

GAO

**Briefing Report to Selected
Members of Congress**

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THRIFT INDUSTRY

**The Treasury/Federal
Home Loan Bank
Board Plan for FSLIC
Recapitalization**



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The Honorable Fernand J. St Germain
Chairman, Committee on Banking,
Finance and Urban Affairs
House of Representatives

The Honorable William Proxmire
Chairman, Committee on Banking,
Housing and Urban Affairs
United States Senate

This report discusses the need for a recapitalization of the Federal Savings and Loan Insurance Corporation (FSLIC). As you requested, we are providing you the results of our study on recapitalization and, more specifically, our analysis of the recapitalization plan first proposed jointly by the U.S. Treasury and the Federal Home Loan Bank Board (FHLBB) in mid-1986. FSLIC, which insures the safety of savings in thrifts and home-financing institutions and plays an important role in sustaining public confidence in the soundness of the U.S. financial system, is in urgent need of additional funds. At issue is FSLIC's ability to deal effectively with a backlog of troubled FSLIC-insured institutions.

In combination with problematic conditions in the thrift industry, FSLIC's current financial weakness is troubling. The Chairman of the Federal Home Loan Bank Board has stated that FSLIC's primary reserves have fallen below \$2 billion. Moreover, preliminary results of our audit of FSLIC's 1986 financial condition suggest that after necessary additions to the insurance fund's reserve for contingent liabilities, FSLIC may have a negative net worth of more than \$3 billion. Clearly, it will be extremely difficult, if not impossible, for the fund to handle the industry problems it faces under these conditions.

The thrift industry's 3,234 institutions have total assets of more than \$1.1 trillion and deposits exceeding \$900 billion. As of the third quarter of 1986, there were 445 operating thrift institutions that were

insolvent under generally accepted accounting principles (GAAP). These insolvent institutions held \$112.7 billion in assets and were losing money at the rate of over \$5 billion a year. The FHLBB has estimated the current cost to FSLIC of resolving already recognized problem institutions at \$23.5 billion.

Quick and decisive action is needed if FSLIC is to protect itself from even greater losses in the future. Unfortunately, the condition of FSLIC's reserves virtually precludes its taking any action at the present time. Against this background there has been much discussion in the industry, Congress, and the press about the need to strengthen FSLIC and to recapitalize the insurance fund.

The Treasury and FHLBB have presented to Congress a proposal that would provide approximately \$25 billion over 5 years for case resolutions by FSLIC--\$15 billion borrowed from the capital markets and about \$10 billion from various sources of FSLIC income. The borrowing would be done by a Financing Corporation (FC), funded by a \$3 billion contribution from the Federal Home Loan District Banks. This contribution would be used to purchase zero coupon bonds in amounts and maturities to guarantee repayment of the principal of the FC's borrowings. The debt service would be paid by all FSLIC-insured institutions through a dollar-for-dollar reallocation to the FC of their FSLIC insurance premium payments.

Officials at Treasury have said that two primary determinants of the recapitalization plan's structure were (1) the plan had to be financed by the industry and (2) there should be no effect on the federal budget deficit. Elimination of one or both of these two criteria would expand the financing options available to rescue FSLIC. For example, it would be simpler and less expensive if FSLIC were to borrow the needed funds directly from Treasury, and rely on industry financing to repay the loan through a combination of a \$3 billion contribution from the FHLBanks and a redirection of a portion of FSLIC's future income stream. Such a plan, however, would increase the budget deficit by \$15 billion as the money was spent to resolve FSLIC cases.

In this report, we examine the Treasury/FHLBB plan's ability to make available to FSLIC the full \$25 billion proposed. We also discuss some of the costs and benefits

of adopting this plan. In order to test the plan's feasibility, we developed a model that allowed us to simulate its operations under a variety of assumptions about conditions in the economy and the industry.

Our model suggests that the FC should be able to borrow the proposed \$15 billion, given reasonable assumptions about interest rates and, given an assumption that the industry does not deteriorate significantly over the plan's 5-year period. However, the full \$10 billion that is to be made available from FSLIC's normal receipts can only be achieved if there is income beyond that derived from regular insurance premiums and from investment income earned on the insurance fund's assets.

FSLIC expects to receive a substantial cash flow from the sale of assets acquired through the liquidation or merger of failed institutions. The Federal Asset Disposition Association (FADA) was created by FSLIC for the purpose of managing and disposing of these assets. However, if the cash flow from the sale of nonperforming assets does not materialize or if it is insufficient, it may be necessary to continue collecting all or part of the special insurance assessment currently paid by FSLIC-insured institutions in addition to their regular premium. With sufficient additional FSLIC income from either of these sources, the Treasury/FHLBB plan can provide the full \$25 billion for FSLIC case resolutions over the 5-year period.

Provision of a large sum of money in a fairly short period is the greatest advantage of the proposal. With these funds, FSLIC should be able to deal with many problem institutions that are now, of necessity, being ignored. By doing so, FSLIC should reduce future costs, both for the industry and for the insurance fund.

The recapitalization proposal does, however, have a major cost attached. The true measure of this cost may not be in money terms, but in reduced flexibility for FSLIC in the years after the 5-year plan is completed. By borrowing a large sum of money for the resolution of current problems, the plan capitalizes FSLIC's future income stream in much the same way that an individual can capitalize his future earnings in order to get enough money now to buy a house.

Borrowing now, however, means less money will be available later for FSLIC needs. In fact, several of our simulations show that virtually all regular premium

income will be needed to pay the debt service on the FC's borrowings by the end of the 5-year plan and for some years beyond. This suggests that after the \$25 billion has been spent, FSLIC's ability to deal with problems that have not yet surfaced or, indeed, with those currently identified if their resolution costs are understated, will be severely constrained. We do not, in this report, address the question of whether \$25 billion is enough to solve the problems facing FSLIC. The recapitalization plan will not, however, leave FSLIC with many resources to meet additional demands once the \$25 billion has been spent.

We have performed financial audits of FSLIC, conducted evaluations of the financial condition of the industry, and studied the implications for market structure and risk of the deregulation of depository institutions for a number of years. On the basis of that work we would like to offer the following observations on actions that need to be considered in conjunction with recapitalizing FSLIC to better assure that the problems of the past do not repeat themselves.

First, we believe that the Treasury/FHLBB plan as presented does not include sufficient oversight by Congress. Any plan for FSLIC recapitalization finally accepted by Congress should include provisions for oversight of both the plans and the actions of the FHLBB and the FSLIC to ensure that the funds are being effectively and appropriately spent.

Furthermore, to better ensure that problems similar to those now existing in the industry and FSLIC do not recur in the future, close examination and supervision is essential to detect and control as early as possible both fraud and regulatory noncompliance. In this regard, it may also be helpful to reexamine the Bank Board's regulations to ensure that speculative and risky activities not appropriate or desirable for institutions with federal deposit insurance are prohibited. Moreover, as the backlog of FSLIC problems is reduced, it may be advisable to reexamine the policy determining when FSLIC action should be initiated to close problem institutions. To the extent that institutions engage in excessively risky activities because they are insolvent and have nothing to lose, earlier FSLIC actions may reduce the incidence of such behavior and the resulting cost to the insurance fund.

Most of the thrifts now receiving FSLIC attention have serious asset quality problems. To a large extent, these bad assets are likely to be the end result of risky and speculative actions by the failing institutions. What is unclear from the evidence available to us is the sequence of the relationship between the firm's activities and its financial condition. That is, we do not know if the thrifts became insolvent and then engaged in high risk activities in an attempt to return to profitability and positive net worth, or whether healthy institutions engaged in risky activities and the losers became insolvent. It may be that both situations are occurring simultaneously in the industry. While the policy prescriptions for these two scenarios are quite different, the regulatory actions suggested above would work to control both.

The Treasury and the Bank Board have seen this report, although at the request of the Chairman of the House Committee on Banking, Finance and Urban Affairs we did not obtain their official comments in order that the report could be made available more quickly. Neither Treasury nor the Bank Board had any substantive disagreements with the report.

Copies of this report will be distributed to interested parties. Any questions you may have can be addressed to me at (202) 275-6059 or Craig Simmons at (202) 275-8678.

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ABBREVIATIONS

CBO	Congressional Budget Office
FADA	Federal Asset Disposition Association
FC	Financing Corporation
FDIC	Federal Deposit Insurance Corporation
FHLBank	Federal Home Loan Bank
FHLBB	Federal Home Loan Bank Board
FSLIC	Federal Savings and Loan Insurance Corporation
MCP	Management Consignment Program
OMB	Office of Management and Budget

THE FSLIC RECAPITALIZATION PLAN

In mid-1986 the Federal Home Loan Bank Board (FHLBB) and the U.S. Treasury presented a plan to Congress that was designed to provide additional reserves to the Federal Savings and Loan Insurance Corporation (FSLIC). This has come to be known as FSLIC recapitalization. The Bank Board has estimated that FSLIC needs \$23.5 billion or more in order to deal with the known problems in the thrift industry. In testimony before the House Banking Committee on January 21, 1987, the Chairman of the FHLBB (Testimony, House Banking Committee, 1/21/87) indicated that the primary reserves of the insurance fund were only \$1.9 billion at that time.

The Treasury/FHLBB plan passed both houses of Congress last year in two somewhat different versions but was not adopted into law because of controversial and unrelated amendments. It was resubmitted in the 1987 session, and hearings on the issue are continuing in the House and Senate Banking Committees.

The proposed recapitalization plan attempts to satisfy several objectives. Primarily:

- the plan is to be industry financed, requiring no additional federal contribution, i.e., from the Treasury,
- FSLIC expenditures from the recapitalized fund are not to contribute to an increase in the federal budget deficit, and
- the plan needs to raise sufficient funds to deal with the known industry problems.

FSLIC recapitalization attempts to satisfy these objectives by combining FSLIC income from insurance premiums and investments, substantial contributions of money from the Federal Home Loan Banks (FHLBanks), and long-term borrowing in the capital markets in order to raise \$25 to \$30 billion over 5 years. In effect, the plan is designed to capitalize FSLIC's future earnings stream, providing funds needed now that will enable FSLIC to deal quickly with the most immediate problems in the industry, thereby arresting its exposure to future losses from its covered caseload.

OBJECTIVES, SCOPE, AND METHODOLOGY

The Treasury/FHLBB plan does appear to satisfy the first two objectives, requiring no public funds and being neutral in its budget effect. Our primary focus in this report, therefore, is on whether the plan can realistically provide as much money as it proposes. We do not here address the question of whether \$25 billion is a reasonable estimate of what is needed to deal with the industry's problem. However, on the basis of our previous

work and our knowledge of the condition of the industry, we do not believe that \$25 billion overstates the extent of the problem facing FSLIC.

Our objective was to examine the FSLIC recapitalization plan and to test its ability to raise the contemplated \$25 billion over 5 years for the insurance fund. We used a computer simulation model to test the sensitivity of the plan to changes in economic assumptions about interest rates, the growth of insured deposits and the availability of additional sources of income to FSLIC. Alternative scenarios were tested individually and in various combinations to evaluate the conditions under which the recapitalization plan could be expected to work. (A detailed discussion of the simulations and their results is presented in app. III.)

Information used in our analysis was collected from a number of sources. Data on the condition of the industry in the third quarter of 1986 were extracted from our data base of industry financial statements. These data are provided to us by the Bank Board from quarterly reports filed by thrift institutions with the FHLBB. We have not verified the data provided by the Bank Board. Any errors that may have occurred in the preparation of the financial statements or their transcription to computerized data files have not been corrected by us. We have discussed the recapitalization plan and the condition of the industry with officials at the Treasury, FHLBB, and FSLIC.

THE MECHANISM OF FSLIC RECAPITALIZATION

Crucial to the workings of the recapitalization plan is the Financing Corporation (FC). The FC would be created by the legislation to act as the intermediary between the Federal Home Loan Banks and FSLIC, and between the capital markets and the FSLIC-insured thrifts.

The FHLBanks' contribution to recapitalization

As proposed in the legislation, FSLIC recapitalization begins with a contribution by the Federal Home Loan Banks to the FC of up to \$3 billion over a 5-year period. This money would be taken from the legal reserve of the FHLBanks, with each Bank contributing approximately its pro rata share based on the total volume of industry deposits held by the FSLIC-insured members in its district.

Most of the reserves of the FHLBank system are comprised of the paid-in stock of the member institutions. The Banks are required, in addition, to set aside 20 percent of each year's net income in a legal reserve. The FHLBank contribution to the FC is to be taken only from the accumulated funds in the legal reserve.

At the end of 1986, FHLBank funds available for contribution from the legal reserve to the FC totaled about \$2.2 billion, up from \$1.8 billion at the end of 1985. The Treasury and the Bank Board believe that the FHLBanks could relinquish these funds, together with future retained earnings up to a total of \$3 billion, without prejudicing the stability of the FHLBank system. As a result, they believe that contributing to the FC would not raise the costs associated with the FHLBanks' regular borrowing activity.

The FC will then borrow up to \$15 billion by selling long-term bonds with maturities of 20 to 30 years. These borrowings are also to take place over 5 years with approximately equal amounts to be borrowed each year. The proceeds will be given to FSLIC to use for resolving problem institutions in the industry. In return, FSLIC will give the FC up to \$3 billion in non-voting capital stock (equal to the FHLBanks' contribution to the FC) together with non-redeemable capital certificates in exchange for the remainder of the funds received.

Over 5 years, initial cash transfers involved in the plan to provide additional money for FSLIC can be summarized as follows:

<u>FHLBanks</u>	<u>Financing Corp.</u>	<u>FSLIC</u>
-3 billion to FC	+\$3 billion from FHLBanks	+\$15 billion from FC
	+\$15 billion from borrowing	
	-\$15 billion to FSLIC	

As a result, FSLIC will have over the next 5 years \$15 billion in funds that were not previously available to use for case resolutions. At the same time, the FC has \$3 billion left from its total cash inflow of \$18 billion. This \$3 billion is an important element in the repayment mechanism, as will be discussed later in this appendix.

The FSLIC contribution to recapitalization

Under the recapitalization plan as proposed, FSLIC would receive an average of \$3 billion per year for 5 years from the FC. Both FHLBB and Treasury say that the plan can provide up to \$25 billion or more for FSLIC case resolution. The additional \$10 billion, or \$2 billion per year for 5 years, is to come from FSLIC income. There are three primary sources of income to

FSLIC--insurance premiums assessed on insured institutions,¹ investment income from earning assets held as reserves, and revenues realized from the sale of nonperforming assets acquired through the merger or liquidation of failed institutions.

FSLIC is authorized to charge a regular insurance premium equal to one-twelfth of 1 percent of the deposits of insured institutions. In addition to the regular premium, FSLIC can also charge special premiums which may not exceed one-eighth of 1 percent of total deposits in any year. Such special assessments have been levied for the last 2 years. Part of the recapitalization plan presented last year to Congress would involve a phase-out of the special assessment over a 5-year period from 1988 through 1992, unless the Bank Board determines that severe pressures on FSLIC necessitate its continuation.

FSLIC also earns investment income on its reserves. At the end of 1986, FSLIC had about \$3.8 billion in earning assets. This amount was, however, down from \$6.1 billion at the end of 1985. Given the need for FSLIC to maintain liquidity and avoid risk, these assets can be expected to earn at rates comparable to those on short-term Treasury securities.

Finally, FSLIC should realize some cash flow from the sale of nonperforming assets acquired through the liquidation and merger of failed institutions. At the end of 1986, FSLIC held claims against assets held in receiverships totaling about \$12 billion. Currently, it is estimated that only about \$5 billion, or 42 percent, will ultimately be collected.

Hoping to improve on this performance, the Bank Board, in November 1985, chartered a wholly-owned association under section 406 of the National Housing Act for the purpose of managing and, ultimately, disposing of nonperforming assets held in FSLIC receiverships. This organization, known as the Federal Asset Disposition Association (FADA), was capitalized by FSLIC with \$25 million and by the end of 1986 was responsible for managing approximately \$3 billion in nonperforming assets. Money realized from the sale of acquired assets could provide an important future source of cash for the FSLIC fund. However, the actual level of expected receipts from asset realizations is difficult to predict.

¹The actual amount of income FSLIC will receive from premiums depends on the FC's debt service payments that are to be deducted from premium income and on the growth rate of insured deposits. If deposits don't grow, for example, because healthy institutions convert to FDIC insurance, then FSLIC's future premium income will not grow.

Repayment

It is expected that the extra \$3 billion held by the FC above its contribution to FSLIC will provide the basis for the repayment of the FC's debt, as well as the necessary security to enable the FC to borrow at low rates in the capital markets. As the FC borrows, it will use the extra money to purchase zero coupon bonds in maturities matching those of its borrowings, and in denominations such that at maturity the face value plus accrued interest will exactly pay off the total principal due on the debt. At present, it is envisioned that up to \$2.2 billion of the FHLBanks' contribution will be spent in this fashion. Thus, the FC's repayment of principal is guaranteed by the matching zero coupon bond purchased at the same time the money is borrowed. This repayment of principal would be the responsibility of the FC and would not be insured by FSLIC or the Bank Board. The legislation as proposed states that neither the principal amount nor the interest costs on the FC's obligations would be backed by the full faith and credit of the United States Government.

The debt service, or interest, on the FC's borrowing was originally intended to be paid by FSLIC out of its premium income. The Congressional Budget Office (CBO) pointed out that this arrangement would result in budget outlays. Therefore, a provision was added to the legislative proposal that, in effect, permits FSLIC-insured institutions to pay part or all of their premiums directly to the FC. The institutions' premiums and any special assessments that would regularly be paid to FSLIC are reduced dollar-for-dollar by the increased debt service requirements of the FC. Moreover, the \$800 million that remains from the original \$3 billion contribution by the FHLBanks is intended as a cushion to be used for debt service or other related costs of the FC.²

As envisioned in the Treasury/FHLBB proposal, both the principal and interest on the FC's debt would be paid with no explicit or implied guarantee from either FSLIC or the U.S. Treasury. However, as noted above, up to 100 percent of FSLIC's insurance premium income could be diverted to pay interest on the FC's debt until the principal is repaid, somewhere around 2020. Such diversion of premium income, however, means that FSLIC would have little income for case resolutions after the \$25 billion raised through the 5-year recapitalization plan is spent.

²The \$800 million could also become available to leverage additional borrowing by the FC if permitted by legislation, possibly increasing the potential borrowing above \$15 billion. This would, however, also increase the debt servicing burden and further reduce FSLIC's future stream of income.

When the entire FC debt is paid off, FSLIC may retire its outstanding capital stock together with a return on that stock, if the condition of the FSLIC insurance fund permits. In other words, repayment of the original \$3 billion provided by the FHLBanks to the FC would occur only after all other debt was paid off and only if the reserve-to-deposit ratio of the insurance fund was adequate. It is possible that this money would never be repaid to the FHLBanks.

AN ANALYSIS OF THE TREASURY/FHLBB
PROPOSAL TO RECAPITALIZE FSLIC

There is an urgent need to provide additional funds to FSLIC in order to deal with the current backlog of problem institutions. For several years the Federal Home Loan Bank Board, which operates FSLIC, has delayed finding merger partners or liquidating institutions with capital adequacy problems. Instead, FSLIC has relaxed accounting standards, engaged in implicit forbearance on capital requirements, provided artificial forms of regulatory capital, and operated institutions under the Management Consignment Program (MCP).¹

Despite these efforts, the number of institutions with serious problems, which we have defined as having GAAP net worth equal to or less than zero, increased sharply from only 16 in December 1980 to 461 thrifts holding \$112.6 billion in assets in mid-1985. By September 1986 there were still 445 insolvent thrifts with \$112.7 billion in assets operating under the FSLIC insurance guarantee. These insolvent thrifts had an average (annualized) return on assets of -5.0 percent in the third quarter of 1986. They comprised 13.8 percent of the industry and held 10.1 percent of the industry's assets.

In recent testimony before the Senate Committee on Banking, Housing and Urban Affairs, on January 21, 1987, (p. 3), the Chairman of the FHLBB estimated the cost of resolving the industry's known problems at \$23.5 billion. At that time 347 institutions were included in the "significant supervisory caseload" and 167 of these thrifts were FSLIC cases.² Moreover, these 347 institutions were losing \$6 million a day or \$2.2 billion a year. This amount, as the Chairman pointed out, is larger than the entire 1986 income to FSLIC.

THE COST OF DELAY

The size of the problems facing FSLIC ensures that case resolutions will have to be accomplished over time rather than all at once. Even if enough money were available to handle all

¹MCPs are institutions for which FSLIC has hired new contract managers after removing the original management.

²Those institutions included in the "significant supervisory caseload" are receiving extraordinary attention from the examination and supervisory staff in the District Banks. FSLIC cases are those whose problems are so severe that the insurance corporation is attempting to find a resolution, either a merger partner or a liquidation.

problems at once, other resources, such as staff, limit the speed at which FSLIC could proceed. The risk is that delay, even necessary delay, could lead to an increase in FSLIC's ultimate resolution cost. Our earlier work showed the potential for FSLIC savings due to reductions in interest rates and also pointed out the large potential costs that could result from the effect of rising rates and declining loan values (GAO/GGD-86-122BR).

FSLIC's resolution costs may rise for other reasons, such as bad management or fraud and the resulting increase in bad assets. Some losses in a failing thrift will have already occurred, even though they may not yet be recognized on the books. Other losses may be unavoidable given the structure and composition of the failing institution's balance sheet. These losses will not be averted by FSLIC action. They will affect the receivership just as they would have affected the operating thrift. What FSLIC action can end is the continuation of incompetent or fraudulent management and resulting future losses for the institution. This can be accomplished through the sale of the thrift to a healthy institution that will replace the management or through the establishment of a receivership. The elimination of bad management may, in fact, be the major reason that prompt action by FSLIC can lead to cost savings for the insurance fund.

The Bank Board has said that the majority of current cases requiring FSLIC action result from asset quality problems rather than from the interest-rate spread problems of the early 1980's. Asset quality problems are potentially much more costly to the insurance fund than are spread problems. A thrift with a negative interest-rate spread, i.e., its cost of funds exceeds the average return on its loans, can continue in operation for a substantial period while experiencing only a gradual erosion of its regulatory capital or net worth. This is because institutions are not required by regulators to use market values for the assets in their portfolios. To be sure, if forced to sell assets during an inflationary period, a thrift would experience large, immediate losses potentially affecting its entire portfolio. Nevertheless, with an appropriate discount to reflect the inflationary adjustment, the assets are still marketable.

The long-term severity of spread problems is mitigated by their inherently cyclical nature. Problems traceable to rising inflation and interest rates are diminished with reductions in these same inflation and interest rates. Also, spread problems do not necessarily mean that problems exist with either the repayment capacity of the borrower or with the collateral on the loan. This is the primary justification for FSLIC's provision of forbearance to institutions with spread problems, as was the case in the thrift industry of the early 1980's.

Problems with asset quality can be much more difficult to deal with than those associated with interest rate risk and negative spreads. A single large asset that goes bad can immediately wipe out an institution's entire net worth with little or no warning outside the firm. When an asset goes bad, the income from debt service payments may cease and realizations from liquidation of the underlying collateral may yield far less than 100 cents on the dollar. Moreover, in contrast to spread problems' improvement with falling inflation, there is much less likelihood of recovery from asset quality problems. We are told by officials at FSLIC and the Bank Board that, in general, problems of asset quality are both less predictable and more costly to the insurance fund than are spread problems. Forebearance, or delay, is much less likely to be helpful to an institution with credit risk and bad assets.

Spread problems are not necessarily a thing of the past. While there is, at present, no indication of rising interest rates in the near future, the thrift industry is nevertheless becoming increasingly exposed to potential losses when interest rates do eventually rise. Today's low interest rate environment has led many thrifts to substantially increase their origination of relatively low-yield, fixed-rate mortgages, both for new loans and refinancings. Adjustable rate mortgages as a percentage of conventional home mortgages closed have fallen from a peak of 73 percent in mid-1984 to about 30 percent in mid-1986. Some of these fixed-rate mortgages are being packaged for resale as mortgage-backed securities in the secondary market rather than held in the thrift's portfolios. Nevertheless, a rise in interest rates would cause many institutions with increasing holdings of these fixed-rate mortgages to encounter problems similar to those experienced a few years ago. This time, however, the industry does not have the net worth that allowed many firms to weather the last increase in interest rates. Industry net worth (GAAP) as a percent of assets was only 3.4 percent in June 1986, as compared with 5.73 percent in mid-1978.

Finally, delay has two other immediate and obvious costs. Every dollar of continuing losses by an insolvent thrift represents an additional cost to FSLIC when the institution is finally resolved. Moreover, the FHLBB has said that insolvent thrifts are offering higher than market rates in order to attract deposits, thus bidding up rates, not only for themselves, but for the healthier institutions as well. This raises the cost of funds for the whole industry and results in slimmer profit margins (or larger losses) for all institutions.

THE TREASURY/FHLBB RECAPITALIZATION PROPOSAL

The joint Treasury/FHLBB proposal to recapitalize FSLIC has the virtue of providing a large sum of money to FSLIC over a

fairly short period of time. Given the extent of the industry's problems and the risks of delay, we feel that the capitalization of future FSLIC earnings is necessary. We therefore modeled the proposed recapitalization plan to see if it could achieve its stated objectives. Success was defined as the ability to provide \$25 billion for FSLIC case resolutions over a 5-year period without reducing FSLIC's earning assets to zero.

Of the \$25 billion, \$15 billion (or \$3 billion a year) is to be raised by selling bonds through the FC. The remaining \$10 billion (or \$2 billion per year) is to be derived from other sources of FSLIC income. FSLIC's sources of income are:

- regular premium income (1/12 of 1 percent of insured deposits),
- special premium income (1/8 of 1 percent of insured deposits),
- investment income derived from the earning assets held by FSLIC, and
- cash flow from the disposition of assets acquired by FSLIC through the liquidation or merger of failed thrifts.

Details on the various alternative scenarios that we simulated in modeling the recapitalization plan are found in appendix III. Briefly, we tested the sensitivity of the model to different assumptions about the levels of interest rates and spreads and to alternative rates of deposit growth. We also varied the dollar amounts received by FSLIC from the sale of distressed assets acquired through case resolutions, and the future availability of income from the special premium assessment. The successful simulations were then examined under different assumptions about changes in the level of interest rates (i.e., increasing or decreasing) over time.

Several conclusions can be drawn from the simulations that we performed.

- The FSLIC recapitalization plan is relatively unaffected by variations in the economic environment.
- With reasonable assumptions about the interest rates that would prevail on the FC borrowings and on the zero coupon bonds that are to be purchased, there should be little difficulty in raising the \$15 billion dollars to be contributed by the FC.
- The appropriate use of zero coupon bonds ensures the repayment of principal on the FC's borrowings.

--The debt service on the FC's borrowing would absorb essentially 100 percent or more of the FSLIC's premium income for several years unless the special assessment were to be continued.

--Income to FSLIC from insurance premiums and from investing its earning assets is not sufficient to provide the full \$10 billion that is FSLIC's share of the recapitalization plan. The shortfall might possibly be made up by receipts from the sale of assets acquired by FSLIC or by a continuation of all or part of the special assessment.

--Even under most of the "successful" scenarios, the earning assets of the FSLIC fund are small during years 6 through 10.

In other words, the FSLIC recapitalization plan will provide \$15 billion over 5 years to the insurance fund from borrowing, and an additional \$10 billion can be made available from FSLIC income. However, the full \$10 billion will be there only if sufficient extra income, either from the sale of acquired assets or from the continuation of all or part of the special assessment, is forthcoming. Even if enough extra income is not generated, the plan will still provide a substantial amount of money to FSLIC--in excess of \$21 to \$24 billion over the 5-year period. The major drawback of the plan is the diversion of virtually all regular future insurance premium income to pay debt service, which will seriously reduce the ability of FSLIC to address future problems.

CONCLUSIONS

There is a serious need for additional money to be used by FSLIC for the purpose of resolving the large backlog of insolvent and unprofitable institutions that continue to operate in the thrift industry. While the exact size of the problem and, more importantly, the exact cost of dealing with the problem cannot be known with certainty, the Bank Board's estimate in January of this year of the cost to resolve the known problems was \$23.5 billion or more.

Our simulations show that the Treasury/FHLBB proposal can raise \$25 billion over 5 years as long as the flow of income to FSLIC is augmented either by continuing the special premium assessment or by receipts from the sale of assets acquired through the liquidation process. However, if the proposal is implemented, it is probable that virtually all of FSLIC's regular premium income will be diverted to pay the debt service for several years. As a result, assuming that all \$25 billion is spent in the next 5 years, there may not be much available to deal with later problems.

Some specific issues should be dealt with in setting up a FSLIC recapitalization plan.

--Congressional review and oversight of the plans and actions of the Bank Board and FSLIC should be included in the legislation. Oversight should be designed to seek answers to questions regarding FSLIC's plans for use of the proceeds from recapitalization as well as how successful the problem resolution process is.

--Provision for some control mechanism in the event that the oversight process results in negative findings.

Finally, unless Congress comes to grips with the causes of the industry's current problems, there is every likelihood that they will continue to occur in the future. If the causes are not effectively dealt with now, the \$25 billion to be raised under the FSLIC recapitalization may solve today's crises but will provide nothing to resolve tomorrow's. Therefore, the deliberations over FSLIC recapitalization provide the opportunity to require the FHLBB and FSLIC to reorganize and streamline their operations and regulatory structure with the intent of reducing the likelihood of future industrywide problems such as those now occurring.

ASSUMPTIONS AND SIMULATION RESULTS OF
THE FSLIC RECAPITALIZATION MODEL

We developed a model of the FSLIC recapitalization proposal in order to test the effect of variations in the proposal as well as the effect of changes in various economic assumptions. The assumptions used to model the plan as it has been outlined by the Treasury and the Federal Home Loan Bank Board (what we term the "base model") are given below, along with a description of those assumptions that were allowed to vary. Use of the model allowed us to investigate the conditions under which the plan may or may not be successful.

ASSUMPTIONS OF THE BASE MODEL

The following assumptions were used in developing the base model.

--The Financing Corporation raises \$3 billion a year for each of the 5 years of the plan by issuing fixed-rate 30-year bonds.¹ It uses as leverage the retained earnings of the Federal Home Loan Banks in the amount of \$440 million each year (a total of \$2.2 billion over 5 years). With these funds it purchases zero coupon bonds whose maturities and

¹In our simulations we assumed that all borrowings of the FC were accomplished by issuing 30-year bonds. The Treasury/FHLBB proposal actually calls for an unspecified mix of 20- and 30-year bonds. We used the longer-term issue rather than make an assumption about the mix for several reasons. Most importantly, the market is much stronger for 30-year bonds than for 20's. The Treasury/FHLBB proposal creates a new untried debt security that would have greater acceptance in the stronger market. In any case, for a given amount of borrowing, the annual interest cost is likely to be about the same for either borrowing term. The major differences are that with 30-year bonds it is possible to borrow a larger total based on a given amount of initial capital and, of course, the financing costs continue for an additional 10 years.

principal match those of the FC's own debt and whose proceeds will be used to repay this debt upon maturity.²

- Up to \$800 million (in addition to the \$2.2 billion) in funds are to be made available by the FHLBanks over the 5-year period. It has been suggested that these funds provide a "cushion" to be used for debt service or other costs of the FC.
- Interest payments on the FC's debt will be met through the direct payment to the FC of insurance premium assessments from member institutions which normally would have gone to FSLIC. Any premium payments in excess of this interest obligation will be channeled back to FSLIC.
- The interest rate at which the FC issues its debt is 50 basis points higher than the 30-year Treasury bond rate. The base Treasury rate is 7.3 percent.
- In addition to the \$15 billion from borrowing, FSLIC will make an additional \$2 billion per year available for case resolutions in each of the 5 years of the plan. This money is to be derived from premium income (net of debt service on the FC's borrowings), investment income on earning assets, and income from the sale of assets acquired through case resolution (assumed to be zero in the base model). If these sources of income total less than \$2 billion in a year, the shortfall is deducted from the earning assets of the insurance fund until those assets are depleted.
- FSLIC earns at the Treasury bill rate on its earning assets. In the base model this rate is 5.5 percent.
- The special assessment (1/8 of 1 percent of deposits) which is currently paid by member institutions to FSLIC will be subject to a straight-line phase-out over a 5-year period beginning in 1988.

²The model assumes that the entire \$2.2 billion in funds from the Federal Home Loan Banks is fully used for purchase of the zero coupon bonds used to repay \$15 billion in FC debt (a leveraging ratio of 6.8 to 1). At current market rates for 30-year bonds, however, these funds could be leveraged by as much as 10 to 1. Thus, only \$1.5 needs to be used to buy zero coupon bonds to repay \$15 billion in 30 years. Therefore, \$700 million of additional funds would be available for use by the FC or by FSLIC.

- The growth rate of insured deposits for the industry as a whole is assumed to be 8 percent per year, i.e., the average annual growth rate observed between 1984 and 1985.
- In the base model, interest rates are assumed to remain constant throughout the period under consideration.
- Our simulations cover a period of 10 years.

SIMULATION RESULTS

The model was run using the base model assumptions as well as various scenarios in which one or more of the base model assumptions were changed. In each of these initial simulations the level of interest rates was held constant over time. As the plan calls for raising \$25 to \$30 billion over 5 years, any case in which \$25 billion could be raised without causing FSLIC earning assets to be fully depleted is termed a success. This means that although FSLIC income in any one year may be insufficient to provide the necessary \$2 billion yearly contribution to the fund, earning assets may be tapped to make up the deficiency. Only if earning assets are completely depleted from their initial level of \$3.8 billion at the beginning of 1987 is the plan said to be unsuccessful.

Base model

According to this criterion, the base model described above was unsuccessful. Without receipts from the sale of assets acquired through case resolutions or from retention of the special premium, FSLIC's \$3.8 billion in earning assets were fully depleted before the total \$25 billion was made available. In other words, the income received by FSLIC over 5 years was inadequate, even when supplemented by \$3.8 billion from the insurance fund's earning assets, to provide \$10 billion for case resolutions.

The model was simulated using many variations on the base assumptions. Some of the different assumptions used include:

- varying the FC's cost of borrowing from 50 basis points above the Treasury bond rate to 150 basis points,
- increasing the rate earned on FSLIC's assets by 100 basis points, and
- lowering the rate of deposit growth at insured institutions from 8 percent per year to 6 percent.

In each of these cases, FSLIC was unable to generate enough income to provide its \$10 billion share of the money for recapitalization before its earning assets went to zero.³

Successful simulations

Of all cases investigated, three were found where success was attained in a constant interest rate environment. In these simulations the plan succeeded by:

- allowing the special assessment to remain in place indefinitely,
- allowing the special assessment to remain fully in place for 6 years and then eliminating it, or
- including in FSLIC's income receipts from the sale of acquired assets.

For the last case, we used the projections of FSLIC's asset realization income provided to us by the FHLBB.

Each of these successful cases was examined under three additional scenarios to see if changing the level of interest rates over time would cause the plan to fail. The three interest rate scenarios were:

- gradually rising interest rates,
- gradually falling interest rates,⁴ and
- explosively rising interest rates.

³In most cases the deficiency was less than \$1 billion. However, it should be noted that our model considered the insurance fund to be bankrupt when earning assets fell to zero. This assumes that all earning assets could be used for case resolution, ignoring the fact that FSLIC has other liabilities. According to recent testimony by the Chairman of the FHLBB, the primary reserves of the FSLIC insurance fund, i.e., the amount actually available for case resolutions, was not \$3.8 billion, but only \$1.9 billion.

⁴Under the base case in this declining interest scenario the plan was able to succeed without the retention of the special assessment or without income from asset realization in the amount projected. In table III.3 it can be seen that earning assets, although totaling only \$100 million after 5 years, do remain at a positive level and so meet the criterion for success of the plan.

Table III.1 shows the successful simulations under constant interest rates. Tables III.2 through III.4 outline the results of our simulations under the three different assumptions about changing levels of future interest rates. For comparison, the base model is also included in each interest rate scenario.

In each case, the maximum yearly interest obligation on the FC's debt that is to be paid out of premium income is reported along with the year in which the maximum occurred and the percent of total premium income which is devoted to the payment of interest in that year. Also reported for each case is the amount of total FSLIC earning assets after the first 5 years of the plan. This value is negative if the plan is not successful. That is, it shows the shortfall, or the amount still needed for the plan to have raised \$25 billion even after all earning assets were depleted.

Earning assets after 10 years are also reported in order to gauge the state of the FSLIC fund at some future point after the end of the recapitalization program. This value is calculated by assuming all \$25 billion raised by the program is spent on case resolution within the first 5 years of the program and that no further FSLIC outlays occur thereafter, apart from interest payments on the FC debt. Lastly, the years in which FSLIC net income is negative are listed. These are the years in which some portion of FSLIC earning assets must be expended in order for FSLIC to meet the requirement of contributing \$2 billion each year to reach the \$25 billion total.

The three successful cases were further analyzed by testing the effect of a smaller deposit growth rate than had been assumed in the base model. Tables III.5 and III.6 report the results of experiments in which the deposit growth rate is decreased to 4 percent assuming constant and increasing interest rates respectively. Although in each case a larger amount of earning assets must be used in order to meet the criterion of a total recapitalization of \$25 billion, the basic results are unchanged. The three cases which were found to be successful previously remain successful even under the assumption of a 4 percent deposit growth rate.

TABLE III.1

Simulation Results Under
Constant Interest Rates

	<u>Maximum Yearly Interest Obligation</u>			<u>FSLIC Earning Assets After 5 Years</u>	<u>FSLIC Earning Assets After 10 Years</u>	<u>Years FSLIC Net Income is Negative</u>
	<u>(Billions \$)</u>	<u>As Percent of Premium</u>	<u>Year Max. Occurs</u>	<u>(Billions \$)</u>	<u>(Billions \$)</u>	
1. Base Model ^a	1.2	96%	7	-.1 ^b	1.1	1 - 5
2. Special Assessment Remains Throughout	1.2	44	5	2.5	15.1	1 - 5
3. Special Assessment Remains 6 years	1.2	96	7	2.5	6.16	1 - 5
4. Asset Realization Income from FADAC ^c	1.2	96	7	3.48	12.58	1 - 3, 5

Notes: ^aThe base model assumptions are:

- Interest rates are constant over the 10 year period under simulation.
- The initial levels of interest rates are Treasury bonds = 7.3 percent, and Treasury bills = 5.5 percent.
- The cost of borrowing for the FC is 50 basis points over Treasury bonds.
- The interest rate earned on the earning assets of the FSLIC is equal to the Treasury bill rate.
- The rate paid on the zero-coupon bonds purchased by the FC is 8.03 percent.
- The rate of growth of insured deposits in the industry is 8 percent per year.
- The special assessment is phased out over 5 years.
- There is no income to FSLIC from the sale of assets acquired through case resolutions.

^bEarnings assets go to zero in year six.

^cThe estimates of asset realization income are provided by the FHLBB.

TABLE III.2

Simulation Results Under
Increasing Interest Rates

	<u>Maximum Yearly Interest Obligation</u>			<u>FSLIC Earning Assets After 5 Years</u>	<u>FSLIC Earning Assets After 10 Years</u>	<u>Years FSLIC Net Income is Negative</u>
	<u>(Billions \$)</u>	<u>As Percent of Premium</u>	<u>Year Max. Occurs</u>	<u>(Billions \$)</u>	<u>(Billions \$)</u>	
1. Base Model ^a	1.3	105%	7	-.2 ^b	.3	1 - 5, 7
2. Special Assessment Remains Throughout	1.3	48	5	2.4	14.8*	1 - 5
3. Special Assessment Remains 6 years	1.3	105	7	2.4	5.6	1 - 5
4. Asset Realization Income from FADA	1.3	105	7	3.38	12.3	1 - 5

Notes: ^aThe base model assumptions in this table are the same as for table IV.1, except that interest rates are as assumed to rise by 50 basis points a years in years 2 and 3 of the plan. Thereafter they remain constant.

^bEarnings assets go to zero in year six.

TABLE III.3

Simulation Results Under
Decreasing Interest Rates

	<u>Maximum Yearly Interest Obligation</u>			<u>FSLIC Earning Assets After 5 Years</u>	<u>FSLIC Earning Assets After 10 Years</u>	<u>Years FSLIC Net Income is Negative</u>
	<u>(Billions \$)</u>	<u>As Percent of Premium</u>	<u>Year Max. Occurs</u>	<u>(Billions \$)</u>	<u>(Billions \$)</u>	
1. Base Model ^a	1.1	87%	7	.1 ^b	1.8	1 - 5
2. Special Assessment Remains Throughout	1.1	40	5	2.6	15.80	1 - 5
3. Special Assessment Remains 6 years	1.1	87	7	2.6	6.60	1 - 5
4. Asset Realization Income from FADA	1.1	87	7	3.6	12.90	1 - 3

Notes: ^aThe base model assumptions in this table are the same as for table IV.1, except that interest rates are assumed to fall by 50 basis points a year in years 2 and 3 of the plan. Thereafter they remain constant.

^bEarnings assets go to zero in year six.

TABLE III.4

Simulation Results Under
Explosive Interest Rates

	<u>Maximum Yearly Interest Obligation</u>			<u>FSLIC Earning Assets After 5 Years</u>	<u>FSLIC Earning Assets After 10 Years</u>	<u>Years FSLIC Net Income is Negative</u>
	<u>(Billions \$)</u>	<u>As Percent of Premium</u>	<u>Year Max. Occurs</u>	<u>(Billions \$)</u>	<u>(Billions \$)</u>	
1. Base Model ^a	1.5	122%	7	-.4 ^b	-.9	1 - 9
2. Special Assessment Remains Throughout	1.5	56	5	2.3	14.8	1 - 5
3. Special Assessment Remains 6 years	1.5	122	7	2.3	5.2	1 - 5
4. Asset Realization Income from FADA	1.5	122	7	3.29	12.7	1 - 3, 5

Notes: ^aThe base model assumption in this table are the same as for table IV.1, except that interest rate rise by 50 basis points a year in years 2 and 3 and by 100 basis points a year in years 4 and 5. Thereafter, they remain constant.

^bEarning assets are zero in years six through ten.

TABLE III.5

Simulation Results Under
Constant Interest Rates

Deposit Growth = 4 Percent

	Maximum Yearly Interest Obligation			FSLIC Earning Assets After 5 Years (Billions \$)	FSLIC Earning Assets After 10 Years (Billions \$)	Years FSLIC Net Income is Negative
	(Billions \$)	As Percent of Premium	Year Max. Occurs			
1. Base Model ^a	1.2	125%	7	-0.1 ^b	-1.8	1 - 10
2. Special Assessment Remains Throughout	1.2	54	5	1.1	8.5	1 - 5
3. Special Assessment Remains 6 years	1.2	125	7	1.1	2.1	1 - 5,7-10
4. Asset Realization Income from FADA	1.2	125	7	2.5	9.4	1 - 5

Notes: ^aThe base model assumptions for this table are the same as for table IV.1, except that the rate of growth of insured deposits is 4 percent per year rather than 8 percent.

^bEarning assets are zero in year six.

TABLE III.6

Simulation Results Under
Increasing Interest Rates

Deposit Growth = 4 Percent

	<u>Maximum Yearly</u> <u>Interest Obligation</u>			<u>FSLIC Earning</u> <u>Assets After</u> <u>5 Years</u>	<u>FSLIC Earning</u> <u>Assets After</u> <u>10 Years</u>	<u>Years FSLIC</u> <u>Net Income</u> <u>is Negative</u>
	<u>(Billions \$)</u>	<u>As Percent</u> <u>of Premium</u>	<u>Year Max.</u> <u>Occurs</u>	<u>(Billions \$)</u>	<u>(Billions \$)</u>	
1. Base Model ^a	1.2	136%	7	-1.2 ^b	-2.5	1 - 10
2. Special Assessment Remains Throughout	1.2	58	5	-.1	7.9	1 - 5
3. Special Assessment Remains 6 years	1.2	138	7	-.1	1.4	1 - 5,7-10
4. Asset Realization Income from FADA	1.2	138	7	2.4	8.9	1 - 5

Notes: ^aThe base model assumptions for this table are the same for table IV.1, except that interest rates increase by 50 basis points a year in years 2 and 3, and the rate of deposit growth is only 4 percent per year.

^bEarning assets are zero in year six.

SOME ALTERNATIVE STRATEGIES
FOR FSLIC RECAPITALIZATION

Several other ways of dealing with the problem of the thrift industry's insurance fund are available. These include a scaled-back version of the Treasury/FHLBB plan, merging the FSLIC and FDIC funds, and borrowing from sources other than the FHLBank system.

An inability to take action relatively quickly on FSLIC recapitalization could easily precipitate a crisis. A crisis could develop from a number of different specific causes. For example, a liquidity crisis could result from a decision by the District Banks not to grant advances to weak institutions. When advances to an institution cannot be collateralized by the institution's assets, FSLIC may guarantee them, substituting its resources as the necessary collateral.

As of January 1987, there were \$2 billion of advances guaranteed by FSLIC with no collateral other than the reserves of the deposit insurance fund. At that time FSLIC's primary reserves totaled \$1.9 billion. A situation may be approaching where FHLBanks will refuse to grant advances on FSLIC's guarantee. This situation may already be occurring in California. The danger arises when the advance is needed for liquidity purposes, i.e., to meet a deposit outflow. Failure to get an advance in this circumstance could result in the inability of depositors to get their money. The thrift crises in Maryland and Ohio have shown how quickly a lack of confidence in the system leads to bank runs. This is only one example of how a crisis could result from an insurance fund with inadequate reserves.

SCALING BACK THE
RECAPITALIZATION PLAN

There are many different ways in which the FSLIC recapitalization could be scaled back. One proposal suggested by the U.S. League of Savings Institutions provides for a 2-year program and slightly less money (over the 2-year period) than the Treasury/FHLBB plan. It is not our purpose in this report to analyze the U.S. League proposal; however, there seem to be three major reasons for scaling back the size of the plan:

- The problem may not be as large as many believe.
- The smaller plan avoids tying up as much future income to pay the interest on borrowed money, but only if it provides enough money the first time.
- The Bank Board is believed to require the degree of oversight and supervision implicit in having to return and

ask for more money if the need is greater than the relatively modest amount provided for in the initial program.

Given our estimates of the potential size of the problems, the first two points do not seem particularly relevant. The question of oversight is, however, an important one. Clearly, oversight is necessary whenever money is being spent in the amounts being discussed here. Not only is it necessary to ensure that the money is being used efficiently, but also appropriately. Nevertheless, a requirement that the Bank Board and FSLIC return after 2 years to explain and justify both their use of the allocated funds and their need for more may result in a substantial interim delay in resolving the problems of the industry. Furthermore, it is not clear why oversight necessarily would be less rigorous under a long-term plan. As has frequently been pointed out, delay can be quite costly.

MERGER OF FDIC AND FSLIC

A merger of the two insurance funds has been suggested as a solution to the problem now facing FSLIC. It is true that a merger might allow FDIC's reserves to be used to resolve FSLIC's problem cases. However, since FDIC's reserves are in the neighborhood of \$19 billion, and the Bank Board estimates that the cost to resolve the thrift industry's known problems could be \$20 billion or more, it is not clear how a merger could resolve the problems in both banking and the thrift industries.

Some of the resources of the FDIC could be used to assist FSLIC, if it were felt necessary, through a borrowing arrangement rather than a merger. We fail to see any benefit in actually merging the funds except where an explicit objective of the merger is to achieve consistent regulation of both the thrift and commercial banking industries and to manage the government's overall deposit insurance exposure in a more comprehensive fashion.

ALTERNATIVE SOURCES OF FUNDS

The purpose of FSLIC recapitalization is to provide additional money to the insurance fund to allow an accelerated resolution of FSLIC cases and other problems. Besides the various recapitalization proposals that have been presented recently, FSLIC and the Bank Board have access to funds from several other sources. However, each of these sources has drawbacks and, in some cases, it would be necessary to declare a crisis in order to access the funds. Moreover, in almost every case, the additional funds do not add to FSLIC's reserves since the money must be paid back, i.e., there is an offsetting liability. This appendix describes these alternative sources of funds.

Borrowing from the Treasury

The FSLIC fund has a \$750 million line of credit available from the Treasury. The Secretary of the Treasury is authorized and directed to lend FSLIC such funds, not to exceed \$750 million in the aggregate at any one time, as FHLBB judges are needed for insurance purposes (12 U.S.C. 1725(i)). These funds are not dependent upon appropriation, and the Treasury may issue public debt securities to raise the necessary funds. Use of these funds by FSLIC would increase the budget deficit.

Borrowing from the Federal Reserve System

There are three authorities that could be used by FSLIC to borrow funds from the Federal Reserve System. The amount available under the following provisions depends upon the amount of suitable collateral at the disposal of FSLIC.

- First, FSLIC may borrow funds from the Federal Reserve System under 12 U.S.C. 347c. Any Federal Reserve Bank may make advances to any corporation on its promissory notes secured by direct obligations of the United States or by any obligation fully guaranteed as to principal and interest by any agency of the United States. These advances are not to exceed 90 days, but it is presumed they are renewable.
- Second, under 12 U.S.C. 343, any Federal Reserve Bank may also discount notes, drafts, and bills of exchange for any corporation, but only if the Federal Reserve Board, by a vote of not less than five members, determines that unusual and exigent circumstances exist. Notes, drafts, and bills admitted to the discount must have a maturity of not more than 90 days.
- Third, 12 U.S.C. 461(b)(7) provides that any depository institution in which transaction accounts or nonpersonal time deposits are held is entitled to the same discount and borrowing privileges as a member bank. In the administration of such discount and borrowing privileges, the Federal Reserve Board must take into consideration the special needs of savings and other depository institutions for access to discount and borrowing facilities, consistent with their long-term asset portfolios and the sensitivity of such institutions to trends in the national money markets. A declaration of unusual and exigent circumstances is not specifically required.

FSLIC cannot borrow directly under this third authority. However, it has established a subsidiary thrift institution under section 406 of the National Housing Act which is eligible to use

the Federal Reserve discount operations under this provision to the same extent as any other bank. Banks may discount commercial loans or agriculture paper, and notes which are secured by residential mortgages. It would be possible for FSLIC to borrow indirectly through a section 406 corporation. Of course, as with any borrower at the Fed's discount window, FSLIC would have to provide acceptable collateral. Given the state of FSLIC's reserves, it is unclear how much could be raised in this fashion.

Borrowing from the Federal Home Loan Banks

FSLIC has the authority under 12 U.S. 1725(d) and 12 U.S.C. 1431(k) to borrow from the Federal Home Loan Bank system. The Garn-St Germain Act (P.L. 97-320) allows FSLIC to borrow from the Federal Home Loan Banks, as long as the rate on the loan is not less than the Banks' marginal cost of funds. There are two other limitations on FSLIC borrowings. First, FSLIC must provide sufficient collateral, based on terms and conditions set by the Federal Home Loan Bank Board. Second, the Bank system itself has a limit on the amount of funds it can raise through borrowing. The Bank system can in turn obtain funds through the issuance of consolidated obligations. By regulation, it cannot borrow in excess of 12 times the paid-in capital stock and reserves of all the banks. These debt instruments are not obligations of the United States (12 U.S.C. 1435) nor do they carry any governmental guarantees.

FSLIC has exercised this authority twice to arrange pass-through loans, once for \$200 million and the other time for \$700 million. The Office of Management and Budget (OMB), according to Treasury, had a problem with their budgetary treatment of the loans: one was shown as an expenditure which increased the budget deficit and the other was treated as a guarantee. According to CBO, when FSLIC borrows directly from the Federal Home Loan Banks, this financing mechanism permits FSLIC to increase its authority to obligate funds. However, when the disbursement occurs, it would be reflected as an outlay. It would, therefore, lead to an increase in the budget deficit.

Under unusual circumstances, other funds are available from the Treasury. The Secretary of the Treasury is authorized to purchase, at his discretion, up to \$4 billion of FHLBank obligations, if he and the Chairman of the Federal Home Loan Bank Board certify to Congress that alternative means of raising funds cannot be effectively employed and the ability to supply such funds is impaired because of monetary stringency and a high level of interest rates (12 U.S.C. 1431(i)). This borrowing authority is not subject to appropriations, and the Treasury may sell public debt securities to raise necessary funds (12 U.S.C. 1431(i)).

Mandatory deposits equal to
1 percent of total deposit

Section 404(h) of the National Housing Act (12 U.S.C. 1727(1)) enables FSLIC to obtain additional liquidity, if necessary, by calling upon insured institutions to make deposits in the Corporation. This authority allows the Federal Home Loan Bank Board to require each insured institution to deposit up to 1 percent of its withdrawable deposits with the FSLIC.

With the deposit base of the industry reaching \$900 billion, there would be between \$8 billion and \$9 billion to be added to FSLIC's reserves. The Bank Board has said that this money could only be used to add liquidity to the Fund, not for case resolutions. Moreover, the 1 percent levy would also have another effect. Under the conditions described here, it would mean an abrupt decrease in the net worth of all thrifts--weakening solvent institutions and driving insolvent thrifts further into insolvency.

Each of the alternative strategies or sources of income discussed here fails to satisfy at least one of the objectives presented at the beginning of appendix I. Either they provide too little money, they use public money (or in the case of the FDIC merger, commercial banks' money), or they increase the deficit. In most cases multiple objectives are violated. While violation of these objectives does not automatically disqualify a proposal, it certainly raises additional questions.

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