Statement of
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before the
Committee on Ways and Means
U.S. House of Representatives

February 22, 1989

NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EST), Wednesday, February 22, 1989.

Mr. Chairman, I am pleased to appear before this Committee to discuss the financial difficulties of the savings and loan industry, and the budget and policy implications of providing federal assistance to resolve the problem. My testimony today will summarize the material presented in a Congressional Budget Office (CBO) staff memorandum prepared for the committee entitled The Savings and Loan Problem: A Discussion of the Issues. More specifically, my statement focuses on three major areas discussed in the CBO paper:

- The size of the problem and the need to move quickly to resolve it;
- The Bush Administration's proposal and its impact on the budget; and
- Issues to be addressed by the Congress, including the financing of a solution and avoiding future problems.

THE SIZE OF THE PROBLEM

Although the Federal Savings and Loan Insurance Corporation (FSLIC) dealt with more than 200 bankrupt thrifts in 1988, the crisis is far from resolved. More than 300 insolvent thrifts still remain open, and many solvent thrifts are financially weak. Because FSLIC itself is insolvent, it has resorted to a variety of creative financing methods in dealing with many of the thrifts acquired with FSLIC assistance, and in the process, it has committed its premium income for many years to come. FSLIC has also left open many questions about both the final cost and the survival of some of the thrifts that have been acquired with government assistance.

To resolve an insolvent thrift, the government must eliminate the gap between the institution's liabilities and its assets. In other words, the government must ensure that assets earning sufficient returns back insured deposits. The ultimate cost of resolving the thrift crisis, therefore, will be roughly equal to the combined negative net worth--the difference between the market value of assets and liabilities--of all insolvent thrifts when each thrift is resolved. The rate at which the net worth of the remaining insolvent thrifts deteriorates reflects the cost of delaying a resolution.

Estimating the ultimate cost of a resolution, however, is extremely difficult. It is even difficult to determine the cost of resolving many institutions that have already been dealt with, the fundamental reason being that thrifts report the book value of their assets--which is based on their historic cost--while the government's liability depends on the market value of those assets. For specialized assets, like incomplete office buildings and idle equipment, only a sale can establish the market value, and it may take years before all the assets are sold. In addition, payments on the notes and guarantees that FSLIC issued when it resolved many of the institutions depend on future interest rates and asset values, as well as on the timing of asset sales.

FSLIC estimates that it has committed $38 billion, in present value terms, to resolve nearly 300 thrifts over the past three years. In addition, FSLIC states that acquirers of insolvent thrifts received, on a net present value basis, more than $5 billion in tax preferences for deals made in 1988 alone. As the result of its efforts, FSLIC has not only exhausted its reserves, but has also more than committed its future premium income, though substantial costs remain to be met. Moreover, a significant segment of the industry, although solvent, is thinly capitalized and not profitable. Indeed, many of these thrifts are likely to become insolvent over the next several years, and so resolving the thrift crisis will also entail dealing with these institutions. Finally, FSLIC must replenish its reserves.

A number of estimates of the cost of the thrift crisis have been made, though they must be viewed with caution. For the most part, they entail a present value cost of at least $100 billion. This amount includes the cost of resolving financially weak thrifts, as well as those that have already been acquired or liquidated. It also includes funds to, at least partly, replenish the reserves of the FSLIC insurance fund. Part of these costs have already been paid for; FSLIC disbursed $16 billion in cash from 1986 to 1988 for case resolution. Thus, if the total cost of the problem is in the range of $100 billion, the federal government would need to spend about another $85 billion in net present value for these purposes. The Administration projects assistance under its plan of roughly that amount. If costs turn out to be greater, however, the Administration's proposal calls for additional resources to be provided by the Treasury.

It is imperative that the problem be dealt with quickly. A major reason for the enormity of the current crisis is that these institutions can continue to operate even when they are insolvent. Because of federal insurance, they have little trouble attracting deposits. They use these funds not only to cover their operating losses, but more significantly they can use them to make additional investments. And because they are insolvent, these thrifts have an incentive to engage in overly risky activities;

they only profit from a successful investment if it generates a large payoff. Thus, moving quickly to deal with insolvent thrifts will reduce the total cost of resolving the problem.

THE BUSH ADMINISTRATION'S PROPOSAL AND ITS IMPACT ON THE BUDGET

The Bush Administration recently announced its plan to deal with the industry's current difficulties. Most of the reforms proposed by the Administration's plan require legislation, however, and hence the Congress will have a number of policy and budget issues to examine in the context of developing a rescue plan.

A major part of the Administration's plan involves raising $50 billion in the private credit markets. These funds, along with direct Treasury payments for any additional cash shortfalls in the insurance fund, would be used to pay for previous commitments as well as to close all currently insolvent thrifts over the next three years. (Much smaller amounts come from the retained earnings of the Federal Home Loan Banks and increased insurance premiums.) The Administration's plan also includes provisions that would strengthen the regulatory and insurance structure of the savings and loan industry to limit risktaking and to restore solvency to the fund.

Within days of announcing this plan, the Federal Home Loan Bank Board, which operates FSLIC, contracted with the Federal Deposit Insurance Corporation (FDIC) to give FDIC control of thrifts that are insolvent. Examiners from several federal agencies are forming teams to help FSLIC stabilize these thrifts. The Bank Board has also suspended sales of insolvent institutions, although it is still liquidating some of them.

While the Administration's plan seems to provide sufficient resources, it is important to consider whether it proposes to raise the funds in the least costly way. The Administration would largely finance the resolution with a mixture of on- and off-budget borrowing. It proposes creating the Resolution Financing Corporation (REFCORP)--an off-budget agency--to borrow $50 billion in fiscal years 1989, 1990, and 1991. In many respects, REFCORP would be similar to the Financing Corporation (FICO), an off-budget agency, created by the Congress in 1987 to raise $10.8 billion for FSLIC. The principal on the REFCORP bonds would be paid by purchasing U.S. Treasury zero coupon bonds that, upon maturity, would be worth $50 billion. The interest payments account for almost all of the cost of this debt. They would be paid in part from FSLIC receipts and Federal Home Loan Bank retained earnings, but they would be paid mostly from the Treasury. By the Administration's estimates, Treasury would cover $6 billion of the $17 billion in interest due in the 1989-1994 period, and at least $16 billion of the $19 billion to be paid in each five-year period thereafter.

The Administration's proposal, like the existing FICO arrangement, is structured to minimize the budgetary impact in the initial years. It would accomplish this by treating REFCORP as off-budget and by recording the $50 billion raised by REFCORP as offsetting collections to FSLIC or to the new Resolution Trust Corporation (RTC), which would resolve the insolvent thrifts insured by FSLIC. As shown in Table 1, this treatment would result in large collections offsetting heavy spending in 1989, 1990, and 1991. Disbursements by FSLIC and RTC would total over $87 billion in that three-year period, but only $18 billion would be scored as budget outlays by these agencies, mostly in 1989.

President Bush's proposal also provides added revenues by increasing the fees that both banks and thrifts pay for deposit insurance, though these increases would contribute little to the cost of resolving the crisis. The Administration estimates that the increase in FDIC fees would generate $7.9 billion over the 1990-1994 period and another $12 billion in the following five years to bolster FDIC reserves. These receipts would reduce the budget deficit, but would not provide resources for thrift resolutions. The proposed assessments on thrifts would increase receipts by only $0.4 billion through 1994, and would result in reduced assessment income thereafter.

Most of the other cash needed under the Administration's plan would come from the Treasury. Including its portion of the interest on the REFCORP bonds, the Treasury would provide about $31 billion to FSLIC and RTC from 1989 to 1994, in order to cover their cash shortfall and provide additional reserves. Another $48 billion would come from the Treasury in the following five years to pay off previously issued notes ($19 billion), pay REFCORP interest ($16 billion), and cover other cash needs.

The Administration's plan, scored in this way, would result in lower outlays than the Reagan budget over the 1989-1994 period. Although 1989 outlays would be increased by $2.4 billion, they would be reduced by $5.0 billion over the next five

TABLE 1. FSLIC/RTC AND TREASURY NET OUTLAYS FROM BUSH PROPOSAL: REFCORP Borrowing Off-Budget (By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994	1989-1994	1989-1999
FSLIC/RTC Disbursements a/	27.7	33.4	26.0	10.4	11.0	8.2	116.5	141.5
FSLIC/RTC Collections								
Proceeds from REFCORP	-10.0	-25.0	-15.0	0.0	0.0	0.0	-50.0	-50.0
Other b/	-7.0	-7.0	-5.0	-5.8	-6.3	-5.9	-36.9	-53.6
Total Collections	-17.0	-32.0	-20.0	-5.8	-6.3	-5.9	-86.8	-103.6
FSLIC/RTC Budget Outlays	10.7	1.4	6.0	4.6	4.7	2.3	29.7	37.9
Treasury Payments for REFCORP Interest	0.5	1.4	1.6	0.9	0.8	1.1	6.3	22.0

SOURCE: Office of Management and Budget.

NOTE: This table assumes that REFCORP is off-budget and that its payments to FSLIC are treated as offsetting collections as proposed by the Administration. The table is based on Administration projections of expenditures and receipts for the various items; it does not reflect CBO economic assumptions or any other possible reestimates. The Administration's figures also do not include any estimates for revenue losses to the Treasury resulting from tax benefits.

a. Disbursements include payments for old and new cases, as well as use of assessment and liquidation income to purchase zero coupon securities and to pay interest on REFCORP bonds.

b. Other collections include proceeds from FICO borrowing, plus income from old and new liquidations as well as current and proposed assessments.

years (see Table 2). This reduction in outlays stems, in part, from the increase in the FDIC assessment, which the Administration estimates would bring in close to $8 billion over the five-year period. The Administration's proposal, excluding the change in FDIC assessments, would increase net budget outlays by $0.7 billion in 1990, and by $5.5 billion over the 1990-1994 period.

By opting to raise funds primarily by borrowing, the Administration's plan meets one major objective of a successful rescue. In view of the need for large amounts of funds quickly, raising the full amount through large temporary increases in taxes would not be efficient and would risk disruptions to the economy. Major changes in taxes may generate substantial adjustments in private expenditures and could lead to sharp changes in economic activity. Relying on debt finance does not pose such problems.

In fact, issuing debt to resolve insolvent thrifts should not have a significant adverse effect on the economy. Any increase in interest rates because of the increased supply of bonds should be temporary and not large. The rescue funds would most likely be used to purchase income-yielding assets such as government bonds, mortgages, and other types of assets; this use of the rescue funds should offset any initial rate increase. In addition, interest rates should be held down by a relative decline in rates on bank and thrift deposits. Since insolvent thrifts would no longer need to offer premium rates to attract ever-increasing deposits to fund their losses, the remaining thrifts could lower what they have to pay depositors.

TABLE 2. BUDGET IMPACT OF BUSH PROPOSAL COMPARED WITH REAGAN BUDGET, Assuming REFCORP Borrowing Off-Budget (By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994	1989-1994
Outlays for Deposit Insurance, Reagan Budget							
FSLIC	8.7	2.1	6.6	4.9	4.9	3.4	30.6
FDIC	3.8	-1.3	-1.9	-2.6	-2.6	-2.7	-7.3
Total Outlays	12.5	0.8	4.7	2.3	2.3	0.7	23.3
Changes Resulting from Bush Proposal							
Net Outlays of FSLIC/RTC	2.0	-0.7	-0.6	-0.3	-0.2	-1.1	-0.9
Additional FDIC collections	0.0	-0.8	-1.6	-1.7	-1.8	-1.9	-7.9
Treasury interest to REFCORP	0.5	1.4	1.6	0.9	0.8	1.1	6.3
Change in Outlays	2.4	-0.2	-0.6	-1.1	-1.2	-1.9	-2.5
TOTAL OUTLAYS: BUSH PROPOSAL	14.9	0.6	4.1	1.2	1.1	-1.2	20.8

SOURCE: Office of Management and Budget.

NOTE: This table assumes that REFCORP is off-budget and that its payments to the FSLIC are treated as offsetting collections as proposed by the Administration. The table is based on Administration projections of expenditures and receipts for the various items; it does not reflect CBO economic assumptions or any other possible reestimates.

Although it seems desirable to finance the rescue plan with borrowing, there is no escaping the fact that such a solution raises the structural budget deficit--interest on Treasury or agency bonds will have to be paid. Financing such interest payments with additional debt would cause the cost of the overall rescue to grow at a compounded rate, and would raise an already large structural deficit. The only way to avoid such an outcome is to impose new taxes or fees or to reduce spending. The Administration's proposal does not identify the revenue sources or cuts in spending on other programs to cover the interest expense of the added debt. The only revenues generated by the proposal are the added insurance premiums paid by the banks and thrifts.

The source of the borrowing is another issue raised by the Administration's proposal. Under the plan, a government-sponsored enterprise, REFCORP, would raise funds for resolving the crisis. Proceeds to FSLIC directly offset agency spending and thus have no effect on the budget deficit. The primary reason for this arrangement would seem to be to reduce the budgetary impact of the proposal so as to avoid the deficit ceilings imposed by the Balanced Budget Act.

A good case can be made that spending on the FSLIC rescue can be distinguished from most government spending and thus should not be governed by the Balanced Budget Act. The outlays for which the debt would be issued are not likely to reduce private investment by diverting private saving to consumption. These funds would probably be returned to the lending stream. Under such circumstances, reducing spending in other programs or raising taxes because outlays to resolve the thrift crisis lead to a breach in the deficit targets would constitute a much greater contraction than the Balanced Budget Act envisioned.

It would, however, be less costly to exempt the $50 billion in expenditures on resolving insolvent thrifts directly rather than by creating an off-budget agency such as REFCORP. Moreover, this exemption would be consistent with the treatment of asset sales by the Balanced Budget Act. In resolving the thrift crisis, the Administration would be making the implicit liabilities of FSLIC into an explicit liability of the government--that is, it would be exchanging one liability for another. Thus, the proposed borrowing would be similar to asset sales by the government; such sales involve the exchange of one asset for another--cash. Asset sales are generally not counted toward deficit reduction targets under the Balanced Budget Act.

This argument does not apply to the interest expense that results from the debt issued to finance the rescue plan. Accordingly, the interest payments should not be exempted from the Balanced Budget Act targets. The Administration's proposal includes these interest payments both in the budget and in computing the budget deficit under the Balanced Budget Act.

Keeping the financing of the thrift crisis on budget has several desirable attributes. The most obvious is that the interest cost on Treasury debt is lower than that on government-sponsored enterprises. In the case of REFCORP, interest expenses would be reduced by $100 million to $200 million a year. Moreover, using Treasury financing should permit the government to move more quickly to resolve the problem. Establishing a separate financing corporation and a secondary market for its securities could be a time-consuming process. Given the need to resolve the remaining insolvent thrifts quickly, the cost of those delays as a result of issuing bonds through REFCORP could be substantial.

The appropriate budgetary treatment for financing a solution to the savings and loan problem is ultimately not a matter to be settled by staff at CBO or the Office of Management and Budget, but a political question to be decided by the Congress and the President. Any legislation that provides additional resources to FSLIC should explicitly stipulate the budgetary treatment of any debt financing used in an assistance plan.

OTHER ISSUES

I would like to touch on two other issues today. The first relates to the existence of tax preferences that are supposed to reduce the cost of resolving insolvent thrifts. The other issue involves the importance of regulatory reform.

Tax Preferences

FSLIC has used two basic methods to fill the gap between an insolvent thrift's liabilities and its assets. The first method is simply to liquidate the institution. While in practice a liquidation can take a variety of forms, in its simplest form, FSLIC pays off the various deposits and then collects the proceeds from the sale of assets of the defunct thrift. In the second method of resolving a thrift, FSLIC provides financial assistance to another firm to acquire the insolvent thrift. FSLIC has tended to emphasize such assisted acquisitions because, among other things, its resources are limited and because the Congress has provided tax advantages that can only be used in acquisitions. The added resources proposed by the Administration should relieve the constraint on FSLIC. Consequently, the Congress may want to reconsider these tax preferences.

FSLIC payments to assist an acquirer of a troubled thrift are not considered taxable income for purposes of the regular corporate income tax. In addition, other tax provisions make it easier for an acquirer of an insolvent thrift to reduce current and future tax liabilities by using the insolvent thrift's net operating losses (NOLs) in previous years. The acquirer can similarly use built-in capital losses--that is, capital losses that are not realized for tax purposes at the time of acquisition.

Permitting acquirers to limit their tax liabilities through the use of these NOLs and built-in capital losses may have undesirable consequences. These tax benefits almost certainly raise the cost to the federal government of resolving the savings and loan problem; in addition, they could create perverse incentives that may harm the industry. By lowering the amount of NOL and capital loss deductions that acquirers of insolvent thrifts were permitted to take, the Technical and Miscellaneous Revenue Act of 1988 reduced but did not remove this distortion.

It is doubtful that the government would receive even the full value of the tax benefits. If the number of potential acquirers was large and FSLIC had reliable information about the current and future tax status of each potential acquirer, FSLIC would be in a favorable bargaining position. In such a situation, it would be able to ensure that its assistance payments reflected nearly the full value of the tax savings. Rarely, however, are these conditions met. Therefore, the tax preferences can be expected to increase the ultimate cost of resolutions.

In an ideal situation, insolvent thrifts would be acquired by those parties who are likely to operate them most efficiently. Yet, rules that facilitate the use of tax-deductible net operating losses and built-in losses could have the unintended effect of awarding the insolvent thrift to the wrong bidder. In particular, the highest bidder may be the one who values the tax consequences of the losses most highly. Thus, the bidding could be dominated by those who expected the greatest tax gain, rather than by those who might operate the thrift most efficiently.

Avoiding Future Losses

The thrift crisis has already been quite costly to the U.S. economy. To say that resolving the thrift crisis will cost $100 billion is to say that the capital stock of the United States is that much smaller and, as a result, that national incomes both now and in the future will be lower. While my previous discussion has largely involved paying for the loss that has already occurred, great importance should also be attached to creating a regulatory system and a deposit insurance system that prevents future crises from developing. This prevention involves limiting future losses of both currently insolvent thrifts and thrifts that will become insolvent in the future.

The best way to reduce the costs associated with the currently insolvent thrifts is to resolve them quickly. These thrifts would then be unable to make more bad investments or drive up interest rates as they seek to fund their ever-increasing operating losses with ever-increasing deposits. Even with unlimited financial resources, however, administrative constraints and other factors will limit the pace at which insolvent thrifts can be resolved. As part of its suggested solution to the thrift problem, the Administration proposes to monitor the activities of insolvent thrifts that remain open in order to limit their losses.

Because federal deposit insurance reduces the incentive of poorly financed thrifts to behave prudently, it is necessary to change these incentives and to monitor the industry more closely. In fact, the Bush Administration has proposed a significant overhaul of the existing regulatory apparatus. It recommends putting much of the regulatory responsibilities for thrifts in the Department of Treasury and the responsibility for insuring thrift deposits with FSLIC. More fundamentally, the Administration proposes that, in certain critical respects, thrifts be treated more like banks.

Specifically, the Administration recommends requiring that thrifts increase their amount of capital, which is the difference between a firm's assets and its liabilities. Capital is essentially the owners' stake in the firm, and increasing the amount of capital that thrifts must maintain should reduce the likelihood of insolvency. A higher capital standard not only reduces the incentives to make risky investments, but it also provides a cushion for the insurer in case the institution experiences financial difficulty. Accordingly, the Bush Administration proposes that by 1991, thrifts must--as banks do now--maintain capital of not less than 6 percent of their assets.

About one-half of the thrifts that are currently solvent meet the new standard. By the same token, over 1,000 thrifts do not. Many of these institutions will be unable to attract the needed additional capital to meet the new requirement. Enforcing the standard may require a substantial number of liquidations and mergers. Since these institutions are solvent, however, the cost to the government should be largely administrative. In fact, many mergers may occur without government intervention. Moreover, higher capital standards should relieve the widely perceived overcapacity in the industry. With higher capital requirements, firms will have to finance loans with more equity and fewer deposits. As a result, operating margins in the industry should increase and the quality of their assets should improve.

A number of other steps would limit the probability that anything like the current thrift crisis will reoccur. One such step would be to give the government greater flexibility to take action when a thrift's financial position deteriorates. Encouraging a financial institution to hold a diversified portfolio of assets would also make it less likely that it will become insolvent. Diversity lessens the likelihood that the poor performance of a particular region or industry would erode the financial strength of an institution. Current federal and state policies that discourage expanded geographic coverage are, at least in this respect, counterproductive.

Regulatory reform is very important. Nevertheless, if addressing this issue were to slow the resolution of insolvent thrifts, a comprehensive reform of the regulatory system could impose significant costs. In the first place, because insolvent institutions must continually attract increasing amounts of deposits just to fund their current obligations, they raise the cost for solvent thrifts that must compete with them. This effect makes it more difficult for solvent institutions to raise necessary levels of capital; in fact, it may ultimately force more institutions toward insolvency. Insolvent thrifts also have incentives to make overly risky investments.

In addition, the Bank Board is already taking steps to improve regulation of the industry. For example, it has proposed increasing the industry's capital requirements and is monitoring the behavior of individual thrifts more closely. Therefore, while it is desirable both to resolve existing insolvent thrifts and develop a new regulatory regime, the Congress should be mindful of the extent to which including comprehensive regulatory reform in any plan could delay an ultimate resolution to the current thrift crisis.

CONCLUSION

The cost to the economy of the thrift crisis has already been considerable. The Congress might want to consider a number of steps to reduce any additional costs. One of the most important is to act quickly. The Congress may also be able to speed the resolution by relying on Treasury funding and considering regulatory reform separately from the resolution of insolvent thrifts. It is, nevertheless, critical to reduce both the incentives and ability of thrifts to act imprudently in the future. While the resolution should be funded with government borrowing, a good case can be made that most of these expenditures should not be counted against budget ceilings in the Balanced Budget Act. Finally, with adequate financing to deal with the problem, there seems little reason for continuing the current tax preferences for acquirers of insolvent thrifts.