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Statement of the Shadow Financial Regulatory Committee

on

Alternatives to Recapitalizing the Savings Association Insurance Fund

May 22, 1995

Recent FDIC proposals to lower premiums for institutions insured by BIF (Bank Insurance Fund), and hearings before both the FDIC and Congress highlight the undercapitalized position of the SAIF (Savings Association Insurance Fund). FIRREA created two new insurance funds - BIF for commercial banks and SAIF for thrift institutions. In addition, the law mandated that insurance premiums be set to achieve set a reserve ratio of 1.25 percent of insured deposits for both the BIF and SAIF insurance funds. BIF reserves are projected to reach the mandated 1.25 percent level by July. At that point, the FDIC is required by law to lower premiums to a level sufficient to maintain the 1.25 percent reserve ratio while maintaining a risk-related premium structure. The FDIC has proposed a structure with an average premium of between 4 and 5 basis points, with a minimum of 4 basis points and a maximum of 31 basis points.

SAIF is far from reaching the 1.25 percent reserve ratio, which presently stands at only .28 percent. To recapitalize the fund immediately would require an injection of approximately $6.8 billion. Under reasonable, but optimistic assumptions, SAIF would not reach the required ratio of 1.25 percent by relying on annual assessments until 2002. The present concerns result from an ill-designed rescue/financing package for resolving troubled thrift institution failures and to

restructure and provide for the partial recapitalization of the deposit insurance funds. Part of the reason for the delay in recapitalizing the SAIF fund has been the need to divert most of the SAIF premiums to cover FICO (Financing Corporation), REFCORP (Resolution Funding Corporation) and FRF (Federal Savings and Loan Insurance Corporation Resolution Fund) bonds issued to partially recapitalize the SAIF and to provide funds for resolving problem institutions. Of the $ 9.3 billion in SAIF premiums collected between 1989 and 1994, $7 billion has been used to cover interest payments, leaving only $ 2.3 billion to replenish the fund.[1] About $8.4 billion would be required to defease the FICO bonds. FICO interest payments presently account for approximately 45 percent of assessment revenues, or about 11 basis points of the 24 basis point average assessment paid by SAIF insured institutions (this compares with the projected average premium of 4 to 5 basis points for commercial banks under the current FDIC proposal).

Several concerns exist regarding the future of the SAIF fund. First, on July 1, 1995 responsibility for resolving thrift failures will fall on the SAIF fund which has limited resources. Second, an increasing number of thrifts are being purchased by banks (so called Oakar banks) or are converting to commercial bank charter status (Sasser banks). While these institutions remain under SAIF insurance, the FDIC has interpreted the law as prohibiting assessments from these institutions from being used to cover FICO bond payments.[2] The present

[1] Principal on the FICO bonds has been defeased by the purchase of zero coupon bonds and interest coverage amounts to $ 779 million per year.

[2] At present, there are approximately 715 banks that have purchased $180 billion in thrift deposits and 319 Sasser institutions with 53 billion in SAIF-insured deposits. These institutions combined account for about 33 percent of safe assessments. At current premium levels, an assessment base of $325 billion is required to generate sufficient premium income to service the FICO bonds. If failures, conversions and acquisitions absorb an additional $161 billion in SAIF-insured deposits, assessment revenues will be inadequate.

assessment base has been declining at about 8 percent per year, over the past several years. If this continues eligible assessment revenues will be insufficient to cover FICO interest payments in 5 years.

Third, concern is that with narrowing spreads and margins, the 19 basis point premium differential will competitively disadvantage SAIF-insured institutions and that many will seek other means to avoid the premium differential, such as the formation of parallel national banks that would be commonly housed in thrift offices. This has already been proposed by Great Western Financial Corporation and several other institutions. If these tactics are successful, SAIF insured deposits would decline by approximately $80 billion, or about half of the assessment cushion.

Part of the earnings drain on the SAIF associated with higher premiums is the statutory requirement to bring the SAIF up to the mandated 1.25 percent coverage ratio. However, this 1.25 percent ratio is no longer justified if early intervention and least cost resolution work as designed. The justification for any particular coverage ratio should rest on expectations about future risk exposure of the fund. The fund's exposure depends upon closure policies and monitoring costs. With an adequate closure policy for capital deficient institutions that resolves them before net worth becomes negative, the Committee believes the only need for a fund is to cover the costs of administration, errors in assessing solvency, and fraud, and to finance the temporary warehousing of assets of failed thrifts until they can be liquidated.

The required size of the assessment can be reduced by abandoning the 1.25 percent coverage ratio. To compensate for this reduced coverage, the Committee proposes that the higher critical level of capital that would trigger the least cost resolution provisions of FDICIA be raised from 2 percent to 4 percent, which would reduce the potential for losses to the SAIF fund even further. This would essentially substitute self insurance and regulatory monitoring for the current system of deposit insurance for SAIF insured institutions. The proposal also relies upon an institution's own capital to protect the insurance fund

and taxpayer and would not impose a burden on other institutions.

Elimination of the 1.25 percent requirement would leave thrifts with an 11 basis point assessment to cover FICO interest payments. This assumes that Congress would stipulate that premiums from Sasser and Oakar institutions could be used to meet FICO obligations. Substituting an appropriately higher critical level of capital to trigger least cost resolution would also set the foundation for addressing the issue of the need for maintaining a separate thrift charter.