

CBO TESTIMONY

Statement of
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before the
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Mr. Chairman, I am pleased to appear before the Committee this morning to discuss several issues related to the funding needs of the Resolution Trust Corporation (RTC). I will use this opportunity to discuss the projected costs of resolving the savings and loan (S&L) crisis. These projections are elaborated in CBO's summer report, *The Economic and Budget Outlook: An Update*. I will also review the economic effects of federal expenditures to protect depositors of failed thrifts. Finally, I will outline various options for financing the costs of resolving this problem.

PROJECTED COSTS OF RESOLVING THE SAVINGS AND LOAN CRISIS

CBO estimates that the cost of cleaning up thrift institutions--other than those already resolved before passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)--would total about \$120 billion if the crisis could be resolved literally overnight. (About \$100 billion would be borne by the RTC, with a caseload of about 925 institutions; and the remaining \$20 billion by the Savings Association Insurance Fund (SAIF), which is expected to handle nearly 800 more institutions.) This cost estimate is uncertain, and the true cost easily could vary from this estimate by \$30 billion in either direction.

The government will not resolve the S&L crisis overnight--not just because the RTC does not have the cash resources, but also because the government faces human resource and other constraints in carrying out its tasks. As a result, CBO expects that it will take at least 10 years to resolve these institutions and dispose of their assets. In present value terms, we project the total cost associated with closing failed thrifts through 2000 to be nearly \$250 billion. Of this total, we estimate the cost of the RTC's activities to be about \$150 billion and that of SAIF's to be \$35 billion. Using the same methods, the present value of the Federal Savings and Loan Insurance Corporation (FSLIC) Resolution Fund, which is charged with making insurance payments for losses incurred prior to FIRREA, amounts to \$60 billion.

Budget Projections Through 1995

FIRREA provided the RTC with \$50 billion to close or assist the sale of hundreds of insolvent thrift institutions. The \$50 billion was intended to pay for deposit insurance losses that would never be recovered. The losses clearly will exceed \$50 billion, and the RTC will exhaust its available funds early in fiscal year 1991. If the RTC is allowed to run out of money, over 600 insolvent thrifts will be left unresolved, and the ultimate costs of the savings and loan crisis will only escalate.

Not only is the RTC running out of funding to pay for insurance losses, but also it faces another constraint. It is currently borrowing from the Federal Financing Bank (FFB) to cover the temporary cost of acquiring assets from failed thrifts until the assets are sold. Section 501 of FIRREA restricts RTC borrowing, though there is some ambiguity as to the limit. The conference report and letters from the Chairmen of the Banking Committees indicate the committees intended that the obligations issued by RTC not exceed 85 percent of the fair market value of its noncash assets, plus available cash and the remaining balance of borrowing authority from the Resolution Funding Corporation (REFCORP). The wording of the statute, however, would allow the RTC to borrow \$18.8 billion in addition to the limit described in the conference report. The \$18.8 billion represents the amount of Treasury funding made available to the RTC in 1989.

Because of the uncertainty as to Congressional intent, the Secretary of the Treasury has indicated that the RTC will not use the authority to borrow the \$18.8 billion without notifying the Congress. If legislation authorizing additional funds for the RTC is not enacted around the beginning of the fiscal year, under current law the RTC could borrow \$18.8 billion from the FFB and \$12 billion from REFCORP (or, temporarily, an equivalent amount from the FFB). The Administration has indicated that this \$30.8 billion, plus proceeds from asset sales, would be sufficient to continue the RTC's operations until the end of calendar year 1990.

Clearly, the RTC must be given more resources. Resolving the savings and loan problem is not a discretionary activity; the government is legally required to fulfill its deposit guarantees. Failure to provide sufficient resources in the past has delayed the cleanup and led to increased costs at the time of resolution; this is also the case today. The government continues to insure deposits in a savings and loan industry that is crowded with weak institutions. Marginal institutions that remain in business continue to incur losses by paying greater returns on their deposits than they are earning on their assets. It may be cheaper to close or merge insolvent thrifts quickly to prevent future losses.

The effect of the RTC's net spending on the budget in 1991 and beyond hinges upon whether the agency is constrained by the limits imposed by current law or receives additional authority to spend as needed. Assuming that the Congress provides sufficient additional Treasury funds so that the RTC is not constrained, CBO estimates that the RTC's net outlays would be \$70 billion in 1991, \$60 billion in 1992, and \$13 billion in 1993. By 1994, the proceeds from asset sales should exceed the spending for case resolutions, and net outlays are expected to drop to -\$30 billion and, by 1995, to -\$18 billion. These figures are summarized in Table 1.

TABLE 1. PROJECTIONS FOR THE RESOLUTION TRUST CORPORATION, WITH SUFFICIENT RESOURCES
(By fiscal year, in billions of dollars)

Outlays	1990	1991	1992	1993	1994	1995
Insurance Losses	35	41	32	28	4	3
Working Capital						
Asset acquisition and repayable advances	30	52	52	19	0	0
Receipts from asset sales	-1	-9	-24	-34	-34	-21
Repayment of advances	-12	0	0	0	0	0
Proceeds from Resolution Funding Corporation	-16	-14	0	0	0	0
Interest and Administrative Expenses	a	a	a	a	a	a
Total	36	70	60	13	-30	-18

SOURCE: Congressional Budget Office.

- a. Administrative costs included in the budget are projected to be \$200 million to \$300 million a year. Administrative costs associated with institutions in RTC receivership are not included. Interest costs reflect only the payments from the RTC to the Federal Financing Bank, an intrabudgetary arrangement stemming from the RTC's working capital agreement. The projections assuming unlimited resources dispense with this intrabudgetary arrangement, and all debt service costs are presumed to be borne directly by the Treasury.

Uncertainties in the Estimates

A great deal of uncertainty surrounds these estimates of the costs of resolving the savings and loan crisis. No one can say for sure how many thrifts the regulators will declare insolvent, how fast the RTC can resolve failed or

failing institutions, or what the costs will be. The recent surge in oil prices is likely to affect interest rates and economic growth, although the precise effect on the RTC's spending and asset sales is unclear. While there is much uncertainty about where oil prices will level off, higher oil prices could help the local economies of oil-producing states, where many of the failed S&Ls are located. If the economies of the oil-producing states do pick up, it could mean lower costs of resolution and increased sales prices for real estate assets held by the RTC. But oil price increases will slow the pace of overall growth for the U.S. economy, resulting in more depressed real estate and mortgage markets nationwide than would otherwise be the case. The high degree of uncertainty concerning the future path of interest rates and the Federal Reserve's role in influencing that path makes predicting a future scenario even more difficult. In light of these offsetting considerations, whether the recent Iraqi invasion of Kuwait will increase or decrease S&L resolution costs is unclear at this time.

As a result of these and other uncertainties, estimating the timing of outlays and asset sales is highly imprecise, even if the RTC receives sufficient funding. For example, in June CBO estimated that the RTC's net outlays for the current fiscal year, which ends this month, would be \$36 billion. Subsequent to the completion of CBO's estimate, the RTC Oversight Board approved a spending plan that could result in net spending in 1990 of about \$66 billion. In July the Office of Management and Budget (OMB) predicted that the RTC's net spending would be \$57 billion. Net outlays through July

were \$35 billion, and we now estimate that 1990 outlays will be in the range of \$45 billion to \$55 billion.

The estimates for 1991 also show a wide range. CBO's estimate prepared in June projected the RTC would need \$70 billion. If 1991 resolutions proceed at the same pace of resolutions in 1990, RTC outlays could be higher by \$10 billion to \$20 billion. In July, Chairman Seidman suggested that the RTC might need an additional \$100 billion in spending authority in fiscal year 1991. The OMB July estimate for 1991 suggests that the RTC would need \$63 billion. These varying estimates underscore the great uncertainty about RTC spending. OMB states in its Mid-Session Review that outlays in individual years might be \$30 billion higher or lower than projected.

ECONOMIC EFFECTS OF EXPENDITURES TO PROTECT THRIFT DEPOSITORS

Although policymakers disagree about how the budgetary consequences of the savings and loan crisis should be handled, most experts agree that RTC outlays do not affect the economy in quite the same way as other government spending. Unlike a benefit check, salary payment, or a purchase of military hardware, deposit insurance payments do not represent current income to their recipients. Depositors do not become wealthier when their savings and

loan institution is closed or merged by the government. They are exactly as well-off as before, undergoing only minor changes in their banking arrangements. Thus, the year-to-year outlay fluctuations related to the S&L problem depicted in CBO's baseline paint a seriously misleading picture of the government's current impact on the income and production markets of the economy.

Similarly, RTC spending has only a limited impact on financial markets. A large fraction of federal borrowing is currently done on behalf of the RTC. Nearly all the money that the government raises for this purpose is directly recycled in the financial markets, as recipients deposit the funds in new accounts or invest them in other assets. The government's borrowing does not reduce the funds available to other borrowers, and there is little reason for it to boost the general level of interest rates.

Long-Term Effect of Thrift Industry Losses

Over a longer time span, thrift industry losses have had definite implications for the economy and for the distribution of resources. The availability of deposit insurance helped to spur certain types of spending. For much of the past decade, savings and loan institutions made wasteful loans backed by their insured deposits. Borrowers and their suppliers benefited, thrift managers and owners were subsidized, and the wealth of depositors was protected from

loss even as many earned unsustainable rates of return. The nation's capital stock was diminished, however, as bad loans and fraud diverted the savings of depositors from more productive uses. This economic impact occurred in the past, when these unproductive investments were made. But as long as problem S&Ls remain unresolved and the regulatory environment is not changed, these economic impacts can continue to occur. Both past and current misplaced investments will affect the productivity of the economy for many years.

Regional Effects of RTC Spending

It is difficult to identify regions as winners or losers from the S&L bailout. Although the high-flying institutions that now require resolution were geographically clustered, all regions of the country shared these economic effects--particularly as nationwide capital markets imply that both deposit-taking and lending effectively cross borders. Many residents of the Northeast and Midwest benefited from high-yielding deposits at failed S&Ls in the Southwest. While empty structures are concentrated in the Southwest, the RTC's list of assets shows clearly that a sizable proportion of the construction projects financed by the failed S&Ls took place outside their local markets as well. Thus, both the economic costs and benefits are widely distributed across geographic regions. Moreover, everyone benefits from the fact that the deposit insurance system remains intact despite the buffeting of the 1980s.

RTC SPENDING AND THE BALANCED BUDGET ACT

The uncertainty and volatility of RTC spending and the treatment of REFCORP have raised questions about the proper treatment of outlays to resolve the S&L problem. Outlays of the RTC belong in the deficit because the budget is meant to present a comprehensive summary of the government's spending and revenues. But it makes sense to exclude most of RTC spending in gauging compliance with the Balanced Budget Act targets. This is because RTC borrowing and spending exert little economic effect because they only liquidate liabilities that the federal government already had. The economic effects are caused by the industry's losses and the consequent accrual of federal liabilities for deposit insurance, not by the government's actions to liquidate these liabilities. Thus, whatever the economic effects of the thrift bailout are, cash outlays for deposit insurance do not measure them in a timely fashion. Accordingly, including spending for the thrift bailout in determining compliance with the Balanced Budget Act's deficit targets could lead to unintended swings in fiscal policy. It could also present budget policymakers with incentives for further manipulation of the accounts.

However, excluding the thrift bailout's costs (except for the interest payments on the public debt) from the process of correcting the deficit gives the misleading impression that thrift failures are irrelevant for long-term budget policy. To many policymakers, such an approach amounts to consigning yet another budgetary problem to future generations. They fear

that unless the nation taxes itself or otherwise faces squarely up to the costs of the thrift crisis, it will not undertake the reforms of the regulatory structure and the deposit insurance program that will be necessary to ensure that similar losses will not happen again.

One way to accommodate these views would be to raise the targets for national saving--that is, lower the target deficits over a period of years--by amounts that recognize the past losses in the capital stock. With these somewhat more ambitious deficit targets, the actual year-to-year spending would be excluded from the assessment of whether the targets are being met. And yet the past losses associated with the savings and loan problem would not be swept under the rug.

OPTIONS FOR FINANCING THE COSTS OF RESOLVING THE S&L PROBLEM

FIRREA tapped several sources for the initial \$50 billion provided to the RTC: \$1.2 billion from the Federal Home Loan Banks (FHLBs), and \$48.8 billion in government financing. Of the latter amount, \$18.8 billion came directly from the Treasury, with spending recorded on budget, and \$30 billion is to be raised by the Treasury through REFCORP, with no net effect on the budget. (The Treasury arranges and conducts the sale of REFCORP securities, determines the amount and timing of the issues, and approves the

use of the proceeds.) Although all the spending is on-budget, the money raised by REFCORP is shown in the budget as offsetting collections, thereby offsetting the spending that it finances. The off-budget borrowing of funds through REFCORP both disguises and increases the cost of the bailout.

Source of Funds

The Administration has proposed that additional funding for the RTC be raised directly by the Treasury, and not by raising insurance premiums, requiring additional payments from the FHLBs, or selling more REFCORP bonds. Industry sources, including the FHLBs and savings and loan institutions, have been sufficiently drained that to seek more cash from them might seriously jeopardize the viability of the healthy portion of the thrift industry. Off-budget funds raised by selling REFCORP bonds are less accessible than Treasury securities and require a higher interest rate than similar Treasury securities. The \$30 billion in REFCORP borrowing authorized by FIRREA adds about \$2 billion, on a present value basis, to the interest payments that the Treasury is obligated to make over the next 40 years.

CBO agrees that additional funding for losses and working capital should come from the Treasury, because it would minimize the government's cost and maximize the government's flexibility. The Treasury could provide

the funds for working capital in either of two ways--through Treasury lending to the RTC, or through direct appropriations. Under current law, the Treasury finances the RTC's requirements for working capital by borrowing funds and lending them to the RTC; the RTC, in turn, pays interest to the FFB, the arm of the Treasury that handles such transactions. In this way, the costs of financing asset acquisitions and sales are charged against the RTC's losses. Alternatively, because the RTC will need to rely on the Treasury to fund its future shortfalls, it also is possible to dispense with the FFB transactions and simply provide appropriations for all of the RTC's funding needs, whether for losses or working capital. Under this arrangement, no interest costs would be charged to the RTC for these funds. Continuing the financing arrangement with the FFB would, however, more accurately track the carrying costs associated with asset disposition and might provide incentives to the RTC to sell assets quickly.

Indefinite versus Definite Appropriations

In July, the Treasury suggested that the Congress could provide the RTC with a specific amount--in the range of \$5 billion to \$10 billion--which would be enough to last the agency until February 1991, when the Administration's study on deposit insurance reform would be available. As an alternative, the Congress could provide specific funding to cover a longer period of time or a permanent, indefinite appropriation to complete the job of resolving failed

thrifts. The selection of the funding mechanism reflects trade-offs between the amount of flexibility provided to the RTC and the amount of control retained by the Congress.

Permanent, Indefinite Appropriation. Because of the uncertainty over the amount and timing of losses associated with closing hundreds of failed thrifts, and in view of the mandatory nature of the payments, the Congress could provide permanent, indefinite funding for the RTC, as the Treasury has requested. This type of approach is typically used for programs for which payments are not discretionary, such as Social Security or Medicare. This approach would provide the RTC with sufficient resources and flexibility to move at its optimum speed, and would not force the agency to adjust its caseload because of inadequate cash.

At the same time, authorizing an agency to spend with no effective cap raises concerns about possible loss of Congressional oversight and control. Oversight is obviously important, given the large amounts of RTC funding required, the effect that this spending will have on communities throughout the country, and the potential for waste and mismanagement. The relevant committees, however, already conduct exhaustive oversight of the agencies charged with responsibility for handling the thrift crisis. One way to reconcile these objectives would be to appropriate indefinite amounts but limit the time period over which the RTC could exercise this authority--for example, a year or two.

Definite Appropriation. FIRREA provided a definite appropriation of \$18.8 billion to the RTC in 1989 to help capitalize the agency and an overall limit of \$50 billion to pay insurance losses. Similarly, the Congress again could appropriate a specific amount to the RTC. One problem with this approach is choosing an amount. Given the uncertainty surrounding the estimate of future losses, such an amount might fall short of the RTC's needs. (CBO estimates that close to \$100 billion in additional funds to cover losses and at least \$60 billion in working capital will be required over the next five years.) To the extent that funding was inadequate, delays and uncertainty could result, as they have in the past, and add to the government's costs. Those who favor a specific funding request argue that the role of the Congress requires regular review and approval of agency spending, particularly given the concern over the way funds have been spent for thrift resolutions in the past and the potential for future abuses.

CONCLUSION

The costs of resolving the savings and loan crisis will substantially exceed the funding provided so far. CBO projections prepared in June, which assume the RTC receives sufficient funds to close or merge over 900 failed thrifts, would result in net outlays of \$70 billion in 1991, \$60 billion in 1992, and \$13 billion in 1993. Congressional action is clearly needed to provide

additional funds to the RTC as soon as possible in order to prevent delays that would boost the long-run costs of resolving failed savings and loans. The cheapest and quickest source of funds is the Treasury. The Congress could either specify an amount that the RTC could use or provide the RTC with an indefinite appropriation. The annual spending for the RTC should be excluded when assessing whether the Balanced Budget Act targets have been met. But the targets themselves could be made more ambitious, depending on the macroeconomic objectives one seeks. In any case, all RTC spending should be on-budget.