NOTES FOR SPEECH AND PANEL DISCUSSION
AT THE BOSTON UNIVERSITY SCHOOL OF LAW
CONFERENCE ON "INSURING CONFIDENCE =
DEPOSIT INSURANCE REFORM"

JUNE 7, 1985
MORIN CENTER FOR BANKING LAW STUDIES
BOSTON, MASSACHUSETTS
DEPOSIT INSURANCE REFORM

(It should be stated at the outset that the questions I pose and the comments I make represent my personal opinions as an FDIC Director, not policies formally adopted by our Board. Also, any numbers in this text are from publicly available sources.)

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Washington is blessed with an abundance of people who have all the answers to problems with our financial system, with the regulatory environment, and with the Federal Deposit Insurance System.

There is just one difficulty: there seem to be as many answers as there are "experts."

Today, I take another approach. I pose to you some questions which bear on policies, laws or regulations not significantly changed in the FDIC’s 52-year history.

Does the fact that off balance sheet items in the nation’s 40 largest banks now exceed these banks’ total book liabilities represent a problem?

Are capital standards that relate only to book assets and liabilities sufficient?

Should good banks pay the same rate of premium for insurance as troubled institutions?

Is it equitable that insurance premiums relate only to domestic deposits, which means all deposits for our smaller banks, but which constitute only a fraction of the exposure in the nation’s multi-national banks?)
Are the biggest banks assured of a bailout if they get in trouble, i.e., do they have de facto 100 percent insurance? If so, are they paying an adequate premium?

When I first came to the FDIC 17 years ago, it was an article of faith that big banks were better managed and were, in fact, subsidizing the smaller ones because a big bank would never fail.

Is it time for another look?

I am not alone in asking some of these questions. On April 29, 1985, the three FDIC Board members instructed our staff to undertake an intensive study of the off balance sheet phenomenon. Joe Selby, who is also here today, a member of our Board of Directors and also acting as Comptroller of the Currency, offered to coordinate similar studies he is doing with those we proposed. The Federal Reserve is also looking at the problem.

The banking industry itself is beginning to stir on the issue. Carl Reichardt, Chairman of Wells Fargo Bank, is reported in the May 8, 1985 American Banker, as urging banks to take a lead in increasing their own capital ratios to provide a cushion for risky business ventures which may not be reflected on the balance sheet. He noted that there has been a significant increase in such off balance sheet items as standby letters of credit, interest rate swaps and loan sales with recourse.
IN TESTIMONY BEFORE THE HOUSE ENERGY AND COMMERCE SUBCOMMITTEE HEARING ON THE EXPANDING SECURITIES MARKET, PRESTON MARTIN, VICE CHAIRMAN OF THE FEDERAL RESERVE BOARD, EXPRESSED CONCERN FOR THE WAY THE BANKS ACCOUNT FOR LOAN SALE TRANSACTIONS. POOLS OF LOANS MAY BE SOLD WITH SOME RECOURSE TO THE ORIGINATING BANK IN CASE OF DEFAULT, BUT EVEN IF THE SELLING BANK REMOVES THE ASSETS FROM THE BALANCE SHEET, THERE REMAINS A CONTINUING LIABILITY.

IN A RECENT RULING, THE COMPTROLLER’S OFFICE ADDRESSED THIS PROBLEM BY REQUIRING CITIBANK TO KEEP ON ITS BALANCE SHEET ASSETS SOLD LAST YEAR BECAUSE THE SALE INCLUDED A RECOURSE AGREEMENT UNDER WHICH THE BANK RETAINED LIABILITY FOR 10 PERCENT OF ANY DEFAULTING LOANS IT HAD SOLD.

CARLETON R. HASWELL, A SENIOR VICE PRESIDENT AT CHEMICAL BANK, COMMENTING IN THE MAY 13, 1985 ISSUE OF FORTUNE, OBSERVED THAT EVEN IF BANKS LIMIT THEIR LETTERS OF CREDIT VOLUME TO THE GROWTH RATE OF THEIR LOANS, THE EXPOSURE WILL STILL BE SUBSTANTIAL BECAUSE MANY LETTERS OF CREDIT GUARANTEE PAYMENTS WELL INTO THE FUTURE.

WHILE THE ASSESSMENT RATE HAS BEEN ESSENTIALLY UNCHANGED IN STATUTORY AMOUNT SINCE OUR BEGINNING OVER 50 YEARS AGO, THE TOTAL LIABILITIES AND FUNDS GENERATION APPARATUS OF BANKS HAVE UNDERGONE SIGNIFICANT CHANGE. BANK OBLIGATIONS SUCH AS NOTES OR DEBENTURES ARE NOT INCLUDED IN THE BASE UPON WHICH WE LEVY INSURANCE ASSESSMENTS. NEITHER ARE DEPOSITS PAYABLE
AT FOREIGN BRANCHES OF AMERICAN BANKS. YET, BOTH OF THESE FUND SOURCES REPRESENT MONEY-GATHERING MECHANISMS WHOSE PROCEEDS, LIKE ANY OTHER LIABILITY, CAN BE INVESTED IN ASSETS WHICH CAN LEAD TO PROBLEMS WHEN THEY DEPRECIATE IN VALUE. HOWEVER, THEY ENTIRELY ESCAPE THE DEPOSIT INSURANCE PREMIUM.

THIS CAUSES CERTAIN OBVIOUS INEQUITIES WHEN BANKS WHICH HAVE EXTENSIVE OVERSEAS BRANCHING OR UTILIZE OTHER LIABILITIES ARE COMPARED WITH BANKS WHICH RELY MORE ON DOMESTIC DEPOSITS.

FOR EXAMPLE, BofA PAID US ALMOST $40 MILLION IN ASSESSMENTS IN 1984, WHEREAS CITIBANK PAID $18.5 MILLION. BOTH, IN MY OPINION, ENJOY DE FACTO 100 PERCENT INSURANCE PROTECTION BUT BofA, WITH LESS TOTAL BOOK LIABILITIES, PAID MORE THAN TWICE AS MUCH IN INSURANCE ASSESSMENTS. NEITHER PAID IN PROPORTION TO THE SMALLER BANK ASSESSMENTS WHICH HAVE VIRTUALLY ALL DOMESTIC DEPOSITS.

TODD CONOVER FOUND HIMSELF IN HOT WATER BY TESTIFYING BEFORE THE CONGRESS IN EFFECT THAT NONE OF THE TOP 20 BANKS WOULD EVER BE ALLOWED TO FAIL. HE SPENT THE NEXT TEN DAYS BACKPEDDLING.

HOPING TO AVOID THAT TRAP, I SIMPLY GIVE YOU: A FACT -- CONTINENTAL WAS BAILED OUT; A SURMISE -- NEITHER OF THE TOP TWO BANKS WOULD BE ALLOWED TO FAIL; A SPECULATION -- WHERE WOULD THE CUTOFF BE? HOW MANY OTHERS, IF ANY, WOULD NOT BE ALLOWED TO FAIL?

THE TREASURY DEPARTMENT STUDY ON FDIC REFORM ALSO TIP-TOES ON THIS POINT: "SOME HAVE BECOME SO LARGE THAT THE REGULATORY
AUTHORITIES APPEAR UNWILLING TO ACCEPT THE DIRECT AND INDIRECT COST OF LETTING THEM FAIL IN THE CONVENTIONAL SENSE."

I AM NOT MAKING A PROPOSAL OR A PREDICTION -- I JUST WANT YOU TO THINK ABOUT THE QUESTION. WHAT IS FAIR? WHAT IS NECESSARY?

The assessment charged by the FDIC to all insured banks has been equal to 1/12th of 1% of deposits since 1935. A provision for a rebate to banks was enacted in 1950. After covering our operating expenses, our insurance losses, and our provisions for anticipated future losses, we refund 60 percent of the remainder to the insured banks. Granted, this has not represented to banks a significant recapture of the insurance assessment expense in recent years, but historically, it had led to effective deposit insurance rates well below the statutory amount -- 1/25th to 1/30th of 1% rather than the statutory level of 1/12th of 1%. In the 1980's, because of our heavy expenses in handling failed banks, the effective rate is only slightly less than the statutory rate. For 1984, it will be between 1/12th and 1/13th of 1%.

Insofar as the larger insured banks in our nation are concerned, at least those with deposit-gathering at foreign branches, the effective assessment rate is actually lower, as we do not collect any insurance assessments on these foreign deposits. That makes some sense. If the deposit is payable solely at a foreign office, it is not considered an insured
DEPOSIT; HOWEVER, IF THESE FOREIGN DEPOSITS ARE LIABILITIES
OF A VERY LARGE INSURED U.S. BANK THAT MIGHT NOT BE ALLOWED
TO FAIL, THEN TO THE EXTENT THAT INSTITUTION HAS PROBLEMS
THAT REQUIRE FDIC FINANCIAL ASSISTANCE, EVEN THESE FOREIGN
DEPOSITS, ALTHOUGH STATUTORILY UNINSURED, ARE PROTECTED.

Take the Continental Illinois example.

Its December 31, 1983 Report of Condition reflected:

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Estimated Insured Deposits</td>
<td>4.5</td>
</tr>
<tr>
<td>Other Domestic Deposits</td>
<td>9.2</td>
</tr>
<tr>
<td>Deposit base subject to insurance assessment</td>
<td>13.7</td>
</tr>
<tr>
<td>Foreign Deposits</td>
<td>16.6</td>
</tr>
<tr>
<td>Total Deposits</td>
<td>30.3</td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>8.5</td>
</tr>
<tr>
<td>Total Book Liabilities</td>
<td>38.8</td>
</tr>
</tbody>
</table>

* Insured deposits were extrapolated based on 6/30/83 reports, but by the time the FDIC became involved, insured deposits had declined to a little more than $3 billion.

Continental, in 1983, paid only the bargain basement assessment of $6.5 million, based on domestic deposits of $13.7 billion, for its 100 percent insurance protection on $69.1 billion in on and off book liabilities.

The law's failure to cover foreign deposits is a reflection of the fact that this was not a significant consideration in the 1930's, when few banks had foreign branches or foreign deposits. That view is no longer appropriate in the 1980's.
When this issue was raised a few years ago, the effective assessment rate was less than 1/25th of 1%. The New York banks agreed that in order to be competitive overseas, they desperately needed the subsidy provided by not paying for insurance on foreign deposits. That's a mighty thin margin.

Senator Proxmire has introduced legislation that would reduce the assessment rate on deposits from 1/12th to 1/15th of 1% and at the same time start assessing foreign deposits. That might be one way of correcting this foreign deposit loophole. It certainly deserves attention.

The Treasury Department agrees the idea has merit. The Administration's study on FDIC reforms on page 51 points to two options: (a) an insurance surcharge on the very largest institutions, and (b) a requirement for insurance premiums on foreign deposits.

Tom Healey is with us today. It was his study and perhaps he can enlighten us further on the relative merits of these two approaches.

The volume of foreign office deposits on which no insurance premium is paid by the ten banks which lead in banking abroad is shown in the following table:
### December 31, 1984

<table>
<thead>
<tr>
<th>Domestic Deposits</th>
<th>Foreign Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>(in Billions of $)</td>
<td></td>
</tr>
<tr>
<td><strong>Citibank</strong></td>
<td>30</td>
</tr>
<tr>
<td><strong>Chase Manhattan</strong></td>
<td>25</td>
</tr>
<tr>
<td><strong>Bank of America</strong></td>
<td>59</td>
</tr>
<tr>
<td><strong>Morgan Guaranty</strong></td>
<td>14</td>
</tr>
<tr>
<td><strong>Manufacturers Hanover</strong></td>
<td>23</td>
</tr>
<tr>
<td><strong>Bankers Trust Company</strong></td>
<td>9</td>
</tr>
<tr>
<td><strong>First Chicago</strong></td>
<td>12</td>
</tr>
<tr>
<td><strong>Chemical Bank</strong></td>
<td>22</td>
</tr>
<tr>
<td><strong>Continental Illinois</strong></td>
<td>8</td>
</tr>
<tr>
<td><strong>Security Pacific</strong></td>
<td>24</td>
</tr>
</tbody>
</table>

**Totals**: 226 222

Quite apart from the foreign deposit question, we have recently found that certain bank liabilities -- standby letters of credit -- which do not appear on a bank's balance sheet, have been ruled, in the Philadelphia Gear case (Philadelphia Gear Corporation v. Federal Deposit Insurance Corporation, 751 F.2d 1131 (10th Cir. 1984)), to be insured deposits. We have requested the Solicitor General to file a petition for a writ of certiorari in the Supreme Court -- we may win, we may lose. We also have asked for Congressional action to rewrite our Act more specifically to make it clear that such contingent liabilities are not deposits.
In another recent case on deposit insurance for standby letters of credit, a U.S. District Court in Tennessee found for the plaintiff and against the FDIC. This case is also on appeal. Our brief was filed yesterday. But the trend in the courts is clear, so far.

If we were to accept the court findings and say that if a bank fails we will pay on these standby letters of credit up to the insurance limitation, then we would have to start collecting insurance assessments against these accounts. In addition, we would have to give consideration to the question of whether the FDIC should, as now permitted by our Act, collect insurance assessments on standby letters of credit for the previous five years as well.

As you know, standby letters of credit are not the only element in the expanding off balance sheet phenomenon. The press has carried articles recently about banker reaction to our capital regulation. It has been suggested that banks may be handling more income-producing activities off balance sheet so they do not need to support these activities with additional capital. In connection with this meeting, I looked at information on insured banks with more than $5 billion in deposits to see what the publicly available official Reports of Condition might disclose. What was extraordinarily interesting to me was the relationship between book liabilities and off balance sheet liabilities.
In the off balance sheet items disclosed in Schedule L on the Reports of Condition, one of the larger categories was loan commitments. Another large off balance sheet category has to do with foreign exchange transactions. Some of the other areas covered are activities involving note issuance facilities, securities lending and repurchasing activities, interest rate swaps, real estate investment and development, and sales of securities with bank assets as collateral. These activities represent only a few of the many that are not reflected on the balance sheet.

A caveat is called for at this point. As Bob Shumway, chief of our Division of Bank Supervision, points out, many nonbook liabilities are so contingent in nature that they can in no way be equated to book liabilities.

Let me share with you my preliminary thoughts arising from this review. There are over 40 insured banks with deposits in excess of $5 billion. In these institutions my staff found that, in the aggregate, insured deposits increased slightly as a percentage of total deposits from approximately 31% as of June 30, 1983, to an estimated 36% on December 31, 1984. The raw data would suggest the insured deposit totals of these 40 institutions have increased from approximately $223 billion to approximately $262 billion. What is even more significant is the role being played by off balance sheet items. While acknowledging that Schedule L of the Report of Condition is
NEW -- REQUIRED ONLY SINCE 1983 -- AND PERHAPS NOT THE EASIEST TO COMPLETE, IT IS OUR ONLY CURRENTLY AVAILABLE METHOD OF DEVELOPING INFORMATION ABOUT THE VOLUME OF OFF BALANCE-SHEET BUSINESS. THESE LARGE BANKS, WHICH HAVE INSURED DEPOSITS OF $262 BILLION, HAVE TOTAL DEPOSITS AND OTHER LIABILITIES OF $958 BILLION BUT EVEN THIS FIGURE IS LESS THAN THE $1.1 TRILLION THE SAME INSTITUTIONS REFLECT AS OFF BALANCE SHEET LIABILITIES. FOR THE 1983/1984 PERIOD MY STAFF LOOKED AT, INSURED DEPOSITS IN THE AGGREGATE REPRESENT SOMEWHERE BETWEEN 11% AND 13% OF THESE INSTITUTIONS’ TOTAL OF BOOK AND NONBOOK LIABILITIES.

I SHARE THIS INFORMATION WITH AN ALERT THAT IT IS RAW DATA. OUR STUDY OF THE OFF BALANCE SHEET PHENOMENON IS IN SUCH AN EARLY STAGE THAT NO CONCLUSIONS ARE PRUDENT. BUT IT IS NOT TOO SOON TO BEGIN THINKING ABOUT THE PROBLEM.

BY WAY OF SUMMARY, THE FEDERAL DEPOSIT INSURANCE SYSTEM IS APPROACHING ITS 52ND BIRTHDAY. LIKE ANYONE ELSE OR ANYTHING ELSE THAT IS 52 YEARS OLD, IT MAY BENEFIT FROM A MAJOR, OBJECTIVE OVERHAUL OF ITS STATUTE AND REGULATIONS.

JUST RECENTLY, OUR BOARD ASKED FOR PUBLIC COMMENT ON TWO PROPOSALS WE HAVE BEEN GIVING SOME THOUGHT TO. ONE IS TO RAISE THE MINIMUM ACCEPTABLE CAPITALIZATION LEVEL FROM 6% TO 9% BUT TO REQUIRE ONLY 6% OF THAT IN EQUITY. THE REMAINING 3% COULD BE EITHER IN EQUITY OR SOME KIND OF DEBT INSTRUMENT. A MAJOR PROBLEM WITH THIS PROPOSAL IS, OF COURSE, THE
FACT THAT THE THREE FEDERAL BANKING AGENCIES HAVE ONLY RECENTLY AGREED ON THE 6% CAPITAL LEVEL. CLEARLY, THE FDIC CANNOT ACT ALONE. I BELIEVE THAT ALL THE REGULATORS WOULD LIKE TO SEE MORE CAPITAL OVER TIME.

I WOULD ALSO ASK YOU WHETHER IT SEEMS REASONABLE THEN TO ESTABLISH OUR CAPITAL STANDARDS ON THE BASIS OF ONLY BOOK FIGURES WHEN WE KNOW THERE ARE SIGNIFICANT NONBOOK FIGURES JUST OFF THE BALANCE SHEET. SIX PERCENT CAPITAL IS SIX PERCENT OF WHAT?

WE ALSO ASKED FOR COMMENT ABOUT A PROPOSAL TO UTILIZE OUR DEPOSIT TRANSFER PROCEDURE IN THE CASE OF VIRTUALLY ALL BANK FAILURES. WE TRIED AN EXPERIMENT WITH TWELVE MODIFIED PAYOFFS IN 1984, EIGHT OF WHICH HAD AN ADVANCE PAYMENT. IN THIS TYPE OF A TRANSACTION, INSURED ACCOUNTS ARE TRANSFERRED TO ANOTHER FDIC-INSURED INSTITUTION WHICH BIDS FOR THE DEPOSITS. WE THEN MAKE AN ESTIMATE OF THE PROJECTED RECOVERY THE UNINSURED DEPOSITORS AND OTHER CREDITORS MIGHT REASONABLY EXPECT, AND MAKE AN ADVANCE IN CURRENT VALUE DOLLARS OF APPROXIMATELY THAT AMOUNT RIGHT AFTER WE ARRANGE THE TRANSFER OF THE INSURED DEPOSITS. IF THIS PROPOSAL WERE TO BE ADOPTED IN EVERY BANK FAILURE, THE LARGE DEPOSITORS AND GENERAL CREDITORS COULD SUFFER SOME LOSS BUT IT WOULD HAVE FAR LESS EFFECT ON THE LOCAL COMMUNITY THAN A DEPOSIT PAYOFF OF ONLY THE INSURED AMOUNT.
The problem with this approach is we know in our hearts that it would not be used for a Citibank or a Bank of America. Should we use it for the others?

It seems to me improper to suggest making any kind of significant overhaul of the Federal Deposit Insurance system for banks without giving thought as well to the Federal Savings and Loan Insurance system as well. There should be consistency in such areas as accounting procedures, disclosure, and capital requirements. I will let Ed Gray talk about this.

The FDIC has sent its own proposed legislative package to the Hill and, in addition, a working group of the Cabinet Council on Economic Affairs has made many recommendations, and the Bush Task Force recommendations may eventually be converted to a legislative proposal. It strikes me that Richard Breeden has a perpetual motion machine in action on this task.

A personal note: In nearly 11 years on the FDIC Board, I have participated in handling 268 failed or failing banks requiring FDIC outlays. This is more than any FDIC Chairman or Director since Leo Crowley, who was chairman during the tumultuous 1930’s. In fact, I have worked on one-third of all failed or failing banks in the 50-plus years the Corporation has been in existence. In terms of dollars, these institutions represent slightly more than 90 percent of the deposits of all the failed or assisted banks in FDIC history.

Many of these were easy to handle, almost by formula. Some have been extraordinarily complicated and difficult.
I know the trauma of a failure and believe in a strong regulatory environment.

Deregulation came in the 1980's and with it all of the anticipated results. As vice-chairman of the Depository Institutions Deregulation Committee, I was part of the process and in fact provided the majority vote on several closely contested issues.

As we expected, deregulation brought on bank failures, as management in some instances sought to grow too fast or took on overly risky endeavors attempting to compensate for their increased cost of funds. After averaging six failures a year in the decades of the 60's and 70's, the toll of institutions requiring FDIC outlays increased to 10 in both 1980 and 1981, and reached 42 in 1982, 48 in 1983, 80 in 1984 and stands at 43 after the first five months of 1985.

The challenge is materially different from the time I left the FDIC Board out of boredom more than a decade ago.

In my first year in 1968, the FDIC had three small failures to handle. In 1972, when I left, there was just one failure all year -- a $20 million institution.

Last Friday, there were seven failures that we handled through the weekend.

Some will tell you that deregulation had nothing to do with bank failures. It, of course, has not been the only factor. As always, bank failures are caused by fraud, greed
OR MISMANAGEMENT. DEREGULATION SIMPLY HAS PROVIDED AN ATMOSPHERE WHERE THESE FACTORS CAN FLOURISH.

THE ONE GOAL THAT CANNOT AFFORD TO BE OVERSHADOWED WHEN CONSIDERATION IS GIVEN TO ANY CHANGES IN THE FEDERAL DEPOSIT INSURANCE PROGRAM IS TO DO NOTHING THAT WILL DIMINISH THE STRENGTH AND REPUTATION ATTAINED BY THE SYSTEM SINCE THE MID-30'S.

THE FDIC LOGO IS THE SYMBOL OF CONFIDENCE AND WE MUST KEEP IT SO.

NONE OF THIS DISCUSSION RELATES TO ANY NEED FOR MORE MONEY FOR THE FDIC. WE HAVE PLENTY.


AFTER ALL THIS, YOU ARE ENTITLED TO SOME CONCLUSIONS. I SUGGEST THAT WE START BY ASSESSING FOREIGN DEPOSITS AND USE THIS EXTRA INCOME TO CUT THE RATE FOR ALL BANKS.
As the President would say in another context: "This is a revenue neutral proposal."