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Testimony by

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before the

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

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I am pleased to appear before this Committee to discuss deposit insurance reform. Your letter of invitation contained a list of important issues and questions which I will try to address Our recent experience with thrift institutions underlines the pressing need for deposit insurance reform Indeed, the Congress recognized that last year's landmark FIRREA was only a first step when it mandated a Treasury study of deposit insurance issues This study, in which the Federal Reserve is an active participant, will be published late this year or early next By holding hearings considerably before that research is complete, I hope that the Congress will be able to focus on the needed legislation immediately after the release of the Treasury study

Your letter of invitation suggested that the topic of these hearings would be solely deposit insurance reform While this subject is complex, the Board believes the issue is intimately related to the need for legislation to also modernize our banking system in other ways The Congress and the Board repeatedly are reminded of the erosion of the competitiveness of our banking system both domestically and internationally The Board believes that addressing this problem should be joined with deposit insurance reform, and my statement will intertwine both topics

The fundamental problems with our current deposit insurance program 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 risk premium they demand on the interest rate they receive on their 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 riskier asset portfolios 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, and incorporated into the financial decisions of millions of households 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

Another relevant factor that should be considered in evaluating the $100,000 insurance limit is the distribution of deposit holders by size of account. Unfortunately, data to analyze this issue by individual account holder do not exist However, we have been able to use data collected on an individual household basis in our 1983 Survey of Consumer Finances to estimate the distribution of account holders While these data are seven years old, they are the best available until results from our 1989 Survey of Consumer Finances become available this fall I have attached as an appendix to this statement summary tables and descriptive text of the 1983 survey results. Briefly, the survey suggests that between 1 0 and 1 5 percent of U S households held, in 1983, deposit balances in excess of $100,000. The demographic characteristics of these account holders suggest that they are mainly older, retired citizens with most of their financial assets in insured accounts These characteristics of heads of households owning deposits are remarkably stable as the size of deposits declines to $50,000

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, often thwarting its purpose 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 We at the Federal Reserve believe that it is administratively feasible--but not costless--to establish controls on the number and dollar value of insured accounts per individual at one depository institution, at all institutions in the same holding company, and perhaps even across depositories of different ownership But we are concerned about the cost and administrative complexity of such schemes, and would urge the careful weighing of benefits and costs before adopting any specific plan

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. Brokered accounts of less than $100,000 also have been used to abuse deposit insurance protection, particularly by undercapitalized institutions However, we must be careful to remember that the use of brokered deposits by healthy firms can be the economy's most efficient way of allocating funds to their most productive use The study should keep in mind these considerations, as well as the power Congress has already provided the agencies to constrain misuse of brokered accounts

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

An example of one such approach is depositor co-insurance or a deductible under which a depositor at a failed institution receives most, but not all, of his or her deposit in excess of a reduced (or the current) insurance limit This option has some attractions, coupling depositor market discipline with relatively modest possible losses to depositors. The Board believes, however, that an explicit policy that requires imposition of uninsured depositor loss--no matter how small--is likely to increase the risk of depositor runs and to exacerbate the depositor response to rumors

Another option to rely more on private-market incentives is the use of private deposit insurance as a supplement or replacement for FDIC insurance. This would require, of course, that all relevant supervisory information--much of which is now held confidential--be shared with private insurers who would be obligated to use that information only to

evaluate the risk of depositor insurance and not for the purposes of adjusting any of their own portfolio options. In addition, it is clearly unreasonable to impose on private insurers any macro-stability responsibilities in their commercial underwriting of deposit insurance Private insurers' withdrawal of coverage in a weakening economy, or their unwillingness to forebear in such circumstances would be understandable but counterproductive Private insurers' inability to meet their obligations after an underwriting error would be disruptive at best and involve taxpayer responsibility at worst. Private insurance and public responsibility unfortunately are not always compatible. We have similar concerns with mutual assurance among groups of banks who would seek to evaluate each other's risk exposure and discipline overly risky entities by expulsion from their mutual guarantee syndicate In addition, a system of mutual guarantees by banks could raise serious anti-competitive issues

There has also been support for the increased use of subordinated debentures in the capital structure of banking organizations. Intriguing attractions of this option are the thoughts that non-runable, but serially maturing, debt would provide both enhanced market discipline and a periodic market evaluation of the bank The Board continues to support the use of subordinated debt for these reasons, as well as the fact that it provides supplementary capital to act as an additional buffer to the FDIC over and above that provided by the owners' equity capital But, in our view, subordinated debentures can only be supporting players and not be awarded the central role in reform This is a limited source of capital and one that may prove difficult and expensive to obtain when advertised as having constrained returns whose holders are expected to

absorb losses for the FDIC Adding features to make it more attractive adds complications which perhaps are best met directly by additional pure equity and other reforms

A promising approach that seeks to simulate market discipline with minimal stability implications is the application of risk-based deposit insurance premiums by the FDIC 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, even with the likely higher capital ratio imposed on them by the market, 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, private insurance, subordinated debentures, 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 This would build upon the groundwork laid in FIRREA, in which Congress recognized as key components of a sound banking system the essentiality of strong capital plus effective supervisory controls 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, 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 standard that will be effective at the end of 1992 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

This method of adjusting and measuring capital by reliance on examiner loan evaluations does not depend on market value accounting to adjust the quality of the assets Some day, perhaps, we may be able to apply generally accepted market value accounting precepts to both the assets and liabilities of a financial going concern with a wide spectrum of financial assets and liabilities But the Board is not comfortable with the process as it has developed so far, either regarding market value accounting's ability accurately to reflect market values over reasonable periods or to avoid being overly sensitive to short-run events. For most banks, loans are the predominant asset, an asset that the examiners should evaluate in each of the proposed annual in-bank supervisory reviews We at the Federal Reserve believe that the examiners' classification of loan quality should, as I noted, be fully reflected in the banks' loan loss reserves by a diversion of earnings or a reduction in capital. 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 pursue 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 It is also intended to help preserve the franchise value of a going concern by acting early and quickly to restore a depository to financial health In this way, the precipitous drop in value that normally occurs when a firm is placed in conservatorship or receivership would, for the large majority of cases, be avoided

While some flexibility is certainly required in this approach, the Board believes there must be a prescribed set of responses and a presumption that these responses will be applied unless the regulator determines that the circumstances do not warrant them. Even though prompt corrective action implies some limit on the discretion of supervisors to delay for reasons that they perceive to be in the public interest, the Board is of the opinion that it would be a mistake to eliminate completely the discretion of the regulator

Accordingly, the Board believes that a system that combined a statutorily prescribed course of action with an allowance for regulatory flexibility would result in meaningful prompt resolution For example, if a depository institution failed to meet minimum capital requirements established by its primary regulatory agency, the agency might be required

by statute to take certain remedial action, unless it determined on the basis of particular circumstances that such action was not required The presumption would thus be shifted toward supervisory action, and delay would require an affirmative act by the regulatory agency

The prescribed remedial action required in a given case would be dependent upon the adequacy of the institution's capital As the capital fell below established levels, the supervisor could be required, for example, to order the institution to formulate a capital plan, limit its growth, limit or eliminate dividends, or divest certain nonbank affiliates In the event of seriously depleted capital, the supervisor could require a merger, sale, conservatorship or liquidation

In adopting such a statutory framework, Congress should consider designing the system so that forced mergers, divestitures and, when necessary, conservatorships could be required while there is still positive equity capital in the depository institution While existing stockholders should be given a reasonable period of time to correct deteriorating capital positions, Congress should specifically provide the bank regulators with the clear authority, and therefore explicit support, to act well before technical insolvency in order to minimize the ultimate resolution costs The presence of positive equity capital, even if at low levels, when combined with any tier 2 capital, would limit reorganization and liquidation costs

In the Board's view, most of the remedial actions discussed above can be taken, and have been taken, by bank regulators under the current legal framework Under current law, however, the actions to be taken are discretionary and dependent upon a showing of unsafe or unsound conditions

or a violation of law, and implementation of a supervisory remedial action can be extended over a protracted period of time where the depository institution contests the regulator's determination In cases where an institution's capital is deteriorating, the progressive discipline framework described above would establish a systematic program of progressive action based on the capital of the institution, instead of requiring the regulator to determine on a case-by-case basis, as a precondition to remedial action, that an unsafe or unsound practice exists. This program would introduce a greater level of consistency of treatment into the supervisory process, place investors and managers on notice regarding the expected supervisory response to falling capital levels, and reduce the likelihood of protracted administrative actions challenging the regulator's actions

The Board is in the process of developing the parameters, processes and procedures for prompt corrective action One of the principles guiding our efforts is the need to balance rules with discretion. In addition, as is the case for higher capital standards, the Board is mindful of the need for an appropriate transition period before fully implementing such a change in supervisory policy.

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.

But until these procedures have been adopted and the banking system has adjusted to them, circumstances could put the existing insurance fund under severe pressure As Chairman Seidman has indicated, the fund is already operating under stress, as its reserves have declined in recent years and now stand, as a percentage of insured deposits, at their lowest level in history At the same time, there remain all too many problems in the banking system, problems that have been growing of late as many banks, including many larger banks, have been experiencing a deterioration in the quality of their loan portfolios, particularly real

estate loans It thus seems clear that the insurance fund likely will remain under stress for some time to come Moreover, pressures would intensify if real estate market conditions were to weaken further or a recession were to develop in the general economy.

It should, however, be clearly underlined that the size or adequacy of the insurance fund does not change the quality of the deposit insurance guarantee made by the federal government, it does allocate the cost of meeting any guarantee between the banking industry, that pays the insurance premiums, and the taxpayers as a whole It should, in our view, be the policy of the government to minimize the risk to taxpayers of the deposit insurance guarantee, and we believe that our proposal does that While some increase in insurance premiums is in all likelihood necessary, we must be concerned that attempts to accomplish this end by substantially higher insurance premiums may well end up--especially if accompanied by higher capital requirements--simply making deposits so unattractive that banks are unable to compete. Avoiding taxpayer costs and maintaining a competitive banking system are just two more reasons why basic deposit insurance reform is so urgent.

Among the deposit insurance reforms that might be considered on the basis of both strengthening the insurance fund and fairness to smaller and regional banks is the assessment of insurance premiums on the foreign branch deposits of U S banks A substantial proportion of the deposits of the largest U.S. banks are booked at branches outside the United States, including offshore centers in the Caribbean Assessing such deposits could yield significant revenue for the FDIC

However, assessing deposit insurance premiums on foreign deposits would involve some costs Such deposits may be quite sensitive to a small decline in their yields Thus imposing premiums could lead to deposit withdrawals and funding problems at some U.S. banking organizations, and possibly inhibit the ability of these organizations to raise capital

Even if no adjustment is made in the insurance assessment on foreign deposits, held almost solely by large banks, other deposit insurance 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, nor should any depositor with deposits in excess of the insurance limit at the largest of U.S banks assume that he or she faces no loss should their bank fail

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 it is only under the very special conditions, which should be relatively rare, of significant and unavoidable risk to the financial system that our policies for resolving failed or failing institutions should be relaxed The benefits from the avoidance of a contagious loss of confidence in the financial system accrue to us all But included in the cost of such action is the loss of market discipline that would result if large banks and their customers presume a kind of exemption from loss of their funds The Board's policies of prompt corrective action and higher capital are

designed to minimize these costs Under these policies, the presumption should always be that prompt and predictable supervisory action will be taken For 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 until it is

It is, by the way, the largest U S banks that would be required under our proposals to raise the most additional capital, both absolutely and proportionally Most banks with assets less than $1 billion already meet capital requirements considerably above the fully phased-in Basle Capital Accord minimums In addition, it bears emphasizing that no deposit insurance reform that truly reduces the subsidy existing in the current system will be costless for banks The issue really is one of achieving maximum benefit from reform at minimum cost. We believe that our proposals achieve this goal

It is worth noting that in many foreign countries large banks are considered so important to their economy that it is widely anticipated that authorities in these countries would support these banks during financial crises. In some countries, notably France and Italy, some large banks are owned by the government, another factor which arguably leads market participants to doubt that these banks could fail. Thus the commitment of foreign authorities presumably extends beyond the rather

limited levels explicitly incorporated into their deposit insurance systems, and may potentially create the same types of problems that the United States faces with institutions deemed "too big to fail."

Virtually all of the major industrial countries have instituted a system of explicit deposit insurance The character of these systems, however, varies widely, and most of them are more modest in scope than the U.S system In many cases, especially in Europe, deposit insurance is not a funded system, but rather an agreement among banks intended to make money available to protect the small depositors at failed banks Except in Germany and Italy, the ceiling on insured deposits is substantially lower than in the United States. Membership in the insurance system is also voluntary in several countries Though most banks in these countries join the system, deposit insurance is not viewed as the primary means of support for large banks As Europe 1992 is implemented, and full cross-border banking becomes a European reality, it is quite likely that the European Community will find itself under pressure to make its deposit insurance system more explicit and more uniform.

I noted earlier that one response of some U.S. 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 either a holding company or a bank from funding problems of an affiliate or subsidiary 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 or subsidiaries 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 at the bank go a long way to limit the transference of the bank safety net subsidies to bank affiliates or subsidiaries 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 activities by banking organizations

It may be more realistic 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 Such limitations could also be applied to transactions between a bank and certain bank subsidiaries

Even with these, or tighter firewalls, the potential for problems in one unit of a firm to affect other units 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 the insured entity and hence either the financial system or the safety net We believe that, in order to protect the insured entity, the financial system, and the safety net, some agency should be responsible for oversight of the entire organization

Authorization to use their expertise over a wider range of markets might well be limited only to those organizations where the bank or the holding company meets 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 the bank or other appropriate entity's capital in

excess of the higher standards Other reductions in regulatory burden for highly capitalized banks or 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 banks and their

subsidiaries or affiliates, 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

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 sufficient to protect the bank from excessive risks taken in other parts of its broader organization 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

Appendix

Selected Characteristics of Household Account Holders

This appendix provides supporting material on the distribution of household ownership of insured deposits The most recent reliable disaggregated information available on the size and ownership of accounts comes from the 1983 Survey of Consumer Finances (SCF) This survey consists of interviews with 4,103 U.S. households drawn from two sampling frames a randomized geographic sample to provide good coverage of broadly distributed characteristics, and a special sample of wealthy households constructed from data at the Statistics of Income Division of the IRS to provide better representation of more narrowly-distributed characteristics, such as ownership of corporate stock Survey experts agree that the SCF provides very reliable estimates of the distribution of financial characteristics[1] The standard error due to sampling error for a figure of ten percent estimated from the entire survey population is about one-half percent.

The 1983 SCF was sponsored by the Board of Governors of the Federal Reserve System, the Department of Health and Human Services, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Federal Trade Commission, the Department of Labor, and the Department of the Treasury Data were collected through in-person interviews between February and August of 1983 under a contract with the Survey Research Center at the University of Michigan

For the financial data collected in the survey, the unit of observation lies between the standard Census Bureau definition of a "family" plus "single individuals" and a "household " Generally, the survey excludes information only for individuals who are not related by blood or marriage to the economically dominant core of the household.

Among other items, the survey gathered information on the amount of money held in each of a household's accounts as well as the types of institutions where those accounts were held. There are three important limitations in the survey data First, there is no information on the ownership of deposits within the household Second, there is no information on how many accounts households may have at a given institution. Third, information on IRAs and Keoghs and CDs is more limited than for other deposits For IRAs and Keoghs, the survey gathers only total holdings and the types of institutions where these accounts are held For CDs, totals were gathered by term of

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1 The survey is discussed in detail in an evaluation study "Measuring Wealth with Survey Data An Evaluation of the 1983 Survey of Consumer Finances," by Robert B Avery, Gregory E Elliehausen, and Arthur B Kennickell, *Review of Income and Wealth*, December 1988

the certificate and no institution information was collected[2]

There are a number of different account constructs that can be created for evaluating the distribution of the coverage of household accounts by deposit insurance. Two cases are considered here. In the first case, it is assumed that all accounts held by a given household at a given type of institution are actually accounts owned by the same person and that the accounts are held at the same institution This construct is referred to below as the "synthetic account" definition In the second case, it is assumed that all accounts are either owned by different household members or are held at different financial institutions This measure is referred to below as the "individual account" definition. The former construct will almost surely overstate the amount of uninsured deposits, while the second may understate that number. Because of data limitations noted below, the second construct is not quite a polar case

Synthetic Account Definition

In the synthetic account measure, accounts and institution are synonymous The creation of this account proceeds in several steps. First, all checking, savings, and money market deposit accounts are summed by the type of institution where the account was held[3] Second, IRA and Keogh accounts are allocated equally to each type of institution where the accounts were held[4] Finally, because no information is available on the institutions where CDs were held, it is assumed that they were held at the institution type that otherwise had the largest level of deposits[5]

Table 1 presents information based on this account concept Households are

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2. In the 1989 SCF, from which preliminary information is expected around the end of October, more detailed institutional data were collected. In that survey, it will be possible to identify accounts that are held by households at the same institution. In addition, the institutions where certificates of deposit are held will be known. However, it will still not be possible to disaggregate accounts by different owners within the household.

3 For example, suppose a household had four such accounts, one of $50,000 at a commercial bank, one of $30,000 at a savings and loan, and two accounts of $20,000 (one belonging to the head of the household and the other to his mother) at a credit union. In this case, the household would then have synthetic accounts of $50,000 at a commercial bank, $30,000 at a savings and loan, and $40,000 at a credit union

4 Continuing the example of the previous footnote, suppose the household has a total of $50,000 in IRA and Keogh accounts and that those accounts are held at commercial banks and savings and loans Then $25,000 is attributed to both the commercial bank and the savings and loan synthetic accounts for a total of $75,000 in commercial banks, $55,000 in savings and loans, and $40,000 in credit unions

5 Again, continuing the example, suppose the household has CDs totaling $125,000 ($110,000 in short-term certificates and $15,000 in long-term certificates) Because the largest synthetic account at this stage of aggregation is the commercial bank account, the entire amount of the CDs is added to this account for a total of $200,000

classified in the columns by the largest of their synthetic accounts[6] As shown in rows 1 and 2, only 2 6 percent (2 2 million) households are estimated to have an account of $75,000 or more at an insured institution However, as shown by row 6, this same group is estimated to hold 38 6 percent of all deposits owned by households. Even when compared to the universe of deposits (computed as gross deposits from the June 1983 call reports for the appropriate types of institutions), the same group is estimated to hold 14.5 percent of all deposits (row 7)[7] This group is also estimated to hold 27.7 percent of insured household deposits (row 9)[8] Note that the aggregation of accounts will tend to understate the amount of insured deposits held by these groups

Data in rows 11 to 26 of table 1 provide other characteristics of the classes of account holders The data indicate that households with an account of $75,000 or more tend to have higher income, financial assets, and net wealth than the whole population (shown in the last column) While they hold a substantial part of their financial assets and net wealth in insured depository accounts, as a group they are also much more likely than the general population to have diversified their holdings into corporate stock, a business, or investment real estate The top two groups also tend to be older and more likely to be retired

The groups with their largest accounts between $25,000 and $75,000 are more like the top groups than like the group with accounts under $25,000 and the group with no accounts The principal differences between the $25,000-$75,000 group and the top two groups are the facts that their levels of financial assets and net worth are lower Like the top two groups, they are more likely to be older and retired and to have a diversified portfolio

Individual Account Definition

In the individual account definition, each reported account is treated separately so far as the data allow Each checking, savings, and money market deposit account is counted as a separate account for purposes of deposit insurance coverage[9] As before, IRAs and Keoghs are divided equally by the number of types of institutions

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6 In the example, the household would be included in the column "≥100K" because its largest synthetic account (the commercial banks account) is $200,000

7 The call report is a regular report of balance sheet, income, and other data made by depository institutions to the regulatory agencies

8 "Insured deposits" includes only the part of accounts that is $100,000 or less In the example, the household has total deposits at insured institutions of $295,000 of which $195,000 ($55,000 in savings and loans, $40,000 in credit unions, and the first $100,000 of the $200,000 in commercial banks) would be insured deposits

9 For example, assuming the same household-level data as in the example beginning in footnote 3, the household would have four accounts, one of $50,000 at a commercial bank, one of $30,000 at a savings and loan, and two of $20,000 each at a credit union

where such accounts were held[10] Finally, long-term and short-term CDs are allocated to the type of institution where the household otherwise had its largest account[11] Note that this definition does not constitute the opposite of the synthetic account definition since there is still some aggregation of accounts in the treatment of the IRA and Keogh accounts and the CDs

Table 2 presents estimates using this second definition that are comparable in structure to the estimates reported in table 1 As would be expected, there is an overall shift of households away from the top groups compared to table 1. By the individual account definition, 1 4 percent (1 1 million) of all households have accounts of $75,000 or more (rows 1 and 2) Correspondingly, the estimated amount of insured deposits increases to $865 9 billion (row 8)[12] While there is some shifting of the characteristics reported in the bottom two blocks of the table, the overall picture is very similar to that in table 1

Estimated Household Share of Insured and Uninsured Deposits

Table 3 gives the estimated coverage of deposit insurance for the current and lower hypothetical ceilings on insurance coverage for each of the two account definitions. According to the synthetic account measure (which provides the greatest understatement of the amount of insured deposits), at the current ceiling of $100,000, 84 8 percent of total household accounts are estimated to have been covered in 1983 If the ceiling were dropped to $50,000, it is estimated that 72 3 percent would still have been covered By the individual account measure, the percent of household deposits insured at the current ceiling rises to 91 3 percent

Household accounts represent only a part of insured deposits. As noted in the last column in row 7 of either of the first two tables, roughly 37.6 percent of total deposits was held by households in 1983 According to call report data tabulated in the 1988 *Annual Report* of the FDIC, in 1983 deposits of $1,268 billion out of $1,691 billion (75.0 percent) at commercial banks were insured[13] The proportion of insured deposits was 75.1 percent in 1988. However, this is a limited definition of insured deposits The underlying data contain no information on either multiple accounts at one

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10 Thus, in the example, the household would now have six accounts, including the four described in the last footnote and two additional accounts of $25,000 each

11 In the example, the household would now have eight accounts, the two additional accounts being one of $110,000 and one of $15,000 and both held at commercial banks

12 In the example, the household has $295,000 of deposits at insured institutions as before, of which $285,000 would be insured (the sum of the initial $50,000 account at a commercial bank, $30,000 at a savings and loan, two accounts of $20,000 at a credit union, two accounts of $25,000 each at a commercial bank and a savings and loan, one CD of $15,000 at a commercial bank, and the first $100,000 of the $110,000 CD at a commercial bank)

13 The total of insured deposits is the sum of all accounts of $100,000 and under and $100,000 for each account of more than $100,000

institution or pass-through accounts, and thus, on net may overstate the amount of insured deposits Using the closest possible survey definition, the individual account definition of table 2, the data suggest that $63 6 billion (not shown in the tables), or 15 0 percent of the FDIC's estimate of uninsured deposits at commercial banks, may belong to households.[14] However, this estimate is rather rough The figure may tend to overstate the true amount of uninsured household deposits by the limited FDIC definition because of the aggregation of IRAs and Keoghs and CDs, but may also tend to understate the true figure because of underreporting in the survey

14 Call report data are not available for the calculation of the household share of potentially uninsured deposits for hypothetical lower insurance ceilings

Table 1
Selected Characteristics of Household Account Holders
By Size of Largest Synthetic Account at an Insured Institution
1983 Survey of Consumer Finances

	Item	Size of largest synthetic account at an insured institution						
		No account	$1-25K	$25K-50K	$50K-75K	$75K-100K	≥$100K	All h'holds
1	Num. of h'holds in grp ($ mil.)	10.3	65 1	4 4	1.9	0 9	1.3	83.9
2	% of all h'holds in group	12 3	77 6	5 2	2 3	1.1	1.5	100 0
3	# of acc'ts held by group (mil.)	0 0	90 8	6 7	2 9	1 4	2.0	103.8
4	Amount of deposits held by group ($ bil.)	0.0	298.9	165 1	118 2	81 0	285 6	948 8
5	Mean account size ($ thou)	0 0	3 3	24 6	40 8	57 9	142 8	9 1
6	% of all household deposits held by group	0 0	31.5	17 4	12 5	8 5	30 1	100 0
7	% of all deposits held by group	0 0	11 9	6 5	4.7	3 2	11 3	37.6
8	Amount of insured deposits held by group ($ bil.)	0 0	298.9	165 1	118.2	81 0	141.6	804.8
9	% of all insured h'hold deposits held by group	0.0	37 1	20.5	14 7	10 1	17.6	100 0
10	Amount of uninsured deposits held by group ($ bil)	0 0	0 0	0 0	0 0	0 0	144 0	144 0
11	Median h'hold income ($ thou)	7.1	21 0	30 0	28 8	32 4	49 0	19 5
12	Median h'hold financial assets ($ thou.)	0 0	2.6	42.6	76 1	100 5	234.0	2 4
13	Median % of h'hold financial assets in insured accounts	0.0	100.0	96.2	88.0	91.9	91 4	99 1
14	Median h'hold net worth ($ thou.)	1.0	34.6	134.7	183 7	193.3	457.1	34.3
15	Median % of h'hold net worth in insured institutions	0.0	6 3	26.3	34 0	47 1	40.3	5 6
16	% of h'holds owning stocks/bonds	1.4	21.0	45.0	57 9	56 3	59.6	21.6
17	% of h'holds owning business	2.2	14 3	29.2	19.1	34.3	36.1	14.2
18	% of h'holds owning real estate other than prin residence	5.6	18 7	34.2	37 1	28 2	42 8	18 8
19	Median age of head of h'hold	42	42	60	65	65	65	44
20	Median years of education of head of h'hold	10	12	12	13	12	15	12
	% of group with head of h'hold in various occupations							
21	Retired	27.3	16 0	33 1	40 5	43 5	47.6	19.6
22	Other not working	28 9	8 8	6 3	10 6	14 3	5.2	11 1
23	Professionals, managers, administrators	5 6	27 6	36 1	26.7	21 0	34 6	25 4
24	Sales, clerical, craftsmen, laborers, military	37 6	46 3	21 6	18 2	20 0	8 0	42 4
25	Farmers	0.6	1 3	2 9	4 0	1 2	4 6	1 5
26	All occupations	100.0	100 0	100 0	100 0	100 0	100 0	100 0

Table 2
Selected Characteristics of Household Account Holders
By Size of Largest Individual Account at an Insured Institution
1983 Survey of Consumer Finances

	Item	Size of largest individual account at an insured institution						
		No account	$1-25K	$25K-50K	$50K-75K	$75K-100K	≥$100K	All h'holds
1	Num of h'holds in grp ($ mil)	10 3	67 4	3.8	1.3	0.3	0.8	83.9
2	% of all h'holds in group	12.3	80 3	4 5	1.5	0 4	1 0	100.0
3	# of acc'ts held by group (mil)	0 0	194.5	17 5	6 3	1 5	4 3	224 1
4	Amount of deposits held by group ($ bil.)	0 0	379 2	197 9	109 8	40 9	221 0	948 8
5	Mean account size ($ thou)	0 0	1 9	11 3	17.4	27 3	51 4	4 2
6	% of all household deposits held by group	0 0	40 0	20 8	11.6	4 3	23 3	100 0
7	% of all deposits held by group	0 0	15 0	7 8	4 4	1 6	8 8	37 6
8	Amount of insured deposits held by group ($ bil)	0 0	379 2	197 9	109 8	40 9	138 1	865 9
9	% of all insured h'hold deposits held by group	0.0	43 8	22 9	12.7	4 7	15 9	100 0
10	Amount of uninsured deposits held by group ($ bil)	0 0	0.0	0 0	0.0	0 0	82 9	82.9
11	Median h'hold income ($ thou)	7.1	21 1	26 8	31 3	38 0	50.4	19 5
12	Median h'hold financial assets ($ thou)	0 0	2 8	62.2	101 3	214 7	251 8	2 4
13	Median % of h'hold financial assets in insured accounts	0 0	100 0	92.6	89 8	65.2	93 8	99 1
14	Median h'hold net worth ($ thou)	1.0	36.5	167.0	198 4	285.3	457.1	34.3
15	Median % of h'hold net worth in insured institutions	0.0	6.6	28.7	44.2	36 6	45 9	5.6
16	% of h'holds owning stocks/bonds	1.4	21 6	54.2	50.7	66.7	60.1	21.6
17	% of h'holds owning business	2 2	14 9	24.4	29.1	34.7	30.4	14.2
18	% of h'holds owning real estate other than prin residence	5 6	19 1	37.1	37.1	31.9	40.0	18 8
19	Median age of head of h'hold	42	43	64	65	65	65	44
20	Median years of education of head of h'hold	10	12	12	12	14	16	12
	% of group with head of h'hold in various occupations							
21	Retired	27.3	16 2	42 9	42 3	35 6	54 4	19 6
22	Other not working	28 9	8.6	10.1	10 8	11 3	3.6	11 1
23	Professionals, managers, administrators	5 6	28 1	27 6	29 8	22.4	32 2	25 4
24	Sales, clerical, craftsmen, laborers, military	37 6	45.7	16 0	12 5	27 4	7 5	42.4
25	Farmers	0 6	1.4	3 4	4 6	3 3	2 3	1.5
26	All occupations	100 0	100 0	100 0	100 0	100.0	100 0	100.0

Table 3

Estimated Percent of Household Deposits Covered by Deposit Insurance
Various Hypothetical Deposit Insurance Ceilings
Synthetic Account Definition and Individual Accounts Definition

Account definition	Hypothetical deposit insurance ceiling			
	$25K	$50K	$75K	$100K
Synthetic accounts	56 5	72 3	80 3	84.8
Individual accounts	71 3	83 5	88 2	91 3