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DEPOSIT INSURANCE FUNDS

Analysis of Insurance Premium Disparity Between Banks and Thrifts

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Madam Chairwoman and Members of the Subcommittee:

We are pleased to provide this statement addressing issues related to the premium rate disparity between banks and thrifts that will develop in the next few months when the Federal Deposit Insurance Corporation (FDIC) reduces the premium rates member institutions pay to the Bank Insurance Fund (BIF) after the Fund attains its target reserve level. FDIC has expressed its intent to significantly reduce BIF premiums once it verifies that BIF has, in fact, recapitalized to the designated level. FDIC expects to confirm that BIF has recapitalized in September 1995.

My statement summarizes the results of our analysis of issues related to the premium rate disparity as contained in our report, Deposit Insurance Funds: Analysis of Insurance Premium Disparity Between Banks and Thrifts (GAO/AIMD-95-84, March 3, 1995).[1] This analysis was performed at the request of the Ranking Minority Member of the House Committee on Small Business and the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs.

My statement also provides our comments on the framework recently proposed by FDIC, the Office of Thrift Supervision (OTS), and the Department of the Treasury to deal with the issues associated with the pending premium rate disparity.

Our analysis, as contained in our March 1995 report, showed the following.

-- A significant premium rate disparity of 19.5 basis points[2] between banks and thrifts will develop in the latter part of 1995 when FDIC reduces bank deposit insurance premiums after BIF is recapitalized.

-- SAIF is thinly capitalized and will remain undercapitalized for a number of years. In addition, SAIF now faces exposure from troubled thrifts since it assumed responsibility for resolving problem thrifts on July 1, 1995, from the Resolution Trust Corporation (RTC).

-- Using SAIF premiums to help resolve the thrift crisis has delayed SAIF's capitalization. Also, the shrinking deposit base SAIF has available to pay interest on bonds used to finance the cost of resolving failed thrifts is a major factor that could result in a continuing significant premium disparity between

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[1]For purposes of this statement, we updated certain figures through March 31, 1995, where data were readily available.

[2]One hundred basis points are equivalent to 1 percentage point. In this context, the 19.5 basis points would translate into a 19.5 cent premium charge for every $100 in insured deposits.

banks and thrifts after SAIF, according to FDIC estimates, is capitalized in 2002.

-- The premium differential will increase thrift costs. The duration of the differential is a significant factor in determining its impact which, in turn, will be more severe for thrifts with low earnings and low capital.

-- As the premium rate differential affects thrifts' costs and their ability to attract deposits and capital, thrifts may replace deposits with other nondeposit sources of funding in an effort to reduce their costs relative to banks. This, in turn, would further decrease SAIF's assessment base and could widen the premium differential. Thrifts are also considering transactions to obtain bank charters to lower deposit insurance fees that, if successful, would further shrink SAIF's deposit base and affect SAIF members' ability to pay bond interest.

In our report, we provide several policy options to address the risks associated with a premium differential, a thinly capitalized SAIF, and a small assessment base to pay bond interest. These risks are interrelated and could result in premium rates increasing to a level which SAIF members could not sustain. The options involve the use of bank, thrift, or appropriated funds at an estimated total present value cost at December 31, 1995, of \$13.8 billion to \$14.4 billion to fully capitalize SAIF and fund the bond interest obligation. We also discuss the option of taking no action, but we believe the risks associated with that option are substantial.

FDIC, OTS, and Treasury recently presented a joint interagency proposal to address the issues associated with the pending premium rate disparity as well as other longer term risks to SAIF. The major provisions of this proposal appear to address the significant risks outlined in our report and could strengthen the soundness of the nation's system of deposit insurance.

Legislative Background and Current Conditions of BIF and SAIF

The thrift crisis of the 1980s overwhelmed the industry's insurance fund, resulting in hundreds of billions of dollars in taxpayer assistance and industry costs to protect insured depositors. Legislative action in 1987 in response to the crisis included establishing the Financing Corporation (FICO) to recapitalize the thrift insurance fund. FICO issued \$8.2 billion in bonds and was given authority to assess thrifts for the annual bond interest expense. The industry's problems, however, required far more funding than that provided by FICO. By the end of 1988, the Federal Savings and Loan Insurance Corporation, the thrift industry's original federal insurer, reported a \$75 billion deficit. In response to the thrift crisis, other legislation was enacted which

-- established RTC to resolve troubled thrifts,

-- created SAIF as a new insurance fund for thrifts and retitled the insurance fund for banks BIF,

-- designated FDIC as the insurer and administrator of the two funds,

-- set a designated target or ratio of reserves to insured deposits of 1.25 percent ($1.25 for each $100 of deposits) for the insurance funds, and provided for the designated reserve ratio to be reached within certain time frames, and

-- gave FDIC authority to set premiums for the funds to reach the designated reserve ratio.

The condition of the nation's banks and thrifts has improved significantly over the past several years. Commercial banks posted record profits of $44.7 billion in 1994, the third consecutive year of record earnings, and continued to show strong earnings through the first quarter of 1995. Similarly, savings associations have shown strong earnings over the last 3 years. While 1994 thrift industry profits of $6.4 billion were down slightly from 1993, overall industry earnings remained strong and showed improvement in the first quarter of 1995. Strong profits the past few years have helped to increase bank and thrift industry capital. At March 31, 1995, the ratio of commercial banks' equity capital to assets equaled about 7.9 percent, and savings associations improved their ratio of equity capital to assets to about 8.1 percent. Improved conditions in the banking and thrift industries also resulted in both substantially fewer-than-anticipated financial institution failures and declines in the number of institutions identified by the regulators as troubled. In 1994, 11 commercial banks and 4 thrifts failed. At March 31, 1995, the regulators identified 215 commercial banks with assets totaling $27 billion and 71 savings associations with assets totaling $39 billion as troubled institutions.

While both the banking and thrift industries have shown substantial improvements in the past several years, the strengthened condition of the banking industry, coupled with the higher insurance premiums BIF-member institutions have paid into BIF since 1990, have resulted in a significant improvement in the Fund's financial condition. At year-end 1991, BIF's reserves were depleted and the Fund reported a deficit balance of $7 billion. By March 31, 1995, BIF's unaudited reserves had increased to over $23 billion, or about 1.22 percent of insured deposits. Current average annual premium rates for BIF-member institutions are 23 cents for every $100 in insured deposits.

In comparison, SAIF's reserves, while increasing each year since the Fund's inception in 1989, remain significantly below their target level. At March 31, 1995, SAIF had unaudited reserves of $2.2 billion, or about 0.32 percent of insured deposits. Current average annual premium rates for thrifts are about 24 cents for every $100 in insured deposits.

Given BIF's financial condition as of March 31, 1995, and its short-term outlook, it is likely that FDIC will shortly confirm that the Fund has achieved its designated ratio of reserves to insured deposits of 1.25 percent. FDIC expects to make this determination in September 1995 and will then reduce bank premium rates. In contrast, FDIC's baseline projections show that SAIF will not attain its target capitalization level until 2002. Although the estimation process has inherent uncertainties, FDIC's baseline projections show that BIF's reduced premiums will average 4 to 5 basis points, while SAIF's will average 24 basis points until SAIF is fully capitalized.

Consequently, a significant premium rate differential will develop within the next few months when FDIC lowers BIF premiums after it confirms that the Fund has achieved its designated reserve ratio. Based on the assumptions underlying FDIC's baseline projections, this premium rate differential will equal about 19.5 basis points and will exist at least through 2002. Significant uncertainties--such as thrift failure and loss rates, banks' and thrifts' responses to the premium rate differential, and the size of the SAIF assessable base--will impact whether and to what extent a premium rate differential will continue beyond 2002.

<u>SAIF's Capitalization Slowed by Obligations Stemming From Thrift Crisis</u>

SAIF originated in 1989 without any initial capital, and no funds authorized for SAIF were appropriated. More recent legislation (1) authorized $8 billion for SAIF for insurance losses, (2) made available, also for insurance losses, any remaining RTC funding (RTC is to terminate by year-end 1995) for 2 years under certain conditions, and (3) increased borrowing authority from the Treasury. While these provisions provide a funding source for insurance losses should the need arise, they are not a source of funds for building SAIF's reserves. Consequently, SAIF's reserves, like BIF's, are being built principally by member institution assessments.

However, SAIF's capitalization has been slowed by its members' premiums being used to pay for certain obligations created in financing the resolution of the thrift crisis. From 1989 through 1994, about $7 billion, or 75 percent, of SAIF's premiums were used for other obligations created in response to the thrift crisis, including the payment of FICO bond interest. Since 1993, only the

FICO obligation remains. However, this annual obligation is significant, averaging about $780 million.

In contrast to projections when SAIF was created of annual thrift deposit growth of 6 to 7 percent, thrift industry deposits have declined 23 percent, or an average of about 5 percent annually since SAIF's inception, from $950 billion in 1989 to $733 billion at March 31, 1995. Shrinkage in the industry's deposit base results in a lower SAIF assessment base and less assessment revenue coming into the Fund. As a result, a fixed obligation such as the FICO bond interest expense becomes a proportionately greater drain on SAIF's assessment revenue.

At the same time that the FICO obligation consumes a greater proportion of SAIF's annual premiums, a growing portion of the assessment base from which SAIF's premiums are charged is not available to fund the annual FICO bond interest. At March 31, 1995, about 34 percent of SAIF's assessment base was attributable to institutions whose premiums are not subject to FICO assessments. Premiums paid on thrift deposits acquired by banks and deposits held by former thrifts that converted to bank charters cannot be used to pay FICO bond interest.[3] Thus, while SAIF's overall deposit base has declined 23 percent since the Fund's inception, the portion of the base available to pay FICO has declined by 49 percent over this period.

Significant Uncertainties Affect Timing of SAIF's Capitalization

Long-range estimates of future thrift failures and losses associated with those failures are very uncertain. Given the unprecedented size of the thrift industry crisis, recent thrift failure and loss experience does not provide a sound basis for estimating future losses. In projecting that SAIF would be capitalized in 2002, FDIC considered historical bank failure rates and current conditions in the thrift industry.

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[3]Thrift deposits acquired by BIF members, referred to as "Oakar" deposits, retain SAIF insurance coverage, and the acquiring institution pays insurance premiums to SAIF for these deposits at SAIF's premium rates. However, because the institution acquiring these deposits is not a savings association and remains a BIF member as opposed to a SAIF member, the insurance premiums it pays to SAIF, while available to capitalize the Fund, are not available to service the FICO interest obligation. Similarly, premiums paid by SAIF-member savings associations that have converted to bank charters, referred to as "Sasser" institutions, are unavailable to fund the FICO interest obligation since the institutions are banks as opposed to savings associations.

FDIC projected that insured institutions holding 0.22 percent of total thrift industry assets will fail each year between 1996 and 2002 and that losses associated with such failures will average 13 percent of their assets. This asset failure rate is equivalent to 40 percent of the assets held by institutions identified by the regulators as troubled institutions at March 31, 1995. However, if SAIF experiences a higher level of failures than that assumed by FDIC in its projections and all other factors are held constant, the Fund's ability to capitalize by 2002 would be seriously jeopardized. For example, if greater annual failure rates of 0.35 percent, 0.53 percent, or 0.70 percent of annual industry assets were experienced, SAIF's capitalization would be delayed until 2004, 2007, or 2010, respectively.

To date, few demands have been placed on SAIF for resolution of failed institutions, since the primary responsibility for resolving failed thrifts until recently had resided with RTC. However, RTC's authority to resolve failed thrifts expired on June 30, 1995. Effective July 1, 1995, SAIF assumed full resolution responsibility for SAIF-insured institution failures.

Currently, SAIF does not have a large capital cushion to absorb the cost of thrift failures. Although FDIC's baseline projections indicate that SAIF could manage the rate of failures currently projected, the failure of a single large institution or a higher-than-projected level of failures could delay SAIF's capitalization and increase the risk of SAIF becoming insolvent. SAIF's exposure will continue until its reserves are substantially increased.

Uncertainties Also Affect Ability to Service FICO Obligation

Long-range forecasts of changes in SAIF's deposit base are also problematic. Changes in the deposit base have significant implications for future premium rates charged SAIF-member institutions as well as the ability to fund the annual FICO interest obligation. Additionally, FDIC's future consideration of FICO debt service requirements in setting SAIF premium rates will also affect future premium rates and FICO's ability to meet its obligations.

FDIC's baseline projections assume annual shrinkage of 2 percent for the portion of SAIF's deposit base available to pay the annual FICO bond interest. However, that portion of SAIF's deposit base available to pay FICO has declined by an annual average of nearly 10 percent. Although these declines reflect to some extent RTC's resolution of problem thrifts, the portion of SAIF's deposit base available to pay FICO interest continues to decrease.

Changes in SAIF's assessment base could have a significant effect on the premium rates charged to institutions with SAIF-insured deposits. If FDIC considers FICO's debt service requirements in setting SAIF premium rates, the portion of SAIF's deposit base available to pay the annual FICO bond interest cannot withstand significant shrinkage without FDIC having to increase premium rates above current levels.

At March 31, 1995, the portion of SAIF's assessment base available to pay FICO bond interest was about $485 billion. Given the current assessment rate of 24 basis points, this base could shrink to about $325 billion before premium rates would need to be raised to meet the FICO obligation. If the portion of SAIF's deposit base available to pay FICO continues to shrink at the average rate of nearly 10 percent experienced since the Fund's inception, FDIC would need to increase SAIF's premium rates by the year 2000 to meet the FICO obligation.

FDIC has stated that, in determining SAIF's premium rates, it may consider FICO assessments and the effects of SAIF premium levels on FICO's ability to meet its annual bond interest obligation. FICO has authority, subject to the approval of FDIC's Board of Directors, to assess SAIF-member savings associations to cover its interest payments, bond issuance costs, and custodial fees. However, FICO's assessment authority cannot exceed the amount authorized to be assessed SAIF members by FDIC for insurance premiums, and FICO's assessment must be deducted from the amount FDIC assesses SAIF-member savings associations. Consequently, the premium levels FDIC sets for SAIF significantly affect FICO's ability to meet its debt service obligations.

At the time we issued our report, FDIC's baseline projections on assessments for SAIF-insured thrifts did not go beyond 2002 or otherwise address to what extent SAIF-insured thrifts may be assessed for FICO bond interest after SAIF achieves its designated reserve ratio. If SAIF premiums are set at a level sufficient to fund the FICO bond interest, using the assumptions underlying FDIC's baseline projections, premium rates could be lowered slightly after SAIF achieves its designated reserve ratio. However, continued declines in the portion of SAIF's assessment base available to pay FICO would cause premium rates to gradually increase. Consequently, maintaining SAIF's premium rates at a level sufficient to cover the FICO bond interest will result in a substantial premium rate differential continuing through 2019, the year in which the last of FICO's bonds mature. If the portion of SAIF's assessment base available to pay FICO shrinks more than FDIC has projected, premium rates for SAIF and the resulting differential could be even higher than the rates and differential currently projected to exist until 2002.

<u>Potential Effects of Premium Differential on Thrift Industry</u>

The impact of a premium rate differential on the thrift industry is difficult to estimate, as it depends on how institutions respond to the change in bank premium rates proposed by FDIC. Banks and thrifts compete in a wide market that includes nondepository financial institutions, which contributes to uncertainties in predicting banks' responses to a decline in premium rates. Reliable statistical evidence is not available to predict these responses. Different scenarios would present different outcomes in terms of the premium differential's impact on thrifts.

For illustrative purposes, assume banks pass 50 percent of the savings from reduced premiums to customers in the form of higher interest on deposits and increased customer service and that thrifts, to remain competitive, fully match bank actions. Using the median thrift return on assets of about 1 percent (100 basis points) and assets financed with 60 to 90 percent of assessable deposits, the estimated cost increase for these thrifts would be about 3.9 percent to 5.8 percent of annual after-tax earnings.[4] A return on assets of only 0.5 percent (50 basis points) would double the cost as a share of earnings.

This scenario could cause institutions which would otherwise have had low earnings to begin incurring losses. The cost increase associated with the premium rate differential would increase the losses of institutions already experiencing losses. Prolonged periods of losses deplete capital and can eventually lead to failure.

The duration of the premium rate differential is a significant factor in determining its impact. FDIC's projections show a premium rate differential of 19.5 basis points existing during the years 1996 through 2002. However, because FICO's bonds will not be fully liquidated until 2019, such a differential could extend an additional 17 years beyond 2002. Regardless of its duration, the impact of the premium differential will be more severe for thrifts with low earnings and low capital.

Because the cost of the premium rate differential is also related to the share of thrift assets financed with deposits that are subject to premium assessments, SAIF members may replace deposits with other funding sources, such as Federal Home Loan Bank advances, in an effort to minimize this cost. Such a substitution, and the resulting decline in the portion of SAIF's assessment base

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[4]Under a 50-percent absorption scenario, an institution with a return on assets of 100 basis points and assets financed with 90 percent of assessable deposits would experience an 8.8 basis point reduction in return on assets on a pre-tax basis (50 percent of the 19.5 basis point differential, multiplied by the 0.90 ratio of assessment base to assets). Assuming a corporate tax rate of 34 percent, the after-tax reduction to return on assets represents 5.8 percent of earnings.

available to pay FICO, would eventually lead to further increases in SAIF's premium rates.

Alternatively, faced with a prolonged period of high premium differentials and increasing costs in an effort to compete with banks, thrifts could find it beneficial to convert their insurance membership from SAIF to BIF. Generally, institutions currently cannot convert their membership until SAIF achieves its designated reserve ratio. Once SAIF is fully capitalized, however, thrifts could find it beneficial to convert their membership to avoid continued higher insurance premiums. Institutions converting their membership must pay an exit fee to SAIF and an entrance fee to BIF. Whether or not institutions will be motivated to voluntarily convert from SAIF to BIF once SAIF achieves its designated reserve ratio will depend, in part, on the cost of the FICO interest obligation in relation to SAIF's assessment base. Such conversions could cause additional shrinkage in SAIF's assessment base, likely resulting in further increases in SAIF's premium rates to fund the FICO obligation.

A number of institutions with SAIF-insured deposits have announced plans to engage in a variety of transactions to take advantage of the pending reduction in BIF premiums. For example, some institutions are considering obtaining new bank charters. These institutions, in essence, would establish new BIF-insured banks which would take advantage of the lower BIF premiums to offer higher rates on bank deposits and better customer services. These incentives would likely cause the institutions' customers to transfer their thrift deposits to bank deposits, causing further shrinkage in SAIF's assessment base. These transactions could avoid the statutory moratorium on insurance fund conversions and the substantial exit and entrance fees associated with such conversions.

Policy Options to Address Concerns Resulting From a Premium Rate Differential

Our report presented a number of policy options for decisionmakers to consider to prevent a premium rate differential between BIF and SAIF members from occurring or to reduce the size and duration of such a differential. Most of these options involve shifting some of the costs of capitalization or future FICO interest payments to either BIF members or to taxpayers.

Arguments have been made that any option that involves the banking industry contributing to service the FICO interest obligation is unfair to the industry. These arguments contend that the FICO obligation was incurred during the thrift crisis of the 1980s and, as such, is an obligation of the thrift industry. However, there are also arguments that those thrift institutions that comprise today's thrift industry still exist because they are healthy, wellmanaged institutions that avoided the mistakes made by many thrifts in the 1970s and 1980s that ultimately led to the thrift debacle. As such, they argue, these thrifts should be no more responsible for the FICO interest burden than the banking industry.

The options presented in our March 1995 report and summarized in this statement do not attempt to judge the merits of either side of this issue but rather present the impact of these options on banks and thrifts, and on eliminating or reducing the risks associated with the premium differential. As we noted in hearings before this Subcommittee this past spring and in recent testimony for the Senate Banking Committee,[5] there are options beyond those we presented in our report, and other combinations of the options we presented are possible.

In costing out the various options discussed in our report, we assumed that implementation of each of these options would occur at the end of 1995. We also assumed continued servicing of the annual FICO interest obligation. Using December 31, 1995, as our starting point, we estimated that the present value of the total cost to increase SAIF's reserves to the designated reserve ratio and to fund the FICO bond interest would be between $13.8 billion and $14.4 billion.[6]

We used these cost estimates to project the cost to BIF- and SAIF-member institutions and to the Treasury of the options we present for preventing the occurrence of a premium rate differential or minimizing the size and duration of the differential.

These options include the following.

-- Take no action at this time, but monitor the effects of the premium differential on the thrift industry and SAIF. Under this option, SAIF members and institutions with SAIF-insured

[5]Deposit Insurance Funds: Analysis of Insurance Premium Disparity Between Banks and Thrifts (GAO/T-AIMD-95-111, March 23, 1995) and Deposit Insurance Funds: Analysis of Insurance Premium Disparity Between Banks and Thrifts (GAO/T-AIMD-95-206, July 28, 1995).

[6]The range is due to the use of different discount rates in our present value computations. The $13.8 billion cost results from using an 8.60 percent discount rate, which is a private market rate equal to the yield on highly rated corporate bonds as of year-end 1994. This rate was used in costing out the various options that do not involve the use of appropriated funds. The $14.4 billion cost results from using a 7.55 percent discount rate, which is the rate equal to the yield on 30-year Treasury bonds as of February 23, 1995. This rate was used in costing out those options that involve the use of appropriated funds to cover long-term obligations.

deposits would fund the total cost of capitalizing SAIF and servicing the FICO bond interest. As previously discussed, several significant risks exist with this option. SAIF will remain thinly capitalized over the next several years and thus remains vulnerable to significant fluctuations in the level of future financial institution failures. Additionally, further shrinkage in the portion of SAIF's assessment base available to fund the annual FICO bond interest could lead to higher premium rates, resulting in a further widening of the premium differential.

-- Merge BIF and SAIF into one combined fund on December 31, 1995, with each fund bringing its current level of reserves into the combined fund. All members of the combined fund would contribute to capitalizing the Fund to a target ratio of reserves to insured deposits of 1.25 percent and would contribute proportionately to service the annual FICO bond interest. Under this option, no premium rate differential would develop, the risks that the assessment base would decline to a level that jeopardizes servicing of the FICO bond interest would also be eliminated, and the risks associated with a thinly capitalized fund would be eliminated, as the combined fund would be fully capitalized in 1996. The cost of this option to BIF-member institutions would be approximately $11.2 billion, and the cost to SAIF members would be about $2.6 billion.

-- Merge BIF and SAIF into one combined fund on December 31, 1995, but require SAIF members to pay a special assessment to first capitalize SAIF. Under this option, SAIF members would contribute $6.1 billion to fully capitalize SAIF. The combined fund members would share the FICO bond interest obligation proportionately. The combined fund would be fully capitalized in 1995, a future premium rate differential would be avoided, and the risk associated with a small assessment base would be eliminated. The cost of this option to BIF-member institutions would be about $5.9 billion, and the cost to SAIF members would be about $7.9 billion.

-- Merge BIF and SAIF into one combined fund on December 31, 1995, but require only SAIF-member institutions to service the annual FICO bond interest. Under this option, all members would contribute to capitalizing the combined fund, which would be fully capitalized in 1996, but SAIF members would still be responsible for funding the FICO obligation. Consequently, while this option eliminates the risk of a thinly capitalized fund, it does not eliminate the risks associated with a premium rate differential and a small assessment base, as SAIF members would still pay higher premiums to service the FICO bond interest, thus increasing the risk of further deposit shrinkage. Under this option, the cost to BIF members would be about $5.8 billion, and the cost to SAIF members would be about $8.0 billion.

-- Maintain BIF and SAIF as separate funds, but require BIF and SAIF members to share the FICO bond interest costs proportionately. Under this option, SAIF members would still be responsible for capitalizing SAIF to its designated reserve ratio. However, by spreading the FICO bond interest obligation among SAIF and BIF members, more SAIF-member premiums would be available to capitalize SAIF. Consequently, SAIF would achieve its designated reserve ratio in 2000, 2 years earlier than FDIC currently projects, while BIF would still be recapitalized in 1995. While a premium rate differential would still exist, its duration would be limited to about 5 years, after which SAIF and BIF member premiums would be comparable. The cost to BIF members under this option would be about $5.9 billion, and the cost to SAIF members would be about $7.9 billion.

-- Maintain BIF and SAIF as separate funds, but require BIF members to fund the FICO bond interest expense. Under this option, if BIF premiums were maintained at their current level, sufficient funds would be raised by early 1997 to pay the FICO obligation on a present value basis. By eliminating the FICO obligation, SAIF members would fully capitalize SAIF by 1999, 3 years earlier than FDIC currently projects. However, BIF's capitalization would be delayed until 1997. This option would reduce the risks associated with a thinly capitalized fund, significantly reduce the risks associated with a premium differential, and effectively eliminate the risks associated with a small assessment base. Under this option, the total cost to BIF members would be approximately $7.7 billion, and the cost to SAIF members would be about $6.1 billion.

-- Use appropriated funds to capitalize SAIF, but require SAIF members to continue to service the FICO bond interest. Under this option, SAIF would be fully capitalized on December 31, 1995, so the risks associated with a thinly capitalized fund would be eliminated. However, SAIF members would still pay higher premiums than their BIF counterparts, so the risks associated with a premium rate differential and a small assessment base would still exist. Under this option, appropriated funds of $6.1 billion would be needed to capitalize SAIF. The cost to SAIF members would be about $7.7 billion.

-- Use appropriated funds to service the FICO interest obligation, but require SAIF members to capitalize SAIF. Under this option, SAIF members would continue to pay higher premiums than BIF members, but only through 1999. SAIF would be fully capitalized 3 years earlier than FDIC currently projects. Appropriated funds totaling $8.3 billion would be needed under this option to fund the long-term FICO interest obligation, while SAIF members would pay $6.1 billion over 4 years to capitalize SAIF.

-- Modify current law to specify that all SAIF assessments, including assessments paid by Oakar and Sasser institutions, are available to service the FICO obligation. This action could help SAIF meet future FICO payments. However, the risks associated with the projected premium rate differential would not be eliminated nor would the risks associated with a thinly capitalized fund.

Interagency Proposed Framework For Dealing with Issues Related To A BIF/SAIF Premium Disparity

On July 28, 1995, FDIC, OTS, and Treasury presented a joint proposal to address the issues associated with the pending premium rate disparity as well as other longer-term risks to SAIF. The major provisions of the interagency proposal, which would require legislation, include

-- charging SAIF members a one-time special assessment to fully capitalize SAIF;

-- spreading the annual FICO interest obligation among all FDIC-insured institutions; and

-- merging BIF and SAIF into one combined fund.

Under the regulators' proposed framework, institutions with SAIF deposits would be charged a special assessment of 85 to 90 basis points to fully capitalize SAIF to its designated reserve ratio on January 1, 1996. The actual assessment rate would depend on the Fund's financial condition and ratio of reserves to insured deposits at December 31, 1995, and the total deposits subject to the assessment. The special assessment would be based on the level of SAIF-assessable deposits held by FDIC-insured institutions as of March 31, 1995.

Because the impact of such a large assessment could be particularly severe for certain weaker institutions, the regulators propose that FDIC's Board of Directors be given authority to exempt certain weak institutions from the special assessment if it determines that providing such an exemption would reduce the risk to SAIF. However, over the next 4 years, those institutions exempt from the special assessment would be required to continue to pay regular assessments under the current risk-based assessment schedule for SAIF, which range from 23 to 31 basis points. Consequently, over time, the weaker institutions would generally pay more than healthy institutions.

In addition to proposing a special assessment to fully capitalize SAIF, the regulators also propose to expand the assessment base available to fund the annual FICO bond interest obligation to include both BIF-member and SAIF-member institutions. Assessment payments from all FDIC-insured institutions--BIF members and SAIF members--would be used to pay the annual FICO bond interest. FDIC estimates that spreading the annual FICO bond interest obligation among all FDIC-insured institutions would result in an annual assessment of 2.5 basis points to cover the annual interest expense.

The third major provision in the regulators' proposal is to merge BIF and SAIF into one combined fund as soon as practical, but no later than January 1, 1998. The regulators believe this is the best alternative to deal with other thrift industry issues that pose longer term risk to SAIF, specifically the lack of geographical and asset risk diversification. The regulators acknowledge that a proposal to merge BIF and SAIF raises other issues, such as the future of the thrift charter and other differences between banks and thrifts. Treasury is conducting a comprehensive study of these issues and expects to report to the House and Senate Banking Committees on the results of this study by the end of September 1995.

We believe the major provisions of the regulators' joint proposal fully address the three critical risks we identified in our March 1995 study. The one-time special assessment to capitalize SAIF to its designated reserve ratio would effectively eliminate the risks associated with a thinly capitalized fund and would provide SAIF with a sufficient capital cushion to ensure that it can effectively handle its resolution responsibilities. Additionally, by basing the special assessment on the level of assessable deposits held by FDIC-insured institutions as of March 31, 1995, the proposal eliminates the incentive for institutions to intentionally shrink their SAIF-insured deposits to reduce the cost of the special assessment.

The proposal to spread the FICO interest obligation among all FDIC-insured institutions, combined with the one-time capital infusion into SAIF to raise its reserves to their target level, effectively addresses the risks associated with a protracted period of significant premium rate differentials between BIF- and SAIF-member institutions,[7] and eliminates the risks associated with a shrinking deposit base. By requiring all FDIC-insured institutions to share the FICO obligation on a pro-rata basis, the proposal effectively eliminates the potential for a default on the FICO bond interest due to a shrinking SAIF deposit base. At the same time, it eliminates a key incentive for institutions to shift charters or otherwise shrink their SAIF deposits.

We also believe that the proposal to merge BIF and SAIF into one combined deposit insurance fund could effectively address the

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[7]However, a premium rate differential would continue to exist for the next 4 years between the weaker institutions exempt from paying the special assessment to capitalize SAIF on January 1, 1996, and all other FDIC-insured institutions.

longer term risks facing SAIF from the thrift industry. While the thrift industry as a whole is generally healthy today, its geographical concentration makes it and SAIF vulnerable to regional market fluctuations. Also, the industry's concentration on the housing sector of the economy hinders its ability to diversify risk and makes it vulnerable to downturns in the housing industry's business cycle. If BIF and SAIF were merged, the combined fund would have the risk diversification and stability that SAIF currently lacks. This would greatly minimize the risks that geographical and asset concentrations pose for the deposit insurance system.

The regulators' joint proposal contains several other provisions which, like the major provisions discussed above, would require legislation. These provisions include

-- authorizing FDIC to rebate assessments paid by BIF members to the extent that BIF's reserves exceed the designated reserve ratio;

-- authorizing FDIC's Board of Directors to manage the deposit insurance funds' reserves within a range between 0.1 percent above or below the designated reserve ratio to provide more stability in assessment rate-setting; and

-- lowering the minimum average assessment rate required when a deposit insurance fund is undercapitalized or when FDIC has outstanding borrowings from Treasury or the Federal Financing Bank (FFB) from 23 basis points to 8 basis points.

Giving FDIC authority to rebate BIF member premiums would, in effect, be reinstating authority FDIC had from 1950 through 1989. If such authority were granted once again, consideration should be given to ensuring that such funds will not be needed for future resolution or other insurance-related activities.

The regulators' proposal to reduce the minimum assessment rate to be charged to insured institutions when the deposit insurance funds fall below their designated capital levels or when FDIC has outstanding Treasury or FFB borrowings could reduce the impact of a substantial assessment rate increase in a given year on insured institutions, particularly if such a rate increase is not needed to make up the capital shortfall. Currently, FDIC is required to increase assessment rates to an average of 23 basis points if the reserves of the insurance funds fall below their designated reserve level. An increase in assessment rates at this level may be more than is needed to recapitalize the insurance funds.

We believe that the insurance funds should be fully capitalized and maintained at their designated reserve ratios, and that any capital deficiency should be made up as soon as possible. To avoid a situation in which a capital deficiency in the insurance funds triggers a rate increase greater than that needed to recapitalize the fund, FDIC's Board of Directors could be given the authority to set rates at a level sufficient to recapitalize the insurance funds within a designated time frame. Such authority would allow FDIC to consider the actual amount of funds needed to recapitalize the insurance funds and the ability of the industry to pay increased assessments.

FDIC and OTS also propose that any unused RTC funds be made available to cover extraordinary, unanticipated SAIF losses until BIF and SAIF are merged. Currently, FDIC projects SAIF losses from resolving troubled thrifts to be $270 million per year; the Congressional Budget Office projects losses of $450 million per year. FDIC and OTS propose that unused RTC funds be available to cover any SAIF losses exceeding $500 million in any calendar year during the period beginning July 1, 1995, and ending when the insurance funds are merged. Treasury does not support the use of RTC funds.

We recognize that using appropriated funds as a contingency mechanism is a highly sensitive issue in light of the billions of dollars in appropriated funds already spent in resolving the thrift industry crisis. In the RTC Completion Act, the Congress made unneeded RTC funds available to SAIF during the 2-year period beginning on the date of RTC's termination if FDIC certified that the RTC funds were needed to pay for SAIF losses and made other statutorily required certifications. Whether to now make RTC funds available to SAIF to cover any losses in excess of $500 million a year is ultimately a policy issue for the Congress to decide.

Finally, in their joint proposal, FDIC, OTS, and Treasury recognized that in proposing to merge BIF and SAIF, issues such as the future of the thrift charter and other distinctions between banks and thrifts should also be examined. As noted earlier, Treasury is studying these issues. However, the regulators have indicated that these issues are complex and may take considerable time to resolve. Consequently, they do not believe that resolution of these issues should delay action on the interagency proposal to deal with the more immediate concerns facing SAIF.

We concur that changes in the financial markets and the blurring distinction between banks and thrifts, coupled with the current and longer term risks facing SAIF and the alternatives to deal with these risks, would support a need for a comprehensive study on charter and related issues. However, we also concur with the regulators that addressing these issues will be a complex and time-consuming process. We therefore would agree with the regulators that the more immediate concern is to address the significant risks to SAIF associated with the pending premium rate disparity. In this context, the major provisions of the joint interagency proposal appear to adequately address these risks and would provide more stability to the deposit insurance system.

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