

Oral Statement by BERT ELY to the
Financial Institutions Subcommittee

March 24, 1995

RESOLVING THE BIF-SAIF PREMIUM DIFFERENTIAL ISSUE

Madam Chairwoman and members of the Subcommittee, I am pleased to testify today on one of the toughest banking issues Congress will have to address this year, the resolution of the BIF-SAIF premium differential issue. I commend you for holding this most important hearing at this time.

You already have heard from fifteen witnesses on this issue, so I will not repeat the material in my written statement that duplicates oral testimony you already have heard. Instead, I would like to touch on several important issues that either need additional emphasis or have not been discussed by the other witnesses.

The Banks are Entitled to a Rate Cut on July 1, No Matter What

Madam Chairwoman, BIF-insured institutions are entitled to a dramatic cut in their premium rates, effective July 1, no matter how the premium differential issue is resolved. I believe tremendous progress can be made in resolving this issue if this Subcommittee will quickly reassure the nation's banks on this point. Quite frankly, they are very fearful that somehow the rate cut that they are entitled to under FDICIA will be taken away from them.

The FDIC has proposed to cut the premium rate for the safest banks from 23 to 4 basis points. My calculations, which are summarized in the table appended to my written statement, show that under present law the BIF premium rate can safely be cut to zero, as of July 1 of this year, and can remain at that level through 1998. One reason BIF premiums can be eliminated for several years is that the BIF will reach the magic 1.25% reserve ratio by the end of next month. By June 30, the BIF will be overfunded by at least \$1 billion!

The Fund Balance Is Irrelevant; Pay-As-You-Go Is What Counts

The Subcommittee has heard extensive testimony about the size of the BIF and the SAIF. Let me assure you, madam chairman, that the size of the two funds is totally irrelevant, leaving aside the fact that these funds are no more real than the Social Security and Highway Trust funds. The reason the balances in these funds are irrelevant is that, under present law, each fund must operate on a pay-as-you-go basis once it reaches its designated reserve ratio, whether that ratio is .5% or 1.25%.

The fund balances do not provide taxpayer protection because these balances already have been spent for other federal purposes. Consequently, the federal debt is lower by the amount of the fund balances. What really protects the taxpayer is the ability of the banking and thrift industries to comfortably pay for deposit insurance losses out of their current income, through FDIC premium assessments. Therefore, key to protecting taxpayers is fostering healthy banking and thrift industries that can pay a reasonable level of FDIC assessments.

Viewed from a pay-as-you-go perspective, SAIF-insured thrifts will not be able to achieve premium parity with BIF-insured banks for another 24 years for the simple reason that even if each fund were at a 1.25% reserve ratio today, the SAIF has a cost obligation, FICO interest, that the BIF does not have. Based on the present SAIF assessment base, and leaving aside the issue of whether or not premiums collected on Oakar and Sasser deposits can be used to pay FICO interest, it is an inescapable fact that the FICO interest obligation currently would cost SAIF-insured institutions 11 basis points of premium that BIF-insured banks with the same risk characteristics would not pay. Worse, as the SAIF assessment base continues to shrink, for whatever reason, the FICO interest, expressed as one component of the SAIF premium rate, will continue to climb.

Move From a Zero-Sum Battle to a Win-Win-Win Solution

What I find most troubling about the premium differential issue is that it has been stuck for months in a zero-sum mode. Quite simply, the banks feel the thrifts are trying to pick their pockets and the thrifts, who need the banks' help, have offered no ideas on how to transform a potential "thrifts win, banks lose" scenario into a solution in which everyone, including the banks, the thrifts, the taxpayer, and Congress, are better off than they are today.

Crafting a win-win-win solution will not be simple, but it must be attempted, for the sake of all concerned. I will briefly cite what I believe have to be the key components of this solution. First, if the banks are asked to help solve this problem, they must receive in return something that almost every bank believes comfortably exceeds whatever cost the solution levies on them. For example, if BIF assumes a proportionate share of the FICO interest obligation, BIF premium rates will rise by 2.5 basis points. Banks in return should be able to increase their income through new powers or be able to lower their regulatory compliance costs by more than their BIF premium increase.

Second, Congress should restore to the SAIF, with interest, \$2.95 billion of premiums diverted from the SAIF in the 1989-92 period. There will be no budget impact if this money is put back into the SAIF. Furthermore, this money should never be spent because the SAIF, like the BIF, must operate on a pay-as-you-go basis once it reaches its required reserve ratio.

Third, SAIF-insured thrifts should be subject to a modest premium differential, perhaps in the 5 to 7 basis point range, for the remainder of the life of the FICO bonds. Alternatively, and this is my preference, the thrifts should make a one-time contribution to the SAIF, equal to the present value of a modest premium differential, to help bring the SAIF up to a 1.25% ratio.

Fourth, the required reserve ratio for BIF and SAIF should be lowered, if necessary, to quickly get the banks and thrifts on a true pay-as-you-go deposit insurance funding basis. As I mentioned previously, the reserve ratio really is irrelevant from the perspective of taxpayer protection; healthy banks and thrifts are what really provide the needed protection. Congress

should not let an artifice such as the reserve ratio, a concept that is totally unsupported by insurance theory, to stand in the way of resolving this issue.

Move Quickly to Permanently Resolve This Issue

Finally, I urge Congress to move quickly to permanently resolve the BIF-SAIF issue. Delay in addressing it or trying to punt it to next year or to the next Congress will be counterproductive. The issue needs to be resolved this year. I strongly believe it can be, if all sides start working today towards a win-win-win solution.

Madam Chairwoman and members of the Subcommittee, I want to thank you again for the opportunity to testify on this most important issue. I would be glad to answer any questions you might have for me.

TESTIMONY BY BERT ELY

to the

FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUBCOMMITTEE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

of the

UNITED STATES HOUSE OF REPRESENTATIVES

on the subject of

RESOLVING THE BIF-SAIF PREMIUM DIFFERENTIAL ISSUE

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RESOLVING THE BIF-SAIF PREMIUM DIFFERENTIAL ISSUE

Testimony by Bert Ely

INTRODUCTION

Madam Chairwoman and members of the Subcommittee, I am pleased to be able to testify today on what I believe is one of the toughest banking issues Congress will have to address this year, the resolution of the BIF-SAIF premium differential issue that will emerge on July 1 of this year. I commend you for holding this most important hearing at this time.

I am testifying in response to an invitation to testify that you extended to National Taxpayers Union (NTU). Due to a prior commitment to testify before a Ways & Means subcommittee, a representative of NTU could not testify today. At NTU's request, I am testifying today on an issue to which I have devoted substantial attention in recent months. NTU has reviewed this written statement and concurs fully in it.

In this testimony, I will first review the background of this issue, specifically the various legislative enactments that have created the premium differential problem. I will then discuss the forces that have brought this problem to a head this year and the specific challenges Congress faces in resolving this problem. Finally, I will review various options for resolving the problem. In my opinion, the resolution of the BIF-SAIF premium differential issue will not be as difficult or intractable as some seem to believe if its resolution can be moved from a zero-sum construct, where it seems to be stuck today (SAIF-insured institutions gain at the expense of BIF-insured institutions), to a win-win-win situation in which all participants in the process gain through the resolution of this problem.

BACKGROUND OF THE BIF-SAIF PREMIUM DIFFERENTIAL ISSUE

The roots of the premium differential issue can be traced back to August 10, 1987, when President Reagan signed into law the Competitive Equality Banking Act of 1987 (CEBA). CEBA authorized the issuance of \$10.825 billion of so-called FICO bonds. FICO is the acronym for the Financing Corporation, the government-sponsored entity (GSE) that Congress created to issue these bonds.

A Brief History of the FICO Bonds

A total of \$8.17 billion in FICO bonds were issued in 14 tranches between October 6, 1987, and September 26, 1989. The proceeds of these bonds were used by the former Federal Savings and Loan Insurance Corporation (FSLIC) to dispose of failed S&Ls. All of the FICO bonds carry 30-year maturities and a fixed rate of interest; they are non-callable. The weighted average rate of interest on these bonds is 9.71%. The principal repayment of these bonds was defeased at the time of their issuance with 30-year zero-coupon Treasury bonds purchased with approximately \$680 million of funds tapped from the retained earnings of the Federal Home Loan Banks. The annual interest actually paid on these bonds totals \$793.33 million; however, interest earned on FICO's temporary investments reduces to approximately \$780 million annually the net interest cost of these bonds to thrifts now insured by the Savings

Association Insurance Fund (SAIF). SAIF was created by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) as the successor to FSLIC. The FICO interest is now paid from premiums paid by SAIF-insured thrifts. Interestingly, the premiums used to pay this interest do not even pass through the SAIF; they flow directly to FICO. Leaving aside special one-time adjustments, FICO interest in 1994 consumed approximately 44% of the total premium income the SAIF was entitled to collect. In 1995, FICO interest may consume as much as half of the total premiums paid on SAIF-insured deposits.

Purely and simply, the FICO bonds were a budgetary gimmick that I and many others criticized when CEBA was being debated. We saw these bonds as just one part of a larger fiction that taxpayer funds would not be needed to clean up the enormous problems in the S&L industry that were clearly evident in 1987 to anyone who cared to look. In fact, the FICO bonds should not have been issued at all for they carried an interest rate that was approximately .5% higher than straight Treasury debt of a comparable 30-year maturity. Had Congress admitted in 1987 that taxpayer funds were going to be needed to help clean up the FSLIC mess, a sad reality I first publicly predicted in a Wall Street Journal article on July 17, 1986, then the FICO bonds would never have been issued. Instead, Congress would have funded the first stage of cleaning up the S&L crisis with straight Treasury debt. Consequently, the premium differential issue would not have emerged for, as FDIC Chairman Ricki Tigert Helfer has stated on several occasions, the premium differential issue in fact is a FICO interest problem. I heartily agree. More importantly, had Congress not engaged in the FICO budgetary subterfuge in 1987, the start of the full-scale clean-up of the S&L mess possibly would have begun two years earlier than 1989, when the cleanup finally started. Tragically, that delay added tens of billions of dollars of taxpayer cost to cleaning up this mess.

As I and others observed at the time, the FICO interest obligation effectively mortgaged a substantial and growing portion of the deposit insurance premiums paid by thrifts because it was apparent even in the late 1980s that the assessment income pledged to pay this interest was going to decline. As recent FDIC statistics note, the assessment base over which the FICO interest is assessed declined 24% from the end of 1989 to the end of 1994. In 1989, Bush Administration officials claimed that this assessment base would grow 7% annually.

Building the SAIF to the 1.25% Designated Reserve Ratio

In recognition of the possibility that the nation's thrifts would not be able to pay the FICO interest obligation and build the SAIF to the 1.25% Designated Reserve Ratio (DDR), Section 211 of FIRREA authorized Congress to appropriate up to \$16 billion of taxpayer funds over the 1991-1999 period to build the SAIF to a fund balance of \$8.8 billion by September 30, 1999. Interestingly, at the end of 1994, a fund balance of \$8.69 billion would have given the SAIF the 1.25% DDR first established for it in FIRREA.

As part of a very complicated financing structure for cleaning up the S&L mess, FIRREA also provided that, through the end of 1991, SAIF premiums not used to pay FICO interest would be used to help purchase zero-coupon bonds issued by REFCORP (The Resolution Funding Corporation, which was created by FIRREA) and to help pay the expenses of FRF (the FSLIC Resolution Fund, also created by FIRREA). In effect, the SAIF was not to start receiving premium income from SAIF-insured thrifts until 1992. The Resolution Trust

Corporation Refinancing, Restructuring, and Improvement Act of 1991 (the "1991 Act") extended the diversion of SAIF premiums from the SAIF by another year. Consequently, \$2.95 billion of premiums were diverted from the SAIF in the 1989-1992 period. Had those premiums been placed in the SAIF when collected, the SAIF today would have a fund balance approximately \$3.5 billion higher than the actual fund balance at the end of 1994. That amount would have raised the SAIF reserve ratio by 50 basis points, 40% of the SAIF's 1.25% DDR.

The Resolution Trust Corporation Completion Act of 1993 went one step further than the 1991 Act and eliminated the FIRREA authorization of taxpayer funds to build the SAIF to an \$8.8 billion fund balance by the end of 1999 (extended by the 1991 Act to 2000). The elimination of this authorization for an appropriation gives great legitimacy to the charge by some thrift executives that Congress has reneged on a portion of the commitment it made in FIRREA to those thrifts that would survive the S&L debacle. In effect, Congress diverted some premiums away from the SAIF in its early years that were supposed to be more than offset by the later use of appropriated funds to build up the SAIF fund balance. The build-up promise has been broken, but the premium diversion has not been corrected.

The Unavailability of Oakar and Sasser Premiums to Pay FICO Interest

The premium differential/FICO interest coverage problem has been further complicated by the FDIC's reaffirmation on January 31 of this year of an opinion the FDIC Legal Division prepared in 1992 stating that premiums paid into the SAIF on "Oakar" deposits and by "Sasser" institutions cannot be used to pay FICO interest. Oakar deposits are SAIF-insured deposits in BIF-insured banks and thrifts; Sasser institutions are thrift institutions formerly supervised by the Office of Thrift Supervision (OTS) that now have commercial or savings bank charters, but whose deposits are still insured by the SAIF. In my opinion, Congress never intended that some portion of SAIF premium assessments could not be used to pay FICO interest. However, the FDIC has opined otherwise, based on a literal interpretation of the phrase "savings association." Hence, barring a court decision overruling the FDIC, Congress has no choice but to deal with the implications of the FDIC's legal opinion since the FDIC does not seem inclined at this time to reverse the opinion it has recently reaffirmed.

At the end of 1994, Oakar deposits and deposits in Sasser institutions totaled \$233 billion, or 32% of all SAIF deposits. Hence, under the FDIC opinion, almost one-third of SAIF premium assessments cannot be used to pay the FICO interest obligation. Consequently, as of the end of 1994, the amount of SAIF premiums that could be used to pay FICO interest exceeded this obligation by just 50%. This "interest coverage ratio" of 1.5 is extremely low for what are supposed to be essentially default-free bonds. As recently as the end of 1992, the FICO interest coverage ratio was 1.82.

Given the rapid rate at which SAIF-insured thrifts are being acquired by BIF-insured banks, which creates Oakar deposits; the continuing conversion of OTS-supervised thrifts to bank charters; and the "tandem operation" threat discussed below, the FICO interest coverage ratio is steadily declining to 1.0, below which point SAIF premiums, at their current range of 23 to 31 basis points, would be insufficient to pay the FICO interest. If SAIF-insured deposits assessable for FICO interest purposes decline another \$158 billion, which would drop the FICO coverage ratio to 1.0, then the FDIC Board will either have to raise SAIF premium rates

or default on the FICO bonds. Given that SAIF-insured deposits assessable for FICO interest purposes declined \$136 billion from the end of 1992 to the end of 1994, a further decline of \$158 billion within the next few years is easily imaginable.

THE FACTORS BRINGING THE PREMIUM DIFFERENTIAL ISSUE TO A HEAD THIS YEAR

The premium differential issue almost certainly will require Congressional action this year. However, this problem has not suddenly emerged -- it is one that I and others have been warning about for several years. However, certain events, which I will discuss below, appear to be bringing this issue to a head even sooner than I thought would be the case.

BIF-Insured Institutions are on the Verge of a Massive Premium Cut

As I first predicted four years ago, the banking industry did not go the way of the S&L industry. In fact, the much greater strength of the banking industry will permit the BIF will reach the 1.25% DDR set for it in FDICIA (the FDIC Improvement Act of 1991) in less than four years after its DDR was established, compared with the 15-year period FDICIA authorized. Based on 1994 financial results the FDIC Board release on Tuesday of this week, I calculate that the BIF will reach the 1.25% target by the end of next month. Further, the BIF should reach a reserve ratio of at least 1.31% by June 30 of this year. At that point, the BIF will be overfunded by \$1-\$1.2 billion.

The Table appended to this testimony presents my financial forecast for the BIF, assuming it is not merged with the SAIF. Given the assumption that the BIF will meet the 1.25% DDR by June 30 of this year, I calculate that the nation's safest banks, that is, those presently paying a BIF premium rate of 23 basis points, should have to pay absolutely no premiums from July 1, 1995, through the end of 1998! According to the FDIC, these institutions account for 91% of the total BIF assessment base. My projection concurs with present banking law, specifically 12 U.S.C. § 1817(b)(2)(A)(iv), which effectively indicates that the FDIC has no choice but to drop the low end of the BIF premium rate schedule to zero for the second half of 1995. Contrary to my analysis, the FDIC has proposed a minimum premium rate of 4.0 basis points for the second half of 1995.

Column 3 of my projection shows an average premium rate of .5 basis points for 1996-1998. This average rate reflects my assumption that riskier BIF-insured institutions, which account for 9% of the BIF assessment base, will pay risk-sensitive premiums ranging from 3 to 27 basis points. The premiums these institutions pay, expressed in relation to the total BIF assessment base, is equal to .5 basis points. Additionally, the premium income amount in Column 4 includes the FDIC's minimum premium of \$2,000 per institution per year for those institutions otherwise eligible for a zero premium rate.

Impact of a Zero BIF Premium Rate on SAIF-insured Thrifts

The FDIC's proposed premium rate for the second half of 1995 would result in a 19-basis point premium differential between BIF and SAIF-insured institutions. The nation's SAIF-insured institutions believe that this differential will hurt them. The 23-basis point

differential I am predicting will be even more painful. In my opinion, though, a BIF-SAIF premium differential will cause few, if any, thrifts to fail. However, this differential probably will accelerate the financial decline of some already marginal thrifts. The OTS, though, using FDICIA's ample "Prompt Corrective Action" powers, should be able to force the sale or recapitalization of these problem thrifts before they fail or, in a worse case situation, take them over once their tangible equity capital slips below 2%. The SAIF's insolvency loss in these failures should be quite manageable for SAIF, if the OTS acts promptly. It is important to note that the FDIC established, as of the end of 1994, a \$432 million loss reserve in the SAIF to deal with these failures.

The far greater impact of a significant premium differential will be on the intangible franchise value of healthy thrifts. Franchise value is derived primarily from the value of a bank or thrift's deposit-gathering network, usually its branches. In short-hand terms, franchise value usually is expressed as a percentage of a bank or thrift's deposits. I estimate that a 23-basis point premium differential will reduce thrift franchise values, expressed as a percentage of deposits, by 1 to 1.5 percentage points. A reduction of this magnitude would equal 17% to 25% of the franchise valuation for a thrift with a 6% leverage ratio ($1\%/6\% = 17\%$; $1.5\%/6\% = 25\%$). This is not an insignificant loss in franchise value, particularly for stockholder-owned thrifts, which is why healthy thrifts understandably are upset about the looming premium differential they face.

Dealing with the Premium Differential -- The Classic Challenge of Tax Avoidance

Deposit insurance premiums are, in fact, a tax because they do not represent marketplace-determined, option-based pricing of deposit insurance. Despite its best intent, the FDIC will never be able to properly charge risk-sensitive deposit insurance premiums, especially when those premiums also have to include substantial fund building charges. In effect, SAIF-insured thrifts will still be paying a fund-building charge while BIF-insured institutions will no longer be paying that charge after July 1 of this year. Further, starting on July 1, BIF premiums will be reduced by what effectively is a return on capital; that is, interest on the fund balance the BIF accumulated as a result of its now almost-complete fund-building activity. Unfortunately, banks do not own the BIF's capital since the BIF is part of the federal government's consolidated budget. Instead, the capital the BIF supposedly has accumulated, in the form of its fund balance, has in fact been spent by Congress for other purposes. Nonetheless, BIF-insured institutions at least get an income benefit from the nonredeemable capital they have involuntarily contributed to the BIF. This capital is invested in Treasury investments which generate interest income for the BIF. This income effectively pays the first dollars of BIF's insolvency losses and administrative expenses. At present interest rates, this interest income is equivalent to a 6 basis point premium rate on deposits in BIF-insured institutions.

SAIF-insured thrifts, as would any rational marketplace participant, will understandably do everything that is lawful and economically justifiable to minimize the SAIF fund-building charge that is causing the BIF-SAIF premium differential. I hope members of Congress are not surprised by the thrifts' response to the premium differential. In fact, these institutions have an obligation to their stockholders to minimize this tax burden. Unfortunately, like all tax minimization schemes, efforts by thrifts to minimize the effects of

the BIF-SAIF premium differential will have uneven effects on thrifts and unintended consequences. These possible effects include the following:

A reduction of deposits as a source of funding. To the extent that BIF-insured banks pass through their premium rate cut to depositors, which is quite likely if bank loan demand continues to grow, thrifts will not be able to profitably match the banks' increase in deposit interest rates. Consequently, some thrift deposits may move to banks, which will reduce the SAIF assessment base, notably that portion of the assessment base that can be taxed to pay the FICO interest obligation. Thrifts that lose deposits will shrink their balance sheets or rely more to non-deposit funding, specifically advances from Federal Home Loan Banks.

Acquisition by BIF-insured banks. The adverse effect of the premium differential on SAIF-insured thrifts will further depress thrift stock prices and make less attractive the conversion of mutually owned thrifts to stockholder-owned institutions. This phenomenon may in turn increase the number of thrifts available to be acquired by banks, which already are active thrift acquirers. The deposits of a SAIF-insured thrift that is merged into a BIF-insured bank become Oakar deposits and hence are still subject to SAIF assessments. However, according to the FDIC legal opinion cited above, those assessments can no longer be used to pay interest on the FICO bonds.

Establishment of "tandem operations" by chartering national banks. Several large thrifts have each announced plans to form a bank holding company. Each thrift's holding company would then obtain a charter for a national bank that would operate as an affiliate of the thrift. The national bank subsidiary would in turn obtain authority from the Comptroller of the Currency to open branches of the bank inside each of the thrift's existing branches. In effect, the thrift would create a "two-window" operation inside each of its branches. One set of windows would serve the thrift's depositors; the other set would serve depositors in the affiliated national bank. The thrift could then "encourage" its customers, particularly holders of certificates of deposit, to move their account balances to the affiliated national bank, which could pay a higher rate of interest. The rate difference would be roughly equal to the premium differential. If customers make this shift on an account-by-account basis, then presumably the thrift and the affiliate bank would not have to pay exit and entrance fees to, respectively, the SAIF and the BIF.

No tandem operations have been established yet and it probably will take months for thrifts to obtain the necessary regulatory approvals to do so. Further, tandem operations will increase thrift operating costs and possibly confuse customers. Therefore, they are not an unalloyed benefit. Nonetheless, larger thrifts may find that, despite the higher operating costs, a tandem operation will permit the institution to "average down" its deposit insurance premium rate. I doubt if any tandem operations will be started before 1996. However, if they pass regulatory muster, tandem operations could become quite popular, particularly among larger thrifts.

The deposit insurance effect of a tandem operation would be to shift deposits from the SAIF to the BIF. This effect could be quite significant over time, as the following data demonstrate. As of September 30, 1994, there were 85 SAIF-insured thrifts with more than \$1 billion of SAIF-insured deposits each. These institutions held a total of \$324 billion in SAIF-insured deposits, or 45% of all SAIF-insured deposits. A switch of half of these

deposits to a BIF-insured bank would trigger either a FICO bond default or higher premium rates on the remaining SAIF-insured deposits, including Oakar deposits and SAIF-insured deposits in Sasser institutions.

Ironically, a fairly rapid switch of deposits to BIF-insured banks could be costly to the present BIF-insured institutions because no BIF entrance fee will be paid on the deposits that are switched to the BIF. Instead, all BIF-insured deposits will have to be assessed to build the BIF to a higher fund balance to keep the BIF's reserve ratio at 1.25%. For example, if \$200 billion of deposits were switched from the BIF to the SAIF in 1996, the BIF balance would have to rise by \$2.5 billion to reflect that switch (\$200 billion x .0125). Some of that amount would be absorbed by the BIF's likely overfunding at the end of 1995; however, absorbing the BIF's overfunding in this manner would hasten the day when the BIF's healthiest banks will have to resume paying premiums. A massive shift of SAIF-insured deposits into affiliated national banks effectively would amount to a partial de facto merger of BIF and SAIF.

The Consequences of a Shrinking Assessment Base Driven by a Premium Differential

The consequences of a continuing shrinkage of the SAIF assessment base, which a BIF-SAIF premium differential almost certainly will accelerate, are several fold. First, the SAIF will grow more slowly towards its 1.25% DDR, thus postponing the day when SAIF premiums can drop down to the range of BIF premiums. I can easily envision scenarios where it might take another 8 to 10 years for SAIF to reach a 1.25% reserve ratio. Second, the shrinkage of the overall SAIF assessment base will be accompanied by an even faster shrinkage of those SAIF deposits that presently can be assessed to pay FICO interest. This accelerated shrinkage in turn raises the prospect of a FICO bond default, as discussed above, or even higher SAIF premium rates, which will increase the premium differential and undoubtedly accelerate the shrinkage of SAIF-insured deposits. One can easily imagine a SAIF death spiral.

SPECIFIC PROBLEMS CONGRESS FACES IN ADDRESSING THE PREMIUM DIFFERENTIAL ISSUE

Congress almost certainly will face three specific problems or areas of concern this year as the BIF-SAIF premium differential issue ripens.

First, the painful cries of the nation's thrifts will grow in volume as July 1 approaches, especially if the premium differential will be 23 basis points rather than 19 basis points, as has generally been reported. The thrifts will charge, as they already have, that a premium differential of this magnitude is patently unfair. Some in Congress will respond sympathetically to this charge.

Second, because it will be less economic for small thrifts to establish a tandem operation, they will not have the same opportunity as much larger thrifts to average down their premium rate by switching customers to an affiliated BIF-insured bank. There may be as many as 1,500 thrifts, out of the 1,844 that the SAIF insured at the end of 1994, that will not find it economical to establish a tandem operation. In effect, tandem operations could create a major division within the thrift industry, pitting smaller institutions against larger ones. I predict that this potential division within the thrift industry may generate broader interest in Congress in

addressing the premium differential issue than will the actual premium differential that will emerge on July 1.

Third, concerns about a potential FICO bond default will increase as the FICO interest coverage ratio continues to decline. I predict that a FICO investors' protection committee will soon emerge, and for understandable reasons. Because of the unusual nature of the FICO bonds (they are so-called "story bonds"), they almost certainly are owned by institutional investors, many of whom know how to hire lobbyists. These bond holders will demand that Congress do something to protect them against a FICO default. These holders almost certainly will be joined by the other GSEs, specifically Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and the Farm Credit System, because the specter of default by any one GSE debt issuer will cause rates to rise on debt issued by other GSEs. Since Congress already has ridden to the rescue of one GSE, the Farm Credit System in 1987, FICO bond holders and the GSEs understandably will expect Congress to do something to prevent a FICO default. Given the declining foreign exchange value of the dollar, the continuing large budget deficits, and Congress's inability to pass a balanced-budget amendment, it is quite likely that Congress will want to muffle alarms about a GSE bond default.

Congress could delay a FICO bond default by a few years by nullifying the FDIC's legal opinion that premiums collected on Oakar and Sasser deposits cannot be used to pay FICO interest or it could direct the FDIC to raise the SAIF premium rates to generate sufficient income to pay the FICO interest. Of course, higher SAIF premiums will increase the BIF-SAIF premium differential, which will aggravate the first two problems discussed above.

RESOLVING THE BIF-SAIF PREMIUM DIFFERENTIAL ISSUE

The BIF-SAIF premium differential issue is not subject to a quick, easy fix. For example, Congressional action to nullify the FDIC opinion barring the use of SAIF premiums on Oakar and Sasser deposits to pay FICO interest and to bar the tandem operation concept will not solve the premium differential issue, for the differential will still exist, along with the many distortions it can cause. In effect, doing nothing this year except improving the FICO interest coverage and attempting to lock deposits into the SAIF assessment base will merely punt the premium differential problem ahead a year or two. That is the strategy Congress followed in the mid-1980s with regard to the S&Ls, which only made the S&L crisis more costly to resolve when the Bush Administration and Congress finally tackled it in 1989. While the ultimate consequences of the premium differential problem do not appear to be anywhere near the size of the S&L fiasco, the magnitude of this problem and the difficulty in resolving it will only worsen with time.

Important Points for Congress to Keep in Mind When Resolving the Differential Issue

I am not prepared today to offer a specific proposal for resolving the BIF-SAIF premium differential. However, I do want to offer several thoughts that I urge Congress, the Administration, the regulatory agencies, and the banking and thrift industries to keep in mind as they start to tackle this issue. I also will discuss a variety of options that potentially could

be stirred together to formulate the sophisticated sausage that is needed to achieve an appetizing solution to the premium differential issue.

Move sooner rather than later. To restate a point I made above, this issue is more like a fresh-caught fish than a fine red wine. The sooner Congress resolves this issue, the better. In particular, it may become increasingly difficult to get the various industry groups involved in this issue to agree to a resolution as their positions harden.

Construct a win-win-win solution. The debate on this issue so far has not moved past a zero-sum game, with SAIF-insured institutions trying to gain cost relief at the expense of BIF-insured institutions. Understandably, the banking industry is not too keen about having its pockets picked. If, for example, some of the FICO interest burden is shifted to the BIF, BIF-insured banks need to immediately get something in return that exceeds the value of the costs assumed by the BIF. A substantial reduction in regulatory compliance costs represents one such trade-off possibility. The CRA, appraisal regulations, RESPA, Truth-in-Savings, and a number of other non-safety-and-soundness regulations offer tremendous potential for regulatory cost savings, none of which will cost the taxpayer any money. These cost savings must be in addition to the regulatory relief bankers already expect to occur this year. Also, it is important that constructing a win-win-win solution not delay a BIF premium rate cut; bankers understandably fear such a delay as this debate heats up. No matter what is done to resolve this issue, BIF premium rates should be cut dramatically as of July 1, 1995.

An example will illustrate how a win-win-win situation can be constructed. One of the policy options the GAO outlined in its report this month on the premium disparity issue (GAO/AIMD-95-84) was a proportionate sharing of the FICO interest obligation, based on each fund's assessment base. Implementing this option would shift about \$600 million annually of FICO interest expense to the BIF, an amount that equals approximately 2.5 basis points of additional premium assessment for BIF-insured banks. Such a cost shift can be turned into a win-win-win situation for the BIF insureds if each bank can clearly see an immediate reduction in regulatory compliance costs that exceeds 2.5 basis points of its domestic deposits. For example, 2.5 basis points of additional BIF premium would cost a community bank with \$100 million in assets and \$85 million in deposits another \$21,250 annually. This bank should therefore be able to identify at least \$21,250 of annual regulatory cost savings in order to be agreeable to shifting some of the FICO interest obligation to the BIF.

A merger of the BIF and the SAIF is inevitable, but an actual fund merger may have to wait for a few years. FIRREA launched a substantial regulatory and marketplace melding of the banking and thrift industries. In order to have a positive outcome, resolving the premium differential issue in a positive manner should advance that melding process, specifically in terms of promoting more acquisitions between the two industries, paving the way for merging the OTS into the OCC, and melding the bank and thrift charters or, alternatively, making it fairly easy for depository institutions to switch between the two charter types. While a fund merger ultimately makes a lot of sense, BIF-insured banks are understandably opposed to any merger that will cost them money. Solving the premium differential in a win-win-win manner should go a long way towards eliminating the cost fears that bankers now have about an outright merger of the two funds.

There is nothing magical about the 1.25% DDR because deposit insurance becomes a pay-as-you-go operation once a 1.25% ratio is reached. A deposit insurance fund's fund balance, or unrestricted reserves, exist only in an accounting sense, as is also true for the Social Security Fund and the Highway Trust Fund. Positive fund balances already have been spent for other federal purposes. In one sense, the BIF and SAIF fund balances are merely prepayments towards the next regulatory disaster, which of course the Prompt Corrective Action provisions of FDICIA are supposed to prevent. In another sense, a fund balance is merely a present value calculation of the total amount of premiums insured institutions have paid into the fund over the years less the losses and expenses the fund has paid out over those same years. The BIF's fund balance, for example, represents a present value calculation that goes back to 1934. According to this calculation, the American taxpayer had received as of December 31, 1994, a \$21.95 billion benefit, in 1994 dollars, from the federal government's operation of the BIF.

Once a fund hits its DDR, then it shifts to a pay-as-you-go operation. That is, the FDIC must then charge a sufficiently high premium rate which, when added to the fund's interest income and when reduced by the fund's losses and administrative expenses, does not drop the fund balance below the fund's DDR. In effect, once a fund hits its DDR, then the DDR percentage becomes irrelevant because the taxpayer is just as well protected at a .5% DDR as it is at a 1.5% DDR, provided the pay-as-you-go mechanism continues to operate. The attached table illustrates this point. Once the BIF reserve ratio drops back down to 1.25% (column 11, the year 1999), then the BIF premium rate (column 3) is determined entirely by other income and expense items (columns 5, 6, and 8). Interestingly, FDICIA's systemic risk assessment provision is a pay-as-you-go mechanism; once BIF and SAIF reach the 1.25% DDR, then the entire FDIC deposit insurance operation will operate on a pay-as-you-go-basis.

It is important to keep the irrelevance of the DDR in mind in developing a resolution for the premium differential issue or in eventually merging the two funds because lowering the amount that banks and thrifts have to prepay towards the next regulatory disaster that is not supposed to happen anyway provides some regulatory cost savings that can help all concerned to reach a satisfactory agreement. A lower DDR also can be justified because of, one, the systemic risk assessment, which presumably will handle the very expensive, fund-depleting failures, and, two, the enactment of depositor preference in the 1993 Budget Act.

Restore diverted premiums to the SAIF. As discussed above, \$2.95 billion of premiums were diverted from the SAIF in the 1990-92 period. With interest, that amount rises to \$3.5 billion, an amount that would raise the SAIF reserve ratio by 50 basis points. Simple fairness demands this restoration. Also, restoring these funds will help to solve the premium differential problem. Fortunately, shifting these funds into the SAIF from another government fund, such as the FSLIC Resolution Fund, will not add to the budget deficit since interfund transfers within the consolidated federal budget have no budgetary effect because these monies will not be spent; they will merely help the SAIF get to the point where it switches to a pay-as-you-go operation. Such a transfer also should not have a "pay-go" effect for budgetary purposes.

The use of RTC funds to pay for future losses or to build up the SAIF balance. Any use of already appropriated RTC funds to resolve failed thrifts adds to the budget deficit in the fiscal year in which the funds are actually spent, not in the year in which they are appropriated.

Therefore, extending the RTC takeover period, which is now scheduled to expire on June 30 of this year, will increase the budget deficit to the extent that thrifts actually fail. However, insolvency losses in thrift failures over the next few years should be fairly low. Therefore, the use of RTC funds for this purpose will not contribute significantly to reducing the premium differential.

Using RTC funds to capitalize the SAIF would have the same budgetary effect as putting back into the SAIF the diverted premiums discussed above. However, it is much harder to make the case that RTC funds should be used to capitalize the SAIF. In any event, using RTC funds to capitalize the SAIF only has the effect of advancing the day when the SAIF will begin to operate on a pay-as-you-go basis. A more straight-forward way to advance that date would be to simply lower the DDR percentage for both the SAIF and the BIF. Simply boosting the SAIF to a 1.25% reserve ratio only partially solves the premium differential problem because the SAIF will still be stuck with all of the FICO interest burden. That burden presently adds about 11 basis points per dollar of deposits to SAIF's operating costs. In a pay-as-you-go environment, SAIF premiums would therefore have to be 11 basis points higher than BIF premiums, all other factors affecting the funds being the same.

SAIF-insured thrifts recognize that they have to make a special contribution to resolve the premium differential problem. Most SAIF-insured institutions acknowledge that they have to make a special contribution to help resolve the premium differential problem. This special contribution could take one of two forms. One form would be a relatively small, single-digit premium differential between SAIF and BIF premium rates for the remainder of the time the FICO bonds are outstanding or until the SAIF reaches the 1.25% DDR. Recently, for example, America's Community Bankers proposed a multi-part solution to the differential issue, one component of which was a 5-basis point premium differential that would expire when the SAIF reached a 1.25% reserve ratio.

The other form of special contribution would be a one-time payment by thrifts to the SAIF that would represent the present value of a premium differential over a number of years or for the remaining life of the FICO bonds. For example, a 7 basis point premium differential discounted over 24 years at 15% equals 45 basis points. (Since a one-time contribution would be a direct charge against thrift capital, I used a discount rate equal to the cost of equity capital.) Asking the banks holding Oakar deposits to pay a comparable fee would be justifiable since such a fee would be much less than the SAIF exit and BIF entrance fees they have not paid by electing for Oakar deposit status. The same rationale would apply in charging Sasser institutions a comparable fee.

Interestingly, a one-time contribution equal to 45 basis points of insured deposits plus a restoration of the diverted SAIF premiums, with interest, which would add another 50 basis points to the SAIF, plus the SAIF reserve ratio at December 31, 1994, of 28 basis points would produce a SAIF reserve ratio of 1.23%. Adding in SAIF income earned so far in 1995 would bring this ratio above the magic 1.25%, which presumably would permit a SAIF premium reduction. Nonetheless, as noted in the preceding section, SAIF premium rates would still have to be 11 basis points higher than BIF premium rates, all other factors affecting the funds being the same, because of the SAIF's FICO interest obligation.

The use of appropriated funds to fund the FICO. As I stated at the beginning of my testimony, the FICO interest obligation would have been an obligation of the taxpayer had Congress tackled the S&L problem in 1987 instead of punting it into 1989. Also, as I noted above, and as FDIC Chairman Helfer has noted, the premium differential problem really is a FICO interest problem. However, at this point in time, it would be inappropriate to use taxpayer funds to pay the remaining interest due on the FICO bonds. Instead, this burden should be "paid for" by reducing the regulatory compliance cost burden of America's banks and thrifts.

Regulatory arbitrage is very wasteful and does not solve problems. The tandem operation concept discussed above is a regulatory arbitrage. In other words, thrifts would charter national banks solely to minimize a regulatory expense, the deposit insurance tax they now pay to the SAIF. However, executing this arbitrage will consume real resources; therefore, it is economically wasteful. While I recommend against a "quick-fix" bill to ban tandem operations, I hope the ultimate resolution of the premium differential issue will be structured so that no thrift will feel compelled to actually establish or continue operating a bank and a thrift in each of its branches. One charter per branch should be enough for any depository institution.

CONCLUSION

The BIF-SAIF premium issue is a difficult one that does not suggest an easy answer. At the same time, it has become a pressing issue that Congress needs to address this year. In working with banks and thrifts to develop a fair and equitable solution, Congress should strive for a true resolution of this problem, instead of smoke-and-mirrors that merely complicate and delay its eventual resolution. Also, this resolution should encourage, and not impede, a future complete regulatory melding of the banking and thrift industries.

Madam Chairwoman, I thank you for this opportunity to testify to the Subcommittee. I would be glad to answer any questions that you and other members of the Subcommittee might have for me.

BIF Forecast Assuming BIF is Not Merged with SAIF

(Assumes Regular Premium (23 - 31 BP) in First Half of 1995 and Premiums Ranging from 0 - 27 BP in Second Half of Year)

Year - end	Domestic Deposits in BIF - Insured Banks (\$ in billions)		Premium Rate in Basis Points [3]	BIF Finances (\$ in millions)				Reported Fund Bal. as % of Insured Deposits [11]	4th Qtr. Nominal GDP (\$ in bill.) [12]	Bank Deposits as % of GDP [13]	GDP Deflator in Qtr. 4 (1987 = 100) [14]	Bank Dep. in Infla. Adj. \$ (Q494 = 100) (\$ in bill.) [15]	Bank Dep. Growth (Shrinkage) in Real \$ from 12/91 [16]			
	Total [1]	Insured [2]		BIF Premium Income(1) [4]	BIF Operating Expenses [5]	Incurred Insurance Losses(2) [6]	Insurance Prof (Loss) [4] - [5] - [6] [7]							Net Int. & Other Inc. (Expense) [8]	True Fund Balance at Year - end(3) [9]	Reported Fund Bal. Year - end [10]
1991	2,520	1,958	21.25	5,160	284	6,993	(2,117)	(473)	9,318	(7,028)	-0.36%	5,797	43.5%	118.8	2,694	---
1992	2,512	1,946	23.00	5,588	361	4,709	518	(349)	10,661	(101)	-0.01%	6,169	40.7%	121.9	2,617	-2.8%
1993	2,490	1,903	24.50	5,784	388	566	4,830	149	16,094	13,122	0.69%	6,478	38.4%	124.1	2,548	-5.4%
1994	2,449	1,896	24.00	5,591	423	139	5,029	262	22,723	21,848	1.15%	6,891	35.5%	127.0	2,449	-9.1%
1995	2,475	1,923	12.35	2,944	433	250	2,261	1,174	26,158	25,201	1.31%	7,304	33.9%	131.4	2,391	-11.2%
1996	2,566	2,010	0.50	142	453	207	(517)	1,298	26,939	25,972	1.29%	7,743	33.4%	136.0	2,414	-10.4%
1997	2,703	2,100	0.50	148	473	216	(542)	1,333	27,730	26,754	1.27%	8,207	32.9%	140.8	2,438	-9.5%
1998	2,824	2,195	0.50	153	494	226	(567)	1,374	28,537	27,551	1.26%	8,700	32.5%	145.7	2,461	-8.6%
1999	2,951	2,293	1.92	556	517	236	(197)	1,424	29,764	28,767	1.25%	9,222	32.0%	150.8	2,485	-7.8%
2000	3,084	2,397	2.01	606	540	247	(181)	1,485	31,069	30,061	1.25%	9,775	31.6%	156.1	2,509	-6.9%
2001	3,223	2,504	2.02	635	564	258	(187)	1,550	32,432	31,413	1.25%	10,362	31.1%	161.6	2,533	-6.0%
2002	3,368	2,617	2.03	665	589	269	(194)	1,619	33,857	32,826	1.25%	10,983	30.7%	167.2	2,558	-5.1%
2003	3,520	2,735	2.04	697	616	282	(201)	1,690	35,346	34,302	1.25%	11,642	30.2%	173.1	2,583	-4.1%
2004	3,678	2,858	2.04	730	644	294	(208)	1,764	36,902	35,844	1.25%	12,341	29.8%	179.1	2,607	-3.2%
2005	3,844	2,986	2.05	764	673	307	(216)	1,842	38,528	37,457	1.25%	13,081	29.4%	185.4	2,633	-2.3%
2006	4,017	3,121	2.06	801	703	321	(224)	1,923	40,227	39,149	1.25%	13,866	29.0%	191.9	2,658	-1.3%

Specific Assumptions (listed under corresponding columns):

Insured Dep as % of Tot Dep: 77.7%	BIF Oper		BIF Interest		Growth Rate in Nominal GDP(5) > 1993: 6.0%
	Exp as % of Year - end Dep: 0.0175%	Losses > 1995 as % of Yr - end Tot Dep: 0.008%	Inc (Exp) as % of Investable Funds(4): 5.0%	Projected GDP Deflator > 1993: 3.5%	

Deposit Growth Assumptions:

Rsrv Ratio Assumption < 1.25%	Deposit Growth	
	As % GDP Growth Rate	Growth Rate
Reserve ratio = 1.25%	25%	2.0%
Reserve ratio = 1.25%	75%	4.5%

Notes:

- (1) BIF Premium income equals BIF premium rate times the average of total domestic deposits for the current and prior year - end.
- (2) Insurance Losses exclude adjustments in the Loss Reserve.
- (3) True Fund Balance equals the Reported Fund Balance (Col. 10) plus its Loss Reserve, which represents BIF's expected loss in future bank closures. After 1994, the BIF Loss Reserve equals \$750 million plus losses in the following year's closures. The True Fund Balance is the total amount available at any one time to cover losses in failed banks.
- (4) Investable Funds equals average of beginning and ending True Fund Balance (column [9]) minus non-income-producing assets, assumed to equal insurance losses incurred in the current and two prior years (column [6]).
- (5) Nominal GDP grew 7.7% annually in the 1950 - 1989 period and 7.6% in the 1980 - 89 period, but it grew only 5.0% in the 1990 - 94 period.