Statement of
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before the
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NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EST), Friday, March 3, 1989.

SUMMARY OF STATEMENT
by James L. Blum

The Size of the Problem

The ultimate cost of the savings and loan problem is very uncertain. Obligations that have a present value cost of about $40 billion already have been made in dealing with nearly 300 insolvent thrifts over the last three years. About 350 thrifts are insolvent today, and another 150 thrifts are expected to become insolvent in the next year or so. The Administration estimates that the cost of closing these thrifts or merging them into healthy financial institutions would be roughly $44 billion in present value terms. This estimate could be too low. The cost could grow if the financial condition of the presently insolvent thrifts continues to deteriorate as it has in recent years. In addition, the recent rise in interest rates may have an adverse effect on the industry.

The Administration's Plan

The main features of the Administration's plan are to:

(1) Borrow $50 billion through an off-budget entity to finance near-term resolutions;

(2) Draw on the resources of the savings and loan industry to the extent possible; and

(3) Provide unlimited Treasury resources to finance the remaining costs.

Regardless of the size of the problem, the Administration's plan would provide sufficient resources to do the job. If costs turn out to be greater, the Treasury would provide additional resources.

The Administration's plan calls for spending $205 billion over the 1989-1999 period, of which $136 billion would be for resolving cases, administrative expenses, and paying off Federal Savings and Loan Insurance Corporation (FSLIC) notes. The remaining $69 billion would be paid to service the debt incurred in financing the plan. The bulk of the needed cash would be raised through borrowing: $50 billion by a new funding corporation, $7 billion by the Financing Corporation (FICO), and $84 billion from the Treasury. Other sources would provide the remainder of the needed cash, including $31 billion in assessments on the thrifts and $6 billion from the retained earnings of the Federal Home Loan Banks. Overall, the Treasury ultimately will account for most of the costs for solving the problem.

Off-Budget Treatment

The Administration proposes an off-budget solution for raising the $50 billion from the private credit markets to avoid adding to the budget deficit problem. A separate funding corporation (REFCORP) would be created to do the borrowing and would be modeled after FICO.

The proposal to avoid an impact on the budget makes sense since spending the $50 billion in borrowed funds would have virtually no macroeconomic impact. One can make a good case for excluding such spending from Balanced Budget Act calculations in the same manner as asset sales and loan prepayments are now excluded.

This treatment would permit less costly Treasury financing and quicker action than setting up a new off-budget funding agency. Excluding

spending from the Balanced Budget Act calculations may set unfortunate precedents, but so does creating off-budget entities to perform government functions.

In any event, CBO believes REFCORP is not a true off-budget entity and should be included in the budget. The appropriate budgetary treatment for financing a solution to the savings and loan problem, however, is ultimately a policy matter that should be settled by the Congress and the President rather than by the staffs of CBO or the Office of Management and Budget.

Regulatory Reform

In addition to acting quickly to close or merge insolvent thrifts, it is important to create a regulatory system and a deposit insurance system that will prevent future problems from developing. The key ingredients are higher capital requirements, stronger control and oversight, and the ability to take appropriate action as thrifts become insolvent. The Administration's proposals for reform include these ingredients and appear to be a step in the right direction.

A substantial portion of the currently solvent thrifts will have difficulty in meeting the new capital standard. The probable effect of the proposed higher capital requirements will be to reduce the relative size of the savings and loan industry, but also to put it on a sounder financial footing. The surviving thrifts--along with other institutions such as banks and insurance companies--should be able to serve more effectively the needs of homeowners and consumers in the future.

STATEMENT OF

JAMES L. BLUM

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 those difficulties. My testimony today focuses on the following major areas:

- The size of the problem;
- The impact of the Bush Administration's proposal on the budget;
- The use of an off-budget entity to finance a resolution; and
- The effect of regulatory reform on the thrift industry.

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. About 350 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 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 longer the delay in resolving the problem, the more the net worth of the remaining insolvent thrifts deteriorates.

The government's remaining obligations fall into three categories: commitments made in resolving previously insolvent thrifts, dealing with currently and prospectively insolvent thrifts, and restoring the reserves of the deposit insurance fund. Under the Administration's proposal, $8.8 billion will be used over the next 10 years to replenish the insurance fund. The ultimate cost of the other components of the President's plans are extremely uncertain.

In dealing with the vast majority of thrifts that have already been resolved, FSLIC provided financial assistance to the acquirer of the insolvent thrift. As a result of these transactions, the Administration estimates that FSLIC has made commitments having a present value of about $40 billion. These commitments depend on a variety of factors, including future interest rates and the prices at which various assets are sold. As a result, there is considerable uncertainty about what the ultimate cost of these outstanding commitments will be.

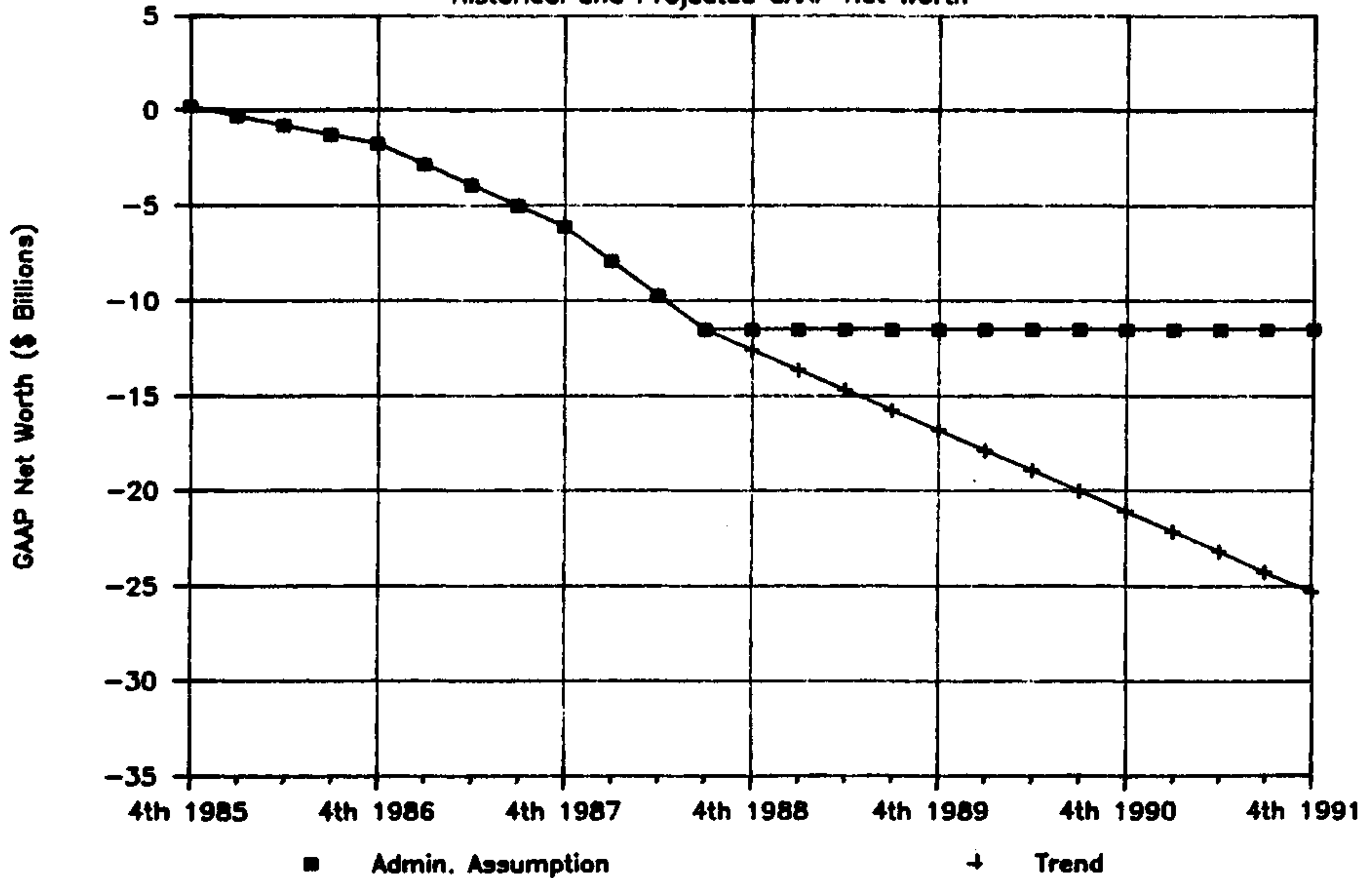
How much it will cost to resolve the currently and prospectively insolvent institutions is even more uncertain. Although the final cost depends on the difference between the market value of the assets and liabilities of insolvent thrifts, there is only a limited basis for determining this difference. While thrifts report the book values of their assets and liabilities, these values are largely based on historic costs, and may have little relation to what they are currently worth. The Bush

Administration estimates that the present value cost of resolving the currently and prospectively insolvent thrifts will be $44 billion, which is several times larger than the book value of their negative net worth. This amount includes the cost of dealing with the 351 thrifts that are presently insolvent as well as the 152 thrifts that would be insolvent if goodwill--an asset that is generally created by the acquisition of another thrift--were excluded.

A number of other estimates have been made as to the total cost of ultimately resolving the thrift crisis. For the most part, they entail a present value cost of at least $100 billion. While the Administration is essentially estimating that the total cost will be around $100 billion, it could be understating the ultimate cost of resolving the existing insolvent thrifts.

In the first place, most of the estimates, as does the Administration's, essentially assume that the thrifts are resolved instantaneously. In all likelihood, however, it will take substantial time before all these insolvent thrifts are liquidated or acquired with financial assistance. Yet, the net worth of insolvent thrifts, measured by book value, has shown a strong tendency to decline over time. In fact, the negative net worth of the 351 firms that are now insolvent by Generally Accepted Accounting Principles (GAAP) more than doubled in each of the previous two years (see Figure). To the extent that this trend continues and the market values mirror it, the ultimate cost would be significantly higher. For example, assume the government can administratively spend at most $25 billion in any year (one-half for liquidations), which is actually the amount the Administration estimates it will spend in 1990. Also assume that the market value of the net worth of insolvent thrifts

FIGURE



SOURCE: Congressional Budget Office using Federal Home Loan Bank Board data.

NOTE: The trend line assumes the average historical rate from 1985 to 1988.

declines by 15 percent per year, which is much slower than the historic decline in the book value of their net worth. Under these assumptions, at the end of 1991 the government would still expect to spend over $15 billion to resolve the remaining thrifts. One of the noteworthy features of the Administration's proposal is that it attempts to restrict lending activities of insolvent institutions to limit this deterioration. Their efforts, however, may not be completely successful.

Another reason that the problem may ultimately be larger than what the Administration estimates is that short-term interest rates have increased significantly since the period on which the last estimates are based, which is the third quarter of 1988. Since assets of thrifts tend to have longer maturities than their liabilities, higher interest rates will increase the size of the problem. The cost of funds for thrifts will increase more rapidly than their return on assets--that is, their profit margins will contract. Thus, the recent rise in interest rates may not only increase the number of firms that become insolvent, but it may very well increase the cost of resolving those thrifts that already have become insolvent.

ESTIMATING THE IMPACT OF THE BUSH ADMINISTRATION'S PROPOSAL ON THE BUDGET

Based on the Administration's financial projections for the 1989-1999 period, the Congressional Budget Office (CBO) has analyzed the Administration's plan and its projected budgetary impact. The three major features of the plan are:

- Borrow $50 billion through an off-budget entity to finance near-term resolution costs;

- o Draw on thrift industry resources to the extent possible; and
- o Provide unlimited Treasury resources to finance the remaining costs.

Overall, most of the costs of the plan will be paid by the Treasury.

Paying for the Plan

By the Administration's estimates, the plan would provide about $136 billion in cash over the 1989-1999 period for use by FSLIC and the new Resolution Trust Corporation (RTC), which would resolve the insolvent thrifts insured by FSLIC. Of this $136 billion, $117 billion would go for case resolution costs, administrative expenses, and interest on existing FSLIC/RTC obligations; and $19 billion would be used to pay off outstanding FSLIC notes (see Table 1). Under Administration assumptions, another $69 billion would be spent over the 1989-1999 period to service the various forms of debt used to finance the plan: $42 billion to cover principal and interest on bonds issued by the new Resolution Financing Corporation (REFCORP), $11 billion to cover principal and interest on bonds issued by the existing Financing Corporation (FICO), and $16 billion for interest on additional Treasury borrowing. (The latter costs are not specifically addressed in the Administration's projections.) Interest costs would continue for many years beyond 1999, starting at about $8 billion in the year 2000.

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

TABLE 1. ESTIMATED USES AND SOURCES OF CASH UNDER THE ADMINISTRATION'S PLAN (By fiscal years, in billions of dollars)

	1989-1994	1995-1999	TOTAL 1989-1999
USES OF CASH			
FSLIC/RTC Activity:			
Case resolutions	85	19	105
Administrative expenses and interest on FSLIC obligations	8	4	12
Repayment of FSLIC notes	2	17	19
SUBTOTAL: FSLIC/RTC ACTIVITY	95	40	136
Debt Service:			
Interest on REFCORP bonds	17	19	36
Purchase of REFCORP zero coupon bonds	6	0	6
Debt service on FICO bonds	6	5	11
Interest on Treasury borrowing	5	11	16
SUBTOTAL FOR DEBT SERVICE	34	35	69
TOTAL USES	129	75	205
SOURCES OF CASH			
Income:			
Assessments on thrifts by FSLIC, REFCORP, and FICO	15	16	31
Liquidation proceeds	18	4	22
Contributions by FHLBs	4	2	6
Miscellaneous income	3	2	5
SUBTOTAL: INCOME	40	23	64
Borrowing:			
REFCORP bonds	50	0	50
FICO bonds	7	0	7
Treasury borrowing	32	52	84
SUBTOTAL FOR BORROWING	89	52	141
TOTAL SOURCES	129	75	205

SOURCE: Congressional Budget Office, based on Administration projections.

NOTES: This table includes the aspects of the Administration's plan involving the savings and loan industry. The effects of increasing FDIC assessments on commercial banks are therefore not reflected in the table.

The figures in the table represent Administration estimates, except for the interest on Treasury borrowing, which was projected by CBO using the Administration's economic assumptions.

contribute little to the cost of resolving the crisis. The Administration estimates that the increase in the Federal Deposit Insurance Corporation (FDIC) fee on commercial banks 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 resolving thrifts and are not included in Table 1. The proposed assessments on thrifts would increase receipts by only $0.4 billion through 1994, and would result in less income thereafter.

Over the 1989-1999 period, sources other than borrowing will account for receipts of about $64 billion, compared with disbursements of about $205 billion. During this period, the only sources of funds, other than borrowing, are about $31 billion in assessments paid by savings and loans (including assessments paid to REFCORP and FICO), $22 billion in liquidation proceeds, $6 billion from the retained earnings of the Federal Home Loan Banks (FHLBs), and $5 billion in miscellaneous income.

The Administration proposes to bridge this gap with a mixture of on- and off-budget borrowing. REFCORP--intended to be an off-budget entity--would borrow a total of $50 billion in fiscal years 1989, 1990, and 1991. FICO borrowing would provide $7 billion, and CBO estimates that Treasury borrowing would fund the remaining $84 billion.

The principal on the REFCORP bonds would be repaid by purchasing U.S. Treasury zero coupon bonds that, on maturity, would be worth $50 billion. The interest payments account for almost all of the cost of servicing this debt. While

these interest expenses would be partly paid from FSLIC receipts and Federal Home Loan Bank retained earnings, they would be paid mostly out of the general funds of 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.

Including its portion of the interest on the REFCORP bonds, the Treasury would provide about $27 billion to FSLIC, RTC, and REFCORP from 1989 to 1994. Another $41 billion would come from the Treasury in the following five years to pay off previously issued notes ($17 billion), pay REFCORP interest ($16 billion), and cover other cash needs. Interest on the increase in its own borrowings would add another $16 billion to Treasury's costs over the 1989-1999 period.

Interest costs on borrowing would continue to be paid after 1999. Most or all would be paid by the Treasury and would add to the deficit in each year. Over the entire life of the plan, the Treasury would account for more than 70 percent of the resources used to finance the Administration's program.

Budgetary Impact of the Plan

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 in payments by REFCORP to the new Resolution Trust Corporation as offsetting collections on the

budget. As shown in Table 2, this treatment would result in large collections offsetting heavy spending in 1989, 1990, and 1991. Disbursements by FSLIC and RTC would total over $84 billion in that three-year period, but the budget would record only $18 billion as budget outlays, mostly in 1989.

The Bush 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 a total of $5.0 billion over the next five years (see Table 3). 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 Bush 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.

The effect of the Administration's plan on the budget is very uncertain, since many components are difficult to predict. I have already discussed the significant uncertainty that surrounds estimates of the cost of resolving currently and prospective insolvent thrifts. Interest costs and assessment income are also uncertain. To the extent that the costs are greater or the income is lower than the Administration projects, expenditures funded by the Treasury and the deficit would both be higher.

CBO's economic assumptions, for example, include interest rates significantly above those used by the Administration in estimating the impact of its proposal. On 30-year government bonds, CBO assumes rates averaging about 200 basis points higher in calendar year 1990 and close to 300 basis points higher in 1991 than the

TABLE 2. THE BUSH ADMINISTRATION'S PROJECTIONS FOR FSLIC/RTC AND TREASURY NET OUTLAYS, Assuming 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	31.7	24.3	10.4	11.0	8.2	113.2	138.2
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	-5.3	-3.3	-5.8	-6.3	-5.9	-33.5	-50.3
TOTAL COLLECTIONS	-17.0	-30.3	-18.3	-5.8	-6.3	-5.9	-83.5	-100.3
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 RTC 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 resulting from tax benefits or additional interest costs associated with Treasury borrowing.

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

b. Other collections include proceeds from FICO borrowing, plus income from old and new liquidations as well as remaining assessment income.

TABLE 3. BUDGETARY IMPACT OF THE BUSH PROPOSAL COMPARED WITH THE 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/RTC	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 RTC 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 resulting from tax benefits or additional interest costs associated with Treasury borrowing.

Administration's. If the CBO assumptions were used instead of the Administration's, interest costs for the REFCORP bonds would be $8 billion higher than the Administration's estimate over the 1989-1999 period. Interest on added Treasury borrowings would be $29 billion through 1999, rather than $16 billion using Administration rates. On the other hand, the amount needed to be invested in zero coupon bonds to cover the principal on the REFCORP bonds would be less than $4 billion rather than the $6 billion projected under lower interest rates.

Assessment income is also very uncertain, because the plan itself--and particularly its regulatory changes--may significantly change the relative size of the industry, as depositors shift to other types of institutions or investments. The Administration's projections assume that thrift deposits will grow by 7.2 percent annually, which represents the average growth from 1983 to 1988. If total insured deposits were to grow at 4 percent a year, FSLIC assessment income over the 1989-1999 period would be $4 billion below the Administration's estimate. If they were not to grow at all, FSLIC assessment income would fall $10 billion below the Administration's projections through 1999. Any such shortfall in funds for thrift resolutions would have to be made up with Treasury funds. The net impact on the deficit, however, would be much smaller. A corresponding increase in deposits at banks would take place, and this rise would result in an increase in assessments paid to the FDIC. Under the Administration's proposal, however, FDIC resources would not be used to resolve thrifts.

Funding the rescue primarily through debt is desirable. Given the need for obtaining large amounts of funds quickly, raising the full amount through large temporary increases in taxes might generate substantial adjustments in private expenditures and could lead to sharp changes in economic activity. Relying on debt financing does not pose such problems.

In fact, issuing debt to resolve insolvent thrifts should not have a significantly 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, a relative decline in rates on bank and thrift deposits should hold down interest rates. 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.

Although financing the rescue plan with borrowing seems desirable, such a solution would inevitably raise 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--the added insurance premiums paid by the banks and thrifts, additional liquidation proceeds, and contributions from Federal Home Loan Banks retained earnings--are far less than the added debt service costs.

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. Because REFCORP's payments to RTC directly offset agency spending, there is 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 any consequences of the Balanced Budget Act's deficit targets.

One can make a good case that spending on the FSLIC rescue can be distinguished from most government spending and thus should be exempt under the Balanced Budget Act. Outlays to pay the debt 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 breached the deficit targets would constitute a much greater contraction than the Balanced Budget Act envisioned.

Excluding the expenditures for resolving thrifts from the deficit calculations in the Balanced Budget Act would be consistent with the treatment of asset sales under the act. In resolving the thrift crisis, the Administration would be making the

implicit liabilities of RTC 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, CBO does not believe the interest payments should be excluded 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.

In addition, keeping the financing on-budget has some sound economic reasons behind it. To begin with, it would be less costly if it is done by the Treasury. Interest on REFCORP borrowing would exceed a comparable amount of Treasury borrowing 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.

Even if the Congress established REFCORP, it should be included in the budget, and the proceeds from its borrowing should not be considered an offsetting collection (see Table 4 for the budgetary impact of using this treatment). The main

TABLE 4. ALTERNATIVE BUDGETARY TREATMENT OF THE BUSH PROPOSAL, Assuming REFCORP Borrowing On-Budget (By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994	1989-1994	1989-1999
FSLIC/RTC Disbursements[a]	27.7	31.7	24.3	10.7	11.3	8.5	114.2	140.6
FSLIC/RTC Collections[b]	-7.8	-8.1	-5.8	-6.1	-6.6	-6.2	-40.6	-58.8
FSLIC/RTC Net Outlays	19.9	23.6	18.5	4.6	4.7	2.3	73.6	81.8
Treasury Payments for REFCORP Interest[c]	0.5	1.4	1.6	0.9	0.8	1.1	6.3	22.0

SOURCE: Congressional Budget Office.

NOTE: 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.

a. Disbursements include payments for old and new cases, as well as use of assessment and FHLB income to pay interest on REFCORP bonds.

b. Collections include proceeds from FICO borrowing, income from liquidations, assessment income (excluding FICO), and payments from retained earnings of the FHLBs.

c. This category does not include interest on $68 billion in Treasury borrowings through 1999 needed to finance the Administration's proposal. Additional Treasury interest costs would total about $5 billion from 1989 through 1994, and about $11 billion during the next five-year period, under the Administration's economic assumptions. The Administration's figures also do not include any estimates for any revenue losses to the Treasury resulting from tax benefits.

reason for counting REFCORP on budget is that it does not appear to be a privately-owned entity. REFCORP would be created by the government for the sole purpose of borrowing funds and transferring them to a federal agency--RTC. REFCORP actions would be controlled by "regulations, orders, and directions" prescribed by the RTC Oversight Board, which would consist of three federal officials. It could not pay dividends to or otherwise benefit its nominal owners, the Federal Home Loan Banks. The bill would also give REFCORP the authority to levy and collect assessments on federally-insured thrifts, functions normally reserved for government agencies. In any case, the Treasury and not these assessments would finance the bulk of REFCORP's borrowing.

Moreover, REFCORP would resemble the Farm Credit System Financial Assistance Corporation (FAC), which was chartered in 1987 to finance assistance to insolvent member institutions of the Farm Credit System. The similarities are striking: the Treasury is obligated to make payments to FAC equal to some or all of the interest payments on its debt for 10 years; FAC exists to finance spending that otherwise would be financed by a federal agency; and it is controlled by federal officials. President Reagan's fiscal year 1990 budget included FAC in the budget as a federal agency. CBO agrees with this scoring, which is consistent with how CBO would score the proposed REFCORP.

Ultimately, the appropriate budgetary treatment for financing a solution to the savings and loan problem is a policy matter. Almost any arrangement sets precedents that could affect future efforts to limit budget deficits. As such, it is a matter to be decided by the Congress and the President rather than by the staffs at

CBO or the Office of Management and Budget. Any legislation that provides additional resources to FSLIC should explicitly stipulate the budgetary treatment of any debt financing used in an assistance plan.

THE EFFECTS OF REGULATORY REFORM

My previous discussion has largely centered on how to pay for the losses that have already occurred because of the thrift crisis. Great importance should also be attached to creating a regulatory system and a deposit insurance system that prevents future crises from developing.

A successful solution to the thrift crisis would enhance the profitability and the survival of healthy thrifts. Most notably, a rapid resolution should substantially benefit the remaining institutions, because the remaining thrifts should experience a significant decline in their cost of funds. On the other hand, much of this benefit might be lost if the surviving thrifts had to pay a large share of the resolution costs.

The long-term prospects of the thrift industry also depend on regulatory reform. Federal deposit insurance reduces the incentive of poorly financed financial institutions to behave prudently. It is necessary, therefore, to establish a regulatory system that both changes these incentives and enables the government 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 a newly created Savings Association Insurance Fund.

More fundamentally, the Administration proposes that, in certain critical respects, thrifts be treated more like banks. Specifically, it recommends requiring that thrifts increase their amount of capital. Capital, which is the difference between a firm's assets and its liabilities, is essentially the owners' stake in the firm. Increasing the amount of capital that thrifts must maintain reduces the incentives to make overly risky investments. 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, with one important distinction: the Administration's proposal allows the thrifts to continue to include goodwill as capital, while banks cannot. Thrifts, however, must write off this goodwill over a 10-year period.

A substantial number of thrifts will probably not be able to raise the necessary capital by 1991. Some solvent thrifts have not been profitable, and others have only barely been so. Based on 1988 third quarter data, less than half of the industry met the standard. However, 379 thrifts had GAAP capital between zero and 3 percent of assets. These thrifts would need an additional $14 billion-- about four times their current capital--to reach the 1991 standard (see Table 5). But these thrifts had net losses on income of about $200 million in 1987 and $646 million in the first three quarters of 1988. Therefore, the ability of those thrifts to generate anywhere near the necessary capital through retained earnings is highly questionable. The 972 thrifts whose GAAP capital was between 3 percent and 6 percent of assets are

TABLE 5. ADDITIONAL CAPITAL NEEDED TO MEET PROPOSED CAPITAL STANDARDS (In billions of dollars)

Current Capital as a Percent of Assets (GAAP Basis)	Number of Thrifts	Current Assets a/ (1)	Current Capital a/ (2)	Current Ratio (3) = (2)/(1)	Required Capital (4)	Additional Capital Needed (5) = (4)-(3)	Additional Capital as a Percent of Current Assets
0 to 3	379	280.6	3.5	1.2	17.7	14.2	5.1
3 to 6	972	627.9	26.3	4.2	38.4	12.2	1.9
0 to 6	1,351	908.5	29.7	3.3	56.1	26.4	2.9
6 or Greater	1,239	317.5	26.3	8.3	18.6	b/	c/

SOURCE: Congressional Budget Office using Federal Home Loan Bank data.

NOTE: Data for third quarter 1988.

a. Assumes 20 percent of goodwill is reduced from assets and capital to account for partial exclusion of goodwill.

b. Has excess capital of $7.7 billion.

c. Has excess capital that is 44 percent of required capital.

somewhat better off, but would still face a challenging task. They had net incomes of $2.8 billion in 1987, and $1.5 billion in the first three quarters of 1988, but would need an additional $12 billion of capital. Even if these thrifts were able to meet the 6 percent standard by 1991, many would still have to increase their capital in future years to compensate for their declining goodwill.

The Administration's proposal to raise insurance premiums on deposits at thrifts for a three-year period beginning in 1991 should not pose a significant obstacle to meeting the higher standard. These extra premiums, while still higher than the historically high levels presently in place, are small relative to the capital these institutions require. They would reduce pre-tax income by about $45 million annually for those thrifts whose GAAP net worth is between zero percent and 3 percent of assets, by about $100 million for thrifts between 3 percent and 6 percent, and by about $55 million for those above 6 percent. Moreover, the increase in premiums takes effect in the beginning of 1991, while the higher capital standard takes effect in June of that year.

Although the proposed increase in premiums is not very large, I believe it noteworthy that the Administration proposes to perpetuate a significant difference in the premiums that thrifts and commercial banks pay for federal deposit insurance. To the extent that there is a differential, it should reflect the difference in the likelihood of future defaults between the two institutions. Otherwise, it would place one type of institution at a competitive disadvantage to the other. For example, while thrifts will soon have to maintain the same levels of capital as banks, thrifts have more discretion in acquiring assets. This greater discretion may increase the

likelihood of default and justify a higher premium. On the other hand, higher capital standards should reduce the probability of default by thrifts. It would be preferable if such differences in premiums were actuarily based and did not simply reflect the historic experience of the different types of institutions.

While much of the industry may have difficulty generating the added capital internally, it may also have difficulty attracting more equity capital from investors. These institutions may not have sufficiently bright earning prospects to attract additional investments. Therefore, the industry will most likely have to meet the standard through a series of mergers, contractions, and liquidations. Other financial institutions may find undercapitalized thrifts to be attractive acquisition targets. Firms that have excess capital may be able to work out favorable terms for acquiring firms with insufficient capital. Alternatively, by shrinking its size, a thrift reduces its assets and liabilities by the same amount and thereby increases its capital-asset ratio.

The Administration and the Congress will have to take significant steps if they hope to ensure that the higher capital standard is met. The regulatory agency must have the resources and the authority to take firm action for those institutions that do not meet the higher standard. To assure the most efficient consolidation, existing banks and thrifts could be given substantial discretion to acquire thinly capitalized thrifts. There could, for example, be no prohibition against banks acquiring thrifts and no preference given to institutions of a particular state in any given merger or acquisition.

The higher capital standard and more vigilant regulatory surveillance will likely lead to a reduction in both the number of thrifts and the relative size of the thrift industry. The financial difficulty of such a large number of firms, coupled with the lack of capital in the industry, suggests that the industry may benefit from such a contraction. In any case, thrifts compete with banks, mutual funds, insurance companies, and other financial intermediaries. These other institutions, along with the surviving thrifts, would be able to serve the needs of borrowers, including home owners, as well as depositors.