TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

ON

PROBLEMS FACING THE SAVINGS AND LOAN INDUSTRY AND
THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

BEFORE THE

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Good morning, Mr. Chairman and members of the Committee. I appreciate this opportunity to testify today concerning the costs facing our nation resulting from the problems of the savings and loan ("S&L") industry and the Federal Savings and Loan Insurance Corporation ("FSLIC"). We believe this matter is a critical issue that requires action by the Congress and the Administration.

It is important for the Federal Deposit Insurance Corporation ("FDIC"), as insurer of bank deposits, to address this issue because the thrift industry problems threaten the profitability -- and potentially even the stability -- of many banks. Moreover, some have suggested that the FDIC should be involved in dealing with the S&L insurance problems.

During the past year, the FDIC has examined ways to improve the current federal deposit insurance system. Our recommendations for legislative and regulatory reform that resulted from that examination are contained in our recently released study, <u>Deposit Insurance for the Nineties: Meeting the Challenge</u>. The appendix to this testimony is the executive summary from the new FDIC study. I also would like to submit the full study for the record.

As part of our review of the deposit insurance system, we discussed the extent of the S&L problem and estimates of the cost of resolving it, and analyzed alternative sources of funding. These areas will be the primary focus of my remarks today.

Before addressing the S&L and FSLIC problem specifically, I would like to make a few comments on our present federal deposit insurance system. It is the FDIC's view that changes must be made to the deposit insurance system to ensure that it is cost-effective. Any legislated resolution of the FSLIC problem, in addition to providing appropriate funding, should change the system to protect against a recurrence of this type of problem. Detailed recommendations for improvements to the system are contained in our study. However, I would like to summarize some of the most important concepts.

NEEDED CHANGES IN THE DEPOSIT INSURANCE SYSTEM

The Federal deposit insurance system has provided many benefits by eliminating bank runs, stabilizing the banking system and providing a safe place for people's money. However, the system requires some fundamental changes if it is to continue to serve the purposes for which it was created by Congress over 55 years ago, and function in a cost-effective manner. Generally, our efforts must be aimed at managing the system better.

One of the fundamental changes recommended in our study is that the federal insurer should be allowed to operate as much as possible like a private insurer. This principle is central to improving the system. To maintain adequate resources, the insurer must have additional controls over revenues, including the ability to adjust insurance premiums paid by insured institutions and to require an entrance fee from those newly obtaining insurance. The insurer also must be able to control costs. This necessitates the ability to set standards for insurability for all institutions and to promptly terminate insurance privileges when an institution is operating in an unsafe manner.

To accomplish private insurer status, the FSLIC and FDIC should be made as financially, operationally and organizationally independent as possible. To ensure political independence, the insurer should continue to be self-funded. It should have a budget separate from the general federal budget and should not be allowed to obligate general federal revenues. The insurer also should be independent from the Congressional appropriations process. The insurer should remain accountable to Congress on an annual basis, but should remain free from annual budgetary controls.

One of the most important concepts contained in the study, within the jurisdiction of this Committee, is that the FSLIC and FDIC trust funds should be separately budgeted and should not be part of the general operational federal budget. In essence, the basic purpose and mandate of the trust funds is to save for emergencies. For decades the insurance funds have been depositing their unspent premium income into the U.S. Treasury. While the insurance trust funds receive no taxpayer dollars, these deposits to the Treasury nonetheless are counted as income to the government rather than savings reserved for future problems in the industry. When funds are withdrawn from the Treasury to deal with a problem institution, that action is treated as a government expenditure. Instead, it should be treated as a payback of money on deposit.

As the present system is designed, it creates a disincentive for saving for future problems. Moreover, because of the immediate negative impact on the general budget, the insurer may be hesitant to draw upon funds to deal with industry problems at an early stage.

For these reasons, we urge the Committee to give strong consideration to setting up a separate budget for the deposit insurance funds. The FSLIC and

FDIC trust funds should be treated as a separate budget and not part of the general federal budget. For macroeconomic purposes, however, analysts could combine the new separate budget with the general federal budget.

I would now like to turn to the FSLIC situation.

SCOPE OF THE FSLIC PROBLEM

Cost Estimate. We estimate the costs associated with handling insolvent S&Ls and recapitalizing the FSLIC to range between $80 and $105 billion. That range is arrived at by totaling three components. First, the FSLIC estimates that the 217 cases involved in FSLIC-supported transactions in 1988 will cost approximately $39 billion. Secondly, based on available data, we estimate that an additional $30 billion to $50 billion may be needed to deal with the remaining troubled S&Ls. And third, we estimate that about $10 billion to $15 billion will be needed to maintain an ongoing S&L insurance fund to deal with future problems that we can foresee.

Calculation of the Cost Estimate. We must emphasize that our estimates are not precise. A more definite estimate of the cost of handling insolvent S&Ls can be made only after the completion of detailed on-site examinations. Even then, uncertainties would remain based on regional and local economic developments, interest-rate trends, and other factors that could influence the future value of S&L franchises.

In the absence of information generated by on-site examinations, we have based our estimates on the formula we have developed from past experience to estimate the cost of bank failures. While no formula can be completely accurate for each individual institution, we have found this method of estimating the costs of bank failures reliable, yielding results that, on average, approximate our actual costs.

Essentially, the formula applies a loss rate to various classes of "risk assets." For banks, these include virtually all assets except cash, marketable securities and other highly liquid short-term assets. A loss rate of 20 percent is applied to all risk assets not adversely classified by examiners. Increasingly severe loss rates are applied to classified assets depending upon the level of examiner criticism. In addition, losses may be adjusted up or down depending upon the geographic location or size of the failing institution.

In applying our formula to S&Ls, we considered intangible assets, such as deferred losses and goodwill, to be worthless. Also, we adjusted our formula to exclude any loss rate on residential mortgages and mortgage pass-through securities -- categories that accounted for about 43 percent of the holdings of unprofitable and insolvent thrifts as of mid-year 1988. While credit losses on such mortgages and securities should be relatively low, because there will be some losses in that category, this adjustment provides a significantly conservative bias to our loss estimates. Thus, the ultimate costs of resolving the S&L problem may be even greater than our estimates.

However, it should be noted that the FDIC cost formula is based on our experience in liquidating banks. Any bias in our formula toward under-estimating losses in insolvent S&Ls could be reduced somewhat to the extent that assisted mergers with healthy institutions can be arranged at costs below liquidation values. Moreover, the formula applies to small banks -- those below $500 million in total assets. Our liquidation experience with large-bank failures evidences lower costs per dollar of assets, although most problem S&Ls are under $500 million in total assets.

Growth of the Problem. The costs of resolving existing S&L insolvencies are growing rapidly. We estimate that insolvent, unprofitable S&Ls lost about $15 billion during the fifteen months ending March 31, 1988, or about $1 billion per month. We estimate that about half those losses are in insolvent S&Ls that were not handled by the FSLIC in 1988. Such losses can be divided into two categories: loan losses and operating losses.

Loan losses do not necessarily reflect the current growth of costs to the insurer. Instead, they reflect our acquired knowledge of costs that already have been incurred, but may not have been apparent earlier. When an insolvent institution is closed, the insurer may discover loan losses that had not yet been recognized. Additional costs resulting from unrecognized loan losses are impossible to estimate without detailed on-site examinations.

Operating losses, on the other hand, are losses incurred solely from current operations. As these losses mount, the S&L's net worth deficit and, hence, the FSLIC's cost increase. The operating losses at insolvent and unprofitable S&Ls that the FSLIC has not yet handled were about $1.7 billion in the first nine months of 1988.

The FDIC believes that insolvent S&Ls incurring the greatest operating losses should be identified and dealt with first. These institutions have the highest rates of growth in estimated present value cost, thus compounding the problem the longer they remain in business. Excluding the cases resolved by the FSLIC in 1988, we estimate that it would cost about $20 to $25 billion to resolve the "worst 100" of these institutions.

Other factors that cannot easily be measured also serve to increase the cost of closing or merging insolvent S&Ls the longer they remain open. These include the incentive for managers to look for risky investments (or "bet the S&L") in an attempt to return to solvency, and the deterioration in franchise value of the S&L the longer it remains open for business. The deterioration in value usually results from attempts to "economize" on expenses -- such as maintenance of property or legal actions to strengthen creditor positions.

RESOLVING THE FSLIC PROBLEM

There are a number of decisions that must be made to meet the problems confronting the S&L industry and the FSLIC. One threshold issue is how to allocate the costs among several sources that may include the S&L industry, the Federal Home Loan Banks ("FHLBs"), the FDIC, the Federal Reserve, the commercial and savings bank industries (or other financial-service industries), and the Treasury, i.e., the American taxpayers. Another fundamental issue is the appropriate budget treatment for the financing.

Sources of Funds. We believe the S&L industry, including the FHLBs, should bear as much of the cost as is prudent to assign to it. Our analysis indicates, however, that there are severe constraints on the industry's ability to finance the FSLIC shortfall. First, the tangible net worth of all solvent S&Ls is only about $40 billion. Even if that entire net worth could be used to deal with the problem, it would not be adequate. Second, insurance premiums for S&Ls are now 150 percent higher than for banks, and accounted for about 67 percent of the average annualized return on assets for GAAP-solvent S&Ls as of midyear 1988. That means a significant proportion of the industry's earnings already are being devoted to this problem. This can continue for only a few years. Any prolonged continuance would jeopardize industry viability.

The remaining source of funds from within the S&L industry is the Federal Home Loan Bank System. The total retained earnings are about $2 billion and profits of the FHLBs are about $1.4 billion per year. Some of this amount should be available. However, using too large a portion of these resources to refinance the FSLIC entails the risk of permanently damaging the Banks' financing capabilities.

We do not believe that the FDIC insurance fund should be a source of payment for the FSLIC shortfall. For 1988 the FDIC will show a 15 to 20 percent reduction in its fund -- its first operating loss ever. The FDIC fund has fallen below one percent of insured deposits, the level which we believe should be maintained as a base for the fund. The FDIC's current and anticipated financial resources are just sufficient to meet its own insurance needs. In addition, use of the FDIC's available reserves for the FSLIC resolution would not provide any federal budgetary benefits because the projected deficit would rise dollar-for-dollar with any FDIC outlay.

We also believe that it would be unwise to target banks to pay the cost of rescuing their competitors, the S&L industry. Banks already have incurred substantial costs in attempting to match inflated deposit rates paid by insolvent S&Ls. Banks also have not enjoyed the same permissive capital regulation, broad geographic expansion and product authorities, or tax subsidies that have been granted FSLIC-insured S&Ls.

Another financing option is the use of Federal Reserve funds. The Federal Reserve has annual earnings of $17 billion. Alternatively, the Federal Reserve could begin paying interest on banks' required reserves -- currently about $3 to $4 billion per year -- and transfer the proceeds to the agency responsible for closing the insolvent S&Ls. This would be of no benefit to the budget deficit since the Federal Reserve's earnings, which are passed to the Treasury each year, would be reduced correspondingly. Further, we believe that interest on reserves, if any is paid, should be paid to those who own them, and not to an insurance fund.

Finally, some have advocated levying a tax on depositors or imposing a fee on new mortgages or deposits. This we call the "reverse toaster plan": Come in and open an account and instead of getting a toaster as a premium the depositor gives one to the government. We do not favor this approach. A flat-rate system of user fees would impose a form of tax, handicap depository institutions competitively and be expensive to administer.

Unfortunately, we believe the Treasury Department will have to provide some of the funding to resolve the FSLIC problem. We have discussed this issue with the Treasury and anticipate that a Treasury proposal will be presented to President Bush in the near future.

Financing Mechanisms. After deciding who is to pay for the FSLIC shortfall, an appropriate financing mechanism must be found. This may involve substantial borrowing by some governmental or quasi-governmental agency. Any borrowing by the FSLIC or the FDIC against future insurance premiums, or borrowing by the Federal Reserve or the Treasury, under current law and procedures, would be part of the general federal budget. This would have the effect of increasing the federal budget deficit and rendering the Gramm-Rudman deficit reduction targets unattainable in the absence of offsetting cuts in other programs or increased tax revenues.

Through a separate-budget-financing approach, power to borrow to resolve S&L insolvencies could be entrusted to the already existing Financing Corporation ("FICO"), or to some other new limited-life, quasi-governmental agency.

Alternatively, the FDIC or the FSLIC -- or a merged version of the two -- could be given sufficient borrowing authority and made subject to a separate budget. Responsibility for interest and principal on the borrowings could be apportioned among the S&L industry, the FHLBs and the Treasury. For example, interest on borrowings of the Farm Credit System Financial Assistance Corporation will be paid by the Treasury for at least the first five years, and half the interest for the next five years. Treasury also guarantees the principal of these borrowings. A similar arrangement could be made to fund the FSLIC shortfall.

The FDIC favors a separate-budget-financing approach under which the insurer borrows the necessary funds directly. First, it would be less costly to generate funds if the insurer were able to borrow directly, rather than through a FICO-type entity. However, as with a FICO-type agency, any such direct borrowing would not be treated as an outlay of general federal revenues. Second, as indicated at the beginning of this statement, we believe that the deposit insurance trust funds should never have been included as part of the general federal budget in the first instance. Combining these funds with the general federal budget discourages the prudent management of the deposit insurance system. And third, a separate budget will still leave the cost of this problem fully apparent -- it is not a vehicle to hide that cost -- but it will facilitate a more efficient and effective solution.

ECONOMIC IMPLICATIONS

From a general economic standpoint, we do not believe that finding a solution to the FSLIC insolvency will adversely affect the U.S. economy. The FSLIC insolvency represents money that has been borrowed and spent, but that has not been repaid. Presently, those borrowings are financed by insured deposits. The proposed solutions do not involve raising additional funds, but instead entail substituting some other form of financing mechanism for insured deposits.

In other words, if the U.S. Treasury or some other government agency has to raise, say, $50 billion, that is $50 billion less that has to be raised in insured deposits. Because aggregate borrowing does not increase, there is no reason for a change in interest rates -- except to the extent that the U.S. government or a government agency can raise funds at a lower cost than can insolvent S&Ls. In that connection, there may be some downward pressure on rates. Also, because aggregate spending does not change under the proposed financing mechanisms, there is no reason for a change in price or employment levels. Overall, we are substituting one form of financing for another, with little real effect on the U.S. economy.

CONCLUSION

In summary, the FSLIC insolvency is substantial, with current estimates ranging up to $105 billion. We have outlined the options available for financing the insolvency.

In conjunction with any resolution of the FSLIC problem, we again emphasize that some important changes in the structure of deposit insurance and regulation are necessary. Relative to this Committee's jurisdiction, the most important change would be to remove the FSLIC and the FDIC trust funds from the overall federal budget, and place them in a separate budget. Moreover, if the insurers were removed from the federal budget, any borrowings to resolve the FSLIC problem would have no impact on the general federal budget and would be less costly than borrowing through a FICO-type mechanism.

Thank you, Mr. Chairman. I will be pleased to answer any questions the Committee may have.

Appendix

EXECUTIVE SUMMARY

This report, "Deposit Insurance for the Nineties: Meeting the Challenge," is a review of the federal deposit insurance system. The FDIC undertook this review because of a growing realization that deposit insurance requires some fundamental changes if it is to continue to serve the purposes for which Congress created it over 55 years ago.

Virtually all agree that deposit insurance has accomplished its basic goals of maintaining stability and confidence in the banking system, and that these goals are vital to our Nation's economy. Deposit insurance has helped ensure a sound banking system by providing a safe haven for people's money, thereby instilling confidence and preventing panic-driven bank runs.

Our Nation must have a sound banking system because that system is at the very heart of our economy. Banks are essential to the payments mechanism, to the control of the money supply, and to the provision of financial intermediation--the bringing together of borrowers and savers.

Deposit insurance also has helped maintain a flexible and responsive banking system by facilitating a decentralized structure where new and smaller banks can compete against larger institutions.

While deposit insurance has provided many social and economic benefits, the events of the last decade have brought into clear focus that the current deposit insurance system has created potentially staggering costs.

Simply put, federal deposit insurance allows thousands of institutions to leverage their capital with government-backed funds--deposits. Imprudent decisions by only a relative handful of financial institutions can generate enormous losses for the deposit insurer. Strong supervision and market discipline are critical to keeping in check the risk-taking incentive created by this structure.

Deposit insurance should be self-funding--premiums collected and invested should be sufficient to cover costs of problems when they develop. The system worked well in the days of limited financial institution competition and relatively stable economies and interest rates--before technological revolutions and global competition required deregulation. Now, the business of deposit insurer is more complex and, often, more costly.

For 1988 alone the FDIC will show a 15 to 20 percent reduction in its fund--its first operating loss ever. While the FDIC expects to make an operating profit in 1989, changes are necessary to ensure sound future operations.

The potential costs of deposit insurance are even more obvious in our sister insurance agency, the Federal Savings and Loan Insurance Corporation

(FSLIC), where hundreds of thrifts are insolvent and even the most optimistic resolution costs greatly exceed the fund's and the thrift industry's resources.

Our Study looks at the FDIC's recent experience, and that of FSLIC, and explores how to improve deposit insurance so that it can be made a cost-effective system for the Nineties.

The FDIC Study concludes that the following principles are required to provide a sound deposit insurance system for the Nineties.

First, deposit insurers should be made as financially and organizationally independent as possible. The insurer must be sensitive to the concerns of chartering authorities and the industry it insures, but it must have the freedom to control costs. To ensure political independence, the insurer should be self-funded. It should have a budget separate from the general federal budget and the insurer should not be allowed to obligate federal revenues. The insurer also should be independent from the Congressional appropriations process. The insurer should remain accountable to Congress and the Administration, yet remain free from annual budgetary controls.

Second, the federal deposit insurer must be given certain basic tools that would be available to a private insurer to control costs. These include:

- o The ability to <u>promptly</u> terminate insurance privileges when an institution is operating in an unsafe manner.

- o The ability to set standards for insurability by a federal deposit insurance system.

- o The authority to examine and assess risk at all insured institutions.

Third, to ensure adequate resources, the insurer should have additional controls over its revenues:

- o The power to adjust insurance premiums, within prescribed limits, to reflect experience and costs on a continuing basis.

- o The power to assess borrowings that are secured by assets--assets that otherwise would be available to the insurer in the event of failure.

- o The power to require that institutions obtaining federal insurance pay an entrance fee sufficient to maintain the ratio between the insurance fund and insured deposits.

- o The power to borrow from both the Department of the Treasury and the Federal Reserve.

- o The power to require all federally insured institutions owned by a common parent to indemnify the insurer against any losses resulting from the failure of an affiliated bank. The FDIC prefers this option to an earlier proposal that would have required the consolidation of affiliated banks.

The Study also offers other recommendations: First, the FDIC seeks clear authority to distinguish between depositor and nondepositor claims in failure-resolution transactions. This approach differs from previous calls for depositor preference statutes in that nondeposit creditors would maintain their pro rata rights to the assets of the failed institution. Such creditors may have to wait along with the FDIC for assets to be liquidated, while depositor liabilities are transferred to another institution.

Second, the FDIC continues to advocate moving toward a system where nontraditional activities take place outside the bank in subsidiaries using excess bank capital or in separately capitalized affiliates. Under such conditions, the FDIC recommends that banking organizations be allowed to become involved in a wide variety of activities.

Third, the experience of the past several years demonstrates that regulatory agencies must work to improve their supervisory capabilities. Regulatory agencies must maintain highly skilled, professional staffs. In addition, regulators must improve their understanding of risk diversification and the competitive and economic environments in which their banks operate. New regulatory methods of anticipating potential problems are suggested. In this regard, the FDIC plans to work with other regulators, industry representatives and academics to develop regional oversight committees.

The Study reviewed other proposals for improvements to the system. A fundamental conclusion is that proposals to increase so-called depositor discipline by curtailing insurance protection should be rejected. The FDIC view is that increasing pressure on depositors to control bank risk in a rational manner is impractical. Most depositors looking for safe, short-term investments cannot be expected to know the true condition of a financial institution. That is challenging enough for examiners and analysts who have regular access to bank management and records. Most importantly, attempts to increase depositor discipline would increase the threat of financial instability and bank runs, and undermine the very reason deposit insurance was deemed necessary.

The FDIC also rejects so-called "narrow-bank" proposals that would restrict depository institutions to only the most liquid and safe investments. Forcing lending operations out of banks, which would be required by these proposals, would be inefficient in view of banks' considerable expertise in financial intermediation. Further, in order to maintain stable economic growth, our government would need to develop other approaches to ensure that short-term, risk averse, investors can be brought together with borrowers with long-term and complex needs for funds.

While the FDIC rejects decreasing depositor protection, it cannot support proposals to increase depositor protection to 100 percent. FDIC experience and recent studies show that depositors remain fairly sensitive to bank risk-taking. To completely eliminate such constraints would increase the potential risk to the insurer.

Arguments to raise or lower deposit protection also stem from the perceived inequity in the way large banks are handled relative to small banks. The FDIC acknowledges that some inequity does exist. Uninsured depositors in very small banks sometimes bear somewhat greater risk of loss than those in large banks. Under current law, the FDIC must determine that protecting uninsured depositors is cost-effective in failure resolutions or that factors exist that make it essential to protect uninsured depositors.

Experience shows that protecting all depositors is more likely to be cost-effective in larger banks because of greater relative franchise value maintained in large banks.

The FDIC can deviate from the cost test on rare occasions when a bank is found to be essential to its community--but such essentiality considerations are more likely to exist with larger banks than smaller institutions. To address this inequity, the FDIC will continue its practice of trying to avoid depositor losses whenever possible. In recent years over 99 percent of all deposits in failed banks have received full protection.

The study concludes that, on balance, the current deposit insurance system provides an appropriate balance between depositor discipline and financial stability. Our view is that risk-taking incentives created by deposit insurance can be controlled through ensuring market discipline by investors and management, adequate capital requirements, improved regulatory structure, and strengthened supervisory process.

While studying deposit insurance, the FDIC reviewed the problems facing its sister insurance agency--the FSLIC. The most obvious problem is to provide funding so that hundreds of insolvent institutions can be resolved. It appears the federal government will have to absorb much of this cost, since the thrift industry is not strong enough to shoulder the burden alone.

Moreover, the FDIC finds no reason for the banks to be singled out to pay for the thrift industry's problems. The Study reviews proposals for ameliorating the impact on the federal deficit of the costs of returning FSLIC to solvency.

Equally as important as arranging for adequate funding is taking steps to ensure current losses do not recur. Many of the recommendations for deposit insurance reform discussed earlier are necessary for a viable and responsive insurance system. There are a variety of alternatives for implementing these reforms for FSLIC. The study recommends three possible options that satisfy the requirements set forth above. These options can be called: (A) A new stand-alone FSLIC; (B) An administrative merger of FSLIC into FDIC; and (C) Comprehensive reform of the thrift regulatory structure. (See attached Appendix A.) The FDIC favors option A.

A stand-alone FSLIC envisions the creation of a separate FSLIC that is independent of the Federal Home Loan Bank Board (FHLBB). The FHLBB would continue to charter and supervise federal thrift institutions and would operate both the Federal Home Loan Bank System and the Federal Home Loan Mortgage Corporation (Freddie Mac). The newly-separated FSLIC would directly supervise all state-chartered thrifts and be responsible for all liquidation activities related to FSLIC-insured institutions. The FSLIC would not be subject to the appropriations process. The district Federal Home Loan Banks would no longer examine or supervise thrifts. Their role would be confined to providing liquidity for institutions meeting housing-related criteria. System membership would be available to any depository institution meeting these criteria.

The second option is an administrative merger of FSLIC into FDIC. There would be common management and an administrative Board over separate FDIC and FSLIC funds. The new FDIC would supervise state-chartered thrifts and state-chartered banks that are not members of the Federal Reserve System and would perform all liquidation activities for insured banks and thrifts.

The third option calls for comprehensive reform of the deposit insurance regulatory structure. The administrative functions of the FSLIC and the FDIC would be merged into a new corporation. The Office of the Comptroller of the Currency (OCC) would assume responsibility for chartering and supervising federal thrifts, and the Federal Reserve Board would supervise thrift holding companies. The FHLBB would continue to oversee the Federal Home Loan Bank System and Freddie Mac, under the umbrella of the Department of Housing and Urban Development or the Federal Reserve Board.

These are the major conclusions and recommendations in our Study. A summary of the discussion in each chapter follows.

Introduction

Chapter 1 provides a brief introduction to the FDIC's examination of our federal deposit insurance system. Concerns about the continued viability of the deposit insurance system stem from the economic, technological and regulatory changes that have affected our economy's financial markets over the past decade. Deposit insurance reform was examined at length following the financial deregulation of the early 1980s. In general, these studies found that the regulators' ability to control excessive risk-taking had been hampered by the changing financial environment.

Today, deposit insurance reform continues to receive attention. Proposals to modify the system range from a major scaling back of insurance guarantees and greater depositor discipline, to increased emphasis on capital requirements, supervision and timely closure of insolvent institutions. This Study examines the current system and recommends changes to enable the deposit insurance system to meet the challenges ahead.

Framework for Analyzing Deposit Insurance Reform

Chapter 2 reviews the benefits and costs associated with the provision of deposit insurance and provides a framework for analyzing deposit insurance reform. Deposit insurance promotes financial stability by preventing bank runs. However, deposit insurance also may create an incentive for banks to take excessive risks. (While the owners of insured deposits have little incentive to participate in bank runs, they also have little incentive to pay attention to the riskiness of their bank's activities.) These two fundamental effects of deposit insurance, and the relative importance one may attach to them, underlie all of the numerous proposals to replace, curtail, or otherwise reform deposit insurance.

Comprehensive deposit insurance reform tends to be favored by those who take the view that the benefits associated with the prevention of bank runs are less important than the costs associated with the risk-taking incentives created by deposit insurance; or that the costs associated with bank runs can be controlled adequately by alternatives to deposit insurance.

Proponents of more modest reform take the view that the more significant costs are associated with bank runs, and that risk-taking incentives created by deposit insurance can be controlled adequately through market mechanisms, capital requirements and the supervisory process. The FDIC's view falls into this category.

Deposit Insurance Pricing

In Chapter 3, "Deposit Insurance Pricing," problems associated with the current flat-rate pricing scheme and the feasibility of implementing a system of explicit risk-related premiums are addressed. In the absence of regulation and supervision, flat-rate premiums provide incentives for excessive risk-taking and inequitably distribute the burden of insurance losses among banks. If unchecked, these perverse incentives may lead to an excessively risky banking system and undermine the viability of the deposit insurance system.

In practice, this incentive toward excessive risk-taking is counterbalanced, to some extent, by existing market discipline and through regulation and supervision. Federal and state regulators periodically examine banks to determine if they are operating in an unsafe or unsound manner. Undesirable behavior is penalized through the issuance of cease-and-desist orders or the imposition of other sanctions. In addition, laws and regulations limit the kinds of activities that insured institutions may engage in and set minimum capital requirements. To the extent that these implicit costs vary with the riskiness of the bank, they function as a system of risk-related premiums and constrain risk-taking.

The major question is whether an explicit risk-related pricing formula could be established that would be an improvement over the current system of flat-rate premiums, regulations and supervisory sanctions. In assessing this question, a number of risk-related pricing schemes are reviewed. Risk-related schemes that rely on market information to assess bank risk generally suffer from problems in obtaining accurate market information for all insured institutions. In the absence of a market-based approach, the FDIC would be left with the task of administratively determining an explicit pricing formula. Thus far, it has not been possible to establish a satisfactory pricing formula based on ex ante or before-the-fact measures of risk.

It does appear feasible to establish a general pricing formula that would complement the existing supervisory sanctions, based on ex post or after-the-fact measures of risk. The adoption of such a system, with only modest premium differentials at first, will not eliminate entirely the incentive for banks to take excessive risks. However, it may offer somewhat greater deterrence, require regulators to assess risks more diligently, and allocate the costs of insurance more equitably among banks.

While a more equitable distribution of the insurance burden is desirable, an even more critical concern is to ensure adequate funding for the insurance agency. An adequately financed deposit insurance system is important for three reasons. First, an insolvent insurer has similar incentives to take excessive risks as does the management of an insolvent insured depository; this helps explain actions of FSLIC in the early 1980s in encouraging thrifts to grow out of their problems by further leveraging nonexistent capital. Second, the passing of expenses and losses to the industry on a more current basis will provide greater incentives for the development of self-regulation and mutual risk-reduction measures. Finally, Congress and the public have every right to have assurances that the need for taxpayer money in the future will be minimal.

To help ensure adequate funding for the insurer over the long run, several recommendations are presented in Chapter 8. First, total assessments to the industry should be based on a modified three-year average of actual loss and expense accruals. Limits may be appropriate for year-to-year changes in assessments and for the maximum level of assessments.

Second, the assessment base should be expanded to include secured borrowings. While there are good arguments for also including foreign deposits in the assessment base, there is sufficient uncertainty with respect to certain issues that no recommendation is made at this time.

Third, the rebate system should be based solely on the relationship of the fund to the assessment base. Rebates would begin when the ratio of the fund to the assessment base exceeded a threshold level.

Fourth, the FDIC should be given direct authority to borrow from both the Department of the Treasury and the Federal Reserve System.

Finally, operating institutions obtaining FDIC insurance should pay an entrance fee sufficient to maintain the ratio of the fund to the assessment base at a constant level. This could be accomplished through a one-time charge or a deposit that is taken into the fund over time.

Market Mechanisms for Controlling Risk

Chapter 4, "Market Mechanisms for Controlling Risk," examines market discipline as a form of risk control in banking. Market mechanisms for controlling risk are considered under four broad categories: insurance coverage (depositor discipline), disclosure, capital standards, and the priority of claims in bank liquidation (depositor preference and nondepositor discipline).

Based on the premise that de facto 100 percent coverage has rendered depositor discipline ineffective, some have argued for explicit, 100 percent coverage of deposits, regardless of size. Full coverage, it is argued, could result in greater stability with respect to bank runs, more equity in the system, and also could allow for a more consistent and orderly resolution of bank failures. Moreover, 100 percent coverage may facilitate certain changes in failure-resolution methods that, according to proponents, would increase the effective level of market discipline. The major problem with this argument is the assumption that depositor discipline is completely absent from the current environment. FDIC experience suggests otherwise and recent studies also contradict this, suggesting that CD markets are fairly sensitive to bank-specific risk and act to constrain banks wishing to pursue riskier activities.

Others have argued that there should be greater depositor discipline; that deposit insurance coverage levels perhaps should be reduced from the present $100,000 level; and that in order to control bank risk-taking, uninsured deposits should be exposed to losses in bank failures. However, the problem with depositor discipline is the same one that existed in the 1930s, which led to the creation of the federal deposit insurance system: depositor discipline can lead to destabilizing bank runs.

What proponents of greater depositor discipline often overlook is that market discipline presently exists in many important respects. Bank stockholders, bank management and bank holding company creditors almost always suffer losses when a bank fails. Each of these groups has an incentive to control a bank's risk-taking. Uninsured depositors and creditors also exert some control over bank risk-taking, since they are not assured of complete protection in a bank failure.

Chapter 4 concludes that existing levels of market discipline appear adequate to control risk-taking by healthy banks. The Study recommends against any change to the $100,000 limit for individual deposit accounts. Limits to insurance coverage on brokered deposits or restrictions on the rates payable for insured brokered funds also are viewed as unnecessary. However, market discipline cannot be relied on to control risk-taking in problem institutions. As a bank nears insolvency the incentive for self-preservation may lead unprotected creditors and bank management to encourage the very risk-taking that is viewed as imprudent when the bank is healthy. As a bank's condition deteriorates, less reliance can be placed on market mechanisms and more reliance must be placed on the supervisory process.

Supervision

In addition to market discipline, supervision is the other major vehicle for controlling bank risk-taking. Rather than diminish its role, deregulation and other changes in financial markets have made the supervisory role even more critical. In Chapter 5, "Supervision," the role and effectiveness of the supervisory process is examined and recommendations for reform are put forth. Three major areas of the supervisory program are reviewed: the examination program, enforcement authority, and the applications process.

The examination program is the primary mechanism for monitoring the risk of individual institutions and for implementing necessary corrective actions. Several areas are identified as needing reemphasis or improvement.

First, because the FDIC's resources are at stake, the authority for the insurer to examine all insured banks needs to be clarified and strengthened.

Second, the regulatory agencies must improve their methods of identifying risk, setting priorities and allocating resources. This includes: (a) improved offsite monitoring through continued development of computer-assisted analyses of bank and industry data; (b) development of online information retrieval systems which will allow regulators computer access to at least the top tier of banks and those that exhibit more than normal risk; (c) development of diversification rules and systems and programs for analyses of industry sectors and geographical groupings in a way that will help focus supervision on potential or emerging problems; and (d) coordination of the information-gathering processes to more systematically establish priorities for onsite examinations of banks that still have satisfactory ratings.

Third, federal bank regulatory agencies must reemphasize and develop better ways to work together and streamline the examination process and information flows between agencies. This includes a rejuvenation of the cooperative examination program whereby the FDIC accompanies the OCC and the Federal Reserve Board in examinations of banks, and the consideration of issuing regional supervisory directives, i.e., alerts to examiners and bankers concerning a local or regional problem that need not wait for a nationwide pronouncement from the Washington offices.

Fourth, an effective examination program is dependent on maintaining a staff of highly skilled, experienced and well-compensated professionals. This means avoidance of periodic hiring freezes, maintenance of a benefits package that is competitive with the private sector, and development or acquisition of specialized expertise to deal with new and changing banking activities.

Finally, the supervision program could be further enhanced by establishing regional economic oversight committees comprised of representatives from different supervisory agencies to evaluate levels of risk in their respective areas. These committees would consult with industry and academic representatives and should seek to anticipate adverse economic trends.

When a bank does not operate in a safe-and-sound manner, regulatory authorities must possess the necessary tools to curb improper behavior. While the types of enforcement tools now available to the FDIC are generally adequate, expanding their applicability and streamlining their implementation would be helpful to the enforcement process. Several recommendations are made.

First, termination of federal deposit insurance should be streamlined to take no more than six months. Existing deposits would continue to be insured for a reasonable period following termination.

Second, capital laws or regulations should be rewritten to clarify restrictions that could be imposed on banks with capital levels below minimum standards. These might include suspension of dividends, restrictions on growth and a prohibition on acquisitions.

Controlling and monitoring risk through the supervisory process also could be enhanced by modifications to the applications process. At present, only state nonmember banks are required to apply to the FDIC for entry into the deposit insurance system. National and state member banks receive FDIC membership automatically upon approval of the OCC or the Federal Reserve.

When granting a charter, the chartering authorities should be required to consider the institution's risk to the insurance fund, using standards developed by the insurer.

Forbearance

Not only does deposit insurance reform require decisions on how much authority to grant bank supervisors, it requires decisions on the amount of discretion to be allowed the supervisor in the exercise of that authority. The trade-off between mandatory rules versus supervisory discretion underlies the discussion in Chapter 6 on "Forbearance." This chapter argues that these are circumstances where it may be appropriate for supervisors to exercise discretion in the face of excessive risk exposure by insured depository institutions; mandatory or rigid enforcement rules run the risk of undermining supervisory efforts to control risks. As used in this context, forbearance should be a deliberate act aimed at achieving control of risk, rather than the consequence of inaction or unwillingness to address problem situations. Many forms of forbearance have been successful in controlling risks, promoting sound operations, and limiting loss to the insurance fund. In Chapter 6 it is argued that the ability to exercise discretion is an important and, in fact, a necessary part of the supervisory process.

Failure Resolution

Chapter 7, "Failure Resolution," reviews alternative failure-resolution policies and evaluates their desirability in terms of how well they meet major policy objectives. As discussed elsewhere, a trade-off exists between the desire to maintain market discipline against bank risk-taking and the need to maintain public confidence and stability in the banking system. There appears to be substantial market discipline against risk-taking by healthy institutions. It is when a bank encounters financial difficulty that market discipline fades and the incentive to take risks becomes significant. These risk-taking incentives in problem institutions mean it is critical to maintain strong and effective supervision, which includes enforcement of appropriate capital standards and a general policy that calls for timely closure of insolvent institutions.

The view that the trade-off between stability (the prevention of bank runs) and depositor discipline must be weighted heavily in favor of stability is the driving force behind the first two recommendations in Chapter 7. First, because market discipline declines as capital levels decline, timely closure of insolvent institutions is a critical element in controlling risk. Further, since loan-loss reserves represent losses that already are anticipated, it should be clarified that chartering authorities should use equity capital rather than a capital measure that includes loan-loss reserves as the appropriate measure for determining solvency. Second, it would be desirable for the FDIC to have clear authority to distinguish between depositor and nondepositor claims in failure-resolution transactions. Such authority would give the FDIC greater flexibility to increase nondepositor discipline against bank risk-taking without risking greater instability in the banking system (through the introduction of greater depositor discipline and the increased possibility of bank runs).

Other recommendations in Chapter 7 would increase the FDIC's ability to maintain adequate funding against potential future problems. First, since evidence concerning the disposition of failed-bank assets suggests that it is more cost-effective to keep assets in the private sector rather than in a government liquidation, the current policy of passing as many failed-bank assets as possible to the acquiring bank should be maintained. Second, in order to eliminate the problems associated with affiliated banks operating as a single entity in good times, but as separate corporate entities in bad times, all federally insured banks should be required to protect the FDIC against losses in any banks owned by a common parent.

Issues Related to Handling Large-Bank Failures

The open-bank assistance provided to Continental Illinois National Bank and Trust Company in 1984 focused the "too-large-to-fail" discussion on banking and the way the FDIC approaches failing- and failed-bank situations. The FDIC always has handled the failure of larger banks in a way that results in full protection to depositors and other general creditors of the bank; on the other hand, uninsured creditors in smaller banks on occasion have been subjected to loss.

Since 1951, the FDIC has followed a set of rules that has forced identification of situations that are handled outside of normal criteria. Specifically, the FDIC must determine whether an institution is "essential" to the community in order to justify any transaction that is more costly than a deposit payoff and liquidation. This system has had two effects. First, the form of this "cost test" is biased towards preserving franchise values were they exist; the result has been a higher likelihood of handling larger banks in a manner that protects all general creditors. Second, the FDIC is forced to explicitly justify any action that cannot be rationalized under the cost test. Thus, the term "too-large-to-fail" is inappropriate in the context of banking; a more appropriate term is "too-important-to-pay-off."

Moreover, the ability to deviate from decisions based solely on the cost test has had a long history and, more importantly, is likely to continue to be a fact of life--i.e., the "too-important-to-pay-off" doctrine in all probability is here to stay. That is to say, there will continue to be certain situations where an individual bank will be perceived to be too important to macroeconomic considerations or international stability to allow to be handled in a way that would inflict losses on bank creditors. This becomes increasingly true as other countries provide de jure or de facto 100 percent coverage to their banks, and as banking and finance become more international in scope. Thus, it would be counterproductive to design a system that does not accommodate this reality.

To the extent that handling bank failures involves broader macroeconomic considerations, some have questioned the appropriateness of vesting this responsibility with the deposit insurer. In Chapter 8, it is suggested that in the U.S. the insurance agency is appropriate for this purpose. First, the responsibility has been with the FDIC since 1934, and the system has worked reasonably well. Second, the way other countries allocate this responsibility--often to the central bank or ministry of finance--is not necessarily appropriate for the U.S. since relationships between government and banking are often much different in those countries. Third, the nature of banking makes it important to act rapidly in a failure situation; this would not be consistent with exposing failure resolution to short-term political influence. Finally, failure resolution creates an interest in maintaining certain asset values; this interest normally will not be consistent with the conduct of appropriate monetary policy.

Resolving the FSLIC Problem

The difficulties experienced by the FSLIC and S&Ls during the 1980s have been the major impetus behind calls for insurance reform. Chapter 9 assesses the extent of the problem and outlines a number of options for dealing with the FSLIC crisis.

The FSLIC shortfall is probably between $60 billion and $115 billion, including $10 billion to $15 billion to provide for an ongoing S&L insurance fund. This is well in excess of the resources available to FSLIC. Because these losses continue to grow, insolvent S&Ls should be closed as quickly as possible and reforms instituted to minimize the chance of existing problems recurring.

The S&L industry should bear as much of the cost as possible. However, severe constraints exist on the ability of the S&L industry to finance the FSLIC shortfall--the tangible net worth of all solvent S&Ls is only $40 billion, or four percent of their assets. There is a substantial risk that extensive use of S&L industry resources could drive presently healthy S&Ls

into insolvency or marginal solvency, and result in insurance-avoidance tactics, pressure to change insurers and increased risk-taking.

The banking industry also does not have the means to pay for the problem. Moreover, from an equity viewpoint, there is no reason why banks should pay for the S&Ls' problems. FDIC resources also should not be used due to the risk of leaving the agency with insufficient funds to fulfill its function.

The federal government must pick up most of the tab for the S&L problem. Concerns about the federal budget deficit could be mitigated by an off-budget financing arrangement, whereby the Treasury pays the interest and guarantees the principal of borrowings by a limited-life quasi-governmental agency. The recently created Farm Credit System Financial Assistance Corporation is an example. Off-budget financing has the advantage that it could avoid the politicalization of deposit insurance, which would seem inevitable if the costs were financed by appropriations.

Ensuring that current problems do not recur is at least as important as finding a short-term financial solution. The fundamental objective of a "regulatory solution" should be strong government regulation of the S&L industry instead of the de facto self-regulation which was a major cause of current problems. Under any scenario in which the FHLBB or FSLIC remain intact, FSLIC should be independent of FHLBB; the FHLBs should provide liquidity for housing, not supervise or examine the S&L industry; and the number of politically appointive positions in the FHLBB ought to be sharply reduced. In addition, in any scenario, banks and thrifts should be regulated according to common standards.

In terms of balancing the objectives of rapid resolution of insolvencies and minimizing the chance that current problems will recur, a recapitalization of FSLIC with reforms to the FHLBB and the FSLIC, an administrative merger of FSLIC into FDIC, or the creation of a new deposit insurance agency combined with more comprehensive reform of the thrift industry are the most desirable options. Other options considered and deemed less desirable in terms of balancing these objectives include a recapitalization of FSLIC without reforms; an immediate full-scale merger of FSLIC and FDIC; a conversion of healthy S&Ls to FDIC insurance, with FSLIC or some other agency resolving the remaining cases; and a complete restructuring of the financial institutions regulatory system.

The three possible options that satisfy the requirements set forth in Chapter 9 can be called: (A) A stand-alone FSLIC; (B) An administrative merger of FSLIC into FDIC; and (C) Comprehensive reform of the thrift regulatory structure. The FDIC favors option A.

A stand-alone FSLIC envisions the creation of a separate FSLIC that is independent of the Federal Home Loan Bank Board (FHLBB). The FHLBB would continue to charter and supervise federal thrift institutions and would run both the Federal Home Loan Bank System and the Federal Home Loan Mortgage Corporation (Freddy Mac). The newly-separated FSLIC would directly supervise all state-chartered thrifts and be responsible for all liquidation activities related to FSLIC-insured institutions. The FSLIC would not be subject to the appropriations process. The district Federal Home Loan Banks would no longer examine or supervise thrifts. Their role would be confined to providing liquidity for institutions meeting housing-related criteria. System membership would be available to any depository institution meeting these criteria.

The second option is an administrative merger of FSLIC into FDIC. There would be common management and an administrative Board over separate FDIC and FSLIC funds. The new FDIC would supervise state-chartered thrifts and state-chartered banks that were not members of the Federal Reserve System and would perform all liquidation activities for insured banks and thrifts.

The third option calls for comprehensive reform of the thrift regulatory structure. An administrative merger of FSLIC and FDIC would occur, creating a new federal deposit insurance corporation for banks and thrift institutions. The Office of the Comptroller of the Currency (OCC) would assume responsibility for chartering and supervising federal thrifts and the Federal Reserve Board would supervise thrift holding companies. The FHLBB would continue to oversee the Federal Home Loan Bank System and Freddy Mac, under the umbrella of the Department of Housing and Urban Development or the Federal Reserve Board.

Conclusions

In addition to the conclusions outlined thus far, Chapter 10 outlines some other broader conclusions and recommendations. One of these conclusions is that the provision of deposit insurance should not interfere with the industry's adaptation to the technological changes affecting financial markets, regardless of whether these changes imply an expanded or more limited role for traditional banking activities. This is consistent with the recommendations of the FDIC's Mandate for Change study, which was published in 1987.

In Mandate for Change, it was argued that firewalls could be established between bank and nonbank affiliates to prevent the use of insured deposits for nonbanking activities, thus eliminating a potential advantage that banking organizations may have over nonbanking organizations. At the same time, the limitations imposed on the types of businesses that may own a bank place artificial restrictions on legitimate economies of scope and the flow of capital and other resources into and out of the banking industry. By eliminating these restrictions, it will be easier for the banking industry to adjust to the technological changes that are occurring, while ensuring that funding advantages are not given to nonbank entities.

The ability of the industry to adapt to technological and economic changes also would be enhanced by allowing for a more orderly entry into and exit from the industry. Restrictions on intrastate branching and interstate banking impede the orderly entry into and exit from the industry, and increase the FDIC's costs of resolving failures. In addition, these restrictions limit loan diversification, thereby increasing risks to the system. The elimination of these geographic restrictions would allow the industry to be more responsive to changing financial conditions and regional difficulties.

Throughout the chapters of this Study, questions concerning the trade-off between financial stability and market discipline are raised. Reform proposals that call for greater market discipline have the potential to reduce the risk-taking incentives that deposit insurance provides, but they also have the potential to create costs by increasing the chances of bank runs.

Underlying reform proposals that call for greater amounts of market discipline, by strictly enforcing de jure coverage or rolling back the insurance coverage, is the view that markets (deposit markets) are relatively efficient at evaluating bank risk and that costs of the increased chances of bank runs are relatively low. Thus, in this view, the benefits of increased depositor discipline outweigh the costs.

In this Study the view is that existing forms of market discipline in well-capitalized banks, when combined with prudent supervision, are sufficient to control any incentives for excessive risk-taking by banks caused by the existence of deposit insurance. At the same time, it is the FDIC's view that bank runs or the threat of bank runs can be costly, and that any moves toward enhancing market discipline must seriously weigh these potential costs. Consequently, the Study stresses the need to enhance existing forms of market discipline; to strengthen supervision so that overly risky behavior is detected and controlled in a timely manner; to maintain strict capital standards and ensure that insolvent institutions are promptly closed; and to provide insuring agencies with the proper incentives so as to facilitate the long-term viability of the federal deposit insurance system.

APPENDIX A to Chapter 9

PROGRAM FOR DEPOSIT INSURANCE REFORM AND AGENCY RESTRUCTURING

SUMMARY

The following summary and outline set forth a program for deposit insurance reform. Part I contains three alternative plans for agency restructuring as part of the resolution of the FSLIC situation. Part II proposes options for resolving the FSLIC/thrift crisis and Part III recommends deposit insurance reforms generally.

The three plans for agency structural reforms are:

- Plan A -- Creation of a separate FSLIC that is independent of the FHLBB. The FHLBB would maintain its current Board composition and continue to charter and supervise federal thrifts and run both the Home Loan Home Bank System and Freddy Mac. The newly-separated FSLIC would, generally, mirror the FDIC. It would supervise all state-chartered thrifts and be responsible for all thrift liquidation activities -- including the resolution of insolvent thrift cases and FADA. The composition of the FSLIC Board, its degree of administrative independence and its authorities and responsibilities would track those of the FDIC. Thus, the Chairman of the FHLBB would be on the FSLIC Board, in the same manner as the Comptroller is on the FDIC Board. Given a choice, the FDIC would prefer Plan A.

- Plan B -- Administrative merger of the FSLIC into the FDIC. The FHLBB would maintain its current Board composition and perform the same functions as under Plan A. However, the FSLIC would be administratively merged into the FDIC. Two new members would be added to the FDIC Board, including the FHLBB Chairman and an additional outside director. In addition to administering the two separate funds, the FDIC would supervise state-chartered thrifts and nonmember banks and perform all liquidation activities for all insured thrifts and banks. Its responsibilities would include disposition of insolvent thrift cases and FADA.

- Plan C -- Comprehensive reform of the deposit insurance system and the supervisory structure. This Plan involves a new Insurance Corporation headed by a politically independent 5-person Board that administers both the bank and thrift insurance funds. Plan C also revises the supervisory structure for all thrift institutions. The OCC would assume responsibility for chartering and supervising federal thrifts and the FRB would be responsible for thrift holding companies. The FHLBB would continue to oversee the FHL Bank System and Freddy Mac under the umbrella of HUD or the FRB.

Following the three plans for agency restructuring, the outline contains recommendations for the FSLIC/thrift crisis (Part II) and deposit insurance reform recommendations (Part III).

PROGRAM FOR DEPOSIT INSURANCE REFORM AND AGENCY RESTRUCTURING

OUTLINE

The following describes a program for deposit insurance reform and resolution of the FSLIC crisis, as well as three alternative plans for agency restructuring. The document consists of three parts:

I. Three alternative plans for agency restructuring

PLAN A - Creation of a separate FSLIC that is independent of the FHLBB (The FDIC favors this Plan)

PLAN B - Administrative merger of FSLIC into FDIC

PLAN C - Structural reform of deposit insurance, chartering and supervisory agencies

II. Recommendations for the FSLIC/thrift crisis

III. Deposit insurance reforms generally

I. Three Alternative Plans for Agency Restructuring

The description of each plan will include: objectives; a diagram of agency structure and functions; and an outline describing the plan.

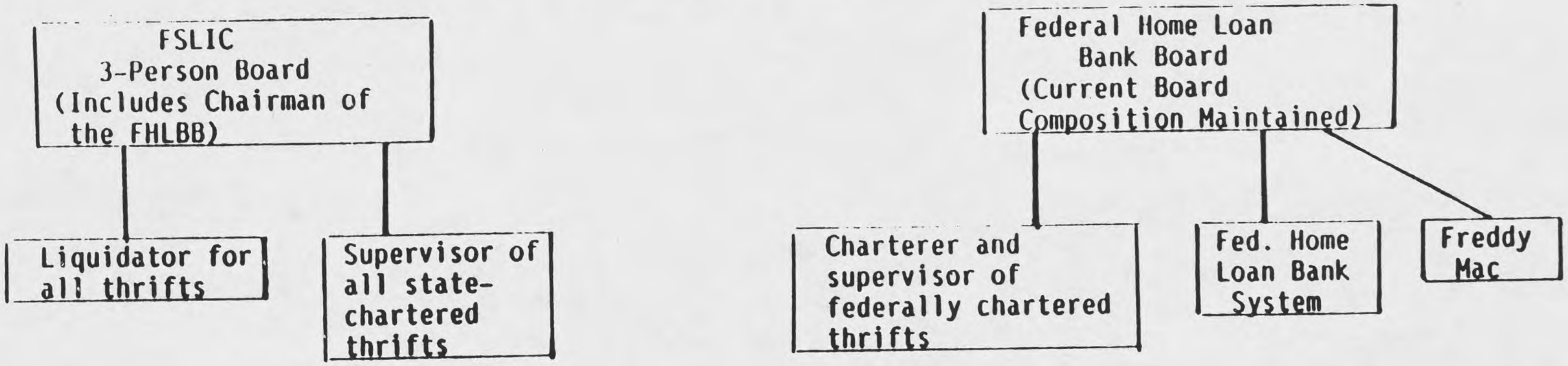
PLAN A

AN INDEPENDENT FSLIC SEPARATE FROM THE FHLBB

Objectives of Plan A

- Separate the FSLIC from the FHLBB
- Avoid "micro-management" by statute of the FSLIC and its mandate -- i.e., allow the FSLIC flexibility to manage the current crisis subject to general guidelines and standards set forth by Congress and require it and the FDIC to make long-range recommendations to the Congress
- The FSLIC should be "off budget" and independent of the appropriations process (FDIC also should be moved "off budget")
- Work toward regulatory and supervisory standards for thrifts that are comparable to those for banks.

DIAGRAM OF PLAN A -- AN INDEPENDENT FSLIC



Functions

- Perform all liquidation activites -- including resolution of all insolvent thrift cases and asset liquidations (would have responsibility for FADA)
- Supervise all state-chartered thrifts
- Make recommendations (along with the FDIC) to Congress for further reforms

Functions

- FHLBB charters and supervises federal thrifts and oversees thrift holding companies. (FHL Banks no longer supervise thrifts)
- Promote housing through the FHL Banks
- Provide funding through the FHL Banks for institutions that meet specified "housing" or other criteria
- Oversee Freddy Mac (which ultimately could be privatized)

Outline of Plan A

A. The FSLIC would be separated from the FHLBB and, generally, the FSLIC would be a mirror image of the FDIC. This is the Plan that is preferred by the FDIC.

1. Board composition - The FSLIC would have a three-person Board. The Chairman of the FHLBB would be on the Board in the same manner as the Comptroller is on the FDIC Board. However, the FHLBB Chairman could not chair the FSLIC.

2. The FSLIC and its budget would not be subject to the appropriations process and would have the administrative independence of a "mixed ownership corporation" (patterned after FDIC).

3. Prospectively, the FSLIC would be the insurer for only those institutions that operate as thrifts -- i.e., those that meet the qualified thrift lender (QTL) or some similar "housing-related" standard.

4. Authorities and responsibilities of the FSLIC.

   a. The FSLIC -- like the current FDIC -- will be charged with protecting insured depositors, the integrity of the insurance fund and the safety and soundness of the FSLIC-insured system.

   b. The FSLIC is to be responsible for all thrift liquidation activities -- including resolution of insolvent thrift cases and FADA. Segregating insolvent thrifts under a separate entity (the "separate trust" concept) and having a separate liquidating entity (FADA) are both unworkable and could substantially increase the ultimate losses.

   c. The FSLIC is to be the primary federal supervisor for all state-chartered thrifts.

   d. The FSLIC will have the same authorities and powers relative to state and federally chartered thrifts that the FDIC now has with respect to state and federally chartered banks (subject to the enhanced authorities recommended in III).

   e. The FSLIC is required to adopt standards for thrifts that are comparable to those for banks -- i.e., capital, accounting, liquidity, lending limits and other safety and soundness standards.

   f. The FSLIC (and the FDIC) will be charged by Congress to make recommendations within one year for further reforms.

4. Some of the existing experienced Federal Home Loan Bank examiners would be allocated to the FSLIC.

B. Federal Home Loan Bank Board

1. Federally chartered thrifts would continue to come under the jurisdiction of the FHLBB. The FHLBB would:

   a. Charter federal thrifts.

   b. Implement and administer the Home Owners' Loan Act.

   c. Supervise and examine federal thrifts (this would remove this function from the Home Loan Banks -- which is desirable since they are not independent of the industry).

   d. Administer the S&L Holding Company Act.

2. The FHLBB would continue to oversee the Federal Home Loan Bank System and Freddy Mac. However, changes would be necessary to the FHLB System.

   a. The System would no longer supervise or examine thrifts.

   b. System membership would be available to other institutions that meet prescribed "housing" or other specified criteria.

   c. Over the long term, it may be advisable to completely privatize Freddy Mac.

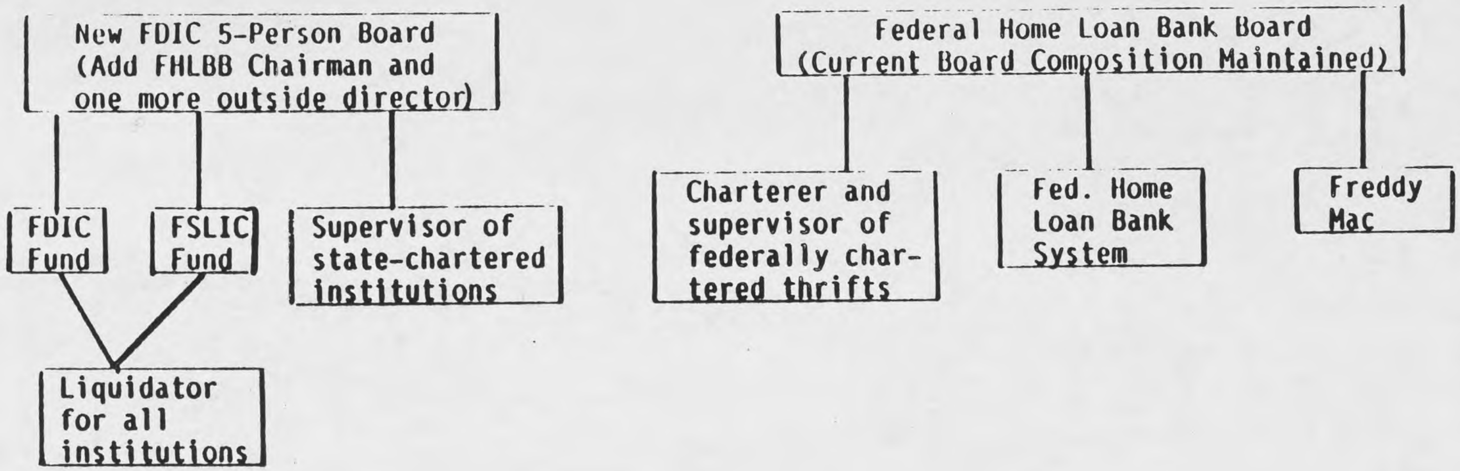
PLAN B

ADMINISTRATIVE MERGER OF FSLIC INTO FDIC

Objectives of Plan B

- Separate the FSLIC from the FHLBB
- Provide for an administrative merger of the FSLIC into the FDIC
- The "new FDIC" should be moved "off budget"
- Avoid "micro-management" by statute of the new FDIC and its mandate -- i.e., allow the FDIC flexibility to manage the current crisis subject to general guidelines and standards set forth by Congress and require it to make long-range recommendations to the Congress
- Work toward comparable insurance premiums and common standards of regulation and supervision for banks and thrifts

DIAGRAM OF PLAN B -- ADMINISTRATIVE MERGER OF FSLIC INTO FDIC



Functions

- Administer two separate insurance funds -- FDIC and FSLIC
- Perform <u>all</u> liquidation activities -- including resolution of <u>all</u> insolvent thrift cases and asset liquations (would have responsibility for FADA)
- Supervise state-chartered thrifts, as well as state nonmember banks
- Make recommendations to Congress for further reforms

Functions

- FHLBB charters and supervises federal thrifts and oversees thrift holding companies (FHL Banks no longer supervise thrifts)
- Promote housing through the FHL Banks
- Provide funding through the FHL Banks for institutions that meet specified "housing" or other criteria
- Oversee Freddy Mac (which ultimately could be privatized)

Outline of Plan B

A. The FSLIC would be administratively merged into the existing FDIC. The FDIC would have responsibility for administering the two funds, taking care of the insolvent thrift institutions (see II) and making recommendations to the Congress for further reforms.

1. FDIC Board Composition

   a. The FDIC Board would be expanded to include the FHLBB chairman and an additional outside director.

   b. No more than two of the three outside directors could be of the same political party.

2. Authorities and responsibilities of the new FDIC.

   a. The FDIC is to administer two financially separate and distinct funds. Two separate premium income streams are to continue to be allocated to the separate funds. Expenses are to be charged against, and reserves allocated to, the appropriate fund.

   b. The FDIC is to be responsible for <u>all</u> liquidation activities -- including resolution of insolvent thrift cases and FADA (which probably would be phased out). Segregating insolvent thrifts under a separate entity (the "separate trust" concept) and having a separate liquidating entity (FADA) are both unworkable and could substantially increase the ultimate losses.

   c. The FDIC is to be the primary federal supervisor for state-chartered thrifts, as well as nonmember banks.

   d. The FDIC has complete authority to determine the administrative structure of the agency.

   e. The FDIC has the same authorities and powers relative to state and federally chartered thrifts that it now has with respect to state and federally chartered banks (subject to the enhanced authorities recommended in III).

   f. The FDIC is charged by Congress to make recommendations within one year for further reforms over and above those made at the time of enactment of the legislation that administratively merges the FSLIC into the FDIC. (See III)

4. Some of the existing experienced Federal Home Loan Bank examiners would be allocated to the new FDIC.

B. Federal Home Loan Bank Board

1. Federally chartered thrifts would continue to come under the jurisdiction of the FHLBB. The FHLBB would:

DIAGRAM OF PLAN B -- ADMINISTRATIVE MERGER OF FSLIC INTO FDIC

a. Charter federal thrifts.

b. Implement and administer the Home Owners' Loan Act.

c. Supervise and examine federal thrifts (this would remove this function from the Home Loan Banks).

d. Administer the S&L Holding Company Act.

2. The FHLBB would continue to oversee the Federal Home Loan Bank System and Freddy Mac. However, changes would be necessary to the FHLB System.

   a. The System would no longer have overall responsibility for supervising thrifts.

   b. System membership would be available to other institutions that meet prescribed "housing" or other specified criteria.

   c. Over the long term, it may be advisable to completely privatize Freddy Mac.

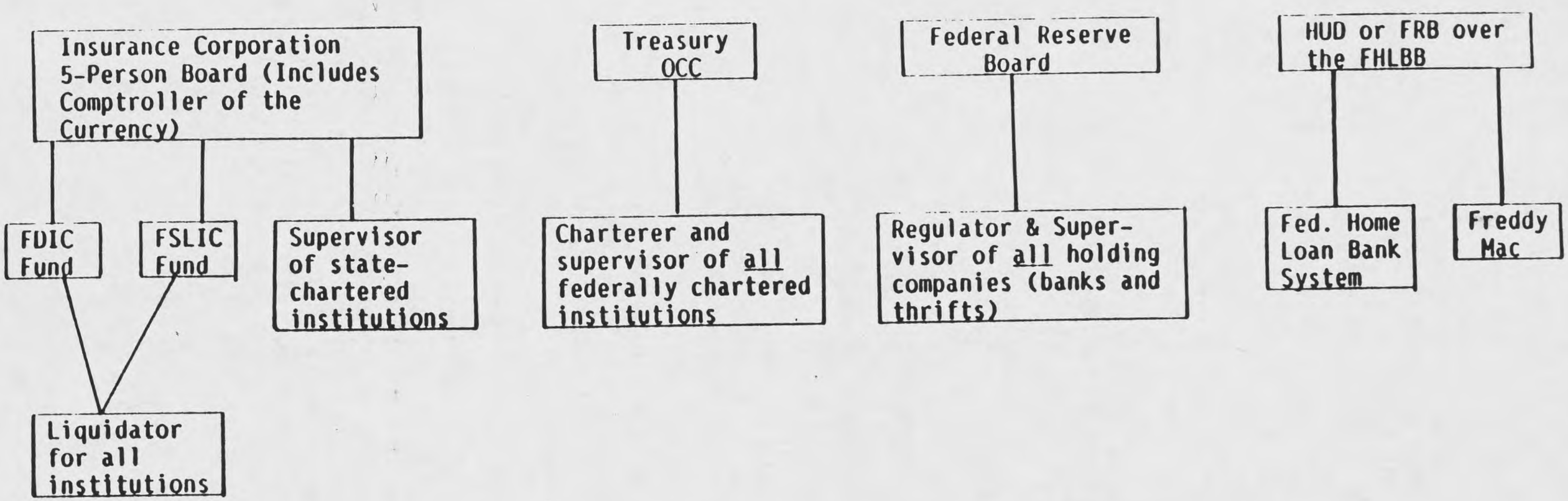
PLAN C

REFORM OF THE DEPOSIT INSURANCE SYSTEM AND THE SUPERVISORY STRUCTURE

Objectives of Plan C

- Separate the FSLIC from the FHLBB
- Provide for common management of the FSLIC and the FDIC by a politically independent Corporation that is responsible for <u>all</u> FSLIC and FDIC-insured institutions -- including the currently insolvent thrifts
- The insurance Corporation should be "off budget" and independent of the appropriations process
- Avoid "micro-management" by statute of the new Corporation and its mandate -- i.e., allow the Corporation flexibility to manage the current crisis subject to general guidelines and standards set forth by Congress and require it to make long-range recommendations to the Congress
- Work toward comparable insurance premiums and common standards of regulation and supervision for banks and thrifts
- Create a structure for chartering and supervising federal thrifts and thrift holding companies that tracks that of banks.

DIAGRAM OF PLAN C -- REFORM OF DEPOSIT INSURANCE AND SUPERVISORY SYSTEMS



- Administer two separate insurance funds - FDIC and FSLIC
- Perform <u>all</u> liquidation activities -- including resolution of <u>all</u> insolvent thrift cases and asset liquidations (would have responsibility for FADA)
- Supervise state-chartered thrifts and state nonmember banks
- Make recommendations to Congress for further reforms

- Charter both nat'l banks & fed. thrifts
- Supervise both nat'l banks & fed. thrifts
- Administer both the National Bank Act and Home Owners' Loan Act
- Comptroller to be on the Board of the Insurance Corporation

- Regulate & supervise both bank & thrift holding companies
- Continue to supervise state member banks
- Continue monetary policy function
- Continue to administer payment system

- Promote housing through the FHL Banks
- Provide funding through the FHL Banks for institutions that meet specified "housing" or other criteria
- FHL Banks no longer supervise thrifts
- Oversee Freddy Mac (which ultimately could be privatized)

Outline of Plan C

The new structure entails breaking up the existing FHLBB structure and moving most of its functions elsewhere. This accomplishes the following objectives: (1) separates the charterer of federal thrifts from the insurer; (2) allows for an administrative merger of the FDIC and FSLIC; (3) consolidates the chartering and supervision of federal thrifts with that of national banks; (4) consolidates the federal regulation and supervision of most state-chartered institutions in one agency; (5) consolidates the regulation and supervision of all holding companies in one agency; and (6) maintains the important functions of the Federal Home Loan Bank System.

A. Insurance Structural Reform - An administrative merger of the FDIC and the FSLIC. This envisions a government-controlled Corporation (hereinafter the "Corporation") that administers two separate and distinct insurance funds. The Corporation is to have responsibility for administering the two funds, taking care of the insolvent thrift institutions (see II) and making recommendations to the Congress for further reforms.

1. Corporation composition - Managed by a board of directors (the "Board") which is structured to promote political independence (similar to the structure of the FRB).

   a. Five-person Board with long, staggered fixed terms (recommend 8-year terms).

   b. President appoints Chairman from the Board for a shorter term (possibly a 4-year term).

   c. The Comptroller of the Currency would be on the Board in the same manner as the Comptroller is now on the FDIC Board.

   d. No specified political composition (although initial Board should have no more than three persons from the same political party to avoid "stacking" the first Board).

2. The Corporation and its budget would NOT be subject to the appropriations process and would have the administrative independence of a "mixed ownership corporation" (patterned after FDIC).

3. Authorities and responsibilities of the Corporation.

   a. The Corporation is to administer two financially separate and distinct funds. Two separate premium income streams are to continue to be allocated to the separate funds. Expenses are to be charged against, and reserves allocated to, the appropriate fund.

b. The Corporation is to be responsible for <u>all</u> liquidation activities -- including resolution of insolvent thrift cases and FADA. Segregating insolvent thrifts under a separate entity (the "separate trust" concept) and having a separate liquidating entity (FADA) are both unworkable and could substantially increase the ultimate losses.

c. The Corporation is to be the primary federal supervisor for state-chartered thrifts and nonmember banks.

d. The Corporation has complete authority to determine the administrative structure of the agency.

e. The Corporation has the same authorities and powers relative to state and federally chartered banks and thrifts that the FDIC now has with respect to state and federally chartered banks (subject to the enhanced authorities recommended in III).

f. The Corporation is charged by Congress to make recommendations within one year for further reforms over and above those made at the time of Corporation formation. (See III)

4. The existing experienced Federal Home Loan Bank examiners would be transferred to the new Corporation, the OCC and the FRB.

B. Federally Chartered Thrifts

1. Federally chartered thrifts would come under the jurisdiction of the OCC.

2. The OCC would perform the same functions for federal thrifts that it now performs for national banks. It would:

a. Charter federal thrifts.

b. Implement and administer the Home Owners' Loan Act.

c. Supervise and examine federal thrifts (this would remove this function from the Home Loan Banks -- which is desirable since they are not independent of the industry).

C. Thrift Holding Companies

1. Regulation and supervision of thrift holding companies under the S&L Holding Company Act would be given to the FRB.

D. Federal Home Loan Bank System/Freddy Mac - The FHLBB would continue to oversee the FHL Bank System and Freddy Mac under the umbrella of HUD or the FRB.

1. The FHLB System would maintain much of its current functions.

    a. It would have a mandate to promote housing.

    b. It would provide funding to the industry.

2. Changes would be necessary to the FHLB System.

    a. The System would no longer supervise or examine thrifts.

    b. System membership would be available to other institutions that meet prescribed "housing" or other specified criteria.

    c. Over the long term, it may be advisable to completely privatize Freddy Mac.

II. Recommendations for the Thrift/FSLIC Crisis

A. Resolution of the crisis would be the responsibility of the insurance agency (i.e. FSLIC under Plan A, FDIC under Plan B and the new Corporation under Plan C), following a program mandated by Congress.

B. The mandate to the insurer would be as follows:

1. To resolve the worst 100 first (estimates are that it will take about $30 billion and at least six months to resolve the 100 or so "worst" institutions).

2. To resolve the rest of the insolvent thrift cases subject to Treasury and Congressional oversight over an extended period.

    a. Funding could be subject to a requirement that periodic draws be approved by Treasury.

    b. Periodic progress reports to Congress also would be required.

C. Broaden potential acquirors for troubled thrifts by mandating that the FRB eliminate the restrictions imposed on bank holding company acquisitions of such thrifts.

D. Funding

1. Funding would be a combination of government borrowing and thrift industry resources (to the extent that the industry can shoulder the burden), including tapping some of the resources of the Federal Home Loan Bank System.

2. The insurance agency(ies) should be on a "separate budget" that is subject to Congressional oversight.

3. The insurer should be permitted to borrow, unsecured, from the FRB (or Treasury) at a rate no higher than the Fed discount rate.

4. The special 1/8 of 1% thrift premium assessment and the moratorium on conversions to the FDIC should be addressed by Congress.

   a. Under Plan A, the special premium would extend for at least one year and the moratorium would terminate when assessments return to normal.

   b. Under Plans B and C, the FDIC or the new Corporation, respectively, would be responsible for making determinations regarding the special assessment and the conversion of institutions from one fund to the other.

III. Deposit Insurance Reforms Generally

These reforms would be contained in the legislation creating the new insurance structure. They would be permanent reforms to the deposit insurance system that would apply to the insurance agency(ies) (i.e. Both FSLIC and FDIC under Plan A, the new FDIC under Plan B or the new Corporation under Plan C).

A. Insurance premiums that reflect the experience of the insurer(s) would be authorized. The insurer would be permitted to increase or decrease premiums as called for by insurance expenditures.

   1. The basic formula would be set out in the law.

   2. If there is a common administrative Board, at the outset the formula would be applied to each fund separately based on the experience of each separate fund. Over the long term, the objective should be to have the formula for establishing premiums the same for both industries.

B. With respect to federally chartered institutions and state member banks, the chartering authority would be required to certify to the insurer that each institution to which it grants a charter is eligible for insurance based on standards established by the insurer.

C. Insurers would be authorized to terminate insurance (i.e., take Section 8(a) action) much more rapidly -- in six months or less -- than under current law.

D. The enhanced enforcement authorities adopted by both House and Senate Banking Committees in the 100th Congress would be enacted.

E. The insurer would be authorized to establish minimum capital standards for all insured institutions in cooperation with the chartering authorities.

F. Insured institutions in holding companies would be required to guarantee their insurer against any insurance losses caused by other insured institutions in the holding company.

G. The insurer(s) would be mandated to make standards of regulation and supervision for banks and thrifts uniform over time.

H. The insurance agency(ies) would be moved "off budget" and removed from the budget process.

I. The insurance agency(ies) and other federal regulatory authorities would be required to make further reform recommendations to the Congress in prescribed areas, including the following:

1. Merger of the two separate insurance funds (or, under Plan A, the two separate agencies).

2. Additional powers (enforcement and otherwise) required by the insurer to protect the insurance funds.

3. Whether there is a need for restructuring of the credit union agency structure -- such as separating the NCUSIF from the NCUA.

4. Comprehensive long-term reforms to the insured financial institutions industry that are necessary to allow those institutions to attract capital and be competitive both at home and abroad. Industry reforms to be considered are:

   a. Permitting an array of activities outside the boundaries of the insured institution itself that are patterned after those permitted unitary thrift holding companies (i.e., unlimited activities).

   b. Strict firewalls around insured institutions and strict supervision and enforcement of the firewalls.

   c. Permitting activities that are required to be outside the "insurance wall" to be conducted either in holding companies or subsidiaries.

   d. Requiring investment in any activities that are impermissible to the insured institution itself to be out of excess capital.

   e. Providing the insurer with clear authority to require any institution to move an activity that the insurer deems inappropriate for insurance coverage outside the insured entity -- into its parent, a affiliate or a subsidiary.