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Supervision and Rescue of Financial Institutions:
the U.S. Experience

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I am honored to have been invited to discuss at this meeting the important and timely question: Should central banks support financial institutions with problems? The central bank of the United States has considerable recent experience with this question, because over the past decade the United States has had to deal with a large number of depository institutions with problems and has provided a great deal of assistance in resolving these problems.

In order to reflect differences among institutional arrangements of countries, it will be helpful to rephrase the question to include as potential providers of support not only the central bank but also other government instrumentalities. In the United States, for example, responsibilities for administering the "safety net" for the nation's depositories are divided between the Federal Reserve, which provides liquidity assistance, and the government sponsored Federal Deposit Insurance Corporation (FDIC), which provides resources to pay off depositors of failed institutions and to facilitate the orderly resolution of these institutions.

Another aspect of U.S. institutional practice should also be noted at this time. It is that the safety net assistance is generally limited to depository institutions. U.S. law specifies that other entities, including other financial institutions, can receive Federal Reserve liquidity assistance but only under highly unusual and exigent circumstances and after a special authorizing vote of the Federal Reserve Board. Indeed,

no liquidity assistance has been provided to a nondepository entity since the 1930s. Therefore, this discussion will focus on depository institutions.

The provision of safety net assistance during the past decade has had important positive effects. Despite the large number of failures of depository institutions, the United States has avoided serious systemic problems in its depository system. Moreover, insured depositors and to a large extent other depositors have not suffered losses when institutions have failed. At the same time, however, the assistance has had various adverse effects, including lessened discipline of the market place over the activities of depositories; inequities in the treatment of different depositors and different institutions; substantial direct and indirect costs to the deposit insurance funds making necessary a large increase in deposit insurance premiums; and a heavy cost burden on the U.S. taxpayer.

Because of these negative effects, the United States is reassessing its policies and practices pertaining to the safety net and related matters. In particular, the Congress is currently considering changes in the U.S. deposit insurance system and in the form and nature of actions taken in supervising depository institutions and assisting those encountering problems. It is also considering changes to strengthen the ability of depositories to operate safely and profitably in today's extremely competitive environment.

Having provided that overview, let me outline how this presentation will proceed. I first will provide a general description of the U.S. depository system and the governmental framework that regulates and provides assistance to these institutions and their depositors. Then follows a brief summary of the U.S. experience with problem institutions over the last decade, noting in some detail the nature of assistance extended in addressing these problems. Arguments that have been made regarding the positive and negative effects of such assistance will then be summarized, followed by a brief discussion of pending legislative initiatives to modify policies and practices followed in administering the safety net. Finally, other initiatives will be reviewed, legislative and otherwise, that are being taken in the United States in an endeavor to strengthen the U.S. financial system and improve government supervision of its operations.

U.S. Depository System

With more than 30,000 depository institutions and nearly \$4.5 trillion in assets, the U.S. depository system is the largest in the world in both number of institutions and total assets. The 12,000 commercial banks have combined assets of \$3.3 trillion and are easily the largest segment of the system. These institutions serve as a key source of financing to businesses, households, and units of government, both domestically and

abroad, and are important repositories for savings and liquid assets.

Savings and loan associations and savings banks (collectively referred to as "thrift" institutions) have always accounted for a much smaller segment of the depository system. As a result of serious problems over the past decade, moreover, this segment has been losing relative market share. Currently there are about 2,700 thrifts institutions with more than \$1 trillion in assets. Thrifts have traditionally provided financing to consumers, particularly for the purchase of a home. In recent years, they have also been permitted to offer their services on a limited basis to business concerns.

Credit unions make up the third sector of the U.S. depository system. There are more than 16,000 of these institutions, but they are generally quite small, with aggregate assets of about \$200 billion. They also concentrate in consumer lending, but only to members sharing a common but broadly defined bond, such as individuals employed by the same firm or industry.

Both state and federal authorities charter, regulate, and supervise depository institutions. At the federal level, the Office of the Comptroller of the Currency (part of the U.S. Treasury department) charters and supervises nationally (or "federally") chartered banks. The Federal Reserve and the FDIC share the federal responsibility for the supervision of state

chartered banks, and perform these duties in cooperation with authorities of the chartering state.¹

The Federal Reserve serves as a "lender of last resort" for banks and more generally for the depository system. That assistance is intended to provide temporary liquidity to institutions that are unable to obtain funding on a reasonable basis in the private market. The FDIC assesses and collects insurance premiums from banks and thrifts and serves as the receiver of insolvent and failed institutions. As receiver, the FDIC assures that deposits insured up to \$100,000 are protected in full and arranges for the orderly resolution of failed depositories.

Thrifts and credit unions are also chartered either by state or federal authorities and are supervised at the federal level, respectively, by the Office of Thrift Supervision and the National Credit Union Association. Both of these sectors of the depository system have their own arrangements for providing liquidity assistance to industry members and for resolving weak and failed institutions. They also have their own deposit insurance funds.² As noted above, the Federal Reserve is

¹ The Federal Reserve supervises state chartered banks that are also members of the Federal Reserve System, while the FDIC supervises those that are not member banks. The Federal Reserve also supervises and regulates companies that own commercial banks (bank holding companies), as well as their nonbank subsidiaries.

²Before 1989 the bank and thrift deposit insurance funds were financed and administered separately. Following the insolvency of the thrift fund, it was recapitalized and moved under the administration of the FDIC as a separate fund. In this new structure, the commercial bank insurance fund is called the

authorized to lend to thrifts and credit unions if liquidity assistance from their own industry sources is not available.

Recent Difficulties in the U.S. Depository System

Among the most troubling developments in the U.S. depository system during the past decade have been the widespread problems in the thrift industry. The origins of these problems can be traced to the industry's longstanding practice of financing its mostly fixed rate, long term assets (primarily home mortgages) with relatively short-term deposit liabilities. This funding structure was protected for many years by regulations limiting the rates depository institutions could pay on deposits. In the late 1970s and early 1980s, however, rising inflation and interest rates and competition from mutual funds and others that offered investment alternatives not subject to rate limitations forced the removal of these deposit rate ceilings. This removal, in turn, led to serious earning problems at many thrifts, as increased funding costs outpaced relatively fixed returns on assets. These losses began seriously to erode industry capital.

Even after rates had declined by the mid-1980s, a large number of thrifts remained in weakened condition because of poor capital positions. In the face of these problems, a policy of supervisory forbearance was adopted, which allowed troubled

Bank Insurance Fund (BIF), while the fund for thrifts is called the Savings Association Insurance Fund (SAIF). In the following discussion, these funds will be referred to generically as the deposit insurance funds.

thrifts to continue operating with deficient and sometimes negative capital accounts. In addition, statutory changes were made to expand the permissible activities of thrifts so that, it was hoped, they could survive and compete more effectively.

Many thrifts took advantage of this new environment and tried to grow out of their problems by channeling funds into assets with higher risks and higher expected returns, particularly into loans on commercial real estate properties and high risk bonds. This growth was often financed by aggressive efforts to attract deposits, sometimes on a nationwide basis, through the facilities of brokers. In order to remove any concern on the part of investors, these funds were typically divided into portions sufficiently small as to be covered by the deposit insurance system. The unfortunate result of these policies and growth strategies was that the problems of many thrifts were intensified, and the volume of already high failures rose sharply.

The industry's difficulties were so substantial that by 1988 its deposit insurance fund was exhausted. The U.S. Congress responded by voting to back-up the obligations of that fund with the full faith and credit of the government. It also took steps to revise the industry's regulatory, supervisory, and insurance framework. A government agency, the Resolution Trust Corporation (RTC), was established to resolve failed thrifts, and a new thrift industry insurance fund was incorporated under the FDIC. In resolving the large number of insolvent thrift institutions,

the RTC is projecting that losses will be about \$80 billion by the end of September, 1991 and that they will climb much higher before all currently troubled thrifts are resolved.

Unfortunately, the commercial banking industry has also been troubled by substantial problems. Serious difficulties first developed during the mid-1980's in states whose economies were heavily affected by severe cyclical downturns in the energy and agriculture sectors. These difficulties were compounded, particularly in the energy producing states, because--like thrifts--many banks in these states had heavy exposures to commercial real estate loans. Depressed regional economic conditions ultimately reduced the values of real estate properties, causing widespread defaults on these loans. As a result of all of these problems, hundreds of banks failed, resulting in substantial losses to the banking industry's deposit insurance fund.

Toward the end of the decade, as recessionary conditions developed in other regions of the country, banks in those areas also came under serious pressure. Their problems were linked to a general erosion in asset quality with, once again, the erosion most pronounced in commercial real estate loans. Of course, many of the largest banks also faced the task of managing significant loan exposures to developing countries and to highly leveraged firms.³

³ These latter exposures refer specifically to loans extended to finance the buyout, acquisition, or recapitalization of an existing business in which the relative level of debt in

Overall, since 1980 more than 1,250 commercial banks with assets of nearly \$200 billion have either failed or required government support. More than 1,000 of these banks have failed since 1985, resulting in a decline in the bank insurance fund from more than \$18 billion to its present official level of \$4.5 billion. Unfortunately, the problems are far from over. Currently 1,000 of the 12,000 commercial banks in the United States are considered to be "problem" banks. Thus, the total cost of resolving failed banking institutions is destined to increase substantially.

The large cost of resolving these failures is expected to exhaust the bank insurance fund by year-end. Consequently, as occurred previously with the thrift fund, the bank fund must be recapitalized soon if the FDIC is to continue to meet its obligations. To date, that fund has been financed exclusively through premiums assessed on the banks' domestic deposits. This practice, however, has forced premium rates to increase nearly three-fold over the past eighteen months--from 0.083 percent of total domestic deposits to 0.235 percent.

Although these increased premium payments will help to cover the fund's costs, they will not in the near term provide the cash flow needed to cover its immediate needs. Moreover, some observers fear that the financial strength of the banking industry, already affected by adverse economic conditions, will be further drained by any additional increase in premiums.

the company is significantly increased.

Accordingly, legislation is pending to recapitalize the insurance fund temporarily through direct borrowings from the U.S. Treasury Department, which would ultimately be repaid from future revenues of the fund.

Structure and Administration of the Safety Net

As mentioned, the Federal Reserve and the FDIC perform central roles in administering the safety net for the U.S. banking system--the Federal Reserve by providing liquidity assistance, and the FDIC by protecting insured depositors and conducting an orderly resolution of troubled institutions. Federal Reserve liquidity assistance through discount window lending is intended to be a temporary source of funds when funding is not available on reasonable terms from alternative sources. Indeed, under existing regulations, discount window loans may not substitute for capital.

The most common reason for depository institutions to borrow from the discount window is to obtain funds to meet unforeseen short-term liquidity needs, including funds to meet legal reserve requirements. These short-term "adjustment" borrowings are generally repaid quickly, usually by the following day in the case of larger banks.⁴

⁴The Federal Reserve also extends credit on occasion for longer periods to healthy institutions that lack effective access to national money markets but that have recurring seasonal liquidity strains. Such institutions are often located in small agricultural communities.

Banks also borrow on a more extended basis when they are encountering sustained liquidity pressures that cannot be met through market sources of funds. In providing extended credit to troubled institutions, the Federal Reserve ordinarily does so when the institution is considered to be solvent.

In some cases, the extended liquidity assistance enables institutions to adjust their funding problems in an orderly fashion and strengthen their condition. In others, when problems prove to be more serious, the Federal Reserve's lending provides time to assess the nature and depth of a bank's problems and, in cases of insolvency, time to facilitate an orderly resolution. In these cases, the Federal Reserve works closely with the borrower's primary regulator, either federal or state, and consults regularly with the FDIC about when discount window lending should cease.

The Federal Reserve always lends on a fully secured basis and thus does not suffer losses on its discount window loans. However, its extended lending can facilitate the withdrawal of funds by uninsured depositors and creditors. Consequently, a delay in closing a failing institution can increase the proportion of its deposits that are insured and, under some circumstances, could lead to higher losses for the FDIC. Recent focus on this possible result of Federal Reserve lending has led some to conclude that restrictions should be placed on the provision of liquidity assistance. These potential restrictions will be discussed later.

The FDIC's principal responsibilities are to protect insured depositors against loss in a cost effective way and to help to maintain the stability of the depository system. To accomplish these ends, the FDIC has several options for resolving a failed institution. Depending on the option selected, uninsured depositors may be fully or partially protected.

In two of the procedures open to the FDIC--insured deposit payoffs and insured deposit transfers--uninsured depositors are not protected. In these cases, a failed bank's assets are placed in receivership, and the FDIC takes the place of the insured depositors as a claimant on the receivership assets. It then shares proportionately with uninsured depositors and other creditors in the proceeds of the liquidation of the assets.

A second resolution option involves what is called a "purchase and assumption" transaction (P&A). In these cases, the FDIC arranges for a third party to purchase all or some of the assets of the failed bank and to assume all or some of its deposits and other obligations. In many cases, all or some uninsured depositors and creditors are fully protected, as well as all insured depositors. Despite the protection often given to uninsured parties, this option has been judged by the FDIC to be less costly than a payout or transfer of insured deposits in the great majority of cases. This reflects, in part, the fact that buyers are often willing to pay a significant amount for the franchise value of an operating institution. In addition, it may

also reflect that most other uninsured depositors have already withdrawn their funds.⁵

A third option is for the FDIC to recapitalize a bank before it fails, using a technique often called "open bank assistance." In these cases, the bank's assets are first marked to their market value. Thereafter, if the bank's capital remains positive, the existing shareholders retain some ownership interest in the institution. To rebuild the bank's capital position, equity is provided by the FDIC and also, in some cases, by one or more private investors. Once again, liability holders are generally protected.

When selecting among its options, the FDIC is prohibited by law from choosing one that is estimated to be more costly than a deposit payoff, except in the case of perceived systemic problems⁶. Therefore, when it has selected an option other than a deposit payoff--in most instances a P&A--it has generally done so because that option is estimated to be less

⁵ In order to give potential buyers time to evaluate the quality of the bank's assets and the value of its business, the FDIC may--particularly in the case of a large failing bank--create a "bridge bank." This approach gives the FDIC temporary control of the institution, while maintaining its activities and much of its value as an operating business.

⁶In 1990, 168 FDIC insured banks with assets of \$16.1 billion failed. Several banks were combined in the resolution process and another was divided; 162 transactions were required to resolve the banks. Of the 162 transactions, 141 purchase-and-assumptions represented 70 percent of the failed assets, 13 insured deposit transfers represented 25 percent of the failed assets, and 8 deposit payoffs represented 5 percent of the failed assets. One bridge bank was established and then resolved as a purchase and assumption. There was one case of open bank assistance.

costly to the fund. As previously noted, uninsured depositors are generally "bailed out" (i.e. protected) in these resolutions.

In cases presenting potential systemic risk a P&A or open bank assistance option is selected in order to protect uninsured depositors and creditors and, thus, minimize the spill-over effect of a failure. It is important to recognize that bank stockholders suffer losses on their investments, and senior bank management is almost always replaced, regardless of the resolution technique used ⁷.

The FDIC reports that the cases in which it has made special accommodations to address systemic risk have been relatively rare--only four times in the past five years. Moreover, it estimates that the costs over what would have been incurred if another option had been chosen were about \$1 billion. This figure suggests that the great majority of the FDIC's net resolution costs during the period were related to fulfilling its obligations to insured depositors.

Providing Support: How, How Much, and When

Our recent experience with troubled depository institutions and the assistance provided them serves to highlight that the operation of a safety net has both positive and negative effects. Let me now turn to some of those effects.

⁷Legislation has prohibited so-called "golden parachutes," which are generous severance benefits for the ousted management.

A major achievement of the safety net has been to provide full protection of small deposits (currently those less than \$100,000 per account). U.S. households have long indicated their strong wish for this protection, and those preferences are being reaffirmed by the current legislative process. The insurance coverage not only fulfills important household demands by reassuring depositors that their funds are safe, it also promotes financial stability and, thereby, discourages runs from small deposit accounts.

More broadly, the safety net operates to minimize systemic risk in the financial system by assuring an orderly resolution of failed institutions. That role is particularly important in the case of large institutions whose failure could cause major disruptions of the system by adversely affecting the condition of other institutions.

In a modern economy, the ability of firms and individuals to make and receive payment for goods and services is critical. If the failure of an institution impairs that payments mechanism, trade and commerce could be disrupted on local, national, and even international levels. Interbank balances, including foreign exchange transactions, are especially vulnerable and dependent upon a smooth-functioning payment system. Since these interbank dealings can involve very substantial amounts, the failure of a large bank to meet its obligations could unsettle financial markets and disrupt credit

and payment flows and the level of trade and commerce, domestically and perhaps worldwide.

In light of the growing "globalization" of financial markets and the growing links among internationally active banks, the failure of a large financial institution also could have worldwide effects that cannot be ignored. It is important, therefore, that authorities consider not only the domestic implications of an unassisted failure, but its international ramifications as well.

Although the need for a government safety net is still widely accepted, our experience during the past decade has led observers to conclude that the dangers of systemic problems can be overestimated. That is to say, the view has grown that failures of most banks, even relatively large banks, can occur without leading to systemic problems. At the same time, there are some institutions that are so large or so strategically positioned that they may be "too big to fail." Any serious problems at these institutions should be handled with special care. Nevertheless, experience has highlighted major drawbacks that can result from extending the safety net too broadly.

Perhaps the most important of these drawbacks is that protecting uninsured depositors weakens incentives for market forces to discipline improper and imprudent behavior by lenders, as well as by depositors. Some, including the Federal Reserve Board, recognize that in the United States the past practice of protecting virtually all depositors has reduced the risks

perceived by depositors to the point where they have become relatively indifferent to the soundness of their banks. To the extent this is true, some depositories have been able to fund high-risk assets at lower costs and in greater amounts than would otherwise have been possible. The result has been a misallocation of resources toward riskier activities, a greater probability of failure of some banks, and higher costs to the FDIC and, potentially, to the U.S. taxpayer.

A second drawback is that concern with systemic problems can lead to results that are unfair. Smaller banks have argued that a "too-big-to-fail" policy places them at a competitive disadvantage in attracting depositor funds. Other observers have cited the inequities involved when uninsured depositors of large banks are protected, while those at smaller institutions have been subject to losses.

Finally, there have also been widespread objections to the cost of the safety net to the deposit insurance funds and the taxpayer. The extent to which costs have been incurred to prevent systemic risk is a matter of some debate. It is clear, however, that even the relatively modest estimates of the costs to the deposit insurance funds of a too-big-to-fail policy involve large absolute amounts.

The issue of how best to administer the safety net ultimately involves questions of balance. A nation must guard against systemic risks, yet take steps to avoid the direct and indirect costs of providing assistance too readily to troubled

institutions. As previously indicated, based upon our recent experience, the United States is reassessing that balance and seems prepared to handle more bank failures in ways that will result in uninsured depositors not being covered by the safety net.

Specifically, in the United States, the Congress is considering proposals that would require the FDIC to obtain approval from the U.S. Treasury and the Federal Reserve before it could protect uninsured depositors, unless its assistance involved the least costly approach. The Federal Reserve and the Treasury support this proposal and have indicated that they would expect to grant their approval only on rare occasions in which the potential for systemic problems is clear.

In addition to the question of whether the safety net should continue to be used to avoid systemic problems, another question raised by such a policy is who should bear the costs. One approach would have the taxpayers bear the cost of resolving banks whose uninsured depositors are protected because society as a whole benefits from the avoidance of potentially widespread problems. The deposit insurance funds, on the other hand, would absorb the cost of all other resolutions.

Finally, as mentioned earlier, proposals have been advanced to place certain limits on the Federal Reserve's discount window lending. In order to reduce the potential for discount window assistance to facilitate withdrawals by uninsured depositors from failing banks, the Congress is considering

initiatives to limit the period during which the Federal Reserve could lend to distressed or insolvent institutions. However, these proposals do permit continued lending under certain circumstances. The Federal Reserve has indicated that it would be preferable not to limit its discretion in administering the discount window. Nonetheless, it has not objected to the proposed restrictions and has begun to adjust its operating policies to reflect the proposed restrictions.

Initiatives to Reduce Bank Failures

The best approach for minimizing the cost of a safety net is, of course, to maintain a strong and competitive banking system. Healthy, competitive depositories are less likely to take excessive risks and fail. It is important, then, to improve their ability to operate profitably in today's highly competitive environment. Over the past decade the financial markets have changed quite radically as technological advances and innovations have increased competitive pressures. The effect of these developments on U.S. depositories has been intensified because key U.S. laws and regulations restricting bank activities were not changed and, consequently, have limited the ability of some banks to compete.

Accordingly, a principal element in the legislation under consideration in the Congress--strongly supported by both the U.S. Treasury and the Federal Reserve--involves eliminating long-standing restrictions on interstate banking. If adopted,

this change will enable banks to diversify their risks geographically, improve their efficiency, and respond more effectively to financial market needs.

A second important set of initiatives would increase the range of financial activities that depositories can conduct. The proposals include permitting the holding companies of banks to engage in investment banking, an activity precluded to them since the 1930's.

In addition to strengthening the ability of depositories to compete in today's market environment, the Congress also appears to be preparing to enact legislation that will establish a more effective framework for supervising depository institutions. The cornerstone of these initiatives is a requirement for frequent on-site examinations, including an intensive review of asset quality, which is the source of many problems. Such examinations offer the best opportunity to detect emerging weaknesses, as well as fraud.

Bank capital adequacy is also vital and is one of the pillars of the current reform proposals in the United States. Strong capital positions lessen incentives for management to take excessive risk and provide a cushion for bank portfolio losses and for the deposit insurance funds. Strong capital, then, reduces the probability that a bank will fail and helps to reduce the misallocations of credit caused by the existence of a safety net.

The U.S. legislative efforts that are underway would also implement a capital-based mechanism of prompt corrective action by supervisors. Under this program, supervisory authorities would take specified actions at predetermined trigger points to reverse undesirable trends soon after they become clear. Banking organizations with capital ratios below certain levels would be placed under prompt and progressively greater pressure, for example, to limit dividends and growth and to modify management practices.

Should capital continue to erode, further supervisory actions would be mandated, including cease and desist orders and, in extreme cases, the prompt seizure of the institution to minimize further loss and to attempt to maintain some of its franchise value. Prompt corrective action would also provide positive incentives for banks to maintain high capital levels, including authorization for expanded activities and reduced supervision.

While capital is to be the focus of this program, other indicators of financial condition would also be considered in assessing the overall condition of the bank. Asset quality, liquidity, earnings, risk concentrations, and judgmental information based on recent examinations, such as classified assets data, would be considered in determining the appropriate level of supervisory action.

The Congress is also considering legislation that would establish uniform standards for the entry and expansion of foreign banks in the United States. This proposal is a result of specific problems we have had in recent years and is highly likely to be adopted. Importantly, these new standards would require consolidated home country supervision as a prerequisite for entry and would also apply comparable financial, managerial, and operations standards to foreign banks as are applied to U.S. banking institutions. The legislation would also expand the supervisory powers of the Federal Reserve to coordinate the examination of U.S. offices of foreign banks and to take enforcement actions, when necessary.

Conclusion

To conclude, the United States has established a federal safety net to provide support for financially distressed depository institutions. Indeed, as lender of last resort, providing liquidity to troubled institutions is one of the principal roles of the Federal Reserve. However, extended assistance by the Federal Reserve or by other government entities to support institutions should not be open-ended but, rather, limited to cases in which recovery is expected or that involve the high probability of systemic risk. Similarly, instances where all depositors, uninsured and insured, are protected should be limited to such circumstances.

A stable banking system is essential for economic stability and growth, and the proper functioning of the payments system must be maintained. In the United States the system of providing private banks with government-backed deposit insurance has produced a natural tension between efficiency and effectiveness on the one hand and safety and soundness on the other.

The safety net has provided financial stability despite strains and pressures, but has also at times reduced the market discipline that is needed to temper risktaking. In modifying the existing structure, the Federal Reserve's preference is to encourage market incentives by increasing the risk of loss by uninsured depositors, strengthen the capital bases of U.S. banks, improve supervisory and regulatory procedures, and limit the insurance fund's losses to an amount that can be covered by affordable premium payments of insured banks and the investment earnings of the insurance fund.

Reform of the U.S. banking structure is underway and, once enacted into law and regulation, should help to achieve these goals. In the United States and in other countries, as well, it is critical to keep in mind the importance of flexibility whenever considering changes to the structure of a financial safety net. No one can guarantee that the failure of a large bank or other financial institution will not involve substantial systemic risk. We must have the tools and flexibility needed to address these situations.