TESTIMONY

OF

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ON

DEPOSIT INSURANCE REVISION AND FINANCIAL SERVICES RESTRUCTURING

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
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Mr. Chairman and members of the Committee: We appreciate the opportunity to testify on the topic of deposit insurance reform. The nation's deposit insurance system is being buffeted as never before in its history. Underlying the problems of the deposit insurance system are the problems of the banking industry itself. Significant changes in both the system and the industry are called for, in part to reduce the exposure of the taxpayer to the costs of the federal safety net.

Supervision, capital, risk: these are the foremost topics that must be addressed in arriving at measures to restore the deposit insurance system and the banking industry to health. Supervision must be strengthened. Capital must be increased. Risk must be limited. We will discuss these three imperatives in our testimony today.

The Chairman of this Committee is to be commended for his foresight over the years regarding troubles in the financial industry, and in particular for his recent proposal from the House floor concerning the current problems. Our testimony will include some initial reactions to the Chairman's proposal. We have also included, as an appendix to the testimony, answers to the questions that were posed in the invitation to testify.

Because the FDIC is currently participating, along with the other federal banking agencies and the Office of Management and Budget, in the Treasury Department's comprehensive study of deposit insurance, some of our testimony is preliminary in nature. That study was mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and is required to be completed by early next year. The study will draw conclusions and make recommendations on a broad range of topics concerning difficulties in the financial industry.

But even though some of what we say is preliminary, there is much that can be said with certainty. Some obvious truths can be emphasized. Some fundamental problems can be highlighted. Some underlying considerations can be pinpointed.

Our testimony begins with a review of the changing, and in many ways deteriorating, state of the banking industry. This is followed by a discussion of the three imperatives: supervision, capital, risk. Then we turn to the structural obstacles to the maintenance of a healthy banking system.

To be effective, deposit insurance reform must embrace these structural problems. Deposit insurance reforms that do not deal with the structural problems will produce few lasting improvements in the deposit insurance system and will not materially reduce the ultimate exposure of the taxpayer to difficulties among banks and thrifts. The purpose of deposit insurance reforms should not be to hold together an antiquated banking industry.

Lastly, we examine deposit insurance reform in the context of Chairman Gonzalez's recent proposal.

A CHANGING INDUSTRY

Banks are operating in a competitive environment that is changing significantly. Because of the legal restrictions that control the structure of the financial industry, banks and other financial institutions have been hampered in their ability to adjust to the changes.

The changes may be characterized as consisting of three interrelated trends: banking is becoming a riskier, more volatile business; banks are encountering greater degrees of competition; and what constitutes the business of banking is undergoing a rapid evolution.

Probably the most pervasive piece of evidence that banking is a riskier business is the number of failed banks. Between 1943 and 1981, the greatest number of banks that failed in any one year was 17, in 1976. Annual failures increased dramatically in the 1980s, however, reaching a peak of 206 in 1989. Also increasing in the industry in the 1980s were net loan chargeoffs, which reached a peak of 1.15 percent of total loans in 1989.

Regarding the increase in competition, a greater variety of players are offering a wider variety of products and services. As a consequence, the banking industry's share of financial sector assets fell from 33 percent of the total in 1980 to 27 percent in 1987. The growth of the commercial paper market is an oft-cited example of a specific inroad into the banking industry's bailiwick. The amount of commercial paper outstanding grew from approximately 10 percent of bank commercial and industrial loans in 1960 to almost 80 percent in 1989.

As for the changing nature of the banking industry, both the proportion of loans in bank portfolios and the composition of the loan portfolios have changed. The loans to assets ratio for the banking industry has steadily climbed. The ratio was 22 percent for the decade of the 1940s, 38 percent for the 1950s, 51 percent for the 1960s, 54 percent for the 1970s, and 58 percent for the 1980s.

Among the changes in the composition of portfolios, the proportion of real estate loans has increased over the years as the proportion of C&I loans has decreased. At year-end 1989, real estate and C&I loans accounted for 38 percent and 31 percent, respectively, of total loans.

Both of these types of changes have increased the riskiness of the banking business. Loans are riskier than the securities they have replaced, and many types of real estate loans pose risks not found in other types of loans.

Thus the banking industry, and the financial marketplace in general, have been undergoing significant changes. Volatility and risk have been on the increase. Because of the outdated restrictions governing what banking organizations can and cannot do, the industry has had trouble adjusting to the changes.

THE THREE IMPERATIVES

Much needs to be done to reverse the decline in the fortunes of the banking industry and to restore the health of the deposit insurance system. But three needs stand out. Supervision must be strengthened. Capital must be increased. Risk must be limited.

Supervision. The essence of prudent banking is to avoid making bad loans and investments. Unfortunately, all the rules and regulations in the world are not going to prevent bankers from making unwise lending and investing decisions. Adequate supervision, however, can restrain, although not entirely prevent, such decisions. Adequate supervision is built upon hands-on efforts by competent, trained examiners.

Indeed, in many ways supervision is superior to regulation. A number of industrialized nations have been highly successful in governing their depository institutions through systems that rely almost solely on supervision as opposed to regulation.

In the United States, there is a partiality toward written rules and regulations. Fairness is viewed as requiring explicit publicly-known standards. Such explicitness, however, can produce a false sense of security. A law is passed, a regulation is promulgated, and a problem is considered solved. Meanwhile, unnoticed events are occurring that will lead to future difficulties.

Thus supervision must occupy a central position in the structure for governing the nation's depository institutions. The

FDIC is spearheading an effort, in conjunction with the other banking supervisors, to improve and enhance the supervision of U.S. banks. This effort can proceed independently of the deliberations on banking and deposit insurance reform. Indeed, a strengthened supervisory effort is necessary to protect the insurance fund and the taxpayers during the period when appropriate reforms are identified and implemented.

Among the measures being actively pursued are: a policy of conducting on-site examinations of all banks no less than once a year; assignment of permanent resident examiners to all of the larger banks; a uniform dividend policy that would apply to all banks encountering difficulties; and a common approach to the evaluation of loan underwriting standards.

Capital. While the degree of risk in the banking system has increased since the 1940s, the proportionate amount of capital has remained relatively static. In the 1980s, this adverse change in the relationship between the degree of risk in the banking industry and the level of capital support was joined by--perhaps even contributed to--soaring numbers of bank failures. These failures in turn produced a fall in the ratio of the deposit insurance fund to insured deposits to the lowest level in the FDIC's history, 0.70 percent. The FDIC believes that the amount of capital--the safety cushion--in the banking industry should be increased.

Capital serves to protect both individual banks and the deposit insurance system. An adequate commitment of capital on the part of the owners of a bank can curtail the temptation to take excessive risks with the bank's funds. Curtailment of risky activity at individual banks would result in a more stable banking system and a healthier deposit insurance fund.

The federal banking supervisors recently reached agreement on a minimum capital ratio for banks. This is only a minimum, however. Over the long term, more capital is needed. How much more is hard to say, but the amount should depend on the riskiness of the activities insured banks are allowed to conduct. In addition to higher capital ratio requirements, an increase in the amount of capital for new bank charters may be called for. This might help improve the staying power of new banks, which historically have experienced a relatively higher failure rate than have longer established institutions.

Although the FDIC believes an increase in capital requirements is necessary, the increase should not be imposed in isolation. Higher capital requirements should be accompanied by industry structural reforms. These structural reforms concern the product and ownership limitations of the Glass-Steagall and Bank Holding Company Acts and the geographic restraints of the McFadden Act, and are discussed later in this testimony.

Risk. The level of risk in the banking industry has increased over the years because, as noted earlier, the banking business itself has become riskier. In addition, many bankers with less aversion to risk have appeared on the scene.

Regarding the latter point, by the time the financially exciting years of the 1980s arrived, the numbers of bankers who remembered the devastating times of the 1930s and the cautious times of the 1940s and 1950s were few. The field of finance became an arena for the robust, the daring, the adventuresome. Concern about risk was not high on their agenda.

Perhaps the events of the last few years have restored a healthy appreciation for, and fear of, the perils inherent in financial activities. If not, additional excruciating lessons might have to be endured. The ease of entry into the banking industry can produce a degree of pessimism in this regard as there is a steady influx of individuals who must relearn old truths.

But assuming that the human aspect of the banking industry's risk problem has been mitigated somewhat, the problem of a generally riskier business still remains. The best way to approach this problem appears to be to limit the types of activities that can be supported with insured deposits. In other words, what can be done in a bank should be restricted. If a banking organization wants to engage in riskier activities, it should do so in nonbanking affiliates adequately separated--both legally and financially--from the bank. This view is elaborated upon in the discussion of structure in the next section of this testimony and was first put forward by the FDIC in its 1987 study, <u>Mandate for Change: Restructuring the Banking Industry</u>.

Determining the activities that could be conducted in the bank--and consequently that would be supported by insured deposits--is no mean task. The FDIC is taking a hard look at the issue. One attractive possibility is to limit the bank to making short and intermediate term loans that have no attributes of equity instruments. All loans would be with recourse. Other activities, including some activities that banks now engage in, would have to be moved to affiliates.

In such a system, a distinction might need to be drawn between larger banks and smaller banks. The difficulties that smaller institutions would encounter in setting up holding companies or separate subsidiaries, and the lesser danger they pose to the deposit insurance system, might justify fewer restrictions on their activities.

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Supervision, capital, risk: these are the three imperatives that must be dealt with if the present troubles engulfing the deposit insurance system and the banking industry are to be overcome. The next topic in this testimony is industry structure, a topic in which the interplay of those imperatives is particularly pronounced.

INDUSTRY STRUCTURE

It was stated previously that because of the outdated restrictions governing what banking organizations can and cannot do, the industry has had trouble adjusting to the many environmental changes that have occurred. The outdated restrictions are the Glass-Steagall Act, the product and ownership limitations of the Bank Holding Company Act, and the geographic barriers imposed by the latter act and the McFadden Act. In 1987, the FDIC considered in detail the first two of these topics. The results were set forth in Mandate for Change: Restructuring the Banking Industry.

Two of the conclusions reached in Mandate were that product limitations on bank holding companies and regulatory or supervisory authority by bank regulators over nonbanking affiliates of banks are not necessary to protect either the deposit insurance system or the payments system. Banking organizations should be free to offer a wide range of products and services, with the major caveat being that many of the products and services should be in uninsured subsidiaries or affiliates of a bank rather than in the bank itself. In addition, the FDIC in 1987 could discern no valid reason to limit the type of entities than can own or be affiliated with banks.

Events in the three years since the publication of Mandate have not vitiated these conclusions. Indeed, developments in other areas of the world, particularly in the European Community as it implements its 1992 program of reduced barriers to the movement of goods and services, have served to emphasize the uniqueness of the banking structure in the United States. The U.S. bank holding company concept is virtually unknown in most other countries, and bank supervisory systems are focused on banks rather than on any corporate owners.

Dissatisfaction with the product and ownership limitations of the Glass-Steagall and Bank Holding Company Acts seems to be fairly widespread among industry members, supervisors, and legislators in the United States. There is less agreement, however, on how the limitations should be altered.

One view, exemplified by Mandate, is that the supervisory effort should be concentrated on banks and not on affiliates and parent holding companies. Moreover, appropriate separations between banks on one hand and affiliates and parent holding companies on the other would permit banks to be part of larger financial, perhaps even non-financial, organizations without the necessity of subjecting those organizations to close supervisory scrutiny. Riskier activities could be conducted in affiliates or subsidiaries of the insured bank without exposing insured deposits to unacceptable risks.

The contrary view is that any relaxation in the restrictions of the Glass-Steagall and Bank Holding Company Acts should be accompanied by strong supervision of both the banking and nonbanking sides of resulting organizations. Underlying this view is the argument that establishing adequate separation between a bank and its affiliates and parent holding company is not feasible. Consequently, the entire organization needs to be supervised. Moreover, affiliates and parent companies of banks should be limited to certain types of financial activities, and there should be no mixing of banking and commerce.

In Mandate, the FDIC came down on the side of focusing on the bank and reducing the control over the holding company and nonbank affiliates. The FDIC still believes that this is the preferable approach.

The third structural obstacle to a healthy banking industry consists of geographic barriers. Despite actions by the states allowing, in various forms, interstate expansion by bank holding companies, the free market ideal of no geographic restraints on the banking business has still not been achieved. The mishmash of state laws imposes substantial restrictions on bank holding company interstate expansion. And the 1927 McFadden Act severely restricts the ability of national and state banks that are members of the Federal Reserve System to branch across state lines.

Interstate banking restrictions have contributed to the increase in risk in the nation's banking industry and to the decrease in banks' competitive capabilities. For one thing, banks have been hampered in attempting to lower risk through diversification. Banks have also been constrained in expanding operations to match the expansion of banking markets that has been caused by technology and economic growth.

To summarize, structural reform of the banking industry is long overdue. To enable banking organizations to function in the changing environment, the obstacles presented by the Glass-Steagall Act, the Bank Holding Company Act, and the McFadden Act should be critically examined. With appropriate changes in the legal underpinnings of industry structure, banking organizations would be in a better position to adjust to the ongoing revolution in the financial marketplace.

DEPOSIT INSURANCE REFORM

Assuming the enactment of structural changes that remove impediments to the pursuit of reasonable profits by the banking industry, reforms in the deposit insurance system should be designed to ensure that the industry and its customers bear the appropriate costs of the government safety net.

There have been no shortage of proposals regarding deposit insurance reform. Some proposals focus on the asset side of the bank balance sheet. Others focus on bank liabilities. Still others focus on the difference between assets and liabilities--capital. And many approaches combine actions on all three balance sheet categories.

Rather than review the many different ideas that have been espoused, the remainder of this testimony sets forth some initial reactions to the recent proposal by the Chairman of the House Banking Committee. The goal of that proposal is to strengthen the deposit insurance system by: providing and enforcing adequate capital standards; limiting insurance coverage and requiring realistic pricing for that coverage; unifying the regulatory system and making it independent; requiring regulators to act promptly and decisively when an insured institution begins to weaken; and making holding companies responsible for losses their insured institutions incur. Each of these topics is considered in turn.

Capital. The need for more capital in the banking industry has already been emphasized. Indeed, it is an imperative that activities funded with insured deposits be backed by adequate capital. Capital is a source of protection for the individual bank and a bulwark for the deposit insurance system as a whole.

An increase in the capital requirements for activities funded with insured deposits should take place in conjunction with action on the structural obstacles to the restoration of a competitive and viable banking industry. The product and ownership limitations of the Glass-Steagall and Bank Holding Company Acts and the geographic restrictions of the McFadden Act should be reduced or eliminated.

Then, as capital requirements for banks were raised, banking organizations would have various options regarding the movement of activities to uninsured affiliates or subsidiaries. The banking regulators would mandate the capitalization of banks, but the marketplace would determine the capitalization of the overall company.

Insurance Coverage and Pricing. There is merit to many of the proposals that would limit insurance coverage in one fashion or another. But most of the proposals would also entail administrative difficulties, some of them significant. The costs of reporting burdens on individual institutions and recordkeeping requirements on the FDIC should be considered before the adoption of any proposal that would limit insurance coverage. Also requiring consideration are the security and privacy issues that would be raised if another extensive system of records were necessary.

Administrative difficulties are only one area of concern, however. Two other factors regarding the insurance limitation proposals have more importance. First, reducing or limiting insurance coverage might lead to increased instability in banking markets. This in turn could result in reduced international competitiveness on the part of U.S. banks.

Second, due to a widespread belief in the Too Big To Fail concept--a better term is too big to allow a default on deposits--a reduction or limitation in insurance coverage could result in a shift in the competitive balance between big banks and small banks. The latter would suffer. This would be the case even though the FDIC does not in fact have a Too Big To Fail policy.

What the FDIC does have regarding Too Big To Fail is the belief that the possible failure of a large financial organization presents macroeconomic issues of considerable significance. These issues can transcend the normal considerations in a failing bank situation, leading to a decision to prevent the bank from going under. A by-product of that decision can be to provide 100 percent insurance for the deposits in the institution.

The macroeconomic considerations cannot be legislated away. The possibility that a failing large bank will be handled in a way that results in losses to uninsured depositors and creditors cannot be guaranteed. Consequently, many participants in the financial marketplace have concluded that large banks are safer than smaller banks. Reductions or limitations in insurance coverage that purport to apply to all banks but in practice only apply to smaller banks might exacerbate this discrepancy in perception, leading to a flight of deposits from smaller banks to larger banks.

Regarding proposals on the pricing of deposit insurance, one suggestion would base deposit insurance premiums on the riskiness of an institution's assets. The FDIC is required by FIRREA to conduct a study of risk-based premium assessments and to report the findings to Congress by January 1, 1991. The FDIC is in the process of conducting this study. Although the ultimate recommendation may well be to institute a system of risk-based insurance premiums, it should be realized that any such system will pose difficult, complex problems concerning the measurement of risk.

<u>Regulatory Structure.</u> Regulatory structure reforms are important, but they are subsidiary to issues of industry structure and to questions concerning the deposit insurance system. Issues of regulatory responsibility and supervisory authority should not be allowed to obscure the more important need to rejuvenate the health and competitiveness of the banking industry. Nor should issues of regulatory structure be the determining factors regarding changes in the deposit insurance system.

Once reforms concerning banking industry structure and the deposit insurance system are agreed upon, the difficult task of improving the rationality and efficiency of the regulatory structure can be tackled. That structure currently consists of three federal bank regulators, one federal thrift regulator, one federal credit union regulator, assorted peripheral federal entities, and a variety of regulators in the fifty states. Responsibilities are often overlapping and redundant. The concept of functional regulation takes second place to the concept of institutional regulation.

The elimination of many of the outdated aspects of this structure would appear to be possible. One guiding principle should be regulatory independence. Financial regulators and insurers should have a degree of insulation from the effects of the latest political fad or from the pressures of powerful economic interests. In addition, banking supervisors should not be subject to a conflict of interest by also being responsible for other important functions and objectives, such as monetary policy, international economic stability, or revenue production.

Further considerations are the preservation of the state-federal dual banking system and the separation of chartering and deposit insurance functions.

A more uniform, more efficient system is possible. But a streamlined structure would make it even more important to keep supervision insulated from political pressures and other public concerns.

Supervisory Promptness and Decisiveness. The FDIC agrees that promptness in dealing with banking organizations in trouble is extremely important. For the most part, the federal bank supervisors have not failed to act promptly once troubles in an institution become known. The difficult problem is determining when a bank is in fact in trouble. This determination requires an adequate supervisory program. As was noted in the discussion of the three imperatives, the FDIC is working with the other banking supervisors to improve supervision.

As for the necessity to act decisively, the FDIC again agrees. Some commentators contend, however, that because the bank supervisors have a certain amount of discretion regarding how banks in trouble can be handled, there is a lack of decisiveness. The S&L crisis is pointed to as a situation where too much discretion resulted in ineffective or no action and a consequent compounding of the original problem.

There is no doubt that the S&L crisis has given supervisory discretion a bad name. It should be remembered, however, that the federal S&L supervisor, the Federal Home Loan Bank Board, was much more a captive of its industry than are any of the three federal banking supervisors. The FHLBB's lack of objectivity resulted in large measure from the fact that it was required by law to be something of a cheerleader for low cost home financing and the S&L industry. Its mandate was to encourage local thrift and home financing and to promote, organize, and develop thrift institutions.

Reducing the current discretion they have regarding troubled institutions would curtail the ability of the bank supervisors to seek the least costly or least disruptive way of handling bank difficulties. Supervisors are not perfect in their reaction to troubled bank situations, but supervisory discretion has contributed enormously to the stability of the financial system. Supervisory discretion in the 1980s enabled the banking agencies to avoid widespread financial and economic disruptions while dealing with troubles in hundreds of institutions, including nine of the ten largest banks in Texas and two of the three largest in Oklahoma.

Moreover, reducing or eliminating supervisory discretion would not, as some commentators contend, obviate the Too Big To Fail problem. As previously indicated, that problem is much more than a problem of the deposit insurance system. The possible failure of a large financial institution presents macroeconomic issues that some arm of the government must consider.

There is a caveat to the FDIC's view that a certain amount of supervisory discretion is desirable. Regarding banks that it does not directly supervise, the FDIC needs to be more involved and to have the final say on who is to be protected by the deposit insurance fund. This requires an increase in the FDIC's statutory powers.

In summary, although promptness and decisiveness are essential attributes of an adequate supervisory system for the banking industry, it is unrealistic to mandate in advance precisely how each troubled bank situation should be handled and exactly who should suffer losses.

Source of Strength. The FDIC has concerns about making parent holding companies and nonbank affiliates of banks responsible for bank losses. This so-called source of strength doctrine suggests that all units within a financial holding company are effectively part of a single corporate entity. An implication is that bank regulation and supervision should extend throughout the entire holding company to include not only the bank or banks but also the holding company itself and any nonbank subsidiaries of the holding company.

In Mandate, the FDIC argued that if there is adequate regulation and supervision at the bank level, and if effective separation exists between the banks and the nonbanking entities of an organization, there is no need for regulation and supervision at the holding company level or of nonbank affiliates.

A doctrine that puts nonbank affiliates at risk for bank failures has many implications for the nation's financial system. If there is no effective insulation between banks and nonbank affiliates, bank holding companies would be impeded in their ability to expand into nonbanking areas because their investments in nonbanking affiliates would always be in jeopardy.

Further, nonbanking firms might be inhibited from entering the banking industry if all preexisting activities and investments were at risk. This situation would reduce market efficiency, restrain the ability of banks to be viable competitors in the financial marketplace, and limit the ability to obtain new capital for the banking industry.

CONCLUSION

Supervision, capital, risk; these are the areas in which actions to attack the troubles of the deposit insurance system and the difficulties of the banking industry are imperative. Beyond these actions, a number of reforms regarding the legal foundations of the nation's banking industry are needed. A danger of the current difficulties facing the industry is that pressing fundamental reforms regarding the industry's structure will be neglected in favor of changes that either do not deal with underlying long-term problems or that exacerbate them.

Both the immediate needs--the imperatives--and the long-term requirements must be attended to. In addition, the interrelationships among industry structure, the deposit insurance system, and regulatory responsibilities must be kept in focus. Only an integrated approach will enable the appropriate changes to be made, changes that will attack the causes of the decline in the soundness of the deposit insurance system and deal with the related underlying problems facing the banking industry.

APPENDIX--ANSWERS TO QUESTIONS

This appendix contains answers to the questions posed in the August 3, 1990, letter from House Banking Committee Chairman Henry B. Gonzalez to FDIC Chairman L. William Seidman. Most of the questions concern topics that are the subject of the Treasury Department's comprehensive study of deposit insurance. Along with the other federal banking agencies and the Office of Management and Budget, the FDIC is participating in this study, which was mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. The study is required to be completed in early 1991.

Because the study will draw conclusions and make recommendations regarding the topics covered by many of the questions, providing final answers now would in many cases be premature. Accordingly, many of the answers given in this appendix are designed primarily to identify the issues. In appropriate instances, the FDIC's current thoughts are presented.

A further cautionary word is in order. The topics of most of the questions should not be considered in isolation. Deposit insurance reform is a subject that should be approached from a broad perspective. How one particular issue is resolved will influence how other issues should be resolved.

Moreover, underlying the subject of deposit insurance reform is the subject of industry structure. The product, ownership, and geographic limitations of the Glass-Steagall, Bank Holding Company, and McFadden Acts are in serious need of rethinking. The route that industry structure reform takes will have an effect on the many issues involved in deposit insurance reform.

Strength of the Insurance Funds: Are current reserves sufficient or should we further raise assessments? Should we merge the two insurance funds, the SAIF and the BIF, to save administrative costs and ensure consistent regulation? Do the funds' balances accurately reflect anticipated future losses?

The FDIC recently proposed an increase in Bank Insurance Fund assessments to 19.5 cents per $100 of assessable deposits. Based on the FDIC's current outlook for the banking industry, the increase should be sufficient for 1991. As with all economic forecasts, however, that outlook is subject to change.

Although the FDIC does not believe an additional assessment increase is warranted at the present time, greater flexibility regarding the timing and magnitude of assessments would seem to be appropriate. Such flexibility would enable the FDIC to respond more quickly to changing economic conditions.

Merging the two insurance funds, the SAIF and the BIF, would have little effect on administrative costs. Within the FDIC, the two funds are not supported by separate organizations. Each fund does not have a distinct administrative apparatus. The separation of the funds is merely a cost accounting concept, with costs being allocated to the appropriate fund.

A merging of the two funds would also, by itself, do little to ensure consistent regulation. Separate supervisory and regulatory schemes for banks and thrifts would remain in existence. Indeed, a thorough consideration of the issue of consistent regulation would require investigation of the much broader issue of whether there should be a legally distinct thrift industry.

Concerning the question of whether the balances in the insurance funds accurately reflect anticipated future losses, the amount in the Bank Insurance Fund, as augmented by the annual assessments on insured deposits, is sufficient to cover any losses that the FDIC currently foresees. As previously indicated, however, changing economic conditions could alter this conclusion.

As for the Savings Association Insurance Fund, it will not be used to cover depositor losses until 1992. At that time, SAIF will be funded by assessments on SAIF-insured institutions. Subject to limits, the Department of the Treasury will ensure that the SAIF receives at least $2 billion a year through 1999 by making up any shortfall in the assessments. In addition, Treasury will provide any funds necessary, up to a $16 billion ceiling, to ensure that a schedule of steadily increasing minimum net worth levels is met by the fund from 1991 through 1999.

Whether these funding sources for SAIF will be adequate depends on the condition of the thrift institutions that remain in existence after the authority of the RTC to resolve new cases expires in 1992. There is growing doubt that they assumptions behind FIRREA's funding of SAIF were accurate.

Capital: Perhaps the greatest deterrent to imprudent or risky behavior is capital. What is your opinion about the importance of capital requirements, including the risk-based capital standards?

Capital requirements are extremely important. Capital serves to protect both individual banks and the deposit insurance system as a whole. An adequate commitment of capital on the part of the owners of a bank can curtail the temptation to take excessive risks with the bank's funds. Curtailment of risky activity at individual banks results in a more stable banking system and a healthier deposit insurance fund.

Nevertheless, a general increase in capital requirements should not take place in isolation. The banking industry is in need of significant structural reforms. The ownership and product limitations of the Glass-Steagall and Bank Holding Company Acts and the geographic restrictions of the McFadden Act are hindering the ability of banks to compete in a fast-changing financial world. Any increase in capital requirements should be accompanied by the appropriate alterations in these outdated laws.

One result of these alterations would be that banking organizations--meaning banks, their parent holding companies, their subsidiaries, and their affiliates--would have greater latitude to conduct activities from uninsured portions of their structure. Then, as capital requirements for banks were raised, banking organizations would have various options concerning the movement of activities to uninsured affiliates or subsidiaries. The banking regulators would mandate the capitalization of banks, but the marketplace would determine the capitalization of the overall company.

Regarding risk-based capital standards, the FDIC believes that they can be useful. Because of limitations, however, risk-based standards do not eliminate the need for unadjusted capital standards.

Identifying risk in advance is difficult, as is measuring the riskiness of broad categories of activities. Indeed, the categories can be so broad as to cover widely varying degrees of risk. If attempts are made to narrow the categories, the result is likely to be a system of costly and complex regulations. For an example of how overbearing a system of risk-based capital standards could become, one has only to recall the pages and pages of regulations that characterized interest rate controls in their heyday.

Implicit credit allocation is another problem with risk-based capital regulations. By making some activities more costly than others, such regulations influence the flow of funds in the economy. Some sectors of the economy may be deprived of funds they would otherwise have received. And other sectors of the economy may receive funds that ordinarily would not have been available.

Moreover, these movements of funds can themselves change the riskiness of activities. More funds flowing to a particular type of activity can result in the riskier niches of the activity category receiving money that would normally have gone elsewhere. Thus the average risk of the activity category increases. Consequently, risk categories are not static entities. They are more in the nature of moving targets.

Risk-based Premiums: What is the feasibility of risk-based insurance premiums?

Section 220(b)(1) of FIRREA requires the FDIC to conduct a study of risk-based premium assessments and to report its findings to Congress by January 1, 1991. The FDIC is in the process of conducting this study. The solicitation and evaluation of comments from the public are being included in the process.

Risk-based premiums would improve a bank's incentive to control risks. A risk-based premium system would also be fairer than the current system in that banks engaged in riskier activities would have to pay more for deposit insurance protection.

It should be recognized, however, that a risk-based premium system would pose difficult questions concerning the measurement of risk. Furthermore, some of the criticisms of risk-based capital requirements that were noted in the previous question could be leveled at risk-based insurance premiums.

<u>Insurance Coverage: How much insurance should be provided to individual depositors? Should we continue to insure an individual's accounts in an unlimited number of institutions?</u>

It is almost impossible to consider in the abstract the question of how much insurance should be provided to individual depositors. The insurance limit is now $100,000 per depositor per bank, and the pertinent question is whether this limit should be changed. The answer to this question depends in part upon the effects a change might produce.

There certainly is no current or foreseeable need to raise the $100,000 limit. On the other hand, lowering the limit might result in disruptions as depositors with accounts in excess of the new limit withdrew funds to reduce or eliminate the uninsured portions of their accounts. The possible impact of these disruptions on banks and thrifts would have to be carefully investigated before any lowering of the insurance limit is seriously considered.

More generally, reducing or lowering insurance coverage might lead to an overall increase in instability in banking markets. This in turn could result in reduced international competitiveness on the part of U.S. banks.

Another concern regarding proposals to reduce or limit deposit insurance coverage is the Too Big To Fail concept. Due to a widespread belief in this concept, a reduction or limitation in insurance coverage could result in a shift in the competitive balance between big banks and small banks. The latter would suffer. This would be the case even though the FDIC does not in fact have a Too Big To Fail policy.

What the FDIC does have regarding Too Big To Fail is the belief that the possible failure of a large financial organization presents macroeconomic issues of considerable significance. These issues can transcend the usual considerations in a failing bank situation, leading to a decision to prevent the bank from going under. A by-product of that decision can be the provision of 100 percent insurance for the deposits in the institution.

The macroeconomic considerations cannot be legislated away. The possibility that a failing large bank will be handled in a way that results in losses to uninsured depositors and creditors cannot be guaranteed. Consequently, many participants in the financial marketplace have concluded that large banks are safer than smaller banks. Reductions or limitations in insurance coverage that purport to apply to all banks but in practice only apply to smaller banks might exacerbate this discrepancy in perception, leading to a flight of deposits from smaller banks to larger banks.

Regarding the specific proposal to limit the insurance coverage of each individual to a total of $100,000 across all institutions, the idea has a certain appeal. The aggregate amount of insured deposits would probably be reduced, thus reducing the theoritical exposure of the deposit insurance funds to losses. And a major purpose of the deposit insurance system would be emphasized: to provide protection for the savings of depositors of modest means.

Nevertheless, there are offsetting considerations. The general concerns just discussed about increased instability in banking markets and about the impact of the widespread belief in the Too Big To Fail concept apply. And there is a further matter: the likelihood of significant administrative difficulties.

A system would have to be devised to verify the total amount that each individual had subject to deposit insurance. The information would have to be continually updated. Such a system would impose extensive reporting burdens on individual institutions and substantial recordkeeping requirements on the FDIC. The costs of the system would likely be high and would ultimately be borne by depositors. The extensive records the system would require would also raise significant security and privacy concerns.

<u>Private or Co-Insurance: Is private or co-insurance feasible? What about a deductible form of insurance for amounts not covered by Federal insurance?</u>

A number of private or co-insurance proposals have been put forth, including proposals for a deductible form of insurance for amounts not covered by Federal insurance. Most of the proposals have some degree of merit. Each of them, however, entails pricing and administrative difficulties. Presumably, many of these difficulties could be worked out by the private sector insurers themselves or in cooperation with the FDIC and the other government agencies involved. Still, the costs incurred in overcoming the difficulties would likely reduce the benefits that are expected to result from implementation of any of the proposals.

Of more importance is the fact that the private and co-insurance proposals would not result in an improved ability to cope with systemic risk. If the banking industry encounters deep troubles, it is unlikely that a private insurance system could handle the situation. The government would remain the ultimate risk-bearer.

<u>Limit Insurance on "Super" Accounts: Should we eliminate or restrict using deposit insurance for the super (greater than $100,000) accounts such as bank insurance contracts and pension funds? Should we restrict insurance coverage of so-called "pass through" accounts like 457 plans?</u>

Earlier this year, the FDIC, in accordance with Section 220(b)(2) of FIRREA, submitted to Congress a study on "pass-through" deposit insurance (Findings and Recommendations Concerning "Pass-Through" Deposit Insurance, Report to the One Hundred and First Congress by the Federal Deposit Insurance Corporation, February, 1990). The study reviewed in detail the FDIC's regulations concerning pass-through insurance coverage.

Under the FDIC's regulations, the deposits of most pension plans, profit-sharing plans, and other trusteed employee benefit plans are entitled to pass-through insurance coverage, provided the pertinent recordkeeping requirements are met. The deposits of most health and welfare plans are not entitled to pass-through insurance since the interests of the employees in such plans are contingent and not readily ascertainable.

Regarding "457 Plans," which are deferred compensation plans established by state governments, local governments, and non-profit organizations, they do not receive pass-through insurance coverage. The FDIC has taken this position because the Internal Revenue Code denies the participants in such plans any ownership interests in the funds of the plans.

Although the FDIC's regulations on pass-through insurance comport with current law, it is time to consider changing the law. The FDIC might be moving toward becoming the insurer for the nation's pension programs. The public policy implications of this state of affairs are not attractive, and the risk inherent in the current situation suggest limitations are in order.

Brokered Deposits: Should we eliminate or further restrict the use of brokered deposits, particularly in undercapitalized institutions?

Steps have been taken to better control the use of brokered deposits. Some of these actions are relatively new, so the jury is still out on their long-term effectiveness. Consequently, brokered deposits will require further monitoring. The actions that have been taken concerning brokered deposits are as follows.

As a result of Section 224 of FIRREA, undercapitalized depository institutions are prohibited from accepting brokered deposits without a waiver from the FDIC. The implementing regulation, 12 C.F.R. section 337.6, uses a broad definition of "undercapitalized." The result is that any depository institution capital deficient by any measure must apply to the FDIC for a waiver before accepting or renewing brokered deposits. Waivers are granted only in certain instances.

Brokered deposits are also addressed by the FDIC's new rule on planned rapid growth (12 C.F.R. section 304.6). This rule generally requires advance notification whenever any insured bank anticipates growing rapidly through the solicitation of brokered deposits, out-of-territory deposits, or secured borrowings. The advance notification permits appropriate supervisory review of the plans.

Finally, brokered deposits are monitored off-site through various analyses of call report data. More specifically, the FDIC uses a growth model and an early warning model of financial problems called CAEL (Capital-Assets-Earnings-Liquidity).

"Too Big (or important) to Fail": How can we set limits on the regulators' discretion on how to treat large institutions as they approach insolvency? Are additional protections, like those we provided in Section 212 of FIRREA for certain qualified financial contracts, needed for contractual and clearing relationships so that those relationships will not be used as a reason for not changing management, selling or closing the institution? Should we raise capital requirements for large institutions so that they pay for being protected from closure? What do you think of the suggestion that we divide institutions into categories based on size and require institutions in the same category to be assessed for all failures in that category? What are the international issues involved in the insolvency of particularly large institutions? Are we working with regulators from other countries on these questions?

The Too Big To Fail problem is much more than a problem of the deposit insurance system. Altering the present regulatory structure in an attempt to eliminate the problem by curtailing regulatory discretion would merely shift responsibilities. The possible failure of a large financial organization presents macroeconomic issues that some arm of the government must consider, and quickness must usually be an important attribute of the consideration. The evaluation of the economy-wide ramifications of the demise of a big bank is a government duty. The quickness requirement means that the duty is best performed by an existing agency.

Therefore, the FDIC believes that the desire to eliminate regulatory discretion regarding troubles in large financial institutions is unwise.

Regarding the raising of capital requirements for large institutions, the FDIC would like to see more capital in the banking industry in general. As indicated in the answer to an earlier question, however, an increase in capital requirements should be accompanied by fundamental reforms in industry structure, allowing the industry to operate more efficiently and to become more profitable. The structural reforms would permit banking organizations to conduct activities in adequately separated subsidiaries and affiliates not subject to capital requirements. The linkage of capital requirement increases and structural reforms would ameliorate any competitive disadvantages that banks might suffer because of higher capital levels.

Making banks of a certain size category responsible for the losses of other banks in the category is a suggestion that triggers two thoughts. First, establishing the category boundaries would be an exercise in arbitrariness. It is difficult to conceive of convincing justifications for various size categories. Second, the proposal would not solve, although it might somewhat alleviate, the problem of systemic risk. Despite being relieved of the costs of some smaller failures, the government would retain its role as ultimate risk-bearer.

The insolvency of particularly large institutions gives rise to three categories of international issues. The first is simply the effect that such an insolvency might have on the domestic, and subsequently the international, economy. The second category covers possible interruptions in cross-border clearings, settlements, and flows of funds. And the third category involves questions of responsibility for foreign branches and subsidiaries.

These issues are among those being considered in a variety of forums involving banking supervisors from different nations. The Bank for International Settlements provides a major forum, the Basle Committee on Banking Supervision. Another BIS body is the Group of Experts on Payment Systems. And along these lines it should be noted that the FDIC is holding tomorrow, September 26, an international deposit insurance conference. The attendees include representatives from a number of supervisory authorities in other nations. A variety of deposit insurance issues will be discussed, including the Too Big To Fail concept.

<u>Foreign Deposits: Should we explicitly insure foreign deposits and assess foreign deposits?</u>

The issue of foreign deposits is one of the topics Congress explicitly required be considered in the forthcoming Treasury study. Consequently, the following comments are limited to pointing out some of the considerations involved.

Foreign deposits are without a doubt one of the more complex and contentious issues in the area of deposit insurance reform. On the one hand, since virtually all foreign deposits are held by large banks, and since these institutions are more likely to be handled in a way that protects most creditors, there is a very good argument that these deposits should be assessed for insurance purposes.

But there are several offsetting considerations. First, the increased costs associated with assessments might reduce the ability of U.S. banks to compete in foreign markets and adversely affect their ability to promote exports from the United States. Second, many U.S. banks might convert foreign offices to subsidiary banks, thus perhaps substantially reducing the amount of foreign deposits subject to assessments.

Finally, if foreign deposits are assessed, there is a strong argument that they should be insured. This raises a variety of further considerations. One is the reaction of foreign governments to U.S. banks offering insured deposits in competition with domestic banks. Another is the liability of the FDIC in cases where a foreign government seizes a bank's assets held in the host country without honoring local claims against the bank.

Secured or Collateralized Borrowings: What are the policy issues involved in deciding whether to include such borrowings in the insurance base for assessment purposes?

The addition of collateralized borrowings to the deposit insurance base is another subject that is specifically required to be covered in the Treasury study. The answer to the question of whether such borrowings should be included in the insurance base appears to be much simpler than the answer to the question of whether foreign deposits should be assessed, however.

In bank failures, assets used to secure bank borrowings are not available to settle the claims of unsecured creditors, one of which is the FDIC. Consequently, unsecured creditors, including the FDIC, receive less reimbursement on their claims as more bank debt becomes secured. Another way of putting the matter is that secured or collateralized borrowings can increase FDIC costs in failed bank situations. Thus the inclusion of at least some secured or collateralized borrowings in the insurance base would seem to be reasonable.

Improve Information on Financial Condition of Institutions: How would it help to strengthen the examination staff of the responsible regulatory agencies? Should all assets and liabilities, on and off the balance sheet, be included in capital computations? For what kinds of assets or liabilities is it most appropriate to use market value accounting rather than cost or book values?

The stronger the examination staff of a bank supervisory agency, the better the agency can ensure the safety and soundness of the banks it supervises. Over the past eight months, the FDIC's Division of Supervision has hired, or made definite job commitments to, over 600 new bank examiner trainees. The trainees are primarily recent college graduates who are selected under a highly competitive and selective placement process, or who meet the eligibility requirements to be hired directly under the Office of Personnel Management's Outstanding Scholar program.

In fact, 63 percent of the most recent hirees have met the standards necessary to qualify as Outstanding Scholars. To attain that status, applicants must have graduated from their college or university with a 3.5 Grade Point Average or have ranked in the top 10 percent of their college or university subdivision.

The recent hiring success should result in a field staff of approximately 2,800 by year-end 1990, a substantial increase from 2,223 at the end of 1989. Nevertheless, the large number of trainees coupled with turnover mean that the experience level of the field staff is lower than in previous years. The critical personnel challenge now facing the FDIC is to maintain the successful recruitment program while finding ways to retain a significant percentage of those already hired. The FDIC expects to continue to increase its supervision staff to implement the strengthened supervisory program outlined in the body of the testimony.

Both on and off balance sheet items should be considered in judging the adequacy of an institution's capital. There are a number of ways that capital adequacy computations can be made, however. Over the last few years, the supervisory agencies have devoted considerable effort to examining the various ways and will undoubtedly continue to do so. Parenthetically, the risk-based capital guidelines currently being phased in explicitly consider off balance sheet activities.

Market value accounting is still another topic that is explicitly required to be considered in the Treasury study. In general, market value accounting is most appropriate for readily marketable items, such as securities that are actively traded.

It should be noted that bank financial reporting already involves a substantial degree of accounting based on market values. For example, both market values and book values for securities must be given. Assets held in trading accounts are marked to market. Repossessed real estate has been written down to market value. And the market value of foreign currencies is reflected in foreign currency translation adjustments.

Determine Appropriate Capital Levels: What problems are there with accounting measures that seriously overstate economic values or understate an institution's liabilities? What are the most important accounting changes that should be made? How can we make sure capital levels are monitored frequently enough so that regulators can detect problems in time to act?

The primary problem regarding accounting measures that overvalue assets or undervalue liabilities concerns the issue of market value accounting and reserving. As indicated earlier, that topic is being dealt with in the Treasury study.

Monitoring banks frequently enough to detect incipient capital difficulties, in part through ensuring that asset valuations are accurate, is a never-ending problem for which there is no simple solution. The FDIC strives for a sufficient degree of supervision through a system of on-site exams, off-site monitoring, informal contacts, and information and exam exchanges with state and other federal agencies. Efforts to improve and update the procedures are continuous. A current priority is to improve the on-site exam capability.

Subordinated Debt: What are the issues involved in using subordinated debt to meet capital requirements?

On one hand, subordinated debt can serve as a form of capital because subordinated debt holders stand behind depositors, general creditors, and the FDIC in a bank failure. Thus, subordinated debt holders stand to lose most, and generally all, of their investment when a bank fails. Because of their inferior status in bank-failure cases, subordinated debt holders serve to lower the FDIC's failure-resolution costs.

Subordinated debt also adds a degree of market discipline-- a bank in trouble would not be able to roll over its subordinated debt. From a bank's standpoint, subordinated debt is attractive because of the tax deductibility of interest expenses.

On the other side of the argument is the fact that unlike dividend payments, interest payments on subordinated debt are difficult to halt in times of trouble. Additionally, an undesirable feature of subordinated debt from the supervisor's standpoint is that it can be used to circumvent dividend restrictions. A bank owner unable to take money out of the bank through dividends might be able to do so through interest payments on subordinated debt.

<u>Improve Enforcement of Adequate Capital: Commentators have almost uniformly agreed that regulators' supervision and intervention authority should increase and their discretion should decrease as an insured depository institution falls into lower capital to asset ratio categories. They have also suggested that those institutions should have less discretion to take actions which</u>

have the effect of reducing capital. First, how should categories like this be measured, by generally accepted accounting principles (GAAP) or market value accounting? Second, what do you think of the following proposal?

1. Adequately capitalized institutions with capital-asset ratios greater than <8> percent (or another specific number) would be required to file periodic reports, but otherwise would be permitted to conduct business within general guidelines largely free of detailed regulation.

2. Weakly capitalized institutions with lower ratios (between <6 and 8> percent, for example) would be subject to more intensive monitoring and supervision at the discretion of the regulators. Regulators could require a plan for restoring capital to a specified level or they could make such measures mandatory.

3. Inadequately capitalized institutions (with ratios between <3 and 6> percent, for example) would be subject to much greater supervisory scrutiny and reporting requirements. Dividends on equity and interest payments on subordinated liabilities would be suspended, unapproved outflows of funds to affiliated firms prohibited, and asset growth set at zero or less. In addition, the institution would be required to submit a plan for recapitalization or reorganization.

4. Solvency endangered institutions (with ratios less than <3> percent, for example) would have to implement the plan previously submitted or sell the institution under terms that bring capital back up to the level required within a very short

time period. Failing this, the institution would be placed into conservatorship.

5. Close insolvent institutions: There would be no regulatory discretion.

As noted earlier, the desirability of market value accounting is a focus of the Treasury study. It was also previously pointed out that financial reporting currently contains a significant amount of information on market values.

Concerning the proposal itself, it has attractive features, and indeed the approach embodied in the guidelines has long been part of the bank supervisory system. Weakly capitalized institutions are more intensely monitored and supervised (guideline #2) than are adequately capitalized institutions (guideline #1). Insolvent institutions are not kept in operation but are liquidated or acquired by viable institutions (guideline #5).

Guideline #3 raises for the FDIC several issues regarding its authority concerning inadequately capitalized institutions. The FDIC has little power to control the actions of national banks or state banks that are members of the Federal Reserve System. And some aspects of its authority regarding the state-chartered banks under its control need clarifying. In general, the FDIC would like to have broader cease and desist power regarding all banks. Further, it would like to have the explicit authority to suspend dividend payments and certain subordinated debt interest payments in the event of financial troubles in an institution.

The FDIC does perceive a difficulty with guideline #4. If implemented, the guideline would seem to reduce the FDIC's ability to resolve cases involving inadequately capitalized institutions in the least costly, least disruptive manner. The lack of supervisory discretion might be particularly constraining when the troubled institution is large and issues with economy-wide ramifications are concerned.

Although the guideline proposal is attractive, one caveat is in order. Regardless of whether a form of generally accepted accounting principles or a form of market value accounting is followed, the sufficiency of capital depends to a large extent on the quality of assets. And asset quality is best both ensured and determined through adequate supervision. The establishment by statute or regulation of capital categories would not alleviate the need to maintain the main bulwark against capital deterioration: adequate hands-on supervision.

<u>Transfer of Uninsured Liabilities: The Resolution Trust Corporation has been transferring a large number of uninsured liabilities which would not be covered during an insurance action (that is, a liquidation or payout). Is it cheaper for the insurance funds to cover these liabilities than to do more payouts? Are the current tests used by the agencies to determine</u>

whether assistance is less costly than either transferring deposits or paying off depositors sufficient and accurate?

The RTC has not been transferring a large amount of uninsured liabilities. In the 96 purchase and assumption transactions arranged by the RTC through June 30, 1990, uninsured and unsecured liabilities amounted to only $88.2 million, which was substantially less than one percent of the $48.2 billion in liabilities involved.

By statute, the FDIC and the RTC must employ, unless an institution is considered essential to its community, a cost test in deciding how to handle an institution whose situation must be resolved. Comparing the costs of the various alternatives for resolving any particular case is not a simple process, but the FDIC and the RTC are satisfied that their current procedures are satisfactory.

Firewalls: Should we replace or supplement "activity restraints" and "firewalls" designed to shield depository institutions from risky activities of their parent or affiliates with indemnification or liability provisions running from the parent or affiliate to the depository institution?

The concept of "firewalls" has received considerable criticism lately. The FDIC, however, is not convinced that separating the activities of depository institutions from the activities of noninsured affiliates is impractical. If such a separation cannot be achieved, there would appear to be severe limits on the activities that can be undertaken by a banking organization--meaning a parent holding company, bank and nonbank subsidiaries of the holding company, and nonbank subsidiaries of the banks themselves. The maintenance of a sufficient degree of legal and financial separation between activities funded with insured deposits and other activities appears to be possible.

One problem with indemnification or liability provisions that go beyond current law is that they might prove to be irrelevant. Risky nonbank activities that result in losses to an affiliate bank are also likely to result in losses to the nonbank affiliate engaging in them. Thus the nonbank affiliate might have no assets from which to provide the indemnification.

A more significant problem with indemnification or liability provisions is the damage they do to the concept of separate corporate entities. This problem is discussed in the answer to the next group of questions.

<u>Liability for Losses: How can we provide for cross-guarantees or codify the source of strength doctrine? What would the advantages be of requiring owners of savings and loan and bank holding companies to enter into net worth agreements ensuring they will provide capital to troubled insured depository subsidiaries or</u>

affiliates if financial assistance from the government is needed?

This group of questions involves the same broad topic as did the preceding group of questions: the degree of separateness that should exist among the distinct corporate entities within a banking organization.

Cross-guarantees among commonly controlled insured depository institutions were provided for in FIRREA. The FDIC has concerns about expanding the cross-guarantee concept to require the nonbanking entities within an organization to support the organization's bank or banks.

This so-called source of strength doctrine suggests that all units within a financial holding company are effectively part of a single corporate entity. An implication is that bank regulation and supervision should extend throughout the entire holding company to include not only the bank or banks but also the holding company itself and any nonbank subsidiaries of the holding company. The FDIC has previously argued that if there is adequate regulation and supervision at the bank level, and if effective separation exists between the banks and the nonbanking entities of an organization, there is no need for regulation and supervision at the holding company level or of nonbank affiliates. (See FDIC, Mandate for Change: Restructuring the Banking Industry, 1987.)

A doctrine that puts nonbank affiliates at risk for bank failures has many implications for the nation's financial system.

If there is no effective insulation between banks and nonbank affiliates, bank holding companies would be impeded in their ability to expand into nonbanking areas because their investments in nonbanking affiliates would always be in jeopardy.

Further, nonbanking firms might be inhibited from entering the banking industry if all preexisting activities and investments were at risk. This situation would reduce market efficiency, restrain the ability of banks to be viable competitors in the financial marketplace, and limit the ability to obtain new capital for the banking industry.

These same comments would seem to apply to a variation of the source of strength doctrine, net worth agreements by owners of savings and loan and bank holding companies.

<u>Limit Investments That Can Be Made With Insured Deposits: Should insured deposits be invested in safer assets? What are the advantages and disadvantages of such an approach, sometimes referred to as a "narrow bank"? What are the different forms such a bank might take?</u>

The primary advantage of limiting what government insured deposits can be used for is that the risk to the deposit insurance fund would be limited.

A principal difficulty with reducing the types of assets that banks are currently allowed to hold is the unpredictable effect the action would have on the major beneficial function of banks: the provision of credit and liquidity to the private sector, which results ultimately in economic growth. If deposit insurance protection were limited to deposits that were only invested in the highest quality securities, the result would be less subsidized credit and liquidity being provided to the private sector.

Furthermore, if deposit insurance protection were so limited, the fact that lending for private sector activities would be from uninsured funding could also increase economic instability. A market economy, however, contains--even depends upon--a certain amount of economic instability.

Despite the disadvantages of limiting what government insured deposits can be used for, the FDIC believes that restricting what a bank can do is necessary to protect the deposit insurance system. If a banking organization wants to engage in riskier activities, it could do so in nonbanking affiliates adequately separated--both legally and financially--from the bank.

The different forms a "narrower bank" might take turn mainly on what would be the permissible investments. At one extreme would be a bank that could invest only in U.S. Government securities. As the range of permissible investments grew, the bank would become "less narrow."

Determining the activities that should be conducted in a "narrow bank" is no easy task. The FDIC is taking a hard look at the issue. One attractive possibility is to limit the bank to making short and intermediate term loans that have no attributes of equity instruments. All loans would be with recourse.

In such a system, a distinction might be drawn between larger banks and smaller banks. The difficulties that smaller institutions would encounter in setting up holding companies or separate subsidiaries, and the lesser danger they pose to the deposit insurance system, might justify fewer restrictions on their activities.

<u>Deposit Insurance in Other Countries: How is deposit insurance treated in other countries, particularly as it affects branches or subsidiaries of American banks and American depositors' accounts in foreign institutions? What efforts are underway to discuss deposit insurance reform and how to deal with particularly large institutions (sometimes considered too large to fail) with regulators from other countries? What do you think will result from these discussions?</u>

At least 29 other nations have some form of deposit insurance system. The systems vary considerable regarding membership, funding, coverage, and administration. Most, however, have a ceiling on insurance coverage, with only a few nations having higher limits than the United States.

Coverage of domestic currency deposits held by nonresidents is accorded in almost all of the systems. A number of the systems, however, do not provide for coverage of foreign currency deposits held by either residents or nonresidents.

According to a recent study (Bartholomew and Vanderhoff, "Foreign Deposit Insurance Systems: A Comparison," a paper prepared for Consumer Finance Law Quarterly Report), nine foreign nations provide coverage of deposits in domestic branches of foreign banks: Chile, France, Germany, Italy, The Netherlands, Nigeria, Norway, Trinidad & Tobago, and The United Kingdom.

Seven foreign nations do not provide such coverage: Austria, Belgium, Ireland, Japan, Paraguay, Switzerland, and Turkey. Information on coverage of deposits in domestic branches of foreign banks was unavailable for the remaining nations with deposit insurance systems.

Deposit insurance is the subject of a conference the FDIC is sponsoring tomorrow, September 26. Senior policy-making officials from central banks, finance ministries, and other government banking agencies in the G-10 countries will attend, as will representatives of the Commission of the European Communities.

Along with other supervisory concerns, deposit insurance is also discussed in meetings of the BIS-sponsored Basle Committee on Banking Supervision.

The short-term result of these ongoing communication efforts will be a fuller understanding of the deposit insurance systems in the various nations. Longer term benefits might include agreements on such matters as the insurance of deposits in domestic branches of foreign banks and the handling of large bank failures. It should be noted that regular, extensive contacts among the bank supervisors of the industrialized nations have been the norm for a number of years and have resulted in, among other things, close cooperative efforts when financial crises with international ramifications have occurred.