STATEMENT ON

THE NEED FOR CHANGES IN THE EXISTING SYSTEM OF FEDERAL DEPOSIT INSURANCE
AND
DEPOSITORY INSTITUTION REGULATION AND SUPERVISION

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

BY

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Deposit Insurance Reform

Federal deposit insurance has worked well in protecting depositors from loss, discouraging runs by smaller depositors and lessening the impact of bank failures on other banks and the business community. By contributing to depositor confidence and stability, insurance has reduced the number of bank failures and private sector losses associated with failures.

There has always been concern that deposit insurance would provide so much comfort to depositors and other creditors that they would cease to be concerned about the condition of their bank, thereby sheltering banks from private sector discipline. That concern was expressed by opponents of deposit insurance in 1933. Throughout much of the FDIC's history, when few banks failed, this concern was largely academic. As failures have increased and more banks, including large banks, face difficulties there has been more and more discussion inside and outside the FDIC about the role played by deposit insurance in encouraging risk-taking by banks and insulating them from market discipline.

Handling of Bank Failures by the FDIC

The manner in which failed banks have been handled by the FDIC has varied over time. For the most part, failures have been handled through payoffs to insured depositors and purchase and assumption transactions (P&As). In a payoff, a bank is closed and a receiver, generally the FDIC, is appointed. Insured depositors are paid by the FDIC. Those with deposits in excess of the insurance limit have a claim on the receivership for the balance of their claims along with other general creditors, including the FDIC, which takes the creditor position of insured depositors.

Assets of the failed bank are liquidated over time and, eventually, funds are distributed to general creditors. If general creditors are fully paid, there is a distribution to subordinated creditors and stockholders. In most cases, general creditors do not receive full principal, let alone foregone interest. Thus, subordinated creditors and stockholders usually get nothing and uninsured depositors and other general creditors incur some loss.

In a P&A, the failing bank is closed and all deposits and other general creditor claims are assumed by another bank. Typically the FDIC will remove classified and certain other loans from the failed bank's portfolio, mark the securities portfolio to market and provide cash to make up any shortfall between assumed assets and liabilities. Eligible banks or banking organizations are asked to submit closed bids on this package. The high bidder receives assets (of good quality), less the amount of its bid, equal to assumed liabilities.

It is important to note that all depositors, insured and uninsured, and other nonsubordinated creditors are made completely whole in a P&A transaction. The FDIC collects on the assets it acquires. However, subordinated creditors and stockholders do not receive any of these collections until the FDIC gets back all the funds it has advanced to make general creditors whole.

During the past 20 years, about three out of every four commercial bank failures, and most of the larger ones, have been handled through P&A transactions. Nearly all payoffs have involved situations where there were no interested bidders or where there was fraud and uncertainty about unbooked liabilities or other contingencies that made it difficult to place reasonable limits on the cost of a P&A. An uninsured depositor has stood the greatest chance to lose money in a failure where the bank was small and where fraud was present, even though he probably had no way to assess the likelihood of fraud. Prior to the Penn Square failure the largest payoff was in Sharpstown, Texas (about $60 million) where there were large potential claims related to lawsuits over securities violations. Between 1960 and July 1982 (when Penn Square failed) the banks paid off by the FDIC had average deposits of less than $8 million.

In connection with failing mutual savings banks, the FDIC entered into transactions very similar to P&As without actually closing failing institutions. Because these institutions did not have stockholders, the transactions were not complicated by a need to eliminate or subordinate any claims they might have. While assisted mergers have differed from P&As in several technical aspects, they have been effected under the same statutory authority as P&As, and in most respects the end result is similar. Deposits and liabilities of other general creditors are assumed by the acquiring or surviving institution. In a limited number of cases the FDIC has provided direct assistance to operating banks under different statutory authority. General creditors, of course, incurred no losses in these transactions, the most notable of which have involved three large banks: Bank of the Commonwealth in Detroit, First Pennsylvania and Continental Illinois.

Among those who have followed FDIC behavior in recent years there has been a general perception that the FDIC would not pay off a large bank -- at least not one with assets of several billion dollars -- and many probably thought not one the size of Penn Square, which had assets of $500 million.

The Impact of Insurance Coverage on Bank Risk

In most firms, creditors play an important role in restraining leverage and overall risk. If it is true that the FDIC can't or won't pay off a very large bank, then depositors and other general creditors at such a bank are not exposed to any risk. Stockholders and subordinated creditors are, but they are not the principal source of bank funding. This is not a phenomenon that has recently come about. It is true that the level of insurance coverage is very high today -- more than 90 percent of the deposits of banks with deposits of less than $100 million are fully insured and roughly another five percent are secured -- but most larger banks have had *de facto* 100 percent insurance coverage for some time.

Economists and others have recognized a lack of equilibrium for some time, but as long as there were few bank failures and most of them were small, this was largely an academic issue. In recent years the economic environment has exposed the banking system to increased risk. At the same time, competition among banks and between banks and other institutions has increased, and this too has made the environment less forgiving of bank management performance. Bank problems and failures have increased dramatically and, as a result, there is an increased concern that the present insurance system does not serve to restrain bank risk.

A lot has been said recently about modifying the deposit insurance system to restrain risk taking by banks. Until recently, two options generally were suggested: (1) restrain risk by pricing deposit insurance premiums according to risk; or (2) increase market discipline by reducing *de facto* deposit insurance coverage. Within the last year increasing support has developed within the FDIC for a third approach: raising capital requirements and allowing subordinated debt to satisfy a significant portion of such requirements.

Variable Rate Insurance Premiums

Legislation has been introduced to give the FDIC authority to vary deposit insurance premiums within a fairly narrow range. As proposed, the FDIC would vary the assessment credit or rebate according to its assessment of bank risk. The maximum variation in net premiums from bank to bank would be about five basis points* (as a percentage of deposits); not a trivial

*The FDIC assesses insured banks 1/12th of one percent of domestic office deposits, subject to some minor adjustments. Operating expenses and insurance loss are subtracted from premium income, and 60 percent of the remainder is rebated to banks in the form of a credit on next year's assessment. When insurance losses were low, premiums, net of rebates, averaged between three and four basis points. However, during the past several years when insurance losses were much greater, rebates have been modest and net assessments have been in the seven-to-eight basis point range.

amount, but not enough by itself to impair a bank's solvency. If such a plan were implemented and worked well, authority to vary premiums to a greater extent might be sought at a later date. The current FDIC legislative proposal also includes a provision that would allow the FDIC to charge problem banks for the extra examinations required by those banks.

For some time many have considered the concept of variable rate premiums to be sound, but questioned whether a satisfactory system could be developed and implemented. One problem is that asset quality is a key to classifying problems and predicting failures. In the past we had to depend on examination reports to obtain such data for most banks. During the past few years banks have been reporting delinquent and nonperforming loans and these data substantially improve our ability to predict problems and failures from publicly reported data. The other problem which will not be readily overcome is that predictive systems still rely on after-the-fact events. Quality deterioration has taken place, whether through loan deterioration, operating losses or other events. Attempts to measure risk exposure based on loan concentrations, asset maturities and other characteristics that might precede poor performance have been less successful. At this juncture, the FDIC position is to move forward on a modest scale on variable rate premiums utilizing a system that relies on such variables as net income, capital and various measures of loan performance. Those banks that would not receive assessment credits would be those having problem bank or near-problem bank characteristics. Those banks facing current difficulty, most likely to fail and requiring greatest supervision would be penalized.

The system currently developed at the FDIC contains imperfections which we recognize. Nevertheless, we consider it to be far more rational and fair than the present system which makes no distinction with respect to risk.

Reducing Insurance Coverage

While some have advocated reducing the present $100,000 coverage, it is doubtful that the general public would support reduced coverage and I doubt that it would serve a useful purpose. The FDIC could try to handle most failures through payoffs, and last spring the FDIC tested a procedure designed to do just that -- the "modified payoff" transaction. Failing banks were closed and insured depositors were paid. However, the form of payment was the transfer of their accounts to another institution which also acquired the premises and certain other assets of the failed bank. Most checks in process were paid as is done in a P&A and most depositors probably were unaware of the difference. However, the liabilities of uninsured depositors and other general creditors were not assumed by the acquiring bank. The FDIC made a conservative estimate of the present value of future receivership collections and provided funds so that a cash advance (generally in the 50 to 60 percent range) could be made almost immediately to uninsured general creditors.

The modified payoff preserved many of the advantages of the P&A transaction. It was less disruptive than a straight payoff, while still retaining some discipline from uninsured depositors and other bank creditors. As indicated, there was little interruption in the payments process. Some of the value of the failed bank's deposits and facilities was preserved and these were sold through a bid process as in a P&A. The cash advance to uninsured creditors removed some of the "sting" of a payoff, although uninsured depositors were still exposed to some loss. The FDIC's experience demonstrated that this type of transaction, while people-intensive, could still be effected over a weekend -- even with a moderate-sized bank.

The modified payoff got mixed reviews among bankers and others, including FDIC staff. From the outset, we all knew that it could not be used for a really large bank, at least not any time in the near future.

As long as sophisticated observers of the FDIC doubted that a really large bank could or would be paid off, large banks would be placed in an advantageous position in competing for deposits. That advantage would be strengthened as more smaller banks were paid off and more depositors lost money in smaller banks. Indeed, the juxtaposition of modified payoffs for small and moderate-sized banks and the handling of Continental focused considerable attention on the fairness issue.

Some have questioned whether depositor discipline can really have a salutary effect on bank behavior. Depositors are not like security holders. In contrast to the latter, depositors can pick a bank whose condition deteriorates and still have enough warning to get out with no loss. When the bad news is out, security holders may stay with the investment if they anticipate survival or improvement. Depositors, on the other hand, don't have any incentive to stay. Thus, depositor discipline mostly comes after the fact. It is apt to hasten the closing of a troubled bank which is generally good if the bank would fail anyway. However, depositor flights may prevent a weak, solvent institution from turning itself around.

Another limitation of the modified payoff is that it provides little discipline for the many institutions whose depositors are virtually fully insured. This problem is exacerbated by the use of brokered deposits which expands the level of insurance coverage.

Recently the modified payoff has received support from some banking groups. They preferred it or viewed it as less expensive than increased capital requirements. I don't want to question the sincerity of large bank support for this proposal. However, a few points should be noted: Use of the modified payoff strengthens the competitive edge of large banks in competing for deposits unless a large bank is actually paid off. It also weakens somewhat the argument for extending the insurance assessment base to foreign office deposits which are concentrated in the largest banks. Consequently, the support of this approach by large banks is not surprising.

Capital Policy

An alternative method of achieving market discipline and reducing FDIC risk is to raise substantially the capital requirement for FDIC-insured banks.**

**A more detailed discussion of the capital proposal, along with responses to the most frequently raised questions about the proposal, is appended to my statement.

An increased capital requirement would provide a larger protective cushion to the FDIC and limit the extent that the insurance fund could be used to leverage a small capital base. There is a downside to high capital requirements: they make it hard to earn a satisfactory return on investment unless banks can operate with larger spreads, that is, raise the price of bank services. That involves a cost to the public if, indeed, competition with nonbanks permits an increase in margins. And, of course, any capital number, whether 5, 7.5 or 10 or whatever, is arbitrary.

A way of substantially mitigating the cost and arbitrariness of high capital requirements is to allow subordinated debt in the bank to meet a significant part of the capital requirement. That way, a well-run bank, perceived to be a good risk by institutional or public investors, will be able to borrow (at the bank or holding company level) to maintain its overall leverage while increasing its capital cushion. The financially strong banking institution will be able to do this while incurring practically no increased capital cost because the funds can be employed to yield a return comparable to the cost of borrowing.

A bank considered to be weaker by financial markets will have to pay more for debt or it may have to rely more on equity. This distinction in market assessment can provide useful market discipline. Note that we would be relying more on professionals with a longer-run investment stake than depositors typically have. In a sense, it would be financial markets that would determine the acceptable equity ratio for a banking institution.

It would be essential that bank regulators be uniform in applying capital standards. There would also have to be appropriate enforcement. If banks fail to meet standards, restrictions would be imposed on branches, acquisitions, etc. If satisfactory progress through increased capital or asset shrinkage doesn't occur, supervisory pressure would be increased and, eventually, the institution might be closed even though it is still book solvent. That probably wouldn't occur very often because most troubled banks would find it more advantageous to recapitalize on terms that substantially dilute existing stockholders or to merge on not-so-favorable terms. One of the problems with the present system is that troubled institutions try to hang on too long (they often are permitted to do so). They are reluctant to merge on someone else's terms and by the time they are willing to seek help, most of their franchise value has gone. The changes would result in fewer bank failures, more open bank mergers and more private sector solutions to banking problems. Capital isn't meaningful unless a uniform satisfactory chargeoff policy is in place. It might also be necessary to factor in off-balance sheet liabilities, though investors in subordinated debt would almost certainly factor off-balance sheet risk into their calculations before pricing and purchasing the debt.

Some argue that small banks will be disadvantaged by this proposal because they won't have ready access to debt markets. First of all, small banks generally start with higher capital so that their need to raise additional capital will be less (the 12,000 banks $100 million or smaller in size currently have an average primary capital ratio of 9.1 percent). Well performing small banks have had access to subordinated debt in the past through correspondent banks, insurance companies and other private placements. Finally, it is necessary to consider the impact of this proposal, taken as a whole, for small banks. It is apt to reduce their net insurance assessment, improve their ability to attract deposits vis-a-vis large banks and represent an overall improvement in the relative treatment of small banks compared with the present system.

Mr. Chairman, in your letter requesting my appearance before this Subcommittee you ask me specifically to comment on the merits and demerits of 12 "widely discussed deposit insurance reforms." I have already discussed my views on the modified payoff, subordinated debt capital and risk-related deposit insurance premiums. The balance of my testimony will be devoted to brief comments on the other nine "reforms" listed in your letter.

Risk-Related Capital Requirements

Risk-related capital requirements have received considerable attention lately, although such requirements appear to mean different things for different people. To some, they appear to mean requiring different capital percentages for different types of loans and investments. That presupposes that loans can be easily categorized by borrower or purpose and that appropriate risk levels can be ascribed to them. This, I believe, is a bad approach. Ascribing levels of risk to various types of loans is not likely to be sucessful. It does not take into account the degree of competence management of the bank may have to deal with the particular activity. Moreover, it is apt to be influenced by most recent experience. Thus, about five years ago some might have said that agricultural loans or energy loans are risk-free. This type of approach also tends to allocate resources and opens the door to using capital requirements for social policy.

Others, in looking at risk-based capital, focus more on after-the-fact risk as reflected in nonperforming loans and other qualitative variables. The federal banking agencies already factor this into capital policy so that banks with high levels of nonperforming or classified loans may be required to maintain higher book capital ratios. Possibly this could be done more precisely or formally so that one could translate levels of past due, non-accruing and otherwise nonperforming loans into some precise reduction in book capital levels. In that way it may be possible to develop a more uniform standard for capital. Thus, capital requirements of six or nine percent might somehow be translated into adjusted or "real" requirements of, say, five or seven percent. I have no quarrel with attempting to move in this direction, although I believe it will be difficult to develop uniform standards. It should be noted, however, that the FDIC's capital proposal, which allows subordinated debt to count for a large portion of the required level of capital, contains some of the same approach as the risk-related capital requirement I have just discussed. Under the FDIC "subordinated debt capital" proposal, financial markets would take account of all available data related to bank risk, including loan quality and off-balance sheet risk, in pricing subordinated debt and equity capital. Thus, it is the market place that determines the risk adjustment in that proposal.

Insurance Fund Recapitalization

While the FDIC experienced insurance losses of approximately $1 billion in each of the four years, 1981 through 1984, the deposit insurance fund (defined as the FDIC's net worth) increased from $11 billion to $18 billion, by more than 60 percent during the same period, and has more than kept pace with the growth of insured deposits. I believe the present level of insurance assessments is adequate to meet the risk faced by the FDIC, and I see no reason why there should be any adjustment to this approach or recapitalization of the FDIC at this time. Implementation of risk-based insurance premiums, which I favor, would allocate net assessments among banks differently, although in the FDIC proposal it would not affect the overall level of assessment income.

In contrast to the FDIC, the FSLIC appears to face significant financial problems. The FSLIC fund declined last year. This year, several large S&L failures will involve substantial costs and the fund may experience a further decline. Publicly reported levels of the FSLIC fund do not appear to take into account outstanding assistance commitments. Recently, the FSLIC has encountered many serious problems and some failures where asset quality and fraud have been dominant factors. These have proven to be very expensive and to require skills not currently present within the FSLIC. Potential failures and loss exposure could easily threaten the solvency of the fund. Very likely some form of recapitalization of the FSLIC fund or the combining of the FDIC and FSLIC will be necessary.

Insurance Fund Merger

I would favor merging the FSLIC and FDIC. It would reduce the likelihood of requiring taxpayer funds to recapitalize the FSLIC. There are other advantages to combining the two funds. It would facilitate implementing uniform capital, accounting and reporting requirements for all insured depository institutions. If deposit insurance is to have the same general characteristics, then I believe such uniformity is essential for reasons related to resource allocation, fairness and the preservation of insurance fund resources. I recognize that such standards for thrifts would have to be phased in over a relatively long period of time.

I believe there are advantages with respect to organization, efficiency and personnel in handling failures and liquidating assets that would develop from a combined fund. In addition, there would be more flexibility in handling failures and in developing standards with respect to levels of assistance to acquiring institutions, interstate acquisitions, permissible activities of acquirers, etc.

100 Percent Deposit Insurance Coverage

I would not favor explicit 100 percent deposit insurance coverage. However, if the FDIC's capital proposal were implemented along with risk-related deposit insurance premiums, I believe there would be fewer bank closings. Most banks that would be forced to go out of business would do so through private sector mergers without outlays from the deposit insurance fund. Most failures would probably be handled through purchase and assumption transactions by the FDIC and there would be less concern about depositor discipline since market place discipline would come from elsewhere. As a result, there would, in fact, be a very high level of de facto insurance coverage for banks of all sizes.

Reduced Deposit Insurance Coverage

If one believed that the modified payoff was the appropriate modification of the deposit insurance system, then some consideration would have to be given to reduced deposit insurance coverage since such a high percentage of deposits at banks and thrifts currently are fully insured. Depositor discipline would not mean much for those institutions having very small amounts of uninsured deposits. My own view is that reducing the level of de jure or de facto insurance coverage would involve a very difficult transition. There would be considerable risk of instability among financial institutions. If we could ever get there, it is not obvious the system would be improved.

I believe that many who advocate reducing insurance coverage have not looked that closely at some of the practical issues associated with paying off depositors in institutions with a million deposit accounts, the likely flight of depositors in response to unfavorable news about banks, the extent to which some bank creditors may be penalized by secured Federal Reserve advances or other closing delays, and other problems associated with paying off a large bank.

Greatly Intensified Supervision

During the past several years the number of bank examiners employed by the federal agencies and the states has not kept pace with the growth in banks and thrifts. The stretching of examination resources has been exacerbated by the high level of nonperforming loans, problem institutions and failures. I believe there is a need to expand supervisory resources substantially, which the FDIC is doing (its authorized examination force will grow by about 40 percent this year). I also believe that more complicated financial transactions and increased sophistication within financial institutions requires some overall improvement in the training and quality of supervisory personnel. In view of some of the differences in pay between the public and private sectors, I am amazed by the general quality of personnel that I have seen among the federal agencies. It is my impression that pay differentials have probably been widening, and I believe that effective supervision requires much more competitive levels of compensation than presently exist. While I believe that improved supervision is very important, I also believe that it is necessary to rely more on appropriate incentives among banks and their creditors and to increase market place discipline. I have already suggested how I believe this could best be done.

Market Value Accounting

While there is substantial logic in favor of using market value accounting, implementing such a system for 20,000 commercial banks and thrifts would be extremely difficult. If bank balance sheets appropriately reflected the value of loans and investments and various intangibles, balance sheet net worth would be an accurate reflection of the worth of an institution. Capital standards could be applied in a uniform fashion and the market place could readily gauge the net worth of an institution, the extent to which it was over- or under-capitalized, etc. Getting there, however, would be very difficult. There are many assets on the books of banks and thrifts whose value could (and perhaps should) be adjusted to reflect interest rate changes. These adjustments are simplest for investments and, indeed, most large banks publish information on market value appreciation or depreciation of investment securities. Market value adjustments for performing, quality fixed rate loans may not be too difficult, either. The degree of difficulty increases immensely when we adjust assets for quality. Generally, there is not much of a market for very risky performing and nonperforming loans, and placing values on these assets would be extremely difficult. The problem is somewhat similar to making appropriate adjustments in capital accounts in order to implement risk-related capital.

Some bank franchises reflect considerable non-balance sheet value because of a strong customer base, comparatively low cost liabilities, operating efficiencies, location, competitive, and other factors. These are extremely difficult to measure. In principle, one might argue that these intangibles are reflected along with asset quality and interest rate associated depreciation in the market value of an institution's stock. However, as Professor Kane and others will tell you, the market value of the stock of an institution with deposit insurance also reflects some value of that insurance. Thus, stock values are an imperfect gauge. Moreover, the vast majority of bank stock does not actively trade in the market and as for thrifts, many are not stock institutions. A gradual movement toward market value accounting would probably be in the public interest; however, it must be appreciated that even partial market value accounting adjustments might suggest that a very large percentage of the thrift industry is insolvent.

Private Deposit Insurance

I do not think there is likely to be an important role for private deposit insurance in our system. Unless we were to move toward more payoffs, or modified payoffs, there probably would not be a very strong market for private insurance. Assuming we would go the modified payoff direction (a direction which I do not favor), then I could foresee some limited role for private insurance. I do not think the insurance industry is in a position to take the kind of risks that would fully cover the non-insured gap for larger institutions. I could foresee a market for private insurance of deposits in moderate-sized institutions, where depositors or banks might pay a premium for additional insurance coverage. There is probably sufficient information in the public domain for a private insurer to vary premiums according to some selected financial ratios (much like risk-based premiums that the FDIC might charge). Whether all this would be of particular importance to the functioning of the banking system is something I am uncertain about. If, in fact, deposit insurance coverage relies principally on purchase and assumption transactions, I do not see a strong market for private insurance emerging. I doubt that depositors or institutions would be willing to pay a sufficient premium to make the provision of that insurance worthwhile to private insurers.

Brokered Deposit Restrictions

Brokered deposits currently expand deposit insurance coverage and facilitate the marketing of deposit insurance for private institutions. Those who favor the modified payoff or some significant reduction in insurance coverage have to come to grips with the brokered deposit problem. To the extent that deposits are exposed to considerable risk, the volume of brokered deposits is apt to expand significantly, and the problem created by brokered deposits will expand. Some form of restrictions will absolutely be necessary.

If we moved to higher, enforceable capital standards, and these standards, indeed, are enforced, then the problems presented by brokered deposits would be diminished. Institutions would have to earn sufficient margins on the funds to support the increased capitalization and many of the problems we have experienced with respect to brokered deposits probably would be diminished.

In today's market, many of the institutions aggressively marketing brokered deposits are substantially undercapitalized (some are probably insolvent). They are relying solely on deposit insurance as a means of raising funds. We hear much discussion about brokers facilitating the free market movement of funds; however, when institutions are insolvent or don't have to meet capital costs, there is not much logic in discussing the role of the free market. Clearly, such institutions could not and would not survive in a free market environment without deposit insurance.

Mr. Chairman, while my written testimony may seem lengthy, my discussion of each of the specific deposit insurance proposals is brief. I will be pleased to develop my views in more detail on any of these proposals should you have any questions.

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BANK CAPITAL REQUIREMENTS AND THE DEPOSIT INSURANCE SYSTEM

For some time there has been concern that the deposit insurance system insulates most bank creditors from risk and, as a result, there is insufficient market restraint or discipline imposed on banks. The FDIC's Deposit Insurance Study suggested that market discipline could be attained by significantly increasing bank capital requirements while permitting subordinated debt to satisfy a portion of the requirement. This suggested approach has gained increased acceptance within the FDIC and it has received increased attention, and some support, outside the FDIC. The purpose of the comments that follow is to spell out how the approach would work, suggest responses to the most frequently raised questions about the appproach, and indicate some unresolved issues that would have to be addressed if the approach were to be implemented.

The Proposal

Bank capital requirement would be raised substantially over a period of several years to a level of, say, nine percent of assets. At the same time regulatory capital policy would be revised so that subordinated debt could meet a substantial portion of the capital requirement (one-third). The additional capital would provide an enhanced capital cushion for the deposit insurance fund and, as will be suggested, would probably result in fewer bank failures.

Those banks perceived to be in a strong financial condition probably would be able to borrow on a subordinated basis to meet the additional capital requirement without significantly impairing earnings. Some would be able to lend out acquired funds on a sound basis at returns comparable to their borrowing cost. Even if costs exceed rates earned on acquired funds by one or two percentage points, the banks' overall reduction in net interest earnings would only be 3--6 basis points (.01 or .02 x 3 percent of assets). Those banks perceived to be riskier would have more difficulty borrowing. Their cost would be high or else they would have to meet the higher capital requirement partly or wholly through a higher equity ratio: by contracting, by reducing dividend payments or by the sale of equity. Whether subordinated debt is used would be a marketplace decision, so that it would be the market that ultimately sets a bank's equity ratio and determines the cost of the increased capital requirement.

Market Discipline

Investors in subordinated debt are likely to be in a better position to assess risk and exercise market discipline than bank depositors. Most will be institutional investors or other banks able to devote resources to evaluating a bank's condition and the riskiness of their investment. Their time horizons will be longer than most depositors. When a bank encounters difficulty, uninsured depositors generally have ample notice so that they can get out without loss and, incidentally, exacerbate the bank's problem. They generally have no incentive to stay with the troubled bank, even if they believe the bank will survive. They won't be sufficiently compensated for the risk and if they are managing a company's or other people's funds, prudence and job security dictate that they pull the funds out.

Investors in subordinated debt will be exposed to potential market loss if the condition of the bank deteriorates, even if it never fails. Thus, they have more reason to appraise management policies. Once a bank gets into difficulty, efforts by debtholders to get out (by selling in the market) won't cause a liquidity problem for the bank except to the extent that market conditions impair future bank financing. Debtholders or potential lenders that have confidence in the ability of the troubled bank to improve its situation can hold or purchase bank debt and gain in the marketplace if their assessment of the bank is correct.

There is another argument why "capital discipline" may be superior to depositor discipline. At the present time 80 percent of domestic deposits is insured. A much higher percentage of deposits in all but the largest banks and most savings banks are insured. Many institutions expose the FDIC to considerable loss even though their deposits are almost fully insured. Depositor discipline can have little impact on those institutions unless insurance coverage were reduced, an extremely unlikely development.

Phasing In An Increased Capital Requirement

Banks would be given several years to phase into the higher capital requirement. That way, they would have some flexibility in timing their financing and financial markets would not be overwhelmed by bank financing. However, it is contemplated that those banks relying on subordinated debt would come to market frequently and be exposed to market discipline continuously. Much of the financing is apt to be intermediate-term or retired on a serial basis. However, even where longer-term debt is used, banks seeking to maintain their overall leverage would find it necessary to add to their debt periodically as their asset base grows.

Enforcement of Capital Requirement

For the proposed policy to be effective, capital requirements would have to be enforced by all supervisory agencies. Once a bank falls below the requirement, some restrictions would come into play immediately. These might include a prohibition on new branches or acquisitions, possibly a higher insurance premium, etc. As time and/or the capital shortfall increases, additional sanctions might come into force (possibly dividend restrictions or restrictions on some types of deposit-taking or lending). At some point, action would be taken to close the bank. Authority for Federal regulators to close solvent banks would probably require Federal legislation. In most instances, actual closings will be averted because bank management will find it in its and the bank's interest to take drastic action. This might take the form of selling off branches, raising capital or merging. Under adverse circumstances the sale of capital might significantly dilute existing shareholders or merger terms might be "unfavorable". However, actions that appear to treat shareholders adversely are apt to be better than the alternative -- having the bank closed.

This is an important point of the capital proposal. By setting capital standards high enough and setting the level where sanctions come into force high enough, many bank failures are apt to be averted. They would be replaced by recapitalizations or mergers where FDIC or other supervisory involvement is limited. From a financial standpoint there would be no FDIC involvement where the system works well.

Under present arrangements, enforcement action sometimes pressures or awakens bank management to recapitalize or merge so that failure is averted. However, frequently the troubled bank is too far gone by the time it considers recapitalizing or merging. The proposal put forth here would require drastic action while the troubled bank is still likely to have value. That is likely to spur management and directors to take action to salvage some of that value.

Fewer bank failures and reduced FDIC outlays will reduce net insurance assessments. These currently run about eight basis points measured as a percentage of deposits. Prior to 1981, when FDIC insurance losses were modest, net assessments averaged four to five basis points. For those banks that incur increased net interest cost through the use of subordinated debt, a portion, all, or perhaps more than all, of that increased cost could be offset by a reduction in net insurance assessments.

Following are the most frequently raised questions about the capital proposal along with responses to these questions.

<u>Will higher capital requirements reduce bank lending and adversely affect the overall economy?</u> Enforced capital requirements will cause some banks to reconsider taking on some low margin volume that would have to be capitalized. However, such evaluation should have always been part of rational bank planning. If banks are able to borrow to meet all or most of the additional capital requirement, there would be no significant reduction in bank loan growth and no adverse macro economic effect. Insofar as bank borrowing is from nonbank sources, the financing of bank subordinated debt can be viewed as an exchange of IOUs between banks and various other sectors of the economy -- the public, nonfinancial firms and other financial institutions. If some phasein is permitted to get banks up to the desired capital level, the impact of the financial transfers will be modest.

<u>Because large banks have easier access to capital markets, won't this proposal favor large banks?</u> Not necessarily. First, smaller banks as a group have higher equity ratios than larger banks and, historically, have been able

to add to equity from internal sources more easily than large banks. Thus, many smaller banks will have less need to supplement capital externally. Second, smaller banks in sound financial condition are likely to be able to sell their subordinated debt on favorable terms to correspondent banks, institutional investors and, in some instances, to their own customers. They would not have the name or size to sell in national public markets, but the cost edge to large banks that can sell public is apt to be modest.

Finally, the impact of this proposal on small versus large banks should be examined within the context of the functioning of the deposit insurance system. If, instead of the suggested approach, the FDIC sought to instill market discipline by reducing de facto insurance coverage, uninsured depositors at smaller banks are apt to consider themselves exposed to more risk. Unless the public believes that even the largest banks will be paid off by the FDIC, the insurance system would continue to favor large banks.

Will unfavorable response to high debt-equity ratios by rating services make it difficult and expensive for banks to sell subordinated debt? It is difficult to anticipate how rating services, bank analysts and underwriters will respond to the increased use of subordinated debt. I believe that rating services would ultimately appreciate that, as long as a bank has satisfactory equity relative to total assets and liabilities, more subordinated debt would not necessarily pose a problem. It is important to realize that some of the financial rules-of-thumb applied to debt coverage for nonfinancial firms are not altogether applicable to banks. Banks should have little difficulty servicing debt (interest or amortization payments). Banks typically accommodate deposit fluctuations that are much larger than any cash drains associated with subordinated debt. As markets gain experience with expanded use of subordinated debt, rating services will make appropriate adjustments. Underwriters may develop new instruments and we are likely to see a variety of marketing techniques (including marketing to bank customers), and variations on interest payments (fixed, variable tied to different security rates, no coupon, convertible, etc.).

Won't higher capital requirements encourage banks to acquire riskier assets? The use of subordinated debt will enable banks to maintain a high degree of leverage while still providing an increased cushion to the FDIC. If the market perceives that a bank is reaching for riskier assets, subordinated debt will become more expensive and difficult to acquire. If a bank takes on additional risk and incurs losses, replacing or adding to required capital will become expensive and difficult. Thus, the proposed system contains elements that will discourage excessive risk-taking.

Won't banks be encouraged to shift activities off balance sheet to conserve on capital? Yes, they probably will. If banks or bank holding companies acquire power to run mutual funds, they may seek to shift some retail deposits -- particularly related to IRA and Keogh accounts -- to mutual funds. That should pose no special problem for bank performance or bank regulators. Banks may also seek to increase income without increasing their balance sheet size through various devices (loan guaranties, etc.) that do increase the bank's risk. It will be necessary for bank regulators to limit such exposure or else factor it into the asset base for determining the capital requirement.

Is there any evidence that higher capital requirements will reduce the number of bank failures? Obviously, most banks that fail have run out of capital. The more interesting question is whether there is a relationship between capital ratios and bank failures when several years' lead time is used. When adjusted capital ratios are used, the relationship is not that strong and some have drawn from this to suggest that capital is not importantly related to bank failures. However, most bank examiners know that when capital is adjusted for asset quality (whether measured by classified assets, nonperforming assets, delinquencies, etc.) there is a very important and predictive relationship.

The report by James Marino in the November Outlook pointed out that adjusted capital ratios for failed banks were dramatically lower than those of their peers several years in advance of their failure. I believe the important and relevant conclusion from the Marino study is that adjusted capital ratios are much more closely related to bank failure than book capital without appropriate adjustments for asset quality. This suggests that required capital ratios should be calculated after appropriate adjustments. These might be based on nonperforming loans or other publicly reported data. At a minimum, more rigorous and uniform chargeoff policies probably are necessary. In addition, it may be appropriate to subtract some percentage of delinquent or nonperforming loans from capital and, possibly, requiring slightly lower capital ratios.

How are the proposed capital requirements affected by the capital structure of bank holding companies? The proposed capital requirement would be at the bank level. A parent holding company might borrow a portion or all the amount of the increased requirement and place it into the bank as equity. While there are some differences, the effect would not be much different than borrowing at the bank level. Presumably, potential lenders would·assess the financial condition of the holding company (whose principal asset may be the lead bank) and much the same market discipline would come into play. In principle, borrowing could occur at both the bank and the holding company level. We would expect market forces to impose restraints on overall leverage, although regulatory agencies may seek to impose some overall equity minimum. My own view is that that would not be necessary.

There are advantages to borrowing at the bank level from the standpoint of the borrower, lender and the FDIC. If the principal asset of a bank holding company is the lead bank, debt in the bank represents a more senior claim on bank assets than debt in the holding company and, other things equal, the former should sell on a lower yield basis than the latter. Interest and amortization payments normally are relatively easy to service in banks. Servicing doesn't necessitate profitability. Bank holding companies do not always have such easy access to cash. Transfers from the bank are limited, especially if the bank can't pay dividends, and other cash sources may sometimes be limited.

Restrictive covenants on bank debt can generally be controlled by regulators. In the current proposal regulators could deem subordinated debt unsatisfactory for meeting capital requirements if, for example, an acceleration clause was present. Holding company debt sometimes contains covenants that restrict the sale of the bank or restrict dilution of bank stock. Such covenants may act counter to resolving problem bank situations by forcing bank sales or mergers. Whether the presence of such covenants are likely to pose real problems probably needs some additional examination.

How would the capital proposal mesh with the handling of failures (P&As versus payouts), variable rate premiums, and the treatment of brokered deposits? If the capital proposal were implemented, capital, including subordinated debt, would afford additional protection for the FDIC and impose marketplace discipline on bank behavior. Most likely there would be fewer failures, and less reason to impose losses on depositors by paying off banks. Most failures would probably be handled through P&As except in those instances where there is no available purchaser or where financial uncertainties make a P&A very risky.

Implementing the capital proposal would not preclude a system of risk-based insurance premiums. However, that would involve the FDIC's basing insurance costs on criteria similar to the market's determination of capital costs. A possibility previously mentioned would be to impose a higher premium on those banks that fail to meet capital requirements. This would not preclude more severe sanctions if the capital shortfall persists and/or increases.

Brokered deposits provide a means of expanding and trading on insurance coverage. Without significant reliance on depositor discipline, deposit brokering becomes less important, although supervisors are still apt to monitor the exposure that comes from excessive reliance on brokered deposits. Brokered deposits, like other deposits, would have to be capitalized and if they are high-cost or their use otherwise entails high risk, that will be reflected in their capital cost.

Won't higher bank capital requirements adversely affect the relative competitive position of banks compared with thrifts? Yes, if higher capital requirements do impose costs on banks. Banks are currently disadvantaged because thrifts have lower capital requirements and because their pricing of deposits does not adequately reflect capital costs and market forces. Savings and loans have experienced substantial low margin growth in recent years, transferring a substantial amount of risk to the FSLIC.

Thrifts should be subject to the same capital requirements as banks. The condition of most thrifts makes it unlikely that satisfactory capital levels could be achieved in the near future, and it is not feasible to close most capital-short thrifts. Institutions that are allowed to operate with insufficient capital should be subject to sanctions. In particular, limitations should be placed on their growth. Recent Bank Board capital proposals would be a modest step in that direction.