United States General Accounting Office 338-23

GAO

Briefing Report to
the Honorable Stan Parris
House of Representatives

February 1986

THRIFT INDUSTRY PROBLEMS

Potential Demands on the FSLIC Insurance Fund

GAO/GGD-86-48BR

034843 / 129361

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

FEB 12 1986

B-221644

The Honorable Stan Parris
House of Representatives

Dear Mr. Parris:

On Friday, October 18, 1985, you requested that we brief you on the condition of the thrift industry and its implications for the financial condition of the Federal Savings and Loan Insurance Corporation's (FSLIC) fund. Shortly thereafter we provided you with calendar year 1984 information and agreed to transmit similar information for mid-1985 when it became available. This briefing report has been prepared to fulfill that agreement.

In recent months growing concerns have been expressed about the condition of the thrift industry. In October 1985, the Chairman of the Federal Home Loan Bank Board stated in testimony the need for FSLIC to take control of as many as 70 thrift institutions. Studies issued by the Bank Board's research staff have indicated that a growing portion of the industry is technically insolvent.[1] These studies also provide information on the potential demands on FSLIC for dealing with these insolvent institutions. Despite these concerns, overall industry profits were projected by the U.S. League of Savings Institutions to be over $5 billion in 1985, breaking the previous record of $3.9 billion set in 1978.

In general, the information contained in this report indicates that the thrift industry is composed of two segments: one with firms which are insolvent and generally unprofitable and the other, larger segment that is solvent and generally profitable. The condition of the poorly performing segment raises questions about the dollar amount of assistance that may potentially be demanded from the FSLIC fund.

---

[1]An insolvent institution has negative net worth measured here either under Regulatory Accounting Principles (RAP) or Generally Accepted Accounting Principles (GAAP).

OBJECTIVES, SCOPE, AND METHODOLOGY

It is the purpose of this briefing report to provide information on the financial performance of the thrift industry and the implications of the industry's financial condition for the financial demands likely to be placed upon FSLIC. An examination of the resources available to the fund for dealing with these demands is an important area of inquiry. However, it is beyond the scope of this report.

Because of the many legislative and economic events that have directly affected the thrift industry in recent years, our analysis covers the period from 1977 through the first half of 1985. The best sources of data on individual FSLIC-insured thrift institutions are the financial statements that all institutions are required to file with the Bank Board. These reports were submitted semi-annually through the end of 1983 and quarterly beginning in March of 1984.

When moving to the quarterly reporting schedule, the Bank Board revised its report content and format. As a result, the report data were no longer consistent over time. We converted the data from the the pre-1984 reports to the format used in the more recent quarterly reports. The result is a consistent set of data on the thrift industry for the entire period from 1977 through mid-1985. We did not, however, independently verify the accuracy of the reported data. We have used these data to calculate various measures of industry financial condition such as return on assets and measures of net worth under three accounting concepts: regulatory accounting principles (RAP), generally accepted accounting principles (GAAP), and tangible net worth (TAP). Of these accounting concepts, GAAP accounting is the most widely recognized and is used within the commercial banking industry.

The Bank Board has been moving to reinstate its use for the thrift industry. For these reasons and except where otherwise indicated, this report uses GAAP accounting principles.[2] Financial results are tabulated for the industry as a whole and for certain of its segments which have similar characteristics.

RESULTS

The data contained in the tables and figures which follow provide information on the condition of the industry, its implications for the possible demands that might be placed on the fund, and the ramifications of implementing one of several recently suggested policy options to buttress the financial resources of FSLIC. Though the tables are largely self-explanatory, in the remainder of this letter we briefly describe their contents.

The significant losses experienced during the industry's crises of 1981-82 were reversed in 1983. From that time through mid-1985, the industry as a whole has been profitable. However, even during the first half of 1985, the return on assets remained low by historical standards. Average industry net worth declined in nearly uninterrupted fashion from the end of 1979 until the first half of 1985 when there was some improvement. Because this improvement is so recent we cannot determine whether it will be sustained. (See tables 1 and 2 and figure 1.)

Despite the industry's return to profitability and the recent improvement in its average net worth, the number of thrift institutions which were insolvent under GAAP continued to grow through the first half of 1985. By June of 1985, there were 461

---

[2]We have modified the thrift net worth data according to GAAP standards. With respect to income, it is difficult or impractical to convert the financial report data collected by the Bank Board to GAAP values. For example, under GAAP, loan origination fees should be recognized as current income to the extent that they cover actual underwriting costs. Fees collected in excess of that amount should be amortized over the life of the underlying loans. The Bank Board's data do not allow loan origination fees to be separated except in an arbitrary fashion. This and other, similar problems do not affect most calculations involving assets, liabilities, and net worth.

institutions with assets of $112.7 billion that were technically insolvent because they had negative GAAP net worth. (See table 3.) There were also 833 thrift institutions (down from 909 at the end of 1984) with GAAP net worth between 0 and 3 percent of assets.[3] These institutions had total assets of $320.6 billion. (See table 4.) In sum, by the middle of 1985 there were nearly 1300 out of 3180 FSLIC-insured institutions whose financial condition was weak when judged by conventional standards of financial strength. The assets of these 1300 institutions totalled $433.3 billion and comprised 42.8 percent of the industry's total assets. While we classify these institutions as financially weak, it is not our purpose to suggest that they will all need assistance.

If there were signs that GAAP-insolvent thrift institutions were recovering, the level of concern over the condition of the industry and its implications for potential demands on FSLIC's resources probably would not be high. However, the data indicate that through the middle of 1985 many of the GAAP-insolvent institutions in the industry continued to experience a deterioration in their financial condition because of losses.

Tables 5 and 6 (pp. 19-20) present the potential cost to FSLIC under two hypothetical scenarios for merging or closing institutions in the weakest sector of the thrift industry. In table 5, estimates of potential demands on the FSLIC are presented assuming all institutions that are both GAAP-insolvent and unprofitable are merged or liquidated. Because of uncertainty

---

[3]Classification of thrift institutions with GAAP net worth between 0 and 3 percent of assets as having low net worth is common practice in studies of the industry, including those done by the Bank Board's staff. Prior to 1980, RAP and GAAP net worth were essentially equal. During this period, the Bank Board required that institutions, to be considered healthy, have net worth of at least 5 percent RAP net worth. By 1982, FHLBB's requirement had fallen to 3 percent RAP net worth and the definition of RAP used by the Bank Board had diverged substantially from GAAP standards. We consider that GAAP accounting provides a more consistent and widely accepted measure of the thrift industry's financial condition. Moreover, given that banks are generally required to hold 6 percent GAAP net worth, we believe that classifying thrifts with less than 3 percent GAAP net worth as "low net worth institutions" is reasonable.

over the realizable value of assets, estimates of cost to FSLIC are presented using various ratios of realizable value. For example, assuming the sale of assets yielded 95 cents on the dollar, FSLIC losses to close or merge these 239 institutions would total about $2.9 billion. Should assets yield only 80 cents on the dollar, FSLIC costs could total about $11.8 billion. As a point of reference, FSLIC's realization on the assets of failed institutions during 1984 was 85.3 cents on the dollar.

Table 6 shows estimates of the potential cost to the FSLIC of closing all GAAP-insolvent institutions. The potential costs of dealing with this subset of thrifts are approximately twice as high as the costs shown in table 5.

Tables 7 and 8 and figures 2 and 3 relate the profitability of thrift institutions to their net worth position. In general, the lower the net worth of an institution, the lower the level of profitability; or, in the case of institutions with negative net worth, the larger were losses as a percent of assets. Conversely, high net worth institutions were generally earning good profits in 1984 and 1985.

FSLIC and the Bank Board have the power to levy a supplemental insurance assessment on their constituent institutions equal to 1 percent of deposits. The proceeds of such an assessment would remain an asset for the thrifts. Consequently, the levy would not affect the net worth position of the institutions or the FSLIC. However, in congressional testimony on October 17, 1985, the Chairman of the FHLBB suggested that the FSLIC be given additional authority that would allow the proceeds of a 1-percent assessment to be transferred from the industry to the FSLIC. This was one of several options proposed for shoring up the fund's reserve. Such an assessment would increase fund reserves by roughly $8 billion. Table 9 shows the effect that such a levy would have on the net worth position of the industry's institutions. Had such a levy been imposed in June 1985, the number of GAAP-insolvent institutions would have increased from 461 to 634 and the number of institutions with net worth between 0 and 3 percent of assets would have increased from 833 to 1037.

Copies of the information contained in this report were provided to the Bank Board and the FSLIC for their review and comments. In commenting, the Bank Board said that we had overstated the problems facing the thrift industry as well as the difficulty that the FSLIC faces in dealing with those problems. We disagree with this reaction to the report. Our purpose was to provide factual information on the financial condition of the industry and estimates of potential demands on the fund under clearly specified assumptions. The Bank Board's comments and our response are contained in appendix II to this letter.

As arranged with your office, no further distribution of this report will be made until you publicly release its contents. At the time of its public release, or not later than 30 days from the report's date of issue, it will be distributed to various bank and thrift industry regulators and to other parties who have or who, we anticipate, will express an interest in its contents.

I trust that this briefing report is responsive to your request. If you have any questions, please call me on (202) 275-8678.

Sincerely yours,

Craig A. Simmons
Associate Director

Table of Contents

LIST OF ABBREVIATIONS

FHLB	Federal Home Loan Bank
FHLBB	Federal Home Loan Bank Board
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	Generally Accepted Accounting Principles
RAP	Regulatory Net Worth
TAP	Tangible Net Worth

GLOSSARY

Accrued Net Worth Certificates	Capital certificates that will be issued by the institution to FSLIC at the end of the current reporting period. Only those institutions that have received written assurance of Net Worth Certificates purchases from their Supervisory Agent may make such accruals.
Appraised Equity Capital	The excess of appraised value over book value of office land, buildings, and improvements of the insured institution or of any of its subsidiaries. The appraisal is a "one time only" appraisal as permitted by the institution's principal regulator.
Assets	Total savings and loan assets consist of mortgage loans and contracts, nonmortgage loans, repossessed real estate investments, liquid assets, fixed assets, and "other" assets.
Deferred Losses	An FHLBB regulation permits FSLIC-insured institutions to defer over time any losses (or gains) incurred on the sale of assets.
Expense	FSLIC-insured institutions report their expenditures either as operating expense, interest charges, or nonoperating expense.
GAAP Net Worth	The sum of preferred stock; permanent, reserve, or guaranty stock; paid-in surplus; income capital certificates; reserves; retained earnings; and net undistributed income; less deferred net losses (gains) on loans and other assets sold. These items are recognized under the Generally Accepted Accounting Principles defined by the Financial Accounting Standards Board.

Goodwill and Other Intangible Assets	The premium over book value of an institution's assets that an acquiring institution pays during a merger or acquisition.
Income	FSLIC-insured institutions report their earnings as operating or nonoperating income.
Income Capital Certificates	Certificates issued to the FSLIC by institutions seeking supplementary net worth. A regulatory program conceived and operated by FSLIC.
Insolvent	Value of liabilities exceeds the value of assets according to some accounting standard; regulatory accounting standards' (RAP), generally accepted accounting principles (GAAP), or some other measure. That is, net worth (or capital) is negative.
Liabilities	Consist of deposits, borrowings, and other liabilities.
Low Net Worth	Net worth, assets minus liabilities, between 0 and 3 percent of total assets.
Mortgage Loans	Loans that are secured by property, specifically residential property. Typically the principal asset of a thrift. They may be guaranteed by the Federal Housing Administration or the Veterans Administration. Where not guaranteed they are called "conventional loans."
Mutual Capital Certificates	A regulatory creation of FHLBB allowing mutual institutions to increase their regulatory net worth
Net Worth Certificates	Created by the Garn-St Germain Act, these certificates are issued by a qualified FSLIC-insured institution to FSLIC for the purpose of increasing the institution's regulatory net worth.

Net Undistributed Income	Profit earned but not distributed to stockholders.
Nonoperating Expense	The provision for losses on the sale of real estate, investment securities, loans, and other assets.
Nonoperating Income	Profit earned from the sale of real estate, investment securities, loans, and other assets.
Operating Expense	Directors' fees; officers' and employees' compensation; legal expenses; directors', officers', and employees' expenses; office occupancy expenses; furniture, fixtures, equipment, and automobile expenses; advertising; commissions and fees paid; amortization of goodwill and of deferred losses; and other operating expenses.
Operating Income	Consists of interest earned, fees received, amortized deferred gains, and net income received from real estate owned, from service corporations and subsidiaries, and from leasing operations.
Permanent, Reserve, or Guaranty Stock	Par value of common stock outstanding.
Qualifying Subordinated Debentures	Subordinated debt determined by FHLBB regulation as qualifying for inclusion in net worth.
Regulatory Net Worth	The sum of preferred stock; permanent, reserve, or guaranty stock; paid-in surplus; qualifying mutual capital certificates; qualifying subordinated debentures; appraised equity capital; net worth certificates; accrued net worth certificates; income capital certificates; reserves; undivided profits (retained earnings); and net undistributed income.

Reserves	Moneys set aside, either voluntarily or required by statute, to absorb losses or contingencies.
Retained Earnings	All unallocated profits from the current and previous report periods.
Subordinated Debentures	Reported as "borrowings" where their remaining period to maturity is less than one year or when not qualifying as net worth.
Tangible Net Worth	Equals GAAP net worth (see above) less goodwill and other intangible assets.

Table 1

Net Income After Taxes of FSLIC-Insured Institutions[a]

	Net Income ($ billions)	Rate of Return on Assets[b]
1977.2	1.72	0.79
1978.1	1.87	0.80
2	2.05	0.82
1979.1	1.82	0.69
2	1.79	0.65
1980.1	0.48	0.17
2	0.30	0.10
1981.1	-1.51	-0.48
2	-3.04	-0.95
1982.1	-3.20	-0.97
2	-0.94	-0.27
1983.1	1.12	0.30
2	0.92	0.23
1984.1	0.34	0.16
2	0.67	0.30
3	0.11	0.05
4	0.61	0.25
1985.1	0.53	0.21
2	1.22	0.48

Source: FHLBB Semiannual and Quarterly Financial Statements, 1977-1985.

Notes: [a]Net income is the sum of net operating income and net nonoperating income less income taxes, or alternatively, total income less the sum of total expenses and taxes.

[b]At an annual rate.

Table 2

Net Worth: All FSLIC-Insured Institutions (1977-1985)

	Percentages of Total Assets		
	RAP[a]	GAAP[b]	TAP[c]
1977.2[d]	5.62	5.70	5.68
1978.1	5.64	5.73	5.71
2	5.66	5.77	5.74
1979.1	5.65	5.75	5.72
2	5.70	5.80	5.78
1980.1	5.60	5.70	5.68
2	5.36	5.47	5.43
1981.1	4.95	5.06	5.02
2	4.35	4.34	3.97
1982.1	3.78	3.59	2.38
2	3.69	3.18	0.77
1983.1	3.82	3.18	0.74
2	4.02	3.33	0.66
1984.1[e]	4.00	3.20	0.61
2	3.94	3.07	0.59
3	3.86	2.94	0.47
4	3.87	2.93	0.49
1985.1	3.93	2.96	0.55
2	4.19	3.18	0.73

Source: FHLBB Semiannual and Quarterly Financial Statements, 1977-1985.

Notes: [a]RAP is regulatory net worth, which is the sum of preferred stock; permanent, reserve, or guaranty stock; paid-in surplus; qualifying mutual capital certificates; qualifying subordinated debentures;* appraised equity capital;* net worth certificates;* accrued net worth certificates;* income capital certificates; reserves; undivided profits (retained earnings); and net undistributed income.

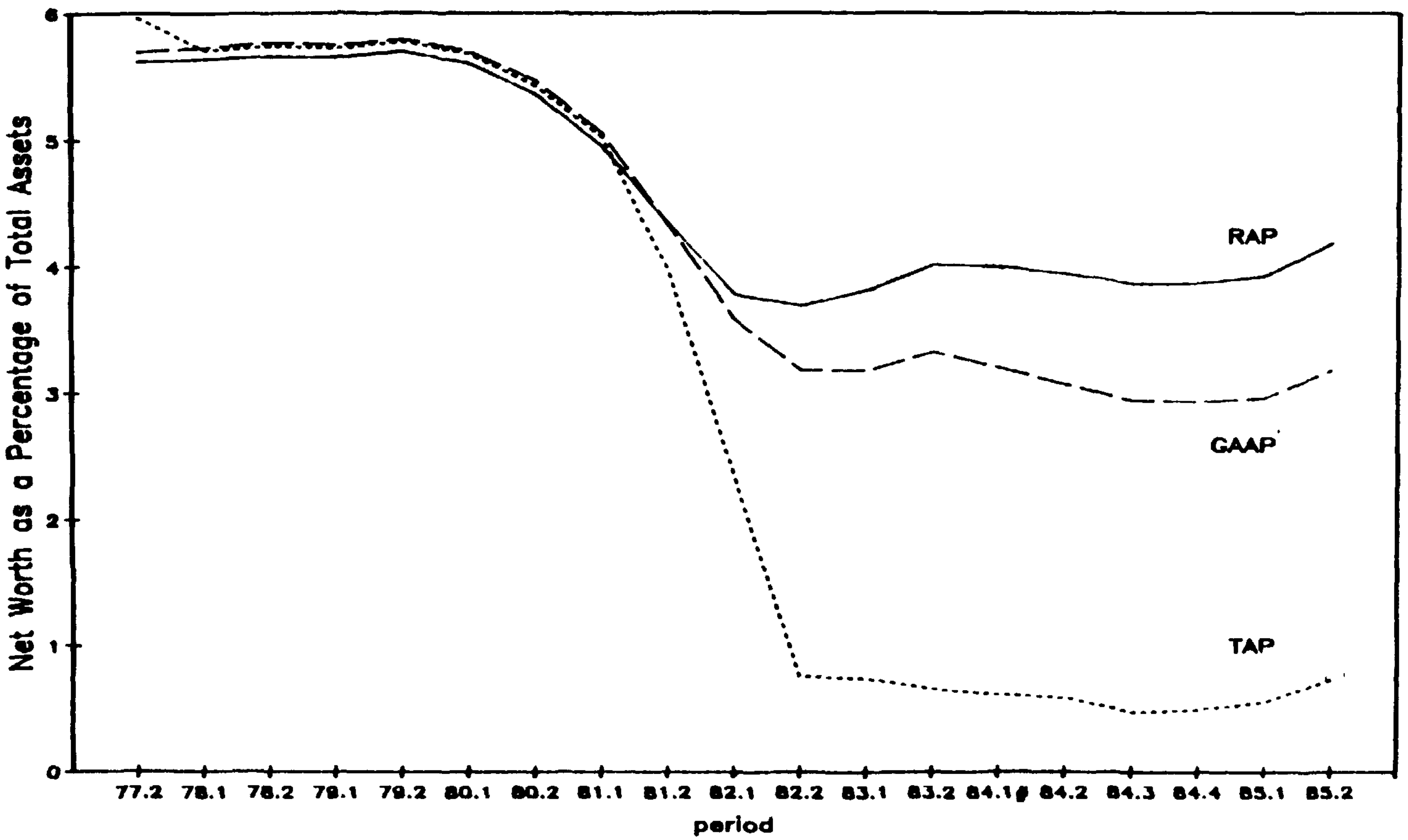
[b]GAAP is net worth as defined under Generally Accepted Accounting Principles (GAAP). It excludes the starred components of regulatory net worth. Deferred net losses (gains) on loans and other assets sold are also excluded from assets.

[c]TAP is tangible net worth which is GAAP net worth less goodwill and other intangible assets.

[d]Data are available semiannually through 1983.

[e]Data are available quarterly in 1984 and 1985.

Figure 1
Net Worth
RAP, GAAP, and TAP
December 1977 — June 1985



Source: Table 2. # Note change in report frequency.

APPENDIX I

Table 3

FSLIC-Insured Insolvent Institutions[a]
(GAAP)

	Total number of institutions	Number of GAAP insolvent institutions	Total assets of insolvent institutions	GAAP net worth	Ratio of GAAP net worth to assets
			----$ billions---		
1977.2	4,055	14	0.1	0.0	-0.6
1978.1	4,051	15	0.1	-0.0	-0.8
2	4,048	10	0.2	-0.0	-1.0
1979.1	4,040	11	0.1	-0.0	-1.1
2	4,038	15	0.1	-0.0	-1.3
1980.1	4,021	16	0.1	-0.0	-2.5
2	3,993	16	0.1	-0.0	-2.4
1981.1	3,916	21	0.7	-0.0	-1.4
2	3,743	53	11.8	-0.3	-2.5
1982.1	3,533	156	47.8	-1.0	-2.3
2	3,287	219	54.3	-2.0	-3.2
1983.1	3,206	243	59.3	-2.3	-3.5
2	3,146	279	72.6	-2.1	-3.5
1984.1	3,139	321	72.9	-2.3	-3.3
2	3,148	370	84.1	-2.9	-3.4
3	3,137	417	96.2	-3.0	-3.3
4	3,135	434	101.6	-3.3	-3.4
1985.1	3,160	455	106.5	-3.6	-3.7
2	3,180	461	112.7	-3.4	-3.7

Source: FHLBB Semiannual and Quarterly Financial Statements, 1977-1985.

Note: [a]Insolvent institutions have GAAP net worth equal to or less than zero.

Table 4

FSLIC-Insured Low Net Worth Institutions[a]
(GAAP)

	Total number of institutions	Number of low net worth institutions	Total assets of low net worth institutions	GAAP net worth	Ratio of GAAP net worth to assets
			——$ billions——		
1977.2	4,055	209	8.5	0.2	2.4
1978.1	4,051	215	9.6	0.2	2.4
2	4,048	194	8.3	0.2	2.1
1979.1	4,040	200	9.1	0.2	2.3
2	4,038	193	11.9	0.2	2.4
1980.1	4,021	241	20.8	0.5	2.4
2	3,993	299	37.8	0.9	2.4
1981.1	3,916	456	78.7	1.8	2.2
2	3,743	691	130.1	2.7	2.0
1982.1	3,533	916	178.8	3.6	2.0
2	3,287	918	222.8	4.5	2.0
1983.1	3,206	939	255.6	5.1	2.0
2	3,146	926	242.9	4.8	2.0
1984.1	3,139	954	296.6	5.8	2.0
2	3,148	927	318.9	6.4	2.0
3	3,137	896	383.1	8.0	2.1
4	3,135	909	382.1	7.8	2.0
1985.1	3,160	903	363.6	6.7	1.8
2	3,180	833	320.6	5.8	1.8

Source: FHLBB Semiannual and Quarterly Financial Statements, 1977-1985.

Note: [a]Low net worth institutions have GAAP net worth between 0 and 3 percent of assets.

Table 5

Estimates of FSLIC Losses on Insolvent and Unprofitable Institutions' Asset Portfolios[a] 1984 and 1985 (first half)

(in billions of dollars)

	Number of insolvent and unprofitable institutions	Total of value of assets	Potential Dollar Losses to FSLIC[b]			
			5 percent	10 percent	15 percent	20 percent
1984[c]	255	$55.8	$2.79	$5.58	$8.37	$11.16
1985[d]	239	58.8	2.94	5.88	8.82	11.76

Source: FHLBB Semiannual and Quarterly Financial Statements, 1977-1985.

Notes: [a]Those institutions with zero or negative GAAP net worth and negative net income for the year.

[b]Dollar losses to the FSLIC assuming 5, 10, 15, 20 percent loss on assets. In 1984, the average cost to the FSLIC of dealing with failed institutions was 14.7 percent of assets.

[c]In 1984 these institutions had combined losses of $0.7 billion leaving them with GAAP net worth of -$2.0 billion.

[d]In the first half of 1985, losses of insolvent and unprofitable institutions were $0.6 billion leaving them again with -$2.0 billion GAAP net worth. Some of the 255 insolvent and unprofitable institutions from 1984 may have become profitable though perhaps still insolvent in 1985 while others may have been closed. Thus, in 1985 the number of insolvent and unprofitable thrifts fell to 239.

Table 6

Estimates of FSLIC Losses on Insolvent Institutions' Asset Portfolios, 1977-1985[a]
(in billions of dollars)

	Number of insolvent institutions	Total value of assets	Potential Dollar Losses to the FSLIC[b]			
			5 percent	10 percent	15 percent	20 percent
1977.2	14	$0.09	$0.00	$0.01	$0.01	$0.02
1978.1	15	0.07	0.00	0.01	0.01	0.01
2	10	0.19	0.00	0.02	0.02	0.04
1979.1	11	0.09	0.00	0.01	0.01	0.02
2	15	0.13	0.00	0.01	0.02	0.03
1980.1	16	0.13	0.00	0.01	0.02	0.03
2	16	0.12	0.00	0.01	0.02	0.02
1981.1	21	0.72	0.04	0.07	0.11	1.44
2	53	11.82	0.59	1.18	1.77	2.36
1982.1	156	47.75	2.39	4.78	7.16	9.55
2	219	54.34	2.72	5.43	8.15	10.87
1983.1	243	59.27	2.96	5.93	8.89	11.85
2	279	72.55	3.63	7.26	10.88	14.51
1984.1	321	72.86	3.64	7.29	10.93	14.57
2	370	84.09	4.20	8.41	12.61	16.82
3	417	96.22	4.81	9.62	14.43	19.24
4	434	101.58	5.08	10.15	15.24	20.32
1985.1	455	106.5	5.33	10.65	15.98	21.30
2	461	112.7	5.64	11.27	16.91	22.54

Source: FHLBB Semiannual and Quarterly Financial Statements, 1977-1985.

Notes: [a]Those institutions with zero or negative GAAP net worth.

[b]Dollar losses to the FSLIC assuming 5, 10, 15, and 20 percent loss on assets. In 1984, the average cost to the FSLIC of dealing with failed institutions was 14.7 percent of assets.

Table 7

Profit Experience by GAAP Net Worth
(All FSLIC-Insured Institutions)

1984 (Full Year)

GAAP net worth as a percentage of assets	Number of institutions	Rate of return on assets	Number of unprofitable institutions	Percentage of unprofitable institutions
≤ - 12%	15	-8.02	14	93%
-12 to -11%	3	-1.30	3	100%
-11 to -10%	6	- .96	6	100%
-10 to -9%	7	-1.62	5	71%
- 9 to -8%	7	-1.20	6	86%
- 8 to -7%	8	- .27	7	88%
- 7 to -6%	23	- .70	18	78%
- 6 to -5%	19	-1.23	14	74%
- 5 to -4%	45	- .31	23	51%
- 4 to -3%	55	- .54	31	56%
- 3 to -2%	58	- .46	34	59%
- 2 to -1%	89	- .08	43	48%
- 1 to 0%	99	- .21	51	52%
0 to 1%	181	- .08	84	46%
1 to 2%	301	.02	122	40%
2 to 3%	423	.26	109	26%
3 to 4%	453	.40	86	19%
4 to 5%	374	.46	43	11%
5 to 6%	269	.51	23	8%
6 to 7%	197	.58	21	11%
7 to 8%	136	.64	6	4%
8 to 9%	96	.62	9	9%
9 to 10%	71	.81	3	4%
10 to 11%	43	.83	3	7%
11 to 12%	32	.81	2	6%
over 12%	71	1.00	7	10%

Source: FHLBB Semiannual and Quarterly Financial Statements, 1977-1985.

Note: Profit is defined as total income less total expenses after taxes. This definition is not strictly consistent with GAAP. For example, the FHLBB treatment of deferred net losses may inflate profits above GAAP levels.

The number of institutions shown in this table differs from the number shown for 1984.4 in tables 3 and 4. This table was constructed using only those institutions with positive total assets for all of 1984 so as to calculate return on assets over a lengthy period. Therefore, 54 institutions that came into existence during 1984 are not included above.

Table 8

Profit Experience by GAAP Net Worth
(All FSLIC-Insured Institutions)

1985 (First Half)

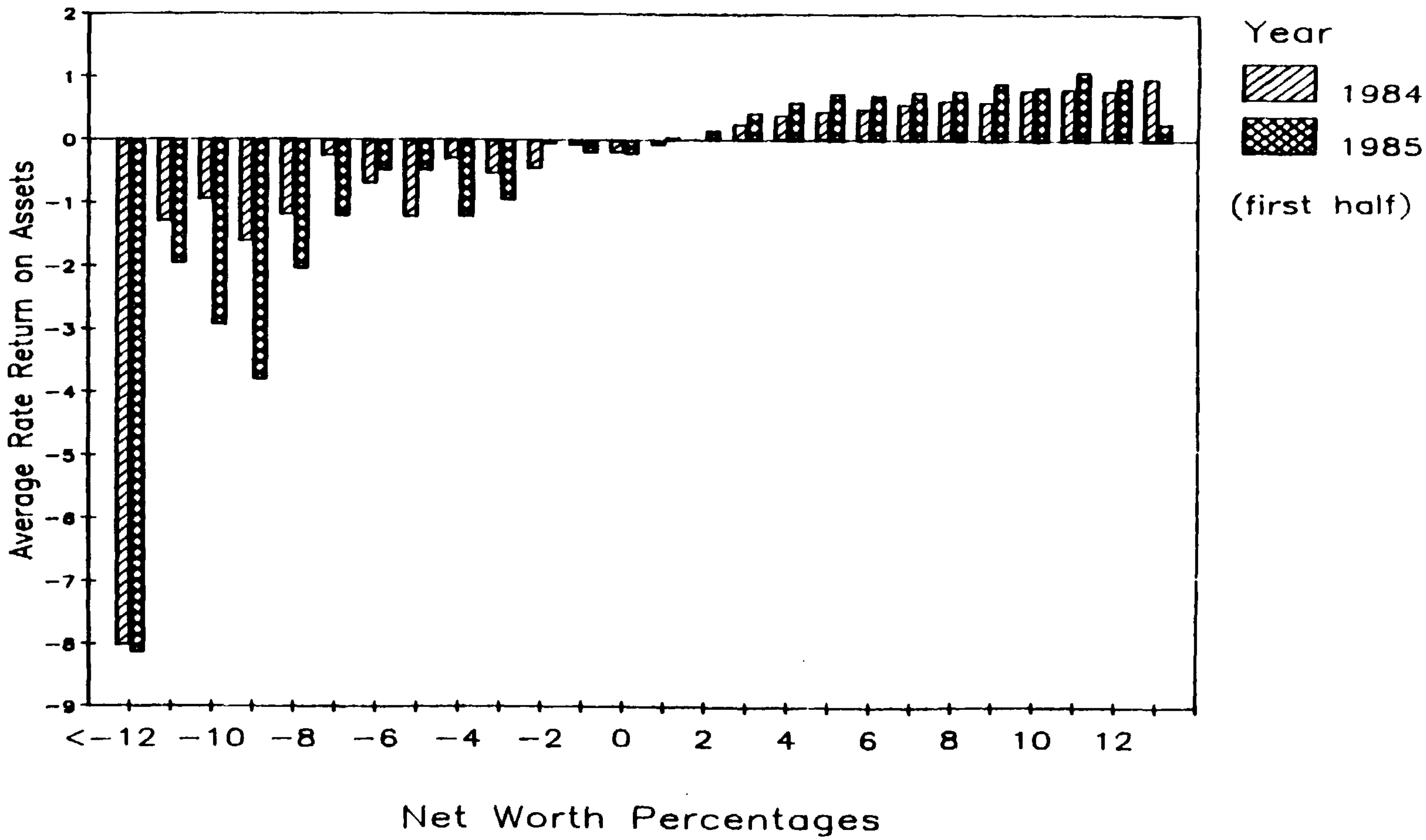
GAAP net worth as a percentage of assets	Number of institutions	Rate of return on assets	Number of unprofitable institutions	Percentage of unprofitable institutions
< - 12%	13	-8.44	12	92%
-12 to -11%	6	-1.97	3	50%
-11 to -10%	8	-2.94	5	62%
-10 to -9%	10	-3.81	7	70%
- 9 to -8%	7	-2.05	6	86%
- 8 to -7%	14	-1.22	11	78%
- 7 to -6%	17	- .50	13	76%
- 6 to -5%	17	- .50	8	47%
- 5 to -4%	41	-1.23	24	58%
- 4 to -3%	53	- .96	27	51%
- 3 to -2%	65	- .07	22	34%
- 2 to -1%	87	- .21	40	46%
- 1 to 0%	122	- .23	60	49%
0 to 1%	194	.05	79	41%
1 to 2%	254	.16	77	30%
2 to 3%	385	.43	77	20%
3 to 4%	433	.60	50	12%
4 to 5%	384	.74	24	6%
5 to 6%	287	.72	21	7%
6 to 7%	235	.77	18	8%
7 to 8%	146	.79	6	4%
8 to 9%	95	.91	6	6%
9 to 10%	78	.86	6	8%
10 to 11%	49	1.10	3	6%
11 to 12%	40	.99	5	12%
over 12%	105	.27	29	28%

Source: FHLBB Semiannual and Quarterly Financial Statements, 1977-1985.

Note: Profit, measured at an annual rate, is defined as total income less total expenses after taxes for the first 6 months of 1985. This definition is not strictly consistent with GAAP. For example, the FHLBB treatment of deferred net losses may inflate profits above GAAP levels.

The number of institutions shown in this table differs from the number shown for 1985.2 in tables 3 and 4. This table was constructed using only those institutions with positive total assets for the first half of 1985 so as to calculate return on assets over a lengthy period. Therefore, 35 institutions that came into existence during the first half of 1985 are not included above. One of these institutions was insolvent and unprofitable in 1985; therefore, the number of insolvent and unprofitable institutions will differ from the number shown in table 5.

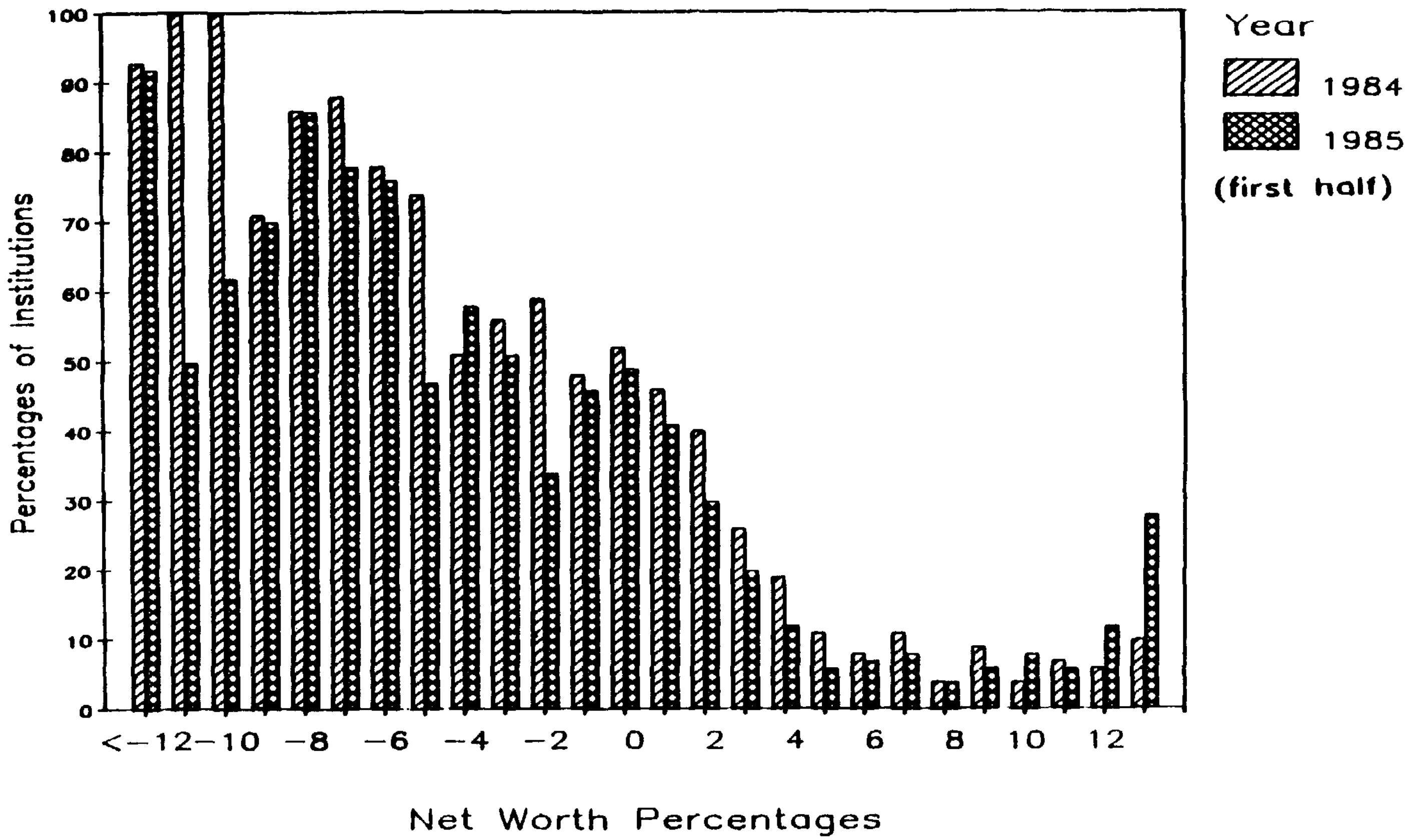
Figure 2
Average Annual Return on Assets
by GAAP Net Worth Percentages
1984 and 1985 (first half)



Source: Tables 7 and 8

APPENDIX I

Figure 3
Percentage of Unprofitable Thrifts
by GAAP Net Worth Percentages
1984 and 1985 (first half)



Source: Tables 7 and 8

APPENDIX I

Table 9

Changes in the Number of Financially Weak Thrifts That Would Have Resulted from Imposing a 1-Percent FSLIC Recapitalization Levy in June 1985[a]

	Insolvent institutions[b]		Low net worth Institutions[c]	
	RAP net worth	GAAP net worth	RAP net worth	GAAP net worth
Actual number of problem thrifts in June 1985	88	461	766	833
Estimated number of problem thrifts after imposing the 1-percent levy in June 1985[d]	190	634	1162	1037
Increase in the number of problem thrifts that would have resulted from the 1-percent levy	102	173	396	204

Source: FHLBB Semiannual and Quarterly Financial Statements, 1977-1985.

Notes: [a]The 1-percent FSLIC recapitalization levy is comparable to that suggested by the Chairman of the Bank Board in which thrifts would all pay 1 percent of their deposits into the FSLIC fund. To show the effect of imposing the levy we have removed this amount from the assets and net worth of the institutions.

[b]Insolvent institutions have net worth less than or equal to zero percent of assets.

[c]Low net worth institutions have net worth between 0 and 3 percent of assets.

[d]Shown here are the number of institutions that would have been insolvent or that would have had low net worth if an FSLIC levy of 1 percent of deposits had been collected in June 1985.

Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

January 27, 1986

Mr. Craig Simmons
Associate Director
U.S. General Accounting Office
Room 3858A
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Simmons:

After carefully reviewing the GAO report entitled "Thrift Industry Problems--Potential Demands on the FSLIC Insurance Fund," I am concerned that the report, perhaps inadvertently, overstates the problems facing the FSLIC. Specifically, on page 4, the report states that the financial condition of nearly 1300 FSLIC insured institutions is weak. To imply that over 42 percent of the industry is likely to require some form of FSLIC assistance seriously distorts the magnitude of the problem. I fear that if such an overstatement were to become public it could seriously worsen the actual situation.

See comment 1.

See comments 2 and 3.

The report's tendency to overstate the size of the problem partially results from its lack of a clear definition of what constitutes a problem institution. While this is a difficult task, such a characterization must be specified before the number of potential problem cases can be estimated. From our own perspective, there are at least three variables that should be weighed before an institution is considered a potential problem case. The level of net worth is clearly an important factor. The report devotes substantial effort to justify its focus on the GAAP measure of net worth. The primary distinction between RAP net worth and GAAP net worth is that the former allows for a gradual amortization of losses while the latter requires an immediate reduction in earnings, and thus net worth, for assets sold at a loss. RAP accounting removed the accounting deterrent inherent in GAAP to portfolio restructuring. Thus, by encouraging thrifts to remove underwater assets from their books, RAP accounting has allowed many thrifts to restructure their portfolios and significantly improve their long term viability. Therefore, while the current level of net worth is important, an equally important factor is a firm's future earning potential. This potential can be approximated by the firm's current reported earnings and its latest supervisory rating. The supervisory rating provides an indication of the underlying quality of the firm's assets and management. Note these variables only indicate <u>potential</u> problem cases and do not imply that an institution will necessarily require FSLIC assistance.

On page 4, the report states that if GAAP-insolvent thrift institutions were recovering, the level of concern over the condition of the industry and its implications for FSLIC would not be high. The report proceeds, however, See comment 4.

Now page 4.
Now table 6,
page 19.

to ignore this statement and to analyze the potential cost to the FSLIC from liquidating or merging all GAAP-insolvent institutions. Thus, in Tables 3 and 4, on pages 16 and 17, the GAO report provides figures on the number of insolvent and low-net-worth institutions. Then, on page 5 and in Table 5 on page 18, the report estimates the potential losses for the FSLIC from liquidating or merging these insolvent institutions to be between 5 and 23 billion dollars. To suggest that all GAAP-insolvent institutions will require FSLIC assistance is simply inappropriate. As I have already indicated, such an approach ignores future earning potential and thus tends to dramatically overstate the size of the problem.

Now table 5.

Now table 5.

Now table 5.

A more reasonable approach is the one used in Table 6. This table identifies the number of insolvent and unprofitable institutions, then estimates the potential cost of resolving only these cases. Contrary to statements on page 1 of the report, only half of the insolvent thrifts were unprofitable during the first half of 1985. Table 6 identifies 239 GAAP-insolvent institutions that were unprofitable for the first half of 1985. These institutions, representing less than 8 percent of the industry, could be considered weak and potential problem cases for the FSLIC. This number is significantly less than the 1,300 institutions with assets of $433 billion, or 42 percent of industry assets reported in the GAO document. Thus, while the numbers used in the other tables are accurate, I feel they substantially misrepresent the current situation. Furthermore, since these figures are thoroughly discussed before those in Table 6, I believe they overshadow this more reasonable approach.

See comment 5.

While the GAO report explains on page 2 why it does not examine the resources available to the FSLIC, such an omission inherently raises doubts as to the adequacy of FSLIC resources. By simply suggesting possible resolution costs, the report ignores the potential for future revenues and the ability of the FSLIC to find no-cost resolutions to many of the cases. For example, some of the cases may be resolved through voluntary or non-assisted mergers and therefore cost very little to the FSLIC. This approach is projected to reach close to 100 institutions over the next year, further reducing the number of potential institutions that may require FSLIC assistance to under 200 firms.

The report also does not acknowledge that numerous techniques exist for replacing the current managers of weak institutions and thereby limiting any growth of the problem. The MCP program, for example, provides a mechanism to assist insolvent and unprofitable thrifts in an effort to reduce further deterioration. Once the growth of the problem has been stopped, various techniques are available to defer the need for FSLIC to make immediate cash outlays. This postponement allows the FSLIC time to accumulate substantial resources from premium income and investment income. Premium income is projected to be approximately $1.89 billion in 1986 and $2.08 billion in 1987 if the special assessment of one-eighth of 1% is continued. Investment income should generate almost one-half billion dollars a year.

The report further fails to include the significant lines of credit available to the FSLIC. The FSLIC may borrow from any of the twelve Federal Home Loan Banks, limited by the financial capacity of the Banks and the willingness of each of their Boards of Directors to authorize funds to FSLIC.

The Federal Home Loan Banks have assets of over $100 billion and are capitalized at close to 9 percent. Furthermore, the Bank's assets are substantially over collateralized. This strength allows them to borrow money at rates slightly above Treasury rates. To date, the FSLIC has borrowed $900 million from the FHLB's which has been passed through FSLIC in collateralized loans from which the FSLIC expects to experience no financial losses. Given a prudent expansion of the Banks' capital base, over an extended period of time, five years for example, this device could provide the FSLIC with up to five billion dollars. FSLIC also has a direct line of credit from the U.S. Treasury in the amount of $750 million. This line was established by legislation in June 1950 and has never been used.

Now page 5.

See comment 6.

The report's analysis on page 6 and in Table 9 of the effect of a 1 percent assessment is especially distorted. The report states "FSLIC and the Bank Board have the power to levy a supplemental insurance assessment on their constituent institutions equal to 1 percent of deposits... Such an assessment would increase fund reserves by roughly $8 billion." The FSLIC may "assess" an amount equal to one-eighth of one percent of accounts in any single year to meet losses of the FSLIC. The statutory provision for a call equal to one percent of accounts, however, provides for a deposit which would be a debt of the corporation. This call would improve the FSLIC's liquidity, but would not affect its net balance sheet position. Thus, the reserve or equity position of the FSLIC would not be increased by $8 billion or by any amount under the Bank Board's statutory authority to make a call equal to one percent of accounts. Also, institutions would not become insolvent as a result of the call since they would now have a FSLIC asset on their books. Their net position would be unchanged. If the report is suggesting a levy comparable to NCUA powers, it is important to note that the Bank Board does not have such powers.

In summary, while the raw data base for this report is accurate, its utilization distorts the magnitude of the problem facing the FSLIC. It also seems inappropriate to suggest a dollar cost of resolution without exploring the specific method of resolution. Furthermore, to examine only the cost of resolution without examining the sources of revenue ignores a vital aspect of the overall nature of the problem. Finally, it also should be mentioned that the industry has had two very profitable quarters not included in this report, and that the industry on a market value basis recently turned positive for the first time in a number of years.

See comment 7.

I trust you share my concern that the magnitude of the problem facing the FSLIC not be, perhaps inadvertently, overstated. Such an overstatement could only serve to worsen the actual situation. I believe that an accurate portrayal of this problem is necessary for the Congress to formulate as it may choose any legislative response.

Sincerely,

Edwin J. Gray

GAO Comments on the Federal Home Loan Bank Board's Letter dated January 27, 1986

1. It was not our purpose to suggest that all of the nearly 1300 insolvent or low net worth FSLIC-insured institutions will need FSLIC assistance, although we do believe that they should be classified as financially weak. (In our report, we define a weak institution as one having less than 3 percent GAAP net worth.) We provide this information in the report as one of a number of measures of the financial condition of the industry.

2. The Bank Board correctly points out that defining a "problem institution" is difficult. Indeed, the Bank Board's explanation of its criteria amply illustrates the difficulty. The Bank Board's comments indicate that RAP-insolvent, unprofitable institutions having adverse supervisory ratings are considered to be "potential problem cases."

In fact, a hierarchy of problems exists and choosing which problems are urgent enough to demand FHLBB action or FSLIC assistance is a policy decision, which in part may be constrained by the resources available to FSLIC. For example, we look at several subsets of the thrift industry that, under well-defined criteria, might be considered to have problems. These sub-groups are:

-- all institutions with GAAP net worth below 3 percent of assets;

-- all insolvent institutions, i.e., all institutions for which the value of liabilities is greater than the value of assets; and

-- all institutions that are both insolvent and unprofitable.

In a real sense, institutions in each of these groups have problems. And, while that does not signify that any particular institution will fail (where failure is determined by the regulators), any of these criteria, or several others that might reasonably be chosen, could be used to define the set of "problem institutions." It is not our intent in this report to select the specific criteria that should be used to classify "problem institutions," but only to delineate the financial condition of the industry using GAAP net worth and profitability as criteria.

3. The FHLBB uses RAP accounting for regulatory purposes in the thrift industry. The Bank Board mentions, for example, that using RAP permits the restructuring of portfolios to allow thrifts to improve their long-term viability. We do not address the importance or the success of RAP accounting in achieving such goals. We do, however, feel that GAAP accounting provides a more consistent and widely recognized measure of the financial health of individual thrift institutions and of the industry. Moreover, using common, widely accepted accounting standards in different financial sectors permits meaningful inter-industry comparisons.

4. As we indicated in our second comment, there is a hierarchy of problems for describing the condition of the thrift industry. We discuss three different criteria, which define groups of thrifts ranging from the most severe cases where institutions are both GAAP-insolvent and unprofitable, to a much broader definition, i.e., all institutions with GAAP net worth less than 3 percent of assets. Other reasonable criteria exist. For example, of the 833 institutions with GAAP net worth between 0 and 3 percent, the data in table 8 indicate that 233 are also unprofitable. If the earnings trend for those institutions continues, they will become insolvent. Even though some of these thrifts will probably require regulatory action, we did not include them in our discussion of the potential demands on FSLIC in tables 5 and 6. The estimates of such demands that are presented in our report are not intended to be forecasts of actual demands on FSLIC, but only benchmarks of the level of demand that could exist under specifically defined criteria.

With regard to the discussion of potential demands on FSLIC that accompanies tables 5 and 6, we have reversed those tables and their accompanying discussion in the final report.

5. The scope of our work did not include a discussion of the current or future resources available to FSLIC for resolving thrift failures. We agree with the Bank Board comment that there are several sources of funds for dealing with the industry's problems, but we are not in a position to comment on their adequacy.

6. We have modified the language of the report on page 5 to more clearly explain the simulation effects shown in table 9. We have been informed by the Bank Board that legal counsel has determined that such a levy under the Bank Board's existing authority would not increase the resources of FSLIC. However, on October 17, 1985, in testimony before a Subcommittee of the House Committee

on Banking, Finance and Urban Affairs, the Chairman of the Bank Board suggested as one among several alternatives that the Bank Board be given additional authority to make such an assessment in order to recapitalize the FSLIC insurance fund from within the industry. The simulation results presented in table 9 remain useful, therefore, for illustrating the effects on the thrift industry of such an assessment even though the suggested change in authority has not been granted.

7. We recognize in the report that the industry, as a whole, was profitable during 1985. Our concern is that this profitability is not evenly spread across all institutions. There are some dangers in relying on future profitability to restore weak institutions to adequate levels of capital. First, institutions that are insolvent and unprofitable are deteriorating, not recovering. Moreover, as they continue to grow in size, the dollar cost to FSLIC of liquidating or merging them is likely to increase. Indeed, the Chairman of the Bank Board stated in his October 17th testimony (p. 9) that deferring action on current and projected cases "can only result in greater costs to the FSLIC down the road."

Secondly, difficulties exist even among those low net worth or insolvent institutions that are profitable. These may ultimately return to an adequate level of capital. However, the results of research presented at the 11th Annual Conference of the Federal Home Loan Bank of San Francisco, demonstrate that, even under optimistic assumptions about earnings and growth, institutions starting from low levels of net worth will not reach adequate levels of capital for many years.[1] During this period, they are vulnerable to deteriorations in the economic environment. This suggests that reliance on internal earnings potential may not resolve the undercapitalization problems in the industry.

---

[1]Mark Flannery, "Re-capitalizing the Savings and Loan Industry."

Requests for copies of GAO reports should be sent to:

U.S. General Accounting Office
Post Office Box 6015
Gaithersburg, Maryland 20877

Telephone 202-275-6241

The first five copies of each report are free. Additional copies are $2.00 each.

There is a 25% discount on orders for 100 or more copies mailed to a single address.

Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.

388228

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

Official Business
Penalty for Private Use $300

Bulk Rate
Postage & Fees Paid
GAO
Permit No. G100