NOTES ON REMARKS FOR
REGULATORS' PANEL
ARKANSAS BANKERS CONVENTION
HOT SPRINGS, ARKANSAS
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1. Basic issue underlying deposit insurance reform is who disciplines banks: supervisors or depositors?

depositors

A. Moral hazard problems associated with insurance--if owners and managers have little to lose, why not take imprudential risks?

B. Could police by significantly reducing scope of deposit insurance, which Treasury proposal has not done.

C. Or could try to strengthen supervisors' hand in assuring that owners and managers have something at risk, hence the proposals on prompt corrective action.

generic

2. [Description of ~~Treasury's~~ prompt corrective action proposal].

close
bypass zones
other stages

higher zones
reflect
"distrust"
of
regulators

3. One question with respect to this approach is whether supervisory actions should be mandatory or discretionary as a bank falls from one zone to the next.

A. An advantage of mandatory actions is that they create certainty on the part of bankers about the consequences of certain developments; in other words, the supervisor looks at a gauge, and if it reads X, then he takes action Y, the simplicity of which has some appeal.

Cannot write something that contemplates

B. But would the process, in fact, be so simple and straightforward? Depending on how the zones were defined, the supervisor would likely be able to influence the measure which determined the zone; and if a small difference in that measure meant a lower zone with significant negative implications for the bank, there might be a temptation to recalibrate the gauge rather than confront bank management. In other words, it is probably not possible, and perhaps not desirable, to eliminate discretion from the process.

GAO
FIG
Congress Comm.

have tools, if used consistently

4. Another question is which gauge to look at; the Treasury proposal suggests capital, but is this really the right one?

Lagging indicator

A. From the perspective of moral hazard, perhaps it is; that is, if there is adequate capital, owners and managers presumably have an incentive to take only prudent risks.

3% equity for loss

25% lending legal limit

asset quality; bank management; examiners

B. But from the perspective of preventing failures and avoiding losses to the deposit insurance fund, is it really effective?

C. The problem is that there is evidence to support the conclusion that most (?) bank failures arise from risks taken when the banks were well capitalized, not when they become undercapitalized.
[Cite evidence].

D. Accordingly, we might be looking at the wrong gauge, or perhaps not enough gauges.

Transition

risk inherent in assets

5. This leads to the final question, which is should regulators take steps to curtail "excessive" risk-taking in adequately capitalized banks?

A. The answer is probably "yes," but would we want them to?

B. Personally, I would be against it, because I am not at all sure they can, in the long run, make better decisions than most bank managements.

capability

philosophically

C. Secondly, this sort of action could lead to credit allocation, which in my opinion should be done through market forces, not by supervisors; markets may overshoot from time to time, but they're better than the alternative.

6. Which brings me full circle; if we want a strong banking system, we should rely more on market (depositor) discipline and less on supervision. Perhaps we're not prepared to make significant steps in this direction just now, but I hope we don't lose sight of the possibility down the road in the next round of deposit insurance reform.

too big to fail
[illegible]

distinguish
supervision
failure
cost
loss to fund