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Statement of

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## I. Introduction

I appreciate this opportunity for the Office of Thrift Supervision (OTS) to reaffirm its support for legislation that would fully and permanently address the financial problems facing the Savings Association Insurance Fund (SAIF) and the Financing Corporation (FICO). We continue to support prompt enactment of the joint proposal submitted to Congress by the Treasury Department, the Federal Deposit Insurance Corporation (FDIC) and OTS. The proposal, which was passed last year as part of the Balanced Budget Act, would permanently solve the financial problems of SAIF and FICO.

## II. Background

The financial problems facing the SAIF and FICO were described in detail in OTS testimony before the House Subcommittee on Financial Institutions and Consumer Credit last August. We described three problems.

First, we noted:

> **the SAIF is undercapitalized and is likely to remain undercapitalized for years to come**

The problem was, and continues to be, that almost half of all insurance premiums paid by SAIF-insured institutions are diverted to fund interest payments on FICO bonds. At the August testimony, we indicated that as of March 31, 1995, the SAIF had reserves of $2.2 billion to cover $704 billion in insured deposits. That was equivalent to a reserve ratio of less than one-quarter of the statutory 1.25% requirement.

In the intervening months, SAIF reserves have risen to $3.4 billion covering $711 billion in insured deposits. The SAIF has benefited because no SAIF-insured institutions have failed since responsibility shifted to the FDIC. Nevertheless, the ratio of reserves to deposits now stands at only 0.47%, or slightly over one-third the 1.25% required for full capitalization. At this rate, the SAIF will not capitalize until the year

2001. As a result, the SAIF remains seriously undercapitalized and its funding mechanism fundamentally flawed.

The second problem we described was that:

> **the BIF/SAIF premium disparity is likely to result in a reduction in SAIF's assessment base and an increase in SAIF's resolution expenditures**

The average SAIF-insured thrift holds $500 million in assets, earns net income of $3.5 million and pays annual insurance premiums to the FDIC of almost $800,000. A comparably sized bank in the same financial condition earns $5.8 million and pays insurance premiums each year of $2,000. This has created a powerful incentive for SAIF-insured thrifts to reduce their SAIF-insured deposit base.

We may have seen the beginnings of this trend in the fourth quarter of 1995. During that quarter, SAIF's assessment base declined by $620 million to $734.4 billion. This decline occurred despite an increase in the assessment base of Oakar banks.[1] The decline is attributable to a dramatic shrinkage in the assessment base of savings associations. The savings association assessment base, which accounted for about two thirds of all SAIF assessable deposits as of September 1995, fell by over $9 billion during the fourth quarter -- almost 2% in one quarter.

Absent legislation, I expect the decline of the SAIF assessment base to continue and possibly accelerate. The prospects of high insurance premiums at Oakar banks will discourage future purchases of SAIF-insured institutions by banks and will encourage

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1. Oakar banks hold both BIF- and SAIF-insured deposits. Their imputed level of SAIF deposits is determined as a fixed percentage of their total deposits. (This percentage is computed at the time they acquire SAIF deposits and is based on the ratio of SAIF deposits to total deposits on that date.) Thus, to shrink their SAIF deposits, Oakar banks must also shrink their BIF deposits. Because most Oakar banks hold far more BIF than SAIF deposits, it is not surprising that they have been slower to respond to the premium disparity.

Oakar banks to begin exploring ways to reduce their SAIF-insured deposits. Recent efforts of Oakar banks to obtain a statutory reduction in their imputed level of SAIF deposits is one example of this phenomenon.

The third problem noted in the August testimony was that:

> **there is significant risk of default on the FICO bonds in the near future**

The FICO problem arises from the declining deposits in those institutions responsible for paying interest on FICO bonds -- SAIF-insured savings associations. As noted above, in the last quarter of 1995, the assessable deposits of these institutions declined by over $9 billion. For all of 1995, the aggregate assessable deposits of SAIF-insured savings associations declined by almost $20 billion. As the assessment base servicing the FICO debt falls, the pressure on the remaining deposit base grows even stronger. Absent legislation, a FICO default is likely.

## III. The Joint Proposal

The joint proposal was passed with some modifications as part of the Balanced Budget Act of 1995. The proposal has two basic components. First, it provides for the immediate capitalization of the SAIF via a special assessment on SAIF-insured institutions. Second, it spreads responsibility for interest payments on the FICO bonds pro rata across all FDIC-insured institutions. These two reforms would fully capitalize the SAIF, eliminate the built-in premium disparity between BIF and SAIF, and provide a permanent and stable source of funding for FICO. Significantly, the joint proposal requires no government funds.

In your letter of invitation, Mr. Chairman, you asked that we comment on four additional options to respond to the problems of the SAIF and FICO. In my testimony today, I will address each of these options and explain why the OTS continues to strongly support enactment of the solution previously passed as part of the Balanced Budget Act.

As I emphasized in prior testimony, several years of sustained profitability for thrifts and banks have opened the window of opportunity to solve the SAIF and FICO problems with nongovernment resources. If we fail to act soon, we may miss the best chance to resolve these problems with minimal risk to the taxpayer.

## IV. Analysis of the Four Alternatives to the Joint Proposal

Before beginning my analysis of the various options outlined in the invitation letter, I want to reaffirm two principles that I believe should guide our analysis.

The first principle is that any solution must take account of market forces. Market forces will drive business decisions and consumer choices. Any response to the SAIF/FICO problems that is based on the premise that private institutions can be prevented by government rules from responding to market pressures may be doomed to failure. For example, the government's failed efforts in the 1970s to limit the ability of banks and thrifts to pay market rates of interest on their deposits (the former Regulation Q), in fact, contributed to the subsequent problems in the thrift industry. It also ended up spawning the money market mutual fund industry, an industry not subject to Regulation Q.

The second principle is that the failure to enact timely and permanent solutions can be counterproductive. In fact, the SAIF/FICO problems arose from earlier legislation that proved to be inadequate. The history of thrift legislation is replete with partial fixes and deferred decisions that ended up costing the thrift industry and, ultimately, the taxpayer, far more than if the problems had been addressed promptly.

With these two principles in mind -- the need for a solution that is both definitive and consistent with market forces -- I will now turn to the alternatives for addressing the SAIF/FICO problem.

### A. Maintenance of the *Status Quo*

One option would be to maintain the *status quo.* This option fails to meet either of the two principles I have suggested. It is akin to the approach that led to delay in addressing the thrift crisis of the 1980s. The disadvantage to a wait-and-see approach is that allowing a problem to fester usually makes it more difficult and costly to solve. Maintaining the *status quo* presents three principal risks.

First, it exposes the FDIC and the thrift industry to an undercapitalized SAIF through at least the end of this decade. Although most SAIF members are healthy, accurately predicting the financial condition of the industry well into the future is very difficult. An economic downturn or a weakness in a particular real estate market could suddenly reverse expectations.

Second, the existing premium disparity will prompt thrifts to engage in the non-productive restructuring of their balance sheets and/or corporate restructurings to avoid the higher SAIF premium. The premium disparity will place pressure on management of SAIF-insured institutions to reduce their exposure to SAIF premiums. This will encourage shifts into repurchase agreements and other debt instruments, expanded use of Federal Home Loan Bank advances, shrinking the balance sheet, and substitution of lower-cost BIF-insured deposits for SAIF-insured deposits. I am concerned that the use of these alternative funding sources may needlessly increase thrift costs and could create future safety and soundness problems.

It is unlikely that the government could successfully set up roadblocks that would prevent the reduction in the SAIF assessment base. Institutions will have a powerful incentive to reduce their operating expenses. At the end of the day, the government cannot prevent thrift customers from voluntarily transferring their SAIF-insured deposits to other financial instruments.

Third, the failure to solve the premium disparity could lead to default on the FICO bonds. Interest on the FICO bonds, which totals $793 million annually, is paid out of draws that FICO is authorized to make against the SAIF premium income stream. Under current law, these draws can only be made against that portion of the SAIF income stream attributable to savings associations. No draws are made against the SAIF premiums of Oakar and Sasser banks.

Currently, FICO consumes 45% of all SAIF assessments, and over 67% of all savings association SAIF assessments. The continuing downward trend in savings association assessments creates the threat of a FICO default.

### B. Spread Responsibility for FICO to Oakar and Sasser Banks

Another option is to amend the applicable statutes to enable FICO to draw against all SAIF premiums. This would provide an additional cushion against default on FICO bonds. It would not, however, provide a permanent solution and in particular does nothing to address the SAIF.

Spreading the FICO responsibility to Oakar and Sasser banks would not address the immediate undercapitalization of the SAIF. Nor would it address the BIF-SAIF premium disparity. In fact, this solution could be viewed as an acceptance by the government of a long-term premium surcharge on SAIF-insured deposits. So long as the premium disparity remains, institutions will have a powerful incentive to reduce their reliance on SAIF deposits. The possibility would remain that the entire SAIF assessment base could shrink to a point that it would be insufficient to support FICO interest payments.

### C. The Taxpayer Solution

Another proposed option is for the Congress to appropriate sufficient funds to pay for the annual FICO obligation, as well as to capitalize the SAIF.

This would provide a permanent solution to the SAIF/FICO problem by funding FICO, capitalizing the SAIF, and eliminating the existing premium disparity. It would eliminate market incentives for SAIF-insured institutions to reduce their reliance on costly SAIF deposits.

The original funding mechanism enacted in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) contemplated a series of payments by Treasury to offset the diversion of SAIF premiums to pay for FICO. This funding mechanism, however, was eliminated in subsequent legislation. There appears to be little support today for shifting responsibility for FICO onto the taxpayer.

In addition, the thrift industry is able and willing to use industry resources to capitalize the SAIF if it is part of a permanent solution to the SAIF/FICO problem. The use of taxpayer funding should be a last resort.

**D. Transferring FICO Responsibility to the Housing GSEs**

Another proposed option is to make the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation responsible for paying for all or a portion of the $793 million annual FICO obligation. The housing GSEs benefitted from the resolution of the thrift crisis and so could arguably be expected to participate in the solution.

Spreading responsibility for the FICO payment beyond FDIC-insured institutions would reduce the burden on banks and thrifts. This approach would reduce the premium disparity and reduce the market pressure on institutions to reduce their SAIF deposits. Because less SAIF assessment income would be diverted to FICO, the SAIF would be able to capitalize more rapidly. A one-time special assessment on SAIF-insured institutions would also still be an option under this approach.

As a practical matter, however, it may be risky at this time to move away from the SAIF/FICO solution passed in the Balanced Budget Act. While arguments can be made in favor of shifting the FICO burden to other entities such as the GSEs and federally insured credit unions, any effort at this stage to alter the joint proposal raises the likelihood of a stalemate and no legislation. The solution in the Balanced Budget Act represents months of detailed drafting and negotiating. If the details of that legislation are reopened, enactment of a solution could be delayed indefinitely.

## E. Enacting the Solution Passed in the Balanced Budget Act

I continue to believe that the joint proposal, as passed in the Balanced Budget Act, is the best approach. In addition to providing a definitive solution to all aspects of the problem -- capitalizing the SAIF, funding FICO, and eliminating the premium disparity -- this approach offers the following advantages:

- It has been thoroughly analyzed and represents the consensus position of the Administration, the FDIC, and the OTS. It is supported by the Federal Reserve Board.

- It represents a complete legislative package that has been carefully reviewed and passed by the Congress.

- It offers a reasonable balance of equities. The cost of capitalizing the SAIF is imposed exclusively on SAIF members. The burden of the FICO obligation is shared among all FDIC-insured institutions. It imposes the FICO responsibility on the institutions that benefited most directly from FDIC insurance and from public confidence in the FDIC.[2]

2. Resolution of the thrift crisis was important to banks, as well as thrifts. If the government had not provided funding through FICO and other sources to pay the depositors of failed thrifts, public confidence in federal deposit insurance would have been shaken and the entire deposit insurance system on which banks depend might have been threatened. Moreover, banks benefited from the government's effort to place weak thrifts into receivership. Weak thrifts frequently paid exorbitant prices for deposits that effectively drove up the cost of funds for all institutions, including banks.

## V. Charter Merger Legislation

Although legislation to merge the thrift and bank charters was not identified as one of the issues to be addressed at today's hearing, this issue arose during the SAIF/FICO debate. In Conference Committee last November, the Conferees agreed that resolution of the problems facing the SAIF and FICO should precede the charter reform debate.

I believe that is the right approach. I am supportive of efforts to modernize both the bank and thrift charters. But there is an even more pressing need to resolve the problems of the SAIF and FICO. Joining the charter merger debate to the SAIF/FICO solution could indefinitely delay enactment of that solution.

## VI. Conclusion

Not so very many years ago, the former Federal Home Loan Bank Board (FHLBB) and the now defunct Federal Savings and Loan Insurance Corporation (FSLIC) were roundly criticized for having failed to come forward promptly to warn Congress of the magnitude of the problems facing the FSLIC insurance fund. The FHLBB and FSLIC were admonished for repeatedly minimizing the seriousness of the thrift crisis, and for advocating stop-gap measures, rather than a comprehensive approach.

The thrift crisis taught us many lessons. One of the most important lessons is that failing to recognize the existence of an insurance fund problem, or delay in responding to that problem, only makes matters worse. The thrift crisis also taught us the value of early intervention in minimizing the costs to the government. Prompt corrective action is now a core concept in the regulation of insured depository institutions.

We must apply this same core concept to the SAIF/FICO problem.