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FDIC: SIX ALTERNATIVES TO THE PRESENT DEPOSIT INSURANCE SYSTEM.

Address by

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before the

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Lincoln, Neb~~raska~~.

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In a recent speech I discussed the adequacy and fairness of the current deposit insurance system, and described in detail how the FDIC deals with bank failures and the bases for our decisions in handling failing banks. After pointing out the inequity in the present system for certain uninsured depositors, I went on to consider briefly the rationale for the one alternative normally suggested -- 100 percent deposit insurance. Today I intend to explore more thoroughly the arguments and implications not only of 100 percent deposit insurance, but also of other alternatives to the present system, some of which may be more desirable than 100 percent insurance.

The basic purpose of deposit insurance is to protect the banking system against destructive runs on deposits as well as to protect the depositors themselves. With respect to the latter, most depositors have fared extremely well in the 531 insured banks which have been closed since the establishment of the Federal Deposit Insurance Corporation. About 99.8 percent of all depositors, large or small, fully recovered their deposits almost immediately. Out of $4 billion in deposits at failed banks through 1975, approximately $267 million was lost or is expected to be lost. Of this amount, unprotected depositors have or will recover all but about $13 million, the Corporation absorbing the remainder.

The high recovery rate for depositors is attributable mainly to the fact that over $9 out of every $10 in deposits were in bank failures which were handled by purchase and assumption transactions, transactions in which the FDIC provides assistance enabling another bank to assume all of the failed bank's liabilities, in effect, providing 100 percent insurance both to uninsured and insured depositors alike. Subordinated creditors and equity investors generally lose most or all of their investments in either a payoff or a purchase and assumption.

The present law, however, restricts our ability to arrange a purchase and assumption in all cases. It requires that we arrange an assumption only when the cost of doing so is less to the FDIC than a payoff. In addition, of course, the FDIC has to be able to find a buyer and in some cases, particularly in unit banking states, that has proved impossible. In Nebraska, for example, of the eight failures since the the FDIC was created all have been payoffs, with the attendant disruptions, rather than assumptions.

Nevertheless, since October of 1974, when the FDIC made this policy explicit, only four of twenty-eight bank failures have been handled by payoff rather than purchase and assumption.

By resorting to purchase and assumptions whenever possible, we have provided _de facto_ 100 percent insurance for all depositors in most banks in recent years. What we have not provided is equity, fairness, and logic in determining which are to be the few depositors who do not have 100 percent insurance. Those instances where depositors have experienced losses in payoffs have reflected special circumstances from the FDIC's standpoint -- not necessarily from the depositors'. That is, there were some cases where it was not possible or appropriate to arrange for a purchase and assumption because of the location of the bank, or because of the state's branch and holding company laws, or because the FDIC could not get a good fix on liabilities because of pending lawsuits or suspected fraud. Uncertainty and potential cost considerations may have afforded logical reasons for a payoff in such cases as far as the FDIC was concerned. However, uninsured depositors were not necessarily at fault. They were unlucky. I recognize that these were large depositors who presumably are sophisticated and knowledgeable enough to scrutinize the condition of the bank before making their deposit, but that probably did not help. The sophisticated depositor is more likely to be able to detect poor management which will probably lead to a purchase and assumption than fraud which is more likely to lead to a payoff.

If we almost have 100 percent deposit insurance and the present system appears to work in an almost random way in its treatment of depositors -- similar depositors getting treated differently in different cases -why not protect those innocent uninsured depositors by going to 100 percent deposit insurance? Let's explore the possibility.

First, the five most obvious arguments in support of such a change:

1. <u>One-hundred percent deposit insurance would provide protection to those depositors whose deposits are not now fully protected</u>. This can be done with only minimal additional cost to the FDIC, if past experience

is any guide. The additional cost to the FDIC of payoffs made throughout the Corporation's history, if none of the loss had been borne by uninsured depositors and the same banks had failed, would be about $13 million. Let me insert a caveat at this point, however. If one or more of the recent large bank failures had been payoffs, the amount of loss to uninsured depositors would be much larger and, therefore, the cost of moving to full insurance much more costly to the FDIC. If just one bank failure, U. S. National Bank in San Diego, California, had been resolved with a payoff rather than a purchase and assumption, the cost to uninsured depositors would have increased from $13 million to $88 million.

2. With 100 percent deposit insurance, depositors would have no need to withdraw funds from banks with problems, and runs on such banks would not be likely to cause a failure. Under our present system, when a bank gets into difficulty or is exposed to adverse publicity, some uninsured depositors tend to flee, exacerbating that difficulty. We must remember, when comparing banks with other corporations, that much of bank liabilities are payable on demand and free to leave in response to adverse publicity. One-hundred percent deposit insurance should limit deposit outflows in adverse circumstances, thus providing more time to work out a solution for the problem bank or for management to turn the bank around. Of course, not all deposit outflows would be forestalled since depositors typically want to do business with banks

that can provide loans and other services, and the troubled bank is apt to be less able to serve its customers.

We expect that these factors would lead to a reduction in the number of bank failures, but that is by no means assured. What is more certain is that there would be fewer payouts. The purchase and assumption procedure could be used in almost every failure if deposits are insured in full.

3. One-hundred percent deposit insurance would have a beneficial impact on competition among banks. At present, institutions deemed to be more solid or more conservative have an advantage in competing for deposits. This is as it should be. However, depositors may not be able to differentiate accurately among banks according to risk and, for some depositors, size becomes a proxy for soundness. Or depositors may simply assume that we will not allow a large bank failure to result in a payoff. Statistically, there is some support for that position, as evidenced by the following: During the period 1971 to the present, of the banks that closed, 30 had less than $21 million in deposits. Twelve of these were paid out, 16 were acquired by a third party in an FDIC-assisted purchase and assumption transaction, and two became Deposit Insurance National Banks. Only one of the seven failed banks between $21 million and $100 million was paid out, and none of the five with more than $100 million in deposits was paid out.

The present system, then, gives a decided competitive edge to very large banks. One-hundred percent deposit insurance would probably improve the competitive positions of small vs. large banks and of new vs. established institutions. Over time this would ordinarily be expected to reduce the levels of concentration in banking, and to lead to more competitive markets for banking services.

4. Because, as I have mentioned, we would not need to fear provoking runs on troubled banks, fuller public disclosure of adverse information on a bank's financial condition could be made. This would lead to more informed business decisions by investors and customers of the bank, and some of the controversy about proper bank disclosure could be eliminated. The FDIC has been concerned that in recent years the capital markets have become less open to banks, particularly to smaller banks. Fuller disclosure would make it easier for well-run banks to open these markets, and to open them at reasonable rates. Large customers could become more confident that their business was safe in smaller banks if they had more disclosure of the condition of the bank.

5. If we had 100 percent deposit insurance, pledging requirements for state and local governments could presumably be eliminated. State and local governments already have preferred treatment with respect to their deposits in banks. They now have insurance coverage of $100,000, and the remainder, in most states, is protected by pledging requirements. Those bankers and others who view pledging requirements as an impediment

to the efficient utilization of bank assets, and a reduction in bank liquidity, would count its elimination as an advantage of 100 percent insurance coverage. Those Treasurers of public bodies and others concerned with the market for state and local government securities probably would view the elimination of pledging requirements as an undesirable aspect of 100 percent deposit insurance. There are other techniques for providing a continuing market for municipal securities, however, that probably would be effective even if pledging requirements were eliminated. Municipalities may be able to improve their markets, for example, by providing fuller disclosure or by moving to taxable, subsidized borrowings.

Let me turn to the obvious arguments against 100 percent deposit insurance:

1. Uninsured depositors place limits on the riskiness of bank operations. While there is some debate about how effective such influence is and no hard evidence is available, few would deny that, to a degree at least, this influence exists. With 100 percent insurance, banks anxious to increase their risk by bidding aggressively for deposits and loans might be able to do so without any market restraints.

No banker wants to lose money or fail, but some would be willing to take on considerable risk if they considered potential rewards in the form of growth and earnings to be sufficient. This weighing of risk and reward works in most sectors of our economy where most of the risk is assumed by equity investors. Where leverage is sought, lenders restrain the extent of overall risk by imposing restrictions, e.g., higher interest rates, and limiting available funds as risk is increased.

In the banking system, however, depositors provide most of the funds. With 100 percent deposit insurance, there would be little reason for large depositors to impose such market constraints. Aggressive high-risk oriented banks, therefore, would be able to bid successfully for sizable additional time deposits at moderately elevated interest rates, which under current conditions might have been available to them only at prohibitive rates or not at all. Under 100 percent insurance, then, all of this additional exposure to loss would be borne by the deposit insurance fund.

Let me emphasize that the argument is not that most or even many bankers would behave irresponsibly if we had 100 percent deposit insurance. Rather, it is that 100 percent deposit insurance would significantly reduce the market restraints that many believe presently limit the amount of deposits available to the overly risky, overly aggressive, overly optimistic and self-serving operation. Of course, there would still be some competitive forces working in the direction of sound bank operations. Many depositors, particularly large business firms, are attracted to a bank by its ability to provide services efficiently and to grant credit when needed. A bank whose continued existence is in question is hindered in this competition for customers.

2. <u>Since under 100 percent deposit insurance the exposure of the FDIC fund may increase, the Corporation may need authority to restrict</u>

leverage or the composition of bank asset portfolios in order to offset the greater risk exposure and costs. Some possible restrictions would be limitations on capital ratios, limitations on asset combinations or some form of both. Traditionally, the FDIC has not sought additional powers over bank leverage or asset composition. In fact, we have tended to favor broader lending and investment powers for banks. Likewise, most bankers have opposed the mix of increased insurance and increased regulation, fearing that regulatory restrictions might be more costly than the benefits of 100 percent deposit insurance.

Over the last year or so, several large banks have gone to market to raise very sizable amounts of capital. Obviously, we are pleased to see that, because increased bank capital becomes part of the cushion for the deposit insurance fund. To some extent these capital issues may have resulted from informal pressure from the supervisory agencies, but I would not want to exaggerate our influence in these decisions. The major factor probably was the bank's concern that capital ratios play a role in the competitive battle for large deposits. In a world of 100 percent deposit insurance, however, bankers may be able to attract fully insured large deposits with very low capital ratios. Since bankers will not have the same incentive to maintain this cushion of capital protection for the deposit insurance fund, we may need authority to impose minimum capital requirements (or minimum liquidity requirements, or more control over types of investments).

3. <u>As long as there are no runs or liquidity pressures on banks in difficulty, supervisors might be reluctant to close banks that are insolvent or operating in an excessively risky fashion.</u> This raises a very important issue concerning bank failures and insurance. Do we want a situation in which a bank cannot fail? That is, do we want to keep inefficient, marginal banks open indefinitely? I do not think so, and 100 percent deposit insurance does not necessarily lead to that result. But there is a legitimate concern that supervisors may be reluctant to close a bank that could otherwise continue to operate indefinitely. Suppose a state supervisor concludes that a bank, on the basis of examiner classifications and market depreciation of securities, is insolvent. Under present conditions, such a bank is closed on an asset valuation basis, or tends to lose deposits, finds it difficult to borrow Federal funds, and is closed on a liquidity basis in a relatively short time. With 100 percent deposit insurance, depositors will not shy away from such a bank and liquidity pressures will be absent. In such a case, human nature might well lead the supervisor to delay taking action to close the bank. He may not intend to delay indefinitely, but it might appear desirable to delay until after the next election or until the supervisor's term is up. The temptation to leave such problems to one's successor is great, <u>and</u> is not unreasonable. After all, perhaps the examiner's loan classifications were too harsh, or perhaps the market will turn around and eliminate the depreciation in the bond

portfolio or maybe something else will come up to improve the bank's condition. Whatever the reason, if supervisors react in this way, the risk of failure for inefficient, incompetent, or crooked owners and managers will be substantially decreased.

4. In view of the greater risks which banks might take and the longer time before they are closed, the ultimate losses to the insurance fund might be large. In fact, our past experience of very limited losses may not be a true indication of the potential risks under 100 percent deposit insurance. I mentioned earlier that if our past bank failures had involved 100 percent deposit insurance the additional cost to the FDIC would only have been about $13 million. But that was in a world in which insolvent banks were closed promptly and in which the prudence of uninsured depositors made it difficult for crooked or incompetent bankers to obtain deposits. If large depositors, with no fear of loss, could put large amounts of fully insured funds in the hands of swindlers, incompetents, or swingers, our losses could be much larger than past experience suggests.

Where do these pros and cons lead us with respect to a position on 100 percent deposit insurance? Allow me to duck that question for the present and suggest other alternatives than 100 percent deposit insurance for dealing with the inequities of the present system.

I see at least four or five alternatives:

1. It is clear that we can achieve all the benefits of 100 percent deposit insurance by adopting a policy of always arranging for purchase

and assumption transactions in the case of bank failure. We can do so nearly all the time now, but there are some situations in which existing statutes do not allow us to use the assumption technique. There are some cases where the amount of uninsured liabilities is so great, or the value of the bank's business is so low, that no potential assuming bank is willing to offer a premium sufficient to meet the statutory test that an assumption transaction can be assisted by the FDIC only if the cost to the FDIC will be less than in a payout. In cases of suspected fraud, we must be concerned that there are liabilities that do not appear on the bank's books, which we obviously do not want to underwrite. In other cases an assumption may appear undesirable because the potential acquiring bank already has too large a share of the market, and an increase in that share would have anticompetitive effects on bank structure.

In some of these cases, we can avoid a payout (and avoid the disruption to the local community from a bank closing) by using a provision of our law which allows us to provide assistance directly to a failing bank to keep it operating. This provision allows us to provide such assistance, however, only when the continued existence of the failing bank is "essential" to its community. Obviously, there are very few cases in which that finding can be made -- in fact, we have successfully used that section only four times in the history of the FDIC.

To accomplish all the effects of 100 percent deposit insurance by a purchase and assumption in each failed bank case, we need a change in the law such that the FDIC would be required to arrange an assumption in all cases or, if an assumption proves impossible, to provide direct assistance to keep the bank in operation. Actually, I believe we could accomplish about the same result with only very minor statutory changes which would give the FDIC Board of Directors greater discretion in arranging assumptions or in providing direct assistance to open banks. Some would object to putting greater discretionary authority in the hands of the FDIC Board on these matters without also having clearer Congressional direction as to the policy to be followed.

2. One of the simpler proposals, and perhaps the most promising, is to provide 100 percent insurance of demand deposits and limit insurance on time deposits, if any insurance is provided for such deposits at all, to something less than $100,000. Large CD's for which Regulation Q ceilings are not applicable would carry only limited insurance, or, perhaps, none at all. Such "deposits," in most cases, are really money market instruments and logically could be distinguished from deposits. The SEC, for example, has long argued that they are securities. Keeping these funds at risk would retain some market discipline for banks, since it would place limits on the ability of the bank operating at high risk to bid successfully for funds on a regional and national basis.

One appeal of this proposal is that it would not represent a substantial departure from present *de facto* arrangements. Unless a bank fails very suddenly (perhaps as a result of some kind of fraud or theft), demand depositors generally can get out quickly by closing accounts, reducing balances to the level of their outstanding loan or borrowing an amount equivalent to their demand balance. Under present arrangements, perhaps unfortunately, demand depositors frequently protect themselves by getting out, further exacerbating the bank's problem. If demand balances were 100 percent insured, protection for these depositors would not require the outflow of deposits. CD's would run off in periods of adverse publicity, but this would be a function of the maturity structure of the bank's CD's, rather than a sudden collapse. The troubled bank would generally have more time to work out its problem and the overall deposit outflow would be less.

3. A third approach toward expanding deposit insurance, one already suggested, would be to <u>combine 100 percent deposit insurance with minimum capital ratios, limitations on asset composition or some combination of the two</u>. At the present time, the supervisory agencies' attitude toward capital adequacy is not subject to explicit rules. Many variables are considered in determining whether a bank's capital is adequate, including such factors as subjective as the quality of the bank's management. We may urge some banks to increase their capital (or their liquidity), but some may not do so, either because they are not able to or because they do not agree with our assessment. Actually, the supervisory agencies tend to be most successful in this area when

the bank needs agency approval in connection with some application (say for a branch or holding company acquisition). Also, some bankers are more easily intimidated by the examiner or by the agency than others. Rules and standards are thus not always evenly implemented or adhered to. As a result, supervisory standards do not always seem uniform -- within as well as between agencies.

In view of this situation, perhaps it would be desirable if all insured banks were required to adhere to an explicit minimum capital-deposit or capital-loan ratio. Such a requirement would not necessarily have to be related to deposit insurance. However, the imposition of such a standard could mesh well with a move toward 100 percent deposit insurance, and would probably be necessary if there is 100 percent insurance. Banks would be prevented from using the expanded insurance to expand their leverage drastically.

4. A modest variation on this alternative would be to <u>allow banks to get expanded or 100 percent insurance if they meet some minimum capital ratio or other standard</u>. However, it would be crucial under such a fluctuating system that there be no doubt or misconception in the depositor's mind as to whether his deposit was fully insured.

5. Another proposal would <u>combine expanded or 100 percent deposit insurance with a system of variable rate insurance premiums</u>. The idea of a variable rate insurance premium has been discussed periodically, particularly by academic economists, and not necessarily

in conjunction with expanded deposit insurance. While there is no necessary link between the two concepts -- the proposal for a variable rate premium can be analyzed on its own -- the variable rate premium could conceivably provide a substitute for the market discipline that is lost under 100 percent deposit insurance.

The advantage of a variable rate insurance premium in this setting is that premiums are geared to risk. The conservatively run bank whose operations pose little risk to the insurance fund is rewarded with a low premium rate and vice versa, just as now the capital requirements serve as a rough approach to the same end.

It is extremely difficult to put risk of failure on anything like an actuarial basis. We have not had that many failures during the past four decades and, despite the substantial efforts in recent years to zero in on those variables providing early warning about failures, few, if any, would attempt to construct and defend a rational premium system based on research that has been completed so far. Similarly, while we try very hard to standardize our criticism of assets, there is sufficient variation between reviews to make it unfair to base any finely tuned system on an asset-classification foundation.

I would not necessarily rule out the idea of variable rate insurance premiums because a rational, actuarially-sound system cannot be constructed. It might be feasible to establish a simple, seemingly arbitrary system that has the effect of putting banks into, say, three, four or five risk categories. These might be based on a few simple ratios relating such variables as capital ratios, asset mix, income ratios, etc., without attempting to defend the premiums in actuarial terms. Rather, they would be related to things the supervisors consider relevant and their level would be set so as to bring about some desired result in terms of bank portfolios. Insofar as a bank placed into a high-risk class was unhappy about that, it could adjust its policies to change its risk category. In that sense, there could be an element of choice in such a system.

If premiums were set sufficiently high for banks in the highest risk category, the system might have a self-regulating quality such that the discipline of the uninsured depositor might not be necessary, and such a system of insurance premiums could mesh with 100 percent deposit insurance.

I recognize that the premiums set under such a system, and the levels of particular financial ratios, would be essentially arbitrary. But that is not so far removed from our present system. The level of premiums at the present time appears adequate for the present risks of the banking system, but we cannot be sure that it is precisely correct or even anywhere near some hypothetical "correct" level. Also, under the present supervisory system, while we attempt to coax many banks to raise capital, the results are certainly not uniform, and the figures we aim at are essentially arbitrary -- except that we know "more is better."

How steep would the variable rate structure have to go to discourage excess risk-taking while still keeping overall premium income in about the same relationship to deposits as exists today? How do you appraise the capital position and asset mix of a bank where half its resources are in foreign branches? Should we base premiums on subsidiary banks or should they be applicable for an entire holding company system? All these are questions that would have to be answered before variable premium rate insurance could be adopted.

Let me conclude not with a selection or advocacy of a particular position but with some few additional comments about the present system. I have heard complaints from small banks that the present structure of deposit insurance and assessment is unfair to small banks. I have heard the same claim made by large banks. Perhaps we can simply assume that if both small and large banks think the present system is unfair to them, then it must be pretty good. But I think the issue is more complicated than that.

Small banks argue that we provide 100 percent insurance for large banks but not small banks in that we have never had a payout of a large bank with losses to uninsured depositors, whereas we have had such treatment of small bank failures. The small banks argue that this inhibits their ability to compete for large deposits. A large depositor may decide to put his uninsured deposit in a large bank, not necessarily because it is better run or a sounder institution, but because of his belief that in case of difficulty the FDIC will not allow a payoff in a large bank situation. As I mentioned earlier, statistics do support this argument. The FDIC has paid off only one failed bank with deposits over $41 million, that a $67 million Texas bank, even though fifteen banks of over $41 million have either failed or required FDIC assistance to stay open.

Large banks sometimes complain about the fact that deposit insurance premiums are based on the total domestic deposits of the bank, not just on insured deposits. Thus a bank with a large percentage of its domestic deposits above $40,000 pays a premium that is higher in proportion to those insured deposits than a small bank with fewer uninsured deposits. Originally, this was done intentionally to provide for a subsidization of the insurance fund by a large bank for the benefit of small banks. Since we now have a world in which large banks can and do fail, it does not appear that large bank premiums are subsidizing the cost of small bank failures. Furthermore, large banks have many correspondent accounts, and clearly benefit from a strong banking system. Small banks also argue that the assessment system is equitable since, in practice, large banks have had 100 percent deposit insurance and hence it is only reasonable that they pay insurance premiums on one hundred percent of their deposits.