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Making the SAIF Safe for Taxpayers

by William P. Osterberg and James B. Thomson

As the Savings Association Insurance Fund (SAIF) begins its operations, its financial stability is being questioned in many quarters. Here, the authors argue that Congress needs to reassess the condition of the fund and weigh the options for recapitalizing it. One option that merits particular consideration is merging the SAIF into the Federal Deposit Insurance Corporation's Bank Insurance Fund.

The first concrete step toward resolving the decade-long thrift debacle was taken by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which overhauled the federal savings and loan regulatory apparatus. A principal goal of FIRREA was to separate the cost of resolving the already insolvent thrifts ("zombies") from the operations of the industry's new deposit insurance fund. Because the Federal Savings and Loan Insurance Corporation was bankrupt, Congress created the Resolution Trust Corporation to dispose of the zombies. This receivership agency was to be funded primarily by taxpayers, while any costs related to federal insurance of deposits at healthy thrifts would be paid for by the thrift industry itself through the Federal Deposit Insurance Corporation's Savings Association Insurance Fund (SAIF).

To help ensure that the costs of resolving the zombies were kept separate from the costs of dealing with future failures, FIRREA set up a transition period between its enactment and the start-up of the SAIF. During this time, the Resolution Trust Corporation (RTC) was charged with selling, merging, or liquidating (generically, "resolving") the third of the industry that was insolvent. At the same time, the SAIF was to be capitalized through deposit insurance assessments on federally insured savings associations.

On October 1 of this year, the SAIF officially began operations and the RTC's statutory authority to accept new receivership cases expired. Unfortunately, because of insufficient funding during its tenure, the RTC's work was not finished. A number of insolvent thrifts remained to be closed by the Office of Thrift Supervision and were left for the SAIF to resolve.[1] Not only was this situation contrary to Congress' intent, but if left uncorrected, the SAIF was likely to be an inadequate backstop for the S&L industry.

Congress responded by passing the RTC Completion Act of 1993, which extended the receivership authority of the RTC from September 30, 1993 to January 1, 1995, and provided it with $18.3 billion to finish its cleanup operations. This additional funding and the extension of the RTC's receivership authority were important first steps in placing the SAIF on sound footing. However, further legislation will be required before taxpayers have any measure of safety from failed thrift losses.

This article traces the evolution of the current regulatory quagmire and takes a look at the policy options facing Congress. Assessing these options requires an understanding of three trends in the financial services industry. First, regulatory changes have largely removed the rationale for separate regulatory structures for banks and thrifts. Second, thrifts are becoming more like banks and in some cases are even changing their charters. And third, as banks become healthier and a portion of the thrift industry continues to falter, the premiums necessary to fund the SAIF will put thrifts at a competitive disadvantage.

■ The SAIF May Be Hazardous to Savings Associations

The SAIF begins its operations with a fund of only $441 million (up from $279 million at the end of 1992). Earlier this year, the Congressional Budget Office (CBO) estimated that the cost of closing troubled thrifts would exceed the SAIF's projected premium income by $43 billion through fiscal year 1998.[2] Although this figure did not factor in the RTC's receivership authority being extended, it did assume that the remaining zombie thrifts would be handled by the RTC, not the SAIF. Even though the savings industry has improved since then and the cost of thrift closings should be lower than the CBO estimate, the size of the shortfall in the SAIF is still likely to be significant.

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Unfortunately, even after the thrift mess is resolved, the SAIF will not be out of the woods because the cost of SAIF insurance will continue to increase relative to the cost of Bank Insurance Fund (BIF) coverage.[3] Currently, thrifts and banks pay approximately 26 basis points (0.26 percent) per $100 of insured deposits to recapitalize the SAIF and BIF, respectively. Soon, however, the SAIF will require an increase in thrifts' premiums to cover the $772 million in annual interest due on the almost $11 billion of Financing Corporation (FICO) bonds issued as part of the S&L bailout between 1987 and 1989.[4]

Worse yet, S&Ls will be at a disadvantage even *without* the FICO charges. FIRREA mandated that both the BIF and SAIF maintain a coverage ratio of 125 basis points per $100 of insured deposits. Currently, deposit insurance premiums consist of a "normal" premium and a recapitalization premium. The normal premium is the amount that would be assessed to cover the funds' ordinary and ongoing operating expenses and their expected losses from depository institution failures. The recapitalization premium is in essence a surcharge aimed at gradually rebuilding the funds to their minimum fund-to-insured-deposits ratios. Once each fund reaches 125 basis points per $100 of insured deposits, the recapitalization assessment may be decreased. However, because its loss reserves are higher than the SAIF's, the BIF will be able to lower its premiums sooner. Current estimates show that BIF premiums will fall to about 11 basis points by 1998. Bert Ely, a noted bank and thrift analyst, estimates that SAIF premiums could exceed BIF premiums by 20 basis points as early as 1996.[5]

As is often the case in economics, policies can have unintended, secondary effects that dominate the intended effects. In this instance, the intended effect of creating the SAIF was to preserve a separate housing finance industry. Unfortunately (and ironically), the cost disadvantage faced by SAIF-insured firms relative to BIF-insured firms seems likely to accelerate the decline of the savings industry.

■ The Historic Rationale for Separate Regulatory Structures

Since regulatory policy clearly plays a key role in the predicament threatening the SAIF, it is important to understand the historic rationale for the current structure. The creation of separate regulatory systems for banks and thrifts was a consequence of federal banking legislation enacted between 1932 and 1934, which led to the compartmentalization of the financial services sector. Banks were forced to divest themselves of their investment banking operations and were prohibited from underwriting securities. On the other hand, they were given the exclusive franchise for issuing demand (checkable) deposits.

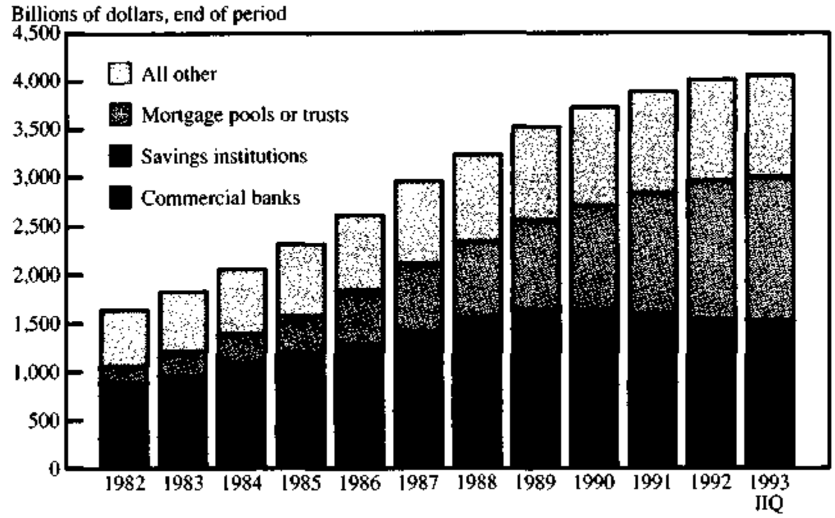
S&Ls were the vehicle through which the federal government promoted the housing industry, and this function provided the rationale for separate regulatory structures. The Federal Home Loan Bank Act of 1932 established the Federal Home Loan Bank Board (FHLBB), an independent agency, to charter and regulate federal S&Ls. It also set up the FHLB System, a network of banks intended to provide funding and liquidity to these institutions. The Federal Savings and Loan Insurance Corporation (FSLIC), a special-industry deposit insurer, was established under the National Housing Act of 1934, one year after the Banking Act of 1933 (the Glass–Steagall Act) established the Federal Deposit Insurance Corporation (FDIC) for banks.

As part of a regulatory structure designed to promote the S&L industry—and thereby home ownership — the FSLIC was placed under the auspices of the FHLBB. This regulatory system included investment restrictions such as the qualified thrift lender test, which effectively limited thrifts to making mortgage loans.[6] Access to FHLB advances (loans originally tied to mortgage lending) at below-market interest rates, coupled with fixed-rate deposit insurance, gave FSLIC-insured thrifts a competitive advantage over other potential mortgage lenders.

Although thrifts were effectively limited to long-term mortgage loans, access to subsidized FSLIC deposit guarantees made it profitable for them to fund themselves with short-term deposits when the yield curve sloped upward. As a result, the industry was extremely sensitive to sudden increases in interest rates that raised the cost of funds above the return earned on long-term mortgage portfolios. By the end of the 1970s, this Achilles' heel spelled the beginning of the end for the FHLBB, the FSLIC, and a large part of the S&L industry. The high interest rates in 1980 and 1981 had a devastating impact on thrifts and rendered a huge portion of the industry insolvent. This massive insolvency bankrupted the FSLIC fund, which by some estimates was $100 billion in the red by 1982. It took nearly a decade for Congress and the Executive Branch to face up to the magnitude of the losses and the size of the FSLIC shortfall.

FIRREA was the vehicle for resolving the thrift debacle. In addition to creating and partially funding the RTC salvage operation, the Act radically changed the structure of the thrift regulatory agencies.[7] The independent FHLBB was replaced by the Office of Thrift Supervision, which, like the Office of the Comptroller of the Currency, is an agency of the U.S. Treasury Department. Moreover, the FDIC administers both the BIF and the SAIF, and membership in the FHLB System is no longer restricted to savings associations.[8] Gone with the FHLBB and the FSLIC was the notion that the S&L regulator should actively promote the industry it regulates, and hence, gone was the special treatment given the nation's thrifts.

FIGURE 1 MORTGAGE DEBT OUTSTANDING



SOURCE: Board of Governors of the Federal Reserve System, *Flow of Funds Accounts.*

TABLE 1 MORTGAGE HOLDINGS AS OF 1992:IVQ (millions of dollars)

Type of Mortgage Loan	Commercial Banks	Savings Institutions
One- to four-family	511,976	489,622
Multifamily	38,011	69,791
Commercial	324,681	68,235
Farm	19,822	324
Total	894,490	627,972

SOURCE: Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin,* August 1993, table 1.54, p. A38.

■ The Evolving Generic Depository Institution

The remaining regulatory distinctions between banks and thrifts no longer serve to define the S&L industry as the unique, or even leading, housing lender. As seen in figure 1, despite being restricted by the qualified thrift lender test, savings institutions are no longer the predominant holders of mortgages. Moreover, thrifts' total mortgage holdings and their share of outstanding mortgages have been falling since 1988 and 1984, respectively. Total mortgages on banks' balance sheets have exceeded thrift holdings since 1990.

Table 1 gives a breakdown of bank and thrift mortgage portfolios. At the end of 1992, banks held over $22 billion more in home mortgage loans (classified as one- to four-family mortgages in the table) than did thrifts, and almost $267 billion more in total mortgages. However, mortgage holdings by banks and thrifts measure only one aspect of the increased competition in mortgage markets. Primary home mortgages held by secondary-market mortgage pools totaled $1,380 billion at the end of 1992, $378 billion more than the combined holdings of one- to four-family mortgages held by banks and thrifts.[9] The secondary-market pools include the Government National Mortgage Association (Ginnie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal National Mortgage Association (Fannie Mae), the Farmers Home Administration (FHA), and private mortgage pools. Advances in communications and information technology have increased the ability of markets to bundle up mortgages and issue securities against them. This market innovation has essentially made thrifts' mortgage specialization obsolete.

The remaining regulatory distinctions seem only to impede an ongoing process of integration of the markets formerly served by banks or thrifts. For example, the Garn–St Germain Act of 1982 allows thrifts to invest no more than 10 percent of their assets in consumer and commercial/industrial loans. Nonetheless, these institutions have made inroads into the small-business lending market. The 1988–89 National Survey of Small Business Finance found that 14.1 percent of the small and medium-sized business respondents used financial services from thrift institutions, although only 6.3 percent listed thrifts as their primary source of services.[10] In spite of the relatively small share of firms using thrifts for their banking needs, the numbers suggest that these institutions have begun to penetrate a market that is still largely considered the domain of banks.

Thrifts have also made inroads into consumer lending, despite being constrained by the asset restrictions of the Garn–St Germain Act. They held nearly 6 percent of outstanding consumer installment credit balances at the end of 1992, while banks held about 44 percent.[11] However, measures of consumer installment credit generally understate the importance of savings institutions as consumer lenders because they ignore home equity lines of credit.[12] Finally, since 1981, differences between depository institutions no longer derive from the types of liabilities they can issue.

Three other developments point to the fact that banks and thrifts are becoming more alike. First is the continuing trend of exit from the savings industry. The decline in the number of S&Ls during the 1980s and into 1991 was primarily due to failures. Increasingly, however, attrition from the industry's ranks can be traced to the conversion of existing institutions from federal S&L charters to state bank charters. Of the 117 thrifts that exited the industry during the first half of 1993, only five were closed by the Office of Thrift Supervision and turned over to the RTC, while 61 converted to state bank charters.[13]

Second, consolidation of the depository institutions sector is occurring both within and across industry lines. Banks and their parent holding companies are increasingly using the acquisition of S&Ls to enter new markets and to increase their presence in the banking markets they already serve. *Mergers and Acquisitions* reports that 59 deals from 1992:IIQ through 1993:IQ involved the acquisition of thrifts or thrift branches by commercial banks and bank holding companies.[14]

Finally, consolidation of savings institution and bank trade associations is under way, especially among associations representing smaller institutions. In fact, the Independent Bankers Association of America recently amended its charter to allow thrifts to join.[15] At the very least, this trend toward generic depository-institution trade groups represents a recognition by banks and thrifts of common interests as well as common problems. It also suggests that both types of institutions increasingly view their competition as being depositories of all types, not just firms with the same kind of charter.

■ The Policy Options

In order to resolve the current threat to the SAIF, policymakers must address more than just the costs associated with the zombies. A more farsighted option would be to acknowledge the blurring of the distinctions between banks and thrifts.

The need for a separately chartered industry devoted to housing finance was questioned in a recent report to the President and Congress.[16] One policy option is simply to facilitate the merger of the two industries by removing all regulatory distinctions. An argument in favor of this course is that maintaining separate regulatory systems could accelerate the decline of the nation's S&Ls, leaving no specialized housing lenders. Moreover, to the extent that regulatory barriers inhibit the evolution and consolidation of the depository institutions industry, retaining separate insurance funds will hinder economic efficiency.

A second option is to maintain the status quo (as embodied in the RTC Completion Act), with separate industries and separate industry insurance funds, but with no new appropriation of funds for the SAIF. This option is also likely to speed the decline of SAIF-insured depositories. As discussed above, thrifts face intense competition from banks in both mortgage and deposit markets. Taxing the operations of SAIF members to cover the interest on FICO bonds will reduce their earnings because competition from banks, which do not face the tax, will prevent them from passing the added costs on to their customers. This in turn will hasten the failure of a number of thrifts and further reduce the size of the S&L industry. The SAIF may be destabilized because as the industry shrinks, the fund's premium income will drop just as the increased failures are boosting its costs.

One possible alternative to this catch-22 scenario for funding the SAIF — congressional appropriation of recapitalization funds — is especially contentious because of the continuing political fallout from the FSLIC debacle. FIRREA was conceived not as a bailout of thrift depositors, but rather as a way to honor the government's commitment to them while ensuring that taxpayers would never again be called upon to rescue a federal deposit insurance fund. This sentiment was echoed by President Bush at the August 9, 1989 signing ceremony for the bill, where he proclaimed, "We will keep the federal deposit insurance system solvent and help serve those millions of small savers who make America great ..." while "...ensuring the taxpayers' interests will always come first....[17] Consequently, there seems to be some reluctance in Congress to bail out a federal deposit insurance fund, particularly one established on the ashes of the now-defunct FSLIC.

A middle ground between maintaining or obliterating all regulatory distinctions between banks and thrifts is to consolidate the FDIC's two funds. To implement the merger, depository institutions currently insured by the SAIF would be allowed to transfer to the BIF between January 1 and December 31 of 1994, and to do so without paying an exit fee. However, to qualify for BIF insurance, the depository would have to be adequately capitalized, as defined by bank regulators in their implementation of the prompt corrective action provisions of the FDIC Improvement Act of 1991 (FDICIA). Furthermore, before joining the BIF, SAIF-insured institutions would be subject to a full-scope on-site examination. This would be conducted jointly by the Office of Thrift Supervision and the Office of the Comptroller of the Currency for federally chartered thrifts and by the FDIC for state-chartered institutions.

In other words, to qualify for BIF insurance, an SAIF-insured institution's capital would have to meet or exceed the minimum capital guidelines required by the Bank of International Settlements (BIS), have an examination rating of one or two (on a scale of one to five, with one being the best), and not be under any written supervisory agreement.

A strong case can be made for adopting this compromise approach. First, many questions regarding the viability of the SAIF will remain even after the RTC finishes mopping up the remaining FSLIC red-ink spill. Second, the historic rationale for separate regulatory systems for banks and thrifts no longer seems valid, particularly given the intense competition between the two.[18] Third, adequate safeguards are in place to ensure that the zombie problem is resolved and not simply passed on to BIF members. And finally, the majority of savings associations already qualify for BIF insurance, so implementing this option would be fairly simple.[19]

■ The Transition: A Nonevent for Most SAIF Members

As of March 31, 1993, 1,733 thrifts (96 percent of the private-sector institutions) with $689 billion in assets (93 percent of private-sector thrift assets) would have met the minimum capital threshold for BIF membership under the merger option. Furthermore, a total of 1,301 institutions (72.9 percent) with $482 billion in assets (65 percent of private-sector thrift assets) would have met the second condition to qualify for BIF insurance.[20] Thus, more than two-thirds of the S&L industry would immediately qualify for BIF insurance, and transferring funds would be a nonevent.

The remaining institutions that are viable but that do not meet the conditions for BIF insurance on January 1, 1994 would have a year to either comply, seek a merger partner, be acquired by a BIF-insured depository, or voluntarily liquidate. Any SAIF-insured institution failing to meet these conditions by the end of 1994 would be placed into an FDIC-managed conservatorship. These depositories would be allowed to operate in conservatorship for up to one year pending an acquirer being found, or until they qualified for BIF insurance. At the end of 1995, any S&Ls still in conservatorship would be liquidated, and any losses associated with their closing would be charged first against the SAIF and second against any surplus RTC funds. Any remaining balance in the SAIF and surplus RTC funds would be transferred to the BIF, and the SAIF and RTC would cease to exist.

■ Conclusion

Increased integration of financial markets, coupled with recent legislative changes in the federal regulatory structure for depository institutions, calls into question the rationale for maintaining separate bank and thrift insurance funds. Given the trend toward merging of the two industries, maintaining the current regulatory distinctions may only serve to hasten the demise of the nation's thrifts.

While the RTC Completion Act of 1993 segregates the costs of the FSLIC debacle from those associated with future thrift insolvencies, it is only a partial solution to the SAIF's funding problems. This suggests that Congress should reassess its current SAIF policy and reexamine its options. A farsighted policy would recognize the current trend toward consolidation. An obvious policy response would be to obliterate all regulatory differences between banks and thrifts. However, it is not clear that Congress wishes to do away with the separate housing finance industry that was the original rationale for the two regulatory structures.

One appealing compromise would be to merge the two deposit insurance funds. This would reduce administrative costs, since the FDIC would not have to keep two sets of books and two separate pools of receivership assets. Consolidation of the SAIF and BIF would also eliminate the projected future difference in the deposit insurance premiums between SAIF- and BIF-insured institutions, thereby removing the latters' competitive advantage.

Finally, dismantling the great wall between the FDIC's insurance funds would facilitate the current trend toward industry consolidation by reducing the transaction costs associated with acquiring a depository institution (or its branches) with a different charter type.

■ Footnotes

1. FIRREA established the Office of Thrift Supervision as an agency of the Treasury to supervise savings associations.

2. See Congressional Budget Office, *Resolving the Thrift Crisis*, Washington, D.C.: CBO, April 1993, pp. 56–59.

3. In the RTC Completion Act, Congress authorized the SAIF to spend up to $8 billion between 1994 and 1998 to cover the losses associated with thrift closings. This spending authorization does not, however, fully address the funding needs of the SAIF or the implications of the projected future gap between SAIF and BIF premiums. In addition, there are a number of conditions that the SAIF must satisfy before it can spend this money. The Federal Deposit Insurance Corporation must certify that 1) the funds are needed to cover SAIF losses, 2) thrift deposit insurance premiums cannot be raised to cover these losses without hurting the industry, and 3) higher assessment rates on SAIF members to cover these losses are likely to increase the government's losses in the future. The legislation also provides for the use of any surplus RTC funds to cover thrift losses from January 1, 1996 to December 31, 1997. The terms and conditions for spending the RTC surplus (if one indeed exists) include those listed above for spending the $8 billion funding backstop.

4. The Competitive Equality Banking Act of 1987 (CEBA) authorized the sale of $10.8 billion of these bonds as a token recapitalization of the old Federal Savings and Loan Insurance Corporation (FSLIC) fund. Under CEBA, FSLIC-insured thrifts and the Federal Home Loan Banks are responsible for repaying the principal and interest on FICO bonds.

5. Ely's estimate accounts for both the differences in BIF and SAIF reserves and the FICO interest charges. See Robyn Meredith's article, "RTC Bill Passes: Thrift Resolutions to Resume," *American Banker*, November 24, 1993, p. 3.

6. The qualified thrift lender test requires an S&L, as a condition of its charter, to hold at least 65 percent of its portfolio in housing-related assets, such as mortgages and mortgage-backed securities.

7. See Christopher J. Pike and James B. Thomson, "The RTC and the Escalating Costs of the Thrift Insurance Mess," Federal Reserve Bank of Cleveland, *Economic Commentary*, May 15, 1991.

8. At the end of 1992, the FHLB System had a total membership of 3,622 institutions, of which 35 percent, or 1,260, were commercial banks (with $311 billion in assets). See Congressional Budget Office, *Federal Home Loan Banks in the Housing Finance System*, Washington, D.C.: CBO, July 1993, table 2.

9. See Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, August 1993, table 1.54, p. A38.

10. Thrift institutions in the survey include savings institutions and credit unions. For more information, see Gregory E. Elliehausen and John D. Wolken, "Banking Markets and the Use of Financial Services by Small and Medium-Sized Business," *Federal Reserve Bulletin*, October 1990, pp. 801–17.

11. See Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, August 1993, table 1.55, p. A39.

12. At the end of 1992, thrifts held $12.6 billion in home equity loans, about 1.2 percent of assets. Banks, by contrast, held $73.2 billion, about 1.2 percent of assets. Data on home equity lines of credit are taken from the December 31, 1992 issue of the Federal Financial Institutions Examination Council's Quarterly Reports on Income and Condition ("call reports") and the December 31, 1992 issue of the Office of Thrift Supervision's Thrift Financial Report.

13. See Robyn Meredith, "Rapid Flight from Thrift Charters May Leave OTS High and Dry," *American Banker*, September 20, 1993, p. 2.

14. See *Mergers and Acquisitions*, various issues, 1992–93.

15. See Robert M. Garrson, "IBAA Votes to Admit Thrifts as Full Members," *American Banker*, October 13, 1993, p. 2.

16. See National Commission on Financial Institution Reform, Recovery, and Enforcement, "Origins and Causes of the S&L Debacle: A Blueprint for Reform," Report to the President and Congress of the United States, Washington, D.C.: U.S. Government Printing Office, July 1993.

17. See "Bush Remarks: 'First Critical Test' Has Been Passed," *American Banker*, August 10, 1989, p. 4.

18. Proposals to consolidate the federal bank and thrift regulatory agencies have been introduced in both houses of Congress, and the Clinton administration is likely to submit similar legislation in January.

19. The issue of who should pay the FICO interest would not be resolved by such a merger. Logically, FICO expenses should be part of the taxpayer-funded resolution of the FSLIC insolvency. However, even if current SAIF members were still assessed separately for FICO, they would be better off under this option.

20. See Office of Thrift Supervision, *NEWS*, OTS 93–47, June 17, 1993.

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