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TESTIMONY OF

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ON

DEPOSIT INSURANCE REFORM

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

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Mr. Chairman and members of the Committee, we appreciate this opportunity to present the current thinking of the Federal Deposit Insurance Corporation regarding reform of the federal deposit insurance system. After our recent experience with losses in the thrift industry and in certain areas of the country in the banking industry, it is most appropriate that we consider changes to the deposit insurance system to reduce the losses to that system and, thus, to taxpayers.

Last year, Congress passed one of the most significant pieces of financial institution legislation since the Great Depression: the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"). The most visible portion of this legislation is the mechanism that was created to recapitalize the insolvent thrift insurance fund and resolve the currently insolvent thrift institutions. However, perhaps the more important provisions of FIRREA are those that are designed to control risks within the system -- either through more stringent standards placed on insured institutions or by means of expanded powers granted to the supervisory agencies. Those provisions provide the framework for a longer-term review of the deposit insurance system. FIRREA is a sound first step in resolving a complex problem: namely, how can the U.S. Government protect against incurring an unacceptable level of risk while maintaining a stable and efficient financial institution system?

Over the next several months this will be one of the most frequently asked questions in the congressional banking committees, the thrift and bank supervisory agencies and the U.S. Department of the Treasury. I wish that we could tell you that the FDIC has all the answers. The fact of the matter is, no one has "the" answer. Each change involves trade-offs between desirable goods -- such as reduced costs, market discipline, financial stability, etc. The only definite thing that one can say today is that any simple solutions to these problems most likely will be counterproductive -- perhaps doing more harm than good if implemented. We must proceed carefully because we are dealing with extremely complex institutions and markets that have a very direct link to the stability and prosperity of our economy.

Today, we will attempt to respond to each question contained in the letter of invitation, but not necessarily in the order that they are presented in that document. As indicated earlier, we are not able to provide many answers for you at this time. However, we will attempt to share our experience and our current thinking with respect to deposit insurance and control of risks within the system. Although the discussion is equally applicable to banks and thrifts, for the sake of simplicity we will refer to both as banks.

The current debate regarding deposit insurance reform appears to focus on what has become known as the moral hazard problem. The scenario is as follows. To the extent that bank creditors are protected by the deposit insurance system, there is no incentive for them to be concerned with the condition of the financial institution. In fact, their incentive is to seek the highest return without having to be concerned with the risk-return trade-off typical of other investments. Further, without any market penalties for assuming more risk, the incentive for bank management is to assume a higher risk profile than would be consistent with safe and sound operations. Because it normally provides the lowest cost solution to the insurance fund, the FDIC has handled most bank failures, and all failures of large institutions, in a way that protects virtually all depositors and other general creditors of the bank. As a result of these "least cost" means of resolution, it is alleged that there is almost no constraint on bank risk-taking other than that provided by the bank supervisory process.

If this story accurately portrays the real world, the logical conclusion is that reintroducing risk of loss to bank creditors will reduce risks in the system. One of the most popular proposals along this line is to limit in some way the amount of federal deposit insurance available to depositors in failed bank situations. While the exact mechanism differs among the various proposals, the basic idea is to expose depositors' funds above some limit to loss when a bank requires financial intervention by the FDIC. For example, one proposal envisages a mandatory deductible for deposit accounts above the basic limit (e.g., the insurance limit could be $100,000 plus 90 percent insured for amounts over $100,000).

Proponents state there are two major advantages to limiting insurance coverage. First, large depositors will have an incentive to monitor the condition of banks in which they place funds and will exert market discipline on more risky banks by either withdrawing funds or demanding a higher return to compensate for increased risk. Second, the system would become more fair in that depositors in both large and small institutions would be treated similarly.

There are several observations that need to be made regarding these types of proposals. First, it would be necessary for those who ultimately are responsible for macroeconomic stability to be willing to take the risks associated with subjecting depositors in a large, multinational bank to the disruptions and loss associated with these plans. Those involved in the rescue of Continental Illinois National Bank and Trust Company were not willing to take those risks. Failure to take those risks would accomplish nothing in terms of increasing market discipline and would increase the disparity of treatment of depositors in large and small banks.

Is it conceivable that a very large bank could be handled as described above without unacceptable disruptions to the domestic economy and international financial arrangements? The answer probably is yes. However, the outcome could be highly uncertain until after the event occurred. No one really knows what would happen if a large bank were allowed to default on deposit obligations with no back up system. Providing some form of emergency or back up ability to handle potential system collapse seems prudent. This back up could be provided by the insurance fund or some other government agency that has responsibility for handling large bank failures.

Another observation regarding plans that are designed to increase market discipline is that there is considerable evidence that significant market discipline exists today, especially for the larger institutions that have large amounts of uninsured deposits and are owned by publicly traded holding companies. Even in smaller institutions, where uninsured deposits are minimal, owners and subordinated creditors and managers have a very good incentive to be concerned with the condition of their banks.

With respect to larger banks, most are owned by publicly traded holding companies that also raise funds by issuing various types of debt instruments. These companies must convince analysts on a regular basis that the overall institution, including the banking subsidiaries, is solvent and profitable. Moreover, these companies face the market at frequent intervals as new debt is issued to finance new activities or refund maturing obligations. In recent years, the FDIC has made it clear through its actions that holding company claimants will not be protected by the deposit insurance system.

At the bank level, the rating agencies make credit quality judgments regarding large CDs issued by the larger banks, resulting in higher funding costs for those institutions judged to be less creditworthy. Moreover, bank runs do occur in large banks. The best known example is Continental, which was unable to fund itself from private sources once the market made a judgment that risk of default had become unacceptably high. More recently, the First Republic system lost over 20 percent of its deposits after the extent of its problems were recognized in the market.

Those who argue that large banks are not subject to market discipline fail to recognize two additional facts. First, money managers do not want to explain why they have an exposed position in a bank that is perceived to be in trouble, even if there is virtual certainty that no loss will result in holding such a position. Second, many large depositors have other business relationships with the bank; to the extent that a weakened financial condition of the bank diminishes the quality, or casts doubt on the continued availability of these services, customers will seek other banking relationships.

Thus, it is unlikely that market discipline will be significantly increased by any of these plans. A reduction in the insurance limit will not materially increase the exposure of large depositors. At the same time, small depositors easily could neutralize any reduction in insurance coverage by rearranging account relationships.

However, costs to the insurance fund could be reduced if there is a willingness to inflict losses on large depositors in banks that are currently considered to be "too-large-to-default." This is because the bulk of the FDIC's costs have been incurred in large bank failures. It is important to remember that this type of policy does involve a trade-off with an increase of systemic problems.

Another means to increase private-sector discipline is to replace some portion of federal deposit insurance with insurance from private-sector companies. One plan envisages FDIC insurance up to the basic limit and private insurance covering uninsured deposits.

There could be considerable merit to some of the private insurance proposals that have been made and this area certainly deserves further study. However, we would like to voice two cautions. First, it will be difficult to fashion a suitable arrangement with private-sector companies that would provide flexibility to accommodate concerns about the effect of a bank failure on macroeconomic stability -- that is, private-sector insurance and too-large-to-default may not be compatible. Second, it is important to ensure that the financial capacity exists in the industry to absorb a realistic expectation of loss. The failure of many seemingly solvent state-sponsored funds in the mid-1980s should not be forgotten.

Having raised these reservations with respect to attempts to control excessive risk by means of increasing discipline on the liability side of the balance sheet, it is fair to say there would appear to be areas where constructive measures can be taken. One such area involves golden parachutes which often provide management with perverse incentives. Safety and soundness issues clearly are raised when it is more lucrative for management if a bank fails than if it continues in operation. These subjects certainly deserve more thought and attention.

Perhaps an equally promising means of controlling excessive risk is by restricting the scope of activities that can be funded with insured deposits while expanding the scope of activities that can be conducted in separately capitalized subsidiaries or affiliates of the insured bank. This is a proposal that the FDIC presented in 1987 in our study, Mandate for Change: Restructuring the Banking Industry.

The basic idea is to restrict activities that are permitted to be conducted within the bank to those that, in some sense, are judged to pose an acceptable level of risk. All other activities could be conducted in separately capitalized direct subsidiaries or affiliates of the bank, provided that a valid and separate corporate identity is established and transactions between the bank and sister companies are severely restricted. We believe that these "firewalls," in conjunction with appropriate auditing and supervisory activities, would adequately protect the insurance fund.

As an integral part of this plan, the FDIC argued that the bank holding company should be free to engage in whatever activities management believes to be appropriate from a business perspective, and that capital regulation at the holding company level served to reduce the ability of the overall company to diversify and to become a viable and profitable organization. In essence, the FDIC's proposal was to eliminate most of the regulation at the holding company level, and concentrate regulatory and supervisory resources on the bank and other operating entities as appropriate.

The FDIC continues to support this position. Clearly, there remain numerous unanswered questions, including what belongs "in the bank" and whether separate rules are necessary for small banks. In this regard, there are credible views that range from restricting the insured bank's investments to short-term government or government-guaranteed obligations to permitting the insured entity to do what is permitted to national banks under existing rules.

As a final note in this area, extending the cross-guarantee provisions of FIRREA -- which are designed to treat insured affiliates as if they are one company -- to nonbanking subsidiaries likely would frustrate attempts to attract capital to bank holding companies, and would be counter to the FDIC's views as articulated in Mandate for Change.

However, it may be necessary to revise certain aspects of the cross-guarantee provisions in order for them to be more effective. Most importantly, since the cross-guarantee provisions now apply only to institutions affiliated at the time of failure, there is an incentive for holding companies to sell or otherwise separate the healthy insured affiliates prior to failure. Thus, the insurance fund should be able to reach assets of affiliated insured institutions that are separated from the common control relationship within a certain amount of time prior to failure of an insured affiliate. For example, the insurer could be permitted to serve notice on a holding company when an insured affiliate has been identified as in danger of failing. The formal notice then would serve to legally obligate the failing institution's affiliates under the cross-guarantee provisions whether or not they are commonly controlled at the time the institution actually fails or receives FDIC assistance. The proceeds of disposing of an insured affiliate then would be subject to FDIC recovery regardless of where held.

Another avenue for controlling risk is to look to the level of capital requirements as a means of providing a larger cushion to protect the deposit insurer. While adjusting capital levels to control risks is attractive, it must be recognized that raising capital standards might have implications for international competitiveness and the ability to attract capital.

In our view, the issues discussed thus far comprise the heart of the options available for meaningful reform of the banking system. In essence, the decisions reduce to three questions. First, how do we control exposure within the insured entity? Do we limit coverage of liabilities, place activity restrictions on the asset side or increase capital requirements? The second question relates to the appropriate position of insured depositories within broader corporate structures, and the implications of this positioning to the longer-term soundness of the banking system. The final question has to do with determining what institutional structure is appropriate for resolving large bank failures.

It is important to note that caution should be exercised in structuring further reform proposals based on either the thrift or commercial bank experience viewed in isolation. One important difference is that thrift institutions typically are funded by fully insured deposits and secured borrowings, whereas banks, especially the larger institutions, rely on significant amounts of uninsured and unsecured funds. Another important difference is the origin of the losses borne by the deposit insurer. The majority of losses in the thrift industry were caused by relaxation of accounting and capital standards and lax supervision; on the other hand, a majority of losses in the banking area is attributable to application of the "too-big-to-default" policy in cases where macroeconomic stability became an issue.

Your letter of invitation raises other issues which we would like to respond to in an abbreviated form.

First, correct measurement of capital (i.e., appropriate asset valuation) and measurement of overall risk clearly are goals that regulators and auditors should strive to achieve. A move toward market-value accounting and/or a risk-based premium system is desirable but neither method is fully developed at this time. Thus, they can not be the "answer" to the problem. The FDIC will continue to attempt to improve techniques in both areas, and FIRREA directs the FDIC to conduct a study of the feasibility of instituting a system of risk-based premiums.

Second, the concept of insuring and assessing deposits in foreign offices of domestic banks raises a host of rather complex questions. The answer to the "too big" doctrine can affect the fairness of this proposal. If there is no "too big" doctrine the fairest basis for insurance premiums is insured deposits, not total deposits as used today.

Further, foreign competitive conditions must be considered, as well as the ability of banks to avoid premium payments by converting foreign branches to subsidiaries. At this point, we see no clear case for including foreign deposits, but further study is required.

Finally, your letter asked that we comment on the current condition of both the Bank Insurance Fund ("BIF") and the Savings Association Insurance Fund ("SAIF").

Based on preliminary results, it appears that the BIF will experience a small loss for 1989. This will be the second operating loss experienced during the history of the FDIC, but much smaller than the over $4 billion loss taken in 1988. From what we see in the system at this time, our expectation is that the fund will begin to increase in 1990 if no large institutions must be restructured.

The major question with respect to the SAIF is the amount of assessment income available from SAIF-insured members over the next few years. Attempts to project this income stream is fraught with problems. The savings association system is entering a transitional period which will determine the fate of the undercapitalized segment of the industry. Events during this transitional period will determine the size of the SAIF assessment base, that is, the deposits of SAIF-insured institutions. The growth of this base has varied dramatically over time. From mid-1978 to the end of 1982, deposits at SAIF-insured institutions grew at an annual rate of 7.4 percent. This was followed by two years of rapid deposit growth of 19.4 percent per year. From the end of 1984 through the first quarter of 1988, deposits grew at a more normal 6.4 percent annual rate. As of the third quarter of 1989, savings association deposits were as they were in March, 1988. Deposit outflows, however, have occurred in recent months.

In light of the uncertainties facing the industry during the next few years, the FDIC has not felt that a "projection" of the SAIF assessment base would be meaningful. The current condition of many savings associations may vary sharply from what is indicated by their public financial statements and old examination reports. Future events are even more uncertain. These include the behavior of interest rates, the condition of local real-estate markets, and the condition of the economy generally. All these factors will influence the ability of the thrift industry to attract capital and hence to grow.