

For release on delivery
11:00 a.m., CDT (12:00 noon EDT)
May 7, 1992

Remarks by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

28th Annual Conference on Bank Structure and Competition

Federal Reserve Bank of Chicago

Chicago Illinois

May 7, 1992

Putting FDICIA In Perspective

A year ago, many of us hoped that we stood on the threshold of major reform of the bank regulatory system. The original Administration's proposals, which the Federal Reserve supported, addressed the immediate need to recapitalize the Bank Insurance Fund. But more fundamentally, the initiative recognized that taxpayer funds were being placed at undue risk by the existing structure of deposit insurance and other elements of the federal safety net. To address this issue, it was proposed that the supervisory and deposit insurance systems be revamped to minimize the chance that a BIF recapitalization would ever again be needed. In addition, the proposals sought to address the increasingly distorted competitive environment of banking by removing a number of statutory restraints on well-capitalized banks and their holding companies. Banks would have been permitted to provide services over wider geographical and product markets. Regrettably, we failed to achieve these latter reforms. Moreover, while the Federal Deposit Insurance Improvement Act of 1991 embodied the proposed changes in the supervisory structure, it increased regulation on all banks rather than reducing regulation for strong banks.

The fundamental concern reflected in the Act that led both to the changes we did get, and to those that we did not, is the moral hazard of deposit insurance and

the safety net and the associated implications for the taxpayer. On many occasions I have noted my preference for less regulation for well-capitalized banks and lower deposit insurance to reduce moral hazard. I have also noted the political difficulties of lowering deposit insurance. John Medlin of Wachovia Corporation points out that if deposit insurance is maintained, it and the rest of the safety net will continue to be a narcotic inducing bankers to accept more risk than they would without the subsidy of the safety net. He urges that "Banks should be managed as if there were no discount window for liquidity, no regulators for examination, or no deposit insurance for bailout." Indeed, it is my observation that such a focus is the common characteristic of all successful banks, regardless of size, market focus, or other strategies. Market forces reward sound banking practice and in our view sound banks need not be subject to intrusive supervision.

I operate on the assumption that deposit insurance will be maintained, and have thus argued that a long-run increase in bank capital ratios is required to offset the moral hazard incentives. I have also supported prompt resolution procedures to impose on weaker institutions, by statute and regulation, actions that market forces would have mandated were the safety net not in place. Short of a substantial reduction in deposit insurance or a significant increase in capital, some form of prompt resolution seems a reasonable compromise.

Many bankers and some regulators have expressed concern that the prompt regulatory action provisions in the Federal Deposit Insurance Corporation Improvement Act of 1991, FDICIA for short, impose an inflexible, mechanical set of rules that could, at worst, accelerate the demise of an undercapitalized bank, and at best, make its recovery more difficult. It is not difficult to understand the basis for those concerns. It is important to note, however, that the required actions imposed on undercapitalized banks are in circumscribed areas, namely the elimination of dividends, the prohibition of brokered deposits, the submission of an acceptable capital restoration plan, and restraints on growth. To be sure, there is a presumption that regulators will bring increasing pressure on weak banks to resolve their problems. However, we do not, and should not, read the statute as requiring the agencies to take a mechanical and mindless response to declining capital at a bank. Rather, the statute, in our judgment, supplements the discretionary tools that are available to address the problems of troubled institutions. The statute does not eliminate the need for, or the ability of, the agencies to apply good judgment in exercising their supervisory tools. FDICIA fortunately also maintains the ability of the supervisor to focus on variables other than capital, which practical experience and research at the Board of Governors, some of which is being presented at this conference, suggest is extremely important. Most relevant, it should be noted that prompt regulatory action in FDICIA imposes little

new burden on banks that meet *minimum* capital requirements, and otherwise operate in a safe and sound manner, and it sets in place a structure that can someday be used to facilitate the original goals of wider activities and less regulation for banks that exceed minimum capital levels

Similarly, other provisions of FDICIA attempt to limit the exposure of the safety net to troubled institutions by placing limits on the authorities' ability to protect large domestic depositors and depositors at foreign branches, as well as to use the discount window for weak banks. However, there are procedures for exceptions when there is genuine systemic risk.

I suspect that some of the concerns about the operation of the regulatory system are really directed at risk-based capital—both its level and the risk weights. Too many bankers still believe that higher capital standards are equivalent to lower return on equity. The evidence, as I indicated at this conference last year, suggests a more complex story. It appears that many U.S. banks, and especially the riskiest ones, have become both safer and more profitable by increasing their capital and reducing their asset risk. This benefit occurs as higher equity buffers reduce the risk premium demanded by uninsured creditors, and as the increased owners' investment apparently

induces management to reduce its portfolio risk somewhat further, contributing to the reduction in the cost of uninsured funds.

Some critics of the higher capital imposed by the Basle Accord may really be addressing the risk-weights used to translate asset groups into capital requirements. These critics fall into two categories. The first group argues the obvious point that not all loans have the same risk, but then jumps to the policy conclusion that therefore much finer gradations among loan risk-weights are needed. I understand the view that capital requirements should be linked to risk, and we have some such linkage in the risk-based capital weights. But we need to be cautious about imposing ever finer government-mandated variation in capital weights. Clearly they create credit allocation, some of which, of course, occurs as soon as any bank supervision takes place. But the last thing we should want is detailed credit allocation by the authorities, which can never have the detailed information needed to create the appropriate capital weights for the average bank, let alone each bank. Credit allocation is—and I fervently hope will remain—the job of bankers, not government. In their internal decisionmaking good bankers do not allocate the same capital charge to all quality loans, regardless of regulatory requirements or minima. To do so would provide management with distorted and erroneous information on the risk and profitability of their credit decisions. Within the loan category now subject to 100 percent *regulatory* weights, I would expect each

bank to impose differing capital charges that reflect the risk that the bank perceives.

Government should not be trying to do that job.

One aspect of the risk weights we now have was designed to minimize the disincentive that banks had felt under the previous capital standards to hold low risk, liquid assets. I refer to the zero risk-weight for Treasury securities, and the low risk-weight for other securities. The second category of critics argues that these lower weights are an important cause of the recent decline in the higher risk-weight loans. But except for the casual observation that disparate growth rates of securities and loans began at about the same time as the phase-in of the international capital standards, it is difficult to find analytical support for this argument. First, a recession also began at about the same time, and this sort of asset redistribution is a typical response to recession-induced weak loan demands. Second, while the disparity is greater this time, so is the degree of refinancing of bank loans in long-term debt and equity markets by businesses whose balance sheets began the period with excessive quantities of short-term debt and low equity ratios. Third, a large share of the holdings labeled "U.S. government securities" in this cycle are government guaranteed mortgage-backed bonds, which may substitute for direct mortgage holdings but are still reported as "U.S. government securities." Finally, if capital weights and the risk-based capital standard were playing the primary role in the build-up of securities in bank

portfolios, we should find the highest relative growth in such holdings at banks with relatively low capital ratios. In fact, the growth rate of securities holdings appears to be about the same at high- and low-capital banks. Such a pattern reinforces the view that the industry's sharp run-up in securities holdings reflects mainly weak loan demand.

Regardless of how one assesses prompt regulatory action or the Basle Accord, much of the disappointment and frustration that most of us feel with the outcome of last year's legislation reflects the failure to provide relief from an outdated competitive straitjacket. However, even the failure to expand bank activities does not fully explain the pessimism of many bankers, we regulators, and other observers. I would guess that these concerns derive in large part from the provisions of FDICIA that require the agencies to establish highly undesirable regulations that involve substantial micro-management. These include limits on interbank credit exposures, thereby risking the disruption of interbank markets and longstanding banking relationships, as well as further restrictions on bank directors, which, coupled with existing law, may add to the difficulties banks are already experiencing in attracting qualified people. FDICIA also imposes a large number of record-keeping requirements in areas such as branch closings, auditing, small business loans, and truth-in-savings. In addition, it requires the agencies to impose operational standards for internal

controls, interest rate exposure, asset growth, compensation of banking employees, and minimum earnings and market-to-book ratios. Guidelines are also required for loan documentation and credit underwriting.

It is my hope that these latter guidelines will be drafted in such a way that bankers will not be prohibited from making traditional so-called "character" loans. If regulations require that all loans be based solely on collateral or always documented by full accounting detail, an important part of the credit granting process that calls for the bankers' special expertise will be lost, to the detriment of the economy. More generally, we must work to be sure that all of these provisions are implemented in a way that preserves the decisionmaking role of bankers—where decisions properly should, and can best, be made—while permitting agencies to identify institutions that take what would be widely agreed are excessive risks or engage in inappropriate practices

Indeed, in recent years in each of the areas addressed by the requirements for additional regulation one can find a number of examples of abysmally poor bank management, or of regulator judgments and decisions that should not have been made. Thus, one can understand that, while this Administration and the Congress were deciding to provide substantial taxpayer funding to the FDIC, there was an inclination to take all steps to see that these poor management practices would

never recur. However, the collection of micro-management regulations which finally emerged in FDICIA represents, in my judgment, an overreaction that imposes significant costs by absorbing real resources and removing desirable flexibility at our nation's banks

On more neutral ground, an important aspect of FDICIA that many commenters have not focused on is its requirement that the regulatory agencies revise the risk-based capital standards to take account of interest rate, asset concentration, and certain other risks. In addition, the agencies are charged with discussing the development of comparable standards with the other signatories to the Basle Accord. However, the statutory deadline of mid-June 1993 for implementing these provisions for U.S. banks is independent of any international agreements on such matters. And indeed, it is most likely that the United States will revise the risk-based standards applicable to U.S. banks well in advance of any similar changes by other nations.

While the FDICIA deadline for domestic banks is likely to expire somewhat ahead of the timing on any international agreement on interest rate risk, it is important to understand that we are seeking domestic and international approaches that are mutually consistent. In addition, I expect any changes in the domestic approach required by an international agreement to be more in the nature of

refinements, not radical revisions. Such refinements would be in keeping with the long-standing recognition by all the Basel signatories that risk-based capital is an evolving concept

The Fed has been working for quite some time to develop a methodology for including interest rate risk in risk-based capital. We have sought an approach that could be applied fairly, and with a minimum increase in reporting burden and other costs, to all U.S. banks, and that would be compatible with ongoing international efforts. The most appealing procedure appears to be one which concentrates on identifying so-called "outlier" banks that are taking exceptionally large levels of interest rate risk. Such banks would be required to hold additional capital to compensate for this excessive risk. An early version of our approach was presented in the Federal Reserve *Bulletin* last August. Since that time this procedure has been refined further and field-tested during bank examinations by the Federal Reserve, the FDIC, and the OCC. The results of these, and other tests, are encouraging. Indeed, I would expect that the banking agencies would be releasing some specific proposals for public comment by early summer.

In conclusion, FDICIA regrettably falls short of expectations. It continues to pin bankers in an over-regulated and over-restrained structure and adds

considerable micro-regulatory imperatives. I hope that we will revisit some of these issues sooner rather than later. Prompt regulatory action is the inevitable type of framework directed at minimizing the increasingly evident moral hazard of the safety net and hopefully simulating market discipline. It should impose only small additional burdens on a bank that meets its minimum capital standards. There is regrettably little alternative to a program like prompt regulatory action so long as the safety net exists. Indeed, if prompt regulatory action succeeds both in inducing banks to maintain high capital ratios and in reducing deposit insurance fund losses to acceptable levels, it may well prove to be an unexpected benefit of FDICIA. A wider range of activities and locations, as well as exemption from some regulations, for well-capitalized banks, not to mention a long-run decline in deposit insurance premiums remain goals of banking policy. We should all work to make such possibilities a reality.

* * * *