CBO TESTIMONY

Statement of
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NOTICE

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Mr. Chairman, I am pleased to appear before the Committee this morning to discuss the Federal Deposit Insurance Corporation's Bank Insurance Fund (BIF). In my statement today, I will discuss the current condition of the fund and estimates we have prepared in order to assess its viability over the next few years.

The banking industry clearly is undergoing considerable stress. Close to 900 banks have been closed in the last five years, more than twice the number closed between 1934, when federal deposit insurance began, and 1979. Yet the industry as a whole is much healthier than the savings and loan (S&L) industry. Of the 13,200 commercial and savings banks at the beginning of 1990, about 11,600 are in satisfactory financial condition, with equity as a percentage of assets exceeding 6 percent. In contrast, less than half of the S&L industry attains that standard.

THE BANK INSURANCE FUND

The Bank Insurance Fund was established in 1989 by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) and is operated by the Federal Deposit Insurance Corporation (FDIC). BIF replaced the bank insurance fund that the FDIC had previously operated and assumed the assets and liabilities of that fund. Like the previous fund, BIF is charged with insuring the deposits of about 13,000 institutions, of which about 95 percent are commercial banks. The fund also insures the

deposits of a small number of federally and state-chartered savings banks and branches of foreign banks that conduct consumer business in this country. The responsibility for regulating the institutions insured by BIF is spread among various federal and state agencies, including state bank supervisors, the FDIC, the Office of the Comptroller of the Currency, the Federal Reserve Board, and the Office of Thrift Supervision.

The Bank Insurance Fund spends money to pay off depositors when a bank is closed, to assist an acquiring institution when a failing bank is merged, and to cover FDIC administrative expenses. The fund derives income primarily from assessments on insured banks and from the sale of assets of failed banks. It is also credited with interest earned from its cash balances, most of which are invested in Treasury securities.

The fund's financial condition can be assessed on either an accrual or a cash basis. The FDIC reports its net income on an accrual basis, and the resulting fund balances represent the accumulated net worth of the fund. For this purpose, the corporation records an allowance for losses each year, both for banks that have been closed or have entered into financial assistance agreements and for those it has identified as highly likely to fail or need assistance. The estimated loss includes expected future income from asset disposition, net of liquidation costs. On this basis, the fund showed a net loss of $2.0 billion in fiscal year 1989 and a fund balance of $14.3 billion at the end of that year. The fund balance as a percentage of insured deposits is

commonly used as an indicator of the fund's financial viability. On September 30, 1989, it was equivalent to 0.8 percent of insured deposits.

The federal budget, in contrast, records FDIC's transactions on a cash basis, reflecting each year only those assistance payments and receipts that have occurred. The condition of the fund can be measured correspondingly in terms of its cash or cash equivalents, largely Treasury securities, which are the resources currently available to carry out its functions. Using these measures, the fund incurred net outlays of $2.8 billion in fiscal year 1989 and had cash and Treasury securities (a cash balance) totaling $15.1 billion. The cash balance is important because in the short term the FDIC's need for cash to finance the acquisition of assets may exceed its expected net losses by substantial amounts, and a shortage of cash could constrain the corporation's actions.

Until recently, the FDIC's bank insurance activities consistently generated more receipts than outlays for the government. From 1970 to 1985, the FDIC recorded positive net income on its books each year, including $2.8 billion in 1985. The accrued balance in the FDIC fund grew from $3.9 billion at the beginning of 1970 to $19.5 billion by the end of 1985. A total of $22 billion was spent from the insurance fund over this period, most of it after 1981, to deal with an average of 24 failing banks a year. Those costs were far exceeded by the fund's income, even after the FDIC regularly rebated a portion of the banks' assessment payments.

In the past few years, however, the financial condition of the fund has deteriorated as the industry's condition declined. In fiscal years 1986 through 1989, 769 banks failed or received assistance, and the fund's gross outlays totaled $27 billion. Spending grew steadily from $3.0 billion in 1985 to $8.6 billion in 1989. We now estimate that spending will total over $11 billion in fiscal year 1990. The fund had net losses of $2.0 billion in both 1988 and 1989, and net budget outlays of $2.1 billion and $2.8 billion, respectively, in those years. Losses and outlays in 1990 will be even greater (see Table 1).

TABLE 1. FDIC BANK INSURANCE FUND PERFORMANCE, FISCAL YEARS 1986-1990 (In billions of dollars)

	Actual				Estimated
	1986	1987	1988	1989	1990
Outlays					
Gross Spending	5.5	4.4	8.2	8.6	11.1
Collections	-4.7	-5.8	-6.1	-5.8	-5.8
Net Budget Outlays	0.8	-1.4	2.1	2.8	5.3
Net Income					
Accrued Net Income	a	-0.2	-2.0	-2.0	-3.5
End-of-Year Balances					
Cash Balance	15.9	17.1	15.6	15.1	10.2
Accrued Fund Balance	18.8	18.3	16.3	14.3	10.8

SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation.

a. Less than $50 million.

The percentage of insured deposits covered by the balance in the fund has also declined substantially in recent years. In the 1970s and early 1980s, the fund balance covered an average of 1.2 percent of insured deposits. That ratio peaked at 1.3 percent in 1985 and has been declining since, to 0.8 percent at the beginning of fiscal year 1990. This is well below the 1.25 percent target established in FIRREA. Table 2 provides a historical perspective on the fund's activity, income, and reserves.

TABLE 2. HISTORICAL DATA ON THE BANK INSURANCE FUND, CALENDAR YEARS 1934-1989

	Average Number of Banks Closed or Assisted Per Year	Average Annual Losses on Failed Banks (Millions of dollars)	Net Fund Income (Billions of dollars)	Fund Balance as a Percentage of Insured Deposits
1934-1939	36	3	0.1	1.7
1940-1949	10	1	1.0	1.6
1950-1959	3	a	1.0	1.4
1960-1969	4	1	2.0	1.4
1970-1979	8	11	5.7	1.2
1980-1985	52	1,106	8.2	1.2
1986	145	1,859	0.3	1.1
1987	203	2,120	b	1.1
1988	221	5,509	-4.2	0.8
1989	207	5,998	-0.9	0.7

SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation.

a. Less than $500,000.
b. Less than $50 million.

BASELINE PROJECTIONS FOR THE BANK INSURANCE FUND

In our June baseline estimates, CBO projected that BIF's net outlays will peak at about $4.2 billion in fiscal year 1990 and will decline gradually over the next five years, averaging about $1.5 billion a year over the 1991-1995 period. This projection was based on the number of institutions on the FDIC's problem bank list. We projected that BIF would continue to provide assistance to failed and troubled banks in amounts that are similar to the historically high levels of assistance experienced recently. These levels reflect a number of problems affecting the banking industry, including regional real estate downturns, questionable loans to developing countries, and exposure to highly leveraged transactions.

Specifically, we estimated that BIF's gross spending will total about $35 billion over the 1990-1993 period, about 30 percent more than it spent between 1986 and 1989. We also assumed that the assessment rate would remain at the minimum established by FIRREA--15.0 cents per $100 of insured deposits, beginning in January 1991. Under these assumptions, the Bank Insurance Fund would continue to show losses, the accrued balance in the fund would continue declining to about 0.3 percent of insured deposits by 1995, and the cash balances, including Treasury securities, would largely be depleted.

Recent developments have changed the financial outlook for BIF. Last month, the FDIC proposed to raise the premium paid by banks to 19.5 cents per $100 of insured deposits, the maximum allowed by FIRREA for 1991. If implemented, this change would add to the fund's income and decrease its net outlays by between $1.1 billion and $1.2 billion a year, compared with our baseline projections. It also appears that BIF's 1990 spending will exceed our previous projections by as much as $1 billion. If the baseline is adjusted for these two factors, assuming that the proposed increase in bank assessments is maintained in subsequent years, we estimate that the Bank Insurance Fund would show net income (on an accrual basis) beginning in 1993 (see Table 3). Under this scenario, the fund balance would be about $12 billion by 1995, or 0.5 percent of insured deposits, still below the minimum set by FIRREA. The cash balance, however, would be down to about $7 billion in 1995, as the FDIC would acquire increasing amounts of bank assets in the course of case resolutions.

TABLE 3. FINANCIAL PROJECTIONS FOR FDIC BANK INSURANCE FUND WITH ADDITIONAL 1990 SPENDING AND HIGHER PREMIUMS (By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
			Outlays			
Gross Spending	11.1	8.9	8.2	7.4	7.1	6.3
Collections	-5.8	-6.9	-7.3	-7.4	-7.6	-7.8
Net Budget Outlays	5.3	2.0	0.9	0	-0.5	-1.5
			Net Income			
Accrued Net Income	-3.5	-1.2	-0.2	0.4	0.8	1.5
			End-of-Year Balances			
Cash Balance	10.2	6.5	5.5	5.2	5.7	6.9
Accrued Fund Balance	10.8	9.7	9.5	9.9	10.7	12.3

SOURCE: Congressional Budget Office.

NOTE: This table represents CBO's June baseline, modified to reflect higher expected spending in 1990 and the proposed premium increase to 19.5 cents per $100 of insured deposits, beginning January 1, 1991.

A LOOK AT BIF'S CONTINGENT LIABILITIES

The FDIC currently records as contingent liabilities only those projected future costs associated with previous resolutions. It also assigns reserves for those banks that it believes are virtually certain to fail during the coming year. These items are both charged as deductions against the fund's net income.

Although these procedures may comport with standard accounting practices, a broader view would be useful for policy decisions. In assessing the contingent liabilities of the Bank Insurance Fund, it is important to estimate losses for several years ahead and not only to consider failures that are highly likely to occur, but also to make allowance for less likely losses. (Private insurance companies prepare such projections on an actuarial basis to determine their own financial condition.) Surprises cannot be ruled out; institutions that appear to be well capitalized can and do fail, even within one or two quarters.

While CBO is not privy to the kind of detailed financial information available to the FDIC, we have analyzed the available industry data to develop an estimate of the fund's potential liabilities over the next few years. We sorted all the insured institutions into five groups, based on the ratios of equity to assets. Banks within each group were categorized as small, medium, or large. For each group, we reviewed actual experience from 1986 to mid-1990 to assess the likelihood that an institution in a given size category would fail over a period of 3 1/2 years. For each category, we then projected net losses over the 1990-1993 period using these historical failure rates, along with FDIC's estimates of the loss per dollar of assets associated with those failures. (The historical information is summarized in Table 4 and the projections in Table 5.)

TABLE 4. BANK FAILURES AND LOSSES OVER THE 1987-1990 PERIOD, BY CAPITALIZATION AND SIZE OF BANKS

	Number of FDIC-Insured Banks 1986	Bank Failures Between 1/1/87 and 6/30/90	Assets of Failed Banks as Percentage of Total Assets in Size Category	Estimated Losses as Percentage of Assets at Failed Banks in Size Category
Group 1				
Large banks	271	8	1.5	7.4
Medium banks	1,694	23	1.6	20.8
Small banks	9,945	278	2.3	24.9
Total	11,910	309		
Group 2				
Large banks	279	16	3.5	10.6
Medium banks	523	60	11.2	15.8
Small banks	1,195	175	12.7	22.7
Total	1,997	251		
Group 3				
Large banks	4	0	0	0
Medium banks	19	12	53.1	11.1
Small banks	113	67	55.7	17.3
Total	136	79		
Group 4				
Large banks	2	1	21.7	24.4
Medium banks	9	5	68.7	28.8
Small banks	73	42	55.5	26.3
Total	84	48		
Group 5				
Large banks	2	2	100.0	8.9
Medium banks	2	2	100.0	35.0
Small banks	45	43	97.2	31.4
Total	49	47		
Total, All Groups	14,176	734	3.7	14.0

SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation and Ferguson and Co.

NOTES: The banks are grouped by equity as a percentage of assets, as follows:

Group 1	Greater than 6 percent
Group 2	Greater than 3 percent, but less than or equal to 6 percent
Group 3	Greater than 1.5 percent, but less than or equal to 3 percent
Group 4	Greater than zero percent, but less than or equal to 1.5 percent
Group 5	Less than or equal to zero percent

Banks with assets of more than $500 million are categorized as large; banks with assets greater than $100 million and less than $500 million are categorized as medium; banks with assets of $100 million or less are categorized as small.

TABLE 5. PROJECTION OF 1990-1993 BIF LOSSES BASED ON 1987-1990 EXPERIENCE

	Number of Insured Banks 12/31/89	Total Assets 12/31/89 (Billions of dollars)	Projected Number of Failures 1990-1993	Projected Fund Losses 1990-1993 (Billions of dollars)[a]
Group 1				
Large banks	479	1,030	14	1.1
Medium banks	2,231	435	31	1.4
Small banks	8,931	338	250	1.9
Total	11,641	1,803	295	4.5
Group 2				
Large banks	228	1,505	13	5.6
Medium banks	330	72	38	1.3
Small banks	743	29	108	0.8
Total	1,301	1,606	159	7.7
Group 3				
Large banks	8	66	5	2.1
Medium banks	15	3	9	0.2
Small banks	84	3	49	0.2
Total	107	72	63	2.5
Group 4				
Large banks	5	35	3	1.8
Medium banks	10	3	6	0.3
Small banks	55	2	31	0.2
Total	70	40	40	2.3
Group 5				
Large banks	6	21	6	2.8
Medium banks	8	2	8	0.5
Small banks	63	2	60	0.6
Total	77	25	74	3.9
Total, All Groups	13,196	3,545	631	20.8

SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation and Ferguson and Co.

NOTES: The banks are grouped by equity as a percentage of assets, as follows:

Group 1	Greater than 6 percent
Group 2	Greater than 3 percent, but less than or equal to 6 percent
Group 3	Greater than 1.5 percent, but less than or equal to 3 percent
Group 4	Greater than zero percent, but less than or equal to 1.5 percent
Group 5	Less than or equal to zero percent

Banks with assets of more than $500 million are categorized as large; banks with assets greater than $100 million and less than $500 million are categorized as medium; banks with assets of $100 million or less are categorized as small.

a. For each category, losses are calculated by multiplying total 1989 assets of insured banks (from this table) times assets of failed banks as a percentage of total assets (from Table 4) times estimated losses as a percentage of assets at failed banks (from Table 4).

As an example of how these projections were made, we can look at the 271 large banks with equity-to-asset ratios of 6 percent or more in 1986--the best-capitalized institutions. Eight of these, accounting for 1.5 percent of the assets in their category, had failed between 1986 and mid-1990. The FDIC has estimated its losses on these banks to be 7.4 percent of assets. Applying these rates to the $1.0 trillion in assets in that class of institutions at the end of 1989 yields projected net losses over the next few years of $1.1 billion for such banks. We carried out similar projections for each of the other categories. The probabilities of failure are much higher in other groups, rising to 29 percent for banks with equity-to-asset ratios between 1.5 percent and 3.0 percent, and to 100 percent for those with no equity at all.

This method produces an estimate of about $21 billion in net losses to be covered by the fund over the 1990-1993 period, or $5 billion to $6 billion a year, from a total of 600 to 700 bank failures. (The FDIC had about 1,100 commercial banks on its problem list as of December 31, 1989.) Over the 1990-1993 period, covering these losses would require gross cash disbursements of $35 billion to $40 billion to finance the acquisition of assets from failed banks. (This would be below the rate of spending we currently expect for fiscal year 1990.) This estimate only slightly exceeds the current CBO baseline projection of cash disbursements over the four-year period, which is $35 billion. As a result, by 1993 it would produce lower cash

balances--of about $4 billion--and a fund balance equivalent to 0.4 percent of insured deposits.

Most of this risk is associated with large banks, those with assets of at least $500 million. Only 50 to 60 such banks would account for two-thirds of these losses. If just one of the 10 largest banks fails, it alone could account for losses of $10 billion or more. While failure of one of these very large banks may be unlikely, it is certainly possible. Only 2 of the top 10 banks report equity-to-asset ratios that exceed 6 percent. These 10 institutions hold more than $43 billion in debt from developing countries, as well as substantial amounts of questionable commercial real estate loans, highly leveraged debt, and nonperforming or delinquent loans.

Of course, any estimate of future losses is very uncertain. There is no assurance that future experience will match recent history or that the FDIC's estimates of losses already incurred will turn out to be accurate. Future loss rates could be higher or lower than past ones, depending on how quickly regulators move to close down failing institutions. In addition, CBO has not taken into account the possible effects of the slower economic growth that now seems likely. The uncertain economic outlook, exacerbated by declines in real estate values and sharp increases in oil prices, raises concerns that spending from the fund could be greater during the next few years than we have estimated. However, the impact of economic conditions on the fund is difficult to quantify. Generally, a weaker economy would increase the

likelihood of bank failures by reducing the value of bank assets, increasing loan defaults, and placing additional pressure on bank earnings. More specifically, the spread of current problems in some regions to real estate markets throughout the nation would reduce the value of these assets and would not only increase the probability that an institution could fail, but also require the government to hold the failed bank's assets longer. This would increase the cost of resolving bank failures or assistance transactions and decrease the FDIC's revenues from the sale of the assets that it retains.

If losses as a percentage of assets were twice the estimated historical rate, and thus similar to S&L losses, the estimate would double. And if the probabilities of failure were changed by as little as 0.5 percentage points, well within the range of uncertainty, the estimate of losses would swing by more than $2 billion.

These loss projections do not include additional potential liabilities of the fund that could result from previous case resolutions. The FDIC has guaranteed in various ways the value of assets transferred to certain acquiring institutions. These commitments could require additional cash outlays by the fund in future years. According to the FDIC, this potential exposure is about $8 billion.

CAN BIF ATTAIN ADEQUATE RESERVES?

No one can predict with certainty the amount of the fund's losses over the next few years. The possible magnitudes range from quite small to very large, with a small likelihood attached to the two extremes and a much greater probability of losses somewhere in between. The losses will be affected by international events, national economic factors, regional conditions, the actions of regulators, and a host of other circumstances. It would not be reasonable or possible to accumulate sufficient reserves to cover the full cost of catastrophic losses, but the government must decide, either explicitly or otherwise, what level of losses the fund should be able to meet from its assessment income and other resources. In FIRREA, the Congress stated that BIF should have reserves of at least 1.25 percent of insured deposits. We estimate that the fund would require a balance of $30 billion by the end of fiscal year 1995 to meet this target, but that it cannot be attained in the next few years without further increases in bank assessment rates.

FIRREA allows the FDIC to increase the rate for assessments charged to insured banks by up to 7.5 cents each year, to a maximum level of 32.5 cents per $100 of insured deposits. As I noted earlier, the agency has proposed an increase of the full 7.5 cents for calendar year 1991. Premiums at the proposed level of 19.5 cents would generate enough cash to finance annual gross expenditures of $7 billion to $8 billion a year, which could cover insurance losses of $4 billion to $5 billion annually. This income would be

less than the expenditures necessary to finance FDIC activity through 1993 under both the June baseline assumptions and our actuarial-type estimate of $21 billion in net losses over the 1990-1993 period. As a result, cash balances would decline over this period in both cases, even with the higher premiums. Under baseline assumptions, outlays in later years would decline, and the fund's receipts would begin to exceed its expenditures. In neither case would the fund balance attain the 1.25 percent target.

If the FDIC were to continue to raise the rate as quickly as possible, reaching the maximum by 1993, the fund balance (on an accrual basis) would reach $27 billion in 1995, or 1.1 percent of insured deposits, under baseline spending assumptions. Under our actuarial-type estimate, the balances of the fund would be slightly lower. These estimates assume no change in the projected deposit base or in the number and cost of bank failures as the result of the change in the assessment rate. They also would require that the FDIC be authorized to raise assessment rates when the fund balance is increasing as a percentage of insured deposits, which cannot be done under current law. Of course, substantially higher premium assessments would erode bank profits. This could well threaten the viability of additional institutions, adding to BIF's case resolution costs and diminishing the assessment base.

Even the 1.25 percent reserve target, which was typical of the fund's status in the 1970s and early 1980s, may not be sufficient to cover BIF's needs

over the next few years. While such a reserve is likely to be sufficient to cover losses incurred by the fund, it might not provide adequate cash resources if much of the fund balance comprises illiquid assets.

CONCLUSION

The banking industry has not reached the dire straits of the savings and loan industry, but the potential risks are there. The industry as a whole is healthier, and losses from bank failures per dollar of assets are estimated to be half those for S&Ls. Nevertheless, the Bank Insurance Fund is very vulnerable. It will have adequate funds over the next few years if losses decline from current levels, but could easily run out of cash if a weaker economy or other factors produce continued substantial losses. The failure of one of the very large banks could, by itself, deplete the fund.

Both the FDIC and the Congress can affect significantly the losses that will have to be covered by BIF. The fund only incurs losses if institutions are closed after the real value of their assets is less than their liabilities. If systems are in place to monitor closely the financial condition of banks and to trigger closure or mandatory disciplinary actions before significant losses occur, the fund's liabilities will be minimized. In addition, reform of deposit insurance may provide incentives for more prudent management and thus reduce the government's exposure to risk.

Further premium increases may be necessary. But even if premium assessments are adequate over the long term, that would not guarantee that BIF's cash resources at any given time would be sufficient. Accordingly, it may be appropriate to increase the FDIC's borrowing authority so that it could respond rapidly to a large bank failure or to a large number of smaller failures over a short period. This would prevent a short-run cash shortage from delaying case resolutions, a practice that added substantially to the costs of the S&L bailout.

Finally, it is important that the Congress carefully monitor the condition of the Bank Insurance Fund, so that the lack of reliable information that contributed to the huge cost of the savings and loan bailout will not occur again. In particular, it would be useful for the FDIC to provide information about how actual realized losses over time compare with the original estimates of losses that are made when institutions are closed or merged. Also, it would be helpful to know more about the supervisory ratings of banks, in order to assess accurately the potential liabilities of the fund. To make the appropriate policy judgments, the Congress and the public should have estimates of all potential losses, not just those already incurred or certain to be incurred in a short time. The estimates should encompass the full scope of possible failures and account for the possibility that both big banks and apparently healthy banks fail.