The Financing Corporation, Government-Sponsored Enterprises, and Moral Hazard

Keith J. Leggett and Robert W. Strand

After the Federal Savings and Loan Insurance Corporation became insolvent, Congress established the Financing Corporation (FICO) in 1987 for the sole purpose of financing a recapitalization of FSLIC. FICO issued over $8 billion worth of bonds over the next three years to replenish FSLIC; the bonds were to be repaid with funds from the Federal Home Loan Bank System and S&L deposit insurance premiums.

In 1995, public concern arose regarding the possibility of default on the bonds (see Wexler 1996). In May of that year, the Treasury Department and the Federal Deposit Insurance Corporation (FDIC) proposed a scheme to shore up the interest payments. That action, which was adopted by Congress in September 1996, set an important precedent by reinforcing the bond markets' belief that the federal government stands behind the debt of any private firm it has established. The persistence of this belief creates a "moral hazard" whereby all government-sponsored enterprises (GSEs) are relieved of bond-market discipline, and raises important questions about the cost and inefficiency of implicit federal backing. This paper examines the development of the FICO problem and addresses the public policy issues raised by the resolution of that problem.

The FICO Bonds

FICO was created by the Competitive Equality Banking Act of 1987 for the sole purpose of issuing bonds to finance a rebuilding of

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FSLIC. Between October 1987 and September 1989, FICO issued 14 series of debt obligations with an aggregate principal of $8.17 billion.

The FICO bonds were intended to be obligations of savings institutions rather than the federal government. The authorizing legislation clearly states:

> Obligations of the Financing Corporation and the interest payable on such obligations shall not be obligations of, or guaranteed as to principal or interest by, the Federal Home Loan Banks, the United States, or the Federal Savings and Loan Insurance Corporation and the obligations shall so plainly state.[1]

To assure that FICO bondholders are apprised of this fact, each bond carries a warning that is essentially a restatement of the legislative provision.[2]

Separate means were set up to pay off the principal and interest on the bonds. For the principal, $3 billion in capital was taken from the Federal Home Loan Bank System and used to purchase zero-coupon U.S. Treasury securities with maturities equivalent to those of the FICO bonds. For the interest payments, FICO was authorized to draw funds from the deposit insurance premiums paid by FSLIC-insured institutions.

Some of Congress' intentions in the 1987 law were not realized, however. First, the FSLIC rebuilding plan proved completely inadequate, so Congress had to act again in 1989 to close the fund and set up a new one—the Savings Association Insurance Fund (SAIF)—which is administered by the FDIC.[3] The FICO bond payments thenceforth were to come out of SAIF premiums instead of FSLIC premiums. Second, when the FICO bond funding scheme was devised, S&L deposits—the FSLIC-SAIF assessment base—were expected to grow by 7 percent per year, so that the FICO obligation would be a diminishing burden over time (U.S. General Accounting Office 1995: 14). Instead, the deposits did not start growing until the beginning of 1995.

An interpretative ruling by the FDIC involving deposit insurance premiums paid on Oakar and Sasser deposits further complicated

[1]Competitive Equality Banking Act of 1987, Section 302.

[2]Each bond states: "The bonds and the interest payable on the bonds are not obligations of, or guaranteed as to principal or interest by, the United States, the Federal Home Loan Banks, the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation Resolution Fund."

[3]The Financial Institutions Reform, Recovery and Enforcement Act of 1989 established the Resolution Trust Corporation to handle the remaining caseload of unsalvageable S&Ls. The SAIF did not commence full operations until the RTC's work was completed in July 1995.

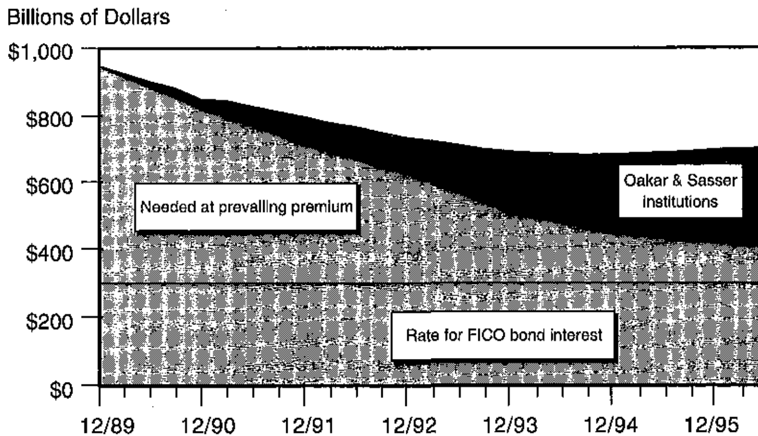
the picture. Oakar deposits are deposits that were once held by an institution that was insured by the SAIF, but were bought by an institution that is insured by the FDIC's Bank Insurance Fund (BIF), or vice versa. Sasser deposits are held by a SAIF-insured institution that has converted to a bank charter. While both Oakar and Sasser deposits remain SAIF-insured (by law), the FDIC interpreted the 1989 law to disallow deposit insurance premiums paid on those deposits from contributing to the FICO bond interest payments.

The Oakar and Sasser portion of the SAIF assessment base grew steadily after 1989 (Figure 1). These deposits amounted to $293 billion, over 40 percent of the SAIF assessment base, in June 1996.[4]

Non-Oakar/Sasser S&L deposits fell at an annual rate of almost 13 percent from 1989 through 1994. This steep decline was primarily the result of the efforts of the Resolution Trust Corporation (RTC), which completed the work of the defunct FSLIC by closing and selling off 747 unviable S&Ls with $403 billion of assets from 1990 through mid-1995 (RTC 1995: 1). With only two S&L failures in 1995, the annual rate of shrinkage dropped below 5 percent.[5] As of June 1996, the non-Oakar/Sasser assessment base was $445 billion, $112 billion

FIGURE 1

SAIF ASSESSMENT BASE



SOURCE: Federal Deposit Insurance Corporation (1996: 16).

[4]These and the following figures on the SAIF assessment base and non-Oakar/Sasser deposits were calculated from data provided by the FDIC (1996).

[5]Continued decline of S&L deposits was largely the result of competition from mutual funds and shifts in S&L funding to sources that are not assessed deposit insurance premiums, including Federal Home Loan Bank advances and repurchase agreements.

above the level needed to cover the FICO bond interest at the prevailing SAIF premium assessment rates.

Legislative Protection of the FICO Bonds

This deposit growth history led to debates about the soundness of the FICO bonds. Some argued that the bonds would not be endangered at the 1995 pace of deposit growth, or if Oakar and Sasser premiums were allowed to help with the FICO bond interest. Others, however, saw the deposit declines starting in 1989 as indication that SAIF premium revenues could eventually become insufficient to cover the FICO bond interest. While assessment rates could have been raised in the event of a revenue shortfall, FDIC officials and others expressed concern that higher rates could have accelerated deposit declines.[6]

To shore up the FICO bonds, the Treasury Department and the FDIC developed a plan whereby BIF-insured institutions (primarily banks) would be asked to help pay the FICO bond interest. A variant of this plan was adopted in September 1996 when Congress passed the Deposit Insurance Funds Act of 1996. That law requires BIF members to share the FICO bond interest obligation with SAIF members; BIF members are to pay a FICO premium that is 1/5 that of SAIF members from 1997 through 1999 then equal thereafter.[7]

Should the FICO Bonds Have Been Protected?

The 1996 law—indeed the very fact that it was proposed—sets an important precedent. Federal officials stated publicly that the reason the FICO bonds had to be protected was to ensure that the bond markets would not become concerned about debt issued by other GSEs.[8] Thus, the initiative to fortify the FICO bonds confirmed bond

[6]See Fiechter (1995), Helfer (1995), and U.S. General Accounting Office (1995).

[7]The FDIC charged BIF members 1.3 cents per $100 (1.3 basis points) of the deposit insurance assessment base (domestic deposits with some adjustments) and SAIF members 6.4 basis points in annual FICO premiums in 1997 (in addition to deposit insurance premiums). The shared annual assessment rate is projected to go to 2.2 basis points for both BIF and SAIF members starting in 2000.

[8]FDIC Chairman Ricki Helfer said in testimony: "Related to the possible insolvency of the SAIF is the question of what would happen if the FICO bonds go into default. This is a subject of more direct concern to the Department of the Treasury, but the effects could be widespread. Among those effects could be downward pressure on the prices—and upward pressure on the interest rates—of securities issued by government-sponsored enterprises such as Fannie Mae, Freddie Mac, Farmer Mac, and Sallie Mae, which like the FICO are not backed by the full faith and credit of the United States" (Helfer 1995: 19).

market suspicions that the federal government will also stand behind other GSE debt.[9]

This action created a classic moral hazard. Moral hazard occurs when a party does not bear the full costs of its actions; some or all of the costs are instead transferred to other parties. If the federal government is expected to cover any shortfalls, GSEs can pursue more risk-aggressive activities without the higher interest charges and bond covenants that normally would be imposed on them.[10] Thus, the costs of responsibility for added risk-taking are transferred to the federal government (and ultimately taxpayers) or whomever will cover any losses.

Not having to bear the full costs of risky projects encourages GSEs to accept higher risk and increases the chance that the federal government will be called on to make good on its implied guarantee.[11] The total scope of the contingent liability, the aggregate outstanding debt of all GSEs, was $949 billion as of July 1997 (Table 1), and it is growing fast—at an annual rate of 17 percent since 1991 (Figure 2).[12]

To limit the chance that the government might have to make good on its implicit guarantee, federal oversight agencies have been established.[13] The administrative costs of these agencies amount to a significant expense, the bulk of which comes out of taxpayer funds. In 1996, the Farm Credit Administration cost taxpayers $40 million, and the Federal Housing Finance Board and the Office of Federal Housing

[9]This is not the first indication that GSE debt is federally protected. In 1987, Congress bailed out the Farm Credit System to prevent its default, at an estimated cost of approximately $1 billion. In fact, the 1995 bailout of $17.4 billion in maturing *tesobonos* during the Mexican "peso crisis" by the United States and some international agencies indicates that the U.S. government may be willing to stand behind debt even in other, trading-partner countries—as is now evident in Southeast Asia.

[10]A publication from the U.S. Department of Housing and Urban Development (1996: 168) points out: "One basis for concern about the status of the GSEs has been that [implicit federal backing] has insulated them from exposure to 'market discipline.' That is, it is claimed that the GSEs have incentives to pursue riskier business strategies than firms in similar circumstances would have if governed more by market forces. It is feared that reduced market discipline could cause the GSEs to: set their capital/asset ratios low; manage interest rate and default risks less conservatively; and, during times of severe financial problems, pursue recovery strategies that involve additional interest-rate risk and default risk. If so, such business practices would increase the probability and severity of taxpayers' potential liability, should Congress elect to assist the GSEs if they should encounter financial difficulties."

[11]See U.S. General Accounting Office (1990).

[12]GSE debt and debt growth figures were calculated from data provided by the Board of Governors of the Federal Reserve System (1995: A33, 1997: A30).

[13]See Congressional Budget Office (1996).

TABLE 1

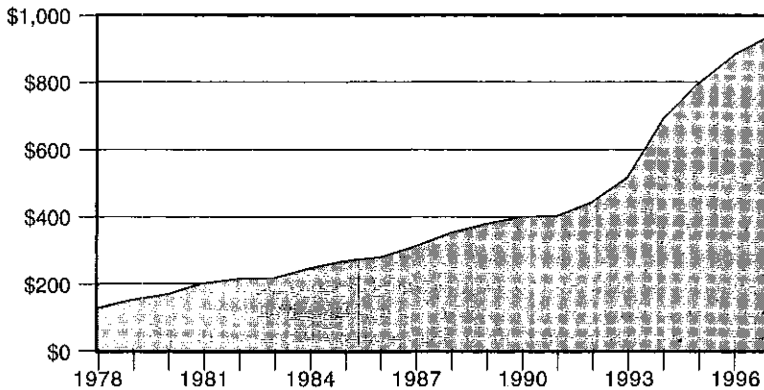
GOVERNMENT-SPONSORED ENTERPRISE DEBT
(AS OF JULY 1997)

Agency	Debt Outstanding (Billions of Dollars)
Farm Credit Banks	61.9
Farm Credit Financial Assistance Corporation	1.3
Federal Home Loan Banks	291.9
Federal Home Loan Mortgage Corporation	161.5
Federal National Mortgage Association	348.6
Financing Corporation	8.2
Resolution Funding Corporation	30.0
Student Loan Marketing Association	45.5
Total	948.8

SOURCE: Board of Governors of the Federal Reserve System (1997: A30).

FIGURE 2

GOVERNMENT-SPONSORED ENTERPRISE DEBT



SOURCE: Board of Governors of the Federal Reserve System (1997: A30).

Enterprise Oversight each cost $15 million (Executive Office of the President of the United States 1995: 538, 972, 992).

These agencies face a difficult task in trying to strike a balance between allowing GSEs to adapt to evolving market demands and yet restricting them from entering into overly speculative business activities. The agencies and legislators who oversee them have learned from the actions of the former Federal Home Loan Bank Board,

which was abolished in 1989 after continually underestimating the magnitude of the S&L crisis. In today's political environment, regulators are encouraged to be cautious, inhibiting the ability of GSEs to perform their functions.

On the other hand, if no action had been taken to protect the FICO bonds, a totally different signal would have been sent to the bond markets. The markets would have been forced to assess the risk of the FICO debt, and similarly of all GSE debt. Because these markets are adept at assessing whether businesses are overly aggressive or foresightfully progressive—without a cautionary prejudice—and are also adept at imposing interest rates and bond covenants commensurate with risks, the market discipline imposed could provide unbiased and cost-effective supervision.

The timing of the adoption of explicit government support of the FICO bonds in 1996 also raises questions as to whether the appropriate party was the beneficiary of the legislation. The law provided a windfall gain for FICO bondholders due to the complete elimination of default risk. Therefore, the resultant lower interest rates on the bonds did not accrue to FICO itself. When an agency like FICO is established in the future, consideration should be given as to how its public purpose can be enhanced by up-front explicit federal backing. If federal backing is specified before an agency issues debt (instead of retro-fitted after the debt is outstanding), the benefits of a lower interest rate can accrue to the agency.

Who Should Support the FICO Bonds?

When Congress determined that it was in the public interest to safeguard the FICO bonds, the question was raised as to who should bear the cost of the bailout. The obvious suggestion was that if the public will benefit, then the public should pay through the federal budget. The legislation, however, chose to use private instead of public funds.

If private monies are to be used, then a fundamental principle of taxation would have those who receive benefits bear the costs. As noted earlier, the argument was made that the FICO bonds should be protected in order to assure market confidence in all GSE debt. If GSE debt is to be government-backed, then the GSEs should be charged in proportion to the benefits gained in the form of lower interest rates. If GSEs are not assessed for the implicit federal backing, they have a competitive advantage over fully private firms. That advantage inhibits the development of market-driven private industry that either does or could provide comparable services.[14]

[14]See Konstas (1995), U.S. Department of the Treasury (1996), and U.S. General Accounting Office (1996).

GSEs could be assessed for the implicit federal backing in at least two ways. A system of cross guarantees could be established, whereby GSEs mutually guarantee each others' debt. The 12 Federal Home Loan Banks have this type of arrangement. Alternatively, a debt issuance fee could be charged to build a fund that backs outstanding GSE debt. For example, a guarantee fee is paid to the Farm Credit System Insurance Corporation for each debt issuance of the Farm Credit System. In the present case, user fees on GSE debt could be used for the FICO bonds.

The FICO legislation did not, however, assess any GSE. Instead, the banking industry was "asked" to share the FICO bond interest cost with the S&L industry. In fact, banks picked up 85 percent of the total burden. This arrangement is a second-order moral hazard whereby the federal government passed the cost of GSE protection on to banks rather than to the beneficiaries of FICO bond protection.[15] If this outcome is the consequence of the government offering implicit guarantees, then U.S. industry must be wary—in case the government is called on again to make good on an implicit guarantee, which industry will be obliged to pick up the obligation next?

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[15]Banks gained to the extent that they were among the holders of GSE debt. The chairman of the FDIC suggested that banks also gained indirectly from the increase in public confidence in federal deposit insurance after banks took over most of S&Ls' FICO payments so that more of S&Ls' deposit insurance premiums could go into the SAIF (Helfer 1995: 19–20).

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