CBO TESTIMONY

Statement of
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before the
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Urban Affairs
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NOTICE

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Mr. Chairman, I appreciate this opportunity to appear again before your Committee to discuss the condition of the Bank Insurance Fund (BIF). I will share with you the Congressional Budget Office's (CBO's) latest baseline projections of the fund's spending and our analysis of the Administration's budget submission. I will specifically address its overall projection of losses, its proposal to convert the budgetary treatment of deposit insurance from cash to accrual, and its banking reform proposals. I will also offer some comments on the Administration's plan to emphasize open bank assistance.

Our principal conclusions are the following:

- o Although a large majority of banks appear relatively healthy, the outlook for a portion of the banking industry remains pessimistic in the near term, primarily because of the delay in the general economic recovery and continuing real estate problems. Bank profits have been depressed, but they are now starting to rebound, and the long-run outlook is more optimistic.

- o CBO projects losses to the BIF to increase in fiscal years 1992 and 1993 before starting to decline. CBO estimates that BIF's net outlays will increase from $7.4 billion in 1991 to $14.5 billion in 1992 and peak at $17.3 billion in 1993. Over the

period from 1992 through 1995, CBO projects that BIF will incur losses of $43 billion in resolving failed banks. Under those circumstances, we estimate that BIF's borrowing authority will be sufficient to cover its needs and that the borrowing can be repaid from bank premiums and asset sales over the next decade.

- The President's budget proposes to convert accounting for federal deposit insurance from a cash to an accrual basis, and to use projected savings from its proposal to offset other spending on the pay-as-you-go (PAYGO) scorecard. CBO agrees that budgetary accounting for insurance programs could be improved, but does not feel that the Administration's proposals are suitable to implement at this time. Furthermore, no PAYGO savings should be scored for the policy changes the Administration proposes.

- The Administration also proposes legislation to permit interstate banking and branching, and it plans to provide open bank assistance. These proposals deserve serious consideration on their own merit. Interstate banking and branching may improve the overall efficiency of the banking industry in the

long term, but it will not necessarily translate into higher bank profits or lower losses to the BIF in the short run. Open bank assistance and other forms of forbearance run the danger of postponing inevitable consolidation, while increasing the future cost to the BIF.

RECENT DEVELOPMENTS

Since I last testified before this Committee, a number of developments have affected the outlook for the banking industry and the Bank Insurance Fund. These include the outlook for the economy, the condition of the banking industry, and the legislation enacted at the end of last year.

Economic Outlook

The economic outlook remains uncertain. Six months ago, CBO and most other forecasters expected the recovery to be fully under way by the start of 1992, but the recovery is not yet here. High vacancy rates for office buildings and rental housing continue to cast a pall over construction and to depress real estate values. They also erode the quality of bank assets and increase the

number of nonperforming loans in bank portfolios. Nevertheless, these indicators have stabilized, and construction activity and retail sales have picked up. Recent growth in the money supply and declines in interest rates should help spur economic growth. CBO believes that a recovery, albeit mild and delayed, is a likely prospect later this year.

Current Conditions in Banking

Despite recent losses, the U.S. banking industry appears relatively healthy overall. Bank earnings were stronger in 1991 than in 1990. Nearly 90 percent of the roughly 12,500 commercial and savings banks in the United States earned profits in the first three quarters of last year. In the third quarter of calendar year 1991 alone, commercial banks earned $4.3 billion, about 170 percent better than a year earlier. At the same time, however, the rate of return on equity remains low, and nonperforming loans and losses on loans continued to increase in 1991.

Underlying these overall figures are really two separate banking industries. One, which comprises a large majority of banks, is well capitalized and earning money. The other, encompassing only a small proportion of banks, is poorly capitalized or losing money or both. As shown in Table 1, in

TABLE 1. COMPARISON OF BANKS REPORTING POSITIVE AND NEGATIVE EARNINGS, JANUARY 1991 THROUGH SEPTEMBER 1991

Capitalization	Number of Banks as of September 30, 1991	Assets (Billions of dollars)	Net Income or Net Loss (Billions of dollars)
Greater than 6 Percent			
Net income	10,488	2,016	15.5
Net losses	961	203	-1.1
Subtotal	11,449	2,219	14.4
Greater than 3 Percent, Less than or Equal to 6 Percent			
Net income	489	891	4.4
Net losses	408	502	-3.7
Subtotal	897	1393	0.7
Greater than 1.5 Percent, Less than or Equal to 3 Percent			
Net income	12	1	0.0
Net losses	76	22	-0.4
Subtotal	88	23	-0.4
Greater than Zero Percent, Less than or Equal to 1.5 Percent			
Net income	13	1	0.0
Net losses	43	11	-0.3
Subtotal	56	12	-0.3
Less than or Equal to Zero Percent			
Net income	2	0	0.4
Net losses	26	2	-0.2
Subtotal	28	2	0.2
Industry Total			
Net income	11,004	2908	20.3
Net losses	1,514	740	-5.7
All Banks	12,518	3648	14.6

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

the first three quarters of 1991, almost 10,500 banks had equity-to-asset ratios of more than 6 percent and reported positive net income. Those banks accounted for over half of the industry's assets and show every sign of being able to survive the recession. Recent experience suggests that such banks have a low probability of failure.

At the other end of the spectrum are approximately 1,500 banks that reported net losses for the first nine months of 1991. Approximately 550 of these banks had equity-to-asset ratios of less than 6 percent. Those institutions account for only about 4 percent of all banks, but they hold about 15 percent of the industry's assets. Many of them are likely to fail within the next two to three years.

The performance of small and regional banks outpaced that of many money center banks, which continue to suffer losses on loans and diminished earnings, primarily attributable to real estate loans. A number of very large banks are particularly vulnerable.

New Legislation

The Congress passed and the President signed into law the Federal Deposit Insurance Corporation Improvement Act of 1991. The act provided the BIF with the authority to borrow working capital based on the value of its assets, plus an additional $25 billion to cover losses. That refinancing of the BIF should enable the Federal Deposit Insurance Corporation (FDIC) to increase the pace of resolution.

In addition, the new law requires timely resolution of failing banks. New capital-based sanctions, such as limits on growth, prohibitions on dividends, and barriers to entry on new activities, are imposed on banks that fall below minimum capital standards. "Critically" undercapitalized institutions are subject to government takeover even if they are solvent according to measures of book value. The 1991 legislation strengthened prudential supervision of banks by requiring annual on-site examinations for all insured banks, carrying out a new regulatory system for domestically operating foreign banks, mandating risk-based premiums and restricting brokered deposits to banks that are well capitalized. Over the next several years, these changes should improve the regulatory oversight of the banking industry and lower BIF losses.

BASELINE PROJECTIONS FOR THE BANK INSURANCE FUND

CBO has updated its baseline budget projections to reflect the continued uncertainty of the economic outlook and actual data on 1991 BIF activity. In particular, we have added about $13 billion to the estimate of losses we expect to be incurred in resolving failed banks over the 1991-1996 period. We have also increased our projection of 1993 and 1994 BIF spending to reflect lower-than-anticipated resolution activity in fiscal year 1991 and the first half of 1992. Our latest baseline projections for the Bank Insurance Fund are summarized in Table 2.

We estimate that gross spending by the fund will rise from about $18 billion in fiscal year 1991 to $27 billion in 1992 and $35 billion in 1993, before dropping off in subsequent years. That spending would cover losses on bank resolutions of $10 billion in 1992, $13 billion in 1993, and another $31 billion over the following four years. (The differences between gross spending and the losses on bank resolutions consist primarily of working capital to cover the cost of acquired assets, as well as administrative expenses.)

CBO's projections assume further premium increases--to 27 cents on July 1, 1992, and to 30 cents on July 1, 1993. Even with such premium

TABLE 2. FINANCIAL PROJECTIONS FOR THE BANK INSURANCE FUND (By fiscal year, in billions of dollars)

	Actual 1991	1992	1993	1994	1995	1996	1997
Outlays							
Gross Spending[a]	18.5	27.4	35.1	31.2	26.5	18.8	15.9
Collections	11.1	12.9	17.8	22.3	24.7	25.8	25.6
Net Budget Outlays[b]	7.4	14.5	17.3	8.9	1.7	-7.0	-9.7
Accrued Income or Losses							
Gross Losses[c]	-7.9	-10.0	-13.0	-11.0	-9.0	-6.0	-5.0
Net Income or Losses[d]	-8.1	-7.1	-5.9	-3.8	-1.1	1.3	2.6
End-of-Year Balances							
Cumulative Borrowings from FFB and Treasury	8.5	19.0	36.3	45.1	46.9	39.9	30.2
Accrued Fund Balance[e]	2.4	-4.7	-10.6	-14.4	-15.5	-14.2	-11.6

SOURCE: Congressional Budget Office.

NOTE: FFB = Federal Financing Bank.

a. Includes cash disbursed for bank failures, plus other cash expenditures.

b. Gross spending less collections.

c. Losses accrued in resolving failed banks.

d. Assessment income less gross losses, additional reserves for future losses, and other expenses.

e. Includes reserve for a portion of the subsequent year's losses.

increases, the fund would incur net losses of about $14 billion from fiscal year 1992 through 1997. The accrued fund balance, which was over $10 billion on September 30, 1990, has disappeared.

We anticipate that BIF will have to borrow from the Treasury for losses and the Federal Financing Bank for working capital each year through 1995, and that the total borrowing will be between $45 billion and $50 billion. Assuming that the banking industry enters a period of relative stability over the last part of this decade, we project that BIF's debt to the Treasury and the Federal Financing Bank can be repaid by roughly the year 2000.

CBO estimates--based on June 30, 1991 data--that approximately 700 banks may fail over the next four years, at a cost to the Bank Insurance Fund of about $40 billion in 1990 dollars. As Table 3 shows, poorly capitalized banks exhibit a higher incidence of failure than better capitalized institutions based on reported book values. Smaller banks also have a higher incidence of failure.

CBO initially based its estimates on the incidence of failures and losses banks experienced from 1987 through 1990. The probabilities of failure based exclusively on recent history probably understate the future incidence of failure and resolution costs, although the evidence is mixed. The industry now

TABLE 3. PROJECTIONS OF THE BANK INSURANCE FUND'S LOSSES FROM 1992 TO 1995, BASED ON THE 1987-1990 EXPERIENCE

Group, Category	Number of Banks as of June 30, 1991	Total Assets as of June 30, 1991 (Billions of dollars)	Projected Number of Failures in 1992-1995	Projected Fund Losses in 1992-1995 (Billions of 1990 dollars)
Group I				
Large asset banks	530	1,274	13	4.0
Medium asset banks	2,386	468	72	5.4
Small asset banks	8,512	337	313	4.6
Total	11,428	2,079	398	14.0
Group II				
Large asset banks	187	1,393	21	17.4
Medium asset banks	241	54	53	3.2
Small asset banks	563	23	130	1.9
Total	991	1,470	205	22.5
Group III				
Large asset banks	8	24	3	0.8
Medium asset banks	17	4	7	0.4
Small asset banks	62	2	27	0.3
Total	87	31	37	1.5
Group IV				
Large asset banks	4	3	2	0.2
Medium asset banks	9	2	9	0.7
Small asset banks	53	2	39	0.3
Total	66	6	50	1.3
Group V				
Large asset banks	5	6	4	0.2
Medium asset banks	8	2	7	0.6
Small asset banks	21	1	19	0.2
Total	34	8	30	1.0
Total, All Groups	12,606	3,595	719	40.3

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

NOTES: Numbers may not add to totals because of rounding. The banks are grouped by equity as a percentage of assets as follows:

Group I = Greater than 6 percent
Group II = Greater than 3 percent, but less than or equal to 6 percent
Group III = Greater than 1.5 percent, but less than or equal to 3 percent
Group IV = Greater than zero percent, but less than or equal to 1.5 percent
Group V = Less than or equal to zero percent

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

is weaker than it was during the 1987-1990 period. Recent increases in premiums and those projected for the near future, although necessary, adversely affect the financial condition of banks. The recession has contributed to greater losses on loans and nonaccruing assets in the industry as a whole, and particularly in larger banks. Banks have become more conservative in their lending policies, however, often choosing to invest in government securities rather than riskier loans. Also, the spread between the banks' cost of funds and the rates they charge for loans is now quite high by historical standards.

CBO adjusts its historical probabilities of failure to reflect changed conditions. Banks are assumed to absorb half of the projected increases in premium assessments, and the recession is assumed to reduce capitalization ratios by 1 percentage point. The net effect of these adjustments is to double projections of BIF losses--from $20 billion to $40 billion.

To confirm the soundness of these projections, CBO consulted with other governmental and private-sector banking experts. Although many of these experts are reluctant to provide specific dollar estimates of bank losses over such a long time period, most confirm that estimates derived from the adjusted historical probabilities of failure and loss rates are reasonable. The projections of private analysts who have gone on record are summarized in

Table 4 and compared with those of CBO and the Office of Management and Budget (OMB). The range of these estimates is quite large--from $15 billion to $63 billion. CBO's projection of $43 billion (in nominal terms) for four-year losses falls near the midpoint of the range of these estimates.

An important aspect of CBO's budget projections is the timing of the regulators' recognition of bank failures. Because the regulators are responsible for determining when a bank fails, CBO places special emphasis on their words and actions, particularly for the near term. Recent events, such as the guidance given to bank examiners at their December 1991 conference and public statements by the Chairman of the FDIC about policy and strategy toward bank closures, lead us to believe that regulators will try to avoid closing banks in 1992 unless it is absolutely necessary. Consequently, BIF outlays for bank losses are likely to be higher in 1993 and 1994 as these deferred closures occur.

Any projection of BIF losses is subject to uncertainty. The data on which CBO bases its projections leave much to be desired. Banks' financial statements show the book value of their assets, which does not accurately reflect current or future values. BIF losses are sensitive to the economy in general and to real estate markets in particular. The banking industry is consolidating as the number of independent banks declines. Although we can

TABLE 4. PROJECTIONS OF BANK INSURANCE FUND LOSSES AT FAILED BANKS

	Projected Losses at Failed Banks (Billions)	Time Period for Projection (Fiscal years)
	Private Forecasts	
James R. Barth, Auburn University	$36 to $63	1992 through 1995
Edward J. Kane, Ohio State University	$53	a
Robert E. Litan, Brookings Institution	$30 to $50	1992 through 1994
Bert Ely, Ely & Company	$15 to $20	1992 through 1995
	Government Forecasts	
Office of Management and Budget	$72	1992 through 1995
Congressional Budget Office	$43	1992 through 1995

SOURCE: Congressional Budget Office

a. Professor Kane's projection is based on his estimate of losses at failed banks that the BIF had not yet reserved for as of December 31, 1991.

expect marginal institutions to leave the industry, it is difficult to project how many of these will exit by way of FDIC closure and how many by way of merger with healthier banks. Moreover, it is virtually impossible to predict how fast consolidation will take place. How promptly regulators close failing banks, how they deal with troubled large banks, and how they set deposit insurance premiums all have significant effects on BIF losses.

The fate of a small number of extremely large banks can swing the projection results substantially in either direction. There is considerable uncertainty about how regulators will close failed large banks, or whether they will close them at all. If the average rates for bank failures and BIF losses were applied to the largest troubled banks, the estimate of the costs of resolution would dwarf the recently buttressed resources of the BIF. Although it is doubtful that these rates of losses would apply to the largest banks, such calculations indicate how sensitive projections of bank losses can be.

THE PRESIDENT'S BUDGET ESTIMATES

The President's 1993 budget for the Bank Insurance Fund has three distinct components. First is the estimate of failed bank losses and the cost to the

BIF under current law. Second is a proposal to change the accounting basis for deposit insurance from cash to accrual. Third is the Administration's proposal of further banking reform measures, most notably interstate banking and branching.

Size of Estimated Losses

The Office of Management and Budget projects that the FDIC will spend almost $72 billion to pay for losses of failed banks from 1992 through 1995 and a total of $90 billion through 1997--two-thirds larger than CBO's estimate. OMB projects that banks failing during the budget period will have almost $500 billion in assets. The OMB's projections are based on the reported capital positions and earnings of banks at the end of June 1991. These data are fed into an econometric model to estimate the market value of insured banks and consequently an estimate of bank losses. Through a complex modeling technique, OMB estimates how these losses are likely to change over time.

A comparison of BIF baseline projections by OMB, CBO, and the FDIC is summarized in Table 5. As one can see, despite substantial differences between OMB and CBO on the size of bank losses, both agencies

TABLE 5. COMPARISON OF BASELINE PROJECTIONS ABOUT THE BANK INSURANCE FUND
(By fiscal year, in billions of dollars)

	Actual 1991	1992	1993	1994	1995	1996	1997
Net Outlays							
OMB[a]	7.4	33.0	38.0	13.7	7.5	-4.5	-19.3
CBO[b]	7.4	14.5	17.3	8.9	1.7	-7.0	-9.7
FDIC[c]	7.4	19.0	13.6	N.A.	N.A.	N.A.	N.A.
Losses on Failed Banks							
OMB	7.9	16.9	23.3	16.8	14.6	11.0	6.5
CBO	7.9	10.0	13.0	11.0	9.0	6.0	5.0
FDIC	7.9	13.2	12.6	N.A.	N.A.	N.A.	N.A.
Assets of Failed Banks							
OMB	57.0	80.0	110.5	85.6	82.7	70.5	43.2
CBO	57.0	58.0	76.0	64.0	52.0	35.0	29.0
FDIC	57.0	86.0	82.3	N.A.	N.A.	N.A.	N.A.
Fund Net Worth							
OMB[d]	2.4	-2.2	-18.3	-28.1	-35.4	-38.9	-37.5
CBO	2.4	-4.7	-10.6	-14.4	-15.5	-14.2	-11.6
FDIC	2.4	-9.6	-18.3	N.A.	N.A.	N.A.	N.A.
Cumulative Borrowing							
OMB	8.3	33.0	71.0	84.7	92.2	87.7	68.4
CBO	8.3	19.0	36.3	45.1	46.9	39.9	30.2
FDIC	8.3	33.8	47.4	N.A.	N.A.	N.A.	N.A.
Deposit Base Growth[e]							
OMB	N.A.	1.1	3.3	3.4	3.4	3.3	3.1
CBO	N.A.	4.5	4.5	5.5	5.5	5.5	5.5
FDIC	N.A.	4.5	4.5	N.A.	N.A.	N.A.	N.A.

SOURCE: Congressional Budget Office (CBO) using data from the Office of Management and Budget (OMB) and the Federal Deposit Insurance Corporation (FDIC).

NOTES: N.A. = Not Available.

a. Office of Management and Budget projections have been converted to a cash basis; assumes premiums rise to $0.30 per $100 of assessable deposits by 1994; also includes special premium assessments beginning in 1992 as required in certain circumstances by the FDIC Improvement Act of 1991.

b. Assumes premiums increase to $0.30 per $100 of assessable deposits by 1994.

c. Federal Deposit Insurance Corporation projections released October 1991; calendar year basis; assumes premiums of $0.23 per $100 of assessable deposits in 1992 and 1993.

d. Except for 1991, does not include a reserve for future losses.

e. Annual growth rate in percent.

show a similar pattern of losses, with the peak appearing in 1993 and tailing off significantly by 1997. Projections of the fund's net worth, assets of failed banks, losses on failed banks, and net outlays are shown. The table also highlights different assumptions about premium assessments and the growth of deposits.

The FDIC, whose October 1991 two-year projections are similar to CBO's current projections, blends two different procedures to project BIF losses. The FDIC is relatively confident of its budgetary projections for an 18-month period based on the judgments of its examiners and the proprietary information it has for banks on its "watch list." For later months in the budget period, the FDIC relies on an actuarial approach, which is similar to that used by CBO.

Accrual Accounting

In commenting on the Administration's proposal to convert accounting for the federal deposit insurance program from a cash to an accrual basis, I wish to emphasize three points that I made in a recent letter to Chairman Sasser of the Budget Committee:

- Federal budgetary accounting for these insurance programs needs to be improved. CBO does not believe, however, that the specific accrual accounting measures the Administration has proposed are suitable for use in the budget at this time;

- No pay-as-you-go savings should be scored for the policy changes proposed by the Administration; and

- The Administration's proposal to provide mandatory appropriations for deposit insurance could increase the liability of taxpayers for these programs.

Cash-basis accounting is necessary to keep track of when money is received or paid out. It fails, however, to provide complete information about the cost of deposit insurance, especially with regard to when losses should be recognized. The budget includes outlays for the acquisition of assets and revenues from the proceeds of asset sales. These transactions distort year-to-year changes in the deficit. Moreover, cash-based accounting does not encourage policymakers to focus on long-term imbalances that may occur in the insurance fund, or to recognize the consequences of economic events when they occur. Accrual accounting systems have the potential to shift the focus of measurement and reporting to one based on the long-term balance

between the present values of premium income and potential insurance claims. To solve some of the problems of cash-based accounting, the Budget Enforcement Act effectively removed the effects of most deposit insurance proposals from the provisions of PAYGO. CBO also removes the deposit insurance cash flows from its budget projections to obtain a clearer picture of budgetary trends. Nevertheless, further improvements can be made.

The Administration's approach to estimating accrued costs for deposit insurance recognizes future costs when economic insolvency occurs. This method is clearly superior to present cash flow accounting for evaluating the financial condition of the BIF. OMB's proposal to remove working capital from annual budget scoring is a positive step because it would eliminate some of the large year-to-year swings caused by the purchase and subsequent disposition of assets. Nevertheless, OMB's specific proposal is complicated, would be difficult to reproduce and carry out, and is not necessarily the best way to estimate accrued costs. Because of the uncertainty of the estimating procedures, we believe it would be imprudent to incorporate them into the budget without substantial study.

The Administration's accrual accounting proposals for deposit insurance also make a subtle--but major--policy change in the primary source of funding for financial shortfalls in deposit insurance programs. In the past,

the first source of money to cover financial deficiencies has been to raise the level of premiums. In contrast, a general fund appropriation has been regarded as a last resort--a discretionary action taken by the Congress when all other resources have been exhausted, as in the case of thrifts. The Administration proposes to replace that approach with an annual mandatory appropriation that would be triggered by any shortfall between annual premium income on the one hand and annual changes in accrued costs on the other. That approach fundamentally changes the priority of liability for the cost of those programs. The taxpayer's share increases; the insured's share decreases.

In sum, the Administration's proposal for accrual accounting, though a step in the right direction for analyzing deposit insurance, is not ready to be incorporated in the budget. Under current Congressional scorekeeping practices, any savings from the Administration's policy changes should not be available to pay for other budgetary initiatives.

Proposals for Reform

The Administration has proposed reforms that would allow interstate banking and branching, expand securities and insurance powers of banks, and

eliminate barriers to ownership of commercial banks by nonfinancial firms. The Administration has estimated that its banking reform proposals would reduce BIF's cash outlays by $7.8 billion in 1994, $11.7 billion in 1995, and $6.6 billion in 1996, and would increase outlays by $7.8 billion in 1997. The Administration believes that the proposals would reduce BIF's costs by raising the earnings of banks, increasing their cost efficiencies, diversifying their risk, and improving their ability to raise capital. Under its accrual accounting proposals, the Administration estimates savings of $0.7 billion in 1992, $1.8 billion in 1993, and continuing savings thereafter. The Administration would credit these savings to the PAYGO scorecard. CBO estimates that these proposals would not have a significant impact on BIF spending over the next five years, on either a cash or accrual basis, and--in any event--believes that any savings that might result should not be credited for PAYGO scoring purposes.

Of those reform measures that it has resubmitted for consideration, the Administration has given most prominence to interstate banking and branching--that is, allowing national banks to expand beyond state boundaries. CBO's analysis is that interstate banking and branching are most likely to have long-term benefits to the U.S. economy. These benefits, however, are not likely to be felt within the five-year period used for budget calculations,

nor are they likely to reduce spending by the Bank Insurance Fund over the next few years.

The primary benefit of interstate banking is to improve the efficiency of the banking sector, primarily through geographic diversification of risk, enhanced competition, and ultimately lower costs to consumers of banking services. Interstate branching may also result in greater operating efficiencies. Ironically, these improvements do not necessarily translate into higher bank profits or a less risky banking system in the short run. Indeed, where interstate banking and branching create competition for local banks that are earning excess profits because they have a local monopoly, average profits will fall and the risk of bank failure will rise.

In addition, geographic expansion, either by merging or creating new establishments, is expensive and will detract from profits in the short term. For the most part, the benefits of interstate banking and branching will accrue in the long run, and then primarily to consumers of banking services. Banks themselves are not likely to see the benefits of interstate banking and branching soon in their profit statements and, more important, the Bank Insurance Fund is not likely to benefit from this change in the next few years.

For PAYGO purposes, the Administration's budget includes $7.4 billion in projected savings over the 1992-1995 period, calculated on an accrued basis. CBO believes that the Budget Enforcement Act precludes counting such savings for PAYGO purposes. We would also note that, over the long term, the proposals may not reduce claims on the general fund of the government. Under CBO projections, present and future insurance premiums fully cover all losses. Under these circumstances, any reduction in BIF losses would result in lower future premium payments by banks, not savings to the Treasury or the taxpayer. If the Administration's--or alternative--reform measures are viewed as urgent, they can be introduced, analyzed, and enacted without changing current budget accounting. Moreover, any savings from such reforms could be used to bolster the Bank Insurance Fund to avoid any potential taxpayer bailout and minimize future increases in premiums.

OTHER POLICY ISSUES

Two important and related policy issues will have a significant effect on the condition of the BIF: regulatory forbearance designed to ease the alleged credit crunch, and the use of open bank assistance, which seeks to avoid bank closures by providing financial assistance to institutions in danger of failing. These issues point to a dilemma bank regulators are currently confronting.

They believe that if they close troubled banks in a timely fashion, costs may be incurred by healthy banks because asset values could be depressed and local credit markets could be disrupted. In addition, they may be concerned that the Bank Insurance Fund could be overwhelmed. If they do not close insolvent banks fast enough, the ultimate cost to the BIF may be higher than otherwise, and healthy banks may suffer from having to compete against riskier institutions. How they resolve this issue will have a major bearing on the viability of the BIF, both in the short and long term.

Arguments for regulatory forbearance grow out of the belief that closing troubled financial institutions has caused problems for credit markets in some regions. Proponents of this view argue that government takeover of failed banks and thrifts and liquidation of their assets has depressed the value of assets, particularly in real estate. On the other side are those who warn that not closing failed banks or quickly disposing of their assets only serves to increase the ultimate cost, since the risk of moral hazard inherent in deposit insurance is given free reign. In addition, most economists would argue that unless the government is going to hold off the market some of the assets it obtains from bank resolutions, the timing of those resolutions does not have much bearing on the value of the assets. Indeed, taking early action to resolve failed banks could add value by removing some of the uncertainty.

As a compromise, the FDIC has suggested using a policy of Open Bank Assistance (OBA), which has been referred to as creating "bank hospitals." Under this policy, a troubled bank would remain open but would be given federal financial assistance to see it through its difficulties. The unfortunate prospect is that these institutions may come to resemble nursing homes, where the terminally ill are kept alive through expensive life support systems, more than hospitals.

There are several dangers in pursuing this policy. Even though the FDIC may restructure a bank's management and impose severe regulatory sanctions, it may still have to resolve the assisted bank at a later date and at a higher cost. The government's experience with thrifts is not encouraging in this regard. Moreover, the form of the federal financial assistance may extend the coverage of deposit insurance to include a bailout of uninsured creditors or even shareholders at the failed institution.

Inherent in the OBA policy is the view that a substantial number of banks are too important to let fail and can be saved. This view is clearly at odds with the consensus of analysts, including CBO, that the banking industry is undergoing an inevitable consolidation and that some banks will leave the industry regardless of the actions of bank regulators. The OBA policy may only delay the inevitable. By substituting its judgement for that of the market,

the government would, in effect, be choosing winners and losers and gambling on restoring a bank that the market had already deemed a failure. How the government would decide which banks it would save and which it would allow to fail is not well understood at present and could be controversial.

CONCLUSION

CBO remains cautiously optimistic that the additional funds provided last year to the Bank Insurance Fund will be sufficient to carry it through this difficult period for the banks. There are certainly dangers that conditions could deteriorate. Much depends on the strength of the economic recovery and how well bank regulators manage the challenges that confront them. As for the Administration's proposal for accrual accounting, CBO would caution the Committee to review carefully the impact of this change--the Administration's specific proposal is not sufficiently developed to be incorporated in the budget. By contrast, the proposal to allow interstate banking and branching is well developed and could improve the overall efficiency of the banking sector. However, neither the Administration's proposals for accrual accounting nor its suggestions for bank reforms are likely to have any near-term benefit to the Bank Insurance Fund.