Looking to the 1990s:
What is Ahead for the Financial Service Industry

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I. Introduction

A. Recent developments in the thrift and banking industries have made regulators acutely aware of the dangers of providing a large federal safety net
   1. the financial exposure of taxpayers is at the mercy of bank and thrift managers
   2. the safety net has allowed bank and thrift managers to take on more risk

B. The regulated sector is growing more slowly than the unregulated sector

C. Fundamental reform of the industry is past due and I recommend the following reforms
   1. changing the deposit insurance contract to encourage depositor discipline
   2. adopting mandatory solvency-based closure rules
   3. developing better information systems
   4. separating the insurance, receivership, and supervisory functions of the FDIC

II. Deposit Insurance System & Regulation

A. Rationale for deposit insurance
   1. Federal deposit insurance has a long and controversial history
   2. Initial fears that deposit insurance would be costly and would subsidize poorly-managed banks eventually panned out in the last decade

B. An intricate system of rules and regulations were put into place to protect the insurance fund (taxpayers) and to guard against subsidies to poorly managed banks

C. To restore proper market discipline, federal deposit insurance coverage must be more correctly priced or limited
   1. at the very least, $100,000 per account should be strictly observed -- protection should not be extended to uninsured claimants when handling a failure
   2. at the Cleveland Fed, we believe that the current statutory limit should be reduced
      a. for those who desire more protection, co-insurance could exist above the reduced limit
      b. a reduction would be quite consistent with the major objective of insurance -- protection of depositors from catastrophic loss
         1. the $2,500 limit that was originally enacted (1934), is worth about $25,000 when adjusted for inflation today
         2. moreover, the average insured deposit account is about $12,000 in banks and about $8,000 in thrifts

III. Closure and the "Too Big To Fail" Doctrine

A. Strict enforecment of the deposit insurance ceiling means that we do not extend insurance to uninsured depositors and other creditors
   1. exceptions are not made for size of institution or type of charter
   2. the "TBTF" doctrine must be done away with

B. Failure of any organization carries many negative connotations, but what does it really mean?
   1. assets are relocated and put to more efficient use
   2. allowing failure removes the need for taxpayers to bail out an unhealthy institution
   3. threat of failure strengthens market forces and discipline

IV. The Development of Better Information Systems

A. Market value accounting systems should be implemented
   1. market value estimates of assets and liabilities would be a better indication of solvency than GAAP and RAP
   2. regulators' closure rules should be based on market value of capital

B. Regulatory agencies should move from suppression to timely dissemination of information
   1. FIRREA is a step in this direction
   2. banks and thrifts ought to have the right to release their examination ratings and reports to the public
   3. annual audits by independent accounting firms should be required and made public

V. Separating Supervisory, Insurance, and Receivership Functions

A. Separation of insurance and supervisory functions is necessary for prompt closure
   1. removes possible conflicts between the two functions
   2. insurance serves as a check on overall regulatory laxity

B. Other changes
   1. deposit insurer must have the right to immediately terminate insurance coverage for new deposits when it determines an institution is being operated in an unsafe and unsound manner
   2. deposit insurer must have ability to charge differential premiums based on risk

VI. Loosening of the Regulatory Reins

A. Only after reform of deposit insurance and the allowance of failure for badly-managed institutions can market incentives be expected to perform

B. Only then, can managers in the financial services industry be freed from restictive rules and regulations
   1. managers and shareholders alike would be forced to more carefully weigh risks and share in the outcomes of their decisions
   2. the ability to attract and maintain deposits would be based on the quality of business decisions, not on a deposit insurance subsidy of taxpayers

C. Role of government authorities would change
   1. government authorities would not be enforcers of rules and restrictions, instead they would monitor and supervise in order to ensure that prescribed financial condition guidelines were being observed
   2. government authorities would not only supervise, but would also help disseminate information so that markets can make well-informed decisions