FDIC's role in the changing financial services environment!

Remarks by

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I am pleased to be here as part of this distinguished panel.

I'd like to focus on certain aspects of the Federal Deposit Insurance Corporation's role in the changing financial services environment, and leave it to other able bodies on this panel to discuss the legislative and other regulatory aspects of financial restructuring.

I'm sure you all have noticed that we have been dealing with a few banking problems in the United States over the last several years.

These problems remind me of a story I heard about a bank that ended up being handled by the FDIC.

A friend of mine walked into a bank in Texas and attempted to cash a huge personal check -- a <u>Texas</u> size check. Unfortunately, the teller returned the check with "Insufficient Funds" stamped across its face. Beneath the stamped words was the handwritten notation: "Not you...us."

As I'm sure you are aware, the FDIC's primary function, as one of the triad of federal bank regulators, is to insure bank deposits -- and increasingly the banking system.

Despite a record number of problems handled, the financial condition of the FDIC fund remains strong, although somewhat strained. That fund has been building for over fifty years through premiums paid by the banks, and income on our accumulated assets. Based on current estimates, including the cost of handling the most expensive U.S. banking problem ever -- First Republic of Dallas, Texas -- the fund will decline by 10 to 15 percent to about the $16 billion range. That will be the first such loss in FDIC history.

In many ways we are finding that the American deposit insurance system is at a watershed period.

One of the areas creating controversy in this changing environment is to what extent should the federal government prevent our largest banks from defaulting on their debt obligations.

We are well aware that the extent the United States stands behind its largest banks, such as First Republic of Texas, is an issue closely followed by investors and banks around the world.

So I thought you might be interested in why we determined that more than just the insured depositors at banks like First Republic need to be protected.

I want to note that at this point I am talking about preventing banks from defaulting, and later I'll turn to the issue of bank holding companies defaulting on their obligations.

When addressing this subject we made a few basic assumptions.

<u>First</u>, the banking system is special because it plays a critical role in the economy -- not only by allocating credit and acting as a depository for funds, but also through its role at the center of the payment system.

<u>Second</u>, given that the banking system is special, and needs to be protected as a whole, we have maintained that it is necessary to protect certain larger institutions to avoid a challenge to the system's overall integrity.

<u>Third</u>, allowing a major bank to default could destabilize the international financial system. Today we have a global financial system. The United States would become the only industrialized nation in that system to have allowed depositors and creditors of a major multi-billion dollar bank to suffer loss, thus undermining the competitive position of U.S. institutions.

That's a subject that might even tempt the likes of Paul Erdman, the author of <u>The Panic of '89</u>.

Fourth, allowing a major bank to default, requiring the FDIC to pay-off insured depositors, but not more, could also prove very costly for the FDIC, and could require huge cash outlays. And there is also a real question of whether it is technically possible to close a gigantic institution, with the massive scope of its ever changing portfolios, without freezing insured as well as uninsured funds for a considerable period.

Some have argued that the risks of allowing large banks to default are worth taking. But that is certainly easier to say from the sidelines, than when you have The Watch.

The bottom line in this discussion is that nobody really knows what might happen if a major bank is allowed to default, and the opportunity to find out is not one likely to be accepted soon.

Given that conclusion, how do we know where to draw the line delineating which banks are so significant that they cannot be allowed to default? This process inevitably must take place on an ad hoc basis, where a variety of factors are examined.

These factors include the sheer size of the institution; the amount of uninsured and exposed liabilities; the cost to the FDIC, including whether another cost-effective solution is available; the perceived net effect on the stability of the banking system; and the anticipated effects on the local and national economy.

The fact we stand behind our largest banks means that more than ever, we need to make sure that banks, protected by the federal safety net, are operated in a safe and sound manner. In addition, the federal safety net, designed to protect the banks, should not protect nonbanking activities or bank owners, including bank holding companies. This, of course, was not the case when Continental Illinois had its problems, and we protected holding company creditors.

Our view that we must limit the extension of the safety net to banks is the reason we allowed First Republic's holding company down in Texas to default on its obligations last month.

Eventually, the forty banks in the First Republic organization did fail, but the assets and labilities of these banks were reconstituted in a new bridge banking structure. Importantly, the obligations of these banks to all depositors and general creditors (except intercompany transactions) were made whole through our support.

However, First Republic's holding company has declared bankruptcy. Recently I received a letter from a foreign bank that discussed our handling of First Republic. I quote from that letter:

"In our opinion the confidence of international banks as well as other investors in the U.S. banking system has been under some strain over the past years through events known to you. The rescue operation mounted in favor of Continental Illinois Corp. some time ago was successful in containing this development.

"To uphold investors' confidence in the U.S. banking system must have been the leading motive for the rescue operation in favor of First RepublicBank Dallas, and this objective alone can justify the expense of such a vast amount of public funds. This purpose is, however, utterly confounded if the interests of holders of senior debt issued or guaranteed by the bank holding company are sacrificed."

Actually, our policy is certainly not a reason for anyone to lose confidence in the American banking system. As I've said, we have protected our large banks, and we are simply making clear that the owners of those banks are like other entities in the U.S., and will not receive special federal protection, despite the fact they are regulated by the Federal Reserve Board.

We regret that this distinction may not always have been presented by sellers of holding company debt. We hope we have made it clear that banks and bank holding companies are separate legal entities, which should be treated as such when funding decisions are made.

The credit markets are recognizing this policy, and are requiring higher returns on holding company debt when compared to direct bank debt. In our view this represents a healthy and efficient development in our marketplace, and one that we hope the international community will support.

Thank you, and I look forward to any questions you may have.