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Budgetary Treatment of Deposit Insurance: A Framework for Reform

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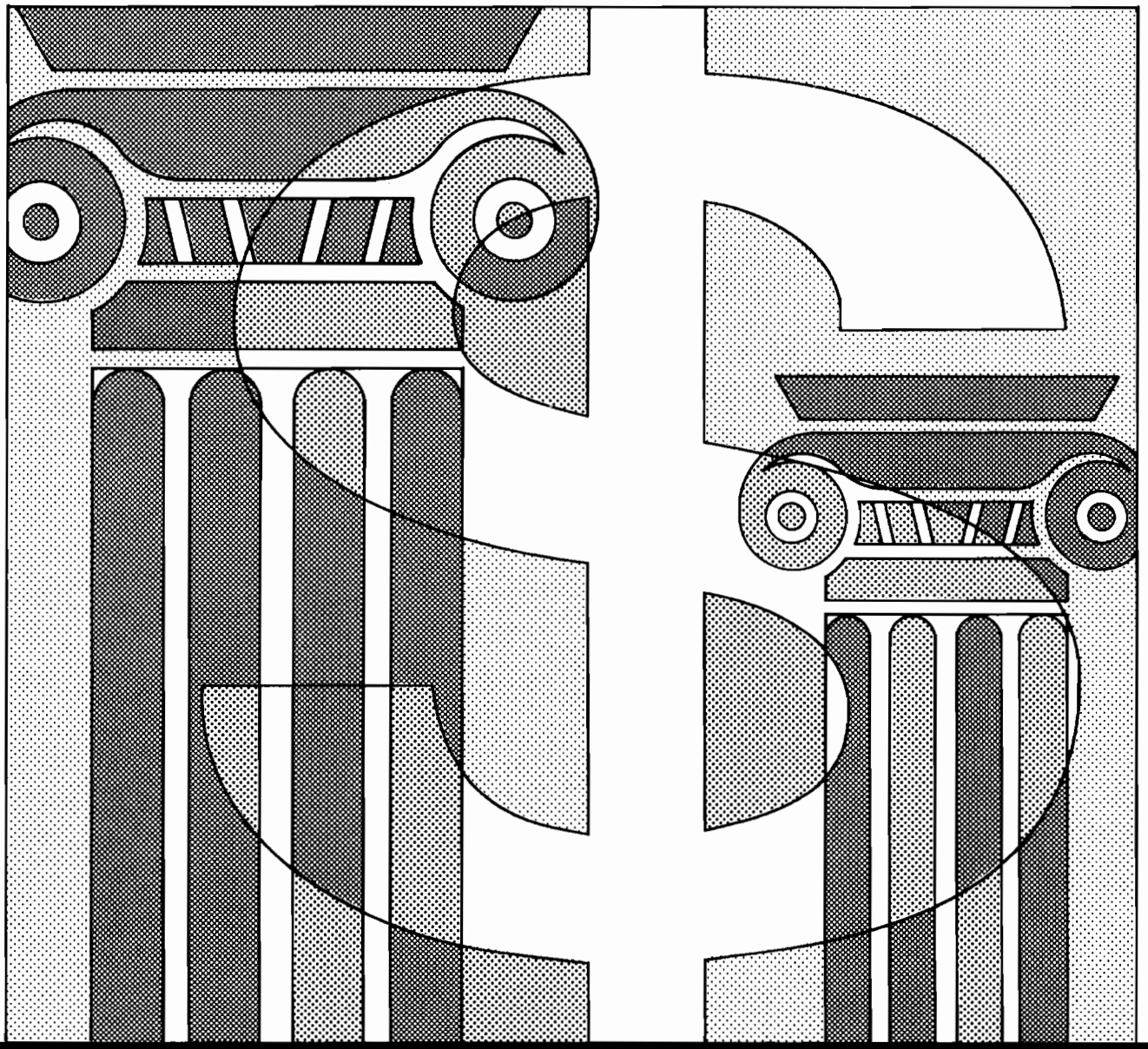

BUDGETARY TREATMENT OF DEPOSIT INSURANCE: A FRAMEWORK FOR REFORM

The Congress of the United States
Congressional Budget Office

PREFACE

This report on the budgetary treatment of deposit insurance satisfies the requirements of section 13201(a) of the Omnibus Budget Reconciliation Act of 1990. That statute directs the Congressional Budget Office (CBO) to "study whether the accounting for federal deposit insurance programs should be on a cash basis, on the same basis as loan guarantees, or on a different basis."

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SUMMARY

The $200 billion loss the Federal Savings and Loan Insurance Corporation (FSLIC) incurred represents a budgetary accounting and control failure of major proportions. This financial disaster was facilitated by FSLIC's operating policies and the treatment of deposit insurance in the budget. The budgetary treatment contributed to the failure because it did not give the timely warning that would have enabled the government to avoid some of these losses. In addition, the budgetary accounting system may have created incentives for deposit insurance authorities to disengage the existing warning signals. The lack of clear indicators from the budget accounting system also obscured the stance of fiscal policy in the 1980s.

CASH-BASIS BUDGETING

The heart of the federal financial information system is the budget, which employs a cash basis of accounting. Cash basis means that transactions are recognized when cash is received or paid out by the government. The difference between these two cash flows is the budget surplus or deficit.

A cash-basis accounting system has many attractive features. For some uses, such as managing cash balances, it is clearly superior to accrual systems, which attempt to recognize the consequences of economic events when they occur rather than when cash changes hands. Cash-basis systems, however, are poorly suited to recognizing costly events in a timely manner when cash flows from an event occur over a period of years.

Last November, the Congress adopted a new budgetary treatment for federal direct loans and guarantees. This new accounting--credit reform--replaces the cash flows for these activities with their estimated cost, when the loans are disbursed. The delay between a loss and its cash flow is also the source of the accounting system's failure for deposit insurance.

An unusually large number of federally insured depository institutions became insolvent in the late 1980s. Insolvency occurs when the value of assets held falls below the value of liabilities owed. The federal government, as insurer of deposits in these institutions, was liable for the difference between the value of the assets and the face amount of insured deposits. The cash-basis accounting system would have given warning of the developing disaster, if the insurance funds had moved promptly to pay off insured deposits and sell the assets in the failed institutions. In that case, the net cost (outlays less collections from asset sales) of insured failures would have been immediately apparent in net budget outlays and the deficit.

A number of factors hampered the prompt payoff of deposits and sale of assets. First, the banking authorities were understandably reluctant to close an institution that was a valued resource to its community. The authorities had to be reasonably certain that an institution was insolvent beyond hope of recovery before closing it. Second, FSLIC was itself experiencing financial difficulties. Shortages of cash at the insurance fund encouraged the authorities to leave insolvent institutions open and to use promises of future, deferred payments to induce healthy institutions to acquire insolvent ones. Third, a precipitous payoff and sale would have posed a risk to the insurer that prices obtained for the assets might be depressed by the urgency of a "distress" sale. Instead, assets were sold at a more controlled pace, in the hope that prices would be higher. All these factors delayed and muted the cash-basis system's warning signal of rapidly rising outlays and deficits. Once the thrift failures were recognized, the only real choice remaining for the federal government was to pay up on its explicit promise to protect insured depositors unconditionally.

IMPROVING BUDGET ACCOUNTING

A consensus exists that a repeat of this financial disaster should be avoided for the surviving insurance funds: the Bank Insurance Fund, the Savings Association Insurance Fund, and the National Credit Union Share Insurance Fund. An uncertain future is bound to hold surprises, financial shocks, and economic disturbances that cannot be avoided or anticipated except in a general way. Yet the cost of such an

event is always less, if it can be quickly recognized and adjustment measures put in place. So it is with deposit insurance. The future financial performance of these programs will include unpleasant surprises, but the adverse consequences from such events can be mitigated by the government's improved ability to recognize these events as they occur rather than after the fact.

Identifying Uses

An effective budgetary accounting system not only reports in a timely manner, but it also provides relevant information. The essential step in improving a budgetary system, therefore, is to identify the information that is vital to the decisionmaking process. This identification permits the essential information to be distinguished from that which is valuable, but clearly secondary. The use to which the information is to be put is the ultimate arbiter of primary and secondary accounting needs. The President's Commission on Budget Concepts asserted that the primary uses of the budget are allocating resources and formulating fiscal policy. If these are still the principal uses of the budget, then for deposit insurance, the vital data pertain to losses and who pays.

Measuring the Costs to the General Fund

Deposit insurance has only two sources of permanent financing: premiums paid by insured institutions and general fund revenues paid by taxpayers. Under current policy, the costs of deposit insurance are to be paid principally from insurance premiums. General federal funds are a backup and last-resort source of financing for extraordinary losses.

A critical piece of information about deposit insurance, therefore, is the extent to which premium income keeps the insurance funds self-sustaining. If an accounting system is to be useful to the process of budgeting general funds, it must be able to monitor and report the balance between:

- Expected deposit insurance income, including premiums but excluding appropriations of general funds, and

- Expected deposit insurance payments, including losses on failed institutions.

In fact, the current budgetary information system already contains, as supplementary information, a statement of financial condition, or balance sheet, for each insurance fund. These statements depict these opposing flows of receipts and payments in the highly convenient form of assets (the present value of expected income) and liabilities (the present value of expected payments). The excess of assets over liabilities (positive or negative) is also shown.

The balance sheet has the potential to provide the information so essential to general fund budgeting for deposit insurance. The excess of an insurance fund's liabilities over its assets is the present value of anticipated claims on the general fund. An increase in this deficiency--from zero--during a budget period measures the current period's consumption of general fund revenues. This cost to the general fund could be recognized in the budget with a payment from the general fund to the insurance fund for the full amount required to restore the insurance fund to balance. In this manner, the cost of deposit insurance to the general fund could be signaled clearly as soon as these claims on the general fund can be anticipated.

Unfortunately, the balance sheet of the federal insurance funds currently has only the potential to meet this need for information. The balance sheet largely reports the consequences of past financial events rather than those that can be anticipated. The General Accounting Office and the insurance agencies, however, are continuing efforts to improve the information content of these statements for the insurance funds.

Identifying the ability of the deposit insurance funds to sustain themselves solely with insurance premiums is critical information. One element of reform would be to specify how this information can be measured and enter it into the budget. The less important financial information can be recognized in nonbudgetary accounts. The amount

of borrowing by the insurance funds to finance the acquisition of assets in failed institutions and to meet temporary imbalances between premiums and expenses clearly falls into the secondary category. So long as the long-term financial balance of the fund is maintained, transitory borrowing to finance spending is of minor importance to budget and fiscal policy decisions, despite the large dollar amounts that may be involved.

OPTIONS

Many ways exist to improve the focus on the important information in the budget and to diminish the prominence afforded to secondary information. Some of these methods are similar to the credit reform approach to direct loans and guarantees, especially mandatory credit programs. Other methods would simply report the cost of deposit insurance in supplementary schedules of the budget; move the working capital activity to the means-of-financing section of the budget; force program adjustments in response to insurance losses; or move the deposit insurance funds off-budget. Adopting a full credit reform approach to deposit insurance has one major advantage and one major disadvantage compared with all other alternatives. The advantage is that only the accrual recognition of costs will provide an early warning of financial disaster in the budget. The disadvantage is that estimating the cost of deposit insurance--when cost is incurred--is very difficult. The Congressional Budget Office makes no recommendation about which of these approaches should be adopted, but this report discusses several options.

Continue to Improve the Balance Sheets. One possibility is simply to maintain current policy. As the continuing efforts to improve the quality of the balance sheets succeed, budget decisions could be guided increasingly by this supplementary information, even if it continued to be excluded from the primary budget data.

Create an Account for Working Capital. Second, a major portion of the less important information could be removed from the primary budget data by transferring the working capital transactions of the deposit insurance funds to financing accounts. These financing accounts could

then be reported in the means-of-financing section of the budget. This approach is similar to shifting the financing accounts for direct loans and guarantees to the less visible portion of the budget, which occurred under credit reform. One difficulty this approach poses to an improved budget information system is that it provides no increase in early warning; that is, deposit insurance losses would continue to be recognized in outlays and the deficit only as they are paid. It would, however, remove from the budget totals a volatile component that does not have any significant economic effects and obscures the fiscal policy implications of the budget.

Link Accrued Deficits to Budgetary or Fee Adjustments. Third, the Congress could take steps intended explicitly to improve the measurement of liabilities and assets and to use the excess of liabilities over assets--if and when an excess occurs--as a mechanism for forcing action. The discovery of such a financial imbalance could trigger either recognition of the loss in budget outlays and the deficit or an increase in deposit insurance premiums sufficient to restore the asset balance of the fund. This option uses a credit reform account structure to separate losses and cash flows. It also modifies the budget process to facilitate early recognition of losses closer to the point at which they occur.

Transform Insurance Funds into Government-Sponsored Enterprises. Fourth, the less important information about the financial activities of the insurance funds could be given the ultimate de-emphasis by removing the deposit insurance funds from the budget and establishing them as privately owned, federally chartered government-sponsored enterprises (GSEs). These entities would affect budget outlays and the deficit only when a general fund appropriation was required to maintain the financial balance of the funds. This option goes beyond accounting and process changes in that it requires a restructuring of the deposit insurance agencies.

Recognizing Past Losses. Finally, the Congress may wish to consider the full and prompt recognition of the inherited losses from the Federal Savings and Loan Insurance Corporation, so that future budgets will not be subject to the residual distortion from past insolvencies.

All of these measures are likely to improve federal financial information about deposit insurance and to provide better support for decisions about allocating resources and formulating fiscal policy. In that important sense, there are no bad alternatives.

CHAPTER I

INTRODUCTION

Two unrelated events led to the Congressional mandate for this study. The first and most important was the financial catastrophe that befell the government in the 1980s from the failure of the Federal Savings and Loan Insurance Corporation (FSLIC). The second was the adoption of a new budgetary treatment of federal direct loans and guarantees in the Federal Credit Reform Act of 1990 (Title XIII of the Omnibus Budget Reconciliation Act of 1990).

THE FSLIC DISASTER

The experience of the Federal Savings and Loan Insurance Corporation in the 1980s has been referred to as a debacle, a disaster, and a mess. By whatever name, it was extraordinarily costly for the government, the taxpayers, and the country. By 1991, estimated cumulative losses surpassed $1,000 for every man, woman, and child in the United States. As the disclosed cost increased, so did the level of frustration with the government's inability to staunch the rush of scarce federal budgetary resources into a financial black hole.

These losses appeared very suddenly in a program that for decades had appeared to be an efficient, self-financing means of providing a safe haven for the savings of millions of Americans and for avoiding banking panics and the associated threat to economic stability and growth. When the losses began to mount, it was too late to take corrective action; the government's only real option was to pay to protect investors who had relied on explicit federal assurances that their deposits would be protected, unconditionally. Many analysts have suggested that the federal budgetary accounting system concealed the problem and that a better system would have provided earlier warning of these massive losses.

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The surprise element was not the only source of discontent with the budgetary accounting for deposit insurance. Plausible arguments were advanced that the largely cash-basis federal accounting system not only failed to provide timely warning, but increased the magnitude of the loss. By measuring cash flows into and out of the government when those flows occur, rather than at an earlier event that causes the subsequent cash flows, the current system recognizes losses in outlays and the deficit only when these amounts are paid. This cash-basis treatment, therefore, gave the deposit insurance authorities good reason for deferring the closure of insolvent institutions. By doing so, they "saved" the current period outlays and increases in the deficit that closure would have entailed. But their failure to act also left institutions open and operating with a powerful incentive to "gamble for resurrection." By adopting a high-risk strategy, a bankrupt insured institution might succeed and win back its losses, or fail and go deeper into insolvency for which the government would be financially liable. Actions by the insurance authorities to defer payments of cash "saved" outlays and the deficit, but probably added billions to the final cost. After this experience, the Congress and the President have made it clear that avoiding a repetition with banks, thrifts, or credit unions is a high priority.

The large number of federal insurance entities can be discouraging to those who would take stock of the government's involvement in this activity. A list and description of all such extant institutions are provided in Table 1.

One way to simplify the information in the table is to single out the permanent deposit insurance agencies. Today, after the passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), there are only two permanent insurance agencies: the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration (NCUA). The FDIC now insures deposits in commercial banks, savings banks, and savings and loans through the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). The NCUA insures deposits in credit unions. Two funds are operating to liquidate FSLIC's accumulated losses: the Federal Savings and Loan Insurance Corporation Resolution Fund and the Resolution Trust Corporation (RTC). All these institutions are

grouped by the type of insured depository in Table 2. One purpose of this paper is to analyze the extent to which a reformed budgetary treatment--accounting and process--of these entities might help avoid a repeat of the FSLIC disaster.

CREDIT REFORM

At roughly the same time that the deposit insurance drama was unfolding, interest was growing in the possibility of improving the budgetary treatment of federal direct loans and guarantees. For many years, users of the federal budget had regarded the budgetary accounting for federal credit programs as unsatisfactory.[1] The reasons for this dissatisfaction were closely related to the complaints about the budgetary treatment of deposit insurance. Principal among these complaints was that the accounting for credit programs on a cash basis failed to recognize the deferred cash component of guarantees and direct loans and, therefore, failed to recognize the true costs of these activities in a timely manner.

In a federal loan guarantee, the government promises now to pay cash to a lender later if the borrower defaults. This binding commitment does not require the federal government to pay out any cash immediately. No effect on outlays and the deficit is recognized under cash accounting. Perversely, if the government collects guarantee fees, these fees are recorded as collections on a cash basis in the current budget period. Thus, even high-risk guaranteed loans could appear to be money-makers during the first budget year--the year that attracts the keenest attention of policymakers.

Direct loans are at a disadvantage in a cash-basis budgetary accounting system because, when disbursed, a federal direct loan has the same effect on outlays and the deficit as a grant of the same amount. This characterization is misleading because some or all of the loan will be repaid later.

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1. *Report of the President's Commission on Budget Concepts* (Washington, D.C., October 1967); Congressional Budget Office, *New Approaches to the Budgetary Treatment of Federal Credit Programs* (March 1984); and Congressional Budget Office, *Credit Reform: Comparable Budget Costs for Cash and Credit* (December 1989).

TABLE 1. FEDERAL DEPOSIT INSURANCE INSTITUTIONS

Institution	Abbre-viations	Estab-lished	Function
		Federal Agency	
Federal Deposit Insurance Corporation	FDIC	1933	Administers the Bank Insurance Fund, Savings Association Insurance Fund, and Federal Savings and Loan Insurance Corporation (FSLIC) Resolution Fund. Before the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), it only insured deposits at commercial banks and some federally chartered savings banks.
Resolution Trust Corporation[a]	RTC	1989	Resolves insolvent thrift institutions insured by FSLIC before August 1989 and for which a conservator or receiver had been appointed between 1/1/89 and 8/9/89 or is appointed within the period 8/9/89 to 8/9/92. Acts as conservator or receiver to any institution for which FSLIC was appointed conservator or receiver during the period 1/1/89 to 8/9/89. Managed by the FDIC and the Oversight Board.
National Credit Union Administration	NCUA	1934	Administers the National Credit Union Share Insurance Fund.
Federal Savings and Loan Insurance Corporation Resolution Fund[a]	n.a.	1989	Inherited the assets and liabilities from resolved cases held by FSLIC on 8/8/89. The fund remains in existence until it has satisfied all debts and liabilities and sold all assets. Managed by the FDIC.

(Continued)

SOURCE: Congressional Budget Office.

TABLE 1. Continued

Institution	Abbre-viations	Estab-lished	Function
		Depository Insurance Fund	
Bank Insurance Fund	BIF	1989	Insures deposits at commercial banks and some savings banks.
Savings Association Insurance Fund	SAIF	1989	Insures deposits at savings and loans and savings banks not insured by BIF.
Federal Savings and Loan Insurance Corporation	FSLIC	1934	Insured deposits at thrift institutions until 1989. Abolished by FIRREA and succeeded by SAIF.
National Credit Union Share Insurance Fund	NCUSIF	1970	Insures deposits at credit unions.
		Mixed-Ownership Government Corporation	
Resolution Funding Corporation	REFCORP	1989	Provides financing for the RTC. Issues debentures, bonds, and other obligations, the proceeds of which are used to purchase non-redeemable capital certificates of the RTC.
Financing Corporation	FICO	1987	Provides financing for the FSLIC Resolution Fund. Issues debentures, bonds, and other obligations, the proceeds of which are used solely to purchase capital certificates issued by the FSLIC Resolution Fund or refund previously issued obligations. Before FIRREA, provided financing to FSLIC.

NOTE: n.a. = not applicable.

a. Temporary federal agency.

When repayments are received they offset, dollar for dollar, the disbursement of new loans. Thus, the net outlays of a high-risk direct loan account could be zero in a budget year if an equal volume of loan repayments from old loans is received at the same time.

The approach of credit reform to this failure of the budget information system is to separate the estimated cost of federal loan and guarantee transactions--defined as the government's loss from an ex-

TABLE 2. FEDERAL DEPOSIT INSURANCE INSTITUTIONS, BEFORE AND AFTER FIRREA

Before FIRREA	After FIRREA
Banks	
Federal Deposit Insurance Corporation (FDIC)	Federal Deposit Insurance Corporation (FDIC) Bank Insurance Fund (BIF)
Thrifts	
Federal Savings and Loan Insurance Corporation (FSLIC) Financing Corporation (FICO)	Savings Association Insurance Fund (SAIF) Federal Savings and Loan Insurance Corporation Resolution Fund Resolution Trust Corporation (RTC) Resolution Funding Corporation (REFCORP) Financing Corporation (FICO)
Credit Unions	
National Credit Union Administration (NCUA) National Credit Union Share Insurance Fund (NCUSIF)	National Credit Union Administration (NCUA) National Credit Union Share Insurance Fund (NCUSIF)

SOURCE: Congressional Budget Office.

NOTE: FIRREA = Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

change of claims of unequal value--from the nonsubsidized cash flows and to focus attention on the former for budgeting and analysis. Central to the concept of credit reform is the recognition of costs when they are incurred and controllable. Without sacrificing the fundamental cash basis of budgetary accounting, credit reform achieves the timely recognition of costs by recording payments of estimated cost to accounts outside the budget when direct and guaranteed loans are disbursed. These payments are recorded in budget outlays and the deficit, but the nonsubsidized cash flows of federal credit transactions are not.

The parallels between the failings of cash-basis accounting for federal guarantees and deposit insurance suggest that credit reform may have a role to play in improving the budgetary treatment of deposit insurance. One purpose of this study is to identify the extent and nature of that role.

CHAPTER II

FUNCTION AND PURPOSE: THE KEY TO GOOD BUDGETARY ACCOUNTING

The term "budgetary accounting," when used in connection with a federal activity, usually refers to the consequences of the activity for the budget deficit (or surplus). Of course, there is much more to budgetary accounting than calculating the deficit. The budget as a planning and control instrument also shows the intended sources and uses of federal financial resources. Nonetheless, the budget's "bottom line" is the deficit, and more than one policy proposal has been rejected because of its projected adverse consequences for this indicator of federal financial performance.

Given the vital importance of the deficit for making budgetary decisions, it is more than a little unsettling to acknowledge that the measured effect of a particular activity on outlays and the deficit depends on the method of accounting used in the budget (see Box 1). Issuing a check for $100,000 can lead to recognition of less than, more than, or precisely $100,000, depending on the nature of the transaction and the accounting system's object of measurement.

Under the accounting system used for loan guarantees before credit reform, guarantees appear in outlays only when the federal government makes a payment to a lender for a loan in default. This payment often occurs many years after the guarantee is issued. Under the new credit reform accounting, the present value of expected future payments for a guarantee is included in outlays and the deficit when the private lender disburses the guaranteed loan. With the change in budgetary accounting, the net expected cost of the activity is recognized in budget outlays and the deficit close to the point of control, rather than when cash is finally paid.

FINDING THE RIGHT ACCOUNTING TREATMENT

Given that the old and new methods of accounting for loan guarantees produce such different results in timing for budget outlays and the deficit, it is reasonable to ask, which is correct? The answer is that both may be right.

The only criterion for determining the rightness of accounting for a particular transaction is the consistency of that treatment with the overall standards or rules of the accounting system. Similarly, the

BOX 1
The Dependency of Budgetary Accounting on the Intended Use of the Information

Suppose the budget has two uses: to support the Treasury's cash management by measuring the government's need for cash and its borrowing requirements; and to serve federal budgetary decisionmaking by measuring the cost of various actions.

Assume a number of insured banks fail in a fiscal year. As a result, federal deposit insurance funds pay out $5 billion to the owners of insured deposits and seize assets in failed banks that are expected to sell for $4 billion next year.

At least two different budgetary treatments are justified for this transaction in year one when the banks fail and insured depositors are paid off. These alternatives would recognize first-year outlays of $5 billion or $1 billion.

Cash Management. The federal government will spend $5 billion in the first year. That amount, which corresponds to the government's use of cash, should be recognized in the budget as an outlay and as adding to the deficit and the need for additional borrowing in year one.

Resource Allocation. The federal government, by this action, has given up $1 billion of its net budgetary resources. That amount should be recognized in outlays and the deficit in year one.

Each alternative has a claim to being correct. The most appropriate treatment depends on the use to which the information is to be put: cash management or budgeting scarce resources. Modern accounting systems can track both cash flows and costs. But if one number is to be singled out as *the* characterization of an event, the other must be assigned secondary status.

only criterion for judging the rightness of the system itself is whether it produces information that is relevant to the needs of the user. The design, structure, and standards of an accounting system are governed by the intended use of the information produced by the system. In accounting, form follows function.

If the budgetary accounting system is used primarily to track the annual cash needs of the government, then budget outlays ought to measure all disbursements of money in a fiscal year, and the deficit ought to measure the federal borrowing requirement for that fiscal year. In this case, in which the accounting system supports the function of cash management, the old accounting for loan guarantees is correct. Cash is needed only when a guarantee has to be honored with a payment. The appropriate measure of outlays is the amount of cash paid, and the appropriate time for recognizing it is when the amount is paid.

If, by contrast, the accounting system is intended to support decisions about the allocation and source (taxes now versus taxes later) of federal financial resources, then a different budgetary focus is required. In this case, budget outlays ought to measure irrevocable uses of federal financial resources when those uses occur. Similarly, the deficit should measure the long-term financing requirements of the use of resources in the current period. If the budgetary accounting system is intended to support allocation decisions, then the new treatment of guarantees is correct.

In identifying "right" accounting treatments of particular activities, therefore, one must acknowledge that a right choice--and there may be more than one--is dictated by the intended use of the information produced. Within the subset of systems that are appropriate to the decisionmaking process, cost and feasibility are also important considerations. Until the reason for measurement is specified, no basis exists for designating a particular accounting treatment as right or wrong. Once the purpose of measurement is fixed, the standards and applications to particular activities and transactions follow logically, if not easily. At the very least, an authoritative declaration of intended use sharply reduces the range of appropriate accounting treatments.

IDENTIFYING THE PRINCIPAL USES OF THE BUDGET

So much for the good news about getting federal budgetary accounting "right." The bad news is that the U.S. government has never declared, unambiguously and definitively, the intended purpose of federal budget information. No single principle defines what the federal budget and its key components of receipts, outlays, and the deficit are intended to measure. Perhaps this ambiguity is unavoidable. In practice, the budget is used for many purposes: to measure federal borrowing requirements; to assess and modify fiscal policy; to make decisions about the allocation of federal resources; to assess the effects of federal policies on intergenerational redistribution; to assure compliance with applicable laws; to measure and constrain the size of government; and to assess federal financial performance. Each of these uses requires different accounting treatments, at least for some activities. Reducing these many uses to one may be impossible.

Twenty-five years ago, the President's Commission on Budget Concepts promulgated a historic and heroic narrowing of the number of primary uses.[1] The commission explicitly rejected the notion of different budgets with different bases of accounting for different purposes. Instead, it recommended a single ("unified") budget that was to include all federal activity. The commission endorsed the use of supplementary accounting tabulations for such purposes as managing the Treasury's cash needs, accounting for national income, and analyzing the effects of the federal budget on financial markets, but it recommended against any supplement that might constitute a rival to the unified budget.[2]

The commission succeeded in narrowing the principal uses of the budget to two. In the commission's judgment, budgetary accounting must be structured to support the processes for two types of decisions:

- Allocative decisions about the use of federal financial resources, and

1. *Report of the President's Commission on Budget Concepts* (October 1967), especially Chapter 2, "Purposes of the Budget of the United States."

2. *Report of the President's Commission*, p. 22.

- Fiscal policy decisions to promote economic stability and growth.

The commission suggested that the budgetary accounting for federal activities could serve both these purposes by focusing on what it repeatedly called the "economic impact" of an activity.[3] That is, the budgetary accounting to be used should characterize an activity in outlays and the deficit based on the magnitude and timing of its economic impact.[4] By "economic impact," the commission apparently meant the effect on aggregate demand in the economy.

A notable feature of the commission's recommendation is that implementation requires general agreement about the economic impact of a federal activity. In the late 1960s, when the commission was carrying out its work, something approaching a consensus existed among analysts as to the effect of various federal transactions on aggregate demand. Since then, the weak consensus has been largely replaced by competing theories of the economic impact of various federal actions. The effect of every transaction is not in dispute, but the effects of many are. An implication could be that where estimated economic impacts differ, the accounting treatment of a transaction should also differ, depending on the user's preferred macroeconomic theory. An attempt to comply fully with the "economic impact" rationale today would undermine the commission's concept of a single, unified budget.

The ambiguity in the accounting implications of the commission's recommendations on the principal uses of the budget should not be overemphasized, however. The macroeconomic effects of most federal transactions are not in dispute, nor does every federal transaction require a different accounting treatment for fiscal policy and allocative decisions. In the case of loan guarantees, for example, the new treatment is consistent for the most part with both the fiscal and allocative decision processes. The commission succeeded in reducing a number of budget uses to secondary status by elevating fiscal policy and the allocation of resources to primary status. Accounting treatments that are

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3. *Report of the President's Commission*, pp. 12-13, 18-19.

4. The commission recommended that the accounting for receipts should also be guided by "economic impact."

inconsistent with both of these uses may be valuable to some users of the budget, but they have no claim to primacy from the President's Commission on Budget Concepts.

For deposit insurance, the commission's report offers guidance that permits some accounting systems to be ruled out. The report leaves open the choice between alternatives that are consistent with either the allocative or fiscal purposes of the budget, but not both. That selection must be based on a judgment by users as to which accounting produces the most useful information.

CHAPTER III

CURRENT BUDGETARY ACCOUNTING FOR DEPOSIT INSURANCE

In analyzing alternative accounting systems, current practice is more than an option: it is the starting point for change. Therefore, before considering other options, one must understand and evaluate the accounting system now used for deposit insurance in the budget.[1]

The current system or, more accurately, systems of accounting for deposit insurance provide two general types of financial information:

- Primary budgetary data that are combined to calculate aggregate budget outlays, receipts, the deficit, and budget authority; and

- Supplementary data that, though included in the budget document and often central to budget decisions, do not directly affect total outlays or the deficit.

The primary focus of budgetary accounting for spending programs is outlays. The priority afforded the data on outlays reflects the use of the deficit as the "bottom line" indicator of federal financial performance. The corresponding bottom line for a particular activity consists of net outlays from all accounts that conduct such activity.

A secondary focus of the primary data is budget authority--the authority the law grants to agencies to enter into obligations that will result in outlays. Although budget authority at the account level is combined to arrive at a budget total, its various forms (authority to spend the proceeds of borrowing, authority to spend collections or receipts,

1. References to budgetary accounting information are to those data and supporting schedules provided in the annual *Budget of the United States Government* prepared by the Office of Management and Budget (OMB). Congressional budgetary accounting systems are consistent in concept with those used by OMB, but in some respects are less detailed.

contract authority, and appropriations) render the budgetwide total for budget authority difficult to interpret.

Supplementary accounting data in the budget measure the financial performance of commercial-type programs. These data are not aggregated into budget totals. Supplementary data on deposit insurance are prepared using a for-profit, proprietary accounting system that focuses on earnings, losses, and changes in the assets and liabilities of the deposit insurance funds.

This chapter describes and evaluates the primary and secondary accounting information reported in the budget document for deposit insurance. All existing accounting systems are found to be significantly deficient in their ability to support federal decisions about fiscal policy and allocating resources with relevant, useful information about the cost and macroeconomic consequences of federal deposit insurance.

PRIMARY BUDGET INFORMATION

Budgeting requires both macro and micro financial information. For setting limits and overall performance goals, primary budgetary information must be aggregated into manageable totals. For allocating available resources among the activities and individual programs that make up the whole of government, budgeting also requires more detailed financial information. Two levels of disaggregation are available for deposit insurance: the sum of all deposit insurance accounts, and the individual accounts themselves.

Aggregate Measures in the Budget

The two bases of accounting are cash and accrual. Budget receipts, outlays, and the residual deficit or surplus are accounted for essentially on a cash basis.

Important exceptions to cash-basis accounting in the budget are interest on the public debt and the cost of subsidizing credit transactions, both of which are accounted for on an accrual basis. An

accrual system attempts to depict the effects of events when the event occurs rather than when cash is paid. There are as many forms of accrual accounting as there are definitions of "events." For example, credit reform defines the event as the disbursement of direct or guaranteed loans. The event for interest on the public debt is the passage of time. The relevant event depends on the object of measurement and the intended use of the information.

The use of a cash basis of accounting in the budget means that, for the most part, both the receipt and outlay sides of the budget measure cash flows when the federal government pays out or receives money. In projecting future budget totals, cash flows are recognized in the year in which they are expected to be received or disbursed by the government.

For most years since deposit insurance was established in 1933, collections have exceeded annual federal cash disbursements. In the 1977-1985 period, for example, deposit insurance reduced the annual budget deficit on average by more than $1 billion per year (see Table 3). In 1991, however, federal deposit insurance is expected to contribute close to $100 billion to the federal deficit. This is the amount by which the outlays of all deposit insurance programs to resolve insolvent institutions exceed agency collections from insurance premiums, interest on invested balances, and sales of acquired assets.[2]

Although deposit insurance currently adds to the deficit, CBO budget projections indicate that by 1995, deposit insurance will again generate annual cash inflows in excess of outflows (see Figure 1). The amount of the reduction in the deficit attributable to insurance is expected to exceed $40 billion per year at its peak. This swing in net outlays for deposit insurance is large in relation to the total federal deficit, estimated to be about $300 billion in 1991. Deposit insurance, therefore, has significantly affected the actual and projected path of the federal government's financial bottom line.

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2. Interest earned from the Treasury is an intragovernmental payment that has no effect on the overall deficit.

Program Cash Flows and the Deficit: The Bank Insurance Fund in 1990

Aggregate net outlays are the sum of net outlays for individual programs. Budget accounting at the program level for deposit insurance calculates net outlays from gross outlays and offsetting collections.

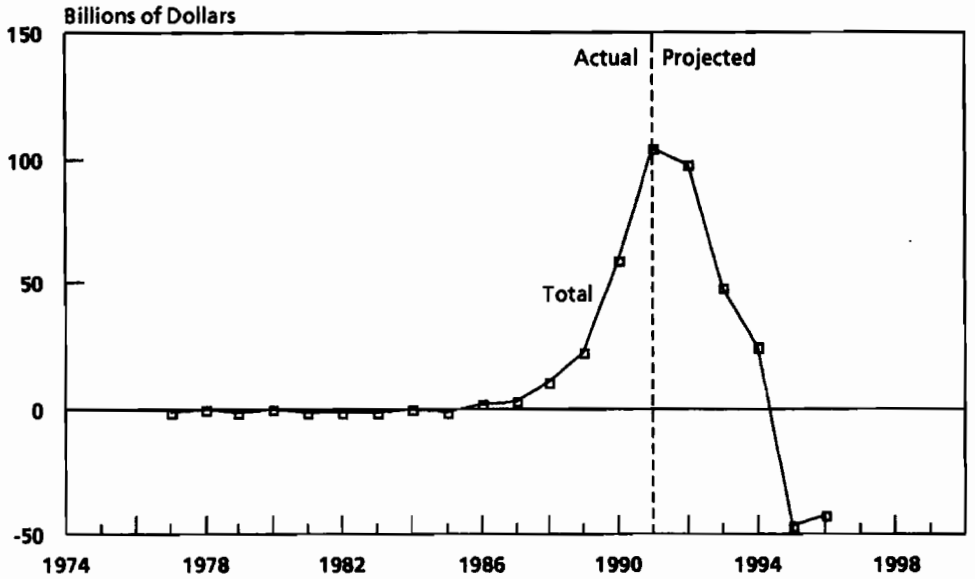
TABLE 3. NET OUTLAYS FOR FEDERAL DEPOSIT INSURANCE, 1977-1996 (In millions of dollars)

	Banks	Thrifts	Credit Unions	Total
		Actual		
1977	-852	-424	-19	-1,295
1978	-567	-404	-14	-985
1979	-1,218	-489	-26	-1,733
1980	-922	553	-11	-380
1981	-1,726	373	-21	-1,374
1982	-1,440	-591	-40	-2,071
1983	-613	-452	-80	-1,145
1984	-248	-562	-34	-844
1985	-1,942	614	-815	-2,143
1986	705	1,060	-248	1,517
1987	-1,438	4,767	-198	3,131
1988	2,146	8,084	-222	10,008
1989	2,846	19,237	-43	22,041
1990	6,429	51,847	-44	58,232
		Projected		
1991	12,600	102,800	-100	115,300
1992	4,100	93,300	-120	97,280
1993	-2,300	49,700	-75	47,325
1994	-3,600	28,200	-50	24,550
1995	-4,100	-42,800	-50	-46,950
1996	-5,900	-36,800	-50	-42,750

SOURCE: Congressional Budget Office using data from the Office of Management and Budget. Data for 1991 through 1996 are CBO projections.

NOTE: Includes outlays for the Bank Insurance Fund, the Savings Association Insurance Fund, the National Credit Union Share Insurance Fund, the Resolution Trust Corporation (RTC), and the Federal Savings and Loan Insurance Corporation (FSLIC) Resolution Fund. The tabulation does not count the funds provided by the Resolution Funding Corporation (REFCORP) and the Financing Corporation (FICO) to the RTC and FSLIC, respectively, as offsetting collections.

Figure 1.
Total Net Outlays for Deposit Insurance, 1977-1996



SOURCE: Congressional Budget Office using data from the Office of Management and Budget. Data for 1991 through 1996 are CBO projections.

NOTE: Funds provided by the Financing Corporation and the Resolution Funding Corporation are treated as offsetting collections.

This accounting can be seen in the budgetary data for the Bank Insurance Fund (BIF), which is fairly typical of the federal insurance fund accounts (see Table 4).[3] BIF, which insures nearly 70 percent of all insured deposits, is currently experiencing operating losses, but its accumulated reserves have been adequate to meet all of its claims.

The Bank Insurance Fund has two major categories of spending: operating or administrative expenses and acquisitions of assets. Operating expenses reported in Table 4 include salaries, rent, supplies, utilities, travel, and other expenditures necessary to carry on the in-

3. Several complicating differences in detail exist at present. The Savings Association Insurance Fund's administrative expenses are currently paid by the Federal Savings and Loan Insurance Corporation Resolution Fund, which is also receiving a portion of the insurance premiums paid by SAIF members. The National Credit Union Share Insurance Fund is currently financed by interest earned on reserve balances, rather than annual insurance premiums. This reserve consists of deposits made by insured credit unions equal to 1 percent of member share accounts. The fund invests this reserve in Treasury securities.

surance fund's activities. The capital assets BIF acquires include money paid directly to protect depositors in failed institutions. One way the insurance agencies provide such protection is to pay off the insured depositors and seize the assets of the insolvent institution. Thus, the category of capital assets acquired is the amount obligated for this purpose. It includes both the estimated market value of assets in the failed depository and the pure loss incurred in paying off depositors. For example, the authorities might pay $100 million to depositors and recover $75 million in assets, for a loss of $25 million.

TABLE 4. PRIMARY BUDGET DATA FOR THE BANK INSURANCE FUND, 1990-1992 (In billions of dollars)

		Projected	
	1990	1991	1992
Obligations			
Operating expenses	0.5	0.3	0.3
Capital assets acquired	13.8	21.4	15.4
FFB interest expense	0.0	0.1	0.5
Total	14.3	21.8	16.3
Offsetting Collections			
Premium assessments	-2.6	-5.1	-6.8
Asset recoveries	-3.7	-3.7	-5.1
Interest on Treasury securities	-1.0	-0.5	-0.3
Total	-7.3	-9.3	-12.2
Excess of Obligations Over Collections	7.0	12.6	4.1
Decrease in Unpaid Obligations	-0.6	0.0	0.0
Net Budget Outlays	6.4	12.6	4.1

SOURCE: Congressional Budget Office using data from the Office of Management and Budget. Data for 1991 and 1992 are CBO projections.

NOTE: Net outlays were financed largely by liquidating investments in Treasury securities in 1990. The Bank Insurance Fund (BIF) is projected to finance its outlays by borrowing from Treasury's Federal Financing Bank (FFB) beginning in 1991. Hence, FFB interest expense is reported in 1991 and 1992. In addition, the BIF redeemed $3.6 billion in debt outstanding to the public and issued $3.5 billion in new notes in 1990. The $0.1 billion difference for debt retirement is not a budget outlay. Total cash outlays in 1990 therefore were $0.1 billion greater than budget outlays, or $6.5 billion.

Capital assets acquired in this case would be reported as $100 million in this budget schedule.

This spending is reported on an obligations basis, which means it is recognized in these schedules when funds are obligated rather than when payment is made. Thus, BIF's 1990 total obligations were $14.3 billion. About 95 percent of these obligations were made to acquire assets and otherwise honor the federal guarantee of insured bank deposits. Acquisitions of assets are projected to increase significantly in 1991. The interest expense in 1991 and 1992 reflects projected borrowing by BIF to meet its obligations.

The primary budget data reported in Table 4 also include money collected by the insurance fund with which it pays current and future claims, to the extent that these resources are adequate. Collections from insurance premiums, asset sales, and interest on accumulated premiums provided $7.3 billion in financing in 1990. These proceeds are treated as negative outlays, or offsetting collections (they are subtracted from obligations in deriving outlays), rather than as receipts.[4]

The fund's offsetting collections of $7.3 billion leave an excess of obligations over collections of $7 billion. Budget outlays, however, were limited to $6.4 billion because unpaid obligations--accounts payable-- were permitted to increase by $0.6 billion. Budget outlays were the fund's contribution to total federal outlays and the deficit. Net outlays for BIF are projected to peak in 1991 at about $13 billion.

Budget Authority and Budgetary Control

Primary budget data also include information on the availability and use of budgetary resources, such as the authority to borrow and the appropriation of funds to the account. For discretionary programs, the appropriation process limits--in advance--the use of federal financial resources to amounts appropriated by law. For mandatory programs,

4. Treating these proceeds as negative outlays reduces both outlays and federal receipts compared with the alternative of classifying these flows as governmental receipts. The budget deficit is unaffected by the offsetting collection treatment, however, because the increase in receipts from reclassification would exactly equal the increase in outlays.

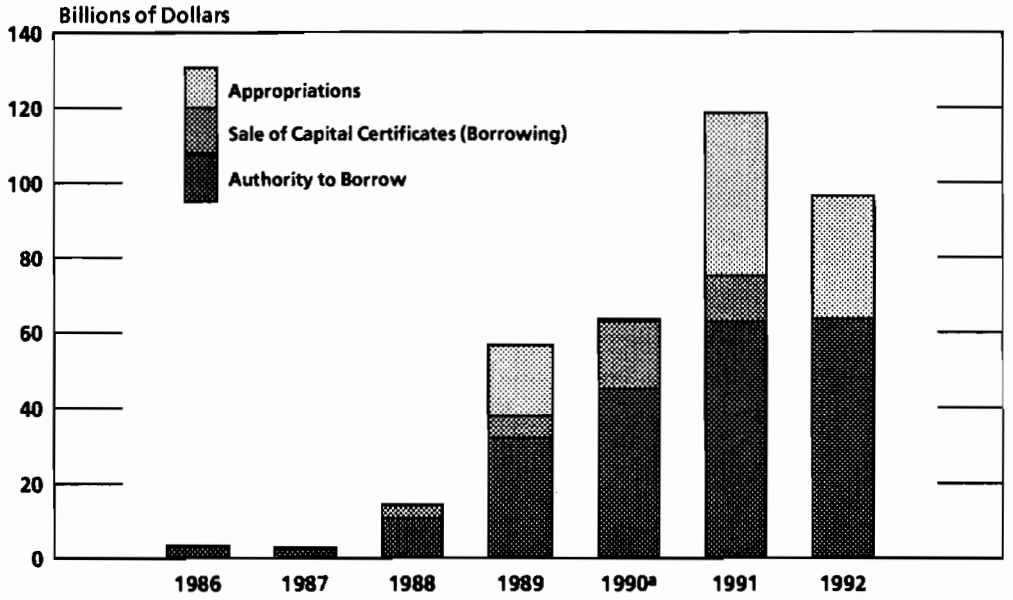
the budget records the authorized use of budgetary resources, but the appropriation process imposes no advance limitation. Instead, funds are made available as needed. Consumption of resources by these programs can be controlled only through legislated changes in authorized benefits, including changes in eligibility criteria.

Federal deposit insurance, as currently structured, is a mandatory program that the authorization process controls. When an insured depository institution fails, the federal government is bound to protect insured depositors against loss. To meet the funding requirements of this commitment, the insurance funds have been created by statute as revolving funds and have the authority to spend insurance premiums, interest, and the proceeds of the liquidations of assets. If these sources are insufficient, the federal government is still responsible for the shortfall.

The first line of support is to permit the fund to borrow from the Treasury. Exercise of this authority is reported in the budget as budget authority. Presumably, debts incurred under borrowing authority are to be repaid from future premiums and proceeds of asset sales. FSLIC, for example, borrowed substantial sums from the Federal Home Loan Banks, the Treasury, and insured institutions before its demise in 1989. When, as occurred in that case, the excess of obligations over collections becomes overwhelming, the government has no choice but to appropriate general funds to cover losses. These appropriations are also scored as budget authority. In addition, appropriations to repay debt must also be provided, if the resources of deposit insurance funds are insufficient to do so. These appropriations to repay debt are not included in budget authority because this use was reported when the funds were borrowed and spent. Similarly, when the insurance fund repays borrowings, this transaction does not add to outlays, because outlays were recorded when the proceeds of the borrowing were disbursed.

Budgetary resources of the insurance funds include the authority to borrow and appropriations (but not appropriations to repay debt). The total budgetary resources provided by the federal government to

Figure 2.
Annual Budgetary Resources for Deposit Insurance, 1986-1992



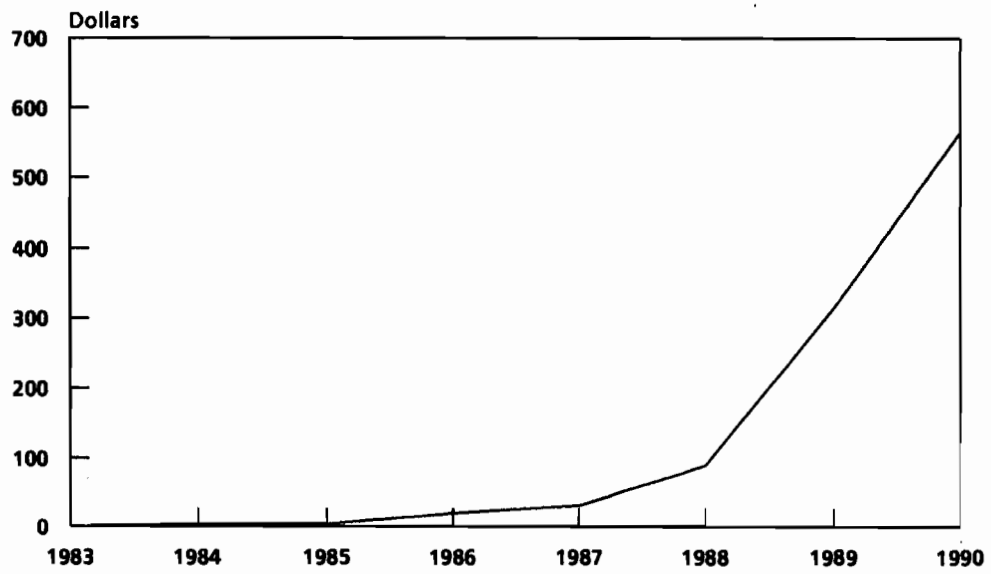
SOURCE: Congressional Budget Office using data from the Office of Management and Budget. Data for 1991 and 1992 are estimates.

NOTE: Budgetary resources excluding insurance premiums and interest and the proceeds from asset sales.

a. Includes appropriation of $0.7 billion.

deposit insurance during the 1986-1992 period are shown in Figure 2. Most of these resources have been provided to support FSLIC or its successors. Those resources designated in the figure as coming from the "sale" of capital certificates were borrowed from the public by the insurance funds through the Financing Corporation and the Resolution Funding Corporation. The magnitude of these budgetary resources, though huge, is difficult to fathom in the aggregate. Figure 3 shows these budgetary resources on a cumulative per capita basis for 1983 through 1990. At the end of 1990, these resources had accumulated to $565 per person. CBO's latest estimate of the present value of the loss to the government, which is a different concept than budgetary resources provided, from FSLIC exceeds $200 billion, or more than $1,000 per person.

Figure 3.
Cumulative Per Capita Budgetary Resources for Deposit Insurance, 1983-1990



SOURCE: Congressional Budget Office using data from the Office of Management and Budget and the *Economic Report of the President* (February 1990).

NOTE: Budgetary resources excluding insurance premiums and interest and the proceeds from asset sales.

SUPPLEMENTARY BUDGET INFORMATION

At the program level, federal budgetary accounting includes measures of financial condition and performance for funds that conduct "commercial-type" activity such as deposit insurance. The two major reports on financial performance included in the budget document for deposit insurance are the statement of financial condition, or balance sheet, and the revenue and expense statement. Both of these statements for BIF are shown in summary form as Tables 5 and 6.

Balance Sheet

Following for-profit accounting practice, the balance sheet consists of assets (or claims on others held by the insurance fund) and liabilities (claims on the insurance fund held by others). This statement of condition shows claims held and owed by the insurance fund at a single point in time--the end of the fiscal year. BIF's two major assets are Treasury securities, accumulated over time from the excess of deposit

TABLE 5. BUDGET STATEMENT OF FINANCIAL CONDITION FOR THE BANK INSURANCE FUND, 1989-1992
(In billions of dollars)

	1989	1990	Projected 1991	Projected 1992
Assets				
Accounts Receivable	0.4	0.4	0.4	0.4
Treasury Securities	15.2	8.5	5.0	5.0
Property and Equipment	0.1	0.1	0.2	0.3
Other Assets	5.3	8.6	12.9	12.6
Total	20.9	17.7	18.5	18.3
Liabilities				
Accounts Payable	0.7	1.0	0.7	0.7
Intragovernmental Debt (Debt to the Federal Financing Bank)	0.0	0.0	4.2	10.6
Notes to Acquiring Banks	3.1	3.0	7.5	5.2
Liabilities Incurred in Failed Banks	3.1	3.2	4.1	3.1
Total	6.9	7.1	16.5	19.6
Excess of Assets Over Liabilities	14.0	10.5	2.0	-1.3

SOURCE: Congressional Budget Office using data from the Office of Management and Budget. Data for 1991 and 1992 are CBO projections.

insurance collections over deposit insurance expenses, and other assets acquired from failed banks as a consequence of protecting insured depositors. When the insurance authorities pay off the depositors in a bank, or induce another institution to assume liability for these deposits, BIF may acquire either all the assets of the failed bank or the portion of assets that the acquiring institution regards as being of unacceptable quality.

BIF's projected holdings of these two types of assets are headed in opposite directions. Treasury securities are expected to decline this year, and other assets are expected to surge. These changes reflect the expectation that BIF will have to resolve a significant number of

TABLE 6. REVENUE AND EXPENSES FOR THE BANK INSURANCE FUND, 1990-1992 (In billions of dollars)

		Projected	
	1990	1991	1992
Revenue			
Interest Earned	1.0	0.5	0.3
Premium Assessments	2.6	5.1	6.8
Other	0.1	0.0	0.0
Total	3.6	5.6	7.1
Expenses			
Incurred in Protecting Depositors	6.7	13.7	10.2
All Other	0.4	0.3	0.3
Total	7.2	14.0	10.5
Net Income or Loss	-3.5	-8.5	-3.4

SOURCE: Congressional Budget Office using data from the Office of Management and Budget. Data for 1991 and 1992 are CBO projections.

bank failures in the near term (more than 150 in both 1991 and 1992). In doing so, BIF will draw down its Treasury holdings and acquire assets in failed banks.

The fund's three major liability categories are debt to the Treasury's Federal Financing Bank (FFB), notes to acquiring banks, and liabilities in failed banks. FFB debt is projected to rise once BIF's Treasury security holdings are drawn down by the continuing need for funds to protect insured depositors. Interest-bearing, short-term notes to acquiring banks are issued by BIF as a cash-conserving inducement for the acquirer to take over a defunct institution. The projected level of these notes rises as projected case resolution activity increases. Liabilities in failed banks are the losses that BIF anticipates from the failure of institutions in the next fiscal year. BIF reports these losses in income, if in its judgment the loss is probable and can be reasonably estimated.

Income Statement

Except for interest earned, which declines as BIF's holdings of Treasury securities diminish, BIF has one source of income (premium assessments) and one major expense (losses incurred protecting depositors). The projected income statement tells a story similar to that of the balance sheet--namely, that costly bank insolvencies are anticipated. As a result, operating losses rise.

The losses BIF incurs feed back onto the balance sheet because these losses have to be financed either by drawing down assets or by incurring additional liabilities. Both of these changes have been noted in the statement of financial condition. By 1992, these losses will have reduced assets and increased liabilities to the point that the fund's acknowledged liabilities will exceed the book value of assets.

Such a projection of "negative net worth" has different implications for a federal deposit insurance fund than for a private firm. From the viewpoint of private accounting standards, this projection implies that BIF will be insolvent or bankrupt in 1992. For a private firm, this condition suggests that the entity will be forced to default on com-

mitments and terminate its activity. Indeed, some observers have already concluded that BIF's financial condition is "precarious," approaching "insolvency," that this condition implies financial "weakness" and an impaired ability to function, and that steps must be taken immediately to prevent this development.

Although these conclusions would be warranted for a private firm, an excess of booked liabilities over recognized assets has no such implications for a federal deposit insurance fund. The ability of the deposit insurance authorities to carry out their duties will not be impaired by an excess of liabilities over assets (as defined in for-profit accounting) so long as the insurance fund can borrow from the Treasury and the Treasury can borrow from the capital markets. Inasmuch as the federal government's ability to borrow is not constrained by the accumulated losses of the insurance funds, these funds will be able to carry on their functions. BIF can continue to meet its obligations indefinitely by borrowing.[5]

The relevant question for deposit insurance is whether the income from premiums over the long term will be sufficient to cover the losses from failed institutions. This question is not addressed in the reported balance sheet because some assets and liabilities are missing under current accounting. The most important missing asset is the present value of future deposit insurance premiums. Under for-profit accounting, future income cannot be recognized until earned. For federal deposit insurance, however, the division of cost bearing between the insured institutions and general federal funds depends on the ability of future premium income to retire debt incurred in meeting the cost of deposit insurance. To assess the long-term self-sufficiency of the fund, expected future income needs to be recognized on the balance sheet along with the missing liabilities.

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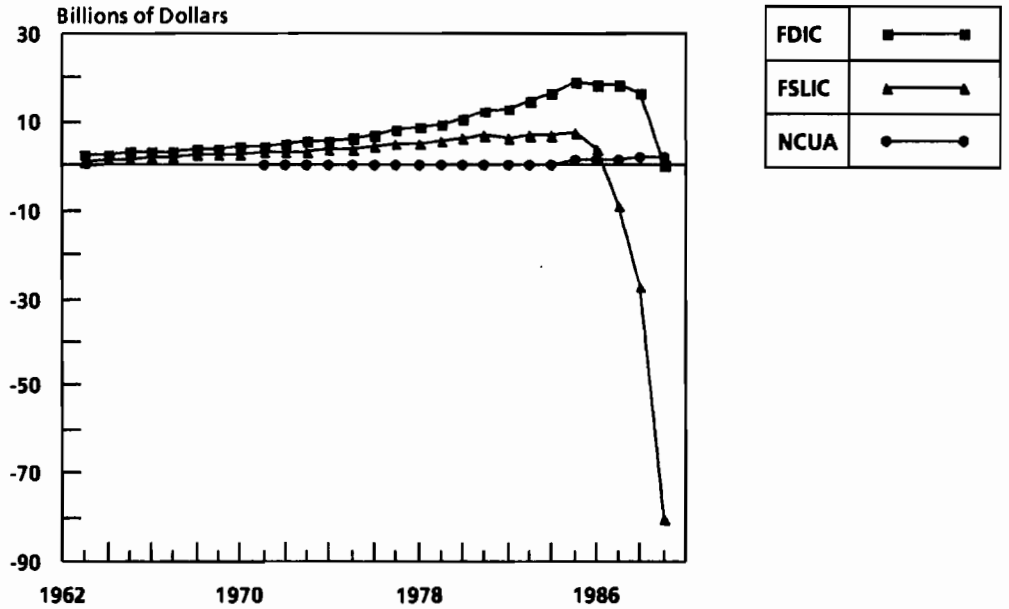
5. As of May 1991, the Federal Deposit Insurance Corporation has a $5 billion line of credit with the U.S. Treasury. In addition, FIRREA granted the FDIC authority to issue other obligations as needed, up to a limit of nine times the excess of fund assets over liabilities, based on the most recent audit by the General Accounting Office. The difficulty with this variable borrowing limit is that it will decline over time as losses occur. The longer the FDIC postpones exercising this authority, the smaller the amount that can be borrowed under this provision. For a clear discussion of BIF's projected liquidity needs, see testimony of L. William Seidman, Chairman, Federal Deposit Insurance Corporation, before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, April 11, 1991.

One of these missing liabilities is the obligation to pay a previously agreed-upon price, or accept a "put," for assets obtained by the acquirer of insolvent institutions. These asset puts arise because the insurance authorities address some insolvencies by selling the insolvent bank to a healthy one. Under many of these "purchase (of assets) and assumption (of liabilities)" transactions, the purchaser has the right to sell acquired assets to the insurer at a fixed--perhaps face value--price. The insurance fund suffers losses from the excess of the put price over the market value of the asset. The value of these obligations is an important factor in assessing the self-sufficiency of the fund, and should be recognized in a statement that attempts to measure the fund's financial condition.

Figure 4.
FDIC, FSLIC, and NCUA Equity (Assets minus Liabilities), 1963-1989

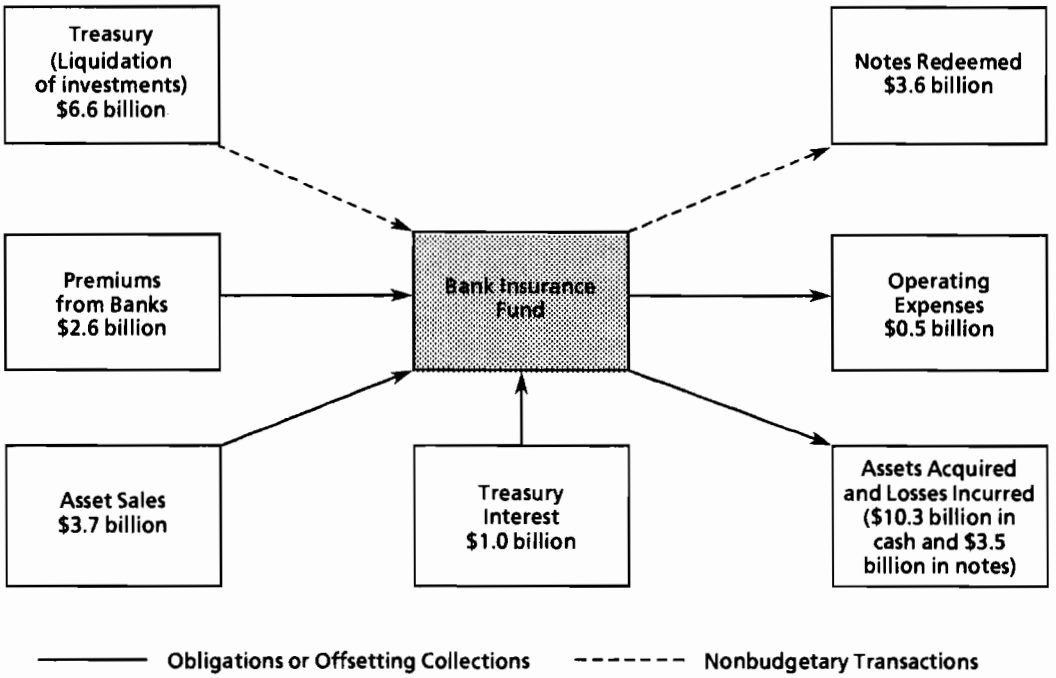


SOURCE: Congressional Budget Office using data from the Office of Management and Budget.

NOTE: FDIC = Federal Deposit Insurance Corporation; FSLIC = Federal Savings and Loan Insurance Corporation; NCUA = National Credit Union Administration.

The most important missing liability, however, is the obligation to protect insured depositors in banks whose failure the insurance authorities have not yet recognized. Under for-profit accounting used by the FDIC, a loss is not recognized until it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. This rule leaves substantial discretion to the insurance authorities in recognizing losses. In recent years, the General Accounting Office (GAO)--the auditor of the federal deposit insurance funds--has been pressing the Federal Deposit Insurance Corporation to increase the recognition

Figure 5.
Financial Flows To and From the Bank Insurance Fund, Fiscal Year 1990



SOURCE: Congressional Budget Office using data from the Office of Management and Budget.

NOTE: Net budget outlays ($6.4 billion) = obligations ($14.3 billion) less offsetting collections ($7.3 billion) less the change in obligated balance ($0.6 billion).

of losses, including those for institutions whose failure the GAO considers probable but with whom the FDIC has not yet begun negotiations for assistance.[6] In unaudited statements for calendar year 1990, the FDIC recognized $3.4 billion for losses on failures expected in 1991. The GAO urged recognition of about twice as much in losses, which it regarded as probable and capable of reasonable estimation.[7]

In sum, the projected excess of liabilities over assets for BIF means only that current assets (excluding future insurance premiums) will be less than recognized liabilities (excluding losses that some observers believe can be anticipated) at the end of fiscal year 1992. It does not indicate that the fund's ability to protect depositors will be impaired, so long as it is permitted to finance its cash needs through borrowing. Nor does this development necessarily imply that the current and future costs of deposit insurance will exceed the resources available to the fund from insurance premiums.

The current business-type accounting system used to assess the insurance fund's financial condition measures its resources and obligations recognizing only those transactions that have already occurred and a portion of those that can be anticipated. This system, therefore, does not assess the long-run ability of the insurance funds to operate without the use of tax-based funds.

The calculated excess of liabilities over assets using for-profit accounting standards is of some limited value, however. For example, in the case of FSLIC, these data clearly confirmed the collapse of the system, after the fact (see Figure 4 on page 29).

The multitude of financial detail provided in the budget can be assembled into a complete picture of the financial flows to and from a deposit insurance account. The financial activity of the Bank Insurance Fund for 1990 is depicted in Figure 5. Offsetting collections and obligations, minus the increase in obligations due ($0.6 billion), sum to the

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6. General Accounting Office, "Audit Opinion, Statements of Financial Position, Bank Insurance Fund, December 31, 1989," B-114831, pp. 1-2; and *Washington Post*, April 25, 1991, pp. E1-E2.

7. Statement of Charles A. Bowsher, Comptroller General of the United States, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, April 26, 1991.

value of net outlays, or $6.4 billion. The $3.5 billion in outlays financed with notes (debt) corresponds to budget authority of $3.5 billion. The nonbudgetary flows reflect the redemption of outstanding notes and the drawing down of investments with the Treasury during 1990.

EVALUATION

CBO has expressed serious reservations about the way deposit insurance is treated in the budget for purposes of calculating the budget deficit.[8] The existing supplementary budget accounting information is also fundamentally deficient as a means of measuring the cost or macroeconomic effects of deposit insurance.

Primary Budget Data

In CBO's judgment, the current accounting for net outlays and the deficit does not meet the information needs of either fiscal policy or allocating resources. From the standpoint of fiscal policy, the current accounting provides a misleading indication of the timing of the effects of deposit insurance on aggregate demand. From the standpoint of federal resource allocation, the current treatment does not accurately indicate the cost of deposit insurance in a timely manner.

In both cases, a major distortion arises from including insurance fund purchases and sales of assets in net outlays. The year-by-year outlays of the insurance agencies depend crucially on the pace at which the insurance authorities are able to resolve insolvencies and acquire assets rather than the point at which the insolvencies occur. Eventually, most of the hundreds of billions of dollars in outlays will reappear in the budget as collections from the sale of these same assets. Neither

8. Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1992-1996* (January 1991), pp. 99-104; *The Economic and Budget Outlook: Fiscal Years 1991-1995* (January 1990), pp. 72-75; and *The Economic and Budget Outlook: An Update* (August 1989), pp. 10-11, 40-44.

the billions of dollars paid now nor the billions of dollars to be collected in the future correspond to the anticipated effects on aggregate demand.[9] Including these amounts in federal outlays when cash changes hands fundamentally misstates the timing of their macroeconomic effect.

Similarly, the annual cost to the government from deposit insurance bears no relation to single-year dollar outflows or inflows from these transactions. Just as the spending numbers on outflow for one year overstate the cost of deposit insurance for that year, the net inflows for another year understate the cost.

Excluding Net Outlays for Deposit Insurance from the Deficit

One means of addressing the distorting effects on the deficit of the year-to-year imbalances in cash flows for deposit insurance is to give special prominence to a measure of the federal deficit that excludes all federal deposit insurance outlays and collections. As an interim step, CBO has encouraged the use of this measure where the deficit is intended to gauge the macroeconomic effects of federal spending. This exclusion, by lowering the deficit more than $100 billion in 1991 and raising it by more than $45 billion in 1995, produces a smoother deficit series for the period since 1987 (see Figure 6).

One difficulty with this interim adjustment is that it reduces the deficit by the full amount of net outlays for deposit insurance. This adjustment excludes too much. For the purposes of fiscal policy and resource allocation, it is desirable to exclude from the current deficit the outlays--or working capital--to acquire assets temporarily from insolvent institutions that eventually will be recovered when the acquired assets are sold. The working capital transactions involving equal-value exchanges of financial claims do not change aggregate demand or impose costs on the government. For decisions about allocating resources, it may be desirable to exclude those outlays for deposit insurance losses that are paid from deposit insurance premiums.

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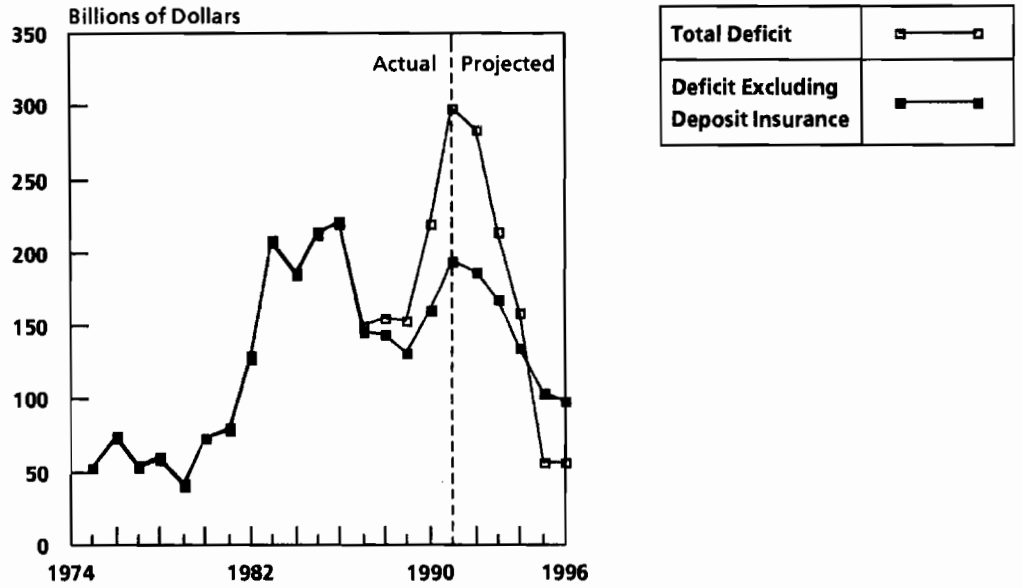
9. See a forthcoming Congressional Budget Office report on the macroeconomic effects of the savings and loan debacle. See also G. Thomas Woodward, "FSLIC, the Budget, and the Economy," *Public Budgeting & Finance*, vol. 9, no. 3 (Autumn 1989), pp. 87-93.

It is inappropriate, however, for both fiscal policy and budgeting, to exclude payments that are pure losses. These losses constitute a real cost of deposit insurance and--although they may be funded for a long time through borrowing--they will need to be funded eventually from taxes or reductions in spending for other purposes. Similarly, outlays for administrative expenses both have an effect on aggregate demand and are a cost to the government of deposit insurance. Finally, this approach encourages the creation of multiple deficits and is at odds with the concept of a single, comprehensive budget.

Budgetary Control

Budgeting, or allocating financial resources to various uses, involves making choices from among alternatives and effecting those choices.

Figure 6.
Total Deficit: With and Without Deposit Insurance, 1975-1996



SOURCE: Congressional Budget Office using data from the Office of Management and Budget. Data for 1991 through 1996 are CBO projections.

To facilitate informed choice and control, the costs of alternatives must be clear and directly related to the action the Congress takes or fails to take.

Under current policy, budgetary accounting for deposit insurance largely involves recording transactions and their effect on the funds: cash flows for the activity, the ex post financial condition of revolving funds, the use of borrowing to finance spending, and appropriations for prior losses. Little here corresponds to budgetary control of deposit insurance. The cash flows, the condition of the funds, and the borrowing reflect transactions that have occurred largely at the discretion of the insurance authorities. Appropriations recognize events that have long since occurred.

Supplementary Budget Data

The supplementary financial information reported in the budget is not highly useful either for assessing the financial condition of the insurance funds (and hence their future cost to the general fund) or for measuring macroeconomic effects. The primary shortcoming of the supplementary accounting systems is that they are driven by transactions conducted largely at the discretion of the insurance authorities. Although the authorities may control the timing of these transactions, the transactions do not limit, or measure in a timely way, the accruing cost of deposit insurance to the federal government.

Financial Condition

The accounting schedules that describe the condition of the insurance funds have too narrow a focus for the purposes of providing a timely measure of the cost of deposit insurance to the government. The statements are restricted--by design--to the present condition of the insurance fund, given past transactions and losses that are probable and subject to reasonable estimation. Losses to the federal government, however, depend also on the magnitude of insolvencies at insured depository institutions--whether or not the fund has recognized these insolvencies--and on the expected future stream of deposit insurance

premiums. That an insurance fund has recognized some unknown portion of the government's liabilities for insolvent institutions is useful only to establish a minimum value of the loss. That all currently collected premiums have been exhausted is not especially significant, if the present value of expected future premiums exceeds current and future expected losses.

Current financial accounting provides a limited measure of the federal financial commitment to deposit insurance and the resources available to meet the commitment. They disclose some information about the static condition of the funds, but little about the government's loss. Nor are the current statements especially useful in predicting the future condition of the funds. For example, the 1990 budget estimated a 1989 loss for FSLIC of $8.2 billion. The actual loss was more than $56 billion.

To move closer to an assessment of the government's cost, two additional measures of the financial condition of the insurance funds would be helpful. One would be the estimated balance sheet, assuming that the insurer has resolved all currently insolvent insured institutions and omitting any recognition of the capitalized value of future deposit insurance premiums. This measure, which stops short of the GAO's preferred balance sheet, would indicate the real "current condition" of the fund. The second measure would be to estimate the excess (or deficiency) of assets over liabilities, recognizing all present and expected future insolvencies and recognizing the present value of future deposit insurance premiums. This step would measure the estimated "permanent condition" of the fund.

Preparing such statements would require a broader focus. Attention must be shifted from the insurance fund to the insured institutions, and from completed transactions to those that can be expected. Some analysts believe that to attempt such statements would be futile. All agree, however, that to assess the current condition of deposit insurance in a manner that is meaningful for federal cost, such a broadened perspective is required.

CHAPTER IV

A CREDIT REFORM APPROACH TO DEPOSIT INSURANCE

The existing budgetary treatment of deposit insurance fails to provide the information that is required for the budget's primary uses: the allocation of resources and fiscal policy. Neither outlays and budget authority nor net income and changes in financial condition measure cost or the fiscal effects of deposit insurance in a timely manner. The primary budget data are misleading because single-period cash flows are not a good indicator of cost or fiscal effect.

One of the lessons of credit reform is that a cash-basis accounting system, which mixes costly transactions with equal-value financial exchanges, will be unable to identify, recognize, or control costs or fiscal effects of activities whose cash flows are spread over many budget periods. For example, mixing current receipts of guarantee fees with outlays to honor old guarantees with the proceeds from the sale of collateral produces a measure of net outlays that is--at best--randomly related to the government's long-term costs of the current period's new guarantees.[1] Similarly, under the current accounting for deposit insurance, all transactions--including payments for wages and salaries, collections of premiums, and purchases and sales of the assets of insolvent institutions--are commingled in a single budget account. Consequently, it is very difficult for a user of the budget to separate the "signal" of the cost from the "noise" of all the other transactions.

Credit reform approaches this clutter of information by separating the cost of a transaction from the other elements, which consist of equal-value financial exchanges and incidental cash flows. The two components are recorded in separate accounts: a program account to recognize costs and a financing account to record all other elements of the transaction. Once an activity is divided into these two components,

1. Congressional Budget Office, *Credit Reform: Comparable Budget Costs for Cash and Credit* (December 1989); and CBO, "An Explanation of the Budgetary Changes Under Credit Reform" (Staff Memorandum, April 1991).

the respective accounts can be distinguished for fiscal policy and budgeting purposes.

The similarities between the credit reform model and the deficiencies of budgetary accounting for deposit insurance suggest that the credit reform approach might be usefully applied to deposit insurance. Despite some obvious parallels between loan guarantees and deposit insurance, however, these two federal activities have some important differences that impede the application of the credit reform approach to deposit insurance.

This chapter identifies some characteristics of deposit insurance that differ from those of loan guarantees and that need to be accommodated if the credit reform approach is to improve the usefulness of budgetary accounting for deposit insurance. After these differences are noted, deposit insurance activity is restated in the accounting terms of credit reform. The results suggest that a pure reform of accounting for deposit insurance may help improve the information provided, but that accounting alone cannot achieve all the results that are expected for credit programs under credit reform.

DEPOSIT INSURANCE AND LOAN GUARANTEES

Deposit insurance and loan guarantees both involve a federal commitment to pay off a borrower's debt in the event that the borrower defaults. The government charges fees--often, in the case of guarantees, and always, in the case of deposit insurance. In both instances, the government retains the right to recover its loss from the defaulting borrower. There, however, the significant program similarities appear to end.

Deposit insurance differs from a loan guarantee in at least three key respects: the nature of the federal commitment, the government's relationship with the borrower, and the flexibility to adjust the fee or premium after the commitment has been made.

Nature of the Commitment

Deposit insurance is a more open-ended, less limited commitment than a guarantee of a fixed-sum loan. With a guarantee, the government commits itself at a specific point in time to guarantee a specific dollar amount for a defined period of time. With deposit insurance, the government commits itself to guarantee unconditionally an unlimited quantity of deposits for as long as the insured institution complies with prescribed regulations, including the payment of the insurance premium. This difference means that in the case of deposit insurance, it is more difficult to know when or how much to recognize as the cost of the commitment. Should the annual budget recognize the losses only for the current year? Or should it recognize the losses for a multiyear period? With a loan guarantee, the loss is more circumscribed in amount and time, and the point at which the guarantee is issued is a more clearly defined basis for recognition.

Controlling costs is also more difficult with deposit insurance than with a loan guarantee. When a limit on the cost of guarantees to be issued in a single year is reached, issues of new guarantees can be halted. No parallel option exists for limiting the cost of deposit insurance. No link exists between a cost ceiling that could be set in the budget process and action by the insurance authorities that would assure compliance with that limit. Such a link is necessary to increase budgetary control over the costs of deposit insurance.

Relationship of Government to the Insured

With a loan guarantee, the government has little association with a borrower after the initial commitment is approved, unless the borrower defaults. Accordingly, once it has committed itself, the government has little influence over the behavior of the borrower as a means of protecting itself against loss. The government's expected loss on a single loan is determined largely by the eligibility requirements for obtaining the guarantee.

With deposit insurance, the relationship between the government and the institution offering insured deposits continues for as long as

insurance remains in effect. An important reason for this ongoing relationship is to enable the insurance authorities to monitor the operations of the insured institution for compliance with regulations designed to protect the insurer against loss. Indeed, for deposit insurance, the cost to the government for a single institution is determined largely by the institution's behavior after coverage is extended, and less so by the institution's characteristics when the insurance is originally granted. If the cost of deposit insurance is to be limited through the budget process, these costs will have to be directly related to some identifiable action that insurance authorities can take as a part of this ongoing regulatory relationship.

Flexibility in Pricing

With a loan guarantee, the fee paid by the borrower is fixed for the life of the guarantee at the time the federal commitment is made. The government does not ordinarily have the option to raise the fee on existing contracts to compensate itself for losses that are higher than expected.

Deposit insurance premiums, by contrast, may be adjusted for currently insured institutions every six months, to reflect losses incurred or expected by the fund. The insurance authorities, however, currently charge insurance premiums that are nominally a flat rate and that vary only slightly with risk. (The higher effective rate on riskier portfolios results from the practice of subjecting entities with higher risk to more intensified surveillance.) Several proposals that would vary the deposit insurance premium explicitly with the risk to the insurance fund are now under consideration.

In sum, the indefinite and open-ended nature of the deposit insurance commitment makes the identification and control of insurance costs more difficult than is the case with loan guarantees. Yet, the insurer's ability to regulate the behavior of the insured and to vary the fees for all insured institutions suggests that budgetary control might be increased, if the relevant costs could be identified in the budget and linked directly to actions that could be taken by the insurance authorities.

DISTINGUISHING COSTLY TRANSACTIONS FROM CASH FLOWS

The first element in implementing credit reform for direct loans and guarantees is to divide all federal credit transactions into two components: cost and equal-value cash flows and financial exchanges. If, for example, the federal government collects a $10 fee now to guarantee a private loan of $100 that will require the government eventually to make a payment whose present value is $25, the government has incurred a loss or cost of $15 on this transaction ($25 minus the $10 fee).[2]

The rest of the cash flows associated with this transaction (the receipt of the $10 fee, the payoff of the guarantee claim, the seizure of the collateral from the defaulting borrower, and the sale of seized assets) are self-financing exchanges of cash and claims on cash. For budgeting scarce resources and formulating fiscal policy, the relevant component of this transaction is its $15 cost, which is the only element counted toward the deficit under credit reform. By focusing on the cost component of the guarantee, credit reform accounting more accurately characterizes the transaction for the primary decisionmaking processes the budget supports: the allocation of resources and fiscal policy.

With credit reform accounting, the costly component of the transaction is recorded in a program account, and the other cash flows are recorded in a separate financing account. Given that only the loss on the transaction is central to the decisionmaking process, the program account alone is used to depict credit activity in the budget. The financing account is reported below the deficit line in the means-of-financing section of the budget. Figure 7 shows the relationship of these accounts to one another.

Below-the-line, nonbudgetary accounts are included in the summary statements of the budget, where they do not affect the budget deficit but are shown to affect the Treasury's borrowing requirement.

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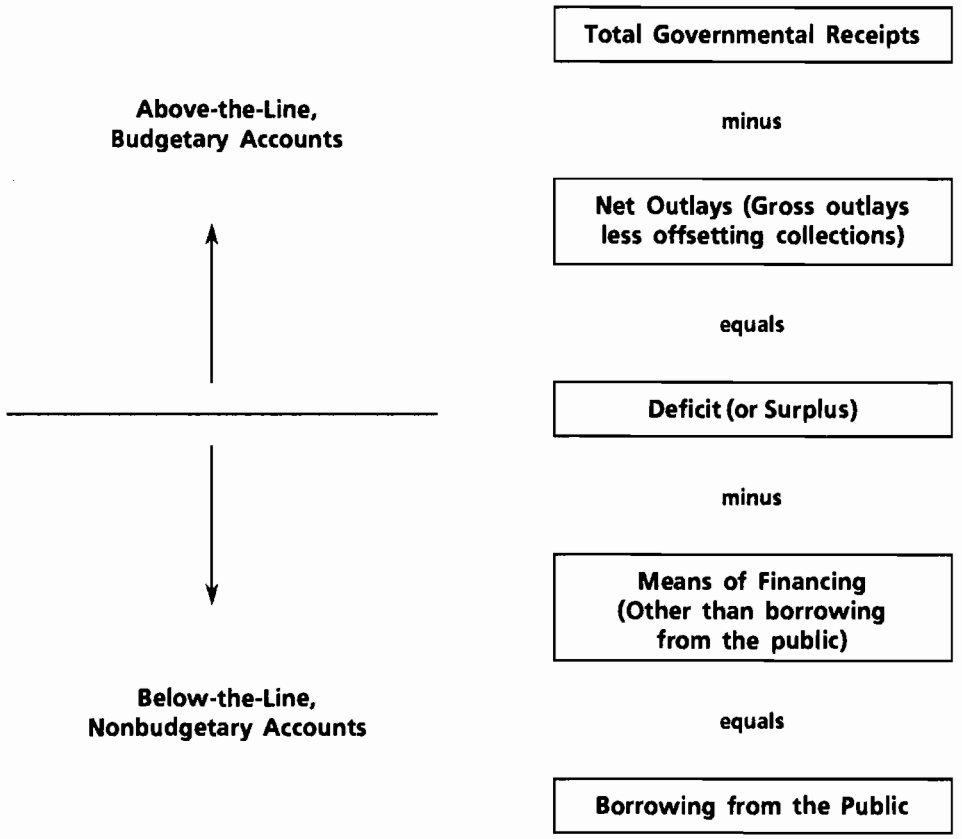
2. Present value refers to the value now of future income or future costs. The present value of future money is calculated by discounting it at the rate of interest at which money could be invested now.

Under credit reform, which is effective in fiscal year 1992, the financing accounts for both direct and federally guaranteed loans will appear only in the means-of-financing section of the budget as a determinant of borrowing from the public. Only the outlays of the program account are included in the deficit.

Moving the financing accounts to the means-of-financing section enables the budget accounting system to focus on the relevant in-

Figure 7.
Above-the-Line and Below-the-Line Accounts in the Budget



SOURCE: Congressional Budget Office.

formation for budgetary and fiscal decisionmaking. By limiting the volume of direct loans and guarantees to those for which an appropriation of the cost component has been provided in advance, credit reform increases Congressional control over these activities. The information on the pure cash-flow component of the transactions is not lost to users of the budget. Rather, these data are carefully recorded, monitored, and reported because of their importance to the secondary budget purpose of managing the Treasury's cash position. Thus, credit reform drives a wedge between the recorded deficit and the government's borrowing requirement, but it enhances the meaningfulness of the deficit for the primary purposes of the budget.

Deposit insurance transactions also have a cost component and an incidental cash flow component. The first step in a credit reform approach to deposit insurance accounting is to separate these components into two accounts. Transactions that constitute a loss to the government and a consumption of budgetary resources must be assigned to the program accounts. Looking ahead, one can anticipate that disbursements for operating expenses and losses, and collections from insurance premiums and appropriations, will appear in the program accounts. The remaining transactions are to be assigned to the financing accounts. The financial flows for deposit insurance, which now are combined in a single budget account, are shown in Figure 8. The categories are all taken from the primary budget schedules discussed in Chapter III.

Classification of Premium Income and Appropriations

With credit reform, the guarantee fees paid by the insured borrower are an important factor in determining the cost to the government of such transactions. The larger the fee, the lower the costs to the government. The receipts from these fees are recorded as collections to the financing accounts.

Figure 8.
Transactions of a Deposit Insurance Fund Under Single- and Two-Account Treatments

Current, Single-Account Treatment

Deposit Insurance Fund	
Disbursements	**Collections**
o Asset acquisitions and losses	o Insurance premiums
o Administrative expenses	o Sales of assets
o Interest paid	o Interest received
	Financing
	o Appropriations
	o Liquidation or accumulation of Treasury securities
	o Borrowing and repayment of debt

Credit Reform, Two-Account Treatment

Program Account	
Disbursements	**Collections**
o Administrative expenses	o Insurance premiums
o Payments to financing account (for losses)	**Additional Sources of Financing**
	o Appropriations

Financing Account	
Disbursements	**Collections**
o Asset acquisitions	o Sales of assets
o Interest paid	o Interest received
	o Payments from program account
	Additional Sources of Financing
	o Liquidation or accumulation of Treasury securities
	o Borrowing and repayment of debt

SOURCE: Congressional Budget Office.

If this credit reform treatment were adopted for deposit insurance, the income from deposit insurance premiums would be credited to the financing accounts, rather than to the program accounts. Doing so could be justified on the grounds that because these funds are not available for general governmental use, their use should not be recorded in an account intended to measure only the cost to the government--the program account.

This study, however, adheres more closely to the current policy of crediting premiums as offsetting collections to an outlay account. Premiums, therefore, are credited to the program account for deposit insurance; when they leave that account, they are thereby recognized as a cost to the government. Thus, the program accounts for deposit insurance have two sources of financing--insurance premiums and appropriations from the general fund.[3]

Costly Cash Flows

The costly, resource-consuming outlays of the deposit insurance funds consist of administrative expenses, interest, and losses on failed institutions. The losses are the excess of insured liabilities, which must be paid, over the assets held by insured, insolvent institutions.

The program account for deposit insurance, therefore, pays for losses and administrative expenses with money from deposit insurance premiums and general fund appropriations. Only two other types of activity need to be classified as costly or not costly to complete the division of activity between the program and financing accounts for deposit insurance: the balancing of premium income and insurance losses over time and the acquisition and sale of capital assets.

3. If premium income was credited to the financing accounts, the program accounts would have only one source of income--appropriations. Accordingly, a program account would report activity only when it received an appropriation for losses to be paid to the financing account. A similar result is achieved through the sponsored-enterprise alternative discussed in Chapter VI.

Imbalances Between Premiums and Losses

During any fiscal year, insurance premiums may be more or less than the loss on failed institutions, even if premium income and losses are equal in the long term. Consequently, the insurance funds will be constantly building up and drawing down investments in Treasury securities and earning interest in the process. A period of unusually high losses may also temporarily (or permanently) exhaust the accumulated premium reserve and force the fund to borrow from the Treasury. In subsequent years, this debt could be repaid from premium collections (or appropriations, if premium income is insufficient). Except for appropriations of general funds, which have already been identified as costly, these temporary imbalances between premiums and losses and the associated buildup and drawdown of reserves are not a cost to the government. Under the credit reform approach to budgetary accounting, changes in reserve balances and the interest earned on these balances would be recorded in the financing account rather than the program account.

Acquisition and Liquidation of Capital Assets

When the insurance funds resolve an insolvent institution, they are likely to acquire some or all of its assets. These assets are held only until the fund can sell them at a price the fund authorities regard as reasonable. Apart from the losses discussed previously, the government bears no cost for the purchase of such assets, the borrowing of funds to finance their acquisition, the sale of the assets, or the repayment of debt. Under the credit reform approach to budgetary accounting for deposit insurance, these transactions would be recorded in the financing account. Figure 8 (on page 44) shows this division of the current single account for the deposit insurance funds into the program (cost) account and the financing account.

An important feature of the credit reform approach is that funds the program account receives from premiums and appropriations are paid to the financing accounts as soon as they are recorded. Thus, this approach implicitly assumes that all the funds the account receives

will be needed now or later to meet deposit insurance losses and administrative costs.

Under this two-account system, the financing account serves as a timing buffer for the budget. The account accumulates and invests premium collections when they exceed current spending requirements, draws on these reserves and borrows when necessary to protect depositors, and repays its debts with future collections. The financing account is intended to be a revolving fund capable of revolving indefinitely because the program account bears all losses from deposit insurance. The consequences of this accounting system for budget outcomes can be seen in the following examples.

Example 1: Collections Exceed Payments

In this example, insurance premiums for the period exceed the immediate cash requirements for deposit insurance. Illustrative federal cash flows for deposit insurance are shown under current policy and with the two-account alternative in Figure 9. The illustration makes the following assumptions:

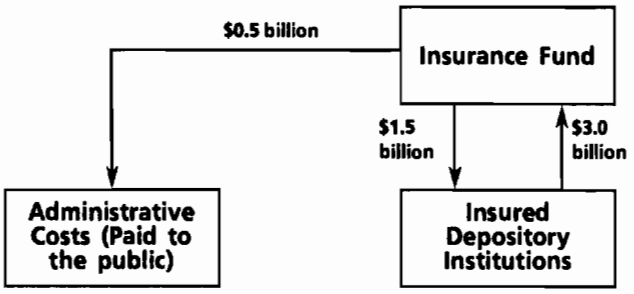
Insurance premiums = $3.0 billion;
Administrative expenses = $0.5 billion;
Outlays for asset acquisition = $1.5 billion; and
No appropriation of general funds.

Under current accounting practices, the excess of collections over disbursements appears in the budget as a negative outlay, which may suggest that "surplus" funds are available for other uses. In fact, however, if the annual premium is set to meet the long-term costs of deposit insurance, these collections will eventually be required to indemnify depositors against loss. The funds can be "loaned" temporarily to other federal activities, but they are already committed to meeting the expected costs of deposit insurance.

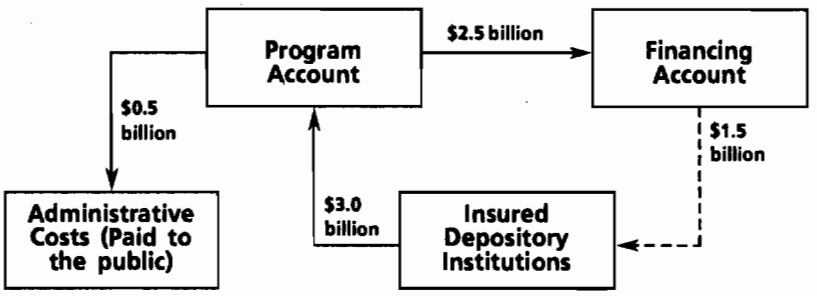
In this example, the $3 billion the insured depository institutions paid to the fund is an offsetting collection to the government, while the

Figure 9.
Illustrative Effects of Deposit Insurance on Outlays and the Deficit Using Single- and Two-Account Treatments: Collections Exceed Payments

Current, Single-Account Treatment[a]



Alternative, Two-Account Treatment[b]



——— Outlays or Collections - - - - - - - Nonbudgetary

SOURCE: Congressional Budget Office.

NOTE: Illustration assumes that insurance premiums = $3.0 billion; administrative expenses = $0.5 billion; outlays for asset acquisition = $1.5 billion; and that there is no appropriation of general funds from the Treasury.

a. Deficit is reduced ($1.5 + $0.5 - $3.0 = -$1.0).

b. Deficit is unaffected ($2.5 + $0.5 - $3.0 = $0.0).

$2 billion ($0.5 billion and $1.5 billion) the fund paid to the public is an outlay under current accounting practices. Deposit insurance thus reduces both budget outlays and the deficit by $1 billion in the current budget period.

Under a credit reform approach, the program account receives the $3 billion in insurance premiums, pays the administrative expenses of the deposit insurance fund ($0.5 billion), and disburses the balance of the premiums ($2.5 billion)--as a reserve for future losses--to the financing account, which has been defined as nonbudgetary. Accordingly, payments from the program account to the financing account appear in the budget as outlays. Collections from insurance premiums are, therefore, offset by outlays and have no effect on total outlays and the deficit. The subsequent investment of the reserve funds by the financing account in Treasury securities is also nonbudgetary and does not affect budget outlays or the deficit (except for interest paid by the Treasury on balances in the financing account, which is not shown in Figure 9).

These alternative treatments provide different measures of the effects of deposit insurance on annual outlays and the deficit. Under current accounting, deposit insurance reduces the deficit by $1 billion. Under the alternative account structure, deposit insurance has no effect on net outlays or the deficit.

The difference between these accounting characterizations of the same events stems from a difference in the focus of measurement. Under current accounting, the focus is on measuring cash flows in each budget period. The alternative aims at measuring the net expected cash flows over a longer term, by assuming that annual premiums are set with a view to meeting the present and future costs of insurance. The preferred choice between these options--as in all accounting practice--should be the alternative that provides the most useful information to the decisionmaking processes supported by the accounting system.

Example 2: Payments Exceed Collections

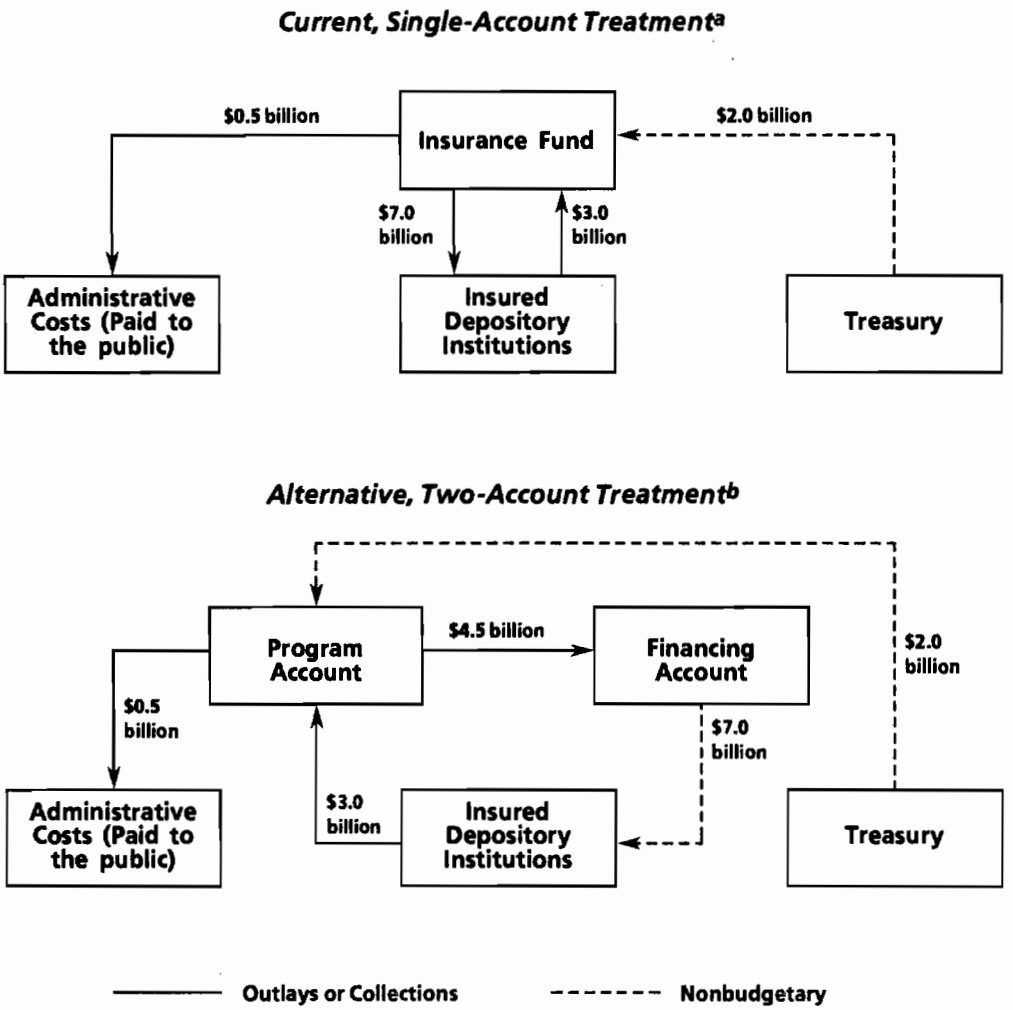
In the next example, shown in Figure 10, collections from current insurance premiums are less than the payments made to protect insured depositors. The example also includes a general fund appropriation to the program account of $2 billion, because current and future premiums are assumed to be less than the payments to be made.

Collections by the government and administrative expenses are the same as in the previous example. The insurance funds will be required, however, to pay out $7 billion to acquire assets in the current year. Total federal outlays of $7.5 billion, partially offset by premium collections of $3 billion, result in net outlays of $4.5 billion under current accounting policies. The insurance fund finances the difference by drawing down its accumulated reserves, using the general fund appropriation, and, if required, borrowing from the Treasury (or the Federal Financing Bank). Gross outlays are $7.5 billion, and net outlays are $4.5 billion. The latter corresponds to the amount of cash the Treasury will have to fund (from tax revenues and borrowing) for this activity in this period.

Under the alternative, two-account treatment, the program account receives $3 billion from insurance premiums and a $2 billion appropriation. The program account pays the operating expenses ($0.5 billion) and then pays the $4.5 billion remaining balance to the financing account. The financing account pays out $7 billion, financing this with the $4.5 billion payment from the program account, drawing on accumulated reserves, and borrowing from the Treasury. Gross outlays are $5 billion, and the net cost to the general fund is recorded as $2 billion. The latter amount corresponds exactly to the amount of the appropriation to the program account.

The difference in the two treatments is again a difference in measurement focus. The current method of accounting focuses on the Treasury's funding requirements ($4.5 billion); the alternative focuses on the general fund cost ($2 billion).

Figure 10.
Illustrative Effects of Deposit Insurance on Outlays and the Deficit Using Single- and Two-Account Treatments: Payments Exceed Collections



SOURCE: Congressional Budget Office.

NOTE: Illustration assumes that insurance premiums = $3.0 billion; administrative expenses = $0.5 billion; outlays for asset acquisition = $7.0 billion; and that there is a $2.0 billion appropriation of general funds from the Treasury.

a. Deficit is increased ($7.0 + $0.5 - $3.0 = $4.5).

b. Deficit is increased ($4.5 + $0.5 - $3.0 = $2.0).

A CRITICAL ASSUMPTION

To interpret the $2 billion appropriation in the last example as the expected net cost to the government of deposit insurance, however, requires an assumption that may not be true. That assumption is that the $2 billion represents an *unbiased* estimate of the general fund cost of deposit insurance. The measurement of this cost has not been discussed, but one possible interpretation of this amount is that it is the difference between all the fund's assets (including the present value of deposit insurance premiums) and all the fund's liabilities (including the present value of expected future net payments to protect depositors). If the $2 billion appropriation is less than the true cost of deposit insurance measured in this way, then the financing account will be forced to borrow more to meet its obligations than it will be able to repay from future income. Under this scenario, the financing account becomes just another underfunded deposit insurance account that will require additional general fund appropriations in the future. It recalls the ill-fated FSLIC, with the added feature that the financing account is outside the budget totals.

The possibility that a financing account for deposit insurance might be underfunded is the greatest danger that the credit reform approach to deposit insurance poses. The objective of reform is to isolate the government's cost in order to recognize it clearly in the primary budget data. Yet, if the amount appropriated does not correspond to an unbiased estimate of loss, "reform" could become a way to hide costs in the means-of-financing accounts. Credit reform for loans and guarantees addresses this danger through the requirement for frequent reestimates of the cost of current activity. Further, when the subsidy appropriation is exhausted, the activity stops. With deposit insurance, this limiting mechanism is absent.

Under current policy, there is no process in place to assure that the annual appropriation to the program account would be the amount of an unbiased estimate of current period cost. If the FSLIC experience during the late 1980s is indicative, under current policy the deposit insurance funds finance with borrowing the losses that the general fund will eventually bear. This borrowing continues to balloon until it

becomes a national policy issue. Only then do these costs begin to be recognized as claims on the general fund through appropriations.

The credit reform approach outlined here has the potential to contribute to a more accurate and timely measure of the effects of deposit insurance on cost and fiscal policy. But it cannot produce this result alone: doing so requires a reliable link between the budget and the current cost of deposit insurance. Such a link might be created, for example, by automatically tying the amount of the annual appropriation to the program account to an unbiased estimate of the shortfall of resources in the financing account.

Ideally, control would run from budget decision to agency action; that is, deposit insurance policy would adjust to budgetary decisions about the acceptable cost to the government of deposit insurance. Failing that, a mechanism is required to monitor and record the current costs of deposit insurance as those costs are incurred. The next chapter sets out some options for supplementing the credit reform approach to deposit insurance with such mechanisms.

STOPPING SHORT OF THE CREDIT REFORM APPROACH

Some analysts have suggested that if credit reform accounting is applied to deposit insurance, it may be prudent to do so in several steps. One possibility would be to divide deposit insurance transactions into program and financing accounts, but to keep the financing account above the deficit line. By doing so, total budget outlays and the deficit would be unchanged from current practice. Although this would be more cautious than the full implementation of credit reform, it would also compromise the objectives of making the budget more germane to fiscal policy and the allocation of resources.

Another step toward, but short of, the credit reform approach would move the financing account to the means-of-financing section but retain all the noncostly transactions in the program account, except for the acquisition, financing, and sale of capital assets. Under this "eliminate working capital" approach, the program account would hold all premium income from deposit insurance until it was paid out

to resolve insolvent institutions. The program account would also earn interest on premium balances, borrow from the Treasury to meet shortfalls of premium income, and pay interest on these loans while they were outstanding.

The motive for moving the working capital acitivity to the financing accounts is to remove at least the "noise" of the purchase and sale of capital assets from budget outlays and the deficit. The two major disadvantages of the working capital approach, however, are that it does not improve the timeliness of recognition and, like a pure credit reform accounting approach, it has no mechanism for improving the link between deposit insurance policy and budget decisions. These features of the working capital alternative are discussed in more detail in Chapter VI, which also summarizes the advantages and disadvantages of the various options.

CHAPTER V

OPTIONS FOR INTEGRATING BUDGET COST AND PROGRAM POLICY

If the credit reform approach is to be usefully applied to budgetary accounting for deposit insurance, new links would have to be created between the budget process and the operating features of deposit insurance that affect its cost to the government and its macroeconomic consequences. If the budget for deposit insurance is to be an instrument of control as well as a means of reporting, budget decisions should shape insurance program policy. It may be preferable to leave deposit insurance to be driven by nonbudgetary processes, with the budgetary consequences being merely a recording of activity, much as is the case with many entitlement programs. But even in that case, the budget ought to be sufficiently connected to the program to enable the budget to recognize the costs and fiscal effects of deposit insurance as they occur, even if those costs and effects are beyond the reach of budgetary decisions.

This chapter describes options for developing such links. The first option aims to increase the ability of the budget to report the costs and fiscal effects of deposit insurance in a more timely fashion, without attempting to increase budgetary control over program cost. This approach--termed the mandatory option--would require an annual, mandatory appropriation of the estimated federal cost of deposit insurance. In combination with credit reform accounting for deposit insurance, this approach intends to inform budget users of the cost and fiscal effects of deposit insurance as they occur. Its chances of success would hinge on the abilities of analysts to provide an accurate and timely estimate of this cost.

The second option is more ambitious. It attempts to increase budgetary control over the cost of deposit insurance by using the premium rate to signal changes in the long-term cost of the insurance. Under this proposal--called the discretionary option--the deposit insurance authorities would be explicitly required to set premiums at a level

sufficient to pay all the present and future expected costs of deposit insurance. Budgetary control could be exercised over the insurance program by the discretionary appropriation of general funds to reduce the insurance premium. In conjunction with credit reform accounting for deposit insurance, this proposal would identify the period-by-period cost of deposit insurance to the general fund, give the Congress enhanced power to control these costs, and better indicate the stance of fiscal policy. Its chances of success would depend on the ability (and willingness) of the insurance authorities to set premiums that reflect the full cost of deposit insurance.

THE MANDATORY OPTION

This approach attempts to modify the budget process so that the budget more accurately and quickly reflects the general fund cost of deposit insurance. Under this alternative, the estimated cost of deposit insurance would become an annual mandatory appropriation to the program account. This amount would then be promptly paid to the below-the-line financing account. The payment, thereby, would be reported in budget outlays and the deficit.

In years in which many banks fail, accumulated reserves from general funds and premiums would be available to the insurance authorities in the financing accounts. The cost of resolving insolvent institutions that had been anticipated in earlier years would already have been recognized. The mandatory option would thereby apportion the recognition of cost in the budget over time. This improved recognition could reduce the possibility that, during times of fiscal crisis, the government might not be able to reach a decision to provide the funding necessary to avoid instability in the financial system.

The major difficulty with this alternative is the uncertainty over the annual general fund cost of deposit insurance. Several solutions have been offered. One could recognize the historical annual average cost of deposit insurance in an annual appropriation to the program

account and payment to the financing account.[1] This approach ignores the past and future changes in the insurance regime and thus could drift far from the true value. Its only advantage is that it spares the expense and effort of trying to identify the true cost.

Most proposals would attempt to estimate the federal cost of deposit insurance each year.[2] One general approach would focus on the difference between the annual deposit insurance premiums collected and the estimated costs as determined by the Federal Deposit Insurance Corporation and the National Credit Union Administration, or by the Treasury. In any year, the full-cost premium might be higher than the statutory rate. If so, the difference between the statutory rate and the full-cost rate (times the assessment base) would be appropriated to the program account and paid to the financing account. If the full-cost premium were less than the statutory rate, no funds would be appropriated.

Variations on this proposal consist of different techniques for measuring annual cost. For example, the insurance authorities might be required to calculate the value of deposit insurance to each insured institution using an analytic model (an option pricing model, for example).[3] The sum of the differences between the amount paid by each bank and the calculated value of the insurance to each institution would be recognized as the cost of deposit insurance to the general fund for that year.

Another variation would use market prices to estimate the expected cost of deposit insurance. Under this approach, some portion of the federal government's deposit insurance liability would be reinsured with private firms. Indemnification against the Bank Insurance Fund's first $50 million in losses at a specified group of banks could be

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1. For historical data on the cost of bank insolvencies, see James Barth, John Feid, Gabriel Riedel, and Hampton Tunis, "Alternative Federal Deposit Insurance Regimes," Research Paper 152, Federal Home Loan Bank Board (January 1989).

2. Edward J. Kane, "Economic Estimates of the 1986-1989 Time Profile of Taxpayer Losses in the S&L Insurance Mess" (report prepared for the Congressional Budget Office, February 18, 1991, with Appendix by Min-Teh Yu).

3. Mark D. Flood, "On the Use of Option Pricing Models to Analyze Deposit Insurance," Federal Reserve Bank of St. Louis, *Review*, vol. 72, no. 1 (January/February 1990), pp. 19-35.

purchased through a competitive process. From a series of such purchases, the federal government would calculate the annual market price of its insurance commitment. The difference between this market price and the premiums actually collected would be the federal cost of deposit insurance. This sum would be provided through a mandatory appropriation to the insurance program account each year and paid to the financing account.

Financing Account Balance Sheets and Budgetary Flows

All these proposals share a central concept: that the true annual cost of deposit insurance to the general fund is defined in terms of the insurance fund's (and, under credit reform accounting, the financing account's) balance sheet. If the present value of expected future income from premiums is at least as large as the present value of expected future payments to protect depositors, then the insurance fund is self-sufficient and no cost to general fund resources is recognized. A balance sheet expresses the present values of those opposing flows as assets and liabilities. As long as the value of assets exceeds the value of liabilities, deposit insurance is expected to be self-sufficient from premium income. If and when an excess of liabilities over assets appears, the difference is a claim on the general fund and should be recognized as a costly use of resources by a payment from the program account to the financing account. Variations of the mandatory option differ only in the methods they use to value liabilities: history, options, or market prices. In every case, the revelation of a resource deficiency automatically triggers a remedial recognition of this general fund cost.

The General Accounting Office's current efforts to improve existing balance sheets for the insurance funds may render those statements more useful to budgeting. The GAO auditors are insisting that the insurance funds take a more prospective view of losses and recognize future losses in the current period, if the losses are probable and subject to reasonable estimation.

If GAO succeeds in getting the insurance funds to recognize all future losses that can be anticipated, including the value of outstanding put options issued by the funds, the balance sheets of the insurance

funds would be halfway--the liability half--toward providing information needed to recognize a meaningful measure of insurance cost in the budget. The other half is the asset side: the present value of future deposit insurance premiums to be received by the funds. GAO is apparently insisting on recognizing future losses, but not future income that is equally probable and reasonably estimated. GAO, however, could take a small, feasible step by requiring the insurance funds to report their balance sheets on an expected and market value basis, including anticipated losses and premiums one year forward. Such a modification in the accounting standards for the deposit insurance funds would lead to an expanded balance sheet, as shown in Table 7.

All of these proposals have the advantage of recognizing costs in the budget closer to the time they are incurred, serving the needs of fiscal policy, insulating the budget from the effects of flows of working capital, and accumulating a reserve against losses. The limited, but important, financial significance of the prefunding of reserves should be understood, however. Payments from the program accounts to the

TABLE 7. HYPOTHETICAL BALANCE SHEET FOR THE BANK INSURANCE FUND, SHOWING EXPANDED ASSETS AND LIABILITIES

Assets	Liabilities
Current Accounting Method	
Cash and accounts receivable	Accounts payable
Treasury securities	Debt to Federal Financing Bank
Property and equipment	Notes to acquiring banks
Acquired assets	Liabilities in failed banks
Proposed Additions	
Present value of future insurance premiums	Put options outstanding
	Present value of future expected losses

SOURCE: Congressional Budget Office.

financing accounts would be recognized in outlays and the deficit. This recognition would convey important information to the users of the budget, but no funds or resources would actually be set aside. Payments to financing accounts increase the deficit, but the financing accounts, as a means of financing the deficit, reduce--by the same amount--the federal borrowing requirement. Thus, the payments to the fund would not be borrowed by the Treasury or collected in taxes. Payments of reserves to the financing accounts would function solely as a device for more timely recognition of the costs of insurance to the general fund. This prefunding of insurance losses is exactly analogous to the prefunding of guarantee losses under credit reform.

Prefunding would have a real significance, however, if the higher outlays and deficit resulting under this option led to a change in federal budget policies. For example, increases in the cost of deposit insurance might lead to higher taxes or a cut in spending for other purposes. Higher costs might also prompt changes in the deposit insurance program aimed at reducing its cost to the general fund. In these cases, a mere accounting change would affect decisions and the future course of the economy.

THE DISCRETIONARY OPTION

Under this proposal, the Federal Deposit Insurance Corporation and the National Credit Union Administration would be required to announce at the beginning of each budget cycle--more frequently, if they choose to do so--schedules of deposit insurance premiums that would meet, in the judgment of the insurance authorities, all anticipated costs of the respective insurance funds. Stated in terms of the financing account's balance sheet, premiums would have to be set to assure that the value of the fund's assets is always at least as large as the value of its liabilities. An excess of liabilities over assets is the trigger mechanism in this case, too. The difference is that a deficiency

of resources triggers a correction in insurance premium rates, rather than an appropriation.[4]

Discretionary Budget and Policy Options

An announced schedule of deposit insurance premiums, synchronized with the budget process, would provide the President and the Congress with genuine budget options for deposit insurance. The President and the Congress could elect to take no budgetary action and, thus, to let the announced premium schedule take effect. In fact, if history is a guide, this is likely to be the most frequently chosen option. Alternatively, the budget framers could choose to appropriate general funds to subsidize or reduce the premium rates. Finally, they might adopt program legislation that would reduce the cost of deposit insurance.

No Action. In the first case, the government would simply adopt as budget policy for the year the presumption that insured institutions and their customers pay the costs of deposit insurance. For most of the history of federal deposit insurance, this has been the case. Further, except for extraordinary episodes such as that of the Federal Savings and Loan Insurance Corporation in the late 1980s, most policymakers appear to hold the view that future losses from deposit insurance are to be paid by insured institutions and consumers of financial services, rather than taxpayers. Thus, under most circumstances, the budget would merely note the premium schedule slated for the budget year and propose no further action.

Discretionary Appropriation. In the second case, the government could decide that the insurance premiums necessary to fund the system fully would be so burdensome as to adversely affect insured institutions and the economy. The President or the Congress could propose, therefore, to use general funds to buy down insurance premiums to tolerable levels with a fixed-sum subsidy to deposit insurance. They might do so on grounds that deposit insurance is providing general social benefits

4. For a discussion of the relationships among premium rates, the financial condition of the Bank Insurance Fund, and the health of the banking industry, see Congressional Budget Office, "Projected Impact of Increased Insurance Premiums on the Banking Industry and the Bank Insurance Fund" (Staff Memorandum, May 1991).

or because of cyclical distress in the banking industry. If such a measure were enacted, funds would be appropriated to the subsidy account and paid to the financing account in the current year. The deposit insurance authorities would then announce a reduction in the premium schedule. The insurance authorities would solely determine the extent of the reduction, but they would not be permitted to reduce present premiums on the strength of promises of future subsidy payments. Because the program account is above the deficit line and the financing account is below it, the amount of the payment from the general fund would be included in budget outlays and the deficit in the year paid. Costs would therefore be recognized in the fiscal year of the decision to incur these costs.

Program Modification. In the third case, the President and the Congress--advised by the deposit insurance authorities and others--could determine that the full-cost premium schedules were excessively burdensome. Lacking budgetary resources to use in providing a federal subsidy, however, they might choose to amend the deposit insurance program to make it less costly. If both deposit institutions and taxpayers find the premiums to be unaffordable, the terms of the insurance indemnification should be modified to make it affordable.[5] Similarly, statutorily mandated increases in the cost of deposit insurance would lead the insurance authorities to announce increases in premiums, unless the legislation were accompanied by an appropriation from the general fund to offset these mandated costs.

The requirement that the insurance authorities must set premiums at the full-cost level does not mean that they would be forced to fund each year's costs entirely with deposit insurance premiums collected in that year. Premium income may be accumulated over time. In years of especially heavy costs, the insurance funds could draw down accumulated reserves and borrow to finance their short-term needs for cash. Borrowing under this proposal, however, is limited by the requirement that insurance premiums be adjusted continuously to maintain a balance between long-term premium income and expected

5. Numerous alternatives for doing so are described in Congressional Budget Office, *Reforming Deposit Insurance* (September 1990); and in G. Thomas Woodward, *Deposit Insurance Reform, Evaluating the Proposals*, CRS Report for Congress (Congressional Research Service, August 27, 1990).

losses. A fund could not borrow, therefore, in excess of its ability to repay debt from future premium income.

The announced premium schedules need not be a flat rate. Premiums could, and to control costs equitably should, vary with risk among depositories.[6] The FDIC and the NCUA already have the authority to set deposit insurance premiums, though the NCUA's authority has some restrictions.[7] This change imposes only two minor requirements on the insurance authorities. First, they must set the premiums explicitly to cover all costs, including debt service for borrowing that is required to finance short-term cash needs. Second, they must affirm or modify the existing premium schedule at the beginning of each budget cycle. The insurance authorities would also be required to disclose the basis for their judgment that the announced premiums would produce sufficient income to maintain the self-sufficiency of the funds.

Advantages

Under current policy, incidence of the losses, which is important for equity and economic behavior, is obscured. Much confusion exists over whether the assistance from the general fund is a grant or merely a loan insured institutions must repay. Both the mandatory and discretionary options, however, identify federal costs throughout the budget process as soon as these costs are recognized. Only--and all--the monetary costs are reported in program accounts. Moreover, the discretionary option reports these costs at the point of control--in the same period that the government chooses this particular use of its budgetary resources. Both options automatically limit borrowing to the amount that can be repaid with premium income.

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6. Risk-based deposit insurance premiums are beyond the scope of this paper, but there is no inconsistency between such program reform and this proposal. See Congressional Budget Office, *Reforming Deposit Insurance.*

7. "The assessment rate for Bank Insurance Fund members [and Savings Association Insurance Fund members] shall be the greater of 0.15 percent or such rate as the Board of Directors, in its sole discretion, determines to be appropriate...." Title II, subtitle A, section 2002, Omnibus Budget Reconciliation Act of 1990. The FDIC is also required to build reserves of both the Savings Association Insurance Fund and the Bank Insurance Fund up to a minimum of 1.25 percent of total insured deposits (with a maximum of 1.5 percent). The limitation on the authority of NCUA to set premiums at no more than 8.33 basis points would have to be removed.

For fiscal policy, it is important that the budget recognize federal financial events when they affect aggregate demand. Under the discretionary plan, unanticipated deposit insurance losses would affect aggregate demand in two stages.[8] The first effect would occur when the deposit insurance authorities revised their expectations about the future cost of deposit insurance and announced an increase in premiums. This announcement's macro effect would be similar to that of any relative price shock, such as an unanticipated increase in oil or food prices. The second effect would occur if and when the government decided to buy down the price of deposit insurance. In that case, taxpayers would incur a loss from the assumed liability when the decision was made to make a payment to the insurance fund's financing account. In both cases, the timing of changes in factors affecting aggregate demand would be apparent. By incorporating a prospective estimate of accruing costs, both options reflect the effect of the budget on the economy much closer to the time when it occurs than does the current treatment.

The Key Element: Full-Cost Pricing of Insurance

Achieving these advantages under the discretionary option depends crucially on the ability of the insurance authorities to set the insurance premiums at the full-cost level. To do so, they must be informed about the financial condition of insured depositories, have an incentive to use this information in establishing appropriate premiums, and have authority to vary rates commensurate with the financial needs of the funds.

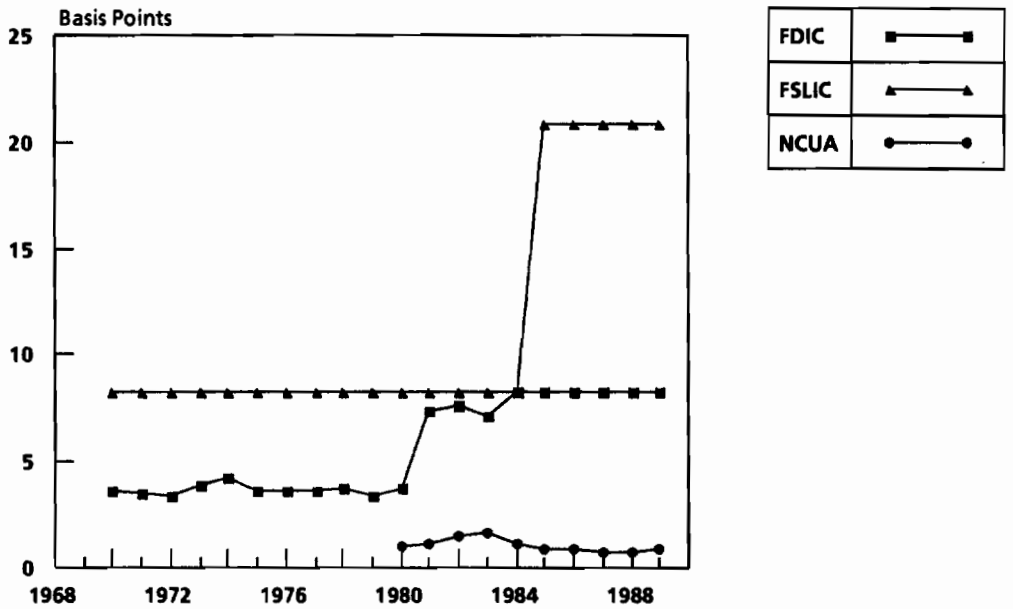
In the past, deposit insurance authorities have raised premiums before a fund's deterioration has been reported, when permitted to do so by statute. Figure 11, for example, shows effective premiums (amounts paid less assessment credits) for institutions insured by the FDIC, FSLIC, and NCUA. The FDIC raised premium rates for banks sharply in 1981, maintained the rates at the elevated level, and increased them to the statutory ceiling of 1/12th of 1 percent (0.000833)

8. The effects on aggregate supply would have been felt earlier. See a forthcoming Congressional Budget Office report on the macroeconomic effects of the savings and loan debacle.

of the assessable base in 1984. There was no room for further increases until the Financial Institutions Reform, Recovery, and Enforcement Act was enacted in 1989, which raised premiums of the Bank Insurance Fund to 12 cents per $100 (or 12 basis points). Since then, BIF premiums have been raised to 19.5 cents per $100 and are scheduled to increase to 23 cents in July 1991.

Similarly, FSLIC maintained the maximum rate until 1985, when it used its authority to levy a supplementary premium in a single step. With greater price flexibility, premium increases might have suc-

Figure 11.
Effective Insurance Premiums for the FDIC, FSLIC, and NCUA, 1970-1989



SOURCE: Congressional Budget Office using data from the FDIC and NCUA.

NOTE: FDIC = Federal Deposit Insurance Corporation; FSLIC = Federal Savings and Loan Insurance Corporation; NCUA = National Credit Union Administration.

ceeded in giving advance warning of FSLIC's impending deposit insurance losses and in a more balanced bearing of costs.

Pricing Incentives

The crucial role assigned to the deposit insurance authorities in pricing deposit insurance requires that special attention be given to the incentive structure that such authorities face. Specifically, some assurance is required that the premiums would tend to be set neither too high nor too low.

A premium schedule is set too high if premium income exceeds the expected cost of deposit insurance. As long as the future cost of insurance is uncertain, the appropriate level of premiums will be a matter of judgment. One means of addressing this uncertainty is to aim over time to build a reserve against future losses. FIRREA sets a minimum target reserve level of 1.25 percent of the assessment base, and the Chairman of the FDIC has suggested a reserve level of 1.5 percent of the assessment base. Once such a target is achieved and the accumulated debt of the insurance fund is retired, then premiums could be set merely to cover the administrative costs of deposit insurance. When expected losses began to increase, higher premiums could be levied.

For individual banks, insurance premiums are too high if they exceed the benefit of the insurance. With a fixed-rate system of deposit insurance, the least risky banks are most likely to decide that premiums are too high. Such banks will have incentives to find substitutes for federal deposit insurance and to exit the system. These departures would leave the insurance system with a preponderance of banks for whom the value of insurance exceeds the premiums--that is, the most risky banks. The natural preference of the insurance authorities to have as many insured institutions as possible will encourage the authorities to hold down average premiums and to vary the premium charged by the riskiness of the insured. Target reserve ratios could be used as a possible counterweight to the tendency for the authorities to set rates too low.

Sources of Borrowing by the Insurance Funds

With ample borrowing authority--limited by the requirement to retire debt with premium income--the insurance funds could apportion premium rates over a cycle of fund losses. Without such borrowing authority, premiums would need to be raised most during the most severe periods of financial failure and insurance fund losses. The least costly and most reliable source of credit available to the insurance funds is the U.S. Treasury.

On occasion, it has been proposed that the deposit insurance funds should borrow from a government-sponsored enterprise (GSE), such as the Federal Home Loan Banks, or from the Federal Reserve Banks. Both options are inferior to borrowing from the Treasury in terms of cost and disclosure. Borrowing by an insurance fund from a GSE is equivalent to borrowing directly in the capital markets, and it is wasteful compared with the cost at which the Treasury could borrow. Borrowing from the Federal Reserve is equivalent to borrowing from the Treasury, because the Federal Reserve is a federal entity, all of whose earnings are paid to the Treasury. If the Federal Reserve charged the insurance funds a rate different from the Treasury rate, the difference would directly affect Federal Reserve payments to the Treasury. Borrowing from the Federal Reserve differs only in appearance from borrowing from the Treasury. Creating a false perception will confound understanding of the cost of deposit insurance and who pays it.

POTENTIAL FAILURE WITH THE MANDATORY AND DISCRETIONARY OPTIONS

In considering the merits and weaknesses of these attempts to integrate budgeting and deposit insurance activity, it may be helpful to consider the consequences of the system's failure. Suppose that either the mandatory option (appropriation triggered by excess of liabilities over assets) or the discretionary option were adopted, and a large number of unanticipated bank failures occurred. Under either plan, costs would be no greater and would be recognized sooner than under the current system. Reflecting market values in the balance sheet

with a one-year look ahead would severely constrain the discretion of the deposit insurance authorities to slow the recognition of losses. GAO audits of the insurance funds would also continue under the discretionary option. If the insurance authorities were no faster in recognizing losses under the discretionary plan than under current policy, the condition of the funds would be exactly as it is now, except that all equal-value exchanges, including working capital, would be accounted for in a nonbudgetary account.

CHAPTER VI

SUMMING UP THE ALTERNATIVES

The federal government has a variety of options for addressing the usefulness of information under the current budgetary treatment of deposit insurance. Neither of the primary uses of the budget--allocating resources or formulating fiscal policy--is well served by the current practice of commingling in a single account a variety of costly and costless cash flows that pay for activities over a long period of time. Costs and fiscal effects are not only uncontrolled, but are also unrecognized until cash is paid out.

This chapter describes a progression of options that range from continuing current policy to converting the deposit insurance funds into self-supporting, mutual insurance enterprises that are completely outside the budget. It also describes a means of fully recognizing the inherited losses from the Federal Savings and Loan Insurance Corporation that would improve the usefulness of the budget for decision-making.

CONTINUE CURRENT PRACTICE

Many strong arguments can be mustered for maintaining the current budgetary treatment of deposit insurance. These arguments include:

- Change is premature. Deposit insurance policy is being reformed to reduce its cost to the general fund. It would be sensible to wait and see how deposit insurance is restructured before attempting to revise its budgetary treatment.

- All federal cash transactions should be reported above the line. All are governmental transactions and should be reported in a manner fully visible to all users of the budget.

- Current efforts by the deposit insurance authorities and the General Accounting Office to improve the supplementary data in the budget are promising. As these improvements occur, the need to change the primary budgetary accounting system may diminish.

- The crucial variable--the cost to the government--is difficult to measure in a timely fashion for deposit insurance. Changing the budgetary treatment may mislead users of the budget into believing that more is being done than is possible. The inevitable uncertainty about the true cost of deposit insurance to the government may create new opportunities--for political reasons--to manipulate the cost estimates and could undermine the credibility of the primary budget data.

MOVE ONLY WORKING CAPITAL TRANSACTIONS BELOW THE LINE

This alternative is espoused with sufficient frequency that it deserves careful examination. Figure 12 shows the requisite division of transactions into a program account and a financing account for working capital.

The failure of an insured institution that led to an insurance fund's acquiring assets would result in two payments: one from the program account for the estimated amount of the loss, and one from the financing account for the estimated value of the acquired capital assets. The financing account would pay for the assets by borrowing the purchase price from the Treasury, garner the interest and other income earned on acquired assets, and pay interest on the Treasury debt. Eventually the capital assets would be sold, and the debt repaid to the Treasury. If the assets were overvalued at acquisition, the working capital account would be unable to pay off its debt from the sale's proceeds. Such errors in valuation may create incentives for authorities to defer the sale of acquired assets in the hope of realizing a higher future price. Of course, future prices may also be lower, and the loss in the account could increase.

Figure 12.
Transactions of a Deposit Insurance Fund Divided Into a Program Account and a Financing Account for Working Capital

PROGRAM ACCOUNT

Disbursements	Collections
o Administrative expenses	o Insurance premiums
o Payments for losses	o Interest received
o Payments to working capital for overvalued assets	o Payments from working capital for undervalued assets
o Interest paid	**Additional Sources of Income**
	o Appropriations
	o Liquidation or accumulation of Treasury securities
	o Borrowing and repayment of debt

FINANCING ACCOUNT FOR WORKING CAPITAL

Disbursements	Collections
o Asset acquisitions	o Sales of assets
o Interest paid to Treasury	o Interest received on assets
	Additional Sources of Income
	o Borrowing and repayment of debt
	o Payments from and to program account for under- and overvalued assets

SOURCE: Congressional Budget Office.

If the proceeds from the sale are less than the outstanding debt, the program account will have to make a payment to the financing account. Similarly, gains from undervalued assets will be paid to the program account.

This approach succeeds in insulating budget outlays and the deficit from the massive outflows and inflows of cash for working capital. But it fails to accelerate the recognition of losses, which are recognized only when paid. No anticipated losses are recognized by the payment of funds to the financing accounts. Further, the working capital approach suffers from the shortcomings of all pure accounting solutions: it does not create a contemporaneous link between the budget and the costly events in the deposit insurance program. No budget or program action is forced by an excess of liabilities over assets in either the program account or the financing account. Unrecognized losses (negative net worth) can accumulate indefinitely in both accounts under this option.

This option could be improved somewhat by joining this accounting change to a variation of the mandatory option. A negative net worth in the working capital account could force a mandatory appropriation to the program account. Payment of the appropriation to the working capital account would result in accelerated recognition of the loss in outlays and the deficit. This solution fails to provide recognition of the accumulating losses in the program account, however, because appropriations to the above-the-line program account do not increase budget outlays or the deficit until they are disbursed.

INTEGRATE PROGRAM COSTS AND THE BUDGET

The budget process can be integrated with deposit insurance by moving the accounting for all deposit insurance activity, except the recognition of costs, to the financing accounts, and by mandating corrective action through either the budget or the insurance program whenever liabilities exceed assets in the financing accounts.

Three key steps will successfully integrate the seemingly uncontrollable and unknowable cost of deposit insurance into the budget process. The first step is to create a financing account for deposit insurance that can be self-financing over the long term. As a second step, the true financial condition of this account must be frequently and fully disclosed. "True" financial condition could be defined initially in terms of the expected value of all account assets and liabilities, assuming that all current insolvencies and those expected over the next year are recognized. Eventually, the length of the balance sheet's time horizon could be extended. GAO audits are already directed at assuring an accurate disclosure of financial condition. Improved quarterly statements of condition would strengthen this oversight process and increase the timeliness of disclosure. The third step is to assure that a negative net worth in the financing account triggers immediate corrective action. Under the mandatory plan, this action consists of an appropriation and an outlay for the deficiency from the program account. With the discretionary option, the adjustment occurs in the deposit insurance premium rate, although other features of the insurance program could also be modified to make up the shortfall.

These efforts toward more timely recognition of general fund losses depend crucially on the ability of analysts to value long-lived flows of income and expenses. This requirement is discussed more fully below.

CONVERT THE INSURANCE FUNDS INTO GOVERNMENT-SPONSORED ENTERPRISES

To assure that a full spectrum of alternatives is included, one might consider removing the deposit insurance funds from the budget. This step could be accomplished by transforming the existing insurance funds into government-sponsored enterprises (GSEs). GSEs are privately owned financial institutions chartered by the federal government to achieve defined public purposes.[1] By virtue of their private ownership, their transactions are not included in the federal budget.

1. Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises* (April 1991).

Under this option, deposit insurance would appear in the budget only if an appropriation from the general fund were required to enable an insurance entity to meet its obligations.

In light of the strong preference policymakers have expressed for avoiding adverse financial surprises, this option is likely to be appealing only if the possibility of future loss from deposit insurance is quite small. For example, GSE status might be appropriate for deposit insurance entities if the anticipated reform reduces the risk of government loss to no more than that for an existing government-sponsored enterprise such as the Federal National Mortgage Association (Fannie Mae).

Converting the Federal Deposit Insurance Corporation and the National Credit Union Administration into sponsored enterprises would require a number of structural changes in these entities. Because private ownership is a prerequisite to GSE status, private capital would be required. A federal regulatory authority would also need to be established to oversee the safe and sound operation of the deposit insurers and to assure that they do not expose the government to substantial risk of loss. The regulatory authority could be expected to pay careful attention to the equity capital of the regulated insurance funds and to the risks of loss inherent in their operating policies.

Although existing GSEs enjoy an implicit federal guarantee of their debt, they have no explicit guarantee. If necessary, the federal government could explicitly guarantee some liabilities of a GSE for deposit insurance. The expected cost of these explicit guarantees, if any, would be treated under the procedures for credit reform.

ADDRESSING THE ACCUMULATED FSLIC LOSSES

Any attempt to improve the budgetary accounting for deposit insurance must consider the accumulated losses of the Federal Savings and Loan Insurance Corporation. These massive claims on federal financial resources are significant for several reasons. First, the bulk of the distortion now affecting the budget deficit from deposit insurance stems from past, rather than current or future, insurance losses. If the

budget deficit is to be insulated from effects of the cash flows that will occur in liquidating accumulated bank insolvencies during the next 10 years or so, any revision of budgetary accounting and process will need to include the accounts established for these transactions.

Second, much of the confusion in the budget about this accumulated loss has a familiar cause: the transactions required to protect depositors and pay off this loss--both the pure costs and secondary cash flows from working capital--are combined in single accounts. Even though the Resolution Trust Corporation and the FSLIC Resolution Fund are accounted for separately, each commingles these two types of transactions in one account. The example of credit reform suggests that recording the pure costs separately from the working capital transactions would provide more relevant information.

Third, the surviving remnants of the savings and loan industry are not able to pay the accumulated costs of the FSLIC insolvency out of future insurance premiums. General funds, therefore, must bear some of this cost. To report the incidence of these costs accurately, they should be included in budget outlays and the deficit.

When should these costs be recognized? The entire estimated loss could be recognized in the current year budget by appropriating the estimated, unrecognized loss to a newly created program account for the RTC and the FSLIC Resolution Fund. This program account could then make a single payment to the RTC and FSLIC Resolution Fund accounts, which would be moved to the means-of-financing section of the budget.[2] Recognizing these losses in the current year would be more straightforward and vastly less complicated than attempting to record these losses in prior fiscal years by revising the historical budget data. CBO estimates that an appropriation of less than $40 billion paid to below-the-line financing accounts at the end of fiscal year 1991 would sweep these old losses from the budget--perhaps once and for all.

One annual cost of the FSLIC disaster would continue to appear above the deficit line: interest on the public debt issued to finance

2. Several technical changes in current policy would also be required, including repeal of the FIRREA provision that diverts some Savings Association Insurance Fund premiums to the FSLIC Resolution Fund.

these losses. This treatment is consistent with the current accounting practice of recognizing annual interest on the federal debt, but not attributing this interest cost to specific federal activities. If $1 billion is spent for a transportation project, the cost is now reported as $1 billion, not $1 billion plus the annual interest paid by the Treasury. Similarly, the cost of resolving the FSLIC debacle would be recognized now, and the interest on the loss incurred by the government would continue to be included in budget outlays and the deficit as net interest paid by the Treasury.

Changing the accounting of the FSLIC losses in this way would be beneficial for two reasons. First, it would clearly signal the taxpayers' share of this loss. Recognizing this loss in the random flow of cash out of and into federal hands merely confuses users of the budget about who will bear this loss.

Second, except for a final payment from or receipt to the financing account when the resolution activity is completed, subsequent federal deficits would be unaffected by this unwinding of FSLIC's affairs. Only new federal costs would be recognized for deposit insurance, except--as noted--for interest on the federal debt. Nor would this one-time outlay and budget recognition mislead macroeconomic analysts, to whom it would be clear that the transaction merely recognizes an accumulated loss.

The current treatment of accumulated losses from FSLIC's operations is inconsistent with both the resource allocation and fiscal policy purposes of the budget. If the budgetary treatment of the FDIC and NCUA funds is modified, that reform ought to include a means of recognizing the FSLIC loss--visibly and unequivocally, but also finally.

WEIGHING THE CASH AND ACCRUAL OPTIONS

Each of these options for addressing the cost of deposit insurance--including the continuation of current policy--has the potential to improve the usefulness of budget information. In identifying the information that is to be regarded as primary for the budget in the future,

the Congress should address a series of questions that only the Congress--as policymaker--can answer:

- What is the intended use of budgetary information about deposit insurance? What decisions that the Congress makes, must this information system primarily support?

- Given this use, what kinds of information are central to those decisions? What information is interesting, and sometimes useful, but clearly of secondary importance?

- Which procedural rules, process requirements, program features, and report formats would highlight the vital information, but diminish the prominence of secondary information in budget and financial reports?

This study has relied on the *Report of the President's Commission on Budget Concepts* to specify the principal uses of the budget as the allocation of resources and setting fiscal policy. These uses may not be operative for the Congress today. If not, the current principal use or uses needs to be specified. That specification is essential because it enables the vast array of financial information that could be produced to be assigned appropriate priorities. Information that is centrally relevant to a decision process can be given the prominence it should have. Other information can be retained and provided on a supplementary basis.

The Congress--in contrast with the President's Commission on Budget Concepts--may prefer to retain the central focus on cash flows that now dominates the budget accounting system. The preference for cash, if that is the choice, however, is likely to be for purposes other than to assist the Treasury in managing the government's cash position. The Treasury and the financial markets can monitor and track the federal borrowing requirement quite well without cash as the central budget focus of measurement.

One reason for maintaining the prominence of cash flows in the budget is that they are widely perceived as a more credible measurement than accruals, which accelerate the recognition of events that

lead to cash payments and receipts. Accelerated, more timely, recognition necessarily occurs before final cash settlement takes place. In turn, this prepayment recognition means that the amounts recognized are not final. Some adjustments are likely to be required when all payments have been made. Knowledge of these overhanging adjustments is discomforting to everyone. It is simply more satisfying to make decisions on the basis of final numbers, rather than estimates, when possible. The difficulty is that at the point of decision for the federal government, the final numbers may not be available for years.

The limited extent to which the accelerated recognition of costs (envisioned above in the option to integrate program costs and the budget) requires future adjustments should also be appreciated. If the budget were to recognize $1 billion today as the estimated cost of an event occurring today, and the final cost turned out to be $5 billion three years later, a major error of estimation and recognition would have occurred. With the error, the federal budget would show a $1 billion cost now and a $4 billion additional cost adjustment in three years. The cash basis of accounting, however, would defer all recognition for three years, when $5 billion would be reported. Major estimating errors reduce the gain in timely recognition. They do not delay further or obscure the final reckoning compared with cash-basis recognition.

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