United States General Accounting Office

# GAO

Report to the Congress

October 1989

# FINANCIAL AUDIT

# Federal Savings and Loan Insurance Corporation's 1988 and 1987 Financial Statements

139868

GAO

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

Comptroller General
of the United States

B-114893

October 31, 1989

To the President of the Senate and the
Speaker of the House of Representatives

This report presents our opinion on the Federal Savings and Loan Insurance Corporation's financial statements for the years ended December 31, 1988 and 1987, disclosing that except for the effect that various uncertainties could have on the estimated allowances for assistance agreements and unresolved cases, the Corporation's financial statements present fairly, in all material respects, its financial position and the results of it operations, cash flows, and changes in financial position. This report also presents our reports on the Corporation's internal accounting controls and on its compliance with laws and regulations. We conducted our audits pursuant to the provisions of 31 U.S.C. 9105 and in accordance with generally accepted government auditing standards.

Our opinion discusses the financial condition of the savings and loan industry and its related effect on the Corporation. We also discuss the abolishment of the Corporation and summarize our views on whether the funds provided by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 are adequate to address the savings and loan industry crisis.

During 1988, the industry's poor financial condition continued to overwhelm the Corporation's resources. As a result, the Corporation incurred a net loss of $66 billion and reported a deficit of $75 billion—the largest ever reported by a public or private corporation.

Based on the administration's estimates, $257 billion will be needed over the next 33 years to resolve the savings and loan crisis. However, because the administration used optimistic assumptions, we believe that the cost will probably be higher than estimated. Further, the cost to resolve the problems of troubled but still operating savings and loan associations may exceed the $50 billion in funds provided for that purpose by the act.

We are sending copies of this report to the Chairman of the Senate Committee on Banking, Housing and Urban Affairs; the Chairman of the House Committee on Banking, Finance and Urban Affairs; the Director of the Office of Management and Budget; the Secretary of the Treasury; and the Chairman of the Federal Home Loan Bank Board.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

# Contents



**Abbreviations**

| | |
|---|---|
| FSLIC | Federal Savings and Loan Insurance Corporation |
| GAAP | generally accepted accounting principles |
| REFCORP | Resolution Funding Corporation |

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**General Accounting Office**
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**of the United States**

B-114893

To the Chairman
Federal Home Loan Bank Board

We have audited the accompanying consolidated statements of financial condition of the Federal Savings and Loan Insurance Corporation (FSLIC) as of December 31, 1988 and 1987, and the related consolidated statements of income and expense and reserves for the years then ended, the statement of cash flows for the year ended December 31, 1988, and the statement of changes in financial position for the year ended December 31, 1987. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits. In addition to this report on our audits of the Corporation's 1988 and 1987 financial statements, we are reporting on our consideration of its system of internal accounting controls and on its compliance with laws and regulations.

We conducted our audits in accordance with generally accepted government auditing standards, except as discussed in the following paragraph. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

During 1988, the Corporation incurred a net loss of $66 billion, resulting in a reported deficit of $75 billion at the end of the year. The Corporation reported a $43.6 billion loss allowance for troubled but still operating savings and loan associations. This allowance represents the Corporation's estimated cost to resolve the problems of 578 institutions. The Corporation also estimated that the present value cost associated with institutions that were merged or sold during 1988 was $33 billion. To develop its estimates, the Corporation used systematic methods based on the best available information at the time. Thus, its estimates appeared reasonable. However, the actual costs depend on various uncertainties, such as the extent of continued operating losses; the quality of each institution's assets; future interest rates; the potential effect of the recently enacted Financial Institutions Reform, Recovery, and Enforcement Act of 1989; and the economic outlook for certain sectors of the economy. The actual cost of its assistance transactions is also dependent on the outcome of detailed reviews of the failed institutions' assets, most of which have not yet been completed. Sufficient evidence on the outcome of these uncertainties will not be available until resolution action is actually taken and the assets are sold and detailed asset reviews are completed. Financial information for the first half of 1989 showed that insolvent institutions incurred operating losses at a rate substantially higher than estimated and that the quality and value of assets may be deteriorating. As a result of these uncertainties, we were unable to satisfy ourselves that the $43.6 billion loss allowance is sufficient to cover the actual cost to resolve the problems of the 578 troubled institutions. We were also unable to satisfy ourselves that the $33 billion is an accurate estimate of the cost related to the Corporation's 1988 assistance transactions.

In our opinion, except for the effects that the uncertainties discussed in the preceding paragraph may have on resolution costs, the financial statements referred to above present fairly, in all material respects, the financial position of the Federal Savings and Loan Insurance Corporation as of December 31, 1988 and 1987, the results of its operations for the years then ended, its cash flows for the year ended December 31, 1988, and its changes in financial position for the year ended December 31, 1987, in conformity with generally accepted accounting principles.

As discussed in Note 1 to the financial statements, the Corporation elected to present the statement of cash flows only for the year ended December 31, 1988. This presentation is permitted by Statement of Financial Accounting Standards No. 95, "Statement of Cash Flows."

As discussed in Note 17 to the financial statements, due to its actions to resolve the problems of failed savings and loan institutions and to its continuing liability for troubled but still operating savings and loans, the Corporation has suffered recurring losses and has reported a $75 billion deficit. As a result of the Corporation's losses and the continuing problems in the savings and loan industry, on February 23, 1989, the administration proposed legislation to provide a mechanism to resolve these problems.

Legislation similar to the original proposal was enacted on August 9, 1989. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 dissolved the Corporation and as of the date of enactment, transferred its assets, debts, obligations, contracts, and other liabilities to a newly established fund, the FSLIC Resolution Fund. The Federal Deposit Insurance Corporation is responsible for administering the fund to ensure its assets are sold and liabilities paid. The act also created the Resolution Trust Corporation and provided it $50 billion to resolve the problems of institutions placed into conservatorship or receivership from January 1, 1989, until 3 years after enactment. The act also transferred the Corporation's insurance function to the Federal Deposit Insurance Corporation, which, among other things, will administer a newly created insurance fund for savings and loan associations, the Savings Association Insurance Fund. We believe that the act provides the means to pay for the Corporation's past actions, but are concerned that resolution costs for troubled but still operating institutions may exceed the $50 billion in funds provided to the Resolution Trust Corporation.

The following sections provide supplementary comments relating to the savings and loan industry, the Corporation's financial condition, and the funding provisions in the Financial Institutions Reform, Recovery, and Enforcement Act.

## Savings and Loan Industry's Financial Condition

Over the past decade, the savings and loan industry has experienced severe financial difficulties. In 1981 and 1982, the industry lost $11.6 billion in equity capital because extremely high general interest rates forced institutions to pay high interest rates to fund their operations. At the same time, they were encumbered with low-yielding, long-term loan portfolios. Also, regulators did not act decisively to close failed savings and loans. Instead, they reduced capital standards, allowed institutions to use accounting gimmicks to artificially inflate reported capital, and even granted forbearance from the relaxed capital standards.

During the same period, many institutions were allowed to diversify their investment activities into potentially more profitable, but risky, activities. The profitability of many of these activities was predicated on continued inflation in real estate values to make them economically viable. Moreover, in many cases, this diversification was coupled with poor internal controls and noncompliance with laws and regulations, thus increasing the risk of these activities. (See GAO/AFMD-89-62, dated June 16, 1989.)

As a result of these factors, many institutions have been adversely affected by substantial losses on their loans and investments. These losses have been exacerbated by the severe economic downturn in the Southwest. By the end of 1987, 505 savings and loan associations were insolvent—had capital as measured by generally accepted accounting principles (GAAP) of less than zero.[1]

In 1988, the industry's financial condition continued to deteriorate. The savings and loan industry reported an overall net loss of $13.0 billion. Although 70 percent of insured institutions operated profitably, earning $5 billion during 1988, these profits were far outweighed by the $18 billion in losses incurred by the remaining institutions, located primarily in the Southwest. Moreover, although the Corporation merged, sold, or liquidated over 200 institutions during 1988, there were still 364 insolvent institutions with assets of $113.5 billion and negative tangible net worth (GAAP capital less intangible assets, such as goodwill) of $16 billion at the end of the year.

## The Corporation's Financial Condition

The deterioration of the industry's financial condition has overwhelmed the resources the Corporation had accumulated to protect depositors. At the end of 1980, the Corporation reported reserves of $6.5 billion, representing 1.28 percent of total insured deposits; at December 31, 1988, it reported a deficit of $75 billion. Due to increasing costs related to insurance activities, the Corporation began incurring losses in 1984. The Corporation's 1988 reported loss of $66 billion was primarily due to (1) the $36 billion in estimated costs related to institutions that have been merged or sold, $33 billion of which related to 1988 assistance transactions, and (2) the $26 billion increase in the Corporation's loss allowance for troubled but still operating institutions.

## The Corporation's 1988 Assistance Transactions

During 1988, due to the insolvency of its insurance fund and the questionable quality of the failed institutions' assets, the Corporation relied on promissory notes and guaranteed assistance to complete assistance transactions with acquirers of troubled savings and loans. The terms and conditions of the assistance agreements often included provisions to cover the negative net worth of the acquired institutions and to protect the acquirers from losses resulting from nonperforming assets and sales of poor quality assets.

The Corporation estimated that the present value cost of its 1988 assistance transactions was $33 billion. To develop its cost estimates, the

[1]Capital as used here is the difference between assets and liabilities as measured by generally accepted accounting principles.

Corporation made various assumptions regarding future economic conditions and acquirer actions to forecast expected future net cash outlays, which it then discounted back to present value. For example, the Corporation assumed that

- for most assistance agreements, interest rates would increase moderately, and
- assets would be sold over periods ranging from 3 years to 7-1/2 years and that the recovery rate on asset book value would range from 43 percent to 67 percent.

Based on our analysis of the assistance agreements, data available at the time of our audit, and the Corporation's support for its assumptions, the Corporation's cost estimates appeared reasonable. Nonetheless, as with any estimate, actual costs as well as cash outlays may differ from those projected. Moreover, at the time that the Corporation estimated costs, neither the Corporation nor the acquirers had performed a detailed review of the failed institutions' assets to produce a more accurate estimate of the institutions' negative net worth or the value of assets to be covered by guarantees. Once such a review is completed, the institutions' deficits and the expected losses on covered assets may differ from the Corporation's estimates.

## Estimated Loss on Troubled but Still Operating Institutions

As discussed in note 15 to the financial statements, at December 31, 1988, the Corporation recorded a $43.6 billion loss allowance for troubled but still operating institutions, an increase of $26 billion from its 1987 allowance. This allowance represents the Corporation's estimated cost to resolve 578 troubled but still operating institutions with assets of $267 billion and negative tangible net worth of $17.2 billion at December 31, 1988. For the first time, in addition to the cost related to insolvent institutions, the Corporation included the cost related to solvent but troubled institutions in its loss allowance. These institutions added about $16.5 billion to the loss allowance.

To estimate its loss allowance, the Corporation made various assumptions regarding future operating losses, economic conditions, and interest rates, and whether an institution would be liquidated or merged. For example, the Corporation assumed that the 578 troubled institutions would be resolved over the next 5 years, and, during this time, they would continue to incur operating losses at a rate similar to the rate incurred during the fourth quarter of 1988.

Based on our analysis of the Corporation's assumptions and cost estimates and data available at the time of our audit, we believe that the $43.6 billion allowance for troubled institutions was reasonable. However, as with any estimate, actual costs may differ from those projected. Information that was not available until after we completed audit work leads us to believe that resolution costs may exceed the Corporation's December 31, 1988, estimate. Specifically, financial information reported by savings and loans showed that insolvent institutions incurred operating losses during the first 6 months of 1989 at a rate substantially higher than expected. Further, during the first half of 1989, insolvent institutions' provisions for losses on assets were almost as high as the loss provisions for all of 1988. Therefore, it appears that the quality and value of assets is continuing to deteriorate.

## Funding Provisions in the Act

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 made numerous structural changes to the regulatory and insurance functions for the savings and loan industry and included mechanisms to provide the funds to resolve the savings and loan crisis as follows.

- The act included provisions to pay for the Corporation's prior obligations (primarily obligations arising from assistance transactions entered into before January 1, 1989) that were transferred to the FSLIC Resolution Fund and to pay administrative expenses from the date of enactment through fiscal year 1999, estimated to be about $60.5 billion. The necessary funds will come from a variety of sources, including savings and loan insurance premiums, proceeds from liquidating receivership assets, and the sale of bonds authorized by the Competitive Equality Banking Act of 1987. Any shortfall in the amounts needed for these obligations and expenses is to be provided by the Department of the Treasury through appropriations.
- The act created the Resolution Trust Corporation and provided it $50 billion to pay for the costs associated with institutions placed into conservatorship or receivership (troubled but still operating institutions) from January 1, 1989, until 3 years after enactment. Of that amount, Treasury will provide $18.8 billion during fiscal year 1989. Another newly created entity, the Resolution Funding Corporation (REFCORP), will provide $1.2 billion during fiscal year 1989, using funds it receives from the Federal Home Loan Banks and the proceeds from certain receiverships. REFCORP will raise the remaining $30 billion by issuing 30-year bonds and will transfer the proceeds to the Resolution Trust Corporation for use in resolution actions.

- A mechanism was also provided to pay Savings Association Insurance Fund obligations during fiscal years 1992 through 1999 and to establish a minimum insurance fund balance. During this period, funds of at least $2 billion are to be provided annually. To the extent that savings and loan insurance premiums do not provide $2 billion annually, Treasury is to provide additional funds to make up the shortfall. In addition, Treasury is to provide additional funds as may be needed to ensure that the insurance fund maintains legislatively mandated annual minimum net worth levels, ranging from zero during fiscal year 1992 to $8.8 billion during fiscal year 2000. The amount of funds Treasury can provide to maintain the fund's net worth cannot exceed $2 billion during either fiscal year 1991 or fiscal year 1992. In addition, the cumulative amount appropriated for fiscal years 1991 through 1999 cannot exceed $16 billion.

Based on estimates of the budget impact and funding needs of the legislation, which the administration issued in February 1989, and the Corporation's estimates of acquirer tax benefits attributed to its 1988 assistance transactions, we estimated that $305.9 billion would be needed over the next 33 years to pay for future and prior resolution actions, to pay interest on $50 billion in REFCORP debt and the debt that was authorized by the Competitive Equality Banking Act of 1987, and to pay other miscellaneous items. Of that amount, Treasury's share would be $157.3 billion—$94.1 billion for REFCORP interest and $63.2 billion for direct program items. This estimate does not include any general budgetary interest costs that Treasury would incur on funds it may have to borrow to make expenditures under the legislation. Excluding these interest costs is consistent with the manner in which the Congressional Budget Office and the Office of Management and Budget treat them.

In July 1989, the administration issued new budget and funding estimates, using different interest rate and deposit growth rate assumptions. Based on the administration's revisions, we estimated that the 33-year funding needs for the plan using $30 billion instead of $50 billion in REFCORP debt would be $257.2 billion. Of that amount, Treasury's share would be $139.0 billion—$50.0 billion for REFCORP interest and $89.0 billion for direct program items. The decrease in funding needs and in Treasury's share is primarily due to Treasury providing $18.8 billion for which no general budgetary interest costs are included in the revised estimate. These funds will replace $20 billion in proposed REFCORP debt for which interest costs were included in the original estimate.

To make its original estimate of the costs and cash needs of the plan, the administration used various assumptions, such as rapidly declining interest rates and fairly high deposit growth rates. We have stated on numerous occasions that we believe these assumptions are optimistic. Although the administration revised some of its assumptions for its July 1989 estimates, we believe that they may still prove to be optimistic. For example, the revised assumptions included the following.

- The interest rate on REFCORP debt would decline from 8.25 percent for debt issued in fiscal year 1989 to 7.25 percent for debt issued in fiscal year 1991.
- The interest rate on the Corporation's notes payable would decline from 9.3 percent in fiscal year 1989 to 6.0 percent in fiscal year 1994.
- Insured deposits would increase by an average of 5.2 percent per year through fiscal year 1999, even though the savings and loan industry has been experiencing record deposit outflows since the end of 1988. Nonetheless, this growth rate is substantially lower than the 7.2 percent used for the administration's original estimate.

Overall, we still believe that the administration used optimistic assumptions. Therefore, we believe that the cost to Treasury to resolve the savings and loan crisis will probably be higher than currently estimated.

Nonetheless, because the act provides for Treasury payments to cover any shortfall in funding for the FSLIC Resolution Fund, we believe it provides the means to pay for the Corporation's past actions. However, the act limits the amount of funds available to the Resolution Trust Corporation for future resolutions. It also limits the amount of Treasury funds available to the Savings Association Insurance Fund and restricts the fund's ability to increase insurance assessment rates and to issue notes and other obligations. As previously discussed, insolvent institutions are incurring operating losses at a rate substantially higher than expected. Also, it appears that asset values are continuing to deteriorate. Therefore, resolution costs for troubled but still operating institutions may exceed the $50 billion in funds available to the Resolution Trust Corporation. To the extent that the Savings Association Insurance Fund must cover any such shortfall, its fund balance may be adversely affected.

Charles A. Bowsher
Comptroller General
of the United States

May 31, 1989

# Report on Internal Accounting Controls

We have audited the consolidated financial statements of the Federal Savings and Loan Insurance Corporation for the years ended December 31, 1988 and 1987, and have issued our opinion thereon. As part of our audits, we made a study and evaluation of the system of internal accounting controls to the extent we considered necessary to evaluate the system as required by generally accepted government auditing standards. This report pertains only to our study and evaluation of the system of internal accounting controls for the year ended December 31, 1988. Our report on the study and evaluation of internal accounting controls for the year ended December 31, 1987, is presented in GAO/AFMD-88-58, dated July 5, 1988.

The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the Corporation's financial statements. For purposes of this report, we have classified the significant internal accounting controls into the following categories:

- assistance to merged/acquired institutions,
- costs related to closed institutions,
- costs related to unresolved institutions,
- expenditures,
- financial reporting,
- revenue, and
- treasury.

Our study and evaluation included all of the control categories listed above. In addition, we reviewed the Corporation's 1988 report issued pursuant to section 2 of the Federal Managers' Financial Integrity Act of 1982 (31 U.S.C. 3512) to determine the existence and status of any internal accounting control weaknesses relevant to financial matters. The Corporation reported that its systems of internal accounting and administrative controls, taken as a whole, provided reasonable assurance that the required control requirements were being complied with. We considered the report's statements in conducting our study and evaluation and determining the nature, timing, and extent of our audit tests.

The Corporation's management is responsible for establishing and maintaining an effective system of internal accounting controls. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system of internal accounting controls are to provide management with reasonable assurance that (1) obligations and costs are in compliance with applicable laws, (2) funds, property, and assets are safeguarded against waste, loss, and unauthorized use or misappropriation, and (3) assets, liabilities, revenues, and expenditures applicable to operations are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over the Corporation's assets. Because of inherent limitations in any system of internal accounting controls, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study and evaluation, made for the limited purpose described in the second paragraph, would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the Corporation's system of internal accounting controls taken as a whole or on the categories of controls identified in the second paragraph. Our study and evaluation did not disclose any internal accounting control weaknesses which we considered to be material in relation to the financial statements taken as a whole. Nonetheless, we believe that the following discussion of the Corporation's systems for estimating the costs associated with troubled but still operating savings and loan associations and with its assistance agreements provides information that will be useful to users of its financial statements.

## The Corporation's Resolution Cost Estimating Systems Are Reasonable

The Corporation has standardized methodologies for estimating the costs associated with troubled savings and loan associations and with its assistance agreements. Although the actual cost to resolve the savings and loan crisis cannot be precisely predicted, we believe that the Corporation's systems provide a reasonable basis for developing resolution cost estimates.

In general, to develop its loss allowance for troubled but still operating institutions, the Corporation used cost estimates which were prepared for each troubled institution by the Federal Home Loan Bank analysts who were most familiar with the institutions' financial condition, asset quality, and prospects for the future. To develop the cost estimates, the analysts used financial information that savings and loan associations submitted to the Federal Home Loan Bank Board, adjusted for items such as intangible assets and deferred losses, which either have no value or increase the loss to the Corporation. They then calculated cost estimates using various assumptions regarding future interest rates, asset values, and other factors that were developed to ensure consistency.

The Corporation then adjusted these estimates to incorporate estimated future operating losses and discounted the resulting total cost to its present value as of the end of 1988. The Corporation also established review procedures to ensure that the individual cost estimates were consistent, complete, and reasonable.

To estimate the present value cost of assistance transactions, Corporation analysts used a computer simulation model. Corporation analysts entered relevant asset and net worth information from an assisted institution's most recent quarterly financial report and the specific rates for yield subsidies and promissory notes from the signed agreement. The model then estimated future Corporation cash outflows using this information as well as standardized assumptions regarding future interest rates and asset disposition schedules. The Corporation then discounted the cash flows to present value using its most recent cost of funds. Corporation case managers revise the cost estimates quarterly to reflect assistance paid under the agreement and to update the calculation for changing interest rates and institution-reported financial information. The Corporation also established limited-access procedures for the computer model and review procedures for the resulting estimates to ensure the accuracy and reliability of its methodology and cost estimates.

Through our audit work, we determined that the Corporation's systems were reasonable methods to estimate the cost of unresolved cases and assistance transactions. We also believe that the Corporation used the best information available at the time. However, as discussed in our opinion on the Corporation's financial statements, until resolution action is completed and the true quality of an institution's assets is known, resolution costs cannot be precisely determined.

During our audit, we identified several internal accounting control matters which, although not material, nonetheless merit corrective action to strengthen the Corporation's internal accounting controls. Accordingly, we are reporting them separately to the Federal Deposit Insurance Corporation, which has taken over responsibility for the Corporation's activities.

# Report on Compliance With Laws and Regulations

We have audited the consolidated financial statements of the Federal Savings and Loan Insurance Corporation for the years ended December 31, 1988 and 1987, and have issued our opinion thereon. Our audits were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of compliance with laws and regulations as we considered necessary in the circumstances. This report pertains only to our review of compliance with laws and regulations for the year ended December 31, 1988. Our report on the review of compliance with laws and regulations for the year ended December 31, 1987, is presented in GAO/AFMD-88-58, dated July 5, 1988.

The Corporation's management is responsible for compliance with laws and regulations. In connection with our audits, we selected and tested transactions and records to determine the Corporation's compliance with laws and regulations, noncompliance with which could have a material effect on the financial statements.

As part of our audit, we reviewed and tested compliance with provisions of title IV of the National Housing Act, as amended (12 U.S.C. 1724-1730), title III of the Competitive Equality Banking Act of 1987 (12 U.S.C. 226 note), the Prompt Payment Act (39 U.S.C. 3901), the Federal Managers' Financial Integrity Act of 1982 (31 U.S.C. 3512(b),(c)), and such other laws and regulations as we considered pertinent to the Corporation. In our opinion, the Corporation complied with the terms and provisions of laws and regulations for the transactions tested that could have materially affected the financial statements. In connection with our audit, nothing came to our attention that caused us to believe that the Corporation was not in compliance with the terms and provisions of laws and regulations for those transactions not tested.

## Consolidated Statements of Financial Condition

DECEMBER 31, 1988 AND 1987
(in thousands)

| | 1988 | 1987 |
|---|---|---|
| **Assets** | | |
| Cash and Cash Equivalents (Notes 1 and 3) | $ 3,090,776 | $ 2,922,824 |
| Investments (Note 3) | 574,002 | 446,764 |
| Interest Receivable on Investments | 765 | 1,000 |
| Insurance Premiums and Accounts Receivable | 8,497 | 11,551 |
| Subrogated Accounts from Receivers (Note 4) | 5,200,380 | 3,988,495 |
| Collateralized Advances due from Receivers (Note 5) | 558,791 | 814,047 |
| Loans to Receivers (Note 5) | 128,612 | 113,573 |
| Interest Receivable on Loans to Receivers | 5,217 | 3,767 |
| Collateralized Loans to Insured Institutions (Note 6) | 830,000 | 900,000 |
| Other Loans to Insured Institutions (Note 6) | 205,123 | 214,181 |
| Interest Receivable on Other Loans to Insured Institutions | 11,485 | 10,533 |
| Real Estate, Mortgage Loans and Other Assets (Note 7) | 1,356,096 | 173,437 |
| Income Capital Certificates (Notes 8 and 10) | 257,819 | 656,742 |
| Net Worth Certificates (Notes 9 and 10) | 171,200 | 225,025 |
| Miscellaneous Assets | 17,473 | 26,508 |
| Total Assets | 12,416,236 | 10,508,447 |
| **Liabilities** | | |
| Accounts Payable and Other Liabilities | 127,066 | 102,230 |
| Notes Payable to Insured Institutions (Note 10) | 19,748,114 | 4,661,093 |
| Miscellaneous Liabilities to Insured Institutions | 286,690 | 286,370 |
| Accrued Interest on Notes Payable to Insured Institutions | 220,456 | 99,905 |
| Notes Payable to Federal Home Loan Banks (Note 6) | 830,000 | 900,000 |
| Allowance for Loss - Assistance Agreements (Note 11) | 22,645,000 | 749,069 |
| Allowance for Loss - Unresolved Cases (Note 15) | 43,550,000 | 17,400,000 |
| Total Liabilities | 87,407,326 | 24,198,667 |
| **Insurance Fund Reserves** | | |
| Capital Stock | 497,000 | 129,500 |
| Capital Certificates | 5,353,000 | 1,070,500 |
| Reserves | (80,841,090) | (14,890,220) |
| Total Primary Reserve (Note 13) | (74,991,090) | (13,690,220) |
| Total Liabilities and Reserves | $ 12,416,236 | $ 10,508,447 |

The accompanying notes are an integral part of these financial statements.

## Consolidated Statements of Income and Expenses and Reserves

FOR THE YEARS ENDED DECEMBER 31, 1988 AND 1987
(in thousands)

| | 1988 | 1987 |
|---|---|---|
| **Income** | | |
| Insurance Premiums (Note 1) | $ 473,167 | $ 734,021 |
| Special Assessment Premiums (Note 1) | 1,195,037 | 1,119,582 |
| Less Secondary Reserve Offset (Note 1) | (162,220) | 0 |
| Interest on Investments | 179,978 | 112,552 |
| Interest on Collateralized Advances and Loans to Receivers | 36,378 | 8,814 |
| Interest on Other Loans to Insured Institutions | 44,130 | 88,617 |
| Interest on Collateralized Loans to Insured Institutions | 62,627 | 101,240 |
| Interest on Advances to Insured Institutions | 1,256 | 47,051 |
| Interest from Real Estate, Mortgage Loans and Other Assets in Process of Liquidation | 11,432 | 17,159 |
| Gain on Sale of Assets | 54,457 | 32,299 |
| Gain on Transfer of Insured Accounts | 73,998 | 31,710 |
| Other Income | 482,603 | 102,084 |
| Total Income | 2,452,843 | 2,395,129 |
| **Expenses** | | |
| Insurance Settlement and Administrative Expenses | 223,928 | 192,593 |
| Services Rendered to FSLIC by the FHLBB (Note 2) | 30,562 | 25,604 |
| Interest on Notes Payable to the FHLBanks | 64,731 | 78,928 |
| Interest on Notes Payable to Insured Institutions | 522,351 | 237,789 |
| Provision for Loss on: | | |
| Subrogated Accounts from Receivers (Note 4) | 2,813,697 | 1,623,060 |
| Collateralized Advances due from Receivers (Note 5) | (3,780) | 145,313 |
| Real Estate, Mortgage Loans and Other Assets in Process of Liquidation (Note 7) | 2,587,454 | 106,943 |
| Loans to Receivers (Note 5) | 8,775 | 24,225 |
| Loans to Insured Institutions (Note 6) | 97,600 | |
| Income Capital Certificates (Notes 8 and 10) | 113,938 | 281,793 |
| Assistance Agreements (Note 11) | 35,794,457 | 1,334,730 |
| Unresolved Cases (Note 15) | 26,150,000 | 6,900,000 |
| Total Expenses | 68,403,713 | 10,950,978 |
| Net Loss From Operations | (65,950,870) | (8,555,849) |
| Primary Reserve at Beginning of Period | (13,690,220) | (6,332,891) |
| Prior Period Adjustments | 0 | (1,480) |
| Net Loss | (65,950,870) | (8,555,849) |
| Capital Stock | 367,500 | 129,500 |
| Capital Certificates | 4,282,500 | 1,070,500 |
| Primary Reserve at End of Period (Note 13) | $ (74,991,090) | $ (13,690,220) |

The accompanying notes are an integral part of these financial statements.

## Consolidated Statement of Cash Flows

FOR THE YEAR ENDED DECEMBER 31, 1988
(in thousands)

| | 1988 |
|---|---|
| **Operating Activities** | |
| Net Loss | $ (65,950,870) |
| Adjustments to Reconcile Net Income to Net Cash Used by Operating Activities: | |
| Gain on Sale of Assets | (54,457) |
| Gain on Transfer of Insured Accounts | (73,998) |
| Provision for Loss on: | |
| Subrogated Accounts | 2,813,697 |
| Collateralized Advances due from Receiver | (3,780) |
| Income Capital Certificates | 113,938 |
| Assistance Agreements | 35,794,457 |
| Loans to Receivers | 8,775 |
| Real Estate and Mortgage Loans | 2,587,454 |
| Loans to Insured Institutions | 97,600 |
| Unresolved Cases | 26,150,000 |
| Changes in Operating Assets & Liabilities: | |
| Decrease in Accounts Receivable | 3,054 |
| Increase in Accrued Interest Receivable | (2,183) |
| Increase in Subrogated Accounts | (2,917,454) |
| Decrease in Other Assets | 9,081 |
| Increase in Accounts Payable | 7,643 |
| Increase in Interest Payable | 120,444 |
| Decrease in Other Liabilities to Insured Institutions | (15,455) |
| Payments made on Assistance Agreements | (1,715,490) |
| Purchase of Acquired Assets | (85,092) |
| Net Cash Used by Operating Activities | (3,112,636) |
| **Investing Activities** | |
| Maturity of Marketable Securities | 54,007 |
| Purchase of S&L Stock | (133,230) |
| Repayment of Collateralized Advances due from Receivers | 259,270 |
| Repayment of Loans to Receivers | (23,804) |
| Net Increase in Other Loans to Insured Institutions | (15,109) |
| Redemption of Income Capital Certificates | 2,334 |
| Net Cash Provided by Investing Activities | 143,468 |
| **Financing Activities** | |
| Sale of Capital Stock | 367,500 |
| Sale of Capital Certificates | 4,282,500 |
| Redemption of Notes Payable to Insured Institutions | (1,512,880) |
| Net Cash Provided by Financing Activities | 3,137,120 |
| Increase in Cash & Cash Equivalents (Note 1) | 167,952 |
| Cash & Cash Equivalents as of January 1, 1988 (Note 3) | 2,922,824 |
| Cash & Cash Equivalents as of December 31, 1988 (Note 3) | $ 3,090,776 |

The accompanying notes are an integral part of these financial statements.

## Consolidated Statement of Changes in Financial Position

FOR THE YEAR ENDED DECEMBER 31, 1987
(CALENDAR YEAR BASIS, $000'S)

| | 1987 |
|---|---|
| SOURCES OF FUNDS | |
| Net Loss | $ (8,555,849) |
| Add (Deduct) Items Not Requiring or Generating Cash: | |
| Depreciation of FF&E | 3,227 |
| Accretion and Amortization of Investments | 1,972 |
| Gain on Transfer of Insured Accounts | (31,710) |
| Provision for Loss on: | |
| Subrogated Accounts (Note 4) | 1,623,060 |
| Collateralized Advances from Receiver (Note 5) | 145,313 |
| Loans to Receivers (Note 5) | 24,225 |
| Income Capital Certificates (Notes 8 and 10) | 281,793 |
| Real Estate, Mortgage Loans and Other Assets (Note 7) | 106,943 |
| Assistance Agreements (Note 11) | 1,334,730 |
| Unresolved Cases (Note 15) | 6,900,000 |
| Funds Provided from Operations | 1,833,704 |
| Sale of Capital Stock | 129,500 |
| Sale of Capital Certificates | 1,070,500 |
| Increase In: | |
| Accounts Payable and Other Liabilities | 41,092 |
| Notes Payable and Other Liabilities to Insured Institutions (Note 10) | 74,713 |
| Accrued Interest on Notes Payable to Insured Institutions | 1,964 |
| Decrease In: | |
| Investments and Interest Receivable | 652,855 |
| Real Estate, Mortgage Loans and Other Assets in Process of Liquidation | 13,136 |
| Income Capital Certificates | 498,247 |
| Net Worth Certificates | 47,625 |
| Other Assets | 2,459 |
| TOTAL FUNDS PROVIDED | 4,365,795 |
| APPLICATION OF FUNDS | |
| Amount Paid Under Assistance Agreements | 1,359,733 |
| Refund of Secondary Reserve | 1,480 |
| Increase in: | |
| Subrogated Accounts | 2,752,355 |
| Loans to Receivers and Interest Receivable | 22,275 |
| Collateralized Advances due from Receivers | 134,876 |
| Loans to Insured Institutions and Interest Receivable | 108,434 |
| Insurance Premiums and Accounts Receivable | 8,526 |
| TOTAL FUNDS APPLIED | 4,387,679 |
| Decrease in Cash | $ (21,884) |

The accompanying notes are an integral part of these financial statements.

## Notes to Financial Statements

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1988 AND 1987

1. Summary of Significant Accounting Policies:

a) Principles of Consolidation - The Federal Savings and Loan Insurance Corporation (FSLIC) began accounting for its investment in the Federal Asset Disposition Association (FADA), a wholly owned subsidiary, through consolidation effective December 31, 1986. However, these consolidated statements, do not include accountability for assets and liabilities of closed insured institutions for which the Corporation acts as receiver or liquidating agent. The Corporation furnishes periodic and final accountability reports of its receivership or liquidating agent activities to courts, supervisory authorities, and other interested parties as requested.

b) Premium Income Recognition - Insurance premium income is recognized as earned when member institutions are assessed. These premiums are assessed annually and semi-annually based on an institution's insured anniversary date. On August 10, 1987, the Congress passed the Competitive Equality Banking Act of 1987 (CEBA), PL 100-86. Title III, Section 305 of this act limits FSLIC's authority to collect premiums by reducing them by the amount the recently created Financing Corporation assesses. The rate of assessment may not exceed 1/12 of one percent of the insured institution's total savings capital, whether the premiums are paid to the FSLIC, the Financing Corporation, or a combination of both. As a result of CEBA, $340.8 and $32.1 million of insurance premiums were assessed and collected by the Financing Corporation during 1988 and 1987 respectively.

c) Special Assessment Recognition - In addition to the regular insurance premiums, the Corporation has the authority under Section 404(c) of the National Housing Act to assess each insured member a special assessment premium not to exceed 1/8 of one percent of their total savings capital. The special assessment is billed quarterly and income is recognized as earned when member institutions are billed. Title III, Section 307 of the Competitive Equality Banking Act of 1987 (CEBA) authorizes insured institutions to offset against future special assessment premiums amounts that were previously part of the "Secondary Reserve". This offset began in 1988 and special assessment premiums were reduced by $162.2 million.

Title III, Section 306(c) of the Competitive Equality Banking Act of 1987 also placed limitations on the amount of special assessments for the years 1987 through 1991. The 1988 limitation was 1/12 of one percent, while the 1987 limitation was 5/48 of one percent. However, the Act allowed the Board to postpone the reduction in the special assessment if the Board determined that severe pressures on the Corporation exist which necessitate an infusion of additional funds. The Board approved postponement of the reduction in 1988, and in 1987.

d) Allowance for Loss - The Corporation's policy is to establish an estimated allowance for loss at the time the Bank Board approves either financial assistance to or the liquidation of an insured institution. Financial assistance or liquidation costs may be in several forms (Notes 4 through 11). The estimated allowance for loss represents the purchase price of the assets of a institution less the estimated recovery value, including all disposition costs. These allowances are reviewed at least annually and are adjusted to reflect changes in projected interest rates, recent appraisals, historical experience, etc.

The Allowance for Loss on Unresolved Cases is the estimated cost to FSLIC of all unresolved, troubled institutions (Note 15). This allowance represents the present value cost of future FSLIC assistance that is probable and can be reasonably estimated as of December 31, 1988, and is not a projection of the cost to resolve all future problems in the Savings and Loan Industry. During 1988, there was a policy change to include in the allowance for loss GAAP insolvent and GAAP solvent but troubled institutions beyond the FSLIC caseload. In 1987, the allowance for loss included institutions in the FSLIC caseload plus additional institutions in the Southwest. This policy change resulted in a significant increase to the amount reported as of December 31, 1988.

The administration has proposed legislation that provides for payment of the Corporation's liabilities for both resolved and unresolved troubled institutions.

e) Furniture Fixtures, and Equipment (FF&E) - The FF&E cost at December 31, 1988 and 1987 was zero. All prior years capitalized purchases were depreciated through September 30, 1987, at which time a review of the FF&E policy was made. It was determined that, for the purpose of consistency, all FF&E should be expensed. This policy change resulted in a one time FF&E reduction of $2,128,626 along with a corresponding increase in depreciation expense in 1987. The FF&E of FADA, however, is capitalized and stated at cost less accumulated depreciation, with depreciation computed on a straight line basis over the estimated useful lives of the assets. The net balance is insignificant and is included in other assets.

f) Statement of Cash Flows - In November 1987, the Financial Accounting Standards Board issued Statement No. 95, Statement of Cash Flows (SFAS 95). The FSLIC has adopted the provisions of SFAS 95 by presenting the Statement of Cash Flows in place of the Statement of Changes in Financial Position for 1988 only. For the purposes of the Statement of Cash Flows, all highly liquid investments with original maturities of three months or less are considered to be cash equivalents.

g) Reclassification - Reclassifications have been made in the 1987 financial statements to conform to the presentation used in 1988.

2. Related Parties - The Federal Savings and Loan Insurance Corporation, a government agency created by the National Housing Act of 1934, is governed by the Federal Home Loan Bank Board. Bank Board expenses are met through assessments to the FSLIC and the Federal Home Loan Banks (FHLBanks). The FSLIC's share of the Bank Board assessment is charged to operating expenses during the year in which the assessment is levied. In addition to the Bank Board, the FSLIC interacts with FHLBanks, FADA and the Financing Corporation which are also under the Bank Board's direction.

FHLBanks - The FSLIC, as part of its default prevention activities, may guarantee repayment of FHLBank advances that have been made to certain insured institutions. These guarantees generally cover advances that are secured. As of December 31, 1988, the FSLIC had guaranteed commitments of $4.5 billion, of which $1.6 billion had been advanced to member associations. By comparison, as of December 31, 1987, guaranteed commitments totaled $7.3 billion, of which $2.3 billion had been advanced. In the event that FSLIC is called upon to honor these guarantees, they are recorded as an asset on FSLIC's books and FSLIC has a claim against any assets pledged as collateral to secure such advances.

The FHLBanks are also authorized, as directed by the Bank Board, to make loans to the FSLIC. All such loans must be in accordance with the provisions of section 402(d) of the National Housing Act. Loans from FHLBanks have been passed through to member institutions as Collateralized Loans (Note 6). These loans totaled $830 million as of December 31, 1988, and $900 million as of December 31, 1987.

FADA - In November 1985, the Bank Board approved the formation of the Federal Asset Disposition Association, or FADA. The FADA, which is a wholly owned subsidiary of the FSLIC, manages and disposes of certain assets received by the FSLIC in case resolution actions. As of December 31, 1986, the FSLIC had purchased 25,000 shares of FADA common stock for

$25 million. At December 31, 1988 FADA reported assets of $21.1 million, liabilities of $3.4 million, a retained deficit of $7.3 million, and total stockholder's equity of $17.7 million.

Under a contract with the Federal Home Loan Bank of Topeka, the FSLIC has guaranteed repayment of up to $50 million in Bank advances to the FADA. As of December 31, 1988 and 1987, the FADA had outstanding borrowings of zero and $7.0 million, respectively, against this open line of credit.

Financing Corporation - Title III, Section 302 of the Competitive Equality Banking Act of 1987 established a newly created Financing Corporation. The Financing Corporation (FICO) is funded by the FHLBanks investment and its issuance of public debt offerings which are limited to $10.8 billion. The net proceeds of obligations issued by the Financing Corporation are required to be used to purchase Capital Stock or Capital Certificates issued by the FSLIC (Note 13). Through December 31, 1988, the FICO has purchased $5.9 billion in FSLIC Capital Stock and Capital Certificates.

3. Cash and Investments - All cash received by the Corporation which is not used to defray operating expenses or for outlays related to assistance to insured institutions and liquidation activities, is invested in U.S. Treasury securities. Other Investments are mostly S&L stock and GNMAs issued by Federal Government Agencies other than the U.S. Treasury which were obtained through the Corporation's default prevention activities.

Investment securities are stated at cost, adjusted for amortization of premiums and accretion of discounts. Such amortization and accretion are computed by the interest method at rates based upon the maturity dates of the related securities. Both amortization and accretion are recognized as an adjustment to Interest on Investments. In 1988, the Corporation earned an average geometric rate of return of 7.49% on all investments, excluding preferred stock.

As of December 31, 1988 and 1987, the Corporation's cash and investment portfolio consisted of the following:

| | 1988 | | 1987 | |
|---|---|---|---|---|
| | Book Value | Market Value | Book Value | Market Value |
| | (in thousands) | | (in thousands) | |
| Cash and Cash Equivalents: | | | | |
| Cash | $ 77,301 | $ 77,301 | $ 11,200 | $ 11,200 |
| U.S Treasury Overnight Funds | 3,004,775 | 3,004,775 | 2,910,410 | 2,910,410 |
| FADA Money Market Funds | 8,700 | 8,700 | 1,214 | 1,214 |
| Total Cash and Cash Equivalents: | 3,090,776 | 3,090,776 | 2,922,824 | 2,922,824 |

| | | | | |
|---|---|---|---|---|
| Investments: | | | | |
| Maturities up to One Year | 0 | 0 | 51,985 | 51,801 |
| Maturities Over One Year | 3,011 | 2,853 | 5,018 | 4,857 |
| Total Securities: | 3,011 | 2,853 | 57,003 | 56,658 |
| Preferred Stock | 570,991 | 570,991 | 389,761 | 389,761 |
| Total Investments: | $ 574,002 | $ 573,844 | $ 446,764 | $ 446,419 |

4. Subrogated Accounts - As required by statute, an institution is closed unless there is a default prevention measure that would be less costly than liquidation. In the case of liquidation, the FSLIC settles insurance claims either by cash payout of insured accounts or by transferring insured accounts to another insured institution. The FSLIC's subrogated account claim against the receivership of the liquidated institution is equal to the amount of the insured accounts transferred or paid out.

As assets are liquidated by the receivership, the FSLIC and other creditors receive periodic liquidating dividends in payment of their claims against the receiver. In most cases, a receivership does not have sufficient assets to pay all claims; therefore, the FSLIC must estimate how much of its claim will be recovered over the life of the receivership and record the difference as an allowance for loss against the claim.

The changes in Subrogated Accounts for the years ended December 31, 1988 and 1987 are:

| | Subrogated Accounts | |
|---|---|---|
| | 1988 | 1987 |
| | (in thousands) | |
| Balance: Beginning of Year | $10,847,248 | $ 7,841,250 |
| Additions During the Year | 5,394,620 | 3,006,765 |
| Receiverships Closed During the Year | (8,478) | 0 |
| Losses Realized During the Year | (398) | (767) |
| Gross Subrogated Accounts | 16,232,992 | 10,847,248 |
| Less: Liquidating Dividends from Open Receiverships | 1,712,612 | 351,974 |
| Less: Allowance for Loss for Open Receiverships | 9,320,000 | 6,506,779 |
| Net: End of Year | $ 5,200,380 | $ 3,988,495 |

5. Collateralized Advances Due from Receivers and Loans to Receivers - The FSLIC sometimes guarantees repayment of advances made by FHLBanks to insured institutions. If, subsequently, an institution is closed by the FSLIC, the FSLIC may be required by the FHLBank to repay the advance. The FSLIC repayment of the advance results in a claim against the receivership for the insured institution and establishment of a FSLIC asset, Collateralized Advances Due from Receivers. These Collateralized Advances are to be recovered by the FSLIC from the receivership's liquidation of assets.

The FSLIC also makes loans available to meet the administrative and operating expense requirements of certain receiverships. These loans are to be repaid from the liquidating of assets of the receivership.

The changes in Collateralized Advances Due from Receivers and Loans to Receivers for the years ended December 31, 1988 and 1987 are:

| | Collateralized Advances | | Loans to Receivers | |
|---|---|---|---|---|
| | 1988 | 1987 | 1988 | 1987 |
| | (in thousands) | | (in thousands) | |
| Balance: Beginning of Year | $990,827 | $855,951 | $137,798 | $117,274 |
| Net Increase (Decrease) | (259,036) | 134,876 | 23,814 | 20,524 |
| End of Year | 731,791 | 990,827 | 161,612 | 137,798 |
| Less: Allowance for Loss | 173,000 | 176,780 | 33,000 | 24,225 |
| Net: End of Year | $558,791 | $814,047 | $128,612 | $113,573 |

6. Loans to Insured Institutions - The FSLIC makes both collateralized and other types of loans in assistance cases. The collateralized loans have been funded by pass-through loans from FHLBanks. In these transactions, FSLIC issues a note payable to the FHLBank and loans the proceeds to an insured institution. The FSLIC has two loans of this type, one for $200 million and one for $630 million, totaling $830 million. Interest rates on the $200 million loan and the corresponding note to the FHLBank are the same and averaged 7.7% in 1988. The interest rate on the remaining $630 million loan receivable is based on the monthly weighted-average cost of funds charged to members of the FHLBank in which the institution is located and ranged from 7.5% to 7.9% in 1988. Interest on the corresponding note payable to the FHLBank is based on the cost of FHLBank funds plus 20 basis points. This rate varied between 6.9% and 8.8% during 1988. Principal payments on the $630 million collateralized loan began in 1988 and end in 1995, while principal payments on the $200 million collateralized loan begin in 1989 and end in 1995.

The $205.1 million in Other Loans to Insured Institutions is shown net of a $103.0 million allowance. The interest rate on these loans varies with each note.

7. Real Estate, Mortgage Loans, and Other Assets - The FSLIC makes direct acquisitions of troubled assets from problem associations in its attempt to merge a failing institution. The vast majority of these assets consists of real estate and mortgage loans. An allowance for loss has been established to reduce these assets to their net realizable value.

The changes in Real Estate, Mortgage Loans and Other Assets for the years ended December 31, 1988 and 1987 are:

| | Real Estate, Mortgage Loans, and Other Assets | |
|---|---|---|
| | 1988 | 1987 |
| | (in thousands) | |
| Balance: Beginning of Year | $ 287,919 | $ 337,479 |
| Add: Increase (Decrease) | 3,755,177 | (49,560) |
| Balance: End of Year | 4,043,096 | 287,919 |
| Less: Allowance for Loss | 2,687,000 | 114,482 |
| Net: End of Year | $1,356,096 | $ 173,437 |

8. Income Capital Certificates - Since 1981 the FSLIC has purchased Income Capital Certificates (ICCs) from insured institutions as part of its default prevention activities. The FSLIC usually purchases an ICC by issuing a note payable and records the ICC at cost (Note 10). The ICCs earn annual income payments based on the United States Treasury Bill rates. The annual income payments and principal are due upon the issuing institution having profitable operations and attaining a specified net worth level.

The changes in the ICCs for the years ended December 31, 1988 and 1987 are:

| | Income Capital Certificates | |
|---|---|---|
| | 1988 | 1987 |
| | (in thousands) | |
| Balance: Beginning of Year | $ 1,645,883 | $ 2,219,544 |
| Add: Net Purchases or (Cancellations) | (1,230,064) | (573,661) |
| Balance: End of Year | 415,819 | 1,645,883 |
| Less: Allowance for Loss | 158,000 | 989,141 |
| Net: End of Year | $ 257,819 | $ 656,742 |

9. Net Worth Certificates - Since 1982, the FSLIC has purchased Net Worth Certificates (NWCs) from insured institutions as part of its default prevention activities. The FSLIC purchases an NWC by issuing a note payable and records the NWC at cost (Note 10). NWCs earn annual income payments based on the cost of Federal Home Loan Bank System Obligations plus 1/4 of one percent. Annual income and principal payments are due upon the issuing institution having profitable operations and attaining a specified net worth level. The legislation authorizing the issuance of net worth certificates expired in October 1986 and was reinstated with the passage of the Competitive Equality Banking Act of 1987 on August 10, 1987. The program will expire on October 13, 1991.

The changes in the NWCs for the years ended December 31, 1988 and 1987 are:

| | Net Worth Certificates 1988 | Net Worth Certificates 1987 |
|---|---|---|
| | (in thousands) | |
| Balance: Beginning of Year | $ 225,025 | $ 272,650 |
| Add: Net Purchases or (Cancellations) | (53,825) | (47,625) |
| Net: End of Year | $ 171,200 | $ 225,025 |

10. Notes Payable and Other Liabilities to Insured Institutions - The FSLIC has outstanding negotiable notes to purchase ICCs and promissory notes to purchase ICCs and NWCs. Generally, variable interest is paid semiannually based on the cost of Federal Home Loan Bank System Obligations or the average auction yield for United States Treasury Notes with maturities from 5-10 years. In addition to issuing notes to purchase ICCs and NWCs, the FSLIC has also issued notes to insured institutions who have acquired the deposits of defaulted S&Ls. The principal on these notes may be paid through the transfer of cash and/or assets to the acquirer. The interest on these notes is paid either quarterly or semiannually based on various indices. The weighted average rate as of December 31, 1988 was 8.98 percent. In addition to these notes, FSLIC has other liabilities to acquiring institutions of $286.7 million.

The aggregate amount of the Notes Payable to Insured Institutions and their maturity dates as of December 31, 1988 are as follows:

| | ICCs | NWCs | Acquirers & Other | Total |
|---|---|---|---|---|
| | | (in thousands) | | |
| 1989 | $ 0 | $ 0 | $ 2,742,397* | $ 2,742,397 |
| 1990 | 218,102 | 0 | 478,335 | 696,437 |
| 1991 | 1,000 | 0 | 174,756 | 175,756 |
| 1992 | 15,000 | 19,600 | 174,756 | 209,356 |
| 1993 | 0 | 37,250 | 705,840 | 743,090 |
| Later | 27,000 | 113,125 | 15,040,953 | 15,181,078 |
| Total | $261,102 | $169,975 | $19,317,037 | $19,748,114 |

* Includes $2,036,490 in renewable notes.

11. Allowance for Loss - Assistance Agreements - The FSLIC enters into assistance agreements, which are usually associated with mergers, to prevent the default of an insured institution. Under these arrangements, the Corporation agrees to give financial assistance over time. All future cash outlays are estimated and discounted to their present value. The changes in the Allowance for Loss on Assistance Agreements for the years ended December 31, 1988 and 1987 are:

Allowance for Loss - Assistance Agreements

| | 1988 | 1987 |
|---|---|---|
| | (in thousands) | |
| Balance: Beginning of Year | $ 749,069 | $ 774,072 |
| Add: Provisions | 35,794,457 | 1,334,730 |
| Less: Assistance Provided | 13,898,526 | 1,359,733 |
| Balance: End of Year | $22,645,000 | $ 749,069 |

12. Retirement Plan - Approximately 36% of the FSLIC's employees are covered by the Civil Service Retirement System (CSRS), which is currently two-tiered. For employees hired prior to January 1, 1984, the FSLIC withholds approximately 7 percent of their gross earnings. This contribution is then matched by the FSLIC and the sum is transferred to the Civil Service Retirement Fund, from which this group will receive retirement benefits.

For employees hired on or after January 1, 1984, with more than five years of service (not necessarily continuous), the FSLIC withholds, in addition to Social Security withholdings, .94 percent of their gross earnings, but matches such withholdings with a 7 percent contribution. At the point such earnings exceed the FICA maximum wages of $45,000 for 1988, employees covered under this tier of CSRS are required to have 7 percent of their earnings withheld while the agency expense remains a 7 percent contribution. This second employee group will receive retirement benefits from the CSRS along with the Social Security System, to which they concurrently contribute.

Beginning in January 1987, all employees hired since January 1, 1984, either as new employees or as having less than 5 years of accumulated service (with a break in service over one year) are included in the new Federal Employee Retirement System (FERS). For such employees, the FSLIC withholds .94 percent of their gross earnings and matches those withholdings with a 12.86 percent contribution. This group of employees will receive benefits from the FERS as well as the Social Security System to which they concurrently contribute. The retirement expenses incurred for all plans during calendar years 1988 and 1987 were $2,323,854 and $1,353,587 respectively.

Although the FSLIC funds a portion of pension benefits under both of the above Retirement Systems relating to its employees and makes the necessary payroll withholdings from them, the FSLIC does not account for the assets of either retirement plan nor does it have actuarial data with respect to accumulated plan benefits or the unfunded pension liability relative to its employees. These amounts are reported by the Office of Personnel Management for both Retirement Systems and are not allocated to the individual employers. The Office of Personnel Management accounts for all health and life insurance programs for retired federal employees.

13. Reserves - As of December 31, 1988 and 1987, the Corporation's Primary Reserve consisted of the following:

| | Primary Reserve | |
|---|---|---|
| | 1988 | 1987 |
| | (in thousands) | |
| Balance: Beginning of Year | $ (13,690,220) | $ (6,332,891) |
| Net Loss | (65,950,870) | (8,555,849) |
| Prior Year Adjustment | 0 | (1,480) |
| Capital Stock | 367,500 | 129,500 |
| Capital Certificates | 4,282,500 | 1,070,500 |
| Balance: End of Year | $ (74,991,090) | $(13,690,220) |

Title III, Section 304 of CEBA authorizes the FSLIC to issue equity in the form of redeemable non-voting Capital Stock and non-redeemable Capital Certificates. The non-voting Capital Stock is issued in an amount equal to the aggregate investment by the FHLBanks in the Financing Corporation. The Financing Corporation is the sole purchaser of both the Capital Stock and Capital Certificates, and proceeds paid to the FSLIC from that purchase are included as part of its Primary Reserve. The FSLIC is prohibited from paying any dividends to the Financing Corporation on the Capital Stock or Certificates.

14. Lease Commitments - The FSLIC is currently leasing office space in five Washington D.C. locations in order to accommodate its increased staffing levels. The minimum yearly rental expenses for all locations is as follows:

| Year | Minimum Rental Expense |
|---|---|
| 1987 | $2,998,276 |
| 1988 | 6,874,346 |
| 1989 | 8,620,840 |
| 1990 | 7,842,012 |
| 1991 | 7,842,012 |
| 1992 | 7,993,012 |
| 1993 | 8,259,012 |
| Later | 60,939,273 |

15. Allowance for Loss - Unresolved Cases - The Corporation has established a liability for future FSLIC assistance to or liquidation of troubled institutions. The recorded liability represents the present value of future FSLIC assistance that is probable and can be reasonably estimated as of December 31, 1988. The liability was determined by using Federal Home Loan Bank Board thrift financial reports and FHLBank estimates to adjust the liability for anticipated asset write downs, interest rate market adjustments and projected resolution costs.

A comparison of the December 31, 1988 and 1987 Allowances for Loss on Unresolved Cases indicates a $26.1 billion on-statement increase that is primarily the result of modifications to the methodology and assumptions used each year. These modifications included the inclusion of troubled thrifts not on the FSLIC caseload; the strict use of FHLBank cost data, thereby eliminating the use of a combination of FSLIC bid cost, negative tangible net worth, and FHLBank cost data as was done in 1987; and the development by the Dallas FHLBank of a cost model for Southwest Plan and other Texas insured institutions whose economic environment is quite different from the rest of the country.

Deterioration of the financial condition of a number of insured institutions in 1988, exacerbated by the rapid decline of real estate values, also contributed to the estimate increase. Various uncertainties could cause this estimate to further increase or decrease. Notably, the effect that accomplished case resolutions might have on the cost of other future case resolutions was not estimated.

Changes in the Allowance for Loss on Unresolved Cases for the years ended December 31, 1988 and 1987 are:

| | Allowance for Loss - Unresolved Cases | |
|---|---|---|
| | 1988 | 1987 |
| | (in thousands) | |
| Balance: Beginning of Year | $17,400,000 | $ 10,500,000 |
| Add: Provisions | 26,150,000 | 6,900,000 |
| Balance: End of Year | $43,550,000 | $ 17,400,000 |

16. Litigation - At the end of 1988, FSLIC was named in numerous legal or administrative actions while serving in its corporate, receivership, or conservator capacities. Currently, it is not possible to predict the eventual outcome of the various actions. However, it is management's opinion that these claims will not result in liabilities to such an extent that they will materially affect the FSLIC's financial position.

17. Subsequent Events:

a) Pending Legislation - Due to its actions to resolve the problems of troubled savings and loan institutions and its continuing liability for troubled, but still operating savings and loans, the corporation has suffered recurring losses and has a $75 billion deficit. As a result, on February 22, 1989, the Secretary of the Treasury submitted to the Congress the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), which was introduced as Senate Bill S.413 and as House Bill HR.1278. Under FIRREA, as proposed by the Secretary of the Treasury, the Bank Board would be abolished and its authority and functions, including its authority to supervise and regulate the FHLBanks, would be transferred to a new bureau within the Department of Treasury.

Also, FSLIC would be dissolved and its insurance function transferred to a newly-created thrift industry insurance fund administered by the Federal Deposit Insurance Corporation (FDIC). Concerning outstanding FSLIC obligations, FIRREA provides that on the date of FSLIC dissolution, all its assets, debts, obligations, contracts and other liabilities would be transferred in their entirety to the FSLIC Resolution Fund (FRF) to be administered by the FDIC.

In addition to the FSLIC Resolution Fund, FIRREA provides for the establishment of a Resolution Trust Corporation (RTC). The RTC shall not be an agency or an executive agency for the purposes of Title 5, U.S. Code. The RTC shall carry out a program to manage and resolve all cases involving institutions, the accounts of which were insured by FSLIC prior to enactment of FIRREA, for which a receiver or liquidating conservator has been appointed or is appointed within the three-year period following the date of the enactment of that Act; to manage the assets of the Federal Asset Disposition Association; and to perform such other functions as authorized under the Act.

FIRREA also provides for the formation of the Resolution Funding Corporation (REFCORP). REFCORP would function as a financing vehicle substantially similar to the Financing Corporation. REFCORP would issue debt obligations in a principal amount of up to $50 billion, the proceeds of which would be used to provide funds for the resolution and disposition of insolvent thrift institutions for which a receiver or conservator is appointed within three years following the enactment of FIRREA.

FIRREA is currently being modified by Congress, and Congress is considering other proposals to resolve the problems of FSLIC and the thrift industry. It is not possible at this time to assess the full impact that FIRREA, or any modification to FIRREA, would have on the FSLIC or the thrift industry.

b) Joint Lending Program - On February 23, 1989, the Bank Board and the Federal Reserve Board announced the establishment of the Joint Lending Program to meet the liquidity needs of savings and loans. For a thrift to be eligible for the program, it would have exhausted its normal sources of liquidity, including FHLBank advances, brokered deposits and funding from repurchase agreements.

Under the program, funding for the loans to these eligible thrifts is shared 45% from Federal Reserve resources, 45% from FHLBank resources, and 10% from the FSLIC, utilizing the proceeds from its $700 million borrowing authority with the U.S. Treasury. After funds from FSLIC's U.S. Treasury borrowings are exhausted, lending to individual thrifts will be shared 50-50 between the FHLBanks and the Federal Reserve Banks.

As of May 31, 1989, $180.9 million in loans have been issued under the program, and FSLIC has utilized $29.3 million of its U.S. Treasury borrowing authority. All loans issued from the Federal Reserve and Federal Home Loan Banks are guaranteed by FSLIC. Both the House and

Senate versions of FIRREA stipulate these guarantees will, upon legislative enactment and without any further action, become obligations of the Resolution Trust Corporation and payable within one year from enactment.

18. Supplementary Cash Flow Information

| | 1988 |
|---|---|
| Noncash Investing Activities: | |
| Increase in S&L Stock | $ 48,000 |
| Increase in Collateralized Advances due from Receivers | 234 |
| Increase in Loans to Receivers | 10 |
| Increase in Other Loans to Insured Institutions | 73,433 |
| Decrease in Capital Certificates | (1,227,730) |
| Total Noncash Investing Activities | (1,106,053) |
| Noncash Financing Activities: | |
| Increase in Notes Payable | 16,599,901 |
| Total Noncash Financing Activities | 16,599,901 |
| Total Noncash Investing and Financing Activities | $ 15,493,898 |

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