

Statement of
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NOTICE

This statement is not available
for public release until it is
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Mr. Chairman, I am pleased to appear before the Committee this afternoon to discuss the Strategic Plan of the Resolution Trust Corporation (RTC). My testimony today will focus on the budgetary aspects of resolving the thrift problem. In particular, I will describe the Congressional Budget Office (CBO) estimates of spending by the RTC and the other federal agencies involved with thrift and bank insurance. I will also discuss the RTC's need for working capital and the alternative budgetary treatments of ways to provide this working capital. As requested by the Committee, I will conclude with some observations on the outlook for resolving problem thrifts and the long-run budgetary **consequences**.

THE BUDGET OUTLOOK FOR DEPOSIT INSURANCE PROGRAMS

The one thing that anyone can say definitively about the budgetary impact of the savings and loan bailout is that it is extremely uncertain and highly volatile. Resolving the problem could involve potential swings of tens of billions of dollars from year to year, and will depend on a host of interrelated factors that are very difficult to predict. These include:

- o The Size of the Problem. No one knows how many institutions will become insolvent and how much it will cost to resolve them. The RTC's strategic plan indicates that around 500 institutions may be placed under conservatorship, to be resolved by the RTC, but the number could be much larger. Indeed, costs are quite likely to exceed the \$50 billion allotted in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (**FIRREA**), particularly since losses are continuing to occur.

- o The Form of the Resolutions. Liquidations require much larger cash expenditures up front than assisted acquisitions, but they result in more cash income in subsequent years from the disposal of assets. The RTC's strategic plan calls for acquirers to bid on a variety of resolution structures in order to ascertain the least costly method for each case. It now appears that more liquidations will be done than CBO previously thought, in part because potential acquirers are not showing great interest. The mix remains uncertain, however, and the RTC's decisions in this regard will significantly affect cash disbursements over the next few years.

- o The Order of Priority of Resolutions. Because the number of cases the RTC can resolve in each year is limited by man-

power constraints and other factors, the specific choice of cases will affect the resources used. Larger institutions, or ones with large losses, may necessitate greater spending than others. The strategic plan calls for giving priority to institutions with relatively high rates of deterioration, while taking into account such factors as ongoing risks to the RTC and the efficient use of resources and staff. While this provides a broad indication of direction, there is no way to predict the specific sequence of resolutions that will result from these criteria.

- o The Pace of Resolutions. How quickly the RTC will be able to resolve the thrifts in its caseload is another key factor in projecting outlays. Managing and resolving hundreds of savings and loans in conservatorship, while building an organization from scratch, is a massive task. The need for both qualified staff and financial resources, as well as the scope and complexity of the problems to be solved, limit the speed at which resolutions can occur. In the meanwhile, the costs to the government will continue to rise. While relatively few cases have been resolved so far, that was probably to be expected. How fast the RTC can proceed from here on out is difficult to predict.

- o The Disposition of Assets. In the course of resolving cases, the RTC will take possession of large quantities of real estate and other illiquid but potentially salable assets. The strategic plan calls for disposing of these assets as quickly as possible in such a way as to maximize the net present value to the RTC. On the other hand, the plan also notes the need to minimize the effects on local real estate and financial markets. CBO projects that assets will typically be sold over an eight-year period following resolution, with about half of the assets sold by the fourth year. No one yet knows, however, how many assets will end up in the hands of the **RTC**, what their market value will be, or how fast they can be sold.

Despite these uncertainties, we have prepared preliminary baseline projections for bank and thrift insurance activities for CBO's annual report, to be released next week. As shown in the table on page 5, CBO is projecting on-budget net outlays for thrift-related activities of about \$50 billion over the 1990-1993 period. Bank insurance expenditures add another \$6 billion. Preparing such estimates in December was particularly difficult, because the RTC was still developing its own cash flow projections, the Oversight Board had not completed the strategic plan, and no plans for raising working capital had been identified. Thus, we had to make assumptions about the key factors I just discussed, with little information from the relevant

agencies. I will now briefly describe for you CBO's current baseline for deposit insurance programs.

Resolution Trust Corporation

CBO's preliminary baseline includes net RTC outlays of \$14.0 billion in 1990 and \$4.9 billion in 1991. Depending on how the working capital needs are resolved, this estimate could change substantially.

TABLE 1. CBO BASELINE OUTLAY PROJECTIONS FOR DEPOSIT INSURANCE ACTIVITY (By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
January Baseline						
Resolution Trust Corporation	14.0	4.9	-3.5	-6.9	-4.8	-3.3
FSLIC Resolution Fund	5.4	3.4	4.4	3.2	2.6	2.7
Savings Association Insurance Fund	0.1	0.0	2.9	14.6	0.6	0.4
Treasury Interest Payment	<u>0.4</u>	<u>2.0</u>	<u>2.4</u>	<u>2.4</u>	<u>2.4</u>	<u>2.4</u>
Total Thrift Programs	19.9	10.3	6.2	13.3	0.8	2.2
Bank Insurance Fund	<u>2.4</u>	<u>1.6</u>	<u>1.3</u>	<u>0.8</u>	<u>-0.1</u>	<u>-0.5</u>
Total Net Outlays	22.3	11.9	7.5	14.1	0.7	1.7

SOURCE: Congressional Budget Office.

Along with the \$30 billion raised by the Resolution Funding Corporation (REFCORP) in the private markets, we assumed that the RTC would issue \$15 billion in notes and guarantees over the next three years, as a source of working capital authorized by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). But the Oversight Board, in its preliminary guidelines, limited this kind of financing to six months, hardly long enough to allow the stream of proceeds from asset sales--an estimated eight years or more--to pay off this debt. Thus, the CBO January baseline limits the estimated net obligations of the RTC to \$50 billion, which is consistent with FIRREA, and includes only limited, short-term RTC borrowing.

Proceeds from the sale of assets acquired from closing insolvent thrifts represent the final major source of cash for the RTC. Based on the projected caseload under our baseline assumptions, collections from asset sales are estimated to total over \$21 billion through 1992.

Cash from REFCORP (\$30 billion), remaining 1989 Treasury contributions (\$10 billion), and asset sales (\$21 billion), plus limited RTC borrowing (\$15 billion) would allow the RTC to spend about \$75 billion over the next three years. (CBO assumed no additional sources of RTC capital would be available in the absence of additional legislation,

though the Oversight Board has recently developed some options for raising additional funds that I will discuss later on.)

This level of spending would permit the RTC to handle only a limited caseload. Assuming that the RTC would liquidate or transfer deposits in about 60 percent of the cases, and would transfer some or all of the assets to an acquirer in the remaining cases, the baseline would accommodate about 150 transactions in 1990, 100 in 1991, and 20 in 1992, based on the estimated cost for a "typical" thrift. These numbers are far short of the approximately 500 institutions that the Oversight Board has targeted for RTC resolution. With additional working capital, more could be done.

FSLIC Resolution Fund

CBO expects that the FSLIC Resolution Fund will be paying \$6 billion to \$7 billion annually over the next three years for assistance to institutions closed by the FSLIC. Offsetting these payments are estimated collections of \$2 billion to \$3 billion annually, resulting in net outlays-financed by Treasury ~~appropriations--of~~ \$3 billion to \$5 billion a year over this period. We project the fund's collections to be somewhat lower than we estimated in August, primarily because we do not expect the remaining \$2.7 billion in borrowing authority for the Financing

Corporation to be used, and also because it appears that more assessment income will be funneled to REFCORP to pay for the zero coupon securities.

Savings Association Insurance Fund

The baseline estimates assume that the Savings Association Insurance Fund (SAIF) will not begin resolving failed thrifts until August 1992, when the RTC no longer has this responsibility. Its primary source of income is from annual assessments on ~~thrifts~~--estimated to be about \$2 billion annually, although roughly half of this income will be needed to support Financing Corporation interest payments. To make up for any shortfall, FIRREA authorized the Treasury to make payments for recapitalizing the SAIF fund, as well as to cover insurance losses, although these contributions were capped at \$2 billion in 1991, \$4 billion in 1992, and \$16 billion through 1999. Although CBO does not expect SAIF to begin resolving cases until 1992, it is likely that SAIF will inherit from the RTC a large inventory of insolvent thrifts. Because spending is limited in 1992, baseline outlays are projected to be \$2.9 billion, the difference between the maximum of \$4 billion in spending and estimated assessment income of \$1.1 billion. By 1993, when the annual cap is lifted, the baseline includes \$16 billion for case

assistance in 1993, which would exhaust Treasury contributions authorized under FIRREA.

Bank Insurance Fund

During the next several years, CBO estimates that the FDIC'S Bank Insurance Fund (**BIF**) will incur annual net outlays of \$1 billion to \$2.4 billion. We expect that BIF will continue to provide assistance to failed and troubled banks in amounts that are similar to the historically high levels of assistance experienced recently. Specifically, we estimate that BIF will be paying \$6 billion to \$7.5 billion in assistance each year from 1990 to 1993. CBO expects that assistance will remain high as a result of problems currently affecting the bank sector, including regional real estate downturns, exposure to highly leveraged transactions, growing delinquency rates for consumer debt, and loans to less developed counties. At the same time, however, the bank assessment rate required in FIRREA will produce income of approximately \$3 billion to \$4 billion annually to offset these outlays from the fund.

ALTERNATIVE WAYS OF PROVIDING RTC WORKING CAPITAL AND THEIR BUDGETARY TREATMENT

I would like to turn now to a brief discussion of the need for working capital by the RTC, as well as various possible sources of working capital and their budgetary treatment.

The Need for Working Capital

In October 1989, just two months after enactment of FIRREA, William Seidman, Chairman of the RTC, testified to the Congress that the RTC needed an additional \$50 billion to \$100 billion in "working capital," as distinct from the \$50 billion provided by FIRREA, which was to cover "the size of the hole," or the government's net cost of resolving the thrift crisis. The strategic plan confirms this need, and a recent letter from Daniel Kearney, President of the RTC Oversight Board, and Chairman Seidman, to the House Committee on Ways and Means further discussed this problem. The letter identified three options for raising \$40 billion to \$100 billion for this purpose. This bridge financing would be used to fund **liabilities**, primarily for purchasing assets from failed institutions, most of which will take years before any cash will be realized from their sale. The difference between the purchase price and the sales price contributes to the ultimate losses

that FIRREA addressed, although what cash represents working capital as distinguished from net losses will not be known until the last asset has been sold.

Several factors seem to be driving the need for additional up-front cash for the RTC. First, the RTC believes that the only or least costly method of resolving many of the institutions would be through liquidations or "clean-bank" transactions, which allow the RTC to strip out bad assets and sell them separately. The likelihood that the RTC would need to liquidate rather than sell an institution, a method requiring less cash for resolving a failed thrift, became more apparent when the regulators started examining the books of the institutions in conservatorships last spring. Second, the primary market for bidders of insolvent ~~thrifts--other~~ healthy thrifts and ~~banks--is~~ drying up as these financial institutions struggle to maintain their own capital levels, and because these potential buyers increasingly view the thrift franchise as declining in value since the enactment of FIRREA and do not want to invest in ~~thrifts~~.

Sources of Working Capital

As a source of working capital, FIRREA allows the RTC to borrow \$5 billion from the Treasury, to issue notes to acquirers of failed

institutions, and to incur other types of contingent liabilities, although the RTC's net outstanding obligations are not expected to exceed \$50 billion. The Oversight Board has issued guidelines that limit the maturity of such notes to six months, though collections from asset sales are expected to take eight years or more. Under these guidelines, notes would be of little help as a source of working capital.

In **mid-January**, the RTC had potential remaining cash resources of \$25 billion from REFCORP and \$5 billion from the Treasury line of credit, plus some \$2 billion to \$3 billion in cash balances. We understand, however, that the Treasury line of credit is being reserved for emergency **liquidity**. Furthermore, all REFCORP borrowing is not immediately available because it will need to match the pace of available collections from premium income and Federal Home Loan Bank **earnings--one** of the sources of cash for purchasing the zero coupon securities. As a result, RTC's resources will not be sufficient to finance the acquisition of **\$100** billion or more in assets of insolvent thrifts. Thus, periodic shortages of cash are likely over the next several years.

In the letter from Daniel Kearney and William Seidman to the House Committee on Ways and Means, the Administration has outlined three options for raising \$40 billion to \$100 billion in working capital, although few details are provided. One approach is to have the

RTC borrow directly from the Federal Financing Bank (FFB), an arm of the Treasury created for the purpose of financing such spending by federal agencies. There is some question as to whether statutory authority currently exists for this type of borrowing but, next to direct Treasury appropriations, this borrowing represents the cheapest, fastest, and easiest method for the RTC to get cash. Borrowing from the FFB, however, would result in an increase in the deficit when the RTC pays its bills; the proceeds from the asset sales would subsequently reduce the deficit when received. Over the long run, the use of working capital may be deficit neutral, although as previously noted, whether there are additional losses cannot be determined until all the asset proceeds have been collected.

The other two options that the Administration proposes for raising working capital are not for purchasing assets but rather for securing cash off-budget from the private markets to help fund (and possibly reduce) the ultimate insurance losses that are accruing in thrifts that continue operating, although they are insolvent. One approach is to increase the level of loans or advances made by the Federal Home Loan Banks (FHLBs) to thrifts in conservatorships. Because the FHLBs require sufficient collateral for advances, not readily available in insolvent thrifts, the FHLBs are likely to require an RTC guarantee or other type of commitment to make these loans. Depending on how the transaction was structured, it is possible that spending of working

capital so financed would not be reflected in the federal deficit. Without further details, however, it is difficult to determine the budgetary treatment of such a transaction. Precedent exists in the budget for scoring a 100 percent loan guarantee as a direct loan, and not a contingent liability. This would put the transaction squarely on-budget. Providing working capital through FHLB borrowing would be more expensive than borrowing from the **FFB**. For each \$5 billion borrowed annually in this manner, the RTC would spend an additional \$25 million to \$50 million, relative to FFB financing.

The Administration has also raised the possibility of generating funds for some cash-starved thrifts in **conservatorship** by packaging brokered deposits and selling them directly to institutional investors rather than through brokers, thus avoiding some fees. Presumably, deposit insurance would be sufficient protection for acquirers of such securities. While CBO would expect this type of transaction to remain totally off-budget, like the previous option, its cost would be higher than FFB or Treasury financing, and would add to the taxpayers' cost of the bailout.

Budget Treatment of RTC Spending

Discussion over the budget treatment of the \$50 billion provided by **FIRREA--whether** or not the spending **would** be on- or **off-budget--held** up passage of the legislation last year. A similar situation appears to be occurring over the working capital issue, having the unfortunate effect of delaying the RTC's planning and resolution process.

Sound budgeting principles suggest that the government should minimize its cost of borrowing, and that agency spending should be on-budget. However, having RTC finance its needs for working capital on-budget would make it significantly more difficult to reach the Balanced Budget Act deficit targets in fiscal year 1991. The cash basis of the unified budget and the Balanced Budget Act is ill-suited to measuring the impact on taxpayers of RTC's activities, which increase the deficit in early years, while lowering it in later years, when the proceeds from asset sales offset other government spending.

A provision of the Balanced Budget Act suggests a possible solution to this problem. The act excludes asset sales from the budget baseline and from credit for budgetary savings - except for "routine, ongoing" asset sales or ones previously mandated by law. It is unclear whether RTC asset sales are covered by this exclusion. If they are, then it would make sense for the Congress also to exclude RTC's

expenditures of working capital to acquire the assets. Counting asset acquisitions but not sales against budget targets would overstate outlays over time and needlessly and inconsistently bias budget policy toward fiscal restraint.

Even if RTC asset sales are counted for Balanced Budget Act purposes, the year-to-year volatility of the spending and receipt figures are incompatible with a steady downward trend in the deficit targets and leave much potential for the Administration to manipulate budget estimates to reach deficit targets. A case can therefore be made that expenditures and receipts associated with the working capital, which in theory should net out to zero over several years, should be excluded from the Balanced Budget Act **calculations** in order to avoid such problems.

Indeed, there is a clear economic case for excluding all of RTC's net expenditures from the Balanced Budget Act baseline deficit calculation. This case is based on the fact that such spending does not change the government's balance sheet and does not affect national saving in the way that most federal spending does. Unlike many recurrent federal expenditures, RTC expenditures for thrift resolution leave the government's financial position unchanged, either because they liquidate some of its existing liabilities or result in the acquisition of existing assets. Moreover, the asset transfers that underlie such

spending do not affect private incomes (or their disposition as saving or consumption), and will have economic effects that are quite different from the consequences of ordinary federal spending.

LONG-RUN OUTLOOK

I would like to close my testimony by providing a brief look at the condition of the troubled portion of the thrift industry and making some comments on the strategic plan for resolving the thrift crisis.

According to RTC data, 46 institutions were resolved in 1989 (7 by the Federal Savings and Loan Insurance Corporation; 39 by the RTC). These institutions had total assets of more than **\$10** billion and regulatory net worth of less than **-\$4** billion. These levels are similar to 1986 and 1987 resolution activity, but well below the 1988 level.

As of January 15, 1990, 296 institutions were under RTC **conservatorship--meaning** they have been taken over and are being run by the **FDIC** and RTC. These 296 conservatorships had, as of third quarter 1989, \$113 billion in assets, \$101 billion in deposits, and **-\$21** billion in regulatory net worth.

The institutions in conservatorships are still losing money. As of September 1989, the most recent quarter for which data are available, those institutions that had been in conservatorship at least one quarter had a negative tangible net worth of about **-\$23** billion. These institutions, which have already been taken over by the government, had losses of more than \$2 billion in the third quarter of last year. Of **course**, some of these losses are merely the overdue recognition of previous problems, but more than half of the losses were sustained as the result of the current operations of these institutions. The only certain way to stop these losses is to resolve these institutions.

There is another group of insolvent institutions, not in conservatorship, that is also losing money. Based on second quarter 1989 data, the Office of Thrift Supervision (OTS) targeted an additional 223 institutions that it recommended be placed into conservatorship. The RTC has since taken over 35 of these institutions. The remaining 188 thrifts had assets of approximately **\$140** billion and tangible net worth of about **-\$4** billion as of September 30, 1989. These institutions lost more than \$700 million in the third quarter, of which about \$270 million were operating losses. It is our understanding that OTS will shortly recommend additional institutions for conservatorship based on third-quarter results.

The size and pace of these losses suggest that moving these institutions into conservatorship and resolving thrifts already in **conservatorship** should both be done as quickly as possible.

As of September 1989, 800 to 1,000 institutions were solvent, but failed to meet the capital requirements established by FIRREA that would take full effect in 1992. While some of these institutions may improve their financial position, the number of failures is likely to grow. CBO expects a substantial portion of these will have to be resolved. In addition, because the OTS has removed some of the forbearances that applied to 1988 deals, some of these institutions may need to be resolved again. Thus, it appears that the strategic plan fails to address the full scope of the potential problem.

The RTC's strategic plan also lacks any mention of the mechanism by which the RTC, in conjunction with OTS, identifies its caseload. The question of how to handle the 800 to 1,000 solvent thrifts that fail the FIRREA capital standard may not be of immediate concern, but unless it is addressed, further commitments of government resources should be expected. As good as the RTC strategic plan is in many respects, it would be improved by recognizing the threat of additional thrift resolution costs and by providing a mechanism for identifying the resolution caseload.

CONCLUSION

The continuing losses of thrifts in **conservatorship** and of those targeted for conservatorship indicate that the RTC must be operating under some constraints that prevent it from acting as swiftly as we presume it would like. I have discussed the RTC's working capital constraint, and believe that there is a need for additional working capital, though the RTC already has access to enough financial resources to start the process. In addition, money may not be the only factor determining the pace of resolutions. The RTC does not yet have sufficient staff to deal rapidly with its growing caseload. Furthermore, assisted acquisitions are more difficult to arrange because thrift charters are less valuable since passage of **FIRREA**.

To the extent that the RTC is unable to resolve all of the problem institutions in its caseload, the responsibility of doing so will shift to the Savings Association Insurance Fund (**SAIF**). Unfortunately, **FIRREA** has authorized limited resources to **SAIF**--the partial use of assessment income and Treasury appropriations of up to \$16 billion through 1999. If the RTC is unable to resolve its identified caseload and future insolvencies continue to occur, as CBO believes they will, **SAIF** will have insufficient funds to continue the resolution process.