

For Release on Delivery  
9:30 A.M. EDT  
September 11, 1985

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

September 11, 1985

I appreciate the opportunity to be here today to comment on proposals for reforming the Federal deposit insurance system and to review some other elements of the appropriate federal approach toward depository institutions.

In the light of recent and current problems in banking and thrift institutions, such a review is natural. At the same time, as proposals for changing deposit insurance and supervisory arrangements for depository institutions are reviewed, we should not lose sight of their successes, both in the past and in coping with the present strains.

For many years, the number of failed depository institutions was miniscule relative to the number of such businesses. Recently, there has been a significant increase in actual or near failures, and the financial system as a whole has been under greater strain. But the points of particular pressure have been dealt with in a manner that has avoided contagious chain reactions, and the health of other financial institutions and the economy has not been undermined. As intended by the Congress, no small depositor

of any federally insured institution has lost money because of a bank failure, and losses to larger depositors and other creditors of banking organizations have been very limited, without calling upon support of the general taxpayer.

As we review this experience, it is also natural and appropriate that you consider whether improvements need to be made in the functioning of our deposit insurance and supervisory systems. We have indeed seen a number of organizations, including some larger ones, fail or be forced into merger or reorganization in the past few years. And, while that number has remained comparatively small, the reports of our federal and state examiners reveal that a sizable number of additional institutions have serious problems. Considerations of how to deal with these problems and, indeed, how to turn around the recent trends, are thus in order.

In part these problems are traceable to the heightened degree of competition to which institutions are now subject,

a development fostered in large part by technological and financial innovations both at home and abroad. Those innovations, in turn, have been accompanied by, and in good part forced, greatly relaxed regulation of interest rates paid on deposits. Some institutions have importantly expanded asset powers.

The economic environment has also changed in a way that has increased the risks in highly aggressive banking practices. That change was punctuated by a major recession in the early 1980s, which itself strained the finances of many businesses and individuals. But we also had a vigorous recovery and expansion, and ordinarily credit quality would be expected to show marked improvement after the first year or so of recovery. That has not happened so far during the current expansion.

In significant part, that is because the nation has also been going through the more fundamental process of moving from a condition of accelerating and anticipated inflation to one of much more moderate price pressures generally. In fact, downward price pressures in some previously inflated sectors of the economy

have been evident, and real interest rates have been unusually high. Many ventures thought likely to be profitable by financial institutions and their customers during an inflationary period have turned out not to be so. The energy, shipping, agricultural, and real estate areas are replete with examples.

Moreover, patterns of thinking shaped during inflationary times are hard to dispel. Thus, some projects undertaken by entrepreneurs and financed by depository institutions--and sometimes those roles are combined--still seem to depend importantly for their success on increased prices, particularly with respect to some kinds of real estate development.

The strength of the dollar in international currency markets has also been a factor adding to pressures on the manufacturing, mining, and agricultural sectors, even as the economy as a whole has grown substantially. A number of important foreign borrowers in Latin America and elsewhere, who were favored lending outlets during the highly inflationary

period, have found themselves in an over-extended position in the current economic climate.

I believe a third major source of our current problems' can be traced to certain changes in banking and public attitudes that emerged gradually as memories of earlier difficulties faded from consciousness and the postwar economy and financial markets displayed remarkable--indeed virtually unprecedented--growth and stability. Banks ended World War II with unusually high liquidity and strong capital positions. It was natural and healthy that these funds would be more actively employed over time, and that the extreme caution bred by depression would be dissipated. In the absence of signs of real difficulty for several decades, a new generation of managers, directors and regulators, basing their judgments on postwar experience, shifted the focus of bank policies away from concerns with safety and toward greater risk-taking in a quest for larger profits in a highly competitive environment. In time, and further induced by the inflationary

expectations bred in the 1970s, these tendencies were carried beyond prudent limits in a few institutions.

These risks have been aggravated more recently by reactions of some managers, particularly in the thrift industry, to a prolonged period of extreme earnings pressures in their traditional lines of business. Implicitly or explicitly, they decided, in effect, to "roll the dice" by undertaking particularly risky activities generating immediate profits or the hope for large gains over time. From the standpoint of managers or owners, the chance of failure of the institution was already large, and should sizable losses rather than gains materialize, depositors would, in any event, in whole or in part, be protected by deposit insurance.

One general question before you is the extent to which these changes in attitude and behavior have been inadvertently encouraged by the federal "safety net"--indeed the extent to which the very

success of those arrangements, in protecting individual depositors and the financial and economic stability generally, has also encouraged some depository organizations to assume inordinate risks for both the institutions and the insurance system.

One aspect of the dilemma for the authorities is that institutions may, consciously or unconsciously, build into their decision-making the view that deposit insurance and the availability of discount window credit will give added time and leeway to deal with unforeseen problem situations that may arise, thus making institutions less self reliant and less concerned about risk despite the vulnerability of equity owners. Depositors and creditors of banking organizations themselves, because of the safety net, may anticipate that the "government," in the last analysis, will take actions to protect them against loss, so they can be relatively indifferent to the risk exposure of depository institutions. That is obviously the case for insured depositors who, by design, rely on the federal insurance backing their deposits rather than on the financial health of their banking institution for the return of their money.



The other side of the dilemma is that the "safety net" provides an essential public service, not only in protecting small depositors, but also in avoiding spreading fear among depositors generally, thus undermining the stability of the system as a whole. Instilling discipline at the expense of a financial debacle would be a pyrrhic victory.

Clearly, part of the challenge is to maintain a strong and effective safety net while minimizing adverse side effects on excessive risk taking. One important means of maintaining such balance is that management and owners of failed and distressed institutions are not, and should not, be immunized from the consequences of bad decision-making and excessive risktaking. Stockholders lose when a bank has failed or gotten into trouble; management has lost jobs and reputations. Moreover, recent events confirm that uninsured depositors and creditors do not feel entirely free of potential risk, and some recent events have alerted managements to the importance of maintaining confidence.

There is one aberrant situation that has been of strong and understandable concern to the insuring agencies. I touched earlier on the apparent temptation of some thrift institutions, finding themselves with negative earnings and impaired capital and concerned about their ability to restore profitability through adherence to normal business practices, to channel funds into risky financial ventures. In some cases, these practices are directly aided and abetted by the fact that the institution is able to obtain more sizable funds than would otherwise be possible by issuing insured deposits at relatively high rates, quite often through the auspices of a broker. Such insured deposits have been highly attractive because they have provided interest returns above the general market level, and because they are fully insured and free of risk regardless of the condition and activities of the issuing institution. Given this potential for abuse, we have supported the concept of strict limitations on certain insured-deposit brokerage activities.

In sum, the burden of my remarks is that the insurance system, the safety net, and the processes of banking supervision, faced with the strongest challenge in decades, have functioned with remarkable effectiveness to protect the stability of the banking system. We must not impair that effectiveness. At the same time, we want to learn all that we can from recent experience to encourage a still stronger, self-reliant system, to deal with the sources of strain, and to speed a return to a situation in which active use of the safety net is reduced. In that process, we want to build on the existing strengths of the system, and to encourage the efforts already strongly underway among many depository institutions to improve their own positions. Perhaps it is also worth emphasizing that this is no time for overreaction--for encouraging the pendulum of attitudes and policies by either managements or officials to swing to the point that reasonable innovation, risk-taking, and growth is stifled by unwarranted fear and uncertainty.

### Market Discipline

One approach toward maintaining a balance between stability and risk-taking would involve reinforcing, or duplicating by other means, disciplines inherent in the market process. Ideas along this line run from more frequent disclosure of information about the condition of banking and thrift institutions to increasing the frequency and the certainty of loss that large depositors and other creditors would suffer in the event of failed institutions. The concept is that, by intensifying the consequences of bad decision-making, depository institutions--their managements, directors, shareholders and depositors and creditors--will be more sensitive to risk, promoting safer and sounder practices.

Obviously, sensitivity of depository institutions and their customers to the consequences of risk-taking is fundamental to prudent banking. Any manager blinded to that fact by years of tranquility has been forcibly reminded by recent events. But our financial history demonstrates unambiguously the dangers of relying on market discipline alone. Prior to the 1930s, market

discipline did not prevent bank failures or systematically discourage excessive risk-taking--until after periodic crises had occurred, at great expense to the economy generally. Indeed, the entire rationale for the establishment of the Federal Reserve and the FDIC lay in the realization that institutions at the core of our payments and financial systems have a unique importance for the stability of the economy generally.

Recent years have seen considerably more public disclosure of loan concentrations and other matters. Normally, the presumption should be in favor of wide disclosure in the interest of full market information to investors, within limits imposed by customer or competitive confidentiality. But such disclosure provides limited protection at best against imprudent lending or other risks, which are usually not apparent in simple listings of concentrations and which, indeed, often are exposed after the fact.

The question remains of striking an appropriate balance. Experience suggests strongly that creditors and investors find

it difficult or impossible in practice to make reliable incremental appraisals of the degree to which institutions are taking excessive risks prior to the time the consequences of such activities become readily apparent. To take one example, the Continental Illinois Bank was an investment favorite, praised for aggressive expansion, virtually until the eve of the exposure of massive problems in its loan portfolio. Those problems were initially centered in the energy area. But aggressive energy lending, in the environment of the 1970s and early 1980s, was considered appropriate and desirable in the marketplace for many banks, and those banks were generally characterized by high earnings, stock prices, and growth. Investors and depositors detected and reacted to the problems only after it was clear that a highly aggressive lending posture in the energy area had yielded bitter fruit. Then left untempered, the reactions would have been so strong as to undermine a number of banks' prospects for viability, with widespread secondary repercussions. A similar pattern of years of complacency, even when the general nature and size of

the lending is well known, could be cited in the growing loan exposures of multinational banks to developing countries. Similarly, the exposure of thousands of small agriculturally oriented banks is today viewed very differently than only a few years ago.

In other words, in an inherently uncertain world, subject to changes in objective circumstances and fashion, the prescience of market forces is necessarily limited and sentiment quickly reversible. Once it becomes reasonably clear that an institution has difficulties, sharp swings in attitude can undercut orderly solutions, posing risks to other banks and the financial system in general.

There is no doubt that market forces ultimately are capable of, and do, impose a severe discipline. We want to take advantage of that. But we would also like those disciplines, to the extent feasible, to work consistent with constructive solutions to problems, which takes time, rather than to exact its lesson at the expense of economic stability generally.

In striking that balance, the Federal Reserve has not favored proposals that would have the federal agencies themselves, as a general rule, disclose detailed cease and desist orders or other disciplinary action they have issued against banking organizations. Such routine disclosure may at times exacerbate an already delicate situation and make more difficult the task of federal regulators seeking an orderly and appropriate resolution of problems that are, in fact, "curable." Larger banking organizations with widespread public ownership are already required to disclose material changes in circumstances, including the official enforcement orders bearing on their outlook. There are situations in which detailed disclosure by a banking agency itself might serve a useful or necessary purpose, particularly when the management is not actively and wholeheartedly moving to deal with its problems. But that is not ordinarily the case. Rather, the entire procedure will often become more, and unnecessarily, adversarial, making it more difficult for examiners to obtain



information or engage in a frank exchange of views, and tying up limited supervisory and enforcement manpower in legal proceedings.

### Risk Based Insurance

One proposal that has been set forth, as a kind of substitute for direct market discipline, to achieve greater control over risk-taking by depository institutions--and also to make the depository insurance system more equitable--is to shift from the present flat-rate deposit insurance premium system to a risk-based system. In concept, institutions taking a significantly riskier position would be required to pay higher premiums than conservatively managed organizations.

In principle, the proposal appears logical and attractive. It seems undeniably fair to require those institutions exposing the insurance fund to greater risk to pay higher premiums to compensate for that risk, an approach long followed by private companies in all areas of insurance.

But there is reason to question the practical benefits of such an approach. If differential insurance premiums are to

effectively deter excessive risk-taking, the range between premiums charged institutions exposed to relatively great risk and those operating more conservatively would have to be fairly wide. But such a wide range for premiums implies more precision in gauging the risk exposure of different institutions or different types of lending than may be objectively possible, or that is widely perceived as fair. We don't, for instance, want to indiscriminately place a drag on commercial lending, or agricultural lending, or energy lending. The size of the insurance premiums might be interpreted as a kind of credit rating, but it would be too crude to bear that burden. And I don't see, in practice, how the premiums could be "fine-tuned" before problems in fact emerge.

It may be possible, for instance, to get general agreement as to the relative riskiness of broad categories of balance sheet positions. All would agree, for example, that private loans are more risky than Treasury securities; that a low liquid asset ratio, particularly if accompanied by heavy reliance on purchased money,

is more risky than a high ratio; that a marked imbalance between asset and liability maturities is more risky than a close balance. But once past those relatively broad concepts, consensus becomes much more difficult to achieve.

There are many less tangible factors--such as the quality of an institution's management, its internal controls, and its credit standards whatever the lending area--that affect the riskiness of an operation and should be taken into account. The principal differences in the quality and relative riskiness of loan portfolios lies within broad loan categories, as much or more than between them.

Bank examiners, of course, make such judgments. But there would be great drawbacks to basing premiums on the already difficult, and inherently qualitative, judgments contained in bank examinations. Such judgments are fallible and our forecasting ability is limited. To reflect those judgments routinely in large changes in insurance premiums, involving both public notice and higher costs, could well diminish prospects for effective remedial action.

Some have suggested the problems inherent in ex ante identification of risk could be dealt with by levying premiums on an ex post basis--that is, to charge institutions experiencing losses higher premiums. But does it really make sense to levy punitive premiums under such conditions, placing an added drain on the earnings of an institution with substantial problems, and, in effect, announcing that added burden to the world? Rather, would it not often work at cross purposes with the efforts that federal regulators would be making at such times to restore the institution to health?

I recognize that, even if the possibility of using sharply differentiated insurance premiums as an effective deterrent to excessive risk is limited, some distinctions based upon the general characteristics of a bank or thrift may appear more equitable in terms of relative contributions to the insurance funds. Moreover, there may be certain types of loan and investment situations which are clearly so risky relative to the "norm" that a sharply higher insurance premium could be clearly justified.

That might be the case, for example, with real estate development activities of the kind that some institutions are actively developing, as permitted by some states. But I would have to question, if the risks are so evident, whether such activities are appropriate for depository institutions at all.

As I have emphasized to this Committee before in this connection, I am deeply concerned about the increasing tendency of states to provide powers for state-chartered institutions operating under the protection of the federal safety net that may be inconsistent with prudent banking or thrift operations. That, indeed, seems to me an area where action is urgently needed.

#### Other Reforms in Deposit Insurance

I should like to comment briefly on several other proposals for reforming the deposit insurance system that have been advanced in recent years. One such proposal is to move the deposit insurance limit back down to a significantly lower level. It is reasoned that this will result in a larger proportion of deposits being subject to loss should an institution fail, and, by increasing

risk exposure, encourage depositors to be more selective in placing their funds with institutions.

The precise level for assured insurance protection is, of course, arbitrary, and I have myself resisted the large increases enacted in the past. But we are not dealing with a blank sheet of paper. Depositors and financial markets generally are accustomed to, and presume maintenance of, the present \$100,000 level.

It seems likely that if insurance coverage were reduced somewhat, the main effect would be that most smaller depositors with amounts to place that exceed the cutoff would simply channel them into two or more deposit accounts with different institutions. Accordingly, costs to depositors and the banking system would be raised. If the insurance level were to be sharply lowered, the proportion of "runable" deposits at all institutions would increase, increasing the potential instabilities of the system at a time of strain.

In concept, looking further into the future, there may be some merit to increasing, in a careful and limited way, the effective risk exposure of larger depositors, inducing them to make a more careful assessment of the conditions of organizations in which they are placing funds, and working in a marginal way to encourage more prudent banking practices. But those depositors are not entirely without risk today, and I do not believe this is the time to inject more uncertainty into the system. Any changes in this respect should be made, in my judgment, only in more settled circumstances, and with long lead times.

I believe a fair description of the present approach in operating the "safety net" is to provide full protection for depositors within the insurance limits but also to protect all depositors when that is practically feasible at reasonable cost through mergers or otherwise, taking account of the costs of alternatives, including the effects on the community and banking stability more generally. The number of cases in which that

protection has not been possible and feasible in practice has been very small, for banks large or small. That approach seems to me to remain broadly appropriate. It does not commit the FDIC or the FSLIC to full protection in every circumstance--such as when some combination of huge potential losses, unknown contingent liabilities, and possibilities of fraud could clearly impose excessive costs relative to practical alternatives. In a few cases, a full payout to insured depositors alone has been necessary.

As the Committee knows, there has been some testing by the FDIC of a modified payoff technique. This technique involves deriving an estimate of the proportionate amounts of the uninsured depositor claims that are likely to be recovered from the liquidation of a closed institution's assets and then paying that amount to the depositor immediately rather than waiting until the liquidation is completed. Any recovery above that minimum is to be passed through after it is realized. That approach, I believe, could be an improvement over the delayed payoff approach that is routine in general bankruptcy proceedings, since it helps reduce



the side effects of uncertainty and reduced liquidity to which depositors are otherwise exposed. But I do not envisage such an approach as a satisfactory substitute for the so-called "purchase and assumption" technique or other forms of assistance when those alternatives are feasible and costs reasonable.

In considering that or other new approaches, careful consideration must be given to the uncertainties inherent in change at a particularly sensitive time. In that spirit, proposals that might partially insure larger depositors, but at the same time increase the risk of loss or illiquidity of an uninsured fraction, could be debated. But any change in that respect should be announced far in advance, and implemented with great care.

Proposals to require institutions to pay the same premiums on their deposit liabilities at overseas branches, and at International Banking Facilities, as they do on all other deposits booked in the U.S., deserve careful review. These depositors benefit from the greater stability of financial conditions that result from the deposit insurance system as much as do other large depositors.

Thus, it seems fair that banking organizations choosing to fund part of their operations overseas--and that proportion can be "managed"--should be subject to the same insurance costs as those that rely on domestic sources of funds.

At the same time, extending insurance costs to foreign branch deposits changes the relative cost burdens among our depository institutions, affects incentives to branch abroad, and raises some competitive questions vis-a-vis banks abroad. A fuller assessment of the pros and cons appears to me in order before proceeding definitively, and if a decision is made to implement the proposal, it should probably be phased-in over a period of years.

Proposals also have been advanced for merging the FDIC and FSLIC insurance funds. In principle, this would appear appropriate if and as these depository institutions are required to adhere to equivalent regulatory and supervisory standards, and particularly if their powers broadly coincide. There has been

some movement in those directions, but there also remains a good ways to go.

Whether one would want to proceed more immediately to merge the funds would appear to depend on how the advantages are weighed, in current circumstances, of bringing the larger resources of the FDIC fund to the support of the savings and loan industry. Against that advantage there is a legitimate question as to whether monies contributed by commercial banks and mutual savings banks should now be made available to protect the depositors of savings and loan associations. At the least, the importance of bringing the regulatory and supervisory standards of the two industries into alignment promptly would be greatly reinforced. But, in addition, I believe the Congress, in addressing such a proposal, should consider possible means for bolstering the size of the FSLIC fund or the relative contribution of the savings and loan industry should it decide to authorize such a merger.

Other Initiatives

Apart from the initiatives in the deposit insurance area I have just reviewed, I believe there are other actions--indeed more important actions--that are being taken and that can be taken to strengthen further our depository system and achieve greater assurance that it will continue to function safely and efficiently.

Federal insurance and other elements of the federal "safety net" necessarily imply a clear federal interest in how the protected funds are employed and managed. To some degree, strong supervision can minimize the need for, and demands upon, the "safety net." And no insurer can afford to be indifferent to the behavior of the insured.

All the federal agencies, individually and in cooperation, have taken steps to strengthen the supervisory and, where necessary, the regulatory process. I can speak directly here only of the Federal Reserve, where a number of steps are underway to implement a comprehensive program for further strengthening our supervisory and regulatory activities.

As you may recall, in conjunction with the other bank regulatory agencies, we have over the past few years tightened significantly our capital standards applicable to banks and bank holding companies. These standards were first put in place on a formal basis in the early 1980s and have helped to reverse the earlier downtrend in capital asset ratios.

We now have under active review, as do the other federal bank supervisors, proposals for supplementing the existing standards. One objective is to take account of the rapid growth in "off-balance sheet" risk exposures and declines in liquidity, particularly at larger banking organizations. To some degree, the simple capital/asset ratios that are at the center of our current guidelines contribute to those developments; institutions work to improve those ratios by holding down asset growth partly by limiting liquid asset holdings and by assuming off-balance sheet commitments in lieu of direct lending.

We can and are approaching the problem in part through strengthening the crucial process of examination, emphasizing that

existing standards are minimums that can and should be exceeded depending upon the risk profile of an institution. We are also carefully considering several variants of proposals for quantifying a risk-related capital measure to supplement the present approach. I anticipate that one or more approaches will be set out for public comment before the end of the year.

In adopting such an approach, we face some of the same difficulties that I outlined in connection with risk-based deposit insurance, particularly the difficulty of assigning appropriate weights to different broad asset categories. But these standards potentially can be applied, and bank performance monitored, in the context of a detailed examination process, and the approach has the further potential advantage of contributing to international comparability.

The Chairman of the FDIC has proposed phasing-in an increase in the minimum capital requirement for banks to 9 percent, permitting the increase to be in the form of subordinated debt. That is another initiative that I find attractive in concept and worthy of study.

The idea is that market discipline would be reinforced at the margin without further jeopardizing depositors--indeed, consistent with stronger depositor protections--by requiring banks to find a larger market for debt (or equity) that would have no insurance protection. At least as important in my view, the added capital would provide an extra cushion of protection against the possibility of loss to depositors and the deposit insurance fund.

The Federal Reserve also has under active review other proposals for modifying the structure of regulations and guidelines in place to see that banking organizations meet appropriate standards in conducting their business activities. Specifically, we are preparing standards to guide a bank holding company with respect to appropriate policies toward cutting or eliminating the payment of dividends when and if the organization is experiencing significant problems. We are also actively considering, within our present authority, appropriate limitations on bank holding companies undertaking particularly risky activities that may be

sanctioned by state law but which appear to extend beyond the intent and framework of federal legislation.

Meanwhile, we have underway a number of significant steps to enhance our ability to identify, and seek correction of, problem situations at individual banking organizations. The frequency and intensity of examinations and inspections of larger banking organizations is being increased, while at the same time we seek to increase cooperation and coordination in the examination of smaller organizations with other federal agencies and state banking authorities. Indeed, if states are willing and have the required resources, we would plan to increase our reliance on their examinations of smaller banking organizations.

Communications with the boards of directors of large organizations with problems are being upgraded in content and official participation. Where warranted, we will make full use of our statutory powers to see that banking organizations cease activities that are causing them harm and adopt policies that will restore their financial health.



## Conclusion

At a time in which domestic and world economies are subject to many imbalances and distortions, banking systems here and abroad have been burdened more heavily than in many years, and we have seen some unaccustomed failures and reliance on the "safety net." That alone justifies a review of steps to ensure that our banking institutions, and their supervisory agencies, are following policies and practices consistent with the earliest possible return to robust health and full self-reliance.

But in making that review, let us not overlook the many continuing elements of strength in the banking system that enable it to deal with points of pressure. The vast majority of our depository institutions have absorbed and adjusted to a less favorable financial and economic environment in a way that retains, and even reinforces their resiliency. Capital ratios are improving, profitability has generally been maintained, well-run thrift institutions, at present interest rates, have the potential for rebuilding capital, and I sense managements of most

institutions have acted to review lending standards and control systems. It is these factors that support confidence and prospects for the future. At the same time, the "safety net" has operated with great effectiveness; it has done what it is supposed to do and what the American public has expected. It will continue to do so.

The issues you are reviewing are as complex as they are important. There is a need to proceed--but to proceed with all due caution--so that any changes will in fact contribute to reinforcing solutions to our current difficulties and to a stronger banking system, not the reverse. I have indicated that the Federal Reserve has been moving to improve its regulatory standards and strengthen its supervisory capabilities. As you know, the other federal agencies responsible for supervising depository institutions are taking steps.

Our problems have been manageable. They should remain so. We welcome the cooperation of the Congress in that effort, not simply with respect to the questions under review today,

but more importantly and fundamentally in dealing with the  
underlying sources of the imbalances and distortions in our  
economy and financial system.

\*\*\*\*\*