CBO TESTIMONY

Statement of
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Mr. Chairman, I appreciate this opportunity to appear before your Committee to discuss the condition of the Bank Insurance Fund **(BIF).** I will share with you the Congressional Budget Office's (CBO) latest baseline projections of the fund's spending and our assessment of its financing needs.

RECENT DEVELOPMENTS

Since I testified before this Committee in September, a number of developments have significantly affected the outlook for the banking industry and the Bank Insurance Fund. These include the changed outlook for the economy, the continued deterioration in real estate prices, the decline in bank profits, the growing losses of the Bank Insurance Fund, and the legislation enacted at the end of the 101st Congress. Let me elaborate on each of these developments.

- o The economic outlook is now gloomier. As do most forecasters, CBO believes that the U.S. economy is now in its ninth recession of the postwar period. We expect the recession to end by the middle of 1991 and to be followed by a period of solid economic growth and reduced inflation. CBO's latest economic forecast calls for real gross national product to grow about 1.3 percent between the fourth quarters of 1990 and 1991. This growth rate is considerably lower

than the 2.5 percent we predicted last summer. Pressures on banks to increase the overall quality of their assets and strengthen their capital ratios could work to slow the recovery by restricting the supply of credit.

- The weakness in regional real estate markets appears to be intensifying and spreading from the Northeast down the Atlantic coast and to the West. Recent surveys indicate that realtors believe that real estate values will continue to fall through 1992 or 1993 and, even worse, could remain depressed for up to five years. Banks are particularly vulnerable to losses on their commercial real estate loans; these loans grew from 5.4 percent of bank assets in 1980 to 10.7 percent in mid-1990. A recent study by Salomon Brothers predicted that commercial real estate prices will decline by 10 percent to 30 percent in the coming year and that the amount of vacant office space now available in the United States could satisfy demand for new space for the next 10 years. Consequently, owners of such properties may have increasing difficulty in paying off their bank loans.

- Bank earnings continue to be weak. In the third quarter of calendar year 1990, commercial banks earned $1.6 billion, or 29 percent, less

than in the second quarter. They set aside $8.3 billion in provisions for loan losses and recorded net loan charge-offs of $6.1 billion. While fourth-quarter figures are not complete, initial reports indicate a number of large banks with growing loan losses and diminishing earnings, primarily attributable to real estate loans.

- Fiscal year 1990 was BIF's worst year ever. Outlays were $6.4 billion, and its net losses totaled $3.5 billion. By comparison, from 1980 through 1988, the fund averaged net budgetary receipts of $0.6 billion and net income of $0.9 billion annually. Fiscal year 1991 shows no improvement. In the past few months, the Federal Deposit Insurance Corporation (FDIC) has continued to resolve failed and troubled institutions at a historically high rate, including the Bank of New England, which by itself the FDIC estimates will cost over $2 billion. The FDIC's inventory of assets being liquidated by receiverships is continuing to grow. At the end of October 1990, the FDIC reported a total of $16.7 billion in assets obtained in resolving failed banks. To help cover the growing costs of bank failures, the FDIC raised the premium paid by banks to 19.5 cents per $100 of insured deposits, as it had previously proposed.

- The Congress enacted and the President signed into law the Omnibus Budget Reconciliation Act of 1990. The new law removes the existing ceilings on BIF premiums and allows the FDIC to increase premiums as often as twice a year. This legislation also provides the FDIC with new authority to borrow from the Federal Financing Bank as long as the net worth of the fund is at least 10 percent of the market value of its assets.

CURRENT CONDITIONS IN THE BANKING INDUSTRY

Despite recent losses, the U.S. banking industry appears relatively healthy overall. Net income as a percent of total assets has been fairly stable during the past decade at around 0.7 percent for commercial banks. The capital-to-asset ratio of commercial banks and savings banks as a group has increased from 5.8 percent in 1980 to 6.5 percent in the second quarter of 1990.

Underlying these encouraging figures are really two separate banking industries. One, which comprises a large majority of banks, is well capitalized and earning money. The other, encompassing only a small proportion of banks, is poorly capitalized or losing money or both. For example, in the first half of 1990, almost 11,000 of the 13,000 banks had equity-to-asset ratios of

more than 6 percent and reported positive net income. These banks accounted for nearly half of the industry's assets and show every sign of being able to survive the recession we believe is currently under way.

At the other end of the spectrum are fewer than 600 banks with equity-to-asset ratios of less than 6 percent that reported net losses for the first six months of 1990. These institutions account for only about one-tenth of the industry's assets, and many of them are likely to fail by the end of 1993.

A number of large banks are vulnerable to an economic downturn. Through 1985, nonperforming loans were roughly 2 percent of assets for the largest banks--those with assets of more than $10 billion. That figure rose to 2.5 percent on average for the last half of the decade. The difficulties have grown during this past year for many of these very large banks. For example, their nonaccruing real estate and commercial loans have increased, as a percentage of equity, from 60 percent in December 1989 to 72 percent in September 1990.

BASELINE PROJECTIONS FOR THE BANK INSURANCE FUND

In September, CBO projected that BIF's net outlays would peak in fiscal year 1990 and then decline gradually over the next five years. At that time, we indicated that the estimates did not take into account the slower economic growth that then seemed likely. Because of the recession and the real estate slump, we now expect BIF's losses to be substantially greater than we previously estimated, particularly over the next two to three years. Our latest baseline projections for the Bank Insurance Fund are summarized in Table 1.

We now estimate that gross spending by the fund will rise from about $13 billion in fiscal year 1990 to almost $22 billion in 1991 and about $16 billion in 1992, before dropping off sharply in subsequent years. This spending would cover losses on bank resolutions of $13 billion in 1991, $9 billion in 1992, and $4 billion to $6 billion a year for the following few years. (The difference between gross spending and the losses on bank resolutions consists primarily of working capital to cover the cost of acquired assets, but also interest on notes issued to acquiring institutions as well as administrative expenses.)

TABLE 1. FINANCIAL PROJECTIONS FOR THE FDIC BANK INSURANCE FUND (By fiscal year, in billions of dollars)

	Actual 1990	1991	1992	1993	1994	1995	1996
				Outlays			
Gross Spending[a]	12.8	21.8	15.7	11.0	9.3	9.3	7.9
Collections	-6.4	-9.3	-11.9	-13.6	-13.2	-13.4	-13.6
Net Budget Outlays[b]	6.4	12.4	3.9	-2.7	-3.9	-4.0	-5.7
				Accrued Income or Losses			
Gross Losses[c]	-7.2	-13.0	-9.0	-6.0	-5.0	-5.0	-4.0
Net Income or Losses[d]	-3.5	-9.1	-4.2	0.2	1.6	1.9	3.3
				End-of-Year Balances			
Cash Balance[e]	8.6	1.1	-5.1	-4.8	-1.4	2.6	7.8
Accrued Fund Balance	10.5	1.4	-2.8	-2.6	-1.0	0.9	4.2

SOURCE: Congressional Budget Office.

NOTE: FDIC = Federal Deposit Insurance Corporation.

a. Includes cash disbursed and notes issued for bank failures, plus other cash expenditures. Excludes interest on assumed borrowing from the Treasury or the Federal Financing Bank.

b. Gross spending less collections. Excludes interest on assumed borrowing from the Treasury or the Federal Financing Bank.

c. Losses accrued in resolving failed banks.

d. Assessment income and interest earnings less gross losses and other expenses. Excludes interest on assumed borrowing from the Treasury or the Federal Financing Bank.

e. Excludes amounts borrowed from the Treasury or the Federal Financing Bank.

At the current assessment rate, BIF would not have adequate resources to cover expenditures of this magnitude. CBO's projections, therefore, assume further premium increases--to 23 cents per $100 of assessable deposits on July 1, 1991; to 27 cents on January 1, 1992; and to 30 cents on January 1, 1993. These levels are somewhat arbitrary in that we do not know what the FDIC is contemplating, but we believe that they are reasonable.

Even with such premium increases, the fund would incur net losses of about $13 billion over fiscal years 1991 through 1993. The accrued fund balance, which was $10.5 billion on September 30, 1990, would almost disappear by the end of 1991, and the fund would be insolvent by early in fiscal year 1992. BIF's cash balances would also be depleted by early in fiscal year 1992. CBO therefore assumed that the fund would borrow about $11 billion from either the Treasury or the Federal Financing Bank (FFB) in order to meet its cash needs. Under our baseline assumptions, BIF would be able to repay this amount by 1996.

These projections reflect a number of different approaches and sources of information. One important analysis was an update of CBO's projection of BIF's contingent liabilities, using the probabilities of failure and loss rates experienced from 1986 to mid-1989 by institutions of different sizes and ratios of equity to assets. In September 1990, this type of analysis suggested BIF

losses of about $21 billion over a 3 1/2-year period beginning in January, 1990.

Our current estimate suggests losses of close to $30 billion over the 3 1/2 years from July 1990 through December 1993 (see Table 2). Much of this increase is the result of the recession, which we assumed would reduce equity-to-asset ratios by an average of 0.75. This adjustment reflects the fact that a weak economy would increase the likelihood of bank failures by increasing loan defaults and reducing bank earnings. The amount of the adjustment is less than the sharp reduction in the equity-to-asset ratios of Connecticut and Massachusetts banks that occurred between mid-1989 and mid-1990, and is intended to project the effect of a somewhat milder economic downturn than has been experienced in New England. The remainder of the increase in BIF's projected gross losses stems from the assumed premium increases, which raise net income by bringing in substantial amounts of additional receipts, but also add to the number of bank failures.

CBO's projection of losses for 1991 is slightly greater than what William Seidman, Chairman of the FDIC, estimated in December. In testimony, he indicated that BIF would incur losses on failed institutions of about $10 billion during calendar year 1991; on a calendar year basis, CBO's projection is about $12 billion.

TABLE 2. PROJECTION OF 1990-1993 BANK INSURANCE FUND LOSSES BASED ON THE 1987-1990 EXPERIENCE

	Number of Insured Banks June 30, 1990	Total Assets June 30, 1990 (Billions of dollars)	Projected Number of Failures July 1990-December 1993	Projected Fund Losses, July 1990-December 1993 (Billions of dollars)
Group 1				
Large banks	524	1,138	14	2.8
Medium banks	2,344	456	62	3.6
Small banks	8,855	341	237	4.6
Total	11,723	1,934	313	11.0
Group 2				
Large banks	189	1,535	25	11.3
Medium banks	219	52	31	2.0
Small banks	594	23	86	1.4
Total	1,002	1,609	142	14.6
Group 3				
Large banks	6	7	4	0.3
Medium banks	14	2	9	0.2
Small banks	83	3	54	0.3
Total	103	13	67	0.8
Group 4				
Large banks	5	27	3	1.6
Medium banks	13	3	8	0.4
Small banks	45	1	27	0.2
Total	63	31	38	2.2
Group 5				
Large banks	2	2	2	0.3
Medium banks	2	0	2	0.1
Small banks	33	1	32	0.4
Total	37	4	36	0.8
Total, All Groups	12,928	3,591	596	29.4

SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation and Ferguson and Co.

NOTES: The banks are grouped by equity as a percentage of assets, as follows:

Group 1	Greater than 6 percent
Group 2	Greater than 3 percent, but less than or equal to 6 percent
Group 3	Greater than 1.5 percent, but less than or equal to 3 percent
Group 4	Greater than zero percent, but less than or equal to 1.5 percent
Group 5	Less than or equal to zero percent

Banks with assets of at least $500 million are categorized as large; banks with assets greater than $100 million and less than $500 million are categorized as medium; banks with assets of $100 million or less are categorized as small.

CBO's estimates are similar to those of three banking analysts--James R. Barth, R. Dan Brumbaugh, Jr., and Robert E. Litan--who prepared a report in December for a subcommittee of the House Committee on Banking, Finance, and Urban Affairs. They estimated that losses on failed institutions in the event of a mild recession would be in the range of $19 billion to $43 billion over a three-year period; CBO's baseline losses are slightly below the middle of their range.

UNCERTAINTIES IN ESTIMATING

Any projection of BIF losses is subject to vast uncertainties. BIF losses are very sensitive to the economy in general and to real estate markets in particular. How promptly regulators close failing banks, how they deal with troubled large banks, and how high they set deposit insurance premiums all have significant effects on BIF losses. The fate of a number of very large banks, some of which are currently in jeopardy, can swing the results substantially in either direction.

Finally, I should note that the data on which we base our projections leave much to be desired. Bank financial statements show the book value of their assets, which does not accurately reflect their current value. Bank

earnings reflect the institutions' judgments as to what losses to record and when. Because it takes years to sell assets, even the loss rates on resolutions that have already occurred are only estimates and will not be known for certain for many years.

To assess some of the variability of CBO's estimates, we have tested the sensitivity of our baseline projections to differing assumptions about the economy. The results are summarized in Table 3. A modest variation in the severity of the recession could increase or decrease outlays and net income

TABLE 3. PROJECTED SPENDING, LOSSES, AND BORROWING OF THE BANK INSURANCE FUND OVER FISCAL YEARS 1991-1994 UNDER DIFFERENT ECONOMIC ASSUMPTIONS[a]
(In billions of dollars)

	Gross Spending	Budget Outlays	Gross Losses	Accrued Net Income	Projected Borrowing Requirement
Baseline	58	10	33	-12	11
Milder Recession	50	3	28	-6	6
Moderate/Severe Recession	68	17	39	-18	18
Severe Recession	92	37	55	-34	38

SOURCE: Congressional Budget Office.

a. Assumes premium increases to 23 cents per $100 of assessable deposits on July 1, 1991; to 27 cents on January 1, 1992; and to 30 cents on January 1, 1993. Spending and losses exclude interest on assumed borrowing.

of the fund by an average of $1 billion to $2 billion a year over the 1991-1994 period. A severe recession could boost outlays and net losses by an average of $6 billion to $7 billion a year over this period. The biggest effects would occur in 1991 and 1992.

FUNDING NEEDS OF THE BANK INSURANCE FUND

CBO's assessment indicates that, within a year or so, the fund will be out of cash and insolvent without some form of cash or capital infusion. For our baseline, we have assumed that the cash shortfall of BIF would be covered by borrowings from the Treasury or the FFB, which we assumed to be unconstrained. Within the five-year period that our baseline covers, BIF should be restored to solvency and be able to repay its borrowings, assuming premium increases of the magnitude CBO has assumed.

Under existing law, BIF can borrow from the Treasury, the FFB, or other sources, but such borrowing is limited. BIF may borrow up to $5 billion from the Treasury without restriction, and may borrow from the FFB or other sources only if it is solvent and maintains a ratio of net worth to assets of at least 10 percent. These limitations on its borrowing authority would prevent BIF from resolving all of the failed banks projected in our baseline over the

next three years. Therefore, if losses are similar to or greater than those projected in our baseline, the fund's current borrowing authority would not be sufficient to cover its cash needs.

How this prospective shortfall is best met depends on the answers to a few key questions:

- o Who should pay for the losses that BIF is incurring during this period--the banking industry (including those who use its services), the taxpayer, or some combination of the two?

- o Are BIF's prospective financial difficulties temporary or long term?

- o To the extent that the industry bears the costs, how should its contribution be timed and structured so as to minimize further disruption?

For the long run, a central issue is whether or not the banking industry can provide the necessary resources. Under the assumptions used for CBO's baseline, which have premiums rising to 30 cents per $100 of assessable deposits, assessments paid by the banking industry could cover BIF's aggregate financing needs over the next several years. They would, however, be

insufficient to cover the heavy losses we anticipate during the first part of this period. They would also fall far short of providing a reserve equal to 1.25 percent of insured deposits, as mandated by law.

At a minimum, some temporary financing seems to be needed immediately. This financing could be provided by granting the FDIC additional authority to borrow from the Treasury or removing the restriction that limits its line of credit. Borrowing, which would require repayment with interest, would permit BIF to meet its obligations over the next few years, while allowing the industry a longer time to cover those costs with its premium payments.

Alternatively, if the insolvency is viewed as being more permanent, BIF can be "recapitalized"--that is, provided an infusion of money that is not repayable. This recapitalization could occur through an increased premium levy on insured banks, a special one-time assessment, or a subvention from the Treasury. If banks are unable to recapitalize BIF, there would appear to be little alternative to calling on the resources of the Treasury--that is, the taxpayers--for more permanent funding.

Since BIF's liabilities and the condition of the banking industry over the next few years are so uncertain, one option would be to use added borrowing

authority to get through this difficult period and to have a recapitalization take effect later, when the industry is likely to be healthier.

We have identified several proposals, which are essentially variations of a single theme, that would recapitalize **BIF** with funds from the banking industry. These range from increasing premiums to placing a direct one-time call on the banking industry that would increase **BIF's** net worth. Some of the differences among the proposals concern the timing of the call on the banking industry to recapitalize BIF. Others involve how funds provided by banks would be treated on their balance sheets.

Let me note that how such proposals would affect the government's budget is now much less important than it used to be. The Budget Enforcement Act of 1990 eliminated the fixed deficit targets that caused such great concern over the budgetary impact of legislation financing savings and loan resolutions. The act also excludes from the new pay-as-you-go procedures legislation providing for "full funding of, and continuation of, the deposit insurance guarantee commitment in effect on the date of enactment." Thus, legislation providing funding for BIF cannot trigger a sequestration, nor would it necessitate compensating reductions in other spending programs. The Congress, therefore, has much more flexibility to deal with **BIF's** financing needs without causing unwanted compensating short-term budgetary

changes. Of course, any further burden on the budget must eventually be paid for.

Any plan for meeting BIF's funding needs depends greatly on how profitable banks are. The financial condition of BIF will mirror the condition of the industry that it insures, and the resources available from the industry will depend on its financial health. While CBO's long-run assessment is optimistic on this score, small changes in circumstances--including the state of the overall economy and regional conditions--can have large impacts on the solvency of the banks and of BIF. Moreover, any new legislation dealing with bank powers could have significant long-term effects. Other factors, such as regulatory practices, are also of key importance. Improving rules and methods for bank closure can help lessen the overall costs of bank failures. One lesson of the thrift crisis was that delay in closing failed thrifts appeared to add greatly to the cost of resolving them. Making sure that failed banks are resolved in a timely fashion is critical to keeping costs down.

BIF's immediate liquidity needs cannot be remedied by long-term regulatory reforms. To avoid delaying necessary bank closures because of a cash shortage, the FDIC must have the resources to undertake those closures. Expanding BIF's ability to borrow from the Treasury or FFB would seem to solve the immediate liquidity problem.

Assuring that the FDIC can continue to resolve failed banks in the immediate future without delay would leave sufficient time available to determine the best way to recapitalize BIF over the long run, should a more permanent funding source be needed. That decision could then be made in conjunction with a consideration of deposit insurance reform and other bank regulatory reforms that appear on the Committee's long-term agenda.