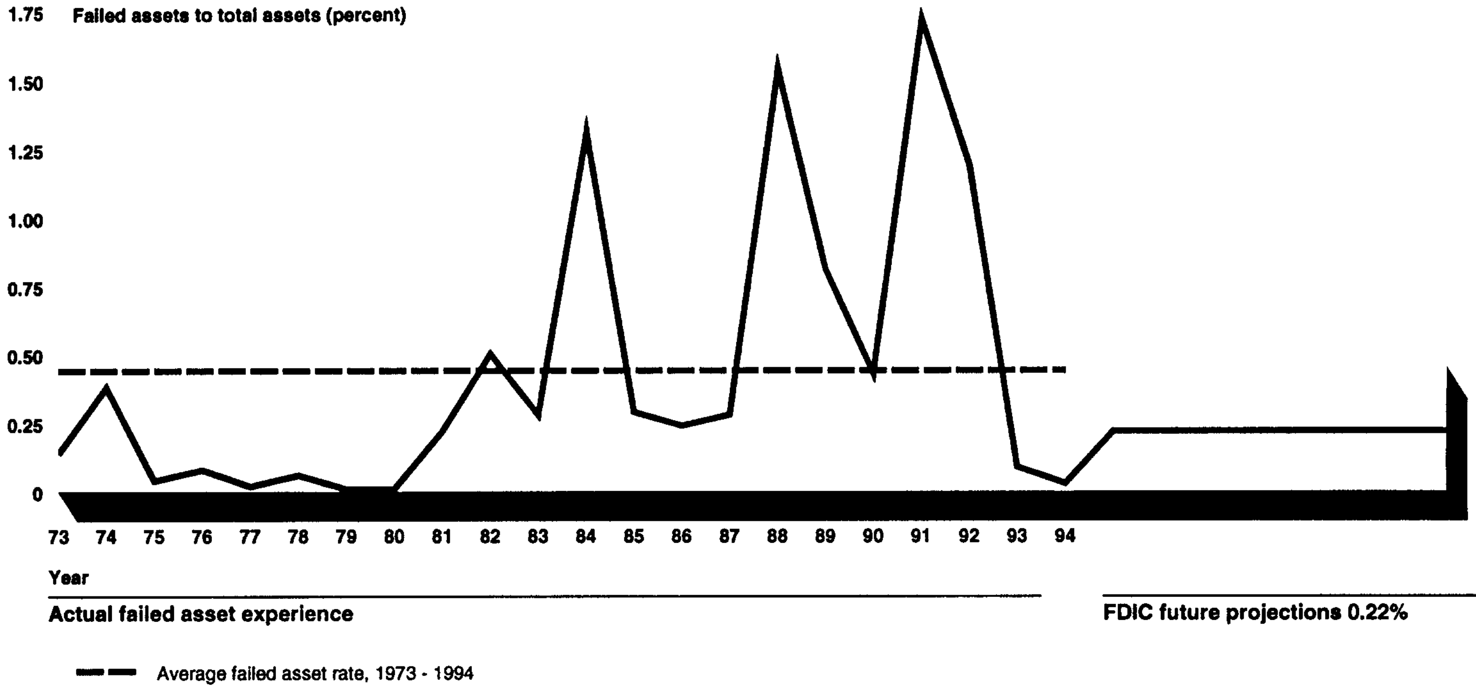
SAIF's ability to achieve its designated reserve ratio in 2002 as currently projected by FDIC is subject to significant uncertainties regarding assumed institution failure rates and associated losses used by FDIC in its projections. Long-range estimates of future thrift failures and losses associated with those failures are extremely uncertain. The health of the industry is subject to many variables which are extremely difficult to predict, such as changes in interest rates, the economy, and real estate markets. If financial institution failures and associated losses for SAIF are higher than those projected, SAIF may not achieve its designated reserve ratio in the time frame projected by FDIC.

Because of the unprecedented nature of the thrift industry crisis, recent thrift failure and loss experience may not provide a sound basis for estimating future losses. Also, requirements for corporate governance and accounting reforms and prompt corrective action by regulators are intended to prevent such high levels of financial institution failures in the future and to limit the losses associated with those that do fail.[4] For these reasons, FDIC used historical bank failure rates, rather than thrift failure rates, as a consideration in projecting future SAIF-institution failures. FDIC also considered current conditions in the thrift industry in projecting SAIF-institution failures. Additionally, FDIC used historical losses on failed bank assets to estimate SAIF's future losses on failed institution assets.

Because recent bank failure rates also may not provide a sound basis for projecting future failures due to recent, significant changes in the business and regulatory environments for financial institutions, FDIC adjusted the average of BIF's failure rate over the last 20 years to arrive at the rate used in SAIF's projections. The institution failure rates used in SAIF's projections are about one-half the average bank failure rate over the last 20 years. Specifically, FDIC projected that, beginning in 1996, institutions holding approximately 0.22 percent of total industry assets will fail each year. (See figure 2.2.)

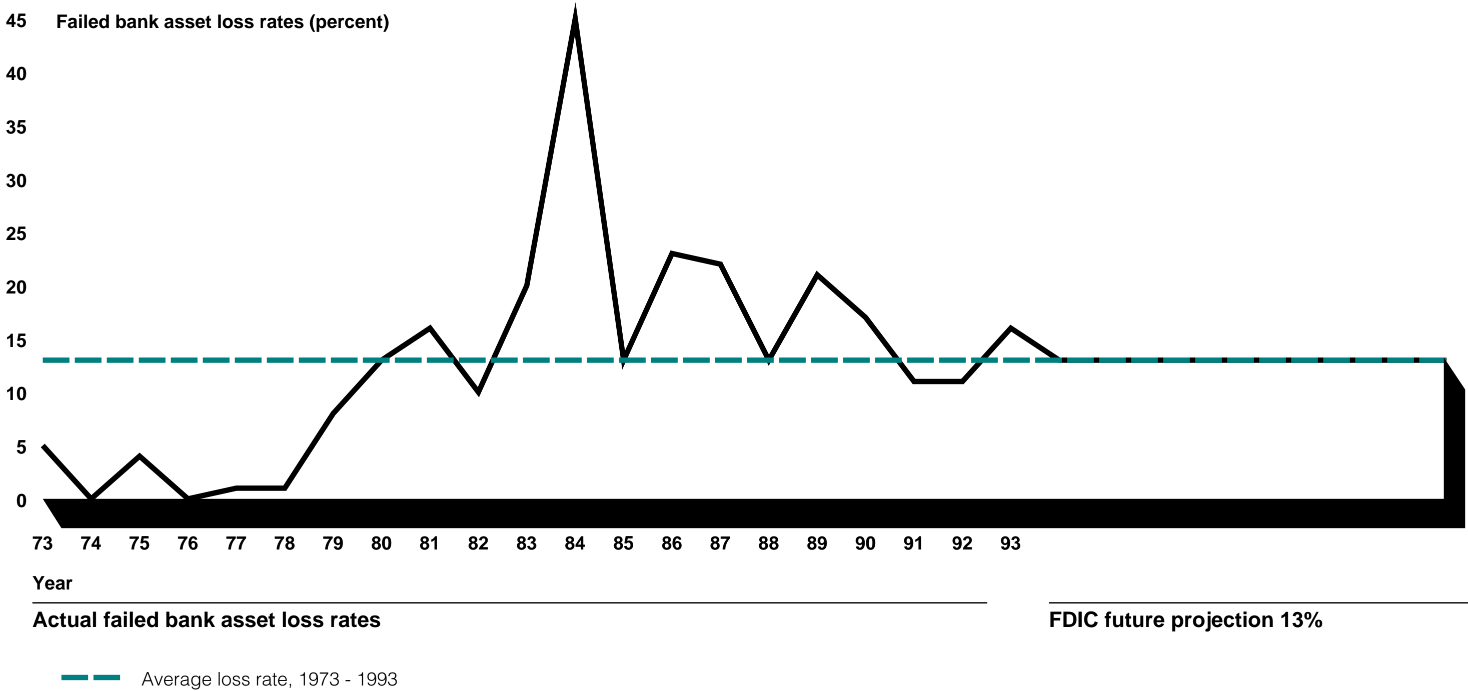
[4]The Federal Deposit Insurance Corporation Improvement Act of 1991 (Public Law 102-242, December 19, 1991).

Figure 2.2: Failed Bank Asset Experience and Future Projections for SAIF



FDIC projected that losses associated with the failures of such institutions will be 13 percent of their assets, which is approximately the average loss experience on failed bank assets over the last 20 years. However, the loss rates have fluctuated significantly from year to year, and future loss rates could be significantly different from those projected. (See figure 2.3.)

Figure 2.3: Failed Bank Loss Rates and Future Projections for SAIF



In addition to the uncertainties associated with failure and loss rates, the rates used in FDIC's projections are constant. As such, they spread the effects of business cycles across all of the years presented. Consequently, the effects of business cycles could cause actual insurance losses for any given year to vary significantly from what FDIC's projections indicate.

Higher Than Projected Failures Could Delay SAIF's Capitalization

If SAIF experiences a higher level of failures than assumed by FDIC in its projections and all other factors are held constant, the Fund's ability to capitalize by the year 2002 would be seriously jeopardized. As of September 30, 1994, FDIC reported in the FDIC Quarterly Banking Profile - Third Quarter 1994 that 62 SAIF members with $47 billion in assets were considered problem institutions, with financial, operational, or managerial weaknesses that threaten their continued financial viability. It is difficult to reliably predict the amount and timing of institution failures, even for problem institutions. Not all problem institutions ultimately fail; many,

historically, have corrected conditions that caused regulatory concerns and strengthened their financial condition. Conversely, institutions not currently considered to be problem institutions could become troubled as a result of unfavorable changes in future economic conditions, including changes in interest rates and real estate markets.

Currently, FDIC projections show that failures totaling 31 percent of the assets in the current group of SAIF-insured problem institutions are estimated to fail between 1996 and 2002, on which SAIF is projected to incur losses equal to 13 percent. If future failures are higher than projected and premium rates remain unchanged at the average annual rate of 24 basis points, SAIF's capitalization could be delayed. (See table 2.1.)

Table 2.1: Effects of Various Failure Rates on SAIF's Capitalization

Total annual asset failure rate (percent)	Percent of 12/94 problem assets failing: 1996-2002	Total asset failures 1996-2002	Year of SAIF capitalization
0.22 (FDIC projection)	31	$15 billion	2002
0.35	50	$24 billion	2004
0.53	75	$35 billion	2007
0.70	100	$47 billion	2010

Another uncertainty affecting the projected institution failure and loss rates for SAIF is the potential effect of a premium rate differential on SAIF institutions. FDIC's failed asset projections for SAIF do not explicitly consider the possible effects of a premium rate differential on thrift failures.[5]

Uncertainties Regarding Assessment Base Growth Assumptions Affect SAIF Members' Ability to Pay FICO Interest

FDIC projected an annual deposit shrinkage of 2 percent for the portion of SAIF's deposit base available to service the annual FICO interest obligation. However, significant uncertainties exist regarding FDIC's assumptions of changes in SAIF's future assessment base. Since SAIF's inception, both its total deposit base and the portion available to pay FICO have experienced significant shrinkage. With the pending significant differential between BIF and SAIF premium rates, the SAIF deposit base available to service FICO bond interest may decline by more than the 2-percent annual rate projected by FDIC.

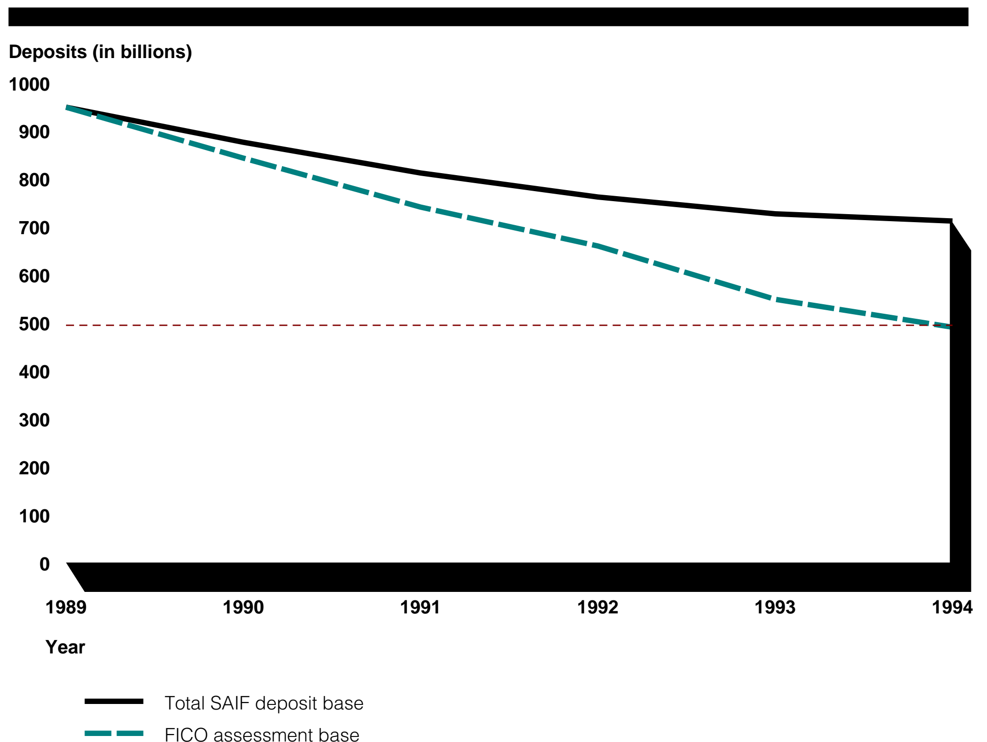
[5]FDIC is currently finalizing an internal study entitled Analysis of Issues Confronting the SAIF, which is expected to be published in February 1995. This study does analyze the impact of a 5- and 20-basis point premium differential on SAIF-member failures.

The FICO Assessment Base Has Experienced Dramatic Shrinkage

Currently, about 31 percent of SAIF's assessment base belongs to institutions whose premiums are not subject to FICO assessments. About 24 percent of SAIF's assessment base consists of Oakar deposits, which are held by BIF members, and about 7 percent is held by Sasser institutions, former savings associations that have converted to bank charters yet retain SAIF membership. As explained in chapter 1, the insurance premiums paid on these deposits cannot be used to pay FICO, since FICO's assessment authority to pay its costs extends only to SAIF-member savings associations.

SAIF's total deposit base has declined by 25 percent since its inception, or an average decline of 5 percent each year, from $948 billion in 1989 to $711 billion in 1994. The portion of SAIF's base available to pay FICO—the FICO assessment base—has experienced a decline of 48 percent since SAIF's inception, or an average annual decline of almost 10 percent. (See figure 2.4.)

Figure 2.4: SAIF Deposit Base Shrinkage Since Inception



It is difficult to predict future shrinkage in the portion of SAIF's assessment base available to pay FICO. Growth in Oakar deposits from BIF-member acquisitions of thrift deposits causes shrinkage in the portion of SAIF's assessment base available to pay FICO. The amount of Oakar deposits has grown rapidly since SAIF's inception. Between 1990 and 1994, Oakar deposits have increased by $136 billion, to a total deposit base of $167 billion. Coupled with a decline in SAIF's total deposit base, Oakar deposits have grown substantially as a portion of SAIF's deposit base. Deposits in Sasser institutions, although significant, have not experienced substantial growth.

Some of the past growth in Oakar deposits resulted from BIF-member institutions acquiring deposits from thrifts resolved by RTC. The unprecedented high number of thrift failures is unlikely to continue. However, it is not possible to predict future BIF-member acquisitions of thrift deposits due to voluntary shrinkage within the thrift industry. For example, in 1993 and 1994, the increase in Oakar deposits was significantly greater than the amount of deposits in institutions resolved by the RTC during this period.

Consequently, it is difficult to predict future growth in Oakar deposits. Nonetheless, if SAIF's Oakar deposits grow at only the 2-percent annual growth rate FDIC projects for BIF members, while the portion of SAIF's assessment base available to pay FICO experiences the 2-percent annual decline projected by FDIC, the Oakar portion of SAIF's assessment base will continue to increase in proportion to the Fund's total assessment base. This would result in a continually decreasing portion of SAIF's total annual premium income being available to service the FICO interest obligation.

Greater Shrinkage in SAIF's Assessment Base Could Result in Higher Premium Rates Than Projected

Changes in SAIF's assessment base could also have a significant effect on the premium rates charged to institutions with SAIF-insured deposits. Assuming payments for the FICO interest obligation are included in SAIF's premium rates, FDIC's projections indicate that the portion of SAIF's assessment base available to pay FICO cannot withstand significant shrinkage without FDIC having to increase insurance premium rates in order to fund the annual FICO interest obligation.

The portion of SAIF's assessment base available to pay FICO totaled about $500 billion at December 31, 1994. At the current assessment rate of 24 basis points, the base could shrink to approximately $325 billion before premium rates would need to be increased in order to pay the FICO

obligation. Under FDIC's assumptions of a 2-percent decline in the portion of SAIF's base available to pay FICO and no future purchases of thrift deposits by BIF members, premiums would need to be increased in about the year 2012 in order to pay the FICO obligation. If the average of past SAIF deposit shrinkage and purchases of thrift deposits by BIF members were to continue, SAIF would need to increase rates in the year 2000 in order to raise enough funds to pay the FICO obligation.

With the pending significant differential between BIF and SAIF premium rates, the SAIF deposit base is likely to continue declining in the foreseeable future. To reduce the burden of a significant cost disadvantage in relation to BIF members, SAIF members could place less reliance on deposits as a source of funding and turn to alternative sources, such as Federal Home Loan Bank advances and repurchase agreements.[6] The differential could also accelerate deposit shrinkage within institutions, further reducing SAIF's assessment base. This, in turn, could cause further increases in premium rates to fund the fixed FICO interest obligation.

The future ability of SAIF-insured institutions to voluntarily convert from SAIF to BIF membership is another factor that could significantly impact SAIF's future assessment base. Generally, institutions cannot currently convert their membership from SAIF to BIF until SAIF achieves its designated reserve ratio. Once SAIF reaches its reserve ratio, the moratorium in effect for conversions from SAIF to BIF membership will be lifted. Institutions converting from SAIF to BIF membership will pay an exit fee to SAIF and an entrance fee to BIF.[7] Whether or not institutions will be motivated to voluntarily convert from SAIF to BIF when the moratorium is lifted will depend, in part, on the cost of the fixed FICO interest obligation in relation to the SAIF assessment base at the time.

Given the fact that the premium rate differential could continue after SAIF's capitalization for the duration of the FICO obligation, institutions could find

[6]The substitution of these funding sources for deposits carries the risk of additional losses to SAIF were these institutions to fail. This is due to the fact that Federal Home Loan Bank advances and repurchase agreements are fully collateralized and have priority over SAIF's claims resulting from payments to depositors in the event the institution is closed and its assets liquidated to satisfy its obligations.

[7]Currently, FDIC regulations set the amount of exit fees payable to SAIF in connection with a conversion transaction as a result of which insured deposits are transferred from a SAIF member to a BIF member at 90 basis points multiplied by the amount of total deposits transferred to BIF. BIF entrance fees payable in connection with such a transaction are calculated by multiplying the dollar amount of total deposits transferred by the BIF reserve ratio at the time of conversion. If BIF's reserve ratio is 1.25 percent, the entrance fee would be 125 basis points. Thus, an institution would have to pay 215 basis points (90 + 125) multiplied by its deposit base in order to convert to BIF membership after SAIF reaches its designated reserve ratio.

it beneficial to convert their membership to avoid continued payment of higher premiums than those paid by BIF members. Therefore, institutions could be motivated to convert from SAIF to BIF membership based on cost. This voluntary conversion would cause further shrinkage in SAIF's assessment base, which would make the fixed FICO obligation relatively more expensive for the shrinking base, in turn, causing additional shrinkage in the base.

Thinly Capitalized Insurance Fund Is Risky

As of December 31, 1994, SAIF had unaudited reserves of $1.9 billion, representing approximately 0.27 percent of insured deposits, or 27 cents for every $100 in insured deposits. FDIC projects that SAIF's reserves will gradually increase until SAIF reaches its designated reserve ratio in 2002, with approximately $8.0 billion in reserves. (See table 2.2.)

Table 2.2: FDIC-Projected Reserves for SAIF

	1995	1996	1997	1998	1999	2000	2001	2002
Reserves (billions)	$2.4	$3.3	$4.1	$4.8	$5.6	$6.5	$7.3	$8.0
Reserve ratio (percent)	0.35	0.49	0.61	0.74	0.86	1.0	1.14	1.25

To date, few demands have been placed on SAIF for resolution of failed institutions, since the primary responsibility for resolving failed thrifts has been with RTC. However, RTC's authority to place failed thrifts into conservatorship expires on June 30, 1995, at which time SAIF will assume full responsibility for failures of SAIF-insured institutions.

Currently, SAIF does not have a large capital cushion to absorb the cost of thrift failures. Although FDIC's projections indicate that SAIF could manage the currently projected rate of failures, the failure of a single large institution or a higher than projected level of failures could delay SAIF's capitalization and increase the risk of SAIF becoming insolvent. SAIF's exposure will continue until its reserves are substantially increased.

Although the condition of the thrift industry has substantially improved over the past few years, a large segment of the industry is still confronting weak economic conditions. The nation's seven largest thrift institutions are headquartered in California and hold 23 percent of the industry's assets. In general, California has lagged behind most of the nation in recovering from the most recent recession. Additionally, a few large institutions have raised supervisory concerns due to low earnings and relatively high levels of risk in their portfolios. Therefore, SAIF still faces

significant exposure relative to its current level of reserves. Any delays in SAIF's capitalization will only extend the period of risk associated with a thinly capitalized insurance fund.

It should be noted, however, that the prompt corrective action provisions and regulatory requirements in FDICIA were designed to minimize losses to the insurance funds. The degree to which regulators exercise their regulatory and supervisory responsibilities under these provisions will thus be a significant factor in preventing or minimizing SAIF's future insurance losses from thrift failures.

Conclusions

A significant premium rate differential will develop in 1995 if FDIC lowers deposit insurance premium rates for BIF members after BIF reaches its designated reserve ratio, although the duration and magnitude of the rate differential are subject to significant uncertainties. FDIC's projections indicate that significant premium rate differentials will exist between BIF and SAIF until SAIF's capitalization. Although FDIC projects that SAIF will reach its designated reserve ratio in the year 2002, the timing is uncertain and could be affected by higher than projected insurance losses from failed institutions. Assuming SAIF-insured thrifts continue to be responsible for paying the FICO bond interest, the differential in premium rates will continue after SAIF's capitalization for the duration of the FICO obligation. Accelerated shrinkage in the portion of SAIF's assessment base available to pay FICO could also cause SAIF premiums to be even higher than the current average rate of 24 basis points.

SAIF's outlook is tenuous given the various uncertainties surrounding its exposure to insurance losses from future financial institution failures and changes in its assessment base, along with the impact of a significant premium rate disparity between its members and those of BIF. Because the fixed FICO obligation is significant in relation to the portion of SAIF's assessment base whose premiums can be used to pay FICO, future shrinkage in SAIF's assessment base, or additional purchases of thrift deposits by BIF members could affect SAIF members' ability to pay the FICO obligation. SAIF's premium rates could be higher than projected, causing the premium differential to be larger than currently projected. The higher premium rates could induce further shrinkage in SAIF's assessment base and jeopardize future payment of the FICO interest obligation.

Premium Rate Differential Will Impact Thrift Industry Costs and Capital

The potential premium rate differential between BIF and SAIF discussed in chapter 2 is likely to have a significant impact on the banking and thrift industries' costs and on their ability to attract deposits and capital. Reliable statistical estimates are not available to predict banks' and thrifts' responses to a premium rate differential. However, the lower cost of insurance coverage could motivate banks to increase interest rates paid on deposits and improve customer services in order to compete more aggressively for deposits. Thrifts would likely incur additional costs in their attempt to match bank actions and remain competitive with banks for deposits.

Banks' and thrifts' actions and the impact of those actions on thrift industry earnings and capital will depend on the duration and amount of the premium differential, which are subject to the uncertainties discussed in chapter 2. The cost increase thrifts are likely to incur will represent a larger share of earnings for thrifts that depend heavily on deposits for funding and have low earnings. Additionally, the high premium rates for thrifts could motivate them to replace deposits with other nondeposit sources of funding in an effort to reduce the costs associated with the premium rate differential. Such action could result in a further shrinkage in SAIF's assessment base and could lead to higher insurance premium rates charged by SAIF.

Banks' and Thrifts' Response to a Premium Differential Is Uncertain

Predicting BIF and SAIF member responses to a reduction in BIF premium rates cannot be done with a high degree of certainty because reliable statistical estimates of the likely behavior do not exist. Consequently, when analyzing the potential effects of the premium rate differential on the thrift and banking industries, it is necessary to make assumptions regarding bank and thrift behavior.

The fact that banks and thrifts compete in a wide market that includes nondepository financial institutions contributes to the uncertainties in predicting banks' responses to a decline in insurance premium rates. Competitive factors within the broader financial marketplace could determine whether banks use their reduction in insurance premiums to increase interest rates paid on deposits and increase customer service. Competition in the broader marketplace could also impact the portion of savings from reduced premiums that banks pass on to customers.

If banks pass on all or part of their savings to customers, it is likely that SAIF members will match bank actions in order to remain competitive. The

borrowing and lending activities of SAIF members have few unique characteristics in relation to BIF members that would help them remain competitive without matching bank actions. Commercial banks compete with thrift institutions in local mortgage origination markets and business lending, and both types of institutions compete for customer deposits to fund their activities.

Cost of Premium Differential to Thrifts Is Uncertain

The portion of the premium reduction that banks pass through to depositors, as well as the extent of SAIF members' attempts to match those actions, are both uncertain factors that will be significant in determining the actual cost increase to SAIF members resulting from the premium rate differential. Thrifts could potentially reduce these costs by replacing deposits with other nondeposit sources of funding.

If banks do not pass on the benefits of their lower premium expenses to customers and instead use these benefits to directly increase earnings, the cost increase to SAIF members from the premium differential would be zero.[1] If banks pass 100 percent of their reduction in insurance premiums through to their customers and SAIF members fully match banks' actions, SAIF members would absorb 100 percent of the premium differential through their increased costs. Similarly, if banks pass 50 percent of their reduction in insurance premiums through to their customers and SAIF members fully match banks' actions, SAIF members would absorb 50 percent of the premium differential through increased costs.

Impact of Thrifts Absorbing the Premium Differential

If BIF members pass 50 percent of their savings associated with FDIC's projected decline in premiums through to their customers and SAIF members fully match those actions, the cost increase for SAIF members on average would be about 4.8 percent of annual after-tax earnings, assuming a 19.5 basis point premium differential.[2] The cost increase to SAIF members would be double if BIF members pass 100 percent of their savings through to customers and SAIF members fully match BIF-member actions.

[1]This assumes that BIF members do not represent a large enough share of investor capital in the financial marketplace to create a general increase in the required rate of return investors demand for investments in depositories.

[2]This calculation is for a SAIF member with a 100 basis point return on assets with an assessment base equal to 75 percent of assets. Under a 50-percent absorption scenario, the above institutions' return on assets would be reduced by 7.3 basis points on a pre-tax basis (50 percent of the 19.5 basis point differential, multiplied by the 0.75 ratio of assessment base to assets) and 4.8 basis points on an after-tax basis, assuming a corporate tax rate of 34 percent. The 4.8 percent after-tax reduction to return on assets represents 4.8 percent of earnings.

The cost increase as a percentage of earnings for individual SAIF members depends on their profitability, as well as the extent to which their assets are financed with assessable deposits. The median return on assets for SAIF members is about 100 basis points. Most SAIF-member assets are financed with 60 to 90 percent of assessable deposits. Under the 50-percent absorption assumption, the cost increase for institutions with a return on assets of 100 basis points varies from about 3.9 percent to 5.8 percent of annual after-tax earnings, respectively. These costs would be double under a 100-percent absorption scenario.

Institutions with a return on assets of 50 basis points, or one-half of the median return on assets, would face double the cost increase as a share of earnings at each level of assessable deposits. Further, this scenario could cause institutions which would otherwise have had low earnings to begin incurring losses. The cost increase associated with the premium rate differential would increase the losses of institutions already experiencing losses. Prolonged periods of losses deplete institution capital and can eventually lead to failure. However, an institution's earnings can vary dramatically over time. Therefore, it is also important to consider an institution's likely earnings over the time horizon of the premium rate differential.

Because the cost of the premium differential is also related to the share of assets financed with assessable deposits, SAIF members are likely to replace deposits with other funding sources, such as Federal Home Loan Bank advances. Therefore, some of the costs referred to above could be mitigated somewhat if an institution replaces deposits with other sources of funding. However, in the aggregate, the cushion provided by such substitution is limited because eventually SAIF's premium rates would need to be increased in response to declines in the portion of SAIF's assessment base available to pay FICO in order to continue paying the FICO bond interest.

Impact on Troubled Institutions Over Time

Although the impact of the premium rate differential will be more severe for institutions with low earnings and low capital, the impact should be considered over the duration of the premium rate differential. Some SAIF members are likely to fail in their business operations whether a premium disparity develops or not. However, institutions that are currently troubled could recover within a short period of time, since national, regional, and local economic fluctuations cause institutions to go through periods of earnings fluctuations in which they experience relatively low earnings for

a number of years, followed by a subsequent recovery. The existence of a differential could make the climb back to recovery more difficult.

For example, the state of California has experienced significant declines in real estate prices over the past few years. Approximately 26 percent of all thrift industry assets are held in California, and, in 1993, 78 of the 98 SAIF members in California had a return on assets of less than 100 basis points. It is possible that some of these institutions could ultimately fail with or without the introduction of a premium differential. However, many of these institutions could experience earnings growth if real estate values rebound and asset quality subsequently improves.

Impact of Premium Differential on Capital Investment in SAIF-Member Institutions

The premium differential will reduce earnings for SAIF members. Also, the premium differential, as well as the expectation of a future differential, will likely reduce capital investments in SAIF-member institutions compared to the outcomes that otherwise would result without the disparity. Unfortunately, reliable statistical estimates do not exist to predict how capital investments in financial institutions will respond to changes in earnings. Furthermore, a number of other factors also affect capital investment in financial institutions, including the term structure of interest rates and the regulatory environment in which financial institutions operate. It should be noted, however, that the thrift industry as a whole is currently well-capitalized, with a median equity capital ratio in excess of 8 percent at September 30, 1994.

Conclusions

The potential premium rate differential is likely to impact banks' and thrifts' costs and their ability to attract deposits and capital. While predicting the response of banks and thrifts to the lowering of premium rates for BIF members is subject to considerable uncertainties, it is likely that banks will take at least some advantage of their lower cost of insurance coverage to expand their deposit base and capital by offering incentives to customers. The likely reaction by thrifts would be to match bank actions to retain and compete for deposits. The severity of the effect of such actions on thrift earnings and capital is subject to the duration and size of the premium differential but will generally be more severe for thrifts already experiencing low earnings or losses and for thrifts that rely heavily on deposits for funding. Thrifts may also replace deposits with other nondeposit sources of funding in an effort to reduce their costs relative to banks, which would further decrease SAIF's assessment base and could lead to a widening of the premium differential.

Policy Options to Address Concerns Resulting From a Premium Rate Differential

Several policy options exist to prevent a premium rate differential between BIF and SAIF members from occurring or to reduce the size and duration of the projected differential. If a premium rate differential is prevented, many of the potential negative effects on the thrift industry and SAIF discussed in chapters 2 and 3 could be avoided. Options that reduce the differential would likely cause the potential effects on thrift institutions and SAIF to be less severe than if a higher differential develops. Some options also reduce or eliminate the risks associated with a thinly capitalized fund and a small assessment base. Aside from the option of taking no action at this time, most of the options in this chapter involve the shifting of at least some costs to either BIF members or the taxpayer.

Table 4.1 presents most of the policy options that are discussed throughout this chapter. These options assume the continued servicing of the FICO interest obligation.

Table 4.1: Policy Options and Related Costs

Dollars in billions, present value

		Merge BIF and SAIF						
	No action[a]	No capital infusion—all members pay FICO	SAIF provides capital—all members pay FICO	No capital infusion—SAIF members pay FICO	BIF and SAIF share FICO proportionally	Use BIF premiums to fund FICO	Use appropriated funds to capitalize SAIF	Use appropriated funds to fund FICO
Cost to SAIF	$13.8	$2.6	$7.9	$8.0	$7.9	$6.1	$7.7	$6.1
Cost to BIF	$0	$11.2	$5.9	$5.8	$5.9	$7.7	$0	$0
Cost to Treasury	No immediate cost	$0	$0	$0	$0	$0	$6.1	$8.3
Year of SAIF capitalization	2002	1996	1995	1996	2000	1999	1995	1999
Year of BIF recapitalization	1995	1996	1995	1996	1995	1997	1995	1995
Risks associated with premium differential	High	Eliminated	Eliminated	High	Significantly reduced	Significantly reduced	Reduced	Significantly reduced
Risks associated with thinly capitalized fund	High	Eliminated	Eliminated	Eliminated	Reduced	Reduced	Eliminated	Reduced
Risks associated with small assessment base	High	Eliminated	Eliminated	High	Eliminated	Eliminated	High	Eliminated

[a]This column represents the effect on the various attributes (cost to SAIF, cost to BIF, etc.) if BIF were to achieve the designated reserve ratio in 1995 and FDIC were to lower BIF-member premiums as outlined in the FDIC Board of Director's January 31, 1995, proposal, which was published in the February 16, 1995, Federal Register.

Total Cost of Capitalizing SAIF and Funding the FICO Interest Expense

At December 31, 1995, we project the present value of the total cost to increase SAIF's reserves to their 1.25 percent designated ratio to insured deposits and to fund the FICO interest obligation, when discounted at 8.60 percent,[2] to be $13.8 billion. When discounted at 7.55 percent,[3] the total cost increases to $14.4 billion. Based on FDIC's projections, SAIF would need

[2]8.60 percent is a private market rate equal to the yield on highly rated corporate bonds as of year-end 1994.

[3]7.55 percent is the rate equal to the yield on 30-year Treasury bonds as of February 23, 1995.

additional capital of $6.1 billion to achieve its designated reserve ratio at the end of 1995. The present value of the total FICO interest obligation from 1996 through 2019 is approximately $7.7 billion using an 8.60-percent discount rate and $8.3 billion using a 7.55-percent discount rate. [4]

SAIF's fund balance at December 31, 1995, is projected by FDIC to be $2.4 billion. Based on FDIC's projections, this would represent a ratio of reserves to estimated insured deposits of 0.35 percent at year-end 1995. SAIF would need an additional $6.1 billion in capital at December 31, 1995, to reach its designated reserve ratio, for a total capital base of $8.5 billion.

Risks Associated With No Action

If no action is taken, and FDIC lowers BIF-member premiums after the Fund reaches its designated reserve ratio in 1995, several significant risks for SAIF's long-term outlook exist which could result in the need for future use of appropriated funds. These risks are interrelated and could result in premium rates increasing to a level which cannot be sustained by SAIF members, thereby calling into question SAIF's long-term viability and its ability to service its members' long-term FICO obligation.

A thinly capitalized SAIF leaves the Fund at risk that it does not have sufficient capital to withstand significant fluctuations in the assumptions of future failures used in FDIC's projections, particularly over the next several years.

As discussed in chapters 2 and 3, a premium rate differential carries the risks that SAIF members will have difficulty competing with BIF members and attracting capital, possibly leading to additional shrinkage in SAIF's assessment base. This is particularly true if future servicing of the FICO interest obligation after SAIF's capitalization is a factor considered by FDIC in setting SAIF's future premium rates.

According to FDIC's projections, the annual FICO interest expense currently represents about 16 basis points in relation to the portion of SAIF's assessment base available to pay FICO. FDIC is currently projecting an annual shrinkage of 2 percent in the portion of SAIF's deposit base available to pay FICO bond interest, which will make the FICO obligation more expensive in relation to the assessment base. According to FDIC's

[4]The annual payments to FICO used for these estimates are based on FICO's 1993 assessment of SAIF members, which was $779 million. Although FICO's actual interest expense in 1993 was $793 million, SAIF was only assessed $779 million due to the fact that FICO uses the interest it earns on its cash balances toward its bond interest expense. Therefore, the amount paid by SAIF each year for the FICO obligation may vary slightly depending on FICO's annual interest earnings.

projections, the FICO obligation will require 19 basis points at the time of SAIF's capitalization and increase to 23.5 basis points in the year 2012. However, as discussed in chapters 2 and 3, SAIF's future levels of assessment base shrinkage is extremely uncertain and could be greater than projected. Greater than projected shrinkage in the portion of SAIF's assessment base available to pay FICO would increase the risk that SAIF members would be unable to service the annual FICO interest obligation without FDIC further increasing premiums above SAIF's currently projected rates.

Options Not Requiring Use of Appropriated Funds

Several options exist to prevent a premium rate differential and its potentially adverse effects from occurring or to reduce the size and duration of the projected differential. The Congress could pass legislation to merge BIF and SAIF into one combined deposit insurance fund, thereby providing a broad assessment base and diversification of risk. Within a merger scenario, several options exist for handling the costs associated with SAIF's capital needs and the fixed FICO obligation. Other options exist which involve a continuation of separate insurance funds for the banking and thrift industries. However, each option has different outcomes, and some options carry more risk and uncertainty than others.

Arguments have been made that any option that involves the banking industry contributing to service the FICO interest obligation is unfair to the industry. These arguments contend that the FICO obligation was incurred during the thrift crisis of the 1980s and, as such, is an obligation of the thrift industry. However, there are also arguments that those thrift institutions that comprise today's thrift industry still exist because they are healthy, well-managed institutions that avoided the mistakes made by many thrifts in the 1970s and 1980s that ultimately led to the thrift debacle. As such, they argue, they should be no more responsible for the FICO interest burden than the banking industry. The options discussed in the remainder of this chapter do not attempt to judge the merits of either side of this issue. Rather, they simply attempt to present how various approaches to dealing with the premium rate differential will impact banking and thrift institutions and eliminate or reduce the risks discussed throughout this report.

Merge BIF and SAIF to Form One Deposit Insurance Fund

An option available to the Congress is to pass legislation which would merge BIF and SAIF into one combined deposit insurance fund. A merger would provide a large assessment base and diversification of risk, thereby

eliminating the current risks associated with a thinly capitalized SAIF. Within a merger scenario, several options exist for dealing with the FICO obligation and SAIF's capitalization. The following scenarios assume a merger on January 1, 1996.

Spread FICO Expense and Combined Fund's Costs Among All Members

The Congress could pass legislation to merge BIF and SAIF into a combined deposit insurance fund on January 1, 1996, with each fund bringing into the combined fund their current level of reserves. If BIF and SAIF are combined without first capitalizing SAIF, and all members of the combined fund continue to pay premiums at the current average annual rate of 23 to 24 basis points until the combined fund reaches the designated reserve ratio, the combined fund would be capitalized in mid-1996. This would be 1 year later than BIF's current projected recapitalization in 1995 and 6 years earlier than SAIF's currently projected capitalization in 2002. Once the combined fund is capitalized, premium rates for the combined fund members could be lowered and would average approximately 6 to 7 basis points annually. This rate would be sufficient to service the annual FICO interest obligation and would be about 2 basis points higher than the future premium rate of 4 to 5 basis points FDIC currently projects for BIF members once BIF attains its designated reserve ratio.

Under this scenario, no premium rate differential would develop, and therefore, the risks associated with a rate differential would be eliminated. The risks associated with a small assessment base would also be eliminated since the FICO obligation would be spread over the combined base. BIF members would, in effect, provide most of the initial capital infusion and pay a portion of the FICO obligation. Assuming that the FICO obligation is spread proportionally between the BIF and SAIF assessment bases and that the bases grow at equal rates after the merger, the present value of the additional premiums BIF members would pay under this scenario would be approximately $11.2 billion.

SAIF Members Capitalize SAIF Prior to Combining Funds

The Congress could pass legislation to merge BIF and SAIF into a combined deposit insurance fund but require that both BIF and SAIF be adequately capitalized prior to the merger. Under this scenario, FDIC could assess SAIF members a special assessment to bring SAIF's reserves up to the designated reserve ratio before merging the two funds. SAIF's reserves could be raised to a ratio of reserves to insured deposits of 1.25 percent by FDIC charging a one-time assessment of approximately 84 basis points on the Fund's assessment base in 1995, prior to merging the funds.

A merger under this scenario would allow BIF to recapitalize in 1995, as currently projected. BIF-member premiums could then be reduced from their current level on schedule with FDIC's current projections. The new premium rates charged to the combined fund members would average approximately 6 to 7 basis points annually. These rates would be sufficient to service the annual FICO interest obligation and would be about 2 basis points higher than the future annual premium rates of 4 to 5 basis points currently projected for BIF members.

Under this scenario, the risks associated with a premium differential and a thinly capitalized fund would be eliminated. Additionally, the risks associated with a small assessment base would be eliminated, since the FICO obligation would be spread over the combined base. SAIF members would provide the necessary infusion of capital, and BIF members would pay a share of the FICO obligation. Assuming equal growth rates among all fund members after the merger, the present value of the additional premiums BIF members would pay under this scenario would be approximately $5.9 billion.

An 84 basis point special assessment to capitalize SAIF would pose some risks to the industry. Specifically, SAIF members and other institutions with SAIF-insured deposits would be forced to contribute $6.1 billion more to SAIF in 1995 than currently projected to bring sufficient capital into the combined fund. Clearly, this is a significant cost to these institutions. Even for profitable institutions, the special assessment could result in losses and a reduction in capital in the year of the assessment. Few institutions that are currently meeting capital requirements would not meet these requirements as a result of the special assessment. However, for some institutions with both low earnings or losses and low capital that are identified as troubled by the regulators, the special assessment could accelerate their failure. The impact of the special assessment on thrifts could be minimized by spreading the special assessment over several years.

However, the risks to the thrift industry under this option are not as great as those associated with the premium rate differential indicated in FDIC's current projections, assuming the prolonged duration of this differential to service the annual FICO interest obligation through 2019. This special assessment would be a one-time cost increase to SAIF members, after which their rates would decline significantly and would be the same as those charged to BIF members. Overall, the one-time assessment of 84 basis points, combined with a merger of the funds, would carry

significantly less risk than the currently projected rate differential extended through the duration of the FICO interest obligation, since the cost to SAIF members would be less than the cost SAIF members would otherwise incur if they were required to capitalize SAIF and fund the entire FICO obligation. Additionally, a future premium rate differential would be eliminated.

Former SAIF Members Continue to Service Combined Fund's FICO Obligation

The Congress could also pass legislation to merge BIF and SAIF into a combined deposit insurance fund with all members contributing to capitalize the fund but require the former SAIF members to retain responsibility for servicing the annual FICO interest obligation. Under this scenario, BIF and SAIF are combined without first capitalizing SAIF. All members of the combined fund would continue to pay premiums at the current average annual rate of 23 to 24 basis points until the combined fund achieves a ratio of reserves to insured deposits of 1.25 percent in 1996. Premium rates would then decline for both former BIF and SAIF members from their current level; however, premium rates for the former SAIF members would only decline slightly if their rates are set at a level sufficient to pay the FICO obligation.

Under this scenario, a premium rate differential would still develop after the combined fund is capitalized because former SAIF members would still be responsible for servicing the FICO interest obligation. BIF members would, in effect, provide a substantial portion of the capital infusion needed to capitalize the combined fund and the cushion against exposure to future financial institution failures. BIF members would pay approximately $5.8 billion more in premiums to cover the capital infusion. It is also possible that the combined fund would incur higher than projected costs in the future if the former SAIF members are negatively impacted by the premium differential that would still develop under this scenario.

If this approach were employed, the risks associated with a small assessment base would not change, since the former SAIF members would still retain responsibility for the FICO obligation. However, the risks associated with a thinly capitalized fund would be eliminated, since the combined fund would be capitalized and better able to withstand insurance losses than an undercapitalized SAIF. The risks associated with the premium differential would probably not change as continued servicing of the FICO obligation would continue to result in a significant premium differential.

Options Not Requiring a Merger

Several options exist for maintaining BIF and SAIF as separate funds, while avoiding the immediate use of appropriated funds. The Congress could require that BIF members fund a portion of the FICO obligation, thereby reducing the size and the duration of the projected premium rate differential. FDIC could reduce SAIF's premiums before the Fund capitalizes, thereby extending the time frame in which SAIF becomes fully capitalized but reducing the size of the premium rate differential currently projected through the year 2002. The Congress could also make all SAIF resources available to service the FICO obligation.

BIF and SAIF Members Service the FICO Obligation

As discussed previously, servicing the interest on the FICO bonds represents a substantial cost for the portion of SAIF's assessment base responsible for paying FICO. This creates the potential for a significant premium rate differential even with a fully capitalized insurance fund. To eliminate this situation and place thrifts on an equal competitive footing with banks, the Congress could pass legislation requiring BIF members to share the cost of servicing the FICO obligation with SAIF members beginning in 1996. Under this option, if BIF and SAIF members shared the FICO obligation proportionally based on their projected 1995 assessment bases, BIF members would fund 77 percent of the FICO obligation and SAIF members would fund the remaining 23 percent, eliminating the risks associated with a small assessment base servicing the FICO obligation. BIF would still attain its designated reserve ratio in 1995 as currently projected; however, SAIF would capitalize in the year 2000, 2 years earlier than currently projected by FDIC.[5] After capitalization, SAIF's projected premium rates could be lowered to a level comparable with BIF's, thereby significantly reducing the risks associated with the premium differential.

Under this scenario, a significant premium rate differential would still exist until the year 2000, when SAIF capitalizes. The present value of the additional premium cost to BIF members under this scenario would be approximately $5.9 billion. SAIF members would still be required to capitalize SAIF and would fund their proportionate share of the FICO obligation. The present value of SAIF members' cost under this scenario would be approximately $7.9 billion.

BIF Members Service the FICO Obligation

Given the relative capital positions of the two insurance funds and the risks associated with a prolonged period of a significant premium rate differential, another option would be for the Congress to pass legislation

[5]This estimate assumes that institution failure and loss rates used in FDIC's SAIF projections would hold true. This estimate also assumes that SAIF members would experience growth in deposits and assets equal to BIF members due to the fact that both funds would be sharing the FICO burden proportionately.

requiring BIF to raise sufficient funds to pay the FICO obligation. If FDIC maintained BIF's premium rate at the current annual average of 23 basis points through early 1997, sufficient funds would be raised to pay the FICO obligation on a present value basis, assuming a discount rate of 8.6 percent. BIF members would pay approximately $7.7 billion more in premiums than currently projected by FDIC.

Under this scenario, BIF premiums would not be reduced until 1997. Additionally, SAIF would reach its designated reserve ratio in 1999, 3 years earlier than currently projected by FDIC. With SAIF's earlier capitalization, the risks associated with a thinly capitalized fund would be reduced. After SAIF's capitalization, its premium rates would be comparable to BIF's. Because SAIF's members would, in effect, be relieved from the FICO interest obligation, the risks associated with a small assessment base paying the fixed FICO interest obligation would be eliminated.

Lower SAIF Premiums Before SAIF Is Capitalized

Under current law, FDIC has the option of lowering SAIF premiums prior to SAIF's capitalization. FDIC's Board of Directors has the authority to lower SAIF premiums to an average annual rate of 18 basis points until January 1, 1998, after which the average rate must remain at 23 basis points or higher until the Fund is capitalized. Reducing the average annual rate to 18 basis points is presently projected to delay SAIF's capitalization for 2 years, until 2004. Although this option would slightly reduce the size of the projected premium rate differential, it does little to address the risks associated with a prolonged premium rate differential. This option would also increase the risks associated with a thinly capitalized fund, since SAIF's capitalization would be delayed until the year 2004 and remain vulnerable to any increases in thrift failures.

All SAIF Resources Available to Service FICO Obligation

As discussed earlier, SAIF's inability to use assessments collected from Oakar and Sasser institutions to help fund FICO interest payments is a significant limitation on its ability to service the industry's FICO obligation. Currently, a significant and growing portion of SAIF's assessment base is not available for this purpose. The Congress could modify current law to specify that all SAIF assessments, including assessments paid by Oakar and Sasser institutions, are available to service the FICO obligation. This action could help SAIF meet future FICO payments without a need to maintain premiums at the current rate beyond the date SAIF attains its designated reserve ratio. However, the risks associated with a thinly capitalized fund over the next several years would not be eliminated. Additionally, the risks associated with the projected premium rate differential would also not be eliminated, as the annual FICO interest obligation would still represent a

significant additional cost in SAIF's premium rates that would not be present in BIF's premium rates.

As discussed in chapter 2, if that portion of SAIF's assessment base available to pay the FICO obligation declines beyond FDIC's current projections, it is possible that SAIF would need to charge higher-than-projected premium rates in the years following its capitalization. These higher premium rates would increase the size of the premium differential and the potential for negative effects on SAIF-insured institutions and SAIF.

If this were the only action taken, a premium rate differential would not be avoided or reduced. Consequently, the potential negative effects for SAIF-insured institutions and SAIF discussed in chapters 2 and 3 would not be avoided or mitigated.

Options Using Appropriated Funds

The options discussed previously to deal with the funding concerns for SAIF and the thrift industry's long-term FICO obligation require significant cost to be borne by banks, thrifts, or a combination of both industries. Alternatively, other options are available that shift this burden to the Treasury and, ultimately, the taxpayers. The Congress could provide SAIF with new funding as a source of capital and as a means to pay the FICO obligation. Another option is to make the funds previously appropriated or the funds authorized, but not appropriated, available for these purposes. Each of these funding options would require legislation and would be subject to budget scorekeeping procedures.[6]

Authorize and Appropriate New Funding

The Congress could appropriate funds to SAIF as a source of capital and as a means to pay the FICO obligation. As discussed earlier, SAIF would require approximately $14.4 billion at the end of 1995 in order to reach its reserve ratio and fund its future FICO obligation, using a discount rate of 7.55 percent.

Remove the Restrictions on Availability of Loss Funding Already Appropriated for RTC

The Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (Public Law 102-233) provided RTC with $25 billion in December 1991 to fund resolution activity. However, these funds were only available for obligation until April 1, 1992. On that date,

[6] Scorekeeping is the process of estimating the budgetary effects of proposed and enacted legislation and comparing them to limits set in the budget resolution or legislation.

RTC returned $18.3 billion of unobligated funds to the Treasury. In December 1993, the RTC Completion Act removed the April 1, 1992, deadline, thus making the $18.3 billion available to RTC for completion of its resolution activities. The RTC Completion Act also makes any unused RTC funding available during the 2-year period beginning on the date of its termination to SAIF for insurance losses. As of December 31, 1993, RTC's audited financial statements showed that RTC could have $13 billion in unused loss funds after resolving all institutions for which it is responsible.[7]

SAIF's use of RTC funding is subject to significant restrictions. Before these funds can be used, FDIC must certify to the Congress, among other things, that (1) SAIF-insured institutions are unable to pay premiums sufficient to cover insurance losses without adversely affecting their ability to raise and maintain capital or to maintain the assessment base, and (2) an increase in premiums could reasonably be expected to result in greater losses to the government.

The Congress could pass legislation removing the restrictions on SAIF's use of RTC funding and make the funds available to capitalize SAIF and to pay the FICO obligation. Based on the estimates presented in RTC's December 31, 1993, audited financial statements, it appears that significant funding may be available to both capitalize SAIF and fund a substantial portion of the FICO obligation.

If this funding were made available at the end of 1995, SAIF would need approximately $6.1 billion to reach its designated reserve ratio, as well as $8.3 billion on a present value basis to cover the future FICO obligation. Because some uncertainty exists regarding RTC's final loss funding needs, the Congress could withhold a portion of the RTC funding for possible future use by RTC until it is either used by RTC, or it becomes fairly certain that RTC will not need the funding.

If the RTC funding were used as a capital infusion and as a mechanism for funding a substantial portion of the FICO obligation, the premium differential would be significantly reduced. Therefore, the risk of negative effects on SAIF members and SAIF resulting from the differential would also be substantially reduced. The capital infusion would provide SAIF with a cushion against future losses, and the risks associated with a thinly capitalized fund would be eliminated.

[7]The estimated $13 billion of unused loss funds is dependent on RTC's ability to recover amounts currently estimated to be collectible from receiverships and future resolutions. Therefore, the amount of unused loss funds available could be higher or lower, depending on RTC's actual recoveries.

Remove the Restrictions on Funding Already Authorized for SAIF

The FDI Act, as amended by FIRREA and by the RTC Refinancing, Restructuring, and Improvement Act of 1991, authorized Treasury to provide funding to SAIF each fiscal year from 1993 to 2000 to the extent that the SAIF member assessments deposited in the Fund did not total $2 billion a year. Additionally, Treasury was authorized to make annual payments necessary to ensure that SAIF had a specific net worth, ranging from zero during fiscal year 1992 to $8.8 billion during fiscal year 2000. The cumulative amounts of these payments were not to exceed $16 billion. However, while the FDI Act, as amended, authorized the appropriation of funds to the Secretary of the Treasury, such funds were not actually appropriated. These funding provisions were later amended by the RTC Completion Act. That act authorized up to $8 billion for SAIF's insurance losses incurred in fiscal years 1994 through 1998 and placed restrictions on the availability of these funds similar to the restrictions on the availability of RTC funding.

The Congress could pass legislation removing the restrictions on this funding source and appropriate the funds to aid in capitalizing SAIF and funding the FICO obligation. The $8 billion authorized would not be sufficient to both capitalize SAIF and completely fund the FICO obligation. However, it would be sufficient to capitalize SAIF and fund about one-fourth of the FICO obligation. If this funding were authorized and appropriated for these purposes, SAIF would be capitalized when the funds are received.

Providing this funding to SAIF would result in SAIF's capitalization, and would have the overall effect of a capital infusion. SAIF would also be relieved of a significant portion of the future FICO obligation. Under this approach, the premium differential after capitalization would be reduced. Alternatively, another option using these funds would be to fund the FICO obligation and let SAIF members continue to fund the cost of capitalizing SAIF as well as paying for the small portion of the FICO obligation not covered by these funds. Under this option, SAIF members would continue to pay higher premiums than their BIF counterparts for 4 years, and the Fund would be capitalized in 1999.

Some uncertainties are associated with these options, since a premium differential would exist, although its size and duration would be subject to how these funds would be applied. However, the risks associated with the differential would be significantly reduced as a result of reducing either the size or duration of the differential.

Comments From the Federal Deposit Insurance Corporation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

February 22, 1995

Gene L. Dodaro
Assistant Comptroller General
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Dodaro:

Thank you for providing the FDIC with a copy of the GAO's draft report on the effects of a premium disparity between banks and thrifts. The report is a useful contribution to the current discussion on the outlook for the SAIF and the thrift industry. This letter outlines my general comments about the report; more detailed or technical comments are presented in an attachment.

See comment 1.

The law governing the setting of deposit insurance premiums is relevant to the issues discussed in the report. The Legal Division of the FDIC has identified the most important statutory provisions:

See comment 2.

- The FDIC is required to maintain the BIF and the SAIF separately, with no commingling of assets, liabilities, revenues or expenses.
- The FDIC is required to "set semiannual assessments for members of each deposit insurance fund independently from semiannual assessments for members of any other deposit insurance fund."
- The FDIC is required to set premiums for an insurance fund that has achieved the designated reserve ratio required by the Congress to maintain that ratio.
- The FDIC may increase the designated reserve ratio for any year only if it determines that circumstances exist raising a significant risk of substantial future losses to the fund for that year.
- The FDIC must maintain a risk-based assessment system.
- Until January 1, 1998, the FDIC is required to set SAIF assessments to increase the reserve ratio to the designated reserve ratio. After January 1, 1998, the FDIC is required

to promulgate a SAIF recapitalization schedule that achieves the designated reserve ratio.

- Until January 1, 1998, SAIF premiums must average at least 18 basis points; after that and until the designated reserve ratio is reached, SAIF premiums must average at least 23 basis points.
- The FDIC may impose higher premiums than the floors established by Congress in order to meet the designated reserve ratio.
- Only assessment revenue from SAIF-member savings associations is available to service the obligations of the Financing Corporation (FICO).
- Assessment revenue from SAIF members that have been purchased by BIF members ("Oakar" institutions), or from SAIF members that convert to a bank charter ("Sasser" institutions), are available to the SAIF but are not available to the FICO.
- In setting SAIF premiums, the FDIC Board is required to take account of expected operating expenses, case resolution expenditures and income, the effect of assessments on members' earnings and capital, and any other factors that the FDIC Board may deem appropriate.
- FICO assessments is a relevant "other factor" that the FDIC Board may consider.
- In setting premiums for SAIF members, the FDIC has the discretion to consider the effects on the ability of the FICO to meet its obligations.

See comment 3.

Given these constraints, and the fact that the BIF will reach its designated reserve ratio this year while the SAIF is not likely to reach its designated reserve ratio until approximately 2002, there will be a substantial premium differential between members of the BIF and SAIF for some time.

See comment 4.

An understanding of the legislative constraints set out above is a prerequisite to a discussion of the policy options for dealing with a premium differential between BIF- and SAIF-insured institutions. I commend the authors of the report for a useful discussion of the policy options. I would only emphasize that, as stated in your report, virtually all of the options discussed would require legislation. The only option discussed in the report that is within the FDIC's authority would be to reduce the average SAIF premium from 23 basis points to 18 basis points until January 1, 1998. This would marginally reduce any impact of the premium differential while delaying for approximately two

See comment 5.

years the time when the SAIF could be expected to meet its designated reserve ratio.

For several years, FDIC representatives have expressed concerns over the undercapitalization of the SAIF[1] and the difficulties in capitalizing the SAIF as long as the FICO obligation continues to drain assessments from the SAIF.[2] I commend you for raising these issues in your report.

A recurring and important theme in the report is the assumption that the FDIC will in future "continue to set SAIF premiums at a level sufficient to service the FICO bond interest." Moreover, the FDIC Board has the authority under the law to approve an assessment level for FICO in excess of its immediate debt service needs in order to create a reserve to meet future debt service obligations should SAIF assessments become inadequate. In setting assessments, however, the FDIC Board has a duty to protect and manage SAIF that is not necessarily driven by the debt service requirements of FICO. Consistent with statutory requirements, including the effect of assessments on SAIF members, this duty could require the Board to withhold approval of the FICO's full assessment in order to protect the SAIF.

The FDIC has not used the funding needs of the FICO as a basis for setting SAIF members' deposit insurance premiums; nor has there been a reason to do so. Given the current premium rates and the size of the SAIF assessment base eligible to fund the FICO, premium revenue has been sufficient to enable FICO to meet its obligations and to allow the SAIF to progress gradually towards its designated reserve ratio. At some future time, however, FICO debt service could become an issue in the event of a dramatic increase in the portion of the SAIF industry whose assessment revenues are unavailable to the FICO, or a reduction in premium rates resulting from the achievement of the designated reserve ratio or any other reason. If the FDIC elects to consider FICO's debt service needs in setting SAIF assessments, this presumably would involve assessing SAIF members for reasons other than capitalizing the fund or pricing risk, which are the

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[1] See Letter to Richard Darman, Director, Office of Management and Budget from William Taylor, FDIC Chairman dated January 10, 1992 and Letter to Jerome H. Powell, Assistant Secretary for Domestic Finance, Department of the Treasury dated February 20, 1992.

[2] See Letters to House and Senate Banking Committee Chairmen and Ranking Minority Members from former Acting Chairman Andrew C. Hove, Jr. dated September 23, 1993 and Testimony of former Acting Chairman Andrew C. Hove, Jr. before the Senate Banking Committee on September 22, 1994.

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principal issues facing the FDIC in setting assessment rates.

My remaining comments concern the report's analysis of the effects of a premium disparity. Of necessity, this amounts to a discussion of a wide range of factors and their effects on the SAIF, the thrift industry, and FICO. The report provides much useful information and insightful analysis. There does, however, appear to be a conflict between the analytical approach and the tone of the writing. The report points out that there are a range of possible outcomes with respect to the SAIF, FICO and the thrift industry, and that there is great uncertainty about which outcomes will occur. There is no attempt in the analysis to take a view about which outcomes are likely. Yet the tone of the writing is much different. "The future of the SAIF is tenuous," the report suggests. The risks from a premium differential are termed "high." By stating repeatedly that there are bad outcomes that could happen, the report gives the impression of taking a position that the analysis has not attempted to support.

See comment 6.

The FDIC has performed its own analyses of the factors affecting SAIF, the FICO and the thrift industry. It must be emphasized as you do in your report that there is a great deal of uncertainty inherent in these analyses. Any attempt to attach numerical values to a wide range of parameters years into the future will by definition be off the mark when measured by hindsight. For policy purposes the most important lessons we can learn from the analysis relate to the sensitivity of the results to changes in parameters, rather than from any specific prediction. The staff considered numerous scenarios regarding the values of a variety of parameters. A set of values was selected to produce a "baseline scenario," intended not as a prediction but as a reasonable benchmark for evaluating the sensitivity of the results to changes in the parameters.

The FDIC estimated that the existence of a premium differential of up to 20 basis points would, _by itself_, cause some additional thrift failures over a five-year time horizon, but the projected losses to the SAIF based on this analysis would be manageable absent losses from causes other than the premium differential. This assumes that banks pass on the full premium reduction to their customers and that thrifts match this in full, thus reducing their interest margins by the full amount of the differential. This finding does not contradict your report, which did not attempt to estimate the increase in failures caused by the differential. As your report indicates, over the long term the continued existence of a substantial premium differential would be expected to affect adversely the ability of SAIF members to raise capital, and should tend to result in a gradual erosion of the SAIF assessment base. These effects could competitively disadvantage SAIF members in relation to BIF members. One caveat is worth mentioning, however. When a SAIF member is purchased by a BIF member (an "Oakar institution"), by

See comment 7.

law, the SAIF-insured deposits of the resulting institution are deemed to grow at the same proportional rate as its BIF-insured deposits so that the ratio stays the same. Therefore a substantial increase in BIF acquisitions of thrifts could mitigate the decline in the SAIF assessment base.

See comment 8.

The factors that were most important to our analysis were the number and size of thrift failures, the shrinkage of the SAIF deposit base, and the change in the proportion of the SAIF assessment base that is eligible to fund the FICO obligation. Our results regarding SAIF failures are in agreement with yours: the time it takes for SAIF to reach its designated ratio is extremely sensitive to changes in the volume of failed thrift assets. Our baseline value for this variable is 0.22 percent of SAIF member assets. This is the same value we used for our baseline BIF scenarios: the traditional distinctions between banks and thrifts are becoming blurred, and their regulatory structures are now very similar. Our baseline failure rate is about half the average bank failure rate for the twenty years from 1973 to 1993. While this may appear to some as optimistic, it assumes that losses of the magnitude of the 1980s are unlikely to recur soon. As you point out in your report, the prompt corrective action provisions and other reforms of FDICIA are likely to result in problems being dealt with more quickly, before they result in losses to the insurance funds.

See comment 9.

As you point out in your report, shrinkage in the size of the SAIF assessment base available to fund the FICO may affect the ability of the FICO to meet its obligations. This shrinkage could occur in two ways. First, shrinkage could occur from economic factors that do not involve conversions or acquisitions: (i) thrifts could avoid assessments by shifting to nondeposit liabilities; (ii) their growth could be limited by a diminished ability to attract capital as a result of the premium differential; and (iii) they could lose deposits if they do not match any premium savings that banks pass on to their customers. Second, shrinkage in the assessment base available to fund the FICO could occur if thrifts are acquired by BIF members or convert to a bank charter. In this event their deposits remain assessed by SAIF but become unavailable to fund FICO.

As your report points out, it is impossible to predict how much shrinkage in the SAIF assessment base, or the amount available to fund FICO, will occur as a result of the premium differential. The FDIC analyzed the issue by considering numerous scenarios for two factors--the shrinkage of the FICO-eligible portion of the SAIF assessment base (intended to capture the effects of the economic factors mentioned above), and the

rate of acquisitions of SAIF members by BIF members.[3] In recent years most shrinkage of the FICO-eligible SAIF assessment base has been through failures and acquisitions of SAIF members by BIF members. For the first three quarters of 1994 the SAIF assessment base shrunk at a 2.4 percent annual rate. The FDIC selected a 2 percent annual shrinkage in the assessment base of FICO-eligible thrifts as its baseline assumption. The FDIC also assumed as its baseline a modest annual increase in the FICO-ineligible portion of the SAIF assessment base. Under these assumptions, the FICO would not experience debt service problems until after the year 2015. As you note in your report, and as the FDIC has emphasized, there is uncertainty inherent in any such analysis. If a four percent annual shrinkage in the "FICO-eligible" assessment base is assumed, then the FICO would be expected to experience debt service problems in about 2004, given the other baseline assumptions.

I look forward to reading the final version of this report. Please do not hesitate to contact the FDIC again should you have further comments or questions about our views or analyses of these important issues.

Sincerely,

Ricki Tigert Helfer
Chairman

Enclosure

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[3] The portion of the SAIF assessment base attributable to Sasser banks represented approximately 7 percent of the total SAIF assessment base as of the third quarter 1994.

The following are GAO's comments on the Federal Deposit Insurance Corporation's letter dated February 22, 1995.

GAO Comments

1. FDIC's technical comments on the draft report were incorporated in the final report as appropriate.

2. We agree with FDIC that the statutory provisions listed are important provisions of law that govern FDIC's setting of deposit insurance premiums. These provisions are discussed as appropriate throughout our report.

3. See chapter 2 for our discussion of the timing and duration of a premium rate differential between banks and thrifts.

4. We agree with FDIC that the policy options discussed in chapter 4, except for FDIC's limited authority to reduce SAIF's premiums until January 1, 1998, would require legislation.

5. See chapter 2 for our discussion of the payment of FICO bond interest.

6. As FDIC acknowledges, there will be a substantial premium disparity between banks and thrifts that will likely continue for some time if FDIC lowers premiums for banks when the Bank Insurance Fund recapitalizes in 1995. SAIF is thinly capitalized and its deposit base is shrinking while a substantial long-term obligation to pay FICO bond interest exists. While analyses of the effects of these conditions are subject to inherent uncertainty, the conditions are facts that present substantial risk to the thrift industry and SAIF.

7. See chapter 3 for our discussion and illustration of how a premium rate differential will impact thrift industry costs and capital. We would note that, while a substantial increase in BIF acquisitions of thrifts could mitigate the decline in SAIF's total assessment base, such an increase would result in a further shrinkage of the portion of SAIF's assessment base available to service the FICO obligation.

8. See chapter 2 for our analysis regarding asset failure rates and loss assumptions affecting the timing of SAIF's capitalization.

9. See chapter 2 for our analysis of deposit base changes and their affect on SAIF members' ability to pay FICO interest.

Comments From the Office of Thrift Supervision

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Office of Thrift Supervision
Department of the Treasury
Director
1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6590

February 23, 1995

Mr. Gene L. Dodaro
Assistant Comptroller General
Accounting and Information Management Division
General Accounting Office
Washington, DC 20548

Dear Mr. Dodaro:

We appreciate your invitation to comment on your February 1995 draft, "Deposit Insurance Funds: Analysis of Insurance Premium Disparity Between Banks and Thrifts."

General Comments

The OTS is in broad agreement with the analysis in your study. We share your concerns about SAIF's currently thin capitalization and limited income, the adequacy of the funding mechanism for Financing Corporation (FICO) bond interest, and the possible adverse effects of a substantial and long-term SAIF-BIF premium differential on SAIF-insured institutions. We agree that it is appropriate to explore these issues by holding public hearings on the effects of such a premium disparity on SAIF and SAIF-insured institutions.

See comment 1.

We agree with your observation that any analysis of the effect of a disparity between SAIF and BIF insurance premiums should be extended through 2019 (the year the FICO bonds mature); stopping the analysis the year SAIF attains its required reserve ratio of 1.25 percent presents an incomplete picture. Our projections for SAIF indicate that if the SAIF assessment base continues to shrink, the FICO burden will produce a large SAIF-BIF premium disparity even after SAIF reaches its capitalization target. Our projections also show that if the rate of shrinkage in SAIF-insured deposits exceed the 2 percent annual decline assumed by FDIC staff or if assets in failed thrifts as a percent of total thrift assets exceed the staff's annual loss assumptions of 22 basis points, then the industry's capacity to capitalize SAIF and finance FICO interest is jeopardized unless the FDIC raises SAIF premiums above their current 24 basis point average. Obviously, as with any tax, there is no assurance that raising insurance premium levels above today's high levels will necessarily generate additional revenue.

See comment 2.

Mr. Gene L. Dodaro
Page 2

Effect on SAIF of Various Assumptions

Chart 1 (attached) shows our projections for the SAIF reserve ratio and SAIF premiums for savings associations under the assumptions used by the staff of the FDIC. Chart 1 shows that even though the SAIF is projected to reach and maintain its capitalization target under this scenario, there will be a continuing and significant SAIF-BIF premium disparity through 2019. If the portion of the SAIF assessment base held by Oakar and Sasser institutions is not liable for the FICO payments, then savings association premiums, after dropping to 18 basis points in 2003 when the fund capitalizes, would immediately begin to rise again because of the fixed FICO payment. By the time the FICO bonds mature in 2019, premiums paid by savings associations will have returned to 24 basis points.

Relatively small changes in the assumptions can have a material effect on the SAIF's ability to reach its capitalization target while servicing the FICO debt. Because of the uncertainty associated with any forecasts that extend out a number of years, it is particularly important to stress test the fund under a variety of assumptions.

See comment 3.

For instance, the FDIC staff's assumptions related to shrinkage in the SAIF assessment base and projected failure rates are more optimistic than recent experience. As shown in Chart 2, since 1989, the total SAIF assessment base has declined at a 5.6 percent rate. The part of the assessment base that is required to service the FICO debt has declined at an even faster rate of over 10 percent. While the rate of shrinkage in the SAIF assessment base has slowed in the last several quarters, the emergence of a BIF-SAIF differential may accelerate the rate of shrinkage. Thus an assumption that the SAIF assessment base will decline at a rate of 2 percent may be too optimistic.

Similarly, the failure rate of 22 basis points used in the FDIC staff projections is lower than the failure rate in any single year between 1980 and 1993. Chart 3 shows the proportion of industry assets in failed thrifts for the period from 1980 through 1994 along with the FDIC's assumption for future failures.

See comment 4.

Again, it is very difficult for anyone to predict with certainty how changes in interest rates, the economy, and local credit and real estate markets will affect future thrift losses. If deposit shrinkage or thrift failures exceed the FDIC's assumptions, the SAIF's viability may be even more in doubt.

Chart 4 shows the SAIF reserve ratio assuming that the average premiums remain at 24 basis points, and using the FDIC staff assumption of a steady 2 percent decline in the SAIF assessment base, but an assumed failure rate of 44 basis points. In this scenario, the premium income can service the FICO debt through maturity, but the higher insurance losses keep the SAIF from reaching its capitalization target prior to 2019.

Mr. Gene L. Dodaro
Page 3

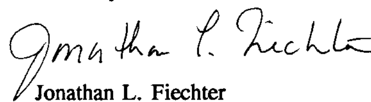
See comment 5.

Options

We are in broad agreement with your analyses of the options for addressing the SAIF's problems. We agree that while extending the liability for FICO interest payments to **all** SAIF-insured deposits may reduce the SAIF-BIF premium disparity and delay the date when the SAIF has problems meeting its FICO obligation, it does not address the SAIF's basic difficulties. We also agree that delaying action increases the risk to the SAIF's viability and to the FICO debt.

Again, we appreciate the opportunity to review and comment on this report.

Sincerely,



Jonathan L. Fiechter
Acting Director

Attachments

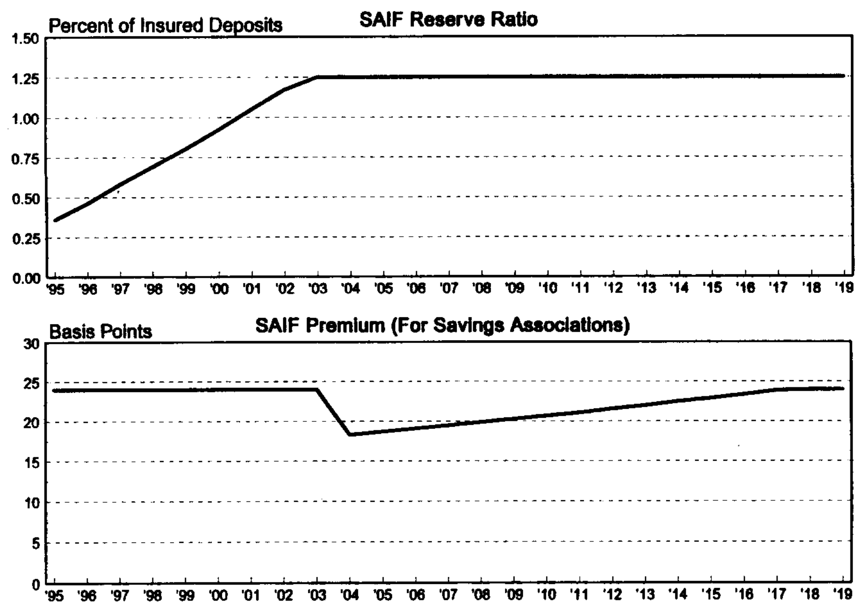
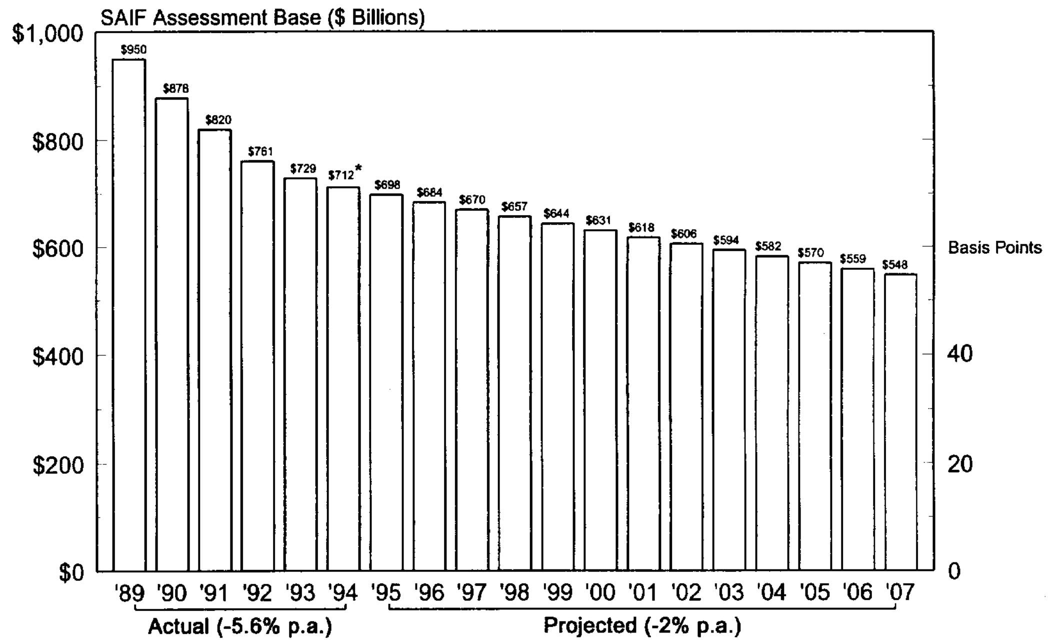


Chart 1
SAIF Reserve Ratio and Premiums
2% Deposit Shrinkage, 22 bp Failure Rate
Percent of Insured Deposits
SAIF Reserve Ratio
1.50
1.25
1.00
0.75
0.50
0.25
0.00
'95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08 '09 '10 '11 '12 '13 '14 '15 '16 '17 '18 '19
Basis Points
SAIF Premium (For Savings Associations)
30
25
20
15
10
5
0
'95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08 '09 '10 '11 '12 '13 '14 '15 '16 '17 '18 '19
Failure rates are assets in failed thrifts as a proportion of industry assets, in basis points (bps). A 22 bp failure rate means that thrifts with assets of $2 billion will fail (based on 1994 assets).
Office of Thrift Supervision / February 1995

Chart 2

SAIF Assessment Base

FDIC Projection: 2 Percent Shrinkage

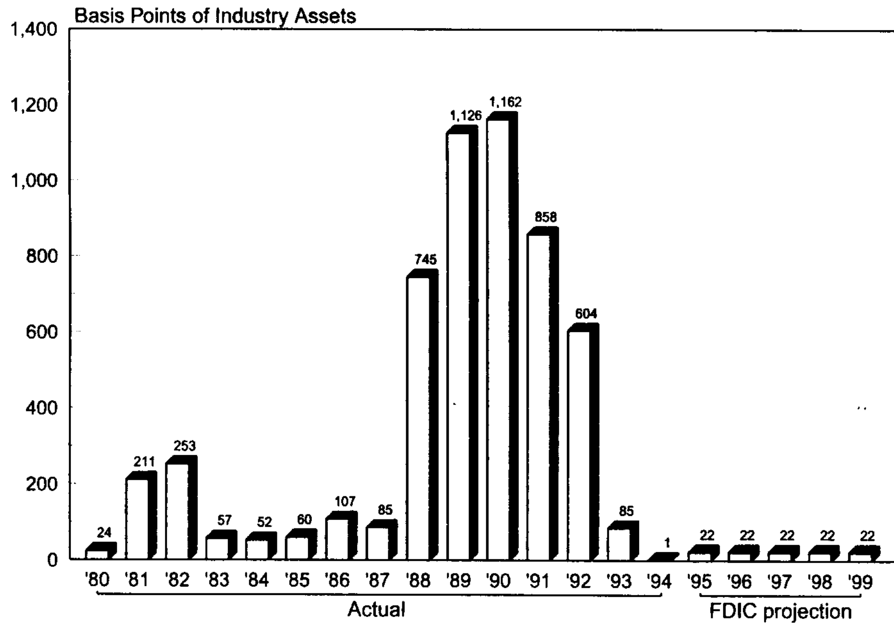


* 1994 assessment base is projected from growth for the first three quarters of the year.

Office of Thrift Supervision / February 1995

Chart 3

Failed Thrift Asset Ratio



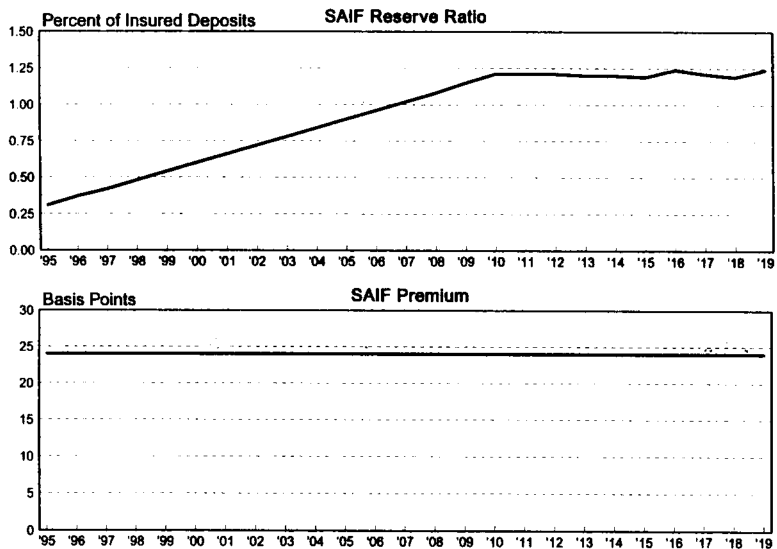
Office of Thrift Supervision / February 1995

Chart 4

SAIF Reserve Ratio and Premiums

Alternative Failure Rate

2 % Shrinkage, 44 bp Failure Rate



Oakar deposits are assumed to grow at 2%. These projections assume a 24 bp SAIF premium until the fund reaches 1.25% of insured deposits.
Failure rates are assets in failed thrifts as a proportion of industry assets, in basis-points (bps). A 22 bp failure rate means that thrifts with assets of $2 billion will fail (based on 1994 assets). A 44 bp failure rate implies $4 billion in assets of failed thrifts.

Office of Thrift Supervision / February 1995

The following are GAO's comments on the Office of Thrift Supervision's letter dated February 23, 1995.

GAO Comments

1. See chapter 2 for our discussion of the usefulness of public hearings to discuss the implications associated with a premium rate differential.

2. See chapter 2 for our analyses regarding asset failure rate and loss rate assumptions affecting the timing of SAIF's capitalization and our analysis of the impact of deposit base changes on SAIF members' ability to pay FICO bond interest.

3. See chapter 2 for our discussion of FDIC's asset failure and loss rate assumptions and actual and projected deposit base changes.

4. See chapter 2 for our discussion of SAIF's current capital position.

5. See chapter 4 for our analysis of several policy options available to address concerns resulting from a premium rate differential.

Comments From the Department of the Treasury

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

February 23, 1995

The Honorable Charles A. Bowsher
Comptroller General of the United States
U.S. General Accounting Office
Washington, D.C., 20548

Dear Comptroller Bowsher:

We appreciate the opportunity to comment upon the GAO's draft report entitled "Deposit Insurance Funds: Analysis of Insurance Premium Disparity Between Banks and Thrifts." The report provides a clear summary of the major issues and we generally agree with your assessment of the issues and options. We strongly agree with your conclusion that taking no action with regard to the BIF/SAIF premium differential poses the most risk of the options presented.

There are three issues in your report that we would particularly like to highlight because they are critical to public debate about the future of the Savings Association Insurance Fund. We have conveyed technical comments orally to your staff.

See comment 1.

First, your report describes intrinsic weaknesses of SAIF -- notably a lack of risk diversification -- that raise questions about SAIF's long-term viability. SAIF-insured deposits are geographically concentrated in California. SAIF's assessment base is much smaller than that of BIF. As of September 30, 1994, there were 1,869 SAIF-members compared to 10,905 BIF-members. SAIF's average assessment base was $715 billion compared to BIF's average assessment base of $2.4 trillion. A handful of large thrifts hold a significant portion of SAIF-insured deposits. As a result, the failure of one or two large institutions could wipe out SAIF's reserves, and deal a severe setback to any SAIF recapitalization schedule.

See comment 2.

Second, we generally agree with your conclusion that a premium differential will be most likely to hurt institutions with capital deficiencies or low earnings. We also concur that the potential long-term effect of a premium differential depends on a number of factors that cannot be easily estimated in advance. We would note, however, that while the differential itself should not create an immediate crisis for savings associations or SAIF, it could (1) make it more difficult for thrifts to compete for capital, (2) reduce the value of the savings association charter, making it more difficult for the OTS and FDIC to find private sector solutions for failing institutions, (3) discourage the formation of new SAIF-insured savings associations, and (4) encourage SAIF-insured institutions to further shrink their

See comment 3.

deposits by seeking alternative sources of funds -- thus reducing SAIF's premium income and exacerbating its problems.

See comment 4.

See comment 5.

Third, your report describes some of the uncertainties regarding FICO payments as the assessable base for FICO shrinks. The possible outcomes here warrant greater consideration. We do not believe that simply broadening the FICO assessment base to include all SAIF-insured deposits will adequately deal with all of SAIF's problems.

I know you share our concern that the problems raised in your report not be allowed to escalate into a crisis. Surely the experience of the past decade underscores the wisdom of dealing with such issues calmly, before they reach the crisis stage. I believe that your report will help to increase awareness of these important issues and I hope that it furthers constructive discussion of possible solutions to SAIF's problems.

Sincerely,

Richard S. Carnell
Assistant Secretary for
Financial Institutions

The following are GAO's comments on the Department of the Treasury's letter dated February 23, 1995.

GAO Comments

1. The Department of the Treasury's technical comments on the draft report were incorporated in the final report as appropriate.

2. See chapter 2 for our discussion of the concentration of SAIF's insured deposits and the effect of higher than projected thrift failures on SAIF's ability to attain its designated reserve ratio.

3. See chapter 3 for our discussion of the effect of a premium rate differential on the thrift industry's costs and ability to attract capital and its effect on institutions with low earnings and low capital.

4. See chapter 2 for our discussion of the effects that shrinkage in the portion of SAIF's assessment base available to pay FICO have on the ability to service FICO bond interest.

5. As discussed in chapter 4, while modifying current law to require all SAIF assessments be available to service the FICO interest obligation could help SAIF meet future FICO payments without a need to maintain premiums at their current rate once SAIF is fully capitalized, the risks associated with a thinly capitalized fund and a premium rate differential would not be eliminated.

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