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Resolving the Savings and Loan Crisis

Statement of
Charles A. Bowsher
Comptroller General
of the United States

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RESOLVING THE SAVINGS AND LOAN CRISIS

SUMMARY OF STATEMENT BY
CHARLES A. BOWSHER
COMPTROLLER GENERAL OF THE
UNITED STATES

In response to a recent request from the Honorable Leon E. Panetta, Chairman of the Committee on the Budget, GAO provided its views on how best to resolve the savings and loan crisis and assure that it is not repeated.

In Summary: GAO recommended a changed approach to resolving insolvent thrift institutions, changes to FSLIC's risk management approaches, and, if those changes occur, provision of sufficient funding to resolve what has become at least an $85 billion problem.

Changed Approach to Resolving Problem Institutions: FSLIC's approach to resolving cases depends too heavily on assistance agreements that minimize FSLIC's need for cash but require subsidies for up to 10 years. FSLIC needs money to achieve more flexibility in its approach. Using personnel resources from other federal agencies, FSLIC should take control of all insolvent institutions over the next year thereby curtailing the ability of these institutions to adversely affect healthy thrifts. FSLIC should then seek to resolve cases at the lowest cost to the government while minimizing adverse competitive impacts on healthy thrifts.

Changed Structure and Management of the Deposit Insurance System: Without changes to the structure and management of the deposit insurance system, the federal government faces potentially large losses in insuring deposits. This potential for loss is most evident in FSLIC. To protect the integrity of the deposit insurance system, an independent FSLIC needs to be created. Healthy and unhealthy thrifts should be put into separate funds so that tougher deposit insurance rules can fairly and equitably be applied to healthy thrifts right away.

Provide Funding: If the changes to risk management and case resolution approaches are adopted, then a plan should be adopted by the Congress that makes funds available to meet the financing shortfall which we estimate at around $85 billion. This plan should (1) require a thrift industry capital contribution to create an adequate insurance fund reserve, (2) provide for budget authority sufficient to finance case resolutions over the next three years, (3) provide FSLIC with the flexibility to undertake short term liquidity borrowing to meet any deposit outflows that might occur, (4) assure adequate controls over spending to protect the tax payers' interests, and (5) use an on-budget approach that fully discloses the funding and outlays that are involved.

Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss the problems in the thrift industry, and provide our recommendations on how best to solve them. My testimony is based on a report we are preparing for the House Banking Committee.

The 1980s have been a turbulent period for our nation's depository institutions. Changes in the financial landscape resulting from market developments and legislated deregulation have drastically altered the way that depository institutions operate. These changes have many positive aspects, but they have also created new risks and a rash of bank and thrift failures.

Two very different approaches have, however, been taken by the bank and thrift regulators to deal with failing institutions. When banks became insolvent, their cases were resolved promptly by closing them or providing assistance under closely supervised arrangements. In contrast, thrift regulators have generally resisted closing failed savings and loans in the hope that the fortunes of these institutions would reverse themselves. This general approach to the thrift industry problem was accompanied by relaxation or even waiving of capital requirements for weak institutions, accounting techniques that hid the true condition of insolvent or weak institutions, and inadequate oversight and supervision.

It is my sincere hope that we have now reached a point where all who are familiar with the thrift industry's problems can at least agree that this policy of not moving quickly to resolve problem cases has been futile and enormously costly. Despite arguments to the contrary, we are convinced that the fiscal situation now faced by the Federal Savings and Loan Insurance Corporation (FSLIC) could have largely been prevented. At the end of 1981, in the face of record setting levels of interest rates and record industry losses, there were only 51 open insolvent institutions that posed a minimal financial threat to FSLIC. Today, even after FSLIC's recent resolution actions, there are still at least 340 insolvent thrifts that FSLIC does not have the financial resources to resolve. A problem that once could have been largely contained has become a matter of utmost national urgency. Resolving this problem will now require concerted action by the Administration and Congress.

Action needs to be taken now. If it is, we estimate that to fully resolve the problem and put FSLIC back on a solid financial footing it will cost at least $85 billion more than FSLIC currently anticipates receiving over the next 10 years. Delaying action will only increase the ultimate cost of dealing with the problem. Delay will also:

-- perpetuate the tendency of weakly capitalized and insolvent institutions to squander our nation's wealth on questionable economic endeavors at no significant risk to their owners,

-- weaken healthy depository institutions and therefore, our financial system, because of their need to match the high rates of interest on deposits paid by weak and insolvent thrifts, and

-- weaken the regulatory process by creating pressure for lower regulatory standards across the depository institutions industry.

In our view, three sets of actions are needed to put the thrift industry problem behind us and reasonably assure that it is not repeated.

-- FSLIC needs to change its approach to resolving problem institutions. FSLIC should concentrate on taking immediate control of insolvent institutions, resolving the cases in a cost effective manner, and minimizing adverse impacts on healthy thrifts.

-- Changes need to be made to the way the deposit insurance system is structured and managed to reduce the exposure of the federal deposit insurance funds to losses.

-- If these two sets of actions are taken, funding must be provided to give a reorganized FSLIC the flexibility it needs to more quickly resolve problem cases and to assure a credible deposit insurance system through restoration of FSLIC's reserves to an acceptable level.

In the remainder of my testimony I would like to discuss our recommendations for accomplishing these actions.

A Different Approach To Resolving Insolvent Institutions Is Urgently Needed

At the beginning of 1988 there were roughly 500 insolvent savings and loans with assets of about $140 billion. During 1988, the Federal Home Loan Bank Board began resolving these cases. The Bank Board reported acting on more than 200 institutions with most of the activity concentrated in the latter part of the year.

The willingness of the Bank Board to begin reducing its problem thrift caseload represents a much needed break from the practices of the past. However, the Bank Board's strategy, based largely on mechanisms to cope with FSLIC's lack of funds and its lack of information on the financial condition of many of its insolvent institutions, seems to depend much too heavily on assisted merger agreements that extend for up to 10 years and that minimize the need for cash. Furthermore, as a result of its large number of December actions, FSLIC has made financial commitments that on a preliminary basis appear to exceed by about $26 billion its expected cash flows over the next 10 years.

We are studying FSLIC's transactions in order to reach conclusions about their appropriateness. We have more work to do. But, I would like at this point to express some general concerns about the approach that has been taken by FSLIC.

-- Ownership capital contributed by private investors has been minimal, and large and thinly capitalized institutions are being created. If history is prologue, inadequate capital creates incentives for such highly leveraged institutions to engage in unsafe and unsound management practices. These institutions may, therefore, continue to pose risks to FSLIC in the future. Should they become insolvent, FSLIC may find it even more difficult to fully resolve their situations because of their larger size.

-- The institutions resulting from the assisted mergers are heavily subsidized by FSLIC, and are therefore competing with healthy nonassisted depository institutions at a cost advantage.

-- FSLIC provides capital loss indemnification and an operating subsidy on assets that appear to make it profitable to simply hold them. We therefore question the strength of institutions' incentives to actively manage and generate recoveries on those assets.

-- Finally, it is questionable whether many of these mergers really save the government money compared to other options that would be possible if FSLIC had the money to resolve cases.

In view of the above drawbacks and questionable savings, an alternative approach is needed that fully resolves insolvent institutions with no lingering adverse competitive effects on healthy thrifts or threats to FSLIC's finances. In this regard, we recommend that:

-- FSLIC take control of all insolvent institutions over the next year. These institutions should be placed in receivership whenever necessary until a decision can be made to liquidate or merge them based on a careful assessment of their asset portfolios, and the comparative cost of each resolution option. Of fundamental importance, these institutions must be effectively isolated from the rest of the depository institutions industry in order to prevent them from competing with healthy institutions. Their operations must be limited to investing in high grade securities, managing bad assets on their books, and accepting deposits at prevailing market rates.

-- In accomplishing this action, the assistance of state and federal regulators and insurance officials should be enlisted to quickly help assess the quality of assets in these institutions and make the necessary resolution decisions.

-- Finally, FSLIC does not possess the infrastructure needed to manage the timely, cost effective resolution of all insolvent thrifts. Consideration should be given to making arrangements with FDIC for asset management and liquidation services until FSLIC can develop the requisite capability.

Risks Faced By Deposit Insurers Must Be Better Managed

Our current system of deposit insurance provides many benefits to the public. Nevertheless, changes are needed to the way the deposit insurance system for banks as well as thrifts manages its exposure to an increasingly risky financial environment. We need to ensure to the extent possible that our experience with the thrift industry is not repeated in this industry--or in banking where the numbers of inadequately capitalized institutions have grown in recent years.

In order to effectively manage deposit insurance risks it is necessary to (1) have sufficient funds to pay for losses, otherwise the credibility of the insurer in taking appropriate action is damaged; (2) ensure that levels of capital in institutions are sufficient to absorb reasonably anticipated losses; and (3) have an effective system of oversight and supervision to quickly identify problems, remedy them if possible, and close institutions at the point of their insolvency.

In accomplishing these risk management goals, there are two significant problems. Both involve FSLIC, and must be overcome in order to better protect the deposit insurance function in the future. The first, and biggest problem, is FSLIC's lack of independence. Presently, FSLIC operates under the direction of the Federal Home Loan Bank Board which both promotes and regulates the industry. The industry itself is overseen and supervised by the Federal Home Loan District Banks, which, in turn, are owned by each District Bank's constituent institutions. In our view, the Federal Home Loan Bank System's role as an industry promoter has been accorded more importance than FSLIC's risk management and insurance function.

The second risk management problem is deciding how best to reorganize thrift industry oversight and supervision in a way that enables quick movement to tougher regulatory and oversight requirements for the healthy part of the industry. This will be exceedingly difficult as long as insolvent and thinly capitalized institutions are allowed to operate with large subsidies, and thereby be given a competitive advantage over healthy institutions. An equitable way must be found to isolate problem cases so that we can "turn the corner" toward more effective oversight, supervision and enforcement of more rigorous rules.

In order to overcome these two problems as well as improve the funding of the deposit insurance system, the financial strength of the industry, and the quality of regulatory oversight, we recommend that the following steps be taken:

-- FSLIC should be made independent of the Federal Home Loan Bank Board, and established with a separate board of directors. An independent FSLIC should oversee two separate insurance funds--one fund for healthy thrift institutions ("good companies") and another fund for insolvent or thinly capitalized thrifts that would be severely curtailed in their ability to compete with the rest of the depository institutions industry.

-- More flexibility should be given to both FDIC and FSLIC to adjust premiums to reflect actual or reasonably anticipated losses.

-- More authority should be given to both FDIC and FSLIC to place stringent controls on improperly operated and undercapitalized institutions including the ability to expeditiously withdraw insurance.

-- Greater consistency between banks and thrifts should be established in matters pertaining to powers and operations that materially affect to the deposit insurers' exposure to risk.

-- Capital adequacy requirements should be strengthened, and the quality of supervision and oversight must be improved through an increase in the personnel and other resources of the deposit insurance funds.

Funding To Fully Resolve Problem Must Be Provided

Insolvent institutions cannot be effectively resolved unless the money to accomplish that result is provided. Unfortunately, deciding precisely how much money will be needed and who should pay will be difficult.

As I indicated at the outset, our best judgement at this time is that it will cost FSLIC at least $85 billion more than it currently anticipates receiving over the next 10 years to pay for losses in insolvent institutions and restore itself to a position of fiscal strength. Of this amount, $26 billion represents FSLIC's unfunded cost of paying for actions taken in 1988 and $34 billion represents the future cost of acting on the remaining insolvent cases. The remaining $25 billion is needed to establish an adequate reserve for FSLIC and resolve any other problems that may occur over the next 10 years. However, given the fluid nature of the situation and the fact that we haven't analyzed all of the actions taken in 1988, I want to stress that these numbers are only estimates.

Similarly, we are not in a position to estimate what the exact annual cash needs will be. They depend on a number of factors including the actual condition and market value of nonperforming assets in insolvent thrift portfolios, and the method used to resolve these institutions. Neither of these factors are presently known.

We believe the thrift industry should pay as much of the shortfall as possible. However, the industry is currently paying premium assessments that are more than two times higher than those paid by the banking industry. Many believe that continuation of the special assessment will weaken healthy thrifts and thereby prove self defeating.

Thus, under the best of circumstances, it is not likely that the thrift industry can contribute much to the funding shortfall. The bulk of the money will have to be found elsewhere. We do not feel that an analytical basis exists for deciding how this burden should be distributed. Judgements must be made based on what is perceived to be fair, and for this reason, we believe that only Congress can appropriately decide the issue. If contributions are not sought from other segments of the depository institutions industry, then the shortfall will have to be met by the federal government on behalf of taxpayers.

If the changes to risk management and case resolution approaches that I have described are made, then we recommend that a plan be adopted by Congress that makes available the funds needed to meet the $85 billion dollar shortfall to pay for insurance losses and restore FSLIC's reserves. This plan should:

-- require a thrift industry capital contribution designed principally to establish an adequate reserve for the good company fund under an independent FSLIC,

-- provide for budget authority sufficient to finance case resolutions which we believe can be completed over the next 3 years,

-- assure adequate controls over spending to protect the taxpayers' interests, and

-- provide FSLIC with flexibility to undertake short-term liquidity borrowing to finance any deposit outflows that might occur while efforts are being made to determine resolution approaches for institutions placed in receivership.

To the extent that federal money is used, we recommend an on-budget approach that fully discloses the funding and outlays that are involved, even if this requires raising the Gramm-Rudman-Hollings deficit reduction targets. We also think that a restructured federal budget along the lines we have proposed elsewhere would better highlight the financing of FSLIC and similar enterprises that are set up to operate a business type cycle of operations.

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I recognize that within the outlines of the actions I have suggested, there are many specific arrangements that need to be worked out. We are prepared to provide whatever assistance this committee and others deem necessary in developing the detailed plans for putting the thrift industry crisis behind us.

That concludes my prepared statement. My colleagues and I will be pleased to answer questions.