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Testimony by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing & Urban Affairs

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I am pleased to appear before this Committee to discuss reform of the deposit insurance system and expanded activities for banking organizations. Like each of you, my colleagues and I have spent considerable time discussing and debating the issues. We are reminded almost daily of the potential for public cost of the deposit insurance obligation, made so painfully apparent by the failures and difficulties of so many thrift institutions. Similarly, both the Congress and the Board repeatedly are reminded of the erosion of the competitiveness of our banking system both domestically and internationally. The time has come when these issues must be addressed.

The hearings you are conducting, Mr. Chairman, will establish a record preliminary to the publication early next year of the FIRREA-mandated Treasury study of the issues. The Board is participating in this study and has conveyed to the Treasury the views expressed in this statement. By holding hearings at this early date, I hope that the Congress will be able to focus on the needed legislation immediately after the release of the Treasury study. Basic reforms are required both of the safety net and of the range of activities permitted banking organizations.

The fundamental problems with deposit insurance that must be addressed are clearly understood and are, I believe, subject to little debate among those with drastically different prescriptions for reform. The safety net -- deposit insurance, as well as the discount window -- has so lowered the risks perceived by depositors as to make them relatively indifferent to the soundness of the depository recipients of

their funds, except in unusual circumstances. With depositors exercising insufficient discipline through the cost of deposits, the incentive of some banks' owners to control risk-taking has been dulled. Profits associated with risk-taking accrue to owners, while losses in excess of bank capital that would otherwise fall on depositors are absorbed by the FDIC.

Weak depositor discipline and this moral hazard of deposit insurance have two important implications. First, the implicit deposit insurance subsidy has encouraged banks to enhance their profitability by increasing their reliance on deposits rather than capital to fund their assets. In effect, the deposit insurance funds have been increasingly substituted for private capital as the cushion between the asset portfolios of insured institutions and their liabilities to depositors. A hundred years ago, the average equity-capital-to-asset ratio of U.S. banks was almost 25 percent, approximately four times the current level. Much of the decline over the past century no doubt reflects the growing efficiency of our financial system. But it is difficult to believe that many of the banks operating over recent decades would have been able to expand their assets so much, with so little additional investment by their owners, were it not for the depositors' perception that, despite the relatively small capital buffer, their risks were minimal. Regulatory efforts over the last 10 to 15 years have stabilized and partially reversed the sharp decline in bank equity capital-asset ratios. This has occurred despite the sizable write-off of loans and the substantial build-up in loan-loss reserves in the last three years or so. But the capital ratios of many banks are still too low.

Second, government assurances of the liquidity and availability of deposits have enabled some banks with declining capital ratios to fund a riskier asset portfolio at a lower cost and on a much larger scale, with governmental regulations and supervision, rather than market processes, the major constraint on risk-taking. As a result, more resources have been allocated to finance risky projects than would have been dictated by economic efficiency.

In brief, the subsidy implicit in our current deposit insurance system has stimulated the growth of banks and thrifts. In the process the safety net has distorted market signals to depositors and bankers about the economics of the underlying transactions. This has led depositors to be less cautious in choosing among institutions and has induced some owners and their managers to take excessive risk. In turn, the expanded lending to risky ventures has required increased effort and resources by supervisors and regulators to monitor and modify behavior.

But in reviewing the list of deficiencies of the deposit insurance system, we should not lose sight of the contribution that both deposit insurance and the discount window have made to macroeconomic stability. The existence and use of the safety net have shielded the broader financial system and the real economy from instabilities in banking markets. More specifically, it has protected the economy from the risk of deposit runs, especially the risk of such runs spreading from bank to bank, disrupting credit and payment flows and the level of trade and commerce. Confidence in the stability of the banking and payments system has been the major reason why the United States has not

suffered a financial panic or systemic bank run in the last half century

There are thus important reasons to take care as we modify our deposit insurance system. Reform is required. So is caution. The ideal is an institutional framework that, to the extent possible, induces banks both to hold more capital and to be managed as if there were no safety net, while at the same time shielding unsophisticated depositors and minimizing disruptions to credit and payment flows.

If we were starting from scratch, the Board believes it would be difficult to make the case that deposit insurance coverage should be as high as its current \$100,000 level. However, whatever the merits of the 1980 increase in the deposit insurance level from \$40,000 to \$100,000, it is clear that the higher level of depositor protection has been in place long enough to be fully capitalized in the market value of depository institutions. The associated scale and cost of funding have been incorporated into a wide variety of bank and thrift decisions, including portfolio choices, staffing, branch structure, and marketing strategy. Consequently, a return to lower deposit insurance coverage -- like any tightening of the safety net -- would reduce insured depository market values and involve significant transition costs. It is one thing initially to offer and then maintain a smaller degree of insurance coverage, and quite another to reimpose on the existing system a lower level of insurance, with its associated readjustment and unwinding costs. This is why the granting of subsidies by the Congress should be considered so carefully: they not only distort the allocation of resources, but also are extremely difficult to eliminate, imposing

substantial transition costs on the direct and indirect beneficiaries. For such reasons, the Board has concluded that, should the Congress decide to lower deposit insurance limits, a meaningful transition period would be needed.

A decision by Congress to leave the \$100,000 limit unchanged, however, should not preclude other reforms that would reduce current inequities in, and abuses of, the deposit insurance system. Serious study should be devoted to the cost and effectiveness of policing the \$100,000 limit so that multiple accounts are not used to obtain more protection for individual depositors than Congress intends. The same study could consider the desirability of limiting pass-through deposit insurance -- under which up to \$100,000 insurance protection is now explicitly extended to each of the multiple beneficiaries of some large otherwise uninsured deposits. Both have been used at times to thwart or abuse the purpose of deposit insurance protection.

No matter what the Congress decides on deposit insurance limits, we must be cautious of our treatment of uninsured depositors. Such depositors should be expected to assess the quality of their bank deposits just as they are expected to evaluate any other financial asset they purchase. Earlier I noted that our goal should be for banks to operate as much as possible as if there were no safety net. In fact, runs of uninsured deposits from banks under stress have become commonplace.

So far, the pressure transmitted from such episodes to other banks whose strength may be in doubt has been minimal. Nevertheless, the clear response pattern of uninsured depositors to protect themselves

by withdrawing their deposits from a bank under pressure raises the very real risk that in a stressful environment the flight to quality could precipitate wider financial market and payments distortions. These systemic effects could easily feed back to the real economy, no matter how open the discount window and how expansive open market operations. Thus, while deposits in excess of insurance limits should not be protected by the safety net at any bank, reforms designed to rely mainly on increased market discipline by uninsured depositors raise serious stability concerns. Public policy, therefore, should rely on other means as the primary mechanism to induce prudent bank policies.

A promising approach that seeks to simulate market discipline with minimal stability implications is the application of risk-based deposit insurance premiums. The idea is to make the price of insurance a function of the bank's risk, reducing the subsidy to risk-taking and spreading the cost of insurance more fairly across depository institutions. In principle, this approach has many attractive characteristics, and could be designed to augment risk-based capital. For example, banks with high risk-based capital ratios might be charged lower insurance premiums. But the range of premiums necessary to induce genuine behavioral changes in portfolio management might well be many multiples of the existing premium, thereby raising practical concerns about its application. Risk-based premiums also would have to be designed with some degree of complexity if they are to be fair and if unintended incentives are to be avoided. In any event, the potential additional benefits on top of an internationally negotiated risk-based capital system, while positive, require further evaluation.

Another approach that has induced increasing interest is the insured narrow bank. Such an institution would invest only in high quality, short-maturity, liquid investments, recovering its costs for checking accounts and wire transfers from user fees. The narrow bank would thus require drastic institutional changes, especially for thousands of our smaller banks and for virtually all households using checking accounts. Movement from the present structure for delivery of many bank services would be difficult and costly, placing U.S. banks at a disadvantage internationally. In addition, this approach might shift and possibly focus systemic risk on larger banks. Banking organizations would have to locate their business and household credit operations in nonbank affiliates funded by uninsured deposits and borrowings raised in money and capital markets. Only larger organizations could fund in this way and these units, unless financed longer term than banks today, would be subject to the same risks of creditor runs that face uninsured banks, with all of the associated systemic implications. If this were the case, we might end up with the same set of challenges we face today, refocused on a different set of institutions. We at the Board believe that while the notion of a narrow bank to insulate the insurance fund is intriguing, in our judgment further study of these systemic and operational implications is required.

If, in fact, proposals that rely on uninsured depositor discipline, risk-based premiums, and structural changes in the delivery of bank services raise significant difficulties, reform should then look to other ways to curb banks' risk appetites, and to limit the likelihood that the deposit insurance fund, and possibly the taxpayer, will be

called on to protect depositors. The Board believes that the most promising approach is to reform both bank capital and supervisory policies. Both would be designed to reduce the value of the insurance subsidy. Neither would rule out either concurrent or subsequent additions to deposit insurance reform, such as the changes discussed previously, other proposals, such as increased reliance on subordinated debt, or new approaches that may emerge in the years ahead. In fact, higher capital, by reducing the need for, and thereby the value of, deposit insurance would make subsequent reform easier. There would be less at stake for the participants in the system.

At the end of this year, the phase-in to the International Capital Standards under the Basle Accord will begin. This risk-based capital approach provides a framework for incorporating portfolio and off-balance sheet risk into capital calculations. Most U.S. banks have already made the adjustment required for the fully phased-in 1992 standard. However, the prospective increasingly competitive environment suggests that the minimum level of capital called for by the 1992 requirements may not be adequate, especially for institutions that want to take on additional activities. As a result of the safety net, too many banking organizations, in our judgment, have travelled too far down the road of operating with modest capital levels. It may well be necessary to retrace our steps and begin purposefully to move to capital requirements that would, over time, be more consistent with what the market would require if the safety net were more modest. The argument for more capital is strengthened by the necessity to provide banking organizations with a wider range of service options in an increasingly

competitive world. Indeed, projections of the competitive pressures only intensify the view that if our financial institutions are to be among the strongest in the world, let alone avoid an extension of the taxpayers' obligation to even more institutions, we must increase capital requirements. Our international agreements under the Basle Accord permit us to do so.

There are three objectives of a higher capital requirement. First, higher capital would strengthen the incentives of bank owners and managers to evaluate more prudently the risks and benefits of portfolio choices because more of their money would be at risk. In effect, the moral hazard risk of deposit insurance would be reduced. Second, higher capital levels would create a larger buffer between the mistakes of bank owners and managers and the need to draw on the deposit insurance fund. For too many institutions, that buffer has been too low in recent years. The key to creating incentives to behave as the market would dictate, and at the same time creating these buffers or shock absorbers, is to require that those who would profit from an institution's success have the appropriate amount of their own capital at risk. Third, requiring higher capital imposes on bank managers an additional market test. They must convince investors that the expected returns justify the commitment of risk capital. Those banks unable to do so would not be able to expand.

We are in the process in the Federal Reserve System of developing more specific capital proposals, including appropriate transition arrangements designed to minimize disruptions. However, at the outset I would like to anticipate several criticisms. For many

banks, raising significant new capital will be neither easy nor cheap. Maintaining return on equity will be more difficult, and those foreign banks that only adhere to the Basle minimums may be put in a somewhat better competitive position relative to some U S banks. Higher capital requirements also will tend to accelerate the move toward bank consolidation and slow bank asset growth. However, these concerns must be balanced against the increasing need for reform now, the difficulties with all the other options, and both the desire of, and necessity for, banking organizations to broaden their scope of activities in order to operate successfully.

More generally, many of the arguments about the competitive disadvantages of higher capital requirements are short-sighted. Well-capitalized banks are the ones best positioned to be successful in the establishment of long-term relationships, to be the most attractive counterparties for a large number of financial transactions and guarantees, and to expand their business activities to meet new opportunities and changing circumstances. Indeed, many successful U S. and foreign institutions would today meet substantially increased risk-based capital standards. In addition, the evidence of recent years suggests that U S banks can raise sizable equity. The dollar volume of new stock issues by banking organizations has grown at a greater rate since the late 1970s than the total dollar volume of new issues by all domestic corporate firms.

Higher capital standards should go a long way toward inducing market-like behavior by banks. However, the Board believes that, so long as a significant safety net exists, additional inducements will be

needed through an intensification of supervisory efforts to deter banks from maintaining return on equity by acquiring riskier assets. Where it is not already the practice, full in-bank supervisory reviews -- focusing on asset portfolios and off-balance sheet commitments -- should occur at least annually, and the results of such examinations should promptly be shared with the board of directors of the bank and used to evaluate the adequacy of the bank's capital. The examiner should be convinced after a rigorous and deliberate review that the loan-loss reserves are consistent with the quality of the portfolio. If they are not, the examiner should insist that additional reserves be created with an associated reduction in the earnings or equity capital of the bank. If the resultant capital is not consistent with minimum capital standards, the board of directors and the bank's regulators should begin the process of requiring the bank either to reduce those assets or to rebuild equity capital.

If credible capital raising commitments are not forthcoming, and if those commitments are not promptly met, the authorities should explore such responses as lowered dividends, slower asset growth or perhaps even asset contraction, restrictions on the use of insured brokered deposits, if any, and divestiture of affiliates with the resources used to recapitalize the bank. What is important is that the supervisory responses occur promptly and firmly and that they be anticipated by the bank. This progressive discipline or prompt corrective action of a bank with inadequate capital builds on our current bank supervisory procedures and is designed to simulate market pressures from risk-taking -- to link more closely excessive risk-taking

with its costs -- without creating market disruptions. Some flexibility is certainly required, but the Board has in mind a set of credible responses in principle and a presumption that these responses will be applied in the absence of compelling reasons not to do so.

Such an approach -- higher capital and prompt corrective action -- would increase the cost and reduce the availability of credit from insured institutions to riskier borrowers. In effect, our proposal would reduce the incentive some banks currently have to overinvest in risky credits at loan rates that do not fully reflect the risks involved. This implies that the organizers of speculative and riskier ventures will have to restructure their borrowing plans, including possibly paying more for their credit, or seek financing from noninsured entities. Some borrowers may find their proposals no longer viable. However, it is just such financing by some insured institutions that has caused so many of the current difficulties, and it is one of the objectives of our proposals to cause depositories to reconsider the economics of such credits. As insured institutions reevaluate the risk-return tradeoff, they are likely to be more interested in credit extensions to less risky borrowers, increasing the economic efficiency of our resource allocation.

Despite their tendency to raise the average level of bank asset quality, higher capital requirements and prompt corrective action will not eliminate bank failures. An insurance fund will still be needed, but we believe that, with a fund of reasonable size, the risk to taxpayers should be reduced substantially. As I have noted, higher capital requirements and prompt corrective action imply greater caution

in bank asset choices and a higher cushion to the FDIC to absorb bank losses. In addition, an enhanced supervisory approach will not permit deteriorating positions to accumulate. Moreover, the Board believes that forced mergers, divestitures, and, when necessary, conservatorships should occur while there is still positive (albeit low) capital in the bank to limit reorganization or liquidation costs. Existing stockholders should be given adequate time to correct deteriorating positions -- including providing new capital -- but Congress should specifically provide the bank regulators with the clear authority, and, therefore, explicit support, to act well before technical insolvency to minimize the ultimate resolution costs.

These reforms should be equally applicable to banks of all sizes. No observer is comfortable with the inequities and adverse incentives of an explicit or implicit program that penalizes depositors, creditors, and owners of smaller banks more than those of larger ones. The Board believes no bank should assume that its scale insulates it from market discipline. Nevertheless, it is clear that there may be some banks at some particular times whose collapse and liquidation would be excessively disruptive to the financial system. But no bank is ever too large or too small to escape the application of the same prompt corrective action standards applied to other banks. Any bank can be required to rebuild its capital to adequate levels and, if it does not, be required to contract its assets, divest affiliates, cut its dividends, change its management, sell or close offices, and the resultant smaller entity can be merged or sold to another institution.

with the resources to recapitalize it. If this is not possible, the entity can be placed in conservatorship and liquidated.

I noted earlier that one response of some banks to the more intense competitive environment has been to draw down their capital buffer. These and other institutions cannot rebuild, strengthen, and maintain the appropriate level of capital unless they are able to adapt to the changing competitive and technological environment. The ability to adapt is crucially dependent on broadening the permissible range of activities for banking organizations. At the same time, we should be sensitive to the implications of the potential extension of the safety net -- directly or indirectly -- under those markets that banking organizations are authorized to enter.

The Board has for some time held the view that strong insulating firewalls would both protect banks (and taxpayers) from the risk of new activities and limit the extension of the safety net subsidy that would place independent competitors at a disadvantage. However, recent events, including the rapid spread of market pressures to separately regulated and well capitalized units of Drexel when their holding company was unable to meet its maturing commercial paper obligations, have raised serious questions about the ability of firewalls to insulate one unit of a holding company from funding problems of another. Partially as a result, the Board is in the process of reevaluating both the efficacy and desirability of substantial firewalls between a bank and some of its affiliates. It is clear that high and thick firewalls reduce synergies and raise costs for financial institutions, a significant problem in increasingly competitive

financial markets. If they raise costs and may not be effective, we must question why we are imposing these kinds of firewalls at all. Moreover, higher capital standards and prompt corrective action go a long way to limit the transference of the bank safety net subsidies to bank affiliates that firewalls are designed to constrain. And, as such, they should greatly limit the risk of distorted market signals and excessive risk-taking over an expanded range of markets, as well as the unfair competition, that might otherwise accompany wider bank activities.

Indeed, authorization to use their expertise over a wider range of markets might well be limited only to those banking organizations that meet a new higher capital standard. Consequently, Congress might wish to authorize bank supervisors to grant certain of these activities only to those entities that exceed such a standard. Those institutions that consistently exceed the capital standard perhaps could receive more flexibility in supervisory treatment. For example, a notice requirement could be substituted for formal applications for activities permitted by law and regulation, provided that such acquisitions leave a banking organization's capital in excess of the higher standards. Other reductions in regulatory burden for highly capitalized banking organizations might also be appropriate. Such organizations would, however, still be subject to the same thorough annual examinations.

As you know, the Board has long supported repeal of the provisions of the Glass-Steagall Act that separate commercial and investment banking. We still strongly advocate such repeal because we believe that technology and globalization have continued to blur the

distinctions among credit markets, and have eroded the franchise value of the classic bank intermediation process. Outdated constraints will only endanger the profitability of banking organizations and their contribution to the American economy. Beyond investment banking, the Board believes that highly capitalized banking firms should be authorized to engage in a wider range of financial activities as a part of the modernization of our financial structure and the maintenance of strong, profitable financial institutions that can compete in world markets. A banking system that cannot adapt to the changing competitive and technological environment will no longer be able to attract and maintain the higher capital level that some of our institutions need to operate without excessive reliance on the safety net.

Firms primarily engaged in the financial activities authorized to banking organizations should likewise be permitted to operate an insured bank. Congress, of course, will have to give careful consideration to how to handle the activities some of these entities are already engaged in that would not be permitted to banking organizations. More generally, as we expand the range of activities available to banking organizations, competitive equity suggests the desirability of functional regulation. Under such an approach, each area of activity should be subject to the same regulatory constraints as equivalent or very similar functions at nonbank firms. But independent of regulatory or organizational structure, all of us should understand that the market, the stockholders, and management will think of the bank and any associated units -- affiliates or subsidiaries -- not as a confederation of businesses, but as an integrated organization. Recognition of this

reality suggests that it is perhaps inefficient, at best, and under conditions of financial distress, ineffective, to try to make integrated businesses behave as if they were a collection of independent firms

As a result, it may be more realistic, as I suggested earlier, to apply more limited firewalls to the new activities. I have in mind here restrictions such as sections 23A and B of the Federal Reserve Act, which already limit the financial transactions between a bank and its affiliates, requiring collateral, arms-length transactions, and -- except when Treasury securities are used as collateral -- quantitative limits based on the bank's capital. Moreover, recognition of the integrated nature of the operations of the insured unit with the rest of the organization raises the question of the implications of a piecemeal regulatory structure, with no means for ensuring that the activities of the organization as a whole do not impose undue risk on either the financial system or the safety net. We believe that some agency should be responsible for oversight of the entire organization, especially if expanded activities and less rigorous firewalls are adopted.

As the Congress considers modernization of our banking structure to meet the needs of the 21st century, it should not only widen the permissible activities of well-capitalized banking organizations, but also eliminate outdated statutes that only increase costs. The McFadden Act forces state member and national banks to deliver interstate services only through separately capitalized bank holding company subsidiaries (where permitted by state law) rather than through branches. Such a system reduces the ability of many smaller banks to diversify geographically and raises costs for all banking

organizations that operate in more than one state, a curious requirement as we search for ways to make banks more competitive and profitable. The McFadden Act ought to be amended to permit interstate branching by banks.

In summary, events have made it clear that we ought not to permit banks, because of their access to the safety net, to take excessive risk with inadequate capital. Even if we were to ignore the potential taxpayer costs, we ought not to permit a system that is so inconsistent with efficient market behavior. In the process of reform, however, we should be certain we consider carefully the implications for macroeconomic stability. The Board believes that higher capital and prompt corrective action by supervisors to resolve problems will go a long way to eliminate excessive risk-taking by insured institutions, and would not preclude additional deposit insurance reform, now or later. Moreover, we believe that with such an approach the Congress should feel comfortable with authorizing banking organizations to expand the scope of their financial activities. Indeed, we believe that permitting wider activities is necessary to ensure that such organizations can remain competitive both here and abroad. Increased activities are also required to sustain the profitability needed if banking firms are to attract capital. To limit the risks of safety net transference, some new activities might be made available by banking regulators only to banks with impressive capital positions. We believe that whatever the regulatory form and structure under which new activities are permitted, one agency should have oversight responsibility for the banking organization as a whole. It is also our view that, with these suggested

reforms, reliance on stringent firewalls would not be necessary. And the McFadden Act should be amended in order to permit banks to deliver their services at the lowest possible costs and to more easily diversify their geographic risks. The Board has shared its views with the Treasury as part of our continuing consultations on these matters, especially in the context of their FIRREA-mandated study.

Finally, in considering all proposals, we should remind ourselves that our objective is a strong and stable financial system that can deliver the best services at the lowest cost and compete around the world without taxpayer support. This requires the modernization of our financial system and the weaning of some institutions from the unintended benefits that accompany the safety net. Higher capital requirements may well mean a relatively leaner and more efficient banking system, and they will certainly mean one with reduced inclinations toward risk. However, the Board believes our proposed reforms -- including the authorization of wider activities by banking organizations -- will go a long way toward ensuring a safer and more efficient financial system and lay the groundwork for other modifications in the safety net in the years ahead.