ADMINISTRATION HISTORY APPENDIX
CHAPTER THREE: IMPROVING FINANCIAL SERVICES, AND MARKETS AND THE FEDERAL GOVERNMENT'S FINANCIAL MANAGEMENT

CREDIT UNIONS

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

November 21, 1997

To: Rich Carnell

MEMORANDUM FOR SECRETARY RUBIN

THROUGH: John D. Hawke, Jr.
Under Secretary for Domestic Finance

FROM: Richard S. Carnell RSC
Assistant Secretary for Financial Institutions

SUBJECT: Credit Union Study

ACTION REQUESTED:

That you sign the attached draft transmittal letters (Tab A) and authorize us to begin the process of printing our study of credit unions.

The executive summary of the report appears as Tab B and the table of contents as Tab C. Please let us know whether you would like to see the body of the report (some 110 pages).

Agree ✓ Disagree ______ Let's Discuss ______

ACTION-FORCING EVENT:

In order to have our report printed and ready for a well-planned release during the week of December 8, we need to send it to the printer shortly after November 24.

DISCUSSION:

Rationale for Releasing Report During Week of December 8

The report was due on September 30. We have been in regular contact with those expressing an interest in the report -- including Senator Bennett, Representative LaFalce, and the credit union trade associations -- explaining the progress made and our plans to publish the report in November or December of this year. These contacts have helped avoid a Congressional or other clamor to release the report. But we may well face such a clamor if we do not release the report in December. Delay would increase credit unions' anxiety about the report and encourage the perception that we are withholding it in order to gain some tactical advantage over them.

Moreover, with each passing week, we face a somewhat increased risk of the Supreme Court announcing its decision in the credit union common bond case heard on October 6 -- meaning that we would have to release the report in a much more highly charged and difficult environment.

We have been developing a specific roll-out approach with the Office of Congressional Affairs and the Office of Public Affairs. A key element of such an approach involves providing a confidential briefing to the heads of the Credit Union National Association (CUNA) and the National Association of Federal Credit Unions (NAFCU) a day or so before release of the report. Such a briefing would better enable those officials to reassure their members and facilitate a constructive response to the report. We would also include in the briefing a leader of the California Credit Union League who has expressed particular interest in helping facilitate a thoughtful and constructive response from credit unions.

Will it get constructive response

As part of such an approach, we see advantages to releasing the report on a Tuesday or Wednesday, so that we could give the confidential briefing the day before release (to reduce the risk of leaks), and so that immediately after release we could do follow-up briefings for Congressional staff and for any interested Members of Congress who are in town or available by telephone.

Credit Unions' Likely Response

Credit unions' fundamental reaction is likely to be one of guarded relief. As we have previously noted, credit unions' greatest fears have been that we would (1) oppose them on the common-bond issue; (2) recommend ending their exemption from federal income taxation; (3) recommend requiring them to expense their 1 percent deposit in the National Credit Union Share Insurance Fund; (4) recommend transferring the regulatory responsibilities of the National Credit Union Administration (NCUA) to another agency, such as a newly created credit union bureau of the Treasury[1]; (5) recommend separating the Share Insurance Fund from the NCUA; or (6) recommend eliminating corporate credit unions or drastically revamping their structure.

Our report does *not* go against credit unions ~~on any of these issues~~. We remain neutral on the common ~~bond and federal~~ income taxation. We recommend against requiring credit unions to expense the 1 percent deposit. We support having the NCUA continue to administer the Share Insurance Fund. We do not recommend transferring the NCUA's regulatory

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[1] *C.U.R.S.E. of the Bankers*, an award-winning 1990 propaganda film produced by CUNA, is premised on an alleged nightmare scenario involving regulation of credit unions by the Treasury's Bureau of Credit Union Regulation, Supervision, and Examination (CURSE) and deposit insurance by the Credit Union Reorganized Share Ensuring Service (CURSES).

responsibilities to another agency, eliminating corporate credit unions, or drastically revamping corporate credit unions' structure.

The NCUA has reviewed the entire report and commented favorably on it. The NCUA's Chairman has orally called it balanced, well-reasoned, and constructive, and stated ~~that implementing its recommendations would be good for credit unions.~~ The NCUA's general counsel has declared in writing that the report is "both a very professional product and fair to the NCUA and credit unions."

Credit union trade associations, like other trade associations, often gripe and quibble -- particularly if they think that doing so will improve their bargaining position or demonstrate their vigilance. The following four recommendations in the report may well elicit some controversy:

First, *requiring credit unions with less than 7 percent net worth to retain as net worth 5 percent of annual gross revenues*. This does represent an increase over the current net worth target of 6 percent of "risk assets" (which on average corresponds to about 4 percent of total assets). We believe that the 7 percent net worth target is appropriate in view of (1) the difficulty that credit unions have, as cooperative institutions without capital stock, in raising capital if they get into financial difficulty; (2) the double-counting of credit unions' 1 percent deposit in the Share Insurance Fund both as reserves of the fund as net worth of insured credit unions; and (3) the arbitrariness of the definition of risk assets. Note, moreover, that the only consequence of failing to have 7 percent net worth would be that credit unions (which pay no corporate income taxes) would have to set aside as retained earnings 5 percent of the current year's gross revenue. Credit unions' balance sheets indicate that credit unions themselves recognize the wisdom of maintaining a net worth exceeding 7 percent. Of the 11,392 credit unions operating at the end of 1996, 10,591 (93 percent) had more than 7 percent net worth, and those institutions held 93 percent of total credit union assets. Of the 800 credit unions that did not have at least 7 percent net worth, 400 (with 5 percent of total credit union assets) had at least 6 percent.

Second, *applying prompt corrective action rules to credit unions*. Such rules, which seek to resolve net worth deficiencies before they grow into large problems, have applied to all FDIC-insured depository institutions since 1992. We recommend applying to credit unions a streamlined version of prompt corrective action, specifically tailored to credit unions as not-for-profit, member-owned cooperatives. Some credit unions may fear that prompt corrective action would be harsh and mechanistic; many bankers had similar concerns before the system took effect for banks in 1992. But experience over the past five years suggests that the system reduces deposit insurance losses, strengthens incentives to keep institutions safe and sound, and still accords regulators reasonable flexibility. Our streamlined proposal for credit unions would be less stringent than the rules already applicable to banks and thrifts. Likewise, although some credit unions may be concerned about whether prompt corrective action is

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consistent with the spirit of "mutual aid" among credit unions, the system would not in fact limit the ways in which credit unions could voluntarily help each other.

Third, *recommending that the NCUA codify its most important safety and soundness rules in regulations.* Credit unions may fear that this could lead to more bureaucratized supervision. But the current system goes too far toward informality by codifying key safety and soundness policies in such remote places as model by-laws, examiner guidelines, and the like. In this respect, it is noteworthy that the National Federation of Community Development Credit Unions emphasized to us its desire for the NCUA to have clearer, more transparent standards and to apply such standards more consistently -- so that its members were less exposed to arbitrary regulatory action.

Fourth, *making two exceptions to the current rule that the NCUA rebate to credit unions every dollar by which the Share Insurance Fund's ratio of reserves to insured deposits (reserve ratio) exceeds 1.3 percent. Specifically, we recommend (1) giving the NCUA discretion to let interest earned on the fund's reserves increase the reserve ratio to 1.5 percent; and (2) not paying rebates if the fund's* liquid *assets were less than 1.0 percent of insured deposits.* Credit unions may fear that the NCUA would needlessly increase the Share Insurance Fund's reserves. But any increase in reserves under this recommendation would be modest, and would come only from interest on reserves (and thus involve no premium charges). Moreover, any such reserves, and any interest earned on them, would ultimately be distributed to insured credit unions.

Even if credit unions have misgivings about our report, they should have some significant incentives to work with us -- rather than launch a large negative campaign. We have worked hard to be good listeners throughout the process. We are emphasizing, and will continue to emphasize, to credit unions (as well as to the NCUA and others) that we see the report as another stage in a continuing dialogue. And, perhaps most importantly, we have reserved judgment on the common-bond controversy.

This past Monday, I discussed our current thinking about corporate credit unions before the Association of Corporate Credit Unions. The audience interrupted several times with applause. The head of the largest regional corporate credit union, although not personally concurring in our belief that corporate credit unions should continue to build net worth, noted that his institution "would have been surprised if you didn't want us to increase our capital." The NCUA stated: "We understand Mr. Carnell had some constructive recommendations, and we look forward to examining those in more detail when the Treasury report is made public."

Likely Response of Banks, Thrifts, and Others

Bank and thrift trade associations complain that credit unions, with their tax exemption and (until recent court decisons) liberalized common-bond rules, have been unfairly eroding other depository institutions' customer base.

In reviewing our report, banks and thrifts will probably like much of what they see. They will be pleased to see that we recommend applying net worth requirements and prompt corrective to credit unions; applying a form of prompt corrective action to credit unions, and also codifying fundamental safety and soundness standards like limits on loans to one borrower.

Banks may well, however, express disappointment that we recommend continuing the 1 percent deposit system and maintaining the NCUA's role as regulator and deposit insurer. Likewise, although Congress never directed us to opine on the common-bond controversy or on credit unions' exemption from federal taxation, some banks and thrifts may criticize us for not having done so anyway.

Note that most of the major bank and thrift trade associations are working with us on a range of issues, notably including financial modernization, which may reinforce their incentives to make their comments generally constructive.

Consumer groups, such as the Consumer Federation of America and the U.S. Public Interest Research Group, are likely to be satisfied with the report.

Likely Journalistic Focus

We would anticipate that press coverage of the report is likely to focus on three topics. First, whether the report would have practical implications for consumers. In fact, it would not -- other than by deflating some overblown bank criticisms of the credit union system's safety and soundness. In a big-picture sense, we largely accept the current system. Our recommendations would make that system safer and stronger, but not in ways that consumers would be likely to notice. Second, journalists will tend to look for the report's implications for the common bond controversy. Again, we remain scrupulously neutral on that controversy, and one could at most draw some remote extrapolations and inferences from the report. And third, some financial journalists may wish to highlight the extent to which the report involves wins and losses for credit unions, on the one hand, and banks and thrifts on the other. We believe that the report is carefully balanced and represents a mixed bag for both sides.

Attachments

cc: Deputy Secretary Summers

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 1, 1997

The Honorable Alfonse M. D'Amato
Chairman
Committee on Banking, Housing,
and Urban Affairs
U.S. Senate
Washington, D.C. 20510-6075

Dear Mr. Chairman:

I am pleased to transmit the Department of the Treasury's report on credit unions.

As required by section 2606 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996, this report evaluates (1) the potential for, and the potential effects of, having some entity other than the National Credit Union Administration (NCUA) administer the National Credit Union Share Insurance Fund; (2) whether the 1 percent deposit that federally insured credit unions have made into the Share Insurance Fund should continue to be treated as an asset on credit unions' books or whether credit unions should, instead, expense that deposit; (3) the 10 largest corporate credit unions, including their investment practices and their financial stability, financial operations, and financial controls; (4) the NCUA's regulations; and (5) the NCUA's supervision of corporate credit unions.

In preparing this report, we consulted with the NCUA and its Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Federal Reserve Board. We also met with all the major credit union, bank, and thrift trade associations, and with numerous credit union representatives. We published a request for comments in the *Federal Register* and received 181 responses. We visited eight credit unions and two corporate credit unions. In evaluating the 10 largest corporate credit unions, we assembled an interagency team of federal banking examiners to assist us, as required by the mandate.

Credit unions intermediate only a small portion of the savings and credit in our financial system, but they serve some 70 million Americans. As a group, they appear to be in strong financial condition. Similarly, the Share Insurance Fund, which insures deposits at credit unions, is at its statutory maximum reserve level and has had few losses in recent years. Although we found credit unions and the Share Insurance Fund in good condition, we also identified several important aspects of the NCUA's safety and soundness regulations, the NCUA's administration of the Share Insurance Fund, and the statutes under which the NCUA operates that need strengthening.

In 1994, several corporate credit unions with investment portfolios heavily concentrated in collateralized mortgage obligations experienced financial difficulties. The NCUA closed one corporate credit union (Capital Corporate) and its member credit unions recorded $60 million in aggregate losses. These developments, coupled with a $225 million investment by U.S. Central Corporate Credit Union in a Spanish bank that failed in 1993, raised questions about the financial strength of the corporate system and the NCUA's oversight of that system. We found that both corporate credit unions and the NCUA have made significant improvements since 1994. However, we also found a need for further strengthening of the corporate credit union system and the NCUA's oversight of it.

An emerging trend among credit unions involves the consolidation of credit unions into fewer but larger institutions, some of which have become quite complex. Our report describes some of the safety and soundness issues raised by this trend. However, the current dispute regarding credit unions' fields of membership is beyond the scope of our report. We continue to monitor the issues involved and await a ruling by the Supreme Court.

If you would like to discuss the findings and recommendations in this report, please contact Assistant Secretary Richard Carnell.

Sincerely,

Robert E. Rubin

Robert E. Rubin

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 1, 1997

The Honorable James A. Leach
Chairman
Committee on Banking and Financial Services
U.S. House of Representatives
Washington, D.C. 20515-6050

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Enclosure

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SUMMARY

Credit unions are depository institutions. Like banks and thrift institutions, they accept deposits and make loans. At this basic financial level, credit unions resemble banks and thrifts: by intermediating funds from savers to borrowers, credit unions take on credit risk (the risk that borrowers will not repay loans) and interest rate risk (the risk that changes in interest rates will alter the value of assets relative to liabilities). Managing these risks represents a key aspect of credit unions' financial operations.

The National Credit Union Administration (NCUA) -- credit unions' federal safety and soundness regulator -- supervises such risk-taking much like the federal banking agencies supervise the safety and soundness of banks and thrifts. The NCUA administers a deposit insurance fund -- the National Credit Union Share Insurance Fund -- that insures deposits at credit unions, just as the Federal Deposit Insurance Corporation insures deposits at banks and thrifts.

However, credit unions have several characteristics that, taken together, distinguish them from banks and thrifts. First, credit unions are member-owned, member-directed depository institutions. Credit unions do not issue capital stock. Instead, they derive their net worth from their accumulated retained earnings.

Second, credit unions rely on unpaid, volunteer board of directors elected by, and drawn from, each credit union's membership.

Third, credit unions do not operate for profit.

Fourth, credit unions have a public purpose. Congress intended credit unions "to make more available to people of small means credit for provident purposes." Of course, other depository institutions also operate under statutes that delineate public purposes, so any distinction here is one of degree.

Fifth, credit unions have certain limitations on their membership, limitations generally based on some affinity among members. The Federal Credit Union Act limits federal credit union membership to "groups having a common bond of occupation or association, or to groups within a well-defined neighborhood, community, or rural district." Most state credit union statutes also impose some sort of common bond requirement. Thus, unlike other depository institutions, a federal credit union cannot serve just anyone from the general public. Current disputes about the terms of the federal common bond requirement are beyond the scope of this study.

At the end of 1996, 11,392 federally insured credit unions provided depository services to some 70 million Americans. Collectively, credit unions' $327 billion in assets pale compared to commercial banks' $4.6 trillion in assets.

Of the 11,392 credit unions, over 7,000 have less than $10 million in assets. These small credit unions offer a simple array of deposit accounts and a limited set of loan products such as

automobile loans and unsecured personal loans. At the same time, a small, but growing number of credit unions are large, complex financial institutions. They offer wide arrays of deposit and loan products generally comparable to the consumer product offerings of mid-size and large commercial banks.

Moreover, all credit unions, large and small, operate in an ever more complex financial system. The NCUA can and should continue modernizing and improving its safety and soundness oversight of, and standards for, all credit unions.

The National Credit Union Share Insurance Fund

We examined the NCUA's oversight of the National Credit Union Share Insurance Fund, the advantages and disadvantages of having some entity other than the NCUA administer the Share Insurance Fund, and the strengths and weaknesses of the Fund's financial structure.

Condition of the Share Insurance Fund

The Share Insurance Fund is well capitalized, has had few losses in recent years, and appears capable of handling various types of stress. We found that the NCUA generally seeks to assist troubled credit unions, for example, by providing such credit unions with cash or noncash assistance through the Share Insurance Fund. We found no particular problems in how the NCUA administers the Share Insurance Fund, although we concluded that the broad discretion available to the NCUA should be channeled to ensure timely and consistent treatment of troubled credit unions.

The Share Insurance Fund's reserve ratio -- its ratio of total reserves-to-total insured deposits -- is the standard measure of the Fund's health. The reserve ratio has been at or near its statutory ceiling of 1.3 percent every year since 1984. We do, however, have two concerns about the reserve ratio.

The reserve ratio does not reflect the actual composition of the Share Insurance Fund's assets. When credit unions come under stress (e.g., during an economic recession), illiquid assets acquired from failed or troubled credit unions will tend to increase at the expense of liquid assets -- leaving the Share Insurance Fund less able to provide cash assistance to other ailing credit unions. We recommend that the Share Insurance Fund maintain an available assets ratio of 1.0 percent of insured deposits. Should the available assets ratio fall below this level, the Fund would not be permitted to pay dividends even if the reserve ratio were to exceed 1.3 percent.

We are also concerned that the NCUA's method of measuring the Share Insurance Fund's reserve ratio generally overstates the reserves actually available. The NCUA calculates the reserve ratio each month by dividing the Fund's reserve balance for that month by the previous year-end total of insured deposits. Thus, each year-end reserve ratio is calculated using a denominator that may be up to 12 months old, which tends to inflate the ratio. For example, at year-end 1996 the Share Insurance Fund had $3.4 billion in reserves and insured $275.5 billion in deposits, which implied a reserve ratio of 1.24 percent. However, the NCUA calculated the Fund's year-end 1996 reserve ratio as 1.3 percent by dividing the year-end 1996 total Fund reserves by the year-end 1995 total insured deposits.

Because the NCUA must, by law, distribute dividends to member credit unions whenever the Share Insurance Fund's reserve ratio exceeds 1.3 percent, the NCUA's procedure has led it to pay dividends when the Fund's reserve ratio, measured contemporaneously, was actually less than 1.3 percent. Paying dividends under such circumstances dissipates the Fund's reserves without good reason. We accordingly recommend that the NCUA correct this non-contemporaneous measurement of the reserve ratio.

The NCUA's Administration of the Share Insurance Fund

Congress directed us to evaluate the potential costs and benefits of having some entity other than the NCUA administer the Share Insurance Fund. Neither the statutory language requiring this study nor its legislative history indicates what entity or entities Congress had in mind as possible candidates to administer the Fund. Nor do they indicate the policy objective of such a change. We identified two possible conflicts of mission in having the NCUA operate the Share Insurance Fund. The first involves the NCUA's role in chartering federal credit unions and in administering the Fund. The second involves the NCUA's role in supervising credit unions and administering the Fund. These two possible conflicts, although distinguishable, significantly overlap (e.g., a chartering entity also supervises the institutions it charters). They raise many of the same issues and invite many of the same arguments.

Based on our review, we found no compelling case for moving the Share Insurance Fund out of the NCUA. In our view, any potential for conflicts of mission is best handled by applying a system of prompt corrective action to credit unions. The tension between the incentives of the charterer and the goals of the regulator may be balanced by prompt corrective action rules that require the regulator to take certain corrective actions when a depository institution's condition deteriorates. For credit unions, charterer, examiner, and insurer are the same entity and, in a sense, make the decision together. The NCUA, with no statutory prompt corrective action requirements like those for the Federal Deposit Insurance Corporation, has broad discretion about whether, when, and how to take corrective action. We believe that prompt corrective action rules for credit unions would impose an important and highly constructive discipline on both the NCUA's supervisory and insurance functions that should, to a significant degree, offset any incentive to permit the promotion of credit unions to interfere with the NCUA's responsibilities for the Share Insurance Fund.

The Share Insurance Fund's Financing Structure

Each insured credit union maintains on deposit in the Share Insurance Fund an amount equal to 1 percent of the credit union's insured deposits. The Fund's reserves consist of this 1 percent deposit plus any additional amounts accumulated through interest earnings and insurance premiums. Although the NCUA has no formal policy about when to assess premiums, it considers charging a premium if the reserve ratio falls below 1.25 percent. The NCUA has assessed a premium only once since 1984. If the reserve ratio exceeds 1.3 percent, the NCUA must pay the excess as a dividend on credit unions' 1 percent deposit.

The Share Insurance Fund counts the 1 percent deposit as its reserves. At the same time, credit unions count the 1 percent deposit as an asset on their own books, which makes their reported net worth higher than it would be than if they had expensed the deposit. This treatment of the same dollars as reserves of the Fund and as an asset of credit unions results in double-counting if one views the Fund and credit unions' net worth as the total buffer available to absorb credit union losses. If the Share Insurance Fund has losses large enough to dip into the 1 percent deposit, credit unions must then expense that portion of the cost and replenish the deposit. Incurring these expenses during a time of stress could further debilitate already weak credit unions.

Proponents of the 1 percent system, including virtually all credit union managers, argue that this funding structure appropriately treats the deposit as an asset because it is refundable (under certain conditions) and it may earn dividends. They also note that the structure provides a mechanism for promptly correcting any deficiencies in the Share Insurance Fund's reserves, and in effect gives the Fund a claim on the entire net worth of all credit unions.

Critics of the 1 percent system, including most bankers, argue that the accounting treatment of the 1 percent deposit overstates the resources available to offset losses to the Share Insurance Fund. During times of economic stress, they argue, credit unions are likely to have reduced income or even have losses, and credit union failures are likely to increase. If the Fund's reserve ratio falls below 1.25 percent, the NCUA may begin assessing premiums. If losses are large enough to impair the 1 percent deposit, then credit unions must write off and replenish the amount that was impaired. The critics point out that credit unions would thus have to pay premiums and write off and replenish the impaired deposit at a time when earnings are depressed and net worth may already be declining. By expensing the 1 percent deposit now, credit unions would not have to expense it during a time of economic stress. They would, however, still have to pay premiums to rebuild the Fund's reserves.

The overriding federal interest in the Share Insurance Fund's financial structure lies in protecting taxpayers from potential losses, while creating a healthy set of incentives for insured credit unions. Thus, whatever the accounting issues and their resolution, the ultimate policy concern must be the Share Insurance Fund's fiscal soundness.

The financing structure of the Share Insurance Fund fits the cooperative character of credit unions. Because credit unions must expense any losses to the Share Insurance Fund, they have an incentive to monitor each other and the Share Insurance Fund. This financing structure makes transparent the financial support that healthier credit unions give to the members of failing credit unions. Credit unions understand this aspect of the Share Insurance Fund and embrace it as a reflection of their cooperative character.

The 1 percent deposit does present a double-counting problem. And it would be feasible for credit unions to expense the deposit now, when they are healthy and have strong earnings. However, expensing the deposit would add nothing to the Share Insurance Fund's reserves, and better ways of protecting the Fund are available. Accordingly, we do not recommend changing the accounting treatment of the 1 percent deposit.

Instead, we recommend a strengthened reserving requirement. Under current law, credit unions set aside a small percentage of their gross earnings as reserves until their net worth reaches 6 percent. We recommend increasing the 6 percent threshold to 7 or 8 percent. Thus, we would not require credit unions to write off part of their net worth but instead to add to it (if they did not already meet the 7 or 8 percent target). This additional net worth cushion would more than offset the double-counting of the 1 percent deposit. And this approach should ultimately strengthen both individual credit unions and the Share Insurance Fund.

In addition, the NCUA should have some flexibility to let the Share Insurance Fund accumulate additional investment earnings in good times that would increase its resiliency during economic downturns. The Federal Credit Union Act currently imposes a rigid 1.3 percent ceiling on the Fund's reserve ratio. We recommend that Congress give the NCUA discretion to let investment earnings increase the Fund's reserve ratio to 1.5 percent.

The statute also permits the NCUA to assess insurance premiums only at a fixed rate of 1/12 of 1 percent of insured deposits. Here again, we believe that the NCUA should have more flexibility to ensure adequate, timely financing of the Share Insurance Fund. Specifically, the NCUA should have authority to charge premiums higher or lower than 1/12 of 1 percent. Similarly, it may be appropriate to consider authorizing the NCUA to assess risk-based premiums and perhaps to make risk-based adjustments in dividends from the Share Insurance Fund. Although this study does not recommend such changes, we see value in a broader debate over their possible advantages and disadvantages.

The NCUA's Safety and Soundness Regulations

The NCUA establishes and enforces safety and soundness regulations as charterer and supervisor of federal credit unions and deposit insurer of both federal and state credit unions. In view of the extensive statutory and administrative modernization of bank and thrift regulation over the past decade, we used the federal banking agencies' safety and soundness regulations as a starting point for our review of the NCUA's safety and soundness regulations. When we identified differences between the two sets of regulations, we evaluated them in light of credit unions' distinctive character and their size and complexity relative to banks and thrifts. We identified four key differences between the NCUA's regulations and those of the federal banking agencies that we believe warrant action by the NCUA or Congress.

Rulemaking

In formulating fundamental safety and soundness policies, the NCUA has often relied on such informal means as examiner manuals, policy statements, or bylaws. To some degree, this informal approach reflects the historical prevalence of small credit unions with relatively simple operations. Such informality has its benefits for the NCUA and for credit unions, but it may also have significant potential drawbacks. For example, reliance on unwritten or informal rules reduces or eliminates the opportunity for public comment. And a lack of clear public rules increases the risk of the NCUA treating or being perceived as treating similarly-situated credit unions differently without good reason. The NCUA should make important safety and soundness rules readily accessible to all interested parties. And, if it intends its rules to have the force of law and apply to credit unions generally, it should promulgate them as regulations and codify them in the *Code of Federal Regulations*. As part of this rulemaking process, the NCUA should publish proposed rules in the *Federal Register* and solicit comments from interested parties.

Net Worth Requirements

Credit unions are not subject to net worth (capital) requirements. Regulators of other federally insured depository institutions establish minimum net worth requirements to help ensure that such institutions have a sufficient buffer to absorb unforseen losses without in turn imposing losses on depositors or the deposit insurance fund. Requiring depository institutions to have adequate net worth also helps counteract the moral hazard of deposit insurance (i.e., the tendency of deposit insurance to permit or encourage insured depository institutions to take excessive risks -- risks that they would not take in a free market). Net worth is like the deductible on an insurance policy: the higher the deductible, the greater the incentive to avoid loss. Adequate net worth gives a depository institution's owners incentives compatible with the interests of the insurance fund because the fund absorbs losses only after the institution has exhausted its net worth and thus eliminated the economic value of the owners' investment.

A credit union's net worth represents the sum of the various reserve accounts on its balance sheet. These accumulated reserves form the buffer that protects the credit union and the Share Insurance Fund from possible losses. Yet the NCUA's regulations do not impose any net worth requirement on credit unions in the sense of requiring credit unions to have at least a given ratio of net worth to assets in order to be in good standing. We recommend the following changes that together should provide adequate, effective net worth requirements.

Most importantly, a credit union should have to meet a net worth requirement -- a requirement that the credit union maintain a specified ratio of net worth to total assets. We recommend that Congress require a credit union that has been in existence for a given number of years or has attained a certain asset size threshold (whichever is reached first) to have at least a 6 percent ratio of net worth to total assets. As described next, we would make such a requirement part of a system of prompt corrective action designed to ensure that credit unions correct any net worth deficiency expeditiously. Credit unions in existence for less than the specified time should be required to build reserves in a manner that ensures that they will meet the 6 percent net worth target by the end of the phase-in period.

Additionally, the existing statutory reserving requirement (i.e., the requirement that a federal credit union set aside as reserves a certain percentage of its gross income) should have a higher target reserve ratio. Specifically, we recommend that Congress raise the current reserving target from 6 percent of "risk assets" to 7 percent of total assets. This one percentage point increase in the reserving target would approximate credit unions' 1 percent deposit in the Share Insurance Fund. Moreover, credit unions should deduct from their reserves, on a dollar-for-dollar basis, all purchase of member capital shares in any corporate credit union.

The NCUA should also receive a mandate to develop an appropriate risk-based net worth requirement for larger, more complex credit unions. This risk-based requirement would supplement the simple 6 percent net worth to total assets requirement and permit the NCUA to take account of risks -- such as off-balance sheet risks or interest rate risk (from, for example, a large mortgage portfolio) -- that may be appreciable only for a small subset of credit unions.

Prompt Corrective Action

Congress enacted a system of prompt corrective action for banks and thrifts in 1991. Prompt corrective action is a capital-based approach to safety and soundness supervision aiming to resolve net worth deficiencies before they grow into large problems. The goal of a prompt corrective action structure is to minimize -- and, if possible, avoid -- losses to the deposit insurance fund. Prompt corrective action lays clear markers for when regulatory action must occur and identifies a range of acceptable actions for a given degree of net worth deficiency.

The NCUA has some informal policies analogous to prompt corrective action. However, it has no regulations or even formal guidelines for taking corrective action regarding a troubled credit union.

We recommend that Congress adopt a system of prompt corrective action for federally insured credit unions. This system would be a streamlined version of that currently applicable to FDIC-insured institutions and would be specifically tailored to credit unions as not-for-profit, member-owned cooperatives. It would thus, for example, omit the various provisions keyed to the existence of capital stock since credit unions have no capital stock.

A prompt corrective action system for credit unions, like the system already in effect for other federally insured depository institutions, might have five net worth categories. A credit union with a ratio of net worth to total assets exceeding the revised reserving target of 7 percent total reserves to total assets would be "well capitalized." In keeping with our recommendation to generally require credit unions to maintain 6 percent net worth credit unions with at least 6 percent net worth would be "adequately capitalized," and credit unions with less than 6 percent net worth would be "undercapitalized." A credit union with less than 4 percent net worth would be "significantly undercapitalized." A credit union with less than 2 percent net worth (or such higher level, not exceeding 3 percent, as the NCUA may prescribe by regulation) would be "critically undercapitalized."

We would not apply these prompt corrective action provisions to credit unions that have been in existence for less than the phase-in period for meeting the 6 percent net worth requirement. New credit unions should, however, be subject to prompt corrective action if they are not making sufficient progress towards meeting the 6 percent requirement within the phase-in period.

Such a system of prompt corrective action would reinforce the commitment of credit unions and the NCUA to resolve net worth deficiencies promptly, before they worsen. Its clarity and predictability should promote fair, consistent treatment of similarly situated institutions. It should also ultimately reduce the number and cost of credit union failures. In so doing, it should conserve the resources of the Share Insurance Fund, make it even more resilient, and make more money available for lending to credit union members. And it would respect and complement the cooperative character of credit unions.

Audit Requirements

Although the NCUA requires each federal credit union to undergo an annual audit satisfying criteria prescribed by the NCUA, the NCUA does not generally require even large credit unions to obtain outside independent audits. Instead, a credit union's supervisory committee, which consists of volunteer members of the credit union appointed by the credit union's board of directors, has responsibility for conducting the audit itself or retaining an independent, licensed certified public accountant to do so. The NCUA requires an independent audit only if the supervisory committee has not conducted an annual audit, the supervisory committee's audit failed to meet the NCUA's requirements, or the credit union has had serious and persistent recordkeeping deficiencies.

With the rise of large, financially complex credit unions, the audit becomes increasingly more difficult for unpaid volunteers to carry out personally. The NCUA has noted the inadequacies of supervisory committee audits in general. Accordingly, we recommend requiring each large federally insured credit union to obtain an annual audit from an independent public accountant. The audit should be at least comparable to those required for banks and thrifts.

Corporate Credit Unions

Corporate credit unions are cooperatively owned by their member credit unions. They serve their members primarily by investing and lending excess funds (or unloaned deposits) that a member credit union deposits at its corporate credit union. At the end of 1996, corporate credit unions held 7 percent of all regular credit unions' assets. Corporate credit unions also provide services comparable to the correspondent services that large commercial banks have traditionally provided to smaller banks. U.S. Central Credit Union is a corporate credit union serving 38 of the 40 other corporate credit unions.

General Observations

Corporate credit unions invest in relatively high-quality, short-term assets and thus have relatively low credit and interest rate risk. At the same time, corporate credit unions tend to be thinly capitalized (that is, have relatively little net worth) and they operate with very narrow margins (that is, have only a small spread between their interest earnings and interest expenses). These narrow margins hinder corporate credit unions from increasing their capital quickly through retained earnings.

This combination of thin capitalization and narrow margins leaves little room for error and heightens the importance of proper internal controls and strong management. Corporate credit unions' asset size may also fluctuate greatly as member deposits rise and fall, and as member loan demand changes. This potential volatility, combined with the difficulty of building capital quickly through retained earnings, reinforces the need for sufficient capital.

In recent years the NCUA has encouraged corporate credit unions to increase their net worth, and corporate credit unions have done so. We believe that this trend is critically important and that further increases in net worth are essential. We anticipate that the NCUA's new corporate credit union regulation will encourage corporate credit unions to continue to build their net worth. In particular, we believe that the new regulation correctly bases permissible investment risk on core capital (retained earnings), and emphasizes the importance of credit unions coming to rely on core capital rather than other forms of capital.

The three-tier cooperative structure of the credit union system -- regular credit unions, corporate credit unions, and U.S. Central -- creates an interdependence risk among and within the various levels. Specifically, a credit union's deposits at its corporate credit union, and its membership capital account, are assets on its books. At the same time, the credit union's corporate credit union carries these funds as (largely uninsured) deposits and secondary capital, respectively, on its balance sheet. The same relationship holds between corporate credit unions and U.S. Central. Thus, a failure at U.S. Central could cause losses to its member corporate credit unions and thereby reduce their net worth, and the failure of a corporate credit union could cause losses to its member credit unions and thereby reduce their net worth.

This interdependence raises at least two issues. First, each level must have sufficient net worth relative to the risks undertaken so as not to pose a risk of losses cascading to the level below it. Second, if a system-wide demand for liquidity arises, corporate credit unions have only limited ability to bring in liquidity from outside the credit union system. Corporate credit unions would largely have to rely on liquidating their investments to meet their members' liquidity needs, but members' deposit withdrawals would tend to deplete those investments.

Corporate credit unions face increasing competitive pressure from each other (due largely but not entirely to their overlapping fields of membership) and from other market participants. The investment services, the liquidity, and the transaction services that corporate credit unions offer to their members are by no means unique; viable market alternatives exist, although small credit unions may have access to a far more limited range of alternatives than large credit unions.

This competitive environment poses important safety and soundness issues for both the near-term and the long-term. Some consolidation among corporate credit unions has begun and we anticipate more in the future. It is unclear what the corporate system will look like in 5 to 10 years, but it is quite likely to look much different than today. How corporate credit unions, and their members, respond to competition among themselves and from other market participants -- whether through rapid growth, developing new activities, consolidation, shifting business strategy, or standing still -- will significantly affect the sort of safety and soundness issues that will arise. The NCUA will clearly need to monitor these developments closely.

Financial Condition of the Largest Corporate Credit Unions

Having analyzed the investment portfolios of the 10 largest corporate credit unions and U.S. Central, we concluded that those portfolios generally have little credit risk exposure, but that concentration risk is an issue and that some institutions' portfolios are vulnerable to changes in interest rates. In particular, we observed a concentration in certain classes of asset-backed securities.

We have several concerns about this concentration of corporate credit union investments in particular classes of assets. First, corporate credit unions' generally small net worth ratios leave little room for error. Second, the NCUA limits the amount that a corporate credit union can invest in obligations of a single issuer but does not limit the amount that a corporate credit union can invest in a class of assets. Third, the risks of concentrating investments in a single asset class are exacerbated by the interdependence risk among corporate credit unions and by the relative homogeneity of the different corporate credit unions' balance sheets.

We therefore recommend that the NCUA develop policy guidance or regulations governing concentration risks. The NCUA also needs to consider the implications of such concentration risk across all corporate credit unions. That is, although an examiner may conclude that any one corporate credit union's concentration in a particular asset class is within some acceptable level of tolerance, the NCUA should also consider the corporate system's overall exposure to that particular asset class.

We found evidence of recent improvements in the financial stability, operations, and controls of the 11 corporate credit unions we reviewed, but also evidence of a need for further improvement. Specifically, we found continued problems involving internal controls and management quality at some of these institutions, and we also found that, during the most recent examination cycle, the NCUA had various degrees of concern with 6 of the 11 institutions.

NCUA's Corporate Credit Union Regulations

Earlier this year, the NCUA completed a sweeping overhaul of its corporate credit union safety and soundness regulation. The new regulation strengthens minimum capital requirements, clarifies the responsibilities of a corporate credit union's management and board of directors, explicitly limits exposure to interest rate risk, implements strict credit review procedures, and requires corporate credit unions to formulate contingent liquidity plans.

These changes reflect significant improvements in the NCUA's regulation of corporate credit unions. With corporate credit unions operating in a highly dynamic market, the NCUA will, over time, need to reexamine various elements of the new regulation. In fact, when the NCUA published that regulation, it committed itself to issuing a report within 18 months on the issues involved.

NCUA's Supervision of Corporate Credit Unions

We evaluated the Office of Corporate Credit Union's approach to supervising corporate credit unions, including its staffing, its policies and procedures. its examiner guidance, and its safety and soundness standards. The Office is still relatively new -- the NCUA created it in 1994 -- yet it represents a significant improvement over the NCUA's previous, less rigorous approach to supervising corporate credit unions. Based on our evaluation, we identified several areas for continued development.

First, we found that the Office of Corporate Credit Unions is understaffed. The resources currently devoted to supervising corporate credit unions fall short of reflecting the proportionate risk these institutions pose to both credit unions and the Share Insurance Fund.

Second, the NCUA's regulatory practices for corporate credit unions diverge in some respects from the best-practice approaches developed cooperatively by other federal regulatory agencies. In particular, the bank and thrift regulators have been developing risk assessment techniques that focus examiner attention on high risk areas and overall portfolio risk. Our review of NCUA corporate examination reports found a more audit-oriented focus, rather than one keyed to the critical risk areas in a particular credit union. We also found that examination reports contained excessive detail about small deficiencies, which detracted from the major findings and prescriptions for corrective action.

Third, the NCUA has not adequately developed written guidance for examiners and corporate credit unions. Moreover, the NCUA should also be developing a capacity to review industry trends, assess potential systemic risks, and assess corporate credit unions as a group.

Fourth, the NCUA needs to update its rating system to better reflect the current risks and risk-taking in corporate credit unions. In particular, the NCUA should consider adopting the federal banking agencies' revised rating system, which includes a component rating for an institution's sensitivity to market risk. More generally, the NCUA could benefit from more regular interaction with the federal banking agencies to learn about, and participate in developing best practices for approaching emerging financial market risks

Fifth, the NCUA's examination reports and work papers for the 11 corporate credit unions we reviewed did not always sufficiently support examiner ratings. We also have concerns about the Office of Corporate Credit Unions' policy of basing the overall rating on the lowest of the five component ratings.

In view of these findings, we recommend that the NCUA: commit greater resources to the Office of Corporate Credit Unions so that it may continue to improve its supervision of corporate credit unions; interact more with the four federal banking agencies; make greater use of risk-based approaches to supervision; and include in its ratings of corporate credit unions a component rating for market sensitivity.

Credit Union Liquidity and the Central Liquidity Facility

Liquidity refers to the relative ease with which one can convert assets into cash. One of the key functions of corporate credit unions is to provide liquidity to member credit unions. Corporate credit unions are currently well positioned to do so because their portfolios consist of investments of high credit quality with relatively short maturities. However, they are not equipped to deal with systemic liquidity demands by regular credit unions. For this purpose, Congress created the Central Liquidity Facility (CLF) in 1978, when credit unions had no access to emergency liquidity from a governmental lender of last resort. In 1980, however, Congress expanded access to the Federal Reserve's discount window to all depository institutions, including credit unions, offering accounts that are subject to reserve requirements.

The CLF is a mixed-ownership government corporation within the NCUA. CLF membership is voluntary and available to all credit unions. Most credit unions join the CLF through their corporate credit union, which holds agent member status. Unlike credit unions, however, corporate credit unions do not actually pay cash for CLF shares. Through a complex series of accounting transactions involving corporate credit unions, U.S. Central, and the CLF, entries are recorded to show stock purchases, although no funds actually change hands. These transactions serve to artificially increase the balance sheets of the interested parties.

The CLF creates a concentration of credit risk for itself by holding all of its investments at U.S. Central. If U.S. Central were ever to become impaired, the CLF's elaborate redeposit-based capital structure could collapse and its share accounts could suffer losses; the combined effect could largely eliminate the CLF's net worth.

The CLF is authorized to lend to member credit unions and the Share Insurance Fund. Currently, the CLF has statutory authority to borrow $17 billion. Moreover, the Justice Department's Office of Legal Counsel has said that such borrowing is backed by the full faith and credit of the United States. Although the CLF may borrow from any source, it has long had a credit arrangement in place with the Federal Financing Bank, which is part of the U.S. Treasury. While various appropriations acts have limited to $600 million the amount that the CLF can lend directly to credit unions, they have not limited the CLF's ability to borrow the full $17 billion at any one time and lending it to the Share Insurance Fund.

On balance, we believe that the best course of action would be to discontinue the CLF. Credit unions, particularly larger ones, should apply to their Federal Reserve Bank for discount window access. Smaller credit unions should at least have firm lines of credit for emergency liquidity from their corporate credit unions or other depository institutions. Additionally, corporate credit unions and the NCUA should each evaluate credit unions' potential liquidity needs and the options available for credit unions and corporate credit unions to meet those needs.

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Friday, November 21, 1997

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DATE CREATED: 11/21/1997

ADDRESSEE: Robert E. Rubin
Secretary

AUTHOR: Carnell, Richard
Financial Institution

SUBJECT: Credit Union Study

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TO REVIEWERS

IN:

TO EXECUTIVE SECRETARY

IN:

TO THE SECRETARY

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

April 14, 1998

ASSISTANT SECRETARY

MEMORANDUM FOR SECRETARY RUBIN

FROM: Richard S. Carnell RSC
Assistant Secretary for Financial Institutions

SUBJECT: Credit Union Safety and Soundness Reforms

This memorandum will describe recent progress toward building support for strengthening the safety and soundness reforms in H.R. 1151, the credit union bill recently passed by the House.

That bill incorporated some of the Treasury's proposed reforms, including those to strengthen the National Credit Union Share Insurance Fund, require the National Credit Union Administration to periodically assess credit unions' access to liquidity, and require the NCUA to prescribe a risk-based capital requirement for complex credit unions. But the bill contained only very weak prompt corrective action provisions.

During the first week of April, we at the Treasury met at length with the major credit union trade associations and others to discuss prompt corrective action. These meetings included a detailed examination of credit union questions and concerns about prompt corrective action and our concerns about the House-passed bill. On April 8, I shared with the credit union trade associations informal draft legislative language that sought to respond to credit unions' concerns while also achieving the basic objectives of the original Treasury proposal.

The basic approach is to specify by statute some key elements of a prompt corrective action system (including a 6 percent capital requirement) and then have the NCUA work out the details under a set of statutory standards. The system must be "comparable to" that applicable under the Federal Deposit Insurance Act. It must also take account of how credit unions are not-for-profit cooperatives that (1) do not issue capital stock, (2) must rely on retained earnings to build net worth, and (3) have volunteer boards of directors.

I believe that our draft legislative language is basically acceptable to the credit union trade associations, but I do expect them to continue haggling over it.

The largest potential point of disagreement involves including the 6 percent capital requirement in the statute. Some credit unions have questioned the 6 percent level and also noted that the statute applicable to FDIC-insured depository institutions generally uses verbal rather than numerical capital definitions.

The case for a 6 percent level may be briefly summarized as follows:

(1) Credit unions cannot correct capital deficiencies as quickly as banks and thrifts. As cooperatives, credit unions cannot issue capital stock; they must rely on retained earnings to build capital. And that may be a slow process, particularly during times of stress. The 6 percent level provides a prudent margin of safety.

(2) Under our proposal, most credit unions would only need to meet the 6 percent requirement, whereas all FDIC-insured institutions must meet two capital standards, including an 8 percent risk-based capital requirement.

(3) Credit unions' capital involves appreciable double-counting: credit unions' 1 percent deposit in the Share Insurance Fund counts both as capital of credit unions and reserves of the Fund (and would amount to 1 percentage point of the 6 percent requirement); and credit unions' equity investment in corporate credit unions counts as capital of both the credit unions and the corporates.

Moreover, 96 percent of credit unions already meet the 6 percent standard, and those credit unions hold 98 percent of credit union assets.

Including the 6 percent capital requirement in the statute would resolve the issue cleanly, and help the ensuing NCUA rulemaking process focus responsibly on the other issues involved in tailoring prompt corrective action to credit unions. I am concerned that if the statute omitted the 6 percent level, credit union trade associations (despite their current protestations to the contrary) would bring enormous pressure on the NCUA to set a lower level -- and those demands would dominate the comment process. Moreover, including a statutory 6 percent level has facilitated flexibility on other points in this proposal.

The Senate Banking Committee staff will soon begin work on possible changes in H.R. 1151. In preparation for that, we are seeking clearance of the legislative language and an accompanying explanatory document.

DEPOSITS

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

INFORMATION

November 7, 1994

MEMORANDUM FOR SECRETARY BENTSEN

THROUGH DEPUTY SECRETARY NEWMAN FNN

FROM: Richard S. Carnell RSC
Assistant Secretary for
Financial Institutions

SUBJECT: Savings Association Insurance Fund

LMB

Problem

The Savings Association Insurance Fund (SAIF) currently has significant weaknesses. It has only $1.7 billion in reserves to cover nearly $700 billion in insured deposits. These reserves would probably not suffice to handle the failure of more than one large thrift institution. Moreover, payments on FICO bonds consume 45 percent of SAIF's premium income, which would allow the Fund to build up reserves only slowly, if at all. If, as expected, premiums for the Bank Insurance Fund (BIF) drop substantially by early 1996, the erosion of SAIF's deposit base could accelerate, with SAIF-insured institutions reducing their reliance on deposits and perhaps also reducing their total assets. Under the Office of Management and Budget's mid-session baseline estimate, SAIF will have exhausted virtually all of its reserves by the end of 1999.

SAIF-insured institutions currently face some $15 billion in deposit insurance obligations:

- $5.7 billion to increase SAIF's reserves to the statutorily required level of $1.25 in reserves per $100 in insured deposits;

- $8.2 billion in payments on the FICO bonds (net present value); and

- over $1 billion in expected insurance losses through 1997.

Although SAIF-insured institutions can bear a substantial portion of these obligations, requiring such institutions to bear the entire amount alone could be self-defeating. It could unacceptably increase the likelihood of SAIF becoming insolvent or the FICO bonds going into a default. The best way to strengthen SAIF is to find other sources of funding for part of these obligations.

EXECUTIVE SECRETARIAT

Options Attached

The attachment to this memorandum outlines five options for resolving SAIF's problems and comments on their rationale, advantages, and disadvantages. Settling now on a particular option would be premature, as we are still necessarily at an early stage of consulting and taking political soundings.

Under the first four options, SAIF-insured institutions would bear a significant proportion of SAIF's obligations, but other FDIC-insured institutions -- namely those insured by BIF -- would also bear part, by helping to make the payments on the FICO bonds, or by accepting a merger of SAIF into BIF. These options need not increase BIF premiums and could permit a substantial reduction in BIF premiums to occur as projected in 1996.

I believe that any of these four options would be acceptable as a matter of policy. Each would: provide sufficient resources to solve SAIF's problems; maintain public confidence in federal deposit insurance and avoid a default on the FICO bonds; impose little or no cost on taxpayers; and have few distorting effects on the thrift industry and the economy.

The fifth option, a minimalist approach, centers on extending current authority to use unspent RTC funds to cover SAIF losses. It would probably not accomplish enough to be worthwhile.

Political Feasibility; Timing

The real question-mark in dealing with SAIF's problems is political feasibility. Members of Congress will prefer to defer dealing with those problems until they present a more imminent crisis.

Even if Members are inclined to deal with SAIF's problems, reaching agreement on a solution would be difficult. Using tax dollars to build up SAIF or defease the FICO bonds would almost certainly be a legislative non-starter, even if it involved unspent RTC funds rather than newly appropriated funds. Nor would it, in my view, be feasible to obtain funds for rescuing SAIF from financial institutions not insured by the FDIC (such as credit unions, Fannie Mae, or Freddie Mac).

agree

This leaves BIF-insured institutions as probably the most realistic major source of funds (other than SAIF-insured institutions themselves). Most banks would object to bearing any of SAIF's burdens. But one could, nonetheless, argue as follows in support of bank participation:

- BIF-insured institutions derive important benefits from maintaining the integrity of the Government's guarantee of deposits. The taxpayers have stood behind BIF even when BIF's reserves were depleted (as in 1991). Thus it is fair to ask BIF-insured institutions to help solve SAIF's problems.

- Congress cannot allow SAIF to fail. If Congress were to face an imminent SAIF crisis, it would very likely turn to BIF-insured institutions to supplement the resources of SAIF-insured institutions. Thus BIF-insured institutions would be better off by coming to the table now -- while they have considerable leverage over the manner and extent of their participation -- rather than by waiting for a crisis.

If we concluded that we would need to call on BIF-insured institutions to share some of SAIF's burdens, there would be real advantages to obtaining legislation *next year* -- before the FDIC reduces BIF premiums. After next year, BIF will be recapitalized, and the FDIC will almost certainly cut BIF premiums sharply from their current average of 24 cents per $100 of domestic deposits -- e.g., to 5-10 cents per $100. Any SAIF legislation could be structured to provide large reductions in BIF premiums (e.g., to 7-10 cents per $100). Thus SAIF legislation need not increase any bank's premiums; it could just mean that premiums fall a little less than the decrease expected under current law. But if the FDIC lowers BIF premiums in the absence of SAIF legislation, then getting BIF-insured institutions to contribute toward solving SAIF's problems may become much more difficult. Such contributions probably would necessitate an increase in the lowered BIF premiums, making the action more conspicuous and less acceptable to bankers.

One can construct a case for deferring Congressional action until 1997. Under the Congressional Budget Office's baseline estimate, SAIF would remain weak indefinitely, without a short-term crisis. Under "moderately pessimistic" CBO scenarios, the crisis would come later, with SAIF becoming insolvent in 1998-99 or the FICO bonds going into default in 2002. Under optimistic projections, such as those of the FDIC staff, SAIF would avoid a crisis altogether. Relying on any of these scenarios, one could wait until 1997 and see if a crisis that would help precipitate Congressional action had begun to build. One could also hope that as banks acquire more SAIF-insured deposits through mergers, the banking industry will become more open to contributing towards a solution.

A wait-and-see approach would, however, entail significant risks of its own. SAIF is already weak, as discussed above, and handling more than one large thrift failure could easily exhaust its reserves. If we fail to speak out about (and provide leadership to help solve) SAIF's problems, we could be held responsible for any SAIF insolvency or FICO default. In addition, waiting is likely to make it difficult for the thrift industry to attract and retain capital, thus harming what remains of the industry and diminishing the industry's capacity to help solve its problems. Delay could also raise the ultimate cost of resolving the problem and reduce the thrift industry's ability to serve housing finance.

If SAIF were to become insolvent, it could draw on the FDIC's $30 billion line of credit with the Treasury -- but only by satisfying the Department that SAIF's premium income is sufficient to assure timely repayment of the amount borrowed.

Proposed Approach

Deputy Secretary Newman, Assistant Secretary Levy, and I believe that the best course for the present is to continue to consult extensively in an effort to clarify the extent of SAIF's problems and identify the approach with the best chance of securing enactment. These consultations include meeting with the Office of Thrift Supervision, Office of the Comptroller of the Currency, OMB, National Economic Council, FDIC, Federal Reserve Board, and General Accounting Office; with banks, thrifts, and their trade associations; with the staffs of both Banking Committees; and with Members of Congress.

agree ✓

We believe it makes sense for the Deputy Secretary and other Treasury officials to begin making more frequent public statements about SAIF's problems (e.g., in speeches and interviews) -- but without yet endorsing a particular solution or committing the Department to seek action in the next Congress.

don't worry the depositors

agree ✓

If you have any questions or concerns about this approach, please let us know.

We believe it would be premature for us to ask you at this time for a decision on these or other options while we are still necessarily at an early stage of taking soundings about the political feasibility of one option versus another. We would, however, appreciate your views on the attached options, and would be happy to meet with you to discuss the issues and alternatives.

Attachment

SOME OPTIONS FOR RESOLVING
THE PROBLEMS OF THE
SAVINGS ASSOCIATION INSURANCE FUND

DISCUSSION DRAFT
November 4, 1994

Best approach if you can overcome banks opposition

OPTION 1: Special Assessment to Capitalize SAIF; FICO Payments Shared; Merger of Funds

- Spread FICO payments over all FDIC-insured institutions, beginning with the first deposit insurance payment due after BIF recapitalizes.

- Capitalize SAIF in 1996 by imposing an 80-basis-point special assessment on all SAIF-insured deposits. Base an institution's special assessment on its average deposits in 1993-94.

- Merge the fully capitalized SAIF into BIF in 1996.

- Protect the merged fund from any losses now embedded in SAIF by modifying the authority to use unspent RTC funds to cover SAIF losses.

<u>Comments:</u> Merging funds corrects SAIF's current vulnerability to the failure of more than one large thrift (as well as any unusual exposure to interest rate risk). Moreover, merging the funds would both remove uncertainty and reduce the potential for distortions created by a shrinking SAIF deposit base.

Option 1 seeks to soften bank opposition to a merger by: requiring SAIF to capitalize before the merger, so that it does not dilute BIF; and protecting the merged fund from any SAIF-related losses for several years after the merger.

Using a retrospective base for the special assessment avoids creating powerful incentives to reduce reliance on SAIF-insured deposits.

Any one-time assessment could reduce funds available for housing as the assessment would likely reduce thrifts' capital. Since thrifts can leverage capital 20 times in *mortgage lending, each $1 billion in special assessment has the potential to reduce credit available from thrifts for housing finance by $20 billion.*

Until December 31, 1997, the FDIC may, under certain circumstances, use unspent RTC funds to cover SAIF losses. The existing certification requirements could be revised to conform to the changes proposed here. These alterations would keep the combined fund from being diluted by the failure of thrifts identified, based on some criteria, as financially troubled at the time of merger.

Could we increase SAIF members' support for Option 1 by allowing them to pay the special assessment in installments over a 4-year period beginning in 1996, rather than making the entire special assessment due in 1996?

OPTION 2: Special Assessment to Capitalize SAIF; FICO Payments Shared

- Same as Option 1, but with no BIF-SAIF merger.

<u>Comments:</u> *Avoids bank opposition to immediate merger of funds, although not to sharing of FICO obligation. Does not correct SAIF's risk concentrations.*

Capitalizing SAIF would automatically lift the moratorium on conversions from SAIF to BIF. We do not know how many SAIF-insured institutions would then convert to BIF. It appears that a SAIF-insured institution would have to pay a 125 basis point entrance fee to join BIF, a steep price. There may be an adverse selection problem in that presumably only strong institutions would be able to pay the entrance fee.

OPTION 3: Special Assessment to Capitalize SAIF; FICO Payments Shared; Merger of Funds; Common Charter and Regulation

- Same as Option 1, but with common charter and regulation added:

    - Merge OCC and OTS, effective in 1996.

- End separate federal regulation of thrift institutions.
  - Abolish federal thrift charter in 1998, and require existing federally chartered institutions to obtain bank charters.
  - Grandfather diversified S&L holding companies in existence on January 1, 1995.
- In the next tax bill, amend the bad-debt deduction to permit any former thrift to convert to a bank charter without triggering bad-debt recapture, so long as the institution continued to meet the Internal Revenue Code's qualifying asset test.

<u>Comments:</u> *This option could be used if common charter and regulation were a net legislative plus.*

Option 3 seeks to soften bank opposition to a merger by: requiring SAIF to capitalize before the merger, so that it does not dilute BIF; ending separate federal regulation of thrifts; and protecting the merged fund from any SAIF-related losses for three years after the merger. Thrifts, concerned about stigma remaining from 1980s, would probably tend to see an end to their separate regulation as a net plus.

In establishing a common charter and regulations, we could permit regulators to tailor capital standards to institutions heavily engaged in residential mortgage lending, by establishing a lower leverage limit coupled with a substantial capital charge for excessive interest-rate risk.

SAIF reform legislation, although not amending the Internal Revenue Code, could contain a sense-of-the-Congress resolution requesting the tax-writing committees to report out legislation granting an exemption from recapture of the thrift bad-debt deduction (e.g., by allowing thrifts that continue to meet a qualifying asset test to avoid bad debt recapture). This change would both reduce the immediate hit to thrifts' capital while also satisfying the concerns of real estate interest that eliminating a separate thrift charter will diminish the role of depositories specializing in housing finance.

Would ending separate federal regulation of thrifts draw significant opposition? Real estate groups such as the National Association of Home Builders and the National Association of Realtors would be concerned if they believed that such changes would significantly diminish thrift institutions' role in housing finance. Retaining the Internal

Revenue Code's qualifying asset test could mitigate such concerns: institutions could change their charters without triggering recapture as long as they continued to meet the test.

OPTION 4: Special Assessment to Defease FICO Obligation; Merger of Funds
(similar to Option 1, but with the special assessment dedicated to defeasing FICO instead of capitalizing SAIF)

- Defease FICO obligation in 1996 by imposing a 120-basis-point special assessment on all SAIF-insured deposits. ("Defease" refers to setting aside enough money now to cover the payments on the FICO obligation as they come due.) Base an institution's special assessment on its average deposits in 1993-94.

  - As an alternative to defeasing the entire FICO obligation, defease part of it and assess former SAIF deposits at a higher rate than BIF deposits until the remainder is paid off.

- Merge SAIF into BIF in 1996 (which would modestly dilute BIF).

- Amend or repeal the statutory requirement that, until BIF is fully recapitalized, BIF premiums must on average yield the equivalent of 23 basis points per dollar of domestic deposits.

- Protect the merged fund from any losses now embedded in SAIF by modifying the authority to use unspent RTC funds to cover SAIF losses.

<u>*Comments:*</u> *SAIF-insured institutions would continue to bear the entire FICO obligation. BIF members would accept some dilution of BIF -- but without having to pay higher premiums.*

Defeasance will be particularly complex if the one-time assessment results in only a partial defeasement. For example, there would be interest rate risk for either the government or for the thrifts if the defeasement is incomplete.

A 120 basis point one-time assessment would result in 50 additional savings associations being categorized as undercapitalized or worse.

OPTION 5: Minimalist

- Extend period during which unspent RTC funds may be used to cover SAIF losses, from 1997 to 1999.
- Give FDIC greater flexibility to extend SAIF capitalization schedule.

Comments: *Probably does too little to be worthwhile.*

TREASURY CLEARANCE SHEET

NO. 94-139550
Date Nov. 4, 1994

MEMORANDUM FOR: ☒ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ______

FROM: Assistant Secretary Carnell RC
THROUGH: Deputy Secretary Newman
SUBJECT: Savings Association Insurance Fund

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Finance
  - ☐ Domestic Finance
  - ☐ Economic Policy
  - ☐ Fiscal
    - ☐ FMS
    - ☐ Public Debt
- ☐ Under Secretary for International Affairs
  - ☐ International Affairs
- ☐ Enforcement
  - ☐ ATF
  - ☐ Customs
  - ☐ FLETC
  - ☐ Secret Service
- ☐ General Counsel
- ☐ Inspector General
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- ☐ Legislative Affairs
- ☐ Management
- ☐ OCC
- ☐ Policy Management
  - ☐ Scheduling
- ☐ Public Affairs/Liaison
- ☐ Tax Policy
- ☐ Treasurer
  - ☐ E & P
  - ☐ Mint
  - ☐ Savings Bonds
- ☐ Other ______

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
R. Carnell			AS Financial Institutions	2-2600
REVIEWERS				
M. Levy	see attached		AS Legislative Affairs	2-1900
J. Bowman			General Counsel	2-1964
E. Knight			General Counsel	2-0286
V. Rojas	see attached		Legislative Affairs	2-1980

SPECIAL INSTRUCTIONS

Please provide comments by close of business Friday, November 4, 1994.

☐ Review Officer ______ Date ______ ☐ Executive Secretary ______ Date ______

DO F 80-02.1 (04/89)

94-11-04-002

TREASURY CLEARANCE SHEET

NO.
Date Nov. 4, 1994

MEMORANDUM FOR: ☒ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY

ACTION

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☐ TESTIMONY ☐ OTHER ______

Rec'd 11/4/94

FROM: Assistant Secretary Carnell RC

THROUGH: Deputy Secretary Newman

SUBJECT: Savings Association Insurance Fund

Michael Victor Jamie

REVIEW OFFICES (Check when office clears)

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FROM: Assistant Secretary Carnell RC
THROUGH: Deputy Secretary Newman
SUBJECT: Savings Association Insurance Fund

REVIEW OFFICES (Check when office clears)

Michael Victor Javier

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Rojas	VR	11/4/94.		

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NO. 94-139550
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THROUGH: Deputy Secretary Newman FN
SUBJECT: Savings Association Insurance Fund

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DO F 80-02.1 (04/89)

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Date Nov. 4, 1994

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☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
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FROM: Assistant Secretary Carnell RC

THROUGH: Deputy Secretary Newman

SUBJECT: Savings Association Insurance Fund

Rec'd 11/4/94

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SPECIAL INSTRUCTIONS

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☐ Executive Secretary Date

DO F 80-02.1 (04/89)

94-11-04-002

TREASURY CLEARANCE SHEET

NO. ______
Date Nov. 4, 1994

ACTION

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☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ______

Rec'd 11/4/94

FROM: Assistant Secretary Carnell RSC
THROUGH: Deputy Secretary Newman
SUBJECT: Savings Association Insurance Fund

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Please provide comments by close of business Friday, November 4, 1994.

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DO F 80-02.1 (04/89)

95144097

INFORMATION

MEMO

Fin Inst

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

March 22, 1995

MEMORANDUM FOR SECRETARY RUBIN

THROUGH: Deputy Secretary Newman FNN

FROM: Richard S. Carnell RSC
Assistant Secretary for
Financial Institutions

SUBJECT: Treasury testimony on the Savings Association Insurance Fund

Issue

The Financial Institutions and Consumer Credit Subcommittee of the House Banking Committee will be holding hearings on the Savings Association Insurance Fund (SAIF) on March 23, 1995. I will be testifying for the Treasury Department.

My testimony will (1) describe the problems SAIF faces; (2) discuss the need for action to resolve those problems; (3) set forth criteria for a solution; and (4) evaluate possible options.

I have met with Jonathan Fiechter and Ricki Helfer who will also be testifying at the March 23 hearing. There is an agreement that SAIF has problems and we all recognize that there are five or six options for resolving these problems. We also agree that there is considerable logic behind developing a solution to the problems by combining several options. However, we do not have an agreement on just what such a combination of options should be.

Frank or I have also spoken with Bob Litan at OMB, Ellen Seidman, and Chairman Greenspan. All of whom agree with our approach.

Therefore, this hearing will simply continue the public dialogue that will begin this Friday with the FDIC's public hearing on the SAIF.

We expect the Senate Banking Committee to hold hearings on the SAIF in April and at that time we would hope to have developed a plan of action that is supported by the independent regulators and the Administration.

Below I have summarized some of the major issues I will be discussing in my testimony.

SAIF's Problems

SAIF has four major weakensses, which together raise doubts about SAIF's long-term viability.

First, SAIF has slender reserves. As of December 31, 1994, SAIF held only 27 cents in reserves for each $100 in insured deposits. The failure of one or two large thrift institutions could easily exhaust these reserves and leave the Fund insolvent.

Second, SAIF has only meager income with which to protect depositors and build reserves. Forty-five percent of SAIF premiums go to pay interest on bonds issued to prop up a prior deposit insurance fund (the so-called FICO bonds).

Third, SAIF has concentrations of risk because it insures a specialized industry and because of the industry's concentration in large California-based institutions.

Fourth, and most importantly, SAIF has a declining assessment base (i.e., base of deposits on which SAIF can levy premiums). Over the past five years, SAIF-insured depsoits, instead of growing over 40 percent (as projected), have shrunk 24 percent.

Need for Action

SAIF-insured deposits wil almost certainly continue to shrink, because depository institutions have both the motive and the means to reduce their use of such deposits. Under a recent FDIC proposal, SAIF premiums for the healthiest institutons will be nearly six times as high as Bank Insurance Fund (BIF) premiums. Institutions with SAIF-insured deposits can avoid high premuims in various ways. They can sell off loans, instead of holding them in portfolio, and thus reduce their need for deposits. They can replace deposits with nondeposit funding sources, such as Federal Home Loan Bank borrowings. Or they can seek to switch deposits from SAIF to BIF, using such approaches as that recently proposed by Great Western (forming an affiliated BIF-insured bank with branches in its thrift lobbies).

Accordingly, we believe it would be unwise to base policy on projections that SAIF's assessment base will stabilize or will shrink only very slowly.

SAIF's greatest vulnerability arises from the interaction between the payments on the FICO bonds, which claim approximately the first $78 million in annual SAIF premiums, and SAIF's shrinking assessment base.

Left uncorrected, SAIF's weaknesses could leave the Fund insolvent and FICO interest payments in default. They could also make it more difficult for savings institutions to attract and retain capital, thus harming what remains of the thrift industry and diminishing the industry's capacity to help solve its problems.

Guiding Principles

We believe that six principles should guide any solution to the problems of SAIF. These principles are to: (1) provide sufficient resources to strengthen SAIF; (2) avoid default of the FICO bonds; (3) minimize cost to the taxpayers; (4) require a significant, but not excessive, contribution from SAIF-insured institutions; (5) avoid perverse incentives and minimize market distortions; and (6) maintain public confidence in the federal deposit insurance system.

Options for Resolving SAIF's Problems

Our testimony discusses a series of options for addressing the SAIF problem. These include:

- Clarifying that all SAIF obligations are available to pay interest on the FICO bonds;
- Using unspent RTC funds to cover SAIF losses;
- Spreading FICO payments over all FDIC-insured institutions, which would add 2.5 basis points to the deposit insurance premium rate that commercial banks would have to pay;
- Assessing SAIF-insured deposits to increase the capitalization level of SAIF;
- Merging the BIF and SAIF, which would clearly deal with inherent weaknesses of SAIF -- its lack of geographic and asset diversification and declining assessment base;
- Ending the separate charter and regulation of savings associations; and providing SAIF-insured institutions relief from tax recapture of the thrift bad-debt deductions, if after changing to a bank charter they remain qualified thrift lenders.

The testimony will indicate that there is logic in having the solution be a combination of several options, but will not provide an example of a combination that we would support.

Political Feasibility

Treasury officials, along with Jonathan Fiechter, have been consulting extensively with Members and their staffs in an effort to clarify the extent of SAIF's problems and identify the approaches with the best chance of securing enactment.

Partly as a result of these discussions the Members seem now to understand there are problems. Chairwoman Roukema and Chairman D'Amato are indicating that they believe some action should be considered.

TREASURY CLEARANCE SHEET

NO. 95-14 4097

Date: 3/21/95

MEMORANDUM FOR: Secretary Rubin

☐ ACTION ☐ BRIEFING
X INFORMATION ☐ LEGISLATION ☐ PRESS RELEASE
☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY OTHER

FROM: Assistant Secretary Carnell
THROUGH:
SUBJECT: Memo to the Secretary regarding SAIF testimony

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Domestic Finance
  - ☐ Financial Institutions Policy
  - ☐ OCC
  - ☐ OTS
  - ☐ Fiscal
    - ☐ FMS
    - ☐ Public Debt
- ☐ Under Secretary for International Affairs
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  - ☐ ATF
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  - ☐ FinCEN
  - ☐ FAC
  - ☐ Secret Service
- ☐ Legislative Affairs
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- ☐ Economic Affairs
- ☐ Chief of Staff
- ☐ Management
  - ☐ Treasurer
    - ☐ Mint
    - ☐ Engraving & Printing
    - ☐ Savings Bonds
- ☐ Public Affairs
- ☐ Tax Policy
- ☐ Inspector General
- ☐ IRS
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NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
Affleck-Smith	[illegible]	3/21/95	Financial Institutions Policy	622-2740
REVIEWERS				
Morales Marks	FMM	3/21	Financial Institutions Policy	622-2610
Knight	See attached		General Counsel	622- 0287
Levy	See attached		Legislative Affairs	622-1900

did not get it all (only got pg 1-2) see comments on those pages

SPECIAL INSTRUCTIONS: Please review and return comments ASAP.

TREASURY CLEARANCE SHEET

NO. ______________

Date: 3/21/95

MEMORANDUM FOR: Secretary Rubin

X INFORMATION ☐ LEGISLATION ☐ ACTION ☐ BRIEFING ☐ PRESS RELEASE
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FROM: Assistant Secretary Carnell
THROUGH:
SUBJECT: Memo to the Secretary regarding SAIF testimony

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Levy			Legislative Affairs	622-1900

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Date: 3/21/95

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FROM: Assistant Secretary Carnell

THROUGH:

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Levy / Rojas	VAR	3/21/95	Legislative Affairs	622-1900

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95 195510

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

May 2, 1995

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin

SUBJECT: Administration Policy Regarding the Savings Association Insurance Fund (SAIF)

The April 10 Weekly Economic Bulletin (WEB) included an article entitled "The Death Spiral of the Thrift Insurance Fund" (Tab A). In response to the article, you asked about Administration policy regarding SAIF.

Assistant Secretary Richard S. Carnell testified for the Administration at the House Banking Committee's March 23 hearing on SAIF. (Tab B briefly summarizes the testimony.) He stated: (1) SAIF has a serious and growing capitalization problem that is structural and unrelated to the (generally healthy) state of the thrift industry; (2) this problem also extends to concern about payment of $793 million in annual interest due on bonds (known as FICO bonds) issued in 1987-89 as part of the thrift bailout, which must be paid out of SAIF deposit insurance premiums, (3) ***there are a number of options to deal with the problem (outlined in the testimony), but the politically easy ones are insufficient to solve the problem***; and (4) all parties, including the thrift and banking industries, the FDIC (which is responsible for SAIF), the OTS (which regulates thrifts), the Administration, and the Congress need to work together to develop a feasible and lasting solution. During the hearing, Subcommittee Chair Marge Roukema strongly urged everyone to develop a solution and bring it back to her. Senate Banking Committee hearings are expected in mid-May, and the Committee will expect to hear at that time the preferred approach of the Administration and FDIC.

The Administration can play a unifying, catalytic, and constructive role in developing a solution to this problem -- which will almost certainly come to a head before 2000, and possibly within the next two years. However, doing so requires that the Administration be a relatively quiet broker and deal-maker, developing the necessary consensus (which may not need to include all the parties) before going public with a solution. Some House Republicans, in particular, are ready to pounce on any Administration-only solution as "using taxpayer money to bail out the thrifts." Treasury is taking the lead in moving forward collaboratively, working with the FDIC, OCC, and OTS, with participation from OMB, NEC, and CEA.

Background

Commercial banks and thrifts have long had two different insurance funds. In the late 1980s, the old Federal Savings and Loan Insurance Corporation (FSLIC) collapsed, requiring taxpayer support to pay off insured depositors. In the end, Congress created a new FDIC-administered insurance fund for thrifts -- SAIF -- and renamed the existing FDIC fund for banks as the Bank Insurance Fund (BIF). Each fund was to collect premiums on deposits at a relatively high rate until it accumulated reserves of $1.25 per $100 of insured deposits, at which time premiums could be lowered.

When SAIF was established in 1989, the Bush Administration asserted (and Congress believed) that it could reach that capitalization level. This assertion rested on two assumptions: (1) that thrift deposits would ***grow at a 7 percent annual rate***; and (2) that Congress would, if necessary, appropriate funds to help capitalize SAIF. ***Neither assumption was correct***. Since 1989, thrift deposits have ***declined at a 5.4 percent annual rate***, thereby shrinking SAIF's assessment base and premium income. Because future Treasury funding was anticipated, Congress believed that a high proportion of the thrift premiums paid to SAIF were not needed to build up SAIF. Thus virtually all SAIF premiums paid before 1993 were diverted to help pay for past thrift failures. At the same time, Congress never appropriated the Treasury funds authorized in 1989 to build up SAIF. As a result, the thrift fund has only 28 cents per $100 of insured deposits and the outlook for reaching the $1.25 level in the next several years is highly uncertain.

The bank fund --BIF -- fared much better. Both banks and thrifts have been paying an average annual deposit insurance premium of 23 cents per $100 of insured deposits. However, because bank failures have declined precipitously, bank deposits have grown, and BIF premiums have not been siphoned off for other purposes, BIF will fully recapitalize this year. Under an FDIC proposal that the agency believes is statutorily required, premiums on deposits of healthy banks are likely to decline to 4 cents per $100 of insured deposits, while premiums on deposits of healthy thrifts would remain at 23 cents unless something is done to recapitalize SAIF and address the FICO obligation.

The Problem

Understandably, ***healthy thrifts do not want to pay almost 6 times more than banks*** pay for the same deposit insurance coverage. Thus thrifts have powerful incentives to maneuver around statutory prohibitions and move their deposits out of SAIF. Indeed, several of the largest thrifts, such as California's Great Western, have filed applications with the regulators to create *de novo* banks that would be located in their thrift lobbies and would move deposits from the thrift to the bank. The regulators are likely to approve these charters. As this happens, ***SAIF will become less and less able to make FICO bond payments and recapitalize***. While the FICO bonds do not carry the full faith and credit of the United States, the government would face strong pressure to step in to prevent a default. SAIF itself is small enough that the failure of one major thrift could cause it to go bankrupt. Although it has a line of credit to the Treasury that could protect thrift depositors, it is unclear that the FDIC could make the findings required by the statute to tap the line of credit. ***We would then be in the midst of another thrift crisis.***

Piecemeal legislative efforts to stop shrinkage of thrift deposits will not solve the problem. The WEB piece notes that many analysts (including inside the Administration) have concluded that as a matter of policy, merging BIF and SAIF is the most credible *long-term* solution. The WEB piece also points out, however, that ***most banks are strongly opposed to this.*** Quite simply, they are taking the position that (i) they're not responsible for the thrift crisis; (ii) they successfully recapitalized their own fund; and (iii) they shouldn't have to pay a nickel to prevent another thrift crisis. This argument is beginning to wear a bit thin around town, including in Congress, because: (i) merging the funds in the long term will produce one stable fund that can protect all FDIC-insured deposits without using taxpayer funds, rather than one good fund and one fund structurally prone to collapse; (ii) another thrift crisis will hurt public confidence in the entire deposit insurance system, including BIF; (iii) the remaining thrifts are no more responsible for the thrift crisis than the banks; (iv) the banks have been benefitting from buying up thrifts cheaply because of the looming premium differential -- a bonanza that will multiply when the actual premium differential materializes; and (vi) because the banking industry is so much larger than the thrift industry, merging the funds would not preclude a huge drop in bank premiums.

Potential Solutions

Over the past several months, the Treasury and others, including the FDIC, have made significant headway in persuading Congress (which very much wanted to ignore this issue) of the need for action. The leadership of the Senate Banking Committee, in particular, has shown itself receptive to acting in a bipartisan manner to resolve the problem -- and to do so in advance of any House action. The Committee would like to hear a proposal from the Administration and the FDIC at a hearing which will probably be held in mid-May. We would want any such proposal we would advance to be made largely in coordination with the FDIC and other bank regulators.

The Treasury and FDIC are coalescing on a comprehensive proposal that includes (i) spreading the FICO payments among both banks and thrifts; (ii) using some funds appropriated to RTC -- but not likely to be spent by RTC -- as a backstop to cover extraordinary thrift losses for a period of time; and (iii) imposing a one-time special assessment on the thrifts to bring SAIF's reserves up to \$1.25 per \$100 of insured deposits. While such an assessment would be unpleasant for thrifts, the FDIC projects that it would not increase thrift failures. Furthermore, the Treasury believes that any package solution such as this one must demonstrate to both Congress and the public that the thrift industry has capitalized its own deposit insurance fund. Final components of a package depend upon resolution of certain issues, including budgetary pay-as-you-go and accounting issues. Congress could also decide whether to take the step of merging the bank and thrift funds. The Treasury will continue working with other Administration offices, including OMB, NEC, and CEA, to ensure that a SAIF solution proposal can have full Administration support. It is important that the Administration encourage constructive steps, and not ignore what is likely to be a growing problem. However, the various parties at interest have significant disagreements, and appropriate Congressional action will be very difficult to attain.

Attachments

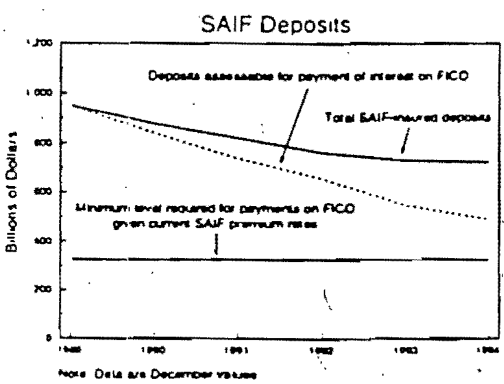
EYES ONLY

CURRENT DEVELOPMENT

The Death Spiral of the Thrift Insurance Fund

On January 31, the Federal Deposit Insurance Corporation (FDIC) announced its intention to cut the deposit insurance premium rates paid by banks while maintaining the rates paid by thrifts at their current levels. (Under current law, the FDIC was compelled to take this action because the Bank Insurance Fund, or BIF, which insures bank deposits, will achieve full capitalization later this year. By contrast, the Savings Association Insurance Fund, or SAIF, which insures thrift deposits, is not projected to achieve full capitalization until 2002.) If implemented, this action will put thrifts at a competitive disadvantage (see Weekly Economic Briefing, October 24, 1994).

In the last few weeks, several of the nation's largest thrifts have moved to apply for bank charters. Evidently, these parent companies intend to induce their depositors to shift their funds to the new bank units. Such maneuvers will accelerate the death spiral of SAIF. As the pool of thrift deposits dries up, the incentive for each remaining thrift to exit will increase. Already, the total volume of SAIF-insured deposits has shrunk 25 percent since 1989, and the volume of deposits assessable for purposes of servicing SAIF's debt to the Financing Corporation (FICO) has fallen by half (see chart).



Analysis. The proposed gap between the thrift and bank insurance premium rates does not reflect any problem with the current health of the thrift industry (it is in good shape), but rather the fact that SAIF was established with no initial capital and with significant debt obligations related to the S&L debacle of the 1980s. Many analysts believe that the best achievable way to resolve the problem is to merge BIF and SAIF. The combined fund would have sufficient resources to assume the remaining obligations of SAIF, and would be fully capitalized in 1996 (only one year later than BIF on its own). At that time, premium rates of the combined fund would drop to about 6 cents per $100, or only about 2 cents more than if BIF were allowed to proceed on its own.

This approach would infuriate bankers because it would impose about $11 billion in costs on them that they might not otherwise bear. Bankers argue that they should not be saddled with these additional costs because they had nothing to do with creating the current situation. However, surviving thrifts can make the same argument; by definition, those most directly responsible for creating the situation are now out of business. Legislation will be required to implement virtually any of the solutions currently under discussion.

THE DEPARTMENT OF THE TREASURY
1789

SAVINGS ASSOCIATION INSURANCE FUND

Testimony of Richard S. Carnell
Assistant Secretary of the Treasury

Before the Subcommittee on Financial Institutions
and Consumer Credit
Committee on Banking and Financial Services
United States House of Representatives

March 23, 1995

SUMMARY

The Savings Association Insurance Fund (SAIF) has four major weaknesses. First, SAIF has slender reserves. As of December 31, 1994, SAIF held only 28 cents in reserves for each $100 in insured deposits. The failure of one or two large thrift institutions could exhaust these reserves and leave the Fund insolvent.

Second, SAIF has only meager income with which to protect depositors and build reserves. Forty-five percent of SAIF premiums go to pay interest on bonds issued to prop up a prior deposit insurance fund (the so-called FICO bonds).

Third, SAIF has concentrations of risk because it insures a specialized industry and because of the industry's concentration in large California-based institutions.

Fourth, and most importantly, SAIF has a declining assessment base (i.e., base of deposits on which to charge premiums). Over the past five years, SAIF-insured deposits, instead of growing over 40 percent (as projected in 1989, when SAIF was established), have shrunk 24 percent.

SAIF-insured deposits will almost certainly continue to shrink, because depository institutions have both the motive and the means to reduce their use of such deposits. Under a recent FDIC proposal, SAIF premiums for the healthiest institutions will be nearly six times as high as Bank Insurance Fund (BIF) premiums. Institutions with SAIF-insured deposits can avoid high premiums in various ways. They can sell off loans, instead of holding them in portfolio, and thus reduce their need for deposits. They can replace deposits with nondeposit funding sources, such as Federal Home Loan Bank borrowings. Or they can seek to switch deposits from SAIF to BIF, using such approaches as that recently proposed by Great Western (forming an affiliated BIF-insured bank with branches in its thrift lobbies). Accordingly, we believe it would be unwise to base policy on projections that SAIF's assessment base will stabilize or will shrink only very slowly.

SAIF's greatest vulnerability arises from the interaction between the payments on the FICO bonds, which claim the first $793 million in annual SAIF premiums, and SAIF's declining assessment base. The combination of fixed FICO payments and a shrinking assessment base tends to create a vicious circle in which (1) shrinkage of the assessment base makes FICO payments consume an increasing share of SAIF premiums, which (2) reduces SAIF's capacity to bear losses and build reserves and renders increasingly remote the prospect of SAIF ever accumulating enough reserves so that it could cut premiums, which (3) makes SAIF-insured deposits less attractive as a funding source, which in turn (4) promotes further shrinkage of the assessment base and leaves SAIF with even less income remaining after FICO payments.

If not corrected, SAIF's weaknesses could leave the Fund insolvent and the FICO interest payments in default. They could also make it more difficult for savings institutions

(5) Merging BIF and a recapitalized SAIF would fully resolve SAIF's problems and would not dilute BIF. Indeed, it would avoid dilution of BIF that could otherwise occur (e.g., if SAIF members form affiliated banks that grow rapidly).

(6) *Abolishing the thrift charter* could be pursued if it would contribute to an overall solution of SAIF's problems.

Having identified SAIF's problems before they develop into a crisis, we have an opportunity to work together to develop a feasible and lasting solution.

ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

May 1, 1995

MEMORANDUM FOR SECRETARY RUBIN

THROUGH: Deputy Secretary Newman FNN

FROM: Richard S. Carnell RSC / for mm
Assistant Secretary for
Financial Institutions

SUBJECT: Memorandum to the President on the Savings Association Insurance Fund (SAIF)

ACTION FORCING EVENT:

In response to an April 10 article in the Weekly Economic Bulletin, entitled "The Death Spiral of the Thrift Insurance Fund" (Tab A), the President inquired about Administration policy on SAIF.

RECOMMENDATION:

That you sign the attached memorandum to the President describing the Treasury's work to date to resolve SAIF's problems.

APPROVE ✓ DISAPPROVE__________ LET'S DISCUSS__________

BACKGROUND:

The memorandum briefly outlines Assistant Secretary Carnell's March 23 SAIF testimony before the House Banking Committee (briefly summarized at Tab B).

The memorandum describes the Treasury's leadership role in developing a solution to this problem by working with the FDIC, Office of Thrift Supervision, OMB, and NEC.

Over the past several months, we have made significant headway in persuading Congress (which would very much prefer to ignore this issue) of the need for action. We continue to work with those agencies, and are aiming to develop a comprehensive proposal for resolving SAIF's problems and offer it jointly with the FDIC and other bank regulators at Senate Banking Committee hearings in mid-May.

Attachments

TREASURY CLEARANCE SHEET

NO. 95-145510
Date: 4/25/95

MEMORANDUM FOR: Secretary Rubin — X ACTION — BRIEFING
INFORMATION — LEGISLATION — PRESS RELEASE
PUBLICATION — REGULATION — SPEECH
TESTIMONY — OTHER

FROM: Deputy Secretary Newman
THROUGH:
SUBJECT: Memorandum to the President on the SAIF's Problems

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Domestic Finance
  - ☐ Financial Institutions Policy
  - ☐ OCC
  - ☐ OTS
  - ☐ Fiscal
    - ☐ FMS
    - ☐ Public Debt
- ☐ Under Secretary for International Affairs
  - ☐ International Affairs
- ☐ Enforcement
  - ☐ ATF
  - ☐ Customs
  - ☐ FLETC
  - ☐ FinCEN
  - ☐ FAC
  - ☐ Secret Service
- ☐ Legislative Affairs
- ☐ General Counsel
- ☐ Economic Affairs
- ☐ Chief of Staff
- ☐ Management
  - ☐ Treasurer
    - ☐ Mint
    - ☐ Engraving & Printing
    - ☐ Savings Bonds
- ☐ Public Affairs
- ☐ Tax Policy
- ☐ Inspector General
- ☐ IRS
- ☐ Public Liaison
- ☐ Other

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
Green/CEA	MPH	4/25/95	Financial Institutions Policy	622-2157
REVIEWERS	JAS	4/26		
Affleck-Smith			Financial Institutions Policy	622-2740
Morales Marks	Amm	4/26	Financial Institutions Policy	622-2610
Carnell	RSC see comments	4-27-95 attached	Financial Institutions	622- 2600
Knight - See attached			General Counsel	622-0287
Bowman			General Counsel	622-1964
Robertson - see attached	see attached		Legislative Affairs	622-1900
Rojas			Legislative Affairs	622-1980

SPECIAL INSTRUCTIONS: Comments due ASAP, memorandum needs to go out tonight.

TREASURY CLEARANCE SHEET

NO. 95-145510

Date: 4/26/95

MEMORANDUM FOR: Secretary Rubin

X ACTION | BRIEFING
INFORMATION | LEGISLATION | PRESS RELEASE
PUBLICATION | REGULATION | SPEECH
TESTIMONY | OTHER

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Am 3025