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The Federal Savings and Loan Insurance Corporation -- Financial Condition and Recapitalization Issues

Statement of
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Before the
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Finance and Urban Affairs

United States House of Representatives

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Mr. Chairman and Members of the Subcommittee:

We are pleased to appear today to discuss your proposed legislation (H.R. 27) "Federal Savings and Loan Insurance Corporation Recapitalization Act of 1987", to provide some observations about the conditions that have made recapitalization necessary, and to offer our views on some actions the Committee should consider to maintain the financial health of the savings and loan industry and the Federal Savings and Loan Insurance Corporation (FSLIC) fund.

CONDITION OF THE SAVINGS AND LOAN INDUSTRY

Almost from the time of its inception in 1934 until about 1979, the savings and loan industry and FSLIC experienced relatively few problems in comparison to today. During those 45 years, FSLIC provided assistance to only 124 institutions, and in only 13 cases were a savings and loan (S&L) association's problems so severe that it was necessary to close the institution and pay its insured depositors. During that time, the thrift industry operated in a relatively simple environment in which deposits generated from the local economy at regulated rates of interest were invested in traditional home mortgages.

However, beginning in the late 1970's, the environment changed dramatically as restrictions on deposit rates were progressively lifted, and escalating competition for deposits

resulted. S&Ls were forced to pay increasingly higher interest rates to preserve their core deposits, while at the same time being encumbered with low-yielding loan portfolios.

Because of this interest-rate spread, thrifts experienced large operating losses and capital depletion, which many sought to correct by making high-risk investments for higher rates of return. Since 1983, FSLIC has observed many of these institutions encountering problems resulting from having to absorb substantial losses on those high-risk investments. The outcome has been an alarming number of S&L failures. From 1981 to 1986, 211 S&Ls were merged with other institutions or liquidated; and the number of insolvent S&Ls (using generally accepted accounting principles) increased from 16 in 1980 to 445 as of September 1986.

It is important to point out, however, that whereas the large number of failures and insolvencies is alarming, a substantial segment of the industry is both solvent and profitable. As of September 1986, the latest information available, about 85 percent of FSLIC insured S&Ls were solvent, while only 15 percent were insolvent. At the same time, about 80 percent of S&Ls were profitable, earning $6.9 billion during the first three quarters of 1986, while the unprofitable 20 percent segment incurred losses of $5 billion.

Diversification Into Nontraditional Assets Has Severely Weakened Some S&Ls' Portfolios

With legislation in the early 1980's liberalizing the types of activities in which S&Ls could participate, many S&Ls began to diversify their asset portfolios away from traditional residential mortgage loans and into other activities, including direct investment, that are far removed from home mortgage lending activities. Such investments, although potentially more lucrative, are recognized as inherently more risky.

In 1985, after having observed the disastrous consequences of some institutions that became heavily involved in high-risk equity investments and in an attempt to limit the industry's exposure to these higher risks, the Federal Home Loan Bank Board implemented rules to require state-chartered S&Ls to obtain FSLIC approval for investments that would cause them to exceed certain investment-to-asset ratio thresholds. We support that rule.

However, because of the asset quality problems that we have observed at failed institutions, we are concerned that some S&Ls are entering into arrangements which, while technically classified as loans, still carry many of the risks associated with equity-type investments but do not require FSLIC approval. Let me briefly discuss some of the activities to which I am referring.

-- Acquisition, Development, and Construction loans. Repayment of such loans only occurs if the project is successfully completed and operating profitably or is sold at a price enabling repayment of the loan, which may in fact require substantial market appreciation. When projects fail--from poor management, regional economic conditions, or for other reasons--as many have, the lending S&L experiences severe financial stress and, all too often FSLIC is left with the responsibility to pick up the pieces.

-- Speculative land investment loans. Here again, repayment depends upon a successful future outcome, which is by no means assured.

-- Related-party transactions. When individuals or groups with significant influence within an organization prevail upon management to invest in risky ventures in which they are involved, the results can sometimes be fatal.

While such arrangements may be characterized as loans, they are in fact a wide departure from thrifts' traditional, and clearly more secure, investments in home mortgages.

The following three S&L failures illustrate the kinds of asset degradation we have observed.

Empire Savings and Loan

In September 1981, Empire began lending money to investors to finance speculative acquisition of land. Empire also made many construction loans to develop condominium communities in Texas.

In January 1981, Empire's assets totaled $12 million; by December 1983, its assets had grown to $315 million. On March 14, 1984, the Bank Board closed Empire due to insolvency. At the time of closing, Empire had 317 outstanding construction loans, almost all of which were delinquent. It also had 658 loans to investors used to finance the purchase of completed, but unoccupied, condominium units. Most of these loans were also delinquent. Losses resulting from the failure of Empire's borrowers to repay the loans are expected to exceed $142 million, or 45 percent of the book value of Empire's assets at the time of its closing.

Beverly Hills Savings and Loan Association

The Beverly Hills Savings and Loan Association, in Beverly Hills, California, was another thrift that attempted to shift its

portfolio from traditional home-ownership and consumer loans to high-risk land development, commercial, and industrial ventures. In only two years, Beverly Hills tripled its asset size, from $834 million at the end of 1982 to $2.9 billion at the end of 1984, primarily through real estate ventures and other nontraditional activities. In April 1985, the Bank Board closed the state-chartered thrift because of insolvency and reopened it as the federally chartered Beverly Hills Federal Savings and Loan.

To obtain a return high enough to cover interest costs on the deposits used to finance its explosive growth, Beverly Hills sought investments providing higher yields than those provided by traditional mortgage lending activities, with a consequent increase in the risk of loss. These investments included real estate, both development and operating properties which were held directly or through joint ventures; construction loans; and high-yield, low-investment-grade bonds often referred to as "junk bonds."

First South Savings and Loan Association

The Bank Board closed First South Savings and Loan of Pine Bluff, Arkansas, in December 1986 because of insolvency. About 18 months before its closing, First South management embarked on an expansion program, selling most of its traditional

collateralized real estate and commercial loans and other marketable assets to obtain cash which it then "lent" for highly speculative projects throughout the nation. When FSLIC took over, about $900 million, or 64 percent of First South's $1.4 billion portfolio, was in speculative investments. Most of these loans were in default and were outside the Arkansas market. In contrast, only about 9 percent of First South's loans were for residential mortgages.

To add to First South's problems, its lending activities were concentrated in loans to 13 borrowers who owned or controlled over 50 percent of First South's stock. The bulk of First South's loan losses were attributable to such loans, which comprised more than 40 percent of First South's unsecured, commercial, and commercial real estate loans.

Insolvent, Unprofitable S&Ls Continue To Operate

Although a number of S&Ls are insolvent, or nearly insolvent, and unprofitable, they continue to operate. At September 30, 1986, of the 445 operating S&Ls that had a GAAP net worth of zero or less, 297 were unprofitable. In addition, another 598 institutions had a GAAP net worth of between 0 and 3 percent, and 198 of these were unprofitable.

In an attempt to preserve FSLIC's resources, the Bank Board has been forced to allow these S&Ls to operate even though many may never regain solvency or profitability. FSLIC has also had to provide a substantial amount of assistance to troubled institutions in the form of loans, contributions, and net worth or income capital certificates, or various combinations thereof. Since 1981, FSLIC has used these types of assistance extensively and, as of December 31, 1986, has provided $6.9 billion through these various types of "open assistance" programs.

Delay Increases Ultimate Resolution Costs

Delaying necessary regulatory actions, including closures where warranted, only increases the ultimate cost of resolving the industry's problems. FSLIC's costs to liquidate failed S&Ls have risen from relatively negligible amounts in the 1970's to 37 cents per dollar of acquired assets in 1982 to 50 cents in 1986. In the early 1980's, the problem facing the industry was interest-rate spread. Given the prospect that interest rates would decline, delay was not unreasonable. Today, however, the majority of current cases requiring FSLIC action are asset quality problems rather than interest-rate spread problems. Asset quality problems are potentially more dangerous to the insurance fund than are interest-rate spread problems and can be more difficult to deal with. A single large defaulting asset could quickly wipe out an institution's entire net worth.

Moreover, in contrast to interest-rate spread problems which improve when inflation declines, an S&L with asset quality problems is less likely to recover simply from a return to economic prosperity, especially when inflation also subsides.

In general, we have seen that asset quality problems are both less predictable and more costly to the insurance fund than interest-rate spread problems. Perseverance is no virtue for an institution with poor credit risks, bad assets, and a worsening insolvency problem. Furthermore, delay has two immediate and obvious costs. First, every dollar of continuing losses by an insolvent thrift adds to FSLIC's cost and creates a growing imbalance between the liabilities for which FSLIC is responsible and the assets it must manage at the time of case resolution. Industry data show that the thrifts in FSLIC's significant supervisory caseload are losing $6 million a day, or $2.2 billion a year. Secondly, according to the Bank Board, insolvent S&Ls are bidding up deposit rates, not only for themselves but also for healthy institutions as well. Thus, the cost of funds for the whole industry is raised, which results in slimmer profit margins or larger losses. The solvent and profitable sector, therefore, is being hurt by FSLIC's continued inability to adequately address the problems of the troubled sector.

IMPACT ON FSLIC'S FINANCIAL STABILITY

The interest rate spirals of the early 1980's and the severe asset quality problems that have since surfaced have resulted in a growing number of S&L insolvencies or near insolvencies. This situation has had a devastating impact on FSLIC's caseload of problem S&Ls, FSLIC's future costs, and on its ability to resolve them. The Federal Home Loan Bank Board's Significant Supervisory Institutions caseload includes 362 institutions with assets of $103 billion.

FSLIC's insurance fund has steadily declined during the last 5 years from $6.3 billion in 1981, to a deficit position in 1986. As part of our audit of FSLIC's calendar year 1986 financial statements, we have preliminarily determined that FSLIC needs to establish a contingent liability in the range of $8 billion to handle cases that will require action in the near future. When this amount is deducted from FSLIC's reserves, FSLIC would have a deficit of over $3 billion as of the end of 1986. Clearly, such a fund balance cannot handle the real liability FSLIC now faces.

During the 1981 to 1986 period, FSLIC incurred expenses for insurance settlements and interest on notes payable to insured institutions amounting to $643 million, while spending $3 billion to provide assistance under contribution agreements related to assisted mergers and acquisitions. These expenditures have not

only adversely affected FSLIC's reserves but have also caused a severe decline in its liquidity. As of December 31, 1986, FSLIC had about $4.0 billion in cash and other liquid assets, but it had notes and accounts payable to insured institutions of $5.0 billion. Most of these payables are held by institutions in FSLIC's Management Consignment Program (MCP) and by de novo Federal Mutual Associations that emerged from partially resolved asset backed transfers (ABT). To completely resolve the MCP and ABT cases will require FSLIC to sell them to or merge them with an adequately capitalized acquiror and to replace the notes with cash that FSLIC does not currently have.

In 1986, FSLIC acted on only about half of its serious cases. During the same time, its serious case list doubled in size. At December 31, 1985, FSLIC had 93 cases involving S&Ls that it considered to be in serious financial trouble. One year later, the list virtually doubled to 183. Of the 93 cases as of December 1985, FSLIC was able to act on only 49 during 1986--9 were placed into the Management Consignment Program and may require additional action in the near future, 23 were acquired by or merged with other institutions that may later require assistance, and 17 were closed. Forty-six of the institutions on the December 1985 list were still on FSLIC's list at the end of 1986.

During 1986, dramatic increases were evident in several aspects of FSLIC's assistance programs. Specifically, from 1985 to 1986

-- the number of institutions FSLIC closed increased from 10 to 21,

-- the cost of liquidations increased from $981 million to $3 billion,

-- FSLIC's claims on assets of closed institutions rose from $2.5 billion to $7.8 billion, and

-- assistance to open institutions rose from $4.8 billion to $6.9 billion.

In summary, FSLIC's reserves for dealing with such problems have steadily declined and, with the additional loss provision expected to be necessary, FSLIC will be in a deficit position. This decline, coupled with FSLIC's sharply higher and increasingly expensive caseload, illustrates the urgent need to infuse new funds into the Corporation. According to a recent statement by the Chairman of the Bank Board, FSLIC will need $23.5 billion to resolve known and borderline cases requiring assistance.

REGULATORY ACTIONS TAKEN TO RESOLVE PROBLEMS

Since the problems in the S&L industry first became publicly recognized in the early 1980's, the Bank Board and FSLIC have experimented with assorted regulatory techniques, such as relaxing accounting regulations, to postpone resolution of them. These regulatory changes did provide breathing space, enabling some institutions experiencing interest-rate spread problems to recover. However, the changes also contributed to permitting other S&Ls time to engage in imprudent and speculative activities. Various industry groups are now proposing further rule changes and a forbearance program as a further attempt to prop up the failing segment of the industry. I would like to briefly discuss both of these proposals.

Further Accounting Rule Changes Will Not Solve Problems

In 1981 and 1983, as a response to problems in the S&L industry, regulatory accounting principles (RAP) were relaxed to allow S&Ls time to work out problem loans and other poor quality assets. Various groups are now proposing changes that would again weaken accounting and reporting procedures. We oppose any such changes and firmly believe that S&Ls should follow generally accepted accounting principles (GAAP).

Relaxing the accounting and external reporting rules of depository institutions results in a misleading picture of the true financial condition of the institutions and does not solve the economic problems in the industry. Although we do not take issue with the need for institutions to work out acceptable recovery programs, we believe that accounting and financial reporting should remain neutral and not become part of the mechanism to deal with troubled institutions or their problem debt. The Congress, regulators, investors, and the general public, all need clear and accurate reporting, in accordance with GAAP, to make the best decisions possible in response to the magnitude of the problems that S&Ls face.

One proposal put forth is to allow S&Ls to amortize loan losses over a period of up to 20 years instead of recognizing them in the period actually incurred, as required by GAAP. Although this practice would improve the appearance of an S&L's financial position, it is not a true picture because it does not reflect the total cost of operations.

We oppose that proposal as we did when similar legislation was proposed for the Farm Credit System. On October 6, 1986, the Comptroller General wrote to the Chairman, House Committee on Agriculture, voicing his concern over the Farm Credit System proposal. Specifically, the Comptroller General noted that such a proposal would hide the very serious financial problems that

the industry faces. Although the current proposal may have short-term salutary effects on the S&Ls financial condition, the short-term benefits will be far outweighed by the long-term costs of failing to deal with financial problems in a direct and forceful manner. The danger of such action is that regulators and others may begin believing the fiction that is created, which, in turn, will slow if not halt efforts toward reform. A copy of our letter is attached for the record.

Another proposal suggests wide-spread use of the principle espoused in Financial Accounting Standards Board Statement No. 15 (FASB 15), "Accounting by Debtors and Creditors for Troubled Debt Restructuring," to account for problem loans. FASB 15 is a much misunderstood accounting principle. Its proponents have often erroneously assumed that FASB 15 would allow S&Ls to avoid loan loss recognition on restructured loans to a greater degree than actually allowed by that principle. Although we do not disagree with the need to occasionally restructure loans to minimize losses, application of FASB 15 does not allow S&Ls to avoid losses. Under another generally accepted accounting principle, FASB 5, "Accounting for Contingencies," management and its auditors are responsible for fairly reporting the value of assets, including restructured loans, by properly accounting for uncollectible amounts. To the extent that portions of the restructured loans are not considered likely to be collected,

under FASB 5, a reserve must be established for the uncollectible amounts.

A second point to note is that FASB 15 is a relatively liberal accounting principle that does not require a reduction in the carrying amount of the loan unless future cash receipts will be less than the recorded investment in the loan, even though by restructuring loans, an S&L can incur a substantial loss in future periods. To illustrate our point, suppose an S&L has a $10 million loan repayable in 1 year with interest at 10 percent. The S&L could modify the loan terms so that the loan is repayable in 10 annual installments of $1 million with no interest. Under FASB 15, the S&L would recognize no loss because the $10 million to be repaid equals the $10 million investment in the loan. Clearly, however, the S&L will not earn the $1 million in interest that would have otherwise been paid, and it has lost the difference between the value of the $10 million originally to be collected at the end of the year and the reduced value of $10 million collected over 10 years. Of course, as noted, FASB 5 would still require the auditors to evaluate whether the 10 payments are collectible or not, and make appropriate reserves if they are not expected to be collectible.

Unfortunately, we believe, and other work we have done shows, that S&Ls have been far too slow in recognizing the uncollectible portion of their loan portfolios. Thus, to appear

to encourage a liberal use of accounting rules related to debt restructuring, without acknowledging the related need to continue to evaluate collectibility and take appropriate writedowns, just exacerbates the problem. This also puts enormous pressure on public auditors who are trying to assure proper financial reporting to the investing public and to depositors.

In conjunction with these proposals, another proposal has been put forth to allow S&Ls to include loan loss reserves as part of RAP net worth. As of September 1986, industry net worth on a RAP basis was 4.56 percent, while net worth on a GAAP basis was 3.61 percent. Due to the already wide disparity between GAAP and RAP net worth, and because we believe accounting information should be reported in accordance with GAAP to provide a true picture of an entity's financial position, we do not think a proposal to further increase the disparity between GAAP and RAP net worth would be wise.

Capital Forbearance

In the past several weeks, a number of proposals have been made for the Bank Board to adopt a policy of capital forbearance as a form of regulatory relief for S&Ls experiencing problems. In a press release on February 26, 1987, the Chairman of the Bank Board issued a statement announcing a capital forbearance policy for the savings and loan industry. The Bank Board's announcement

noted that its forbearance policy would be closely patterned after the commercial banking regulatory agencies' forbearance program for dealing with agricultural and energy banks. In considering the Bank Board's program, it is important to understand specifically how forbearance is applied in commercial banking and to note what it does and does not do.

In March 1986, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Controller of the Currency (OCC) announced a policy, commonly referred to as capital forbearance, which defers, in specified circumstances, normal regulatory action against well-managed, viable institutions whose net worth fall below the normal regulatory requirements. Essentially, the commercial bank forbearance policy permits well-managed institutions that have experienced declines in their primary capital ratios below the customary 5.5-percent requirement, and that have met the other requirements of the program, to continue operating without the normal regulatory actions. The capital forbearance program, as practiced in the banking industry, is primarily intended to provide a temporary moratorium for well-managed banks with sufficient capital to absorb loan losses and with reasonable prospects for recovery to rebuild their capital reserves. It is clearly not a program designed to prop up poorly run or insolvent institutions, or to mask or minimize financial problems. Instead, because participating banks whose capital ratios fall below normal regulatory requirements can operate

without fear of closure, one of the benefits expected of the program is to provide them with an incentive to promptly recognize losses arising in their loan portfolios.

The program is primarily targeted for institutions with a substantial portion of their portfolios in agriculture, oil, or energy loans. Other key features of the program are as follows.

-- The program is available, only upon banking regulators' approval, to institutions whose capital ratios decline from the established 5.5-percent requirement to 4-percent. Exceptions can be granted to otherwise sound institutions with lower capital ratios. For example, FDIC may permit participation by an institution with a 3-percent ratio if it has good prospects for achieving a 4-percent ratio within 12 months.

-- The institution's weakened capital position generally must have resulted from external problems in the agricultural, oil, and gas sectors of the economy, not from such factors as poor management, high operating costs, or excessive dividends.

-- Participating institutions must provide a reasonable plan for restoring capital to required minimums by January

1993 and must file annual reports on their progress in achieving their plans.

Clearly, the commercial banking supervisory agencies have adopted a selective approach to capital forbearance, targeting it toward institutions with good chances of achieving strengthened financial positions. The program is definitely not intended to keep insolvent banks in business. To illustrate, as of December 31, 1986, FDIC has approved applications of 33 institutions, while disapproving those of 27 institutions seeking capital forbearance generally because FDIC did not think they would recover.

We recognize that a similar policy of capital forbearance might be a useful regulatory tool for the savings and loan industry. The Bank Board's newly announced plan, however, differs from that used by the commercial banking regulators in one major respect which causes us concern. The Bank Board targets eligibility for participation in the program to institutions with regulatory net worth as low as one half of one percent, as opposed to the 4-percent requirement for commercial banking. We think this proposal is too liberal. In our view, the Bank Board's capital forbearance program should not be significantly less stringent than that practiced by the commercial banking industry. Any actions by either thrift or banking industry regulators that confer a competitive advantage

on one of these industries at the expense of the other potentially weaken both and, as a result, increase the federal government's overall deposit insurance risk exposure.

GAO ANALYSIS OF RECAPITALIZATION PROPOSAL

We have recently completed an analysis of the Treasury/FHLBB proposal to recapitalize FSLIC and are releasing our report (GAO/GGD-87-46BR) to the Committee at this time. Therefore, I would just like to summarize our findings and conclusions.

Clearly, FSLIC needs additional funds to resolve the large backlog of insolvent and unprofitable S&Ls that continue to operate. With its insurance fund rapidly declining and in a deficit position, and with its substantial decrease in liquidity, without recapitalization FSLIC will be unable to keep its head above water, let alone resolve cases of failing institutions. Furthermore, FSLIC's inability to deal with the problems facing the S&L industry has had a detrimental effect on public confidence in the entire thrift industry. This lack of confidence has caused S&Ls to pay increasing interest rates on deposits, which may result in even higher future resolution costs to FSLIC. Moreover, this lack of confidence is readily apparent when comparing the deposit mix of solvent institutions with those of insolvent institutions. Insured deposits make up a much larger percentage of deposits in insolvent institutions than they

do in solvent institutions. Since FSLIC must pay off insured depositors when an S&L is liquidated, its costs may be much higher because of this disparity.

While we did not attempt to determine whether the $25 billion to $30 billion proposed in the Treasury/FHLBB plan is adequate to finance the resolution of known problems, our previous work, knowledge of the condition of the industry, and the Bank Board's own analyses suggest that a smaller amount would be too little. In our analysis, we therefore assumed that to be successful, the plan must be able to raise at least $25 billion in the next 5 years.

Our analysis shows that the Treasury/FHLBB proposal can raise $25 billion over 5 years without depleting the fund's reserves as long as FSLIC's income is augmented either by continuing special premium assessments, which are phased out over 5 years under the proposal, or by receipts from sales of assets acquired through liquidations. We wish to emphasize that this solution, however, virtually preempts FSLIC's future income stream to deal with current problems. Accordingly, if the industry were to suffer significant further declines--either from imprudent management at individual institutions or from adverse economic conditions--FSLIC would not have funds available to deal with the consequences. Given the inherent uncertainties in assessing future economic conditions, and the current pressures

to further liberalize regulatory guidelines, the emergence of further problems is a definite possibility. Therefore, the Congress should recognize that enactment of this legislation will not necessarily preclude the need for an additional infusion of capital at some future time. Despite these considerations, we do not oppose enactment of H.R. 27 because of the urgency we attach to the need for FSLIC to promptly deal with its inventory of failed and failing institutions. Delay can only increase the problem--and increase the likelihood for a further loss of public confidence in the industry.

In its deliberations on recapitalization, however, we believe the Congress should also consider requiring FSLIC to limit the industry's ability to enter into high-risk investments and loans. When these high-risk ventures fail--as many have and will probably continue to do--FSLIC and the profitable sector of the industry are left to pay the bill. We do not believe the Congress envisioned that FSLIC would be insuring S&Ls investing in high-risk activities to the exclusion of traditional residential mortgages to the degree some S&Ls have. In developing recapitalization, this Committee has an opportunity both to provide the funding FSLIC desperately needs now and to require FSLIC to take action that will reduce the potential that recapitalization will be required again at some future time.

We believe the Congress should also address the following in setting up the FSLIC recapitalization plan.

-- Ensuring congressional review and oversight of the FHLBB's and FSLIC's plans and actions, and providing some control mechanisms if the oversight process reports negative findings;

-- Providing a means to ensure that sufficient funds will be available to pay the debt service if FSLIC premium income is inadequate; and

-- Strengthening regulations and oversight to reduce the speculative-type activities that have resulted in the severe asset quality problems of the industry's troubled sector.

Mr. Chairman, this concludes our statement. At this time, we will be pleased to respond to any questions you may have.

ATTACHMENT I

GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

October 6, 1986

The Honorable E. (Kika) de la Garza
Chairman, Committee on Agriculture
House of Representatives

Dear Mr. Chairman:

I wish to convey my deep concern over recently introduced legislation that would allow the Farm Credit System to amortize over a period of 20 years the losses resulting from its poorly performing loan portfolio and the high current cost of its debt. This legislation, if enacted, could have the effect of hiding the very serious financial problems that the System will experience in the future. We estimate that the accounting changes allowed by the legislation could overstate earnings by $5 billion or more over the next 30 months.

Of more importance, adoption of this legislation could impede the speed of reforms to the management practices and operations of the Farm Credit System that were contemplated by the Congress when the 1985 amendments to the Farm Credit Act were enacted into law just 9 months ago. In addition to putting the System on a solid basis of financial accounting, the amendments were designed to achieve desperately needed reforms to credit evaluation and approval procedures. In effect, the legislation may turn the clock back to the earlier era of undisciplined accounting practices and loose credit analysis and approval.

I urge you to carefully weigh the effect of the proposed legislation on the long-run viability of the Farm Credit System. These amendments may have short-term salutory effects on the appearance of the financial condition of the System as well as the federal deficit. However, reliance on legislatively sanctioned regulatory accounting in the thrift industry has taught us all too well that these short-term benefits may

be far outweighed by the long-term costs of failing to deal with financial problems in a direct and forceful manner. The danger here, as there, is that System officials will begin believing the fiction that is created, which, in turn, will slow if not halt efforts at reform.

Sincerely yours,

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States