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STATEMENT ON

CURRENT REGULATORY AND SUPERVISORY PROPOSALS
AND THEIR IMPACT ON THE
DEPOSIT INSURANCE FUNDS

PRESENTED TO the

SUBCOMMITTEE ON COMMERCE, CONSUMER AND MONETARY AFFAIRS of the House
COMMITTEE ON GOVERNMENT OPERATIONS
U. S. HOUSE OF REPRESENTATIVES

BY

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Mr. Chairman:

I am pleased to have the opportunity to testify on behalf of the FDIC before the Commerce, Consumer, and Monetary Affairs Subcommittee of the Committee on Government Operations on various regulatory and supervisory proposals and their impact on the deposit insurance funds.

You have raised a number of questions under five broad headings: (1) proposed rules on the use of expanded powers by FDIC-insured institutions; (2) capital maintenance requirements; (3) the coordination and consistency of rules in (1) and (2) between the FDIC and the Federal Home Loan Bank Board; (4) the views of this agency with respect to restrictions imposed on savings and loan growth by the Bank Board; and (5) the financial condition of the FDIC Deposit Insurance Fund.

I will address each of these general questions, although it will simplify my presentation if I adjust the sequence of my responses. Insofar as my prepared remarks do not adequately respond to some of your more specific questions, I will try to respond in more detail today or in a subsequent written submission.

Proposed Rulemaking on Various Bank Activities

On August 30, 1983 the Board of Directors of the FDIC adopted an Advance Notice of Proposed Rulemaking soliciting comment on the need for rulemaking to govern the direct or indirect involvement of insured banks in real estate brokerage and underwriting, insurance brokerage and underwriting, data processing for third parties, travel agency activities, and other financially related services.

In December 1984, the FDIC proposed rules requiring that certain activities that are otherwise permitted for banks be carried out only in bona fide subsidiaries. Certain conditions were proposed with respect to personnel and other links between a bank and these subsidiaries. Moreover, it was proposed that a bank's investment in these subsidiaries be subtracted from the bank's capital for purposes of determining whether a bank's capital meets regulatory requirements.

The activities that would be most affected if the proposed rules were put in place are insurance underwriting and real estate development. At the present time, most commercial banks do not undertake these activities because of federal and state restrictions. However, some states (including California and New York) recently enacted legislation that permits state banks to make direct real estate investments. Other states are considering permissive legislation related to real estate and insurance underwriting. The FDIC is concerned that direct investment in these areas, particularly real estate development, may expose banks to abnormal risk thereby adversely exposing the Deposit Insurance Fund. Additionally, existing accounting and regulatory requirements with respect to insurance activities argue for placing insurance underwriting outside the bank. The FDIC's proposed rules also dealt with other areas of activity that banks have been entering or may enter in the future. In these areas the FDIC's preliminary conclusion was that risk considerations did not warrant establishing separate subsidiaries.

The FDIC has received a substantial volume of comments on these proposals. Commercial and savings banks have argued that the FDIC proposals are overly restrictive, whereas nonbank businesses that might be affected by bank competition argued that our proposed regulation was too permissive. Some pointed out that many savings banks have had good performance and favorable loss experience in their real estate investments undertaken through state leeway provisions. Comments have also pointed out that savings bank life insurance has been a successful, low risk activity that should not be prohibited by FDIC rules. If our rules were implemented without change from those proposed in December, savings banks would probably be most affected by our restrictions due to existing leeway investment powers for savings banks in many states.

We are still in the process of evaluating comments on our proposal and examining data on savings bank and savings and loan experience in real estate investments. Our concern is that such investment not overly expose FDIC-insured institutions to loss. At the same time, however, we want to avoid unduly limiting activities that may sometimes be the logical extension of bank real estate lending. While we have not completed our review and analysis, one possible approach might be, for example, to permit some modest amount of direct real estate investment to be made at the bank level.

We support the concept of the Bank Board's restricting investments in service corporations and other direct investments. However, these restrictions still permit equity investments which are likely to be several times book capital and that suggests more than acceptable risk for many institutions.

Capital Maintenance Requirements

Two weeks ago the FDIC Board of Directors approved new capital requirements for FDIC-insured, state-chartered savings banks and nonmember commercial banks. Because of some adjustments on technical matters, the public release of these requirements has been delayed; that release should be forthcoming soon. There are some revisions from the proposal put forth in July, although the basic requirements -- primary capital of 5.5 percent of assets and total capital of six percent -- have not been changed.

We do not anticipate a substantial, immediate impact on the banking system. The direction of our thinking and that of the other federal banking agencies has been apparent for some time. As a result, many banks have taken steps to bolster their capital position during the past year. Few larger commercial banks would not be able to meet the requirements today. For the most part, primary capital ratios of larger banks have increased appreciably during the past several years. Smaller banks on average have had higher capital ratios and most of those that don't currently meet requirements are known problem situations.

Over time, we would expect capital ratios, in the aggregate, to rise as institutions operating at or near minimum levels increase their capital ratios to provide more flexibility to capitalize expansion or to meet adverse circumstances. This should reduce the overall level of risk in the system. While some institutions will find their growth constrained -- those are the ones whose growth should be constrained -- we would not anticipate that the capital requirements will materially affect overall bank growth or have any adverse macro economic impact.

The bank supervisory process will have to assure that loan chargeoff policies are sufficiently uniform so that capital is appropriately stated. There will continue to be a need for monitoring increased risk through off-balance sheet exposure or other means that may overly encumber a bank's capital. However, the hand of supervisors will be strengthened by capital requirements. Some area of debate will be removed; uniform minimum requirements will make for a fairer system and banks will more likely take capital enhancement action on their own.

The FDIC's capital requirement is considerably higher than the net worth percentages that are required for FSLIC-insured institutions. There are other considerations related to accounting standards, asset values and other factors that widen the difference in requirements. Over the long run we think that competitive and safety considerations dictate common capital standards and that this parity should be achieved by raising the standards for FSLIC-insured institutions rather than lowering those for banks. We recognize that the thrift industry has faced problems for several years and that it would not be feasible to enforce dramatically higher capital requirements all at once. However, it is important that we start moving in the right direction. This relates to your question on restrictions on growth. However, before addressing that issue, I would like to offer some comments on a related subject: how the FDIC's capital policy will treat mutual savings banks.

Primarily because of an asset-liability mismatch and increased deposit costs, many savings banks, like S&Ls, have experienced several years of operating losses and a deterioration in their surplus position. Many of these institutions do not meet FDIC capital requirements and will not be able to do so in the near future unless interest rates decline significantly. We have provided a several-year phase-in of our requirements for those institutions whose surplus is three percent or more. Many of those below that level are participating in the net worth certificate program and have submitted capital plans under that program. If they are not participating in the program they will have to enter into a written agreement with the FDIC to raise capital. If they fail to enter into an agreement or to comply with it, they would be subject to enforcement action. We recognize that it is neither desirable for the economy nor the Deposit Insurance Fund to force these institutions to close. They have no stockholders who are being "bailed out" and, in most instances, their continued operation does not increase the FDIC's exposure. To assure this, restraints are placed on excessive risk taking related to asset quality and maturity mismatch and limits are placed on overly aggressive policies in bidding for deposits and taking on too much growth.

<u>Tying net worth requirements of FSLIC-insured institutions to growth</u>.
We believe that the Bank Board's policy in tying net worth requirements to growth is an important step toward improving the capital position of S&Ls.

We do not necessarily endorse the specific numbers since, as I have suggested, we think S&L capital requirements should be much higher than present levels. Rapid liability growth, without comparable capital growth, makes it more difficult for S&Ls to eventually achieve satisfactory capital ratios. It also increases the exposure of the FSLIC. Policies geared to achieve rapid growth frequently put pressure on interest margins and asset quality so that the performance of depository institutions in the aggregate is apt to suffer.

This may seem like advocating restraints on free competition, but I don't think that is the primary issue here. When institutions are undercapitalized and, in some instances, insolvent, I don't think we can equate their pricing policies to free market behavior. Their ability to attract deposits rests almost solely upon FSLIC insurance. Any perceived positive spread on deposits may improve the net worth of the institution -- but that's not a market pricing situation. Adequately capitalized institutions will price deposits and other services to earn a spread at least equivalent to capital costs. It is not appropriate, fair or market-justified for institutions whose existence depends solely on the deposit insurer and its forebearance to undercut institutions subject to market forces and, in the process, increase the risk of the FSLIC.

Some have argued that Bank Board policies will prevent S&Ls from servicing existing customers. However, it should be noted that a considerable portion of S&L growth has come from jumbo CDs and borrowings. Curtailing increases in these funding sources or substituting retail deposits for them would provide considerable room for most S&Ls to accommodate local deposit growth.

Consistency and Coordination

As I already indicated, we believe that capital requirements should be the same for banks and thrifts -- whether FDIC- or FSLIC-insured. There are financial realities that prevent attaining or imposing that goal in the near future; however, we believe that should be the goal and that some realistic time table should be set to achieve it. This view has been expressed by officials of this agency in various official and unofficial interagency meetings, including the Bush Task Force group and the staff discussions on deposit insurance chaired by Mr. Healey. To my knowledge, there was no specific, official discussion between the Bank Board and the FDIC on their revised capital requirements or ours. We have closely followed their capital proposal and, very likely, they have followed ours. In addition, I believe that Chairman Gray and Chairman Isaac have addressed these issues in informal discussions.

In addition to like capital requirements we believe that insured depository institutions should be subject to common accounting standards, similar reporting and disclosure requirements and similar examination standards. As long as depository institutions compete for the same potential deposit customers and can substitute deposit insurance for financial strength, equity and the interest of the insurance funds argue for common standards with respect to safety and soundness.

The powers issue is somewhat more complicated. There remain important differences in powers between banks and thrifts in several areas. Many of these differences can only be eliminated by Congress. Some, like access to a long-term funding source (Home Loan Banks), are not easily addressed. While the FDIC has sought to establish rules to limit risk and protect the insurance fund, it does not have authority to bestow on banks powers that are not otherwise present. Whether the present system favors banks or savings and loans is debatable. We would favor action by Congress to provide greater uniformity in powers as long as issues are addressed comprehensively to encompass capital and supervisory standards at the same time.

With respect to the specific question on consultation regarding our proposed regulation concerning expanded powers, it should be noted that, in our current review of available data and experience on real estate development, we have sought assistance from Bank Board staff and are using studies that the Bank Board staff has undertaken or commissioned. We appreciate that savings and loan experience in real estate investment can be useful in assessing the potential risk of expanded bank activity in this area.

FDIC Financial Condition

Despite 79 failures of FDIC-insured banks in 1984, the FDIC's Deposit Insurance Fund (defined as its net worth) rose by more than $1.6 billion, by 10.5 percent and stood at over $17 billion at the end of 1984. Because the percentage increase in the Deposit Insurance Fund exceeded that of insured and total deposits in 1984, the ratio of the Insurance Fund to those deposit totals increased last year, and at year-end the Deposit Insurance Fund was about 1.20 percent of FDIC-insured deposits.

Insurance expenses in 1984 were about $1,050 million and, when added to the FDIC's operating expenses ($150 million), the total absorbed most of 1984 assessment income ($1,350 million). As a result, the assessment rebate which will be credited against 1985 assessments will be modest (about $90 million), making the net assessment rate for 1984 about 1/13th of one percent of the assessment base. By law, insurance expenses and FDIC operating expenses are subtracted from gross assessment income and 60 percent of the remainder is rebated to insured banks.

Insurance expenses primarily reflect reserves for current year losses (reflecting FDIC cash outlays and the estimated value of receivership assets or other assets assumed by the FDIC) and adjustments to loss estimates from earlier years. In addition, 1984 insurance expense includes approximately $180 million in reserves for net worth certificates given to four mutual savings banks which would have otherwise been book insolvent. Total outstanding net worth certificates at the end of 1984 were $580 million, including the $180 million reserved for in 1984. No loss estimate thus far has been made in connection with the Continental assistance package. It is too early to assess possible losses on the assets that have been or will be purchased from the bank.

The bulk of FDIC assets were in U.S. Government securities ($14.4 billion), as of year-end 1984. At year-end the market value of these securities was slightly above their book value. Other assets are principally notes owed to the FDIC from advances to acquiring institutions to facilitate P&A transactions or assisted mergers. Other liabilities are principally notes to the Federal Reserve and Federal Home Loan Banks that were assumed in failing bank situations. In previous years, when the FDIC assisted savings bank mergers and committed to future income maintenance payments, the FDIC reserved for these expected future payments. The expected value of these remaining future payments is reflected in the FDIC's balance sheet and net worth. We believe that our balance sheet reflects a reasonable statement of our financial position.

Over the past four years, the FDIC has handled a post-World War II record number of bank failures and has absorbed losses far in excess of those experienced during the previous 46 years of operations. Despite this, the Deposit Insurance Fund grew by almost 55 percent from the beginning of 1981 to year-end 1984. This has been accomplished because of a large and growing investment portfolio, an assessment system that effectively passes a portion of insurance losses and operating expenses to insured banks and sufficient flexibility to handle failing and failed bank situations so as to minimize losses. We feel that the Deposit Insurance Fund and current assessment income are adequate to handle any likely number of bank failures and losses.