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**FINANCIAL REFORM OR LOST OPPORTUNITY**

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## FINANCIAL REFORM OR LOST OPPORTUNITY

I am sure that my views on our current system of federal deposit insurance are well known to you. In fact, I am probably Ken Guenther's favorite whipping boy and my views have been the subject of several Independent Bankers Association of America (IBAA) news bulletins. Because I believe that deposit insurance reform is one of the most important issues facing the banking industry today, I would like to thank Ken for providing me with the opportunity to present my views to the members of the IBAA in person.

We have had plenty of time to rethink the current system of bank regulation and the size and scope of the financial safety net. There have probably been as many government studies, academic papers, and professional conferences on banking reform during the past few years as there have been bank and thrift failures. Unfortunately, this interest in banking reform has so far produced few tangible benefits. As currently structured, deposit insurance and bank regulation have continued to fall behind changes in financial markets and, as a result, have contributed to the problems that now face us in the banking industry. Instead of meaningful reform, the climate of concern that surrounds banking today, coupled with the intense pressures to recapitalize the federal deposit insurance system, could just as easily result in hasty legislative actions that would make matters even worse.

Bank profitability and franchise values have been eroded by a combination of overregulation and new competition from unregulated financial

services providers who have successfully gained entry into traditional banking markets. Some of the new competition faced by banks today is the result of regulations limiting the ability of banks to meet the needs of their customers. One can only wonder how banks would have fared in a less-regulated and less-subsidized environment.

At the same time, bank franchise values are being eroded by increased deposit insurance assessments, as the ballooning cost of the federal safety net for banks becomes more evident. In my view, the only way to stop the deterioration of bank franchise values is to reintroduce market forces into banking markets to increase the efficiency and competitiveness of our banking system. Key to any regulatory reform is meaningful deposit insurance reform that reduces both the size and the scope of federal deposit guarantees. I do not favor eliminating deposit insurance altogether. What I propose is limited deposit insurance priced and administered in a way that more appropriately aligns costs with risks. Well-capitalized banks (the majority of which are small banks) and taxpayers should not bear a disproportionate share of the costs of the system, as they currently do.

In the remarks that follow, I will make three points. First, the costs of supporting our current deposit insurance system exceed the benefits it provides. Second, as Ken Guenther and the IBAA have correctly pointed out, there can be no real reform of federal deposit insurance as long as the "Too Big To Let Fail" (TBTLF) policy is adhered to by bank regulators. Third, before proceeding to recapitalize the FDIC's bank insurance fund (FDIC-BIF), we should specify more clearly the objectives of federal deposit insurance and

insist that those federal funds that are used should come from a direct Congressional appropriation and be funded by Treasury debt. For banks, especially small ones, my message is that continuing along the same path we have traveled will mean a faster and inevitable decline in competitive position. However, meaningful reforms to deposit insurance and bank regulation would enable banks to compete head on with nonbank firms and to remain important players in the financial system.

#### Costs of Deposit Insurance and the Need for Reform

The estimated \$200 billion needed to resolve the thrift insurance mess, along with rapidly rising estimates of the costs of recapitalizing the FDIC-BIF, represent just the monetary costs of maintaining our current federal deposit insurance system. Other costs to the economy include a less-efficient banking system, an overinvestment in risky assets, and the inefficient use of society's savings.

As it is currently structured, the federal government's deposit guarantee program provides incentives for insured depository institutions to take on excessive risks. The fixed-rate premium penalizes safe banks and rewards risky ones by subsidizing the cost of funds for risky institutions. Marginal banks and thrifts pay nearly the same rate for deposits as well-capitalized depository institutions because, except for large deposits in small banks, all deposits are equally insured and deposit insurance premiums are not based on risk.

The deposit insurance subsidy and the attendant system of bank regulation protects weak and inefficient depository institutions at the expense of their well-capitalized siblings. The direct costs of the present system have risen rapidly and, in all likelihood, will continue to do so. Deposit insurance premiums that used to average 4 to 5 basis points per dollar of domestic deposits in the early 1980s will rise to 23 basis points this year, and may go as high as 30 basis points. Although there has been talk of capping the deposit insurance premium at 30 basis points per dollar of domestic deposits, Congress will always prefer to increase taxes on banks rather than to explicitly allocate general taxpayer monies to recapitalize the FDIC-BIF.

Unlimited deposit insurance also means further government involvement in the business decisions of banks, an intrusion that ultimately reduces banks' efficiency, profitability, and ability to compete with unregulated financial services providers. The safety net has been, and will continue to be, used to justify treating banks as public utilities. Community Reinvestment Act guidelines, lifeline checking, and assorted other consumer-oriented measures are additional burdens that banks have been, or will be, asked to bear.

In addition to the reduction in the efficiency of the financial system, the current deposit insurance system exacts other economic costs. Society's savings, a scarce resource, are not efficiently used. Many projects were undertaken only because mispriced federal deposit guarantees and regulatory capital forbearance practices transferred risk to the government.

The funding of speculative projects by insolvent banks and thrifts was at the expense of good, sound projects. This imposes a deadweight loss on society and reduces aggregate economic efficiency. Society would be better off if the monies used to finance speculative real estate booms in the Northeast and Southwest had been used to finance the modernization of the U.S. industrial base and to rebuild the decaying public infrastructure.

### Getting Rid of the Too Big To Let Fail Doctrine

"I wonder if we might have been better off today if we had decided to let Continental fail, because many of the large banks that I was concerned might fail have failed anyway, .... And they probably are costing the FDIC more money by being allowed to continue several more years than they would have had they failed in 1984." William Isaac<sup>1</sup>

The "Too Big To Let Fail" doctrine arose out of the regulatory handling of the insolvency of the Continental Illinois Bank and Trust Company of Chicago in May 1984. In the fall of that year, the Comptroller of the Currency defended the bailout of Continental by asserting that Continental was one of a limited number of banks that was "Too Big To Fail." I refer to this misguided regulatory philosophy as "Too Big To Let Fail" rather than "Too Big To Fail" to emphasize that the rationale for TBTLF is political rather than economic.

Policymakers and bank regulators have relied on the specter of the risk of systemic failures in the financial system to justify TBTLF. Regulators

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<sup>1</sup> William Isaac, quoted in Robert Trigaux, "Isaac Reassesses Continental Bailout," American Banker, p. 6 (July 31, 1989).

have argued that the failure of a large bank could result in a loss of confidence in the banking system as a whole and thereby produce runs on solvent banks. You will recognize this explanation as a reference to the Great Depression, a period in which the actual losses to depositors from bank failures have been greatly exaggerated. Regulators have argued that the failure of a large bank will cause the collapse of a great number of small banks because of the interbank exposure that arises from normal efficiency-producing correspondent banking relationships.<sup>2</sup> The final and currently most cited argument for continuing TBTLF is payments system risk. Some fear that the default of a large bank on the Federal-Reserve-operated payments system could result in the failure of other large banks with payments system exposure to the bank that failed, and possibly in the collapse of the payments system itself.

Although the aforementioned arguments for TBTLF have considerable political appeal in that they allow regulators to avoid the uncomfortable task of closing a large bank, none of these arguments can be justified on economic

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<sup>2</sup> Interbank exposure arguments were initially used by the FDIC to defend the bailout of Continental Illinois. In testimony before Congress in October 1984, then FDIC Chairman Isaac stated that allowing Continental Illinois to fail would have caused the failure or capital impairment of hundreds of small correspondent banks. This argument was refuted by a Congressional staff report to the same Congressional committee that, using reasonable estimates of Continental's portfolio losses, found that few if any of Continental's 2300 correspondent banks would have failed or been seriously affected. See United States Congress [Hearings]. House of Representatives. 1985. Committee on Banking, Finance and Urban Affairs, Subcommittee on Financial Institutions, Supervision, Regulation, and Insurance. Inquiry into Continental Illinois Corp. and Continental Illinois National Bank, October 4, 1984 (98th Congress, 2nd Session). Washington, D.C.: Government Printing Office. Staff report cited above is at pp. 418-445; testimony of William M. Isaac is at pp. 457-491.

grounds. For example, there is no reason that the failure of a large bank should cause depositors to run on solvent banks. Should such runs occur, they could be handled both through appropriate open-market operations to protect the economy's liquidity in general, and through use of the Federal Reserve's "lender of last resort" facility to lend directly to solvent banks. Moreover, if bank regulators adhere to strict closure rules for all banks, then depositor confidence should not be affected by the failure of a bank of any size.

The current high level of risk in the financial system, which is used to justify TBTLF, is in a very real sense a *consequence* of TBTLF and the expanding size of the financial safety net. A reduction in the financial safety net and the elimination of TBTLF would increase the risk to counterparties of both interbank holdings and payments system transactions. The effect of privatizing this risk exposure would be closer counterparty scrutiny by banks in correspondent dealings and in payments system transactions. Interbank exposure risk and payments system risk would be managed carefully, and this in turn would minimize the effects of the failure of a single large bank on other banks and on the payments system. Furthermore, the Federal Reserve's provision of liquidity to the financial system through open-market operations and directly to banks through the discount window could minimize or even eliminate any disruptions caused by the failure of an individual bank or even a small number of banks.

I agree with Ken Guenther that TBTLF is inequitable and that *de facto* deposit insurance coverage should be the same for all banks, regardless of



size. I also agree with the IBAA position that there can be no meaningful deposit insurance reform as long as bank regulators subscribe to the TBTLF doctrine. Where I part company with the IBAA position is on how to level the playing field between large and small banks. The IBAA's belief that the de facto 100 percent deposit insurance coverage now enjoyed by TBTLF banks should be extended to all banks would mean a continuation of burdensome regulation, increased deposit insurance premiums, and a further erosion in bank franchise values.

The solution to TBTLF that I advocate is to limit regulatory discretion to deal with failing banks in a manner that eliminates TBTLF as a regulatory policy. Instead of extending large bank coverage to small banks, I would reduce the protection afforded to large banks by limiting federal deposit insurance to \$25,000. I would have the FDIC provide 90 percent coinsurance for deposits from \$25,000 to \$50,000, and 70 percent coinsurance for deposits in excess of that amount. Private insurance markets might offer insurance to cover some, or all, of the deductible. To do this, there must be an explicit, statutory prohibition against the FDIC or the Federal Reserve from taking actions to protect uninsured depositors. Only Congress, with full political accountability, should be allowed to appropriate taxpayer funds to protect uninsured claimants of financial institutions.

I also urge statutory limitations on regulatory discretion in handling bank failures which would include the adoption of mandatory solvency-based closure rules and coinsurance haircuts (deductibles) for uninsured depositors in banks of all sizes. I would phase in these changes gradually, but according

to a definite timetable, so that they do not themselves become a source of uncertainty. These reforms would give the TBTLF doctrine the decent burial it deserves.

### Recapitalizing the FDIC-BIF

Another idea that deserves a quick burial is the proposal to recapitalize the FDIC with Federal Reserve funds. Official estimates of the magnitude of the FDIC-BIF's funding needs seem to be growing almost daily. The Treasury and the FDIC have requested \$70 billion in borrowing authority, \$25 billion of which would be direct borrowing from the Federal Reserve Banks. While it is important that the FDIC be recapitalized and given the resources to resolve more banking problems, the urgency of the FDIC-BIF funding-needs should not overwhelm the need to clarify the principles that will guide the administration of the program. Otherwise, we will just perpetuate the undesirable status quo, with billions more being spent before we deal with the fundamental problems that face the present system.

There are two aspects of the various proposals that have surfaced to deal with the FDIC-BIF solvency crisis that are of particular concern to me. First, there is great reluctance to admit that taxpayer funds will be required. It may be politically convenient to avoid the appearance that public funds will have to be tapped. But this will be costly because it will delay recognition of the problem and, as the thrift crisis taught us, allow the problem to worsen further, increasing future and final costs. One cannot help but remember the reluctance, as late as 1987, to admit that thrift industry

resources could not possibly handle the deficit in the FSLIC fund, even though the size of the hole in that fund was several times the industry's book capital. I am not suggesting that the shortfall today in the FDIC-BIF is as large. But it is becoming increasingly clear that, under some circumstances, the FDIC-BIF deficit could be large enough that increased taxes on banks will be unable to make up the difference. The federal government has always acted as if its full faith and credit stood behind the thrift and bank deposit insurance systems. Now that the banking industry's capacity to shore up the system may be exhausted, it is time for the federal government to meet its responsibilities openly.

Even more troubling is the desire to use the Federal Reserve System to recapitalize the FDIC-BIF. While this would delay direct Congressional appropriations to resolve the FDIC-BIF solvency crisis, it would do no more than maintain the facade of taxpayer noninvolvement. The repercussions of not dealing directly and openly with the funding problem are straightforward. Effective control of the money supply will mean that Federal Reserve lending to the FDIC must be offset by sales of other government securities from its portfolio. Any losses on Federal Reserve lending to the FDIC would mean less income for the System to turn over to the Treasury. This is yet another example of the kinds of policy proposals that come along when something needs to be done in a hurry.

I think that this idea is unsound in another very fundamental way. The Federal Reserve System was set up explicitly to be separate from the Treasury in order to preclude central bank financing of Treasury operations.

Large-scale, long-term loans to government agencies like the FDIC are a clear violation of this important principle, and today's violations are likely to invite further violations in the future. This could put us on the slippery slope of monetizing government outlays through central bank financing rather than through Congressional appropriations.

The primary responsibility of any central bank is to protect the purchasing power of the nation's currency. Even people who want the Federal Reserve to take on the additional task of smoothing out the bumps of the business cycle balk at the prospect of using the central bank as a tool of fiscal finance. The inflation experience of countries in which the central bank has been required to print money to support government outlays has been extremely disappointing. Furthermore, extensive monetizing of government expenditures can result in a breakdown in fiscal discipline, which in turn requires further reliance on the central bank to monetize government debt. This can become a vicious cycle that eventually produces extremely high levels of inflation. Breaching the barrier that separates the monetary function of the central bank from the constitutionally based appropriation process could have dire consequences for the future independence of monetary policy and for the control of inflation.

### Conclusion

The time to enact financial reform outside of a crisis environment has passed us by. Legislation inevitably will have to take a bow in the direction of expediency. But we still must decide what course our financial system

should take. Do we move toward more government involvement in the financial sector, or do we move toward a more market-oriented banking system? To me, the choice is clear. Financial markets will continue to evolve and circumvent governmental attempts at regulation. As financial innovation continues to break down the barriers between banking and commerce, banks will continue to have one hand tied behind their backs by outdated regulations such as the McFadden and Glass-Steagall restrictions. Without reforms to deposit insurance and bank regulation, banks will slowly disappear from the financial landscape as unregulated firms take more and more of their business. With reforms, banks will be able to retain a place in their markets, alongside nonbank firms, and provide value to our economy through the financial system.

For small banks, the message is clear: Continuing along the same path we have traveled means a continuing decline. Both higher deposit insurance assessments and burdensome regulations will further reduce the ability of small banks to meet the competitive challenge posed to them by the large regional and super-regional banks, credit unions, and unregulated nonbank firms like GMAC, General Electric Credit Corporation, AT&T, Sears, and American Express. Only through real reform of our system of bank regulation and federal deposit insurance can the slide be halted.

Finally, the funding needs of the FDIC-BIF should be addressed in a manner that is equitable and produces a sound insurance fund. Unfortunately, the solutions currently being considered appear to be as much concerned with papering over the losses in order to avoid the appearance of a taxpayer bailout as they are with producing a sound, well-capitalized insurance fund.