Description of document:	Federal Deposit Insurance Corporation (FDIC) Paper: The FDIC-FSLIC Merger: A Preliminary Report, 1985
Requested date:	2016
Released date:	20-July-2016
Posted date:	25-July-2016
Source of document: FDIC	FOIA Request Legal Division FOIA/PA Group 550 17th Street, N.W. Washington, D.C. 20429 Fax: 703-562-2797 Online Electronic FOIA Request

FDIC
Federal Deposit Insurance Corporation
550 17th Street, NW, Washington, DC 20429-9990 Legal Division

July 20, 2016

FDIC FOIA Log Number 16-0207

This will respond to your request, pursuant to the provisions of the Freedom of Information Act (FOIA), 5 U.S.C. §552, for a copy of the paper by Michael Hovan, Jr., James A. Marino, Gary B. Sarsfield, William Via and Robert W. Walsh entitled *The FDIC-FSLIC Merger*, dated June 1985.

Please be advised that the requested document is being released in part, with some minor redactions made under Exemption (b)(6). Exemption (b)(6) permits the withholding of information the disclosure of which would constitute a clearly unwarranted invasion of personal privacy. I note that public information on the structure and organization of the former FHLBB and FSLIC was limited and, therefore, the study should be considered a preliminary investigation. Further, the December 1984 data, which provided the bulk of the information used for the study, was also in preliminary form.

As information has been partially withheld in the record provided to you, you may appeal our response to the FDIC's General Counsel within 90 business days following receipt of this letter. If you decide to appeal, please submit your appeal in writing to the Legal Division, FOIA/Privacy Act Group, at the above address. Please refer to the FDIC log number and include any additional information that you would like the General Counsel to consider.

You have the right to seek dispute resolution services from the FDIC FOIA Public Liaison, or the Office of Government Information Services (OGIS). To contact the FDIC FOIA Public Liaison, call Acting FDIC Ombudsman Gordon Talbot at (703) 562-6040, or email to GTalbot@fdic.gov, or regular mail to FDIC, 3501 N. Fairfax Drive, Arlington, VA 22226-3500. You may contact OGIS by telephone, by E-mail, by Mail or by Fax. Contact information for OGIS is available at https://ogis.archives.gov/

If you have any questions concerning this response, please feel free to contact me at 703-562-2761 of LSnider@FDIC.gov.

Sincerely,

Lisa M. Snider

Lisa M. Snider
Government Information Specialist
FOIA/Privacy Act Group, Legal Division

Enclosure

Page 1

Confidential

FDIC Personnel Only

THE FDIC-FSLIC MERGER: A PRELIMINARY REPORT

by

Michael A. Hovan, Jr.
Associate Director (Operations), DOL

James A. Marino, Chief
Financial Markets Section, DRSP

Gary B. Sarsfield, Chief
Assessments and Financial Operations Section, DACS

J. William Via, Counsel
Legal Division

Robert W. Walsh
Examination Specialist, DBS

FEDERAL DEPOSIT INSURANCE CORPORATION

June 5, 1985

Page 2

THE FDIC-FSLIC MERGER: A PRELIMINARY REPORT

by

Michael A. Hovan, Jr.
Associate Director (Operations), DOL

James A. Marino, Chief
Financial Markets Section, DRSP

Gary B. Sarsfield, Chief
Assessments and Financial Operations Section, DACS

J. William Via, Counsel
Legal Division

Robert W. Walsh
Examination Specialist, DBS

FEDERAL DEPOSIT INSURANCE CORPORATION

June 5, 1985

TABLE OF CONTENTS

Page 4

INTRODUCTION

This paper outlines the major issues involved if a merger between the FDIC and the FSLIC were required. It is assumed that a decision to merge the deposit insurance funds would be based upon: 1) a judgment that the FSLIC's insurance fund is inadequate to handle existing and expected thrift problems and 2) a policy determination that a merger would be preferable, from an overall public policy perspective, to an expenditure of taxpayer funds to preserve the present system. This paper does not consider the validity of these conclusions or the advantages of such a merger (such as in terms of risk diversification). The paper's primary purpose is to alert readers to the logistical problems of a merger and to discuss additional FDIC resource requirements; as such, it dwells more on the negative implications and does not provide an even-handed discussion of the merits of a merger. Although a combined fund probably would not be seriously compromised if the two deposit insurance funds were merged, the following analysis presents a clear indication that serious strains could be placed on the FDIC's financial and human resources. Nevertheless, the public benefits in terms of system stability and public perception may make a merger the only viable option.

It is also assumed that the resulting relationship between the joint insurance agency (the FDIC) and the Federal Home Loan Bank Board (FHLBB) would be akin to our current relationship with the Office of the Comptroller of the Currency (OCC) as regards nationally chartered banks insured by the FDIC. That is, the FHLBB would act as the primary regulator of all federally insured S&Ls, yet the FDIC would reserve the right of examination. Ideally the FDIC would ultimately exercise this right only in the case of large or problem S&Ls with a random sampling of others.

It is further assumed that the enabling merger legislation would contain language requiring a phasing in of regulatory standards for S&Ls to a level comparable to that of commercial banks. In the event individual S&Ls do not meet these phase-in requirements, the FDIC should be empowered to impose sanctions.

A ground rule established at the beginning dictated that FDIC staff were not to disclose the existence of this study to outside parties. This limited the ability of the authors to communicate freely with FSLIC and Bank Board personnel. Over the past several years the FHLBB has significantly reduced the flow of information to the public on the condition of the S&L industry. In addition, public information on the structure and organization of the FHLBB and the FSLIC is limited. Therefore, this study should be considered a preliminary investigation. Any formal proposals for a merger should not be completed without explicit communication with Bank Board personnel.

The following section of this paper will provide a brief overview of the functions of the FSLIC and how it fits into the Bank Board System. This will be followed by a listing of the major issues.

default, the FSLIC will be appointed as conservator or receiver and; as such, is authorized: 1) to take over the assets of and operate the S&L, 2) to take such action as may be necessary to put it in a sound and solvent condition, 3) to merge it with another insured institution, 4) to organize a new Federal S&L to take over its assets or 5) to proceed to liquidate its assets in an orderly manner (12 U.S.C. Section 1729(b)). The FSLIC also has comparable authority with respect to State-chartered S&Ls. The ability of the FDIC to act as conservator is questionable and our ability to operate insolvent institutions is limited. The FDIC can establish a Deposit Insurance National Bank (DINB) to assume the liabilities (but not the assets) of a failed institution, but a DINB is designed to be a temporary institution and is not designed to be operated as an ongoing entity. In addition, the FDIC is prohibited from taking a voting ownership interest in a bank. These restrictions make it difficult for the FDIC to operate banks in the same manner as the FSLIC can operate an S&L, though the FDIC's pending legislative package would give the FDIC roughly comparable authorities.

The FDIC is also more limited in its ability to arrange for interstate mergers of distressed institutions. The FDIC can arrange for interstate mergers of commercial banks which have closed or for mutual savings banks which have closed or are in danger of closing only if they have assets of $500 million or more. Neither the size limitation nor the closure restrictions apply to FSLIC-insured institutions. The FDIC's pending legislative package would eliminate the closure requirement.

In the event of a merger, these discrepancies should be resolved. It should be noted, however, that these broader powers have enabled the FSLIC to handle some failures in ways traditionally not acceptable to the FDIC. For example, in the case of the Beverly Hills S&L -- which failed due to credit losses -- the FSLIC created a new institution which assumed the assets and liabilities of the failed S&L. The FSLIC has contracted with another S&L to manage Beverly Hills and it appears they will continue to operate the institution indefinitely in the hope that it will someday have a positive market value. This approach to the handling of an institution which failed due to credit losses has not been acceptable to the FDIC but will likely become an unavoidable alternative to a payout, purchase and assumption transaction or assisted merger if the FDIC is to successfully spread the costs of S&L failures over a reasonable time period. Later sections of this paper will indicate that the extent of the thrift problem is so severe that the immediate disposition of all insolvent S&Ls would deplete a joint fund at an unacceptable rate.

Supervision of State-Chartered S&Ls

The second function of the FSLIC -- supervision of state-chartered S&Ls -- would be transferred to the FHLBB under the type of [illegible] currently contemplated. It is, however, unlikely that the FDIC would be comfortable if the current supervisory standards which apply to S&Ls would continue in a post-merger setting. As mentioned previously, a [illegible] condition of a merger should include a legislative [illegible] in [illegible] "freezes" standards on S&Ls which are [illegible] to [illegible] of commercial banks. Comparable standards, and the ability to [illegible], would seem a necessity in light of the considerable risk the FDIC would be undertaking through a merger.

S&L Holding Companies

The FSLIC's third function -- supervising S&L holding companies -- is far different from any power exercised by the FDIC, and different even from the Federal Reserve's authority over BHCs. The FSLIC has virtually no control over one-S&L holding companies. These companies may engage in any kind of business whatever, and have whatever subsidiaries they please, without being constrained by a "closely related to banking" test. But the FSLIC has full control over all parts of multi-S&L holding companies: that is, over the holding company itself; over all the S&L subsidiaries, whether federal or state; and over the non-S&L subsidiaries. The inter-agency jurisdictional problems, which are so common in the sphere of bank regulation, do not arise.

The FDIC, however, must determine whether it wants to inherit this supervisory power or transfer it to the FHLBB. On the one hand, the FDIC has not traditionally regulated or examined holding company structures but, on the other hand, it is likely that there are potential risks hidden in some S&L holding company subsidiaries. Of prime importance with respect to holding company activities is the presence of the proper barriers between an insured S&L and its affiliates. To the extent these restrictions exist, risk to the insurance agency will be limited. The restrictions on financial dealings between an S&L holding company's subsidiary insured institution and its affiliates are similar in some respects to the restrictions of Section 23A of the Federal Reserve Act that apply to bank holding companies and FDIC insured banks. The FSLIC, however, does appear to have wide discretion to approve transactions notwithstanding these restriction. This discretion leaves open the possibility of more freedom, and thus of more risk, for S&Ls in this realm that in the case of banks. This is an area which will need further examination.

In addition, it appears that S&Ls generally have a greater exposure through their service corporation subsidiaries than is typically found in a commercial bank subsidiary. Not only do S&Ls have an equity interest in their subsidiaries, in some cases, they also have a significant volume of assets invested in these subsidiaries.

THE FINANCIAL CONDITION OF FSLIC-INSURED INSTITUTIONS AND THEIR IMPACT ON A JOINT INSURANCE FUND

Introduction

As a source of information, this section relies primarily upon quarterly financial reports supplied to the FDIC by the FHLBB on computer tapes (the FDIC data base is limited to the 1984 reports). These reports contain balance sheet and income data along with limited structure information. The sample was limited to S&Ls which filed a report for all four quarters of 1984. It should be noted that the December data, which provided the bulk of the information for this study, is still in preliminary form. Although the preliminary nature of the data does result in limitations, overall results and conclusions likely will not be altered.

Current Condition

The current and past problems of the S&L industry, stemming from an asset-liability maturity mismatch, have been well publicized. Although thrifts have made some progress toward balancing their maturity structure, interest rate risk still remains a major problem. Fortunately, interest rates have remained relatively stable over the past several years allowing the industry to make some progress as compared to the more difficult times of the early 1980's.

Income

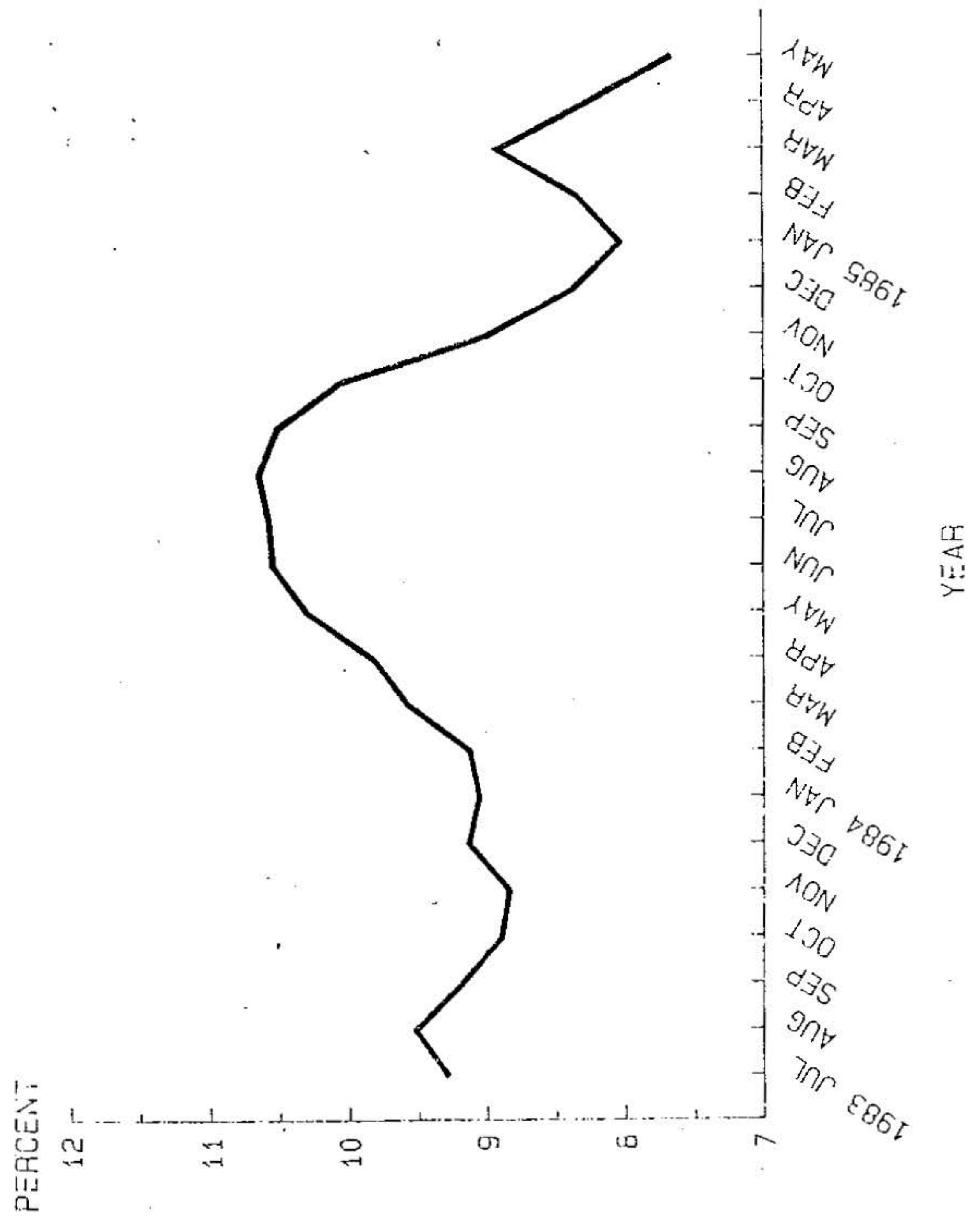
FSLIC-insured institutions earned $1.6 billion in 1984 for a return of eighteen basis points on average assets. The bulk of these earnings, however, were due to the benefits derived from purchase accounting. Net of these benefits, S&Ls earned $550 million in 1984 for a return of six basis points on an average assets. These modest earnings should show substantial improvement during 1985 provided interest rates stay at their current levels. Rates have generally fallen since last August (see Chart 1) and, more recently, Treasury bill rates have averaged more than 200 basis points under their 1984 averages. Indeed, at recent auctions both three-and six-month bill rates were under 7.5 percent.

Capital Adequacy

Overall, as of December 31, 1984 the S&L industry had capital of $34.1 billion for a capital-to-asset ratio of 3.51 percent. Capital, as defined here and throughout most of this study, consists of what the FDIC would consider primary capital; excluded are items such as subordinated debt, appraised equity capital and net worth certificates. Goodwill and deferred losses from the sale of assets are not subtracted from capital because they represent a marking-to-market of a portion of an S&Ls assets. Thus, S&Ls which used purchase accounting would appear to have lower capital ratios than those who did not. It is true, however, that in some cases assets acquired via purchase accounting which were marked-to-market were sold at a profit without reducing goodwill. These

CONFIDENTIAL

CHART 1: SIX-MONTH TREASURY BILL RATES,
AUCTION AVERAGE, BANK-DISCOUNT BASIS



profits probably should be subtracted from goodwill. Since the bulk of these sales occurred during 1982 and 1983 -- periods for which the FDIC has no individual S&L data -- proper adjustments for this factor were not possible. Purchase accounting does boost income; however, this advantage was removed in the simulations of this paper. Table 1 presents a distribution of S&Ls according to this capital ratio along with the total capital and assets of each subgrouping. Also included in this table is a definition of capital which excludes deferred losses (gains) from assets sold, goodwill and other intangible assets. Excluded from this and subsequent tables are the Phoenix institutions, those which are operated under the conservatorship of the FSLIC and those which have failed so far this year. This group will be discussed below.

Excluding the above mentioned group, there are 103 S&Ls which have a negative capital position if deferred losses, goodwill and other intangibles are counted as assets. Total assets of this group are $18.1 billion and their total capital equals $-394 million. Subtracting intangibles from capital would leave 663 S&Ls insolvent. Total assets of this group are $336.2 billion and their capital is $-13.74 billion.

Asset Quality

Over the past several years asset quality has been of increasing concern to the FSLIC. The failures of Empire, San Marino, State S&L and Beverly Hills S&L and the troubles of American S&L illustrate the FSLIC's growing problems with asset quality.

At this point the true extent of asset quality problems within the S&L industry is a great unknown. To an outside observer, the available data for measuring asset quality is limited. S&Ls do report on their non performing loans (so called "slow" loans) and on other distressed assets (scheduled items). Generally speaking, for commercial banks, a level of nonperforming assets which exceeds capital implies a problem bank which, in turn, has at least a ten percent chance of failure. But commercial bank standards cannot be applied to S&Ls since a high proportion of their assets are either insured or pose low default risk.

Alternatively, rapid growth frequently results in asset quality problems. American S&L and Beverly Hills S&L are examples of two institutions which have grown rapidly over the past several years. In their efforts to grow so quickly these institutions have often neglected to properly evaluate the quality of some of their loan customers.

In the absence of reliable examination data, it was assumed that credit quality problems existed in institutions which either had substantial quantities of slow loans and scheduled items or had grown rapidly, net of mergers, over the past several years.

If, for an individual S&L, slow loans and scheduled items were in excess of ten percent of assets, this was assumed to imply a significant failure risk. This decision is somewhat arbitrary; however, ten percent of assets is a high threshold by both commercial bank and thrift standards

TABLE 1: DISTRIBUTION OF FSLIC-INSURED INSTITUTIONS
BY CAPITAL-TO-ASSET RATIO, DECEMBER 31, 1984

pital Range	Number of Institutions		Capital ($ Billions)		Assets ($Billions)	
	Definition I[a]	Definition II[b]	Definition I	Definition II	Definition I	Definition II
ss than 0 %	103	663	$-0.4	$-13.7	$ 18.1	$336.2
tween 0 % and 1 %	154	191	0.3	0.7	46.5	105.7
tween 1 % and 2 %	306	287	1.5	1.4	99.9	95.8
tween 2 % and 3 %	475	367	6.0	3.0	233.6	123.3
:ween 3 % and 4 %	530	381	8.8	4.1	252.5	116.3
ween 4 % and 5 %	453	327	5.3	2.6	117.5	59.0
ater than 5 %	1047	852	12.7	8.1	187.7	119.5
ıl	3068	3068	$34.1	$ 6.2	$955.8	$955.8

[a]In this definition, capital consists of what the FDIC would consider primary capital; excluded items such as subordinated debt, appraised equity capital and net worth certificates.

[b]In this definition, capital consists of Definition I minus deferred losses (gains) from assets goodwill and other intangible assets.

and, in most cases, is a level generally several times the capital of these S&Ls.

It was also assumed that credit quality problems would be present in S&Ls which: 1) have more than doubled in size (net of mergers) over the past three years, or if not in existence three years ago, have shown comparable growth rates and 2) have above-risk assets in excess of their capital level. Above-risk assets are defined as nonconforming loans and contracts to facilitate the sale of real estate owned, commercial loans, repossessed assets and real estate investments. Since these growth calculations must be done by hand, the analysis is limited to S&Ls with deposits of $1 billion or more (these institutions hold roughly fifty percent of industry assets).

Net of recent failures, there are 52 S&Ls which have slow loans and other scheduled items in excess of ten percent of assets. Total assets for these institutions amount to $6.2 billion. In addition, there are thirteen excessive-growth S&Ls which are not included in the above 52. These hold assets of $57.0 billion. Included in the later group are several S&Ls whose troubles have been reported in the press; such as, American S&L of Stockton, CA, Bell S&L of San Mateo, CA, and Sunrise S&L of Boynton Beach, FL (Beverly Hills S&L would have been included had it not failed).

Phoenixes, Conservatorships and Others

Currently the FSLIC is operating three Phoenixes, four conservatorships and one institution which recently failed but has yet to be disposed of (Beverly Hills). These S&Ls are listed on Table 2 along with their assets and their capital levels net of goodwill and deferred losses on assets sold. These institutions were excluded from the other parts of this study because it would be more accurate to treat them as institutions which have already failed but for which a solution has not yet been found. Clearly the FSLIC has opted to operate insolvent institutions to defer the expense of a solution to their problems. Overall, these institutions hold $15.5 billion in assets and have a negative capital level of $2.1 billion.

The FSLIC's Exposure from Existing Problems

The FSLIC faces an exposure from three fronts. First, there are the phoenixes, conservatorships and the Beverly Hills S&L failure. These institutions hold $15.5 billion in assets. Second, there is the threat from the institutions which have negative capital ratios (103 institutions with total assets of $18.1 billion). Finally, the FSLIC is confronted with credit quality risk. Excluding institutions included in the 103 S&Ls with negative capital ratios, there are 39 S&Ls ($4.3 billion) which have a high volume of slow loans and an additional thirteen ($57.0 billion) which are thought to have credit problems due to rapid growth. In all, estimated problem institutions hold $94.9 billion in assets.

Initially the FSLIC was able to handle failures for roughly five to ten percent of assets. More recently, however, due to diminishing

Page 12

CONFIDENTIAL

TABLE 2: PHOENIXES, CONSERVATORSHIPS AND OTHERS

Name and Location	Assets ($ Millions)	Capital[a] ($ Millions)	Type[b]
First FS&LA of Rochester Rochester, NY	$ 4,434	$-1,110	P
First Federal Savings Bank Santurce, PR	1,191	-24	P
The Talman Home Chicago, IL	6,520	-856	P
Northlake FS&LA Covington, LA	141	-13	C
Alliance FS&LA Kenner, LA	209	1	C
First FS&LA of Redding Redding, CA	47	-8	C
Hacienda FS&LA Oxnard, CA	37	-10	C
Beverly Hills S&LA Beverly Hills, CA	2,949	-76[c]	F
Total	$15,528	$-2,096	

[a]Primary capital net of goodwill and deferred losses on assets sold.

[b]P = Phoenix, C = Conservatorship, F = Failure.

[c]Year-end 1984 capital minus $100 million in losses as reported in the press.

problems

Fine condition
of FSLIC insured instit.

special assessment
continued

interstate merger opportunities and an increase in credit quality problems, the expected average cost of failure during 1984 rose to fifteen percent of assets. (See "Thrift-Institution Failures: Causes and Policy Issues," Research Working Paper No. 117, Office of Policy and Economic Research, Federal Home Loan Bank Board.) Thus, it is likely that the cost of future failures will fall in the ten to fifteen percent range rather than between five and ten percent of assets. If interest rates stay low, the average cost of a failure may likely fall at the lower end of this range. Applying this cost range to the FSLIC's exposure of $94.9 billion yields a rough cost estimate of between $9.5 and $14.2 billion.

The resources available to the FSLIC include their reserve fund (although listed at just under $6 billion, its true size is probably closer to $4 billion when the true present value of the FSLIC's financial commitments are taken into account) plus premium payments. Regular assessments amount to about $640 million and the special assessment of one-eighth of one percent will bring in roughly $1 billion. Thus, including interest income from its fund, the FSLIC should have a 1985 income of just over $2 billion and a usable fund of roughly $4 billion. It is clear that the potential problems of the S&L industry far exceed the current resources of the FSLIC.

Future Projections

It is also of interest to the FDIC to determine the direction in which the S&L industry is going. Using simulations it is possible to estimate this direction under various interest rate assumptions.

In this section, the capital distribution of the S&L industry, three years from now, is estimated. To do this a model was constructed which takes the year-end 1984 capital position of each S&L and assumes that its 1984 income level, net of the impact of purchase accounting, will continue over the next three years. Income, however, is adjusted in three ways. First, each S&L is assumed to grow at the same rate as it experienced over the second half of 1984 (not compounded and not to exceed 20 percent per year). It was assumed S&Ls will earn 75 basis points on this new money. The lack of compounding and the 20 percent restriction does limit growth but this is probably not unreasonable in light of recent actions by the Bank Board to do just that. In addition, the benefit from growth (assumed to be 75 basis points) may be illusory if an institution grows rapidly. As growth rates increase, spreads can be expected to decline and asset quality problems would likely increase. Second, the S&L benefits from the rollover of old assets. The model assumes that ten percent of their real estate mortgage portfolio with maturities in excess of ten years will roll over each year. The benefit from this rollover is calculated as the difference between the current mortgage rate (assumed at 14 percent) and the average rate the individual S&L is earning on these old mortgage assets. Finally, the impact of interest rate changes is calculated by constructing maturity gaps.

One factor complicating the analysis is the ability of the FSLIC to assess S&Ls an additional one-eighth of one percent premium. The FSLIC has already assessed S&Ls one-fourth of this potential premium increase for the first quarter of 1985 and it appears likely it will do the same for subsequent quarters. This special assessment, if continued, will bring in roughly $1.07 billion in 1985, $1.17 billion in 1986 and $1.28 billion in 1987. This would represent a significant cost to the industry. From the standpoint of a merger of the insurance funds it is not clear whether this special assessment will be continued. In this light, this paper will list the results of separate simulations assuming that the special assessment continues and that this assessment is stopped.

Admittedly the assumptions made in this model are somewhat crude. Many factors which could alter future S&L income are not taken into consideration; for example, additional taxes and dividend disbursements were not factored in he analysis. These are probably minor items for many institutions given their ability to carry losses forward and the likely restrictions on dividend payments for poorly capitalized institutions in the event strict capital requirements are imposed. It is felt that the major items were covered and that the general results of the model are valid. Overall, the model should err in favor of the S&L industry. Note that the simulations listed below exclude those institutions listed in Table 2 as well as the 1985 failures.

Table 3 lists the results of the model assuming interest rates remain at 1984 levels over the next three years. Under this assumption the year-end 1987 capital level of the industry increases from its current level of $34.1 billion to $46.1 billion if the special assessment is discontinued or $42.6 billion of it is continued, resulting in a capital-to-asset ratio of 3.59 or 3.32 percent, respectively. Over the three year period assets would grow at an annual rate of 10.3 percent (1984 growth rate for the industry was 18.2 percent). Income, as a percent of average assets, would be 18 basis points in 1985, 36 basis points in 1986 and 50 basis points in 1987 if the special assessment is discontinued. Otherwise, return on assets is estimated to be 8, 25, and 40 basis points, respectively. Despite the improving income picture, and the removal of the special assessment, the number of S&Ls with a negative capital position increases to 270 (total assets of $126.3 billion). With the special assessment, the number of S&Ls with negative capital will increase to 297 in 1987 (total assets of $135.1 billion).

As mentioned previously, however, short-term interest rates for 1985 recently have averaged roughly 200 basis points below the 1984 levels (for the first five months of 1985, average rates have been about 150 basis points below 1984 levels). Should these rate levels continue, the condition of the S&L industry would be better reflected by assuming interest rate decreases of between 100 and 200 basis points.

The model was run assuming an interest rate decrease of 100 basis points over the average 1984 level (old mortgages were assumed to roll over to 13 percent rather than 14 percent). These results are listed in Table 4. Total capital increases to $56.9 billion if the special assessment is discontinued or $53.4 billion otherwise, resulting in capital-to-asset ratios of 4.43 and 4.16 percent, respectively. Income, as a percent of average assets, would be 47 basis points in 1985, 71 basis points in 1986 and 82 basis points in 1987 if the special assessment is

TABLE 3: SIMULATION RESULTS (YEAR-END 1987)
ASSUMING NO INTEREST RATE CHANGES

	Number of Institutions		Capital ($ Billions)		Assets ($ Billions)	
	Special Assessment Discontinued	Special Assessment Continued	Special Assessment Discontinued	Special Assessment Continued	Special Assessment Discontinued	Special Assessment Continued
Less than 0 %	270	297	$-2.9	$-3.3	$ 126.3	$ 135.1
Between 0 % and 1 %	105	128	0.2	0.3	41.3	48.5
Between 1 % and 2 %	169	194	1.4	1.7	84.2	105.5
Between 2 % and 3 %	304	345	4.4	6.0	171.8	231.9
Between 3 % and 4 %	430	435	11.7	10.9	337.1	315.7
Between 4 % and 5 %	396	410	8.4	7.6	190.4	168.4
Greater than 5 %	1394	1259	23.0	19.4	331.8	277.8
Total	3068	3068	$46.1	$42.6	$1282.9	$1282.9

NOTE: If the special assessment is discontinued, then:
1985 Income = $1.9 billion,
1986 Income = $4.0 billion,
1987 Income = $6.1 billion.

If the special assessment is continued, then:
1985 Income = $0.8 billion,
1986 Income = $2.8 billion,
1987 Income = $4.9 billion.

TABLE 4: SIMULATION RESULTS (YEAR-END 1987)
ASSUMING A 100 BASIS POINT INTEREST RATE DECREASE

	Number of Institutions		Capital ($ Billions)		Assets ($ Billions)	
	Special Assessment Discontinued	Special Assessment Continued	Special Assessment Discontinued	Special Assessment Continued	Special Assessment Discontinued	Special Assessment Continued
Less than 0 %	185	207	$-1.8	$-2.0	$64.4	$74.5
Between 0 % and 1 %	79	89	0.4	0.4	60.0	63.2
Between 1 % and 2 %	109	126	0.7	0.8	46.4	53.7
Between 2 % and 3 %	190	236	2.4	3.1	98.2	123.4
Between 3 % and 4 %	321	340	9.1	10.4	255.4	294.9
Between 4 % and 5 %	417	432	13.5	12.2	304.4	277.2
Greater than 5 %	1767	1636	32.5	28.4	454.2	395.9
Total	3068	3068	$56.9	$53.4	$1282.9	$1282.9

NOTE: If the special assessment is discontinued, then:
1985 Income = $4.8 billion,
1986 Income = $8.0 billion,
1987 Income = $10.0 billion.

If the special assessment is continued, then:
1985 Income = $3.7 billion,
1986 Income = $6.8 billion,
1987 Income = $8.7 billion.

discontinued. Otherwise, return on assets is estimated to be 37, 61, and 71 basis points, respectively. It is therefore possible that by 1987 S&Ls as a whole will equal their 1978 income level of 82 basis points. Without the special assessment, 185 institutions would have a negative capital position (total assets of $64.4 billion). With the special assessment, this number jumps to 207 (total assets of $74.5 billion).

Assuming an interest rate decrease of 200 basis points over the average 1984 level (old mortgages are assumed to roll over to 12 percent) and no special assessment the capital level of the industry increases to $67.7 billion by year-end 1987 for a capital ratio of 5.27 percent, otherwise capital is estimated at $64.1 billion for a capital ratio of 5.00 percent (Table 5). Without the special assessment income, as a percent of average assets, would be 76 basis points in 1985, 107 basis points in 1986 and 113 basis points in 1987. The respective numbers under the assumption of a continuation of the special assessment are 65, 96, and 103 basis points. Without the special assessment, 118 institutions would have a negative capital position in 1987 (total assets of $30.0 billion). Otherwise, the number would be 135 (total assets of $34.3 billion).

Should rates remain at average 1985 levels, or even go a bit lower, the 1987 condition of the S&L industry would probably fall somewhere between that presented in Tables 4 and 5. Although, for the industry as a whole, income and capital levels improve significantly, the number of insolvent institutions actually increases. There appears to be a thinly capitalized, poor-earning segment of the current industry which will not be aided enough by the current low interest rates to build up their capital positions.

On the less optimistic side, there is also a reasonable chance that rates will increase above 1984 levels. Table 6 lists the results of just a 100 basis point interest rate increase (old mortgages were assumed to roll over to 15 percent). Under these assumptions industry capital would be $35.3 billion in 1987 resulting in a capital ratio of 2.75 percent if the special assessment is discontinued. With the assessment, total capital would be $31.8 billion for a capital ratio of 2.48 percent. Without the special assessment income, as a percent of average assets, would be -10 basis points in 1985, 0 basis points in 1986 and 18 basis points in 1987. In contrast, income would be -21, -11, and 8 basis points with the special assessment. The number of insolvent institutions increases to 381 ($166.0 billion in assets) without the assessment and to 426 ($180.8 billion in assets) with the assessment. Clearly the overall health of the industry is dependent on interest rates not going much beyond 1984 levels.

The results of these simulations, for the most part, do not include considerations for asset quality problems. As noted earlier, there are cur- rently a significant number of S&Ls which show signs of substantial asset problems. To a certain extent asset quality troubles are a result of rapid growth. Since these simulations do allow for fairly rapid growth, it is likely that some of this growth will turn into problem assets. This fact cannot be measured and the extent to which greater asset quality problems will appear in the S&L industry over the next three

TABLE 5: SIMULATION RESULTS (YEAR-END 1987)
ASSUMING A 200 BASIS POINT INTEREST RATE DECREASE

	Number of Institutions		Capital ($ Billions)		Assets ($ Billions)	
	Special Assessment Discontinued	Special Assessment Continued	Special Assessment Discontinued	Special Assessment Continued	Special Assessment Discontinued	Special Assessment Continued
Less than 0 %	118	135	$-1.4	$-1.5	$ 30.0	$34.3
Between 0 % and 1 %	63	72	0.2	0.2	30.1	39.4
Between 1 % and 2 %	79	85	0.5	0.5	33.1	31.0
Between 2 % and 3 %	129	145	2.6	3.3	99.4	129.3
Between 3 % and 4 %	222	262	4.3	5.7	124.1	157.9
Between 4 % and 5 %	331	347	15.5	15.4	340.4	339.4
Greater than 5 %	2126	2022	46.0	40.6	625.9	551.5
Total	3068	3068	$67.7	$64.1	$1282.9	$1282.9

NOTE: If the special assessment is discontinued, then:
1985 Income = $7.7 billion,
1986 Income = $12.0 billion,
1987 Income = $13.9 billion.

If the special assessment is continued, then:
1985 Income = $6.6 billion,
1986 Income = $10.8 billion,
1987 Income = $12.6 billion.

TABLE 6: SIMULATION RESULTS (YEAR-END 1987)
ASSUMING A 100 BASIS POINT INTEREST RATE INCREASE

	Number of Institutions		Capital ($ Billions)		Assets ($ Billions)	
	Special Assessment Discontinued	Special Assessment Continued	Special Assessment Discontinued	Special Assessment Continued	Special Assessment Discontinued	Special Assessment Continued
Less than 0 %	381	426	$-4.7	$-5.2	$ 166.0	$ 180.8
Between 0 % and 1 %	173	193	0.4	0.5	63.1	81.7
Between 1 % and 2 %	272	312	2.6	2.7	169.4	182.6
Between 2 % and 3 %	406	457	6.2	8.3	246.9	326.4
Between 3 % and 4 %	426	403	9.4	7.0	274.1	199.3
Between 4 % and 5 %	378	338	6.5	5.3	147.2	120.8
Greater than 5 %	1032	939	15.0	13.2	216.3	191.2
Total	3068	3068	$35.3	$31.8	$1282.9	$1282.9

NOTE: If the special assessment is discontinued, then:
1985 Income = $-1.1 billion,
1986 Income = $ 0.0 billion,
1987 Income = $ 2.3 billion.

If the special assessment is continued, then:
1985 Income = $-2.1 billion,
1986 Income = $-1.2 billion,
1987 Income = $ 1.0 billion.

years cannot be determined with any degree of accuracy. It would be safe to assume, however, that asset quality will remain an issue for S&Ls for some time to come. Thus, the results presented in Tables 3 through 6 should be considered an underestimate of the total problems facing the industry.

Projected Impact of Thrift Losses on a Joint Fund

This section estimates the impact of thrift losses on a joint FDIC/FSLIC insurance fund; that is, under various scenarios, what would a joint fund look like three years after a merger? To a certain extent estimations are made difficult because expenditures are often made at the discretion of the insurance agency. This seems particularly to be the case with thrift failures. Previous parts of this paper have noted that generally insolvent S&Ls hold assets of $33.6 billion. In addition, significant credit quality problems likely are present in institutions holding an additional $61.3 billion. It would be unrealistic to assume the FDIC would want to address the problems of all of these institutions immediately, rather they would be handled over time. For the purposes of this section, it is assumed that the FDIC elects to handle twenty percent of the existing S&L problems per year. Problem institutions are defined to include the currently insolvent S&Ls (assets of $33.6 billion), those with significant credit problems ($61.3 billion) and those which are projected to become insolvent in the future. The size of this later category is a function of the level of interest rates assumed and will reflect the insolvency levels listed in Tables 3 through 6.

Two scenarios will be calculated. The optimistic scenario assumes that interest rates remain at current levels and, three years from now, the S&L industry will be somewhere between what is depicted in Tables 4 and 5. The pessimistic scenario assumes rates at 1984 levels, or slightly higher, with the industry looking something like that presented in Tables 3 and 6.

Further assumptions are as follows:

1. The FDIC starts with a fund of $18 billion and the FSLIC with a fund of $4 billion. Over the next three years the FDIC will spend as much as it did in 1984 to handle commercial bank and MSB failures. Thus, revenues to handle S&L problems will consist of interest income and additional premiums from deposit growth. Bank rebates are calculated as if the funds had been kept separate (so that S&L expenses are not taken into account). FSLIC income amounts to premium income of $640 million plus additional premium income on deposit growth. The results of the simulations are listed both with and without the imposition of the special premium of one-eighth of one percent. Interest income from the fund varies depending on the interest rate scenario. For the optimistic scenario, the average return on the fund is assumed to be 11.0 percent in the year following the merger, 10.5 percent during the second year and 10.0 percent during the third year. Under the pessimistic scenario, these respective rates are 11.0, 11.5 and 12.0 percent.

2. Both the S&L and the commercial bank industry grow at roughly ten percent per year.

3. An S&L failure will cost roughly ten percent of assets.

Discontinuation of the Special Assessment

The results of the scenarios assuming a discontinuation of the specified assessment are listed in Table 7. Under the optimistic scenario the number of problem S&L assets handled in each successive year declines. The insurance fund continues to grow but at a rate slower than of the deposit growth of insured institutions. The fund-to-insured-deposits ratio, which begins at 1.01 percent immediately after the merger (it is currently 1.23 percent), drops to 0.92 percent after three years.

With the pessimistic scenario the quantity of problem S&L assets handled increases each successive year. The insurance fund would still grow in an absolute sense and would reach a fund-to-insured-deposits ratio of 0.88 percent after three years. Even through the joint fund's income would be assisted by a higher level of interest income, the size of the fund at the end of year three remains lower than in the optimistic scenario, reflecting a larger number of insolvencies. It is likely that the fund-to-asset ratio would continue to deteriorate for several more years but eventually rebound as the problem S&Ls diminish.

Continuation of the Special Assessment

Continuation of the special assessment would have a significant beneficial impact on a joint fund (Table 8). Under the optimistic scenario the joint fund would grow from $22.0 billion at the beginning to $30.5 billion after three years (a 39 percent increase). This growth rate exceeds deposit growth and will result in a modest increase in the fund-to-total-deposit ratio beginning at year two.

The pessimistic scenario also shows significant fund growth, from $22.0 billion to $29.3 billion (33 percent). This growth is sufficient to keep the fund-to-insured-deposit ratio roughly constant (at 1.00 percent) over the three years of the simulation.

The simulations which assume a continuation of the special assessment do show a significantly healthier fund than would be the case without the assessment. The cost of the increased assessment, however, comes in terms of reduced income to the industry which is reflected in lower capital levels and an increased number of failures. Under the optimistic scenario the FDIC would handle $900 million more in failed S&L assets over a three year period and would be left with $5 billion more in unresolved assets than if the special premium had been discontinued. Under the pessimistic scenario the respective numbers would be $2.3 billion and $9.0 billion.

CONFIDENTIAL

TABLE 7: SIMULATION RESULTS OF THRIFT LOSSES ON A COMBINED FUND, SPECIAL ASSESSMENT DISCONTINUED

Year	Problem S&L Assets Handled ($ Billions)	Cost of S&L Problems ($ Billions)	Insurance Fund ($ Billions)	Total Insured Deposits ($ Billions)	Fund-to-Insured-Deposit Ratio
Optimistic Scenario:					
Start	--	--	$22.0	$2,187	1.01%
1	$19.0	$1.9	23.3	2,416	0.96
2	17.2	1.7	25.0	2,659	0.94
3	16.0	1.6	26.9	2,918	0.92
Pessimistic Scenario:					
Start	--	--	22.0	$2,187	1.01%
1	$19.0	$1.9	23.3	2,416	0.96
2	23.8	2.4	24.5	2,659	0.92
3	27.6	2.8	25.6	2,918	0.88

NOTE: Since only twenty percent of existing S&L insolvencies are handled per year, some of the problem S&L cases will still be unresolved by the end of year three. Under the optimistic scenario the FDIC is left with $73 billion in problem S&L assets yet to handle after year three. This number under the pessimistic scenario is $154 billion.

Page 23

TABLE 8: SIMULATION RESULTS OF THRIFT LOSSES ON A COMBINED FUND, SPECIAL ASSESSMENT CONTINUED

Year	Problem S&L Assets Handled ($ Billions)	Cost of S&L Problems ($ Billions)	Insurance Fund ($ Billions)	Total Insured Deposits ($ Billions)	Fund-to-Insured-Deposit Ratio
Optimistic Scenario:					
Start	--	--	$22.0	$2,187	1.01%
1	$19.0	$1.9	24.3	2,416	1.01
2	17.6	1.8	27.2	2,659	1.02
3	16.5	1.7	30.5	2,918	1.05
Pessimistic Scenario:					
Start	--	--	22.0	$2,187	1.01%
1	$19.0	$1.9	24.3	2,416	1.01
2	24.6	2.5	26.7	2,659	1.00
3	29.1	2.9	29.3	2,918	1.00

NOTE: Since only twenty percent of existing S&L insolvencies are handled per year, some of the problem S&L cases will still be unresolved by the end of year three. Under the optimistic scenario the FDIC is left with $78 billion in problem S&L assets yet to handle after year three. This number under the pessimistic scenario is $163 billion.

Conclusion

The results of these simulations yield several conclusions. First, the future condition of the S&L industry is heavily dependent upon the level of future interest rates. Even rate increases to levels only modestly higher than 1984 levels will cause severe problems for the industry. Second, under relatively favorable conditions (Tables 4 and 5) the number of insolvent institutions increases beyond the year-end 1984 number of 103. This would indicate that the S&L problem will not just "go away" and that temporary solutions that merely mask the problem are not sufficient. If we wait three years the assets held by insolvent S&Ls (excluding those S&Ls listed in Table 2) probably will be in the $30 to $75 billion range assuming interest rates remain at current levels. Disposition of these S&Ls would likely cost between $3.0 and $11.0 billion. This, of course, does not include potential costs associated with the disposal of the better capitalized institutions which have credit problems.

It is also safe to conclude that the potential risk to the FDIC from acquiring the responsibilities of the FSLIC could be staggering. If, over the next 3 years, interest rates average 100 basis points higher than in 1984, the FDIC could be faced with insolvent institutions with assets totaling $165 to $180 billion (Table 6). The potential cost here could be $16.5 to $27 billion. Such large costs would have to be spread over a long period of time. But even then these losses would stunt the growth of the insurance fund over the next 10 to 20 years diminishing our fund-to-insured-deposit ratio and forcing commercial banks to pay for the at least some of the S&L problem.

Page 25

IMPLICATIONS FOR THE DIVISION OF BANK SUPERVISION

Introduction

This section identifies and briefly discusses some of the major operational problems likely to confront the Division of Bank Supervision. This analysis is based on S&L industry financial data gathered from various public sources, and on our overall impression of the FHLBB examiner's ability to support a combined supervisory program.

Admittedly the information is somewhat sketchy. However, the available evidence overwhelmingly supports the conclusion that DBS could not undertake the additional burden of monitoring 3,100 S&Ls without seriously jeopardizing the integrity of our present examination program. Moreover, if the examination burden were assumed by DBS, an extraordinary amount of stress and strain would be placed on a field staff that already is saddled with an unprecedented number of problem and failing banks.

The overall unstable condition of the S&L industry stemming from a severe asset/liability mismatch has been well-publicized. But new evidence is beginning to surface that suggests that the industry's problems are far more serious than originally thought and far more serious than can be determined by reviewing available public information.

Compounding the interest rate risk problem is an emerging asset quality problem. Over the past year several large S&Ls have failed primarily due to asset quality problems. This is a new phenomenon for S&Ls. Undoubtedly the origins of this problem began with the decision by some S&Ls to try to grow out of their interest rate risk problem. Apparently that decision led to the extension of a large volume of high yield, high risk loans which are now beginning to go sour. Although the available information is incomplete, we have identified a number of S&Ls showing signs of rapid growth while another group has high delinquency ratios. Historically, institutions with these characteristics have been found to have major asset quality problems.

The full extent of the asset quality problem cannot be determined without further data. It is unlikely, however, that even the FHLBB is fully aware of the problem because until recently FHLBB examiners did not perform any credit analysis during an onsite examination. Combining this unknown credit risk problem with the well-known interest rate risk problem results in a very bleak picture indeed for the S&L industry.

If the insurance funds were merged, the FDIC would suddenly be responsible for an additional 3,100 institutions with assets totaling roughly $1 trillion supported by net worth of only $34 billion, most of which is intangible. As insurer, the FDIC would insist on the right to examine any S&L at any time. In the past when the FDIC provided insurance to a large group of institutions, it has made a concerted effort to examine them as quickly as possible to determine the potential exposure to the fund. Performing such entry examinations would be even more critical in this situation because of the obvious potential risk to the fund.

There is no doubt that the 3,100 S&Ls would immediately become the FDIC's number one problem and that estimating the true potential exposure to the fund would be our first priority.

Examination Program

The potential impact to the DBS examination program would be, in a word, overwhelming. The problem is compounded because, unlike the Fed or the OCC, the FHLBB examiners generally do not have the experience to perform the type of examination needed to develop a realistic estimate of the credit quality exposure to the insurance fund. This is not to impugn the abilities of the FHLBB; it is merely stating the reality of the situation.

In the past, FHLBB examinations have emphasized proper documentation of mortgages and compliance with laws and regulations. Until recently, most S&Ls invested primarily in single family real estate mortgages. Now they have authority to invest in a much broader range of investments. Many S&Ls have become very aggressive in seeking higher yielding investments particularly in the commercial real estate field. Unfortunately, due to their inexperience in the credit quality area, it has been difficult for Bank Board examiners to properly evaluate credit risk. Although it is likely that training programs are under way to remedy this problem, the result is that prior examination reports are probably of little value to the FDIC in evaluating asset quality risk or in determining a proper CAMEL rating. Thus, even if the assumption is made that the FHLBB will remain the primary regulator for the industry, in reality the burden of examining S&Ls to determine the potential exposure to the fund would likely fall on the FDIC.

Assuming very little help from the FHLBB (over the short run), DBS will have to provide the field staff to perform whatever type of examination is necessary to estimate the extent of credit quality problems. Any such commitment would come at a particularly difficult time for the Division. At the present time DBS barely has enough field examiners to comply with its own examination requirements as outlined in GM 1. Our entire field staff encompasses 1,377 person years. Of that total, 464 person years are used to examine 4- and 5-rated institutions. An additional 490 person years are being used to examine 3-rated institutions. Details to the Liquidation Division require 191 person years but projections call for that number to increase to approximately 290-person years over the course of 1985. This leaves 232 (131 if the higher Liquidation projection is used) person years currently engaged in the examination of 1- and 2-rated institutions, the FDIC/OCC Cooperative Examination Program (large banks), and all other field examination related activities. Even this total is somewhat inflated because it does not account for anticipated sick or annual leave in all categories.

Given all unknowns, it is extremely difficult to project the number of S&Ls that would require examinations merely to estimate the true exposure to the fund. It is likely that the FDIC may find it desirable to look at those S&Ls with capital ratios of less than five percent (some 2,000 institutions). The scope of such an examination program is also difficult to project, but clearly a credit examination would be a minimum requirement for those S&Ls with expanding commercial real estate and commercial loan portfolios. If the information available from the FHLBB is not adequate to accurately project the potential interest rate risk in an S&L, it may be necessary to expand the scope of the examination to gather this information. Furthermore, the recent large losses suffered by many S&Ls as a result of the failure of several Government securities dealers is an indication that the securities portfolio may need to be reviewed closely as well. There also may be other areas that need close scrutiny.

Gathering the necessary field staff to even begin a credit review of 2,000 institutions would require a virtual suspension of many nonmember bank examinations. Obviously, the 232 person years used to examine 1- and 2-rated institutions would be switched to the S&Ls. It may even be possible to shift some or all of the 490 person years currently examining 3-rated institutions to the S&L examination program. But even this total would be small in relation to the examination program. Furthermore, with the suspension of 3-rated examinations, the FDIC would arguably be eliminating the most important examination in terms of attempting to prevent banks with relatively small problems from becoming banks with very serious problems.

Liquidation Details

As previously mentioned, DBS is currently supporting the Liquidation Division with 191 person years. That number is expected to increase in 1985 even though Liquidation has been hiring a growing number of permanent and temporary staff. If the funds are merged, demands on the Liquidation Division will undoubtedly increase as S&Ls continue to fail. While we cannot accurately predict the number that will fail, it is safe to say that the number will be significant. This would, of course, mean that DBS would be asked to provide even more support to the Liquidation Division.

Offsite Monitoring System

Merging the funds and the subsequent disruption of the examination program would place a burden on the FDIC's offsite monitoring system. That system has been extensively redesigned over the past year and the changes are still not fully implemented. At least one to two years of operation would be required to test the overall effectiveness of the system. However, if DBS is thrust into the situation where it must divert resources to the S&L industry, virtually all responsibility for detecting emerging problems in the banking industry would be placed on an untested monitoring system.

In the longer term the implications are also significant. Even if the FHLBB retains primary regulatory responsibility for the S&L industry, the FDIC, as insurer, would have to develop on offsite monitoring system for S&Ls. Informal discussions with FHLBB staff indicate that the Bank Board does not have a sophisticated system other than a simple model designed to take into account interest rate risk which projects when an

Page 28

S&L will have zero net worth. Thus, the FDIC would have to help design a system and collect the necessary data for an effective monitoring system.

Problem and Failing Bank Sections

While we do not presently have accurate estimates on the number of problem S&Ls, it is safe to say that by FDIC standards the total could easily reach 2,000. Here again, even with the FHLBB as the primary regulator, the FDIC would be required to maintain a group of review examiners to monitor the condition of these institutions. This would require a fairly large increase in staff at both the Regional and Washington Office level.

Training

There can be no question that an effective training program will be necessary to train examiners from both agencies concerning the activities of the S&L industry. Most FDIC examiners are not experienced at thrift examinations (though many are, due to our supervision of the savings bank industry), and it is felt that FHLBB examiners need more experience in the credit quality area. A major resource commitment will be necessary, but it is unclear when the bulk of the training could take place. In the short run examiners may not be available to act as instructors and we may not have the time to conduct extensive training programs for our examiners. Therefore, it is likely that most organized training will take place over the long term after the initial series of S&L examinations are completed.

Administrative and Policy Issues

The above discussion has concentrated primarily on the short-term immediate problems facing DBS if the funds were merged. There are, of course, numerous other longer term administrative and policy concerns that would have to be worked out. We have touched on some longer term issues (i.e., offsite monitoring and training) but there are a few others that deserve mentioning.

o Expanded information systems will have to be developed to collect more detailed structural information and S&L company information for analysis purposes.

o Procedures for coordinating regulatory and supervisory action between FDIC and FHLBB Washington and Regional Offices will be necessary.

o Standardized regulatory and supervisory policies will have to be developed and implemented over a phase-in-period.

o Specialty examination programs will have to be developed in areas like EDP where FHLBB examiners have limited experience.

o The FDIC will have to deal with a potentially serious morale problem as examiners will be faced with constant high pressure situations and extended travel assignments.

The Economy

Finally, outside forces must be taken into consideration. We have not mentioned the potential impact of an unfavorable economy or a new international crisis would have on the banking system and the FDIC. It is safe to say that if such an event took place at a time when the FDIC is struggling to evaluate risk in the S&L industry the result could be devastating. While most economists are projecting a relatively stable economy over the next several years, there are several potential serious problems looming in the horizon. Any one of those problems (e.g., rapid fall in the value of the dollar, continued high Federal deficits, continuing farm industry problems) could suddenly become much worse.

In the final analysis, it appears that DBS would need a minimum of three years to prepare adequately for the increased workload. There is no question that a large number of field examiners would have to be hired and trained. New DBS information systems would have to be developed while existing systems would need to be expanded. Unfortunately, if most analysts are correct, the FSLIC may not be able to survive long enough, without some form of Government assistance, for DBS to make these preparations.

IMPLICATIONS FOR THE DIVISION OF LIQUIDATION

Introduction

The Division of Liquidation (DOL) is presently managing $10.3 billion (book value) of assets in liquidation, and DOL's staff exceeds 2,500, with employee staffing projections estimated to be in the 3,000 to 4,000 range by year-end 1985. The Division has handled 33 bank failures through May 10, 1985, and we are running about 11 bank failures ahead of the pace experienced at this time last year. DOL is preparing for as many as 70 more failures for the remainder of 1985, and prognostications are that there will not be a significant decline in the number of bank failures during 1986.

The FDIC was not prepared, in terms of staffing, for the prolonged increase in bank closing activity which has been experienced since 1981. As a result DOL has been playing "catch-up" for the last three years in terms of staffing field liquidation positions. Inadequate staffing has resulted in an extremely overworked and inexperienced force of field Bank Liquidation Specialists (BLS) which has caused employee frustration resulting in heavy attrition which has further exacerbated staffing problems. DOL is in the process of filling 355 vacant positions (80 positions from the old staffing table and 275 new BLS positions).

Since the Division is only able to assimilate 50 new employees per month, it is not expected that the staffing process will be completed until January 1986. While staffing will be concluded in early 1986, the training of these employees will take well into 1987 until we have a cadre of reasonably experienced and trained field BLSs.

The merger of FSLIC, coming on the heels of the aforementioned unanticipated bank closing activity, will compound DOL's staffing shortages. The FSLIC has reportedly increased its staffing levels over the last year, but it has only 160 employees. The FSLIC's major receivership activity is handled by outside consultants under the oversight of FSLIC employees.

Merger Impact

In order to determine the impact of the FSLIC merger proposal with any reasonable accuracy the following issues must be resolved:

1. The magnitude and timing of anticipated S&L failures;
2. The amount of assets retained by the FDIC;
3. The depth and level of expertise of FSLIC employees;
4. The direction the FDIC proposes in handling both bank and thrift failures; and
5. The availability of outside liquidation consultants.

Page 31

A previous section of this paper indicates that there are approximately 155 S&Ls with $94.9 billion in assets that would be categorized as serious problem institutions with a likely probability of failure. In view of DOL's problems in digesting its burgeoning workload, there is no way DOL can realistically assume the management of an increase in workload of the magnitude anticipated from the FSLIC merger in the near term without substantial assistance from FSLIC employees and/or outside consultants.

The FSLIC's nationwide staff consists of 160 employees, and the majority of these individuals have reportedly been hired during the past eighteen months. In a recent meeting with [redacted] (b)(6), Director of Operations and Marketing for FSLIC, he remarked that his employees needed training, particularly in the area of assessing the quality of real estate loans and in closing procedures. Given the brief tenure of most FSLIC employees and the necessity for training in the critical job elements of loan analysis and closing procedures, it is unlikely that these employees will be able to provide much support to the FDIC in the event of a merger with FSLIC. (b)(6) [redacted] also noted in this meeting that the number of qualified outside liquidation consultants was modest, numbering in his opinion only five to six firms, negating any substantial support for FDIC liquidation activities from the private sector.

DOL's present growing workload, coupled with only minimal support anticipated from the FSLIC staff and outside consultants, dictates that the only viable alternative for the FDIC to follow, if a merger of the FSLIC and FDIC is to be pursued, would be to alter or modify significantly the FDIC's philosophy on insolvency and the prompt closing of an institution when insolvency is ascertained. This can be accomplished through any or all of the following:

1. Expansion of the net worth certificate program;

2. Pursuit of a "phoenix" approach to handling failing institutions;

3. Relaxation of the FDIC's capital assistance standards; and/or

4. Using outside consultants more frequently to assist the FDIC in liquidation activities. (This alternative assumes that the private sector will respond to the new demand for this service and spawn a host of new consulting firms specializing in liquidations.)

Summary and Conclusion

The FDIC's DOL is not in the position at this juncture to assume the additional responsibilities for managing the liquidations of an anticipated large volume of closed S&L associations. Very little near term assistance can be anticipated from either FSLIC of the private sector to help the FDIC cope with the volume of liquidations activities. It will be at least two years before a reasonable level of comfort can be provided to the FDIC's Board of Directors that any additional workload of the level proposed through the FDIC-FSLIC merger can be attempted by DOL's staff.

The conclusion is that the FDIC might be able to handle the added workload if: 1) Bank closing activity peaks and declines within the next year to eighteen months; 2) DOL is allowed time to properly train its growing staff; 3) The private sector responds to the demand for new liquidation consulting firms; and 4) The FDIC relaxes its standards on institution insolvency and providing assistance to failing institutions.

ACCOUNTING AND ASSESSMENT IMPLICATIONS

Accounting and Portfolio Management

It is assumed that, although the two insurance funds would be merged for the purpose of external reporting purposes, income and expenses arising from commercial banks and MSB operations will be calculated separately for some interim period (five to seven years). Thus, for a time, assessment credits would remain unchanged, a necessary gesture to lessen bank opposition.

As pointed out in previous sections, however, losses in the S&L industry are probably so large that banks will end up footing at least part of the S&L bill even if the phase-in period were extended far beyond the five-to-seven year period which has been suggested. On the one hand, the FDIC would likely be forced into the position of deferring S&L losses as far into the future as possible. To the extent the FDIC will be successful at this, banks will pick up part of the tab when S&L expenses are included in the assessment credit calculations. On the other hand, the FDIC is currently required to change the assessment credit from sixty percent of net assessment income to fifty percent in the event the FDIC's fund-to-insured-deposits ratio falls below 1.10 percent (12 U.S.C. Section 1817(d)). Even under an optimistic scenario, it is possible that this ratio will be below the 1.10 percent level five to seven years from now.

There appears to be a fundamental difference in accounting treatment between the FDIC and FSLIC in the handling of closed-institution transactions. Due to the lack of records available from the FSLIC, this difference cannot be ascertained completely; however, it is generally believed that liabilities to the FSLIC fund are not being accurately reported, particularly with respect to ongoing thrift assistance and maintenance agreements. This makes it impossible to determine the FSLIC's true liabilities and, hence, the total amount of unencumbered resources available to them or to us in the event of a merger.

Assessments

A number of issues arise with respect to the differing assessment systems of the two agencies.

First, S&Ls and banks are assessed at different rates. Banks currently pay one-twelfth of one percent of deposits with a rebate of sixty percent of the FDIC's net assessment income. S&Ls are currently paying a rate of one-twelfth plus one-eighth of one percent with no rebate. Under a merged insurance fund we will need a plan for assessing all institutions equally. This may involve the imposition of standards (capital adequacy, disclosure, etc) which, if met, the S&L would become eligible for the lower bank rate. There is also the question of whether the FSLIC's special assessment should be continued and, if so for how long? Continuing this assessment would increase the insolvency numbers presented in Tables 3 through 6 by roughly ten to fifteen percent but would increase premium income by about $3.5 billion over a three year period. Clearly the benefits of the special assessment (in terms of extra premium income) outweigh the costs of additional insolvencies; however, maintaining such a high premium level may not be politically expedient.

Differing assessment procedures must also be considered. Currently premiums are paid by S&Ls on their anniversary dates rather than on a semiannual basis. The FSLIC also assesses S&Ls on a slightly different base than does the FDIC.

A major portion of the FDIC assessment base is field audited retroactively for its integrity on a three to five year basis. A similar system or procedures would have to be devised for determining the integrity of the S&L assessment base. In addition, the FDIC office assessment system is linked to a data base supplied by information on Reports of Condition filed by member institutions. The reporting requirements of S&L would need to be adjusted to conform to this system and a means of maintaining an accurate and current record of the S&Ls in existence would have to be implemented to ensure the correct assessment of all member institutions.

DIFFERENCES IN FDIC AND FSLIC INSURANCE COVERAGE

A pragmatic problem of some magnitude arises from the fact that, despite substantial similarities in statutory authority and professed "competitive equality" in insurance coverage, the coverage provided in practice by the FSLIC is significantly more generous than that provided by the FDIC. This expansive coverage has evolved principally, but not exclusively, through staff interpretations.

For example, the insurance regulation administered by the FSLIC states (12 C.F.R. Section 564.3(b)(2)) that, "A loan servicer who receives loan payments and places or maintains such payments in an insured institution prior to remittance to the lender or other parties entitled to the funds shall, for insurance-of-accounts purposes, be considered an agent of each borrower." The result is that mortgage payments of principal and interest which are deposited by a mortgage servicer in an FSLIC-insured institution are, for all practical purposes, fully insured because such payments seldom exceed $100,000 per borrower per month. This result is reached despite the fact that the borrowers have no ownership interest in such deposits, but are discharged from their obligation for the payment of principal or interest represented by their mortgage payments. The amount so insured by the FSLIC at any given time is probably several billion dollars. The FDIC looks to the ownership of deposits and would recognize either the secondary purchaser of a mortgage, or subsequent investors in pass-through securities, depending on ownership as evidenced by the agreements among the parties. Where a secondary purchaser is found to be the owner of the deposit (as was determined in a lawsuit involving FHLMC) the insurance would be limited to $100,000. Where investors in pass-through securities are determined to be beneficial owners of a deposit, each investor's interest in the account would be insured to the maximum of $100,000. Because the interest of some large, institutional investors could reasonably exceed $100,000, deposits of principal and interest payments by a mortgage servicer would be insured in an amount in excess of $100,000, but for less than the full amount. If the insurance funds are merged, it is obviously likely that the FHLMC, the FHLBB and the S&L industry will lobby for a change in the FDI Act requiring the FDIC to provide at the outset this and other expansive insurance coverage now provided by the FSLIC.

Another similar example of expansive insurance coverage by FSLIC is the virtual full coverage of certain "deferred compensation plans" (which are treated as trusts (see 12 C.F.R. Section 561.4)). This is done although the funds in such plans are owned by the respective employers, and not the employees. In addition, the FSLIC (unlike the FDIC) has not yet renounced the use of sham "custodians" by public units, which allows state and local governmental units <u>de facto</u> 100 percent deposit insurance, potentially.

In short, merging the FDIC insurance fund into the FDIC fund raises an equity issue because of the relatively more generous coverage provided by the FSLIC, which expanded coverage has been provided both by regulation and staff interpretations. It is possible that special interest groups would lobby Congress for legislation requiring expanded coverage thereby increasing the FDIC's exposure. The best result that the FDIC could expect, following a merger, is that the FDIC would be permitted to phase-out the more generous FSLIC rules over some period of time.

CONFIDENTIAL

DATA PROCESSING IMPLICATIONS

The FDIC data base currently contains quarterly Call Report information for all FSLIC-insured institutions only for the year of 1984. In the event of a merger of the insurance funds the FDIC likely would want to expand the S&L data base to that comparable to our current commercial bank files. This would involve the acquisition and storage of five years of Call Report data and the five most recent examination reports for each S&L. The Bank Board also collects a monthly report from each S&L (containing a limited amount of Call data). It is not clear, however, whether we would need this on our system.

The storage of this data would require the purchase of additional disk storage capacity. In addition, the processing of this new information may require an extra computer. Discussions with [redacted] (b)(6) indicates that an expansion in our capacity would not be that difficult. Plans to purchase a new computer are apparently already being discussed and the acquisition of new disk storage should not be a problem.

DISPOSITION OF TROUBLED INSTITUTIONS

In inheriting the responsibilities of the FSLIC, the FDIC will be faced with a new and sizeable set of problem institutions. In the event of failure, it is likely that the bulk of these institutions will be handled through some type of assisted merger or through a stand-alone assistance agreement rather than by a traditional P&A or payout. Generally the construction of these agreements in the case of mutual savings banks has taken a considerable amount of resources both from the standpoint of making the "deals" and drawing up the legal documents. The Bowery Savings Bank (New York City) agreement is a good example.

The responsibility of S&L failures will have important implications for the FDIC in the sense that we will have less time to ponder assistance agreements but we will also need to devote considerable resources to these deals. It is not clear to what extent we will inherit FSLIC personnel with enough experience in this area and the number of FDIC people with this type of experience is limited. This seems to be an area worthy of further consideration.

CONCLUSION

It is clear that a merger between the FSLIC and the FDIC would put a significant drain on corporate resources at a time when the FDIC can least afford it. During the past several years FDIC expenses have been at historically high levels, and adding the entire thrift problem to our burden would be substantial. Although it is likely that a joint fund would survive financially, the strength of the fund would be damaged and the transmission of some costs to the commercial banking industry seems unavoidable.

The resources of the Division of Bank Supervision and the Liquidation Division are already severely strained. An additional drain on their resources at this time would impose a direct cost to the FDIC. A reduced examination effort would result in fewer bank problems detected and resolved. Giving Liquidation more business would mean a slower collection rate, at least over the short run.

As promised in the Introduction, this paper dwells primarily on the negative aspects of an FDIC-FSLIC merger and, to a certain extent, the reader may be left with an overly pessimistic impression of the consequences for the FDIC.

It can be argued that in examining a merger, we must consider a greater public interest. Merging the insurance agencies may be the only viable solution to the S&L problem. The Treasury could infuse cash into the FSLIC. This alternative, however, would be detrimental to the banking system in that it would contribute to the impression that banking is a public utility and it would not solve one of the major problems of the industry: regulatory standards that are driven more by the necessity of preserving what probably is an inadequate fund, rather than by a direct attempt to solve the underlying problems of the industry. This may be solved only by the intervention of a third-party regulator.

Since the cost to the FDIC of a merger could be high, we would have to demand authority to regulate and supervise the S&L industry. The FDIC must insist that comparable regulatory standards apply to thrifts and that some foolproof mechanism to enforce these standards be put in place. This would be a necessity from the standpoint of both the survival of the FDIC and the security of the financial system.

At any rate, should a merger be considered a likely outcome, the implications for the FDIC are too serious not to begin contingency planning immediately. We may want to expand the size of DBS and accelerate the hiring of Liquidation personnel. We should also think about a stand-by arrangement to borrow examination resources from both the OCC and the Federal Reserve. It may also be desirable to begin or accelerate training programs particularly in the area of real estate and holding company affiliates.