ECONOMIC IMPLICATIONS OF THE "TOO BIG TO FAIL" POLICY

HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

MAY 9, 1991

Printed for the use of the Committee on Banking, Finance and Urban Affairs

Serial No. 102-31

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-035335-1

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HENRY B. GONZALEZ, Texas, *Chairman*

FRANK ANNUNZIO, Illinois
STEPHEN L. NEAL, North Carolina
CARROLL HUBBARD, Jr., Kentucky
JOHN J. LaFALCE, New York
MARY ROSE OAKAR, Ohio
BRUCE F. VENTO, Minnesota
DOUG BARNARD, Jr., Georgia
CHARLES E. SCHUMER, New York
BARNEY FRANK, Massachusetts
BEN ERDREICH, Alabama
THOMAS R. CARPER, Delaware
ESTEBAN EDWARD TORRES, California
GERALD D. KLECZKA, Wisconsin
PAUL E. KANJORSKI, Pennsylvania
ELIZABETH J. PATTERSON, South Carolina
JOSEPH P. KENNEDY II, Massachusetts
FLOYD H. FLAKE, New York
KWEISI MFUME, Maryland
PETER HOAGLAND, Nebraska
RICHARD E. NEAL, Massachusetts
CHARLES J. LUKEN, Ohio
MAXINE WATERS, California
LARRY LaROCCO, Idaho
BILL ORTON, Utah
JIM BACCHUS, Florida
JAMES P. MORAN, Virginia
JOHN W. COX, Jr., Illinois
TED WEISS, New York
JIM SLATTERY, Kansas
GARY L. ACKERMAN, New York

CHALMERS P. WYLIE, Ohio
JIM LEACH, Iowa
BILL McCOLLUM, Florida
MARGE ROUKEMA, New Jersey
DOUG BEREUTER, Nebraska
THOMAS J. RIDGE, Pennsylvania
TOBY ROTH, Wisconsin
ALFRED A. (AL) McCANDLESS, California
RICHARD H. BAKER, Louisiana
CLIFF STEARNS, Florida
PAUL E. GILLMOR, Ohio
BILL PAXON, New York
JOHN J. DUNCAN, Jr., Tennessee
TOM CAMPBELL, California
MEL HANCOCK, Missouri
FRANK D. RIGGS, California
JIM NUSSLE, Iowa
RICHARD K. ARMEY, Texas
CRAIG THOMAS, Wyoming

BERNARD SANDERS, Vermont

Subcommittee on Economic Stabilization

THOMAS R. CARPER, Delaware, *Chairman*

JOHN J. LaFALCE, New York
MARY ROSE OAKAR, Ohio
BRUCE F. VENTO, Minnesota
PAUL E. KANJORSKI, Pennsylvania
ELIZABETH J. PATTERSON, South Carolina
PETER HOAGLAND, Nebraska
CHARLES J. LUKEN, Ohio
JAMES P. MORAN, Virginia

THOMAS J. RIDGE, Pennsylvania
BILL PAXON, New York
MEL HANCOCK, Missouri
JIM NUSSLE, Iowa
RICHARD ARMEY, Texas
CRAIG THOMAS, Wyoming

CONTENTS

ECONOMIC IMPLICATIONS OF THE "TOO BIG TO FAIL" POLICY

THURSDAY, MAY 9, 1991

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN FINANCE,
SUBCOMMITTEE ON ECONOMIC STABILIZATION,
Washington, DC.

The subcommittee met, pursuant to call at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Thomas R. Carper [chairman of the subcommittee] presiding.

Present: Chairman Carper, Representatives Vento, Patterson, Hoagland, Luken, Moran, Ridge, Hancock, Nussle, and Thomas.

Also Present: Representative McCandless.

Chairman CARPER. Welcome to each of you here with us today.

The Democratic Caucus of the full House of Representatives is having a session this morning. I think it deals with the confirmation of a subcommittee chairman or a committee chairman, and we will be joined probably during the next hour by most of the Democrats on the panel.

We have already been joined by a number of our Republican colleagues, including Mr. McCandless, who is sitting in today, though not a member of our subcommittee. We welcome him.

I want to thank my fellow members of our subcommittee and our witnesses for joining us here today to discuss the economic implications of the too-big-to-fail policy and proposed legislative changes to this policy.

Bank failures occurred at a record level in the 1980's. In the last 3 years alone, close to 600 banks have failed or received assistance, and this trend is not likely to significantly change in the near future. Yet, not all of these failed institutions have been resolved in the same manner.

While deposit insurance protection has been routinely extended to insured depositors when large banks fail, such protection has not always been afforded to uninsured depositors when small banks fail.

This policy of protecting uninsured depositors in large bank failures in order to prevent adverse effects on the financial system and the macro economy is commonly referred to as the too-big-to-fail doctrine.

While some argue that the policy has been important in maintaining a stable financial system in our country, it has resulted in inequitable treatment of depositors and banks, increased costs to the bank insurance fund, increased taxpayer exposure, and market discipline.

For those reasons, the too-big-to-fail policy is one of the most controversial issues in the banking community today. It presents Members of the House and Senate Banking Committees with one of the thorniest problems to resolve as we debate bank reform this year.

Congress' ultimate goal should be to reform the banking industry in a way that will restore vitality to the banking industry, benefit consumers and avoid another taxpayer bailout.

To reach that goal, the too-big-to-fail issue must be resolved. I commend Chairman Gonzalez and Chairman Annunzio for beginning to address the too-big-to-fail issue in H.R. 2094, but I believe that important questions still remain unanswered.

The purpose of today's hearing is to review in detail the economic justifications for a too-big-to-fail policy, and the economic implications of proposed changes to this policy. We have a full plate before us today, with a number of witnesses scheduled to testify.

I will save all of you from a long opening statement at this point, and just say that I look forward to hearing from each of our distinguished panel of witnesses. Having said that, I will defer to any of our colleagues who have an opening statement. Please.

Mr. NUSSLE. Thank you, Mr. Chairman, and thank you for the opportunity to participate in an important debate on the too-big-to-fail policy. I also want to thank the distinguished members of the panel for coming before the subcommittee.

I realize my duties in Congress are two-fold. First, I have the interests of Iowa to consider, but I also have a national responsibility to work for sound national policies. Quite frankly, I have a concern that too-big-to-fail policy is neither.

Is it good policy and is it good for Iowa? I come from a small town in Iowa with a population of 5,000, some say, when everyone is there visiting relatives and friends, and the communities surrounding my town are not much bigger.

The current situation with too-big-to-fail banks is, in some people's opinions, unfair to Iowa bankers who run the healthiest banks in the Nation, and who are paying deposit insurance premiums which go to cover uninsured deposits.

We now have an opportunity to fix this inequity in the banking system via the proposed banking reform legislation. I am encouraged by the Treasury's proposal for early intervention into troubled banks to solve the problem before the question arises about covering those uninsured deposits.

However, I am troubled with the legislation the way it is now. I am afraid that limiting deposit insurance for individuals, while too-big-to-fail policy is still intact, will drive deposits out of Iowa banks and into big city banks. And when loan making authority is taken from local bank officials, community needs are not given the same consideration as the bottom line.

In closing, I want to reiterate my strong desire to see the banking industry nursed back to wellness, but I ask that it not be done at the expense of Iowa banks and those small community banks that we find in towns like the town I come from.

Thank you, Mr. Chairman.

Chairman CARPER. Thank you, Mr. Nussle.

Any other opening statements?

Mr. THOMAS. Thank you, Mr. Chairman.

This is the first time I have been on this subcommittee. I appreciate very much your talking about this subject.

Chairman CARPER. We are always glad to have another at-large representative here.

Mr. THOMAS. Yes, there aren't many of us, are there? I probably have heard more about this than most any of the other several items we talk about from the banks in Wyoming, so I look forward to this hearing. Thank you.

Chairman CARPER. Thank you very much.

Gentlemen, we have three panels today.

The first of those panels is assembled before us, and I will call on Mr. Seidman to present the first testimony. Before I do, I would just share with our audience that I noted to Mr. Seidman that I had not seen him earlier this year on Capitol Hill, and he said this was the first time he has been called to testify.

He said that with tongue firmly in cheek, but we are glad you were able to work this into your schedule.

Mr. Clarke, I noted that this year as the number of hearings is going up, banking failures seem to be diminishing, so maybe we can continue to hold more hearings and hopefully that trend line will continue.

In any event, we welcome you all. Chairman Seidman, why don't you be our lead off hitter. Thank you.

STATEMENT OF L. WILLIAM SEIDMAN, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. SEIDMAN. Thank you, Mr. Chairman, members of the subcommittee. I am pleased to appear before you today to discuss the Federal Deposit Insurance Corporation's views on the resolution of large failing banks and on proposed legislative changes to the FDICs cost test.

These issues have become known as too-big-to-fail problems. First, let me point out that too-big-to-fail is not really a deposit insurance issue.

Every major country has to deal with the problem, whether or not they have a deposit insurance system. In our country it has become a deposit insurance issue because the fund is where money is available to deal with the problem.

As Willy Sutton said, when asked why he robs banks, he replied, that is where the money is, and that is how deposit insurance fund, I think, has become the focal point for this issue. There is no question that our too-big-to-fail system has raised problems.

Unfortunately, there are no easy answers. We want to provide both fairness between small and large banks, and at the same time to provide safety and soundness for the system in the event of a major institution failure. Our long run goal, of course, should be to strengthen the entire banking system so that the question of which institutions can fail will no longer be of paramount concern.

In the interim we suggest that constructive ambiguity as to who will be too big to fail should continue, and too big to fail should be administered and paid for by the administration in power, after consultation with other regulators.

In making such a recommendation, we must realize that it puts small banks at a competitive disadvantage that can only be compensated for by fairly extensive deposit insurance coverage. Without it, funds will flow from the small to the large institutions because too-big-to-fail is still a possible event.

As I have said, in our view there can be situations in which the need to maintain financial stability is the overriding concern and an institution is too big to be allowed to have its depositor—uninsured depositors take losses and therefore action is required.

However, I would point out that over the past 5 years the FDIC has determined that only four banks were, "too big to fail"—that is, essential under the statute. Therefore we have protected all depositors under that doctrine in only four banks. The cost of protecting the uninsured depositors of these institutions was less than $1 billion or about 3.5 percent of the FDICs total insurance losses over this time period.

If one is looking for a way to insure that the BIF fund restores its solvency, one should not look to eliminating the too-big-to-fail doctrine as a major source of revenue. The losses have simply been very small in relation to the total losses we have suffered. So too-big-to-fail is not a major factor in the situation that we are facing with respect to recapitalization of the fund.

Although most other countries do not have a deposit insurance entity with powers equivalent to the FDICs, as I have said, all other major countries have reserved for themselves considerable flexibility in the handling of large bank failures.

While publicly no foreign government will admit that their country has a too-big-to-fail policy, privately they acknowledge that there may be banks that are too big to fail, simply because large banks often are such important components in the Nation's payment system, and the failure of a major bank could have very adverse macroeconomic effects, particularly where the concentration in banking is much larger than it is in the United States. So I think that the countries of the world agree that an absolute elimination of the government's ability to deal with a failure of a large institution by law is not wise and that there must be in the government somewhere the ability to deal with the possible effects of a large bank failure.

In recognizing this fact of life, however, we must also recognize that we have an unusual banking system, with over 30,000 small institutions using deposit insurance to help them in the competition in gathering funds. To the extent that we find we cannot eliminate too big to fail entirely, we must view deposit insurance as a compensating factor in keeping our small banks and our dual banking system healthy.

The two are intimately related and in my view cannot be separated. Thank you, Mr. Chairman.

[The prepared statement of Mr. Seidman can be found in the appendix.]

Chairman CARPER. Mr. Seidman, we thank you very much. I am going to turn to Mr. Clarke as our second witness.

Mr. Clarke.

STATEMENT OF ROBERT L. CLARKE, COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. CLARKE. Thank you. Mr. Chairman and members of the subcommittee, I am pleased to be here with my colleagues this morning to discuss whether and when it may be necessary, under limited circumstances, to preserve the stability of financial markets by protecting the uninsured depositors of a bank that fails. I have submitted a detailed written statement for the record, and so in the interest of time this morning I would like to focus my opening remarks on the approach to the issue that has been outlined in the administration's bill, H.R. 1505, an approach that has my full support.

The Treasury has developed a reasoned and balanced approach to the issue in a legislative package that would narrow the circumstances under which coverage of uninsured depositors would be provided, in large part by strengthening supervisory standards and by stressing the importance of equity capital.

Deciding when and how much protection to grant these depositors is an extraordinarily difficult choice to make. Too little protection could threaten the stability of financial markets. Why do I say that? Because of two distinct risks. The first is the possibility that the failure of a prominent bank may provoke both insured and uninsured depositors at other banks to withdraw their funds. The second is that the failure of a large bank could seriously disrupt the payment system and the markets for Federal funds, government securities, mortgage-backed securities, foreign exchange and a variety of other financial instruments. Large banks provide clearing and settlement services to smaller banks, and they play a central role in organizing these markets.

On the other hand, too much protection for uninsured depositors also causes problems. It raises serious questions about competitive equity. It can reduce incentives for uninsured depositors to monitor the riskiness of institutions, and it has the potential to strain the resources of the Federal deposit insurer.

The administration's proposal strikes a balance between the conflicting objectives of preservation of systemic stability, protection of the insurance fund, and the equitable treatment of large and small banks. I stress again that it is a difficult issue to come to grips with.

Determining policies to resolve the failures of banks, particularly large ones, is a complex task. It involves weighing the need to control the risks that I noted earlier against the objectives of limiting exposure to the insurance fund and promoting market fairness and discipline.

Some have proposed to eliminate altogether the policy of covering uninsured deposits at any bank that fails. That would go too far in one direction. While it could greatly increase market discipline, it would do so at the cost of preventing action in those instances when covering insured deposits is necessary. It would also place U.S. banks at a disadvantage in competing with banks in other countries, as Chairman Seidman just indicated, where full protection is frequently provided to all deposits, although not necessarily through a deposit insurance system such as we have in this country. It could also reduce the willingness of foreign banks to deal with U.S. banks.

But the opposite extreme, covering uninsured deposits at all banks, which others have proposed as a fair solution, would go too far in the other direction. It might solve the systemic risk problem, but at the cost of exposing the deposit insurance fund and taxpayers to far too much risk.

A more reasoned approach is for the government to retain the authority to protect uninsured depositors in exceptional cases when failing to do so would pose unacceptable systemic risk, but to use that authority sparingly. The administration's banking reform bill would accomplish this objective by doing two things: First of all, requiring the FDIC always to resolve bank failures at the least cost and, second, by giving the Federal Reserve Board and the Treasury Department joint authority in consultation with the Office of Management and Budget and the FDIC, to direct the FDIC to provide broader coverage if they consider it necessary to protect the financial system.

At the same time, as I noted earlier, other provisions in the administration's bill should reduce the frequency with which the government is faced with these types of decisions. The bill's emphasis on equity capital and prompt corrective action can be expected to modify banking behavior and attitudes to make costly failures of large banks less likely.

This is the sensible approach. Mr. Chairman, the current deposit insurance system, in effect, provides coverage for virtually all bank deposits, an extension of the Federal safety net that goes well beyond the original purpose of deposit insurance. The deposit insurance system should generally limit protection to insured deposits, except where more extensive coverage is less costly to FDIC, while retaining the flexibility to deal with the genuine and very real issues of systematic risk. The administration's bill is designed to do just that.

Thank you, and I look forward to your questions.

[The prepared statement of Mr. Clarke can be found in the appendix.]

Chairman Carper. Mr. Clarke, we thank you for your testimony today. I note the arrival of Mr. Luken, and we welcome you to our hearing today. Now, I would like to turn to a representative from the Department of the Treasury, Mr. Glauber, who is the Under Secretary of the Treasury for Finance. We welcome you and look forward to your testimony.

STATEMENT OF ROBERT R. GLAUBER, UNDER SECRETARY OF THE TREASURY FOR FINANCE, DEPARTMENT OF THE TREASURY

Thank you, Mr. Chairman, members of the subcommittee, with your permission, I will read a shortened form of my full testimony and ask that all of it be put in the record.

It is a pleasure to explain the administration's proposal to roll back the Federal Deposit Insurance Corporation's too-big-to-fail policy, which currently results in the protection of all uninsured deposits in most bank failures, particularly larger ones.

This broad expansion of the Federal Deposit Insurance guarantee has greatly increased taxpayer exposure. It is also unfair to those smaller banks that do not receive this blanket de facto protection.

Our proposal ends this routine protection of uninsured depositors without compromising the safety and stability of our financial system. We firmly believe that this is the most sensible way to address this very difficult problem. Let me acknowledge at the outset that the administration's proposal preserves the flexibility of the government to protect the Nation's financial system in times of crisis.

In rare cases this may result in the protection of uninsured depositors in bank failures. These rare occasions will no doubt raise some of the same questions of unfairness and taxpayer exposure as today's policy of routinely protecting most uninsured deposits. But a policy that risks our financial system to avoid an exceptional case of "unfairness," would be dangerous and irresponsible, in my view.

In the end, the only way to truly eliminate our continual confrontations with the unfairness of protecting uninsured depositors is to fix the underlying system. Other countries rarely confront the too-big-to-fail issue because they rarely have bank failures.

We simply must have fewer costly bank failures and fewer threats to our economy. That means comprehensive reform that results in stable and profitable banks, prompt corrective action for weak banks, streamlined supervision, and a recapitalized Bank Insurance Fund.

That, Mr. Chairman, is exactly what the administration has set forth before the Congress in H.R. 1505. Too big to fail is a part of the FDICs current policy to routinely extend deposit insurance protection beyond $100,000 limit to uninsured depositors.

There are three fundamental problems arising from this policy, increased taxpayer exposure to losses, the removal of market discipline over weak and risky banks, and the unfairness of protecting some uninsured deposits, but not others. Since the first two problems are self-evident, let me concentrate on the fairness issue. Protection of uninsured depositors in large banks, but not small banks can give large banks an unfair funding advantage for large deposits.

This unfairness was brought into sharp contrast with the recent decisions to protect uninsured depositors in the resolution of the Bank of New England and not to protect them in the resolution of the Freedom National Bank in Harlem.

We all know the unfairness of protecting some uninsured depositors and not others has become the battle cry of smaller banks and the public, and with good reason. There are basically three ways to address this fairness problem.

First is to expand the current practice even further; that is to simply protect all depositors, insured and uninsured at all banks. This is the position preferred by small banks as being most fair because it would neutralize bank size as a major factor in the competition for funds.

But it would not be fair to the taxpayers. Their exposure could go up. Extending the Federal safety net of deposit insurance to all deposits eliminates all market discipline, even from sophisticated depositors. That can only make the banking system more risky.

The second approach is never to protect uninsured deposits at all. This approach, too, would be "fair." Banks of all sizes would be treated identically and uninsured depositors would have no incentive to place funds on the basis of protection in the event of failure, but this approach creates problems of systematic risk.

It is simplistic and I think dangerous. We believe that the only sensible solution is a third approach that balances all of the factors involved—one that rolls back the routine protection of uninsured depositors, preserves the government's ability to protect the financial system, and embraces new ways to reduce the systematic risk involved in bank failures.

Our approach is intended to reduce taxpayer exposure and reduce unfairness to small banks. It would roll back the too-big-to-fail doctrine to true instances of systematic risk and make it the rare exception in bank failures. The routine coverage of uninsured deposits would be eliminated by demanding least cost resolutions.

The regulators would be made more visible and accountable when they do decide to protect uninsured depositors. And specific measures would directly reduce systematic risk. Let me not go through the details of our proposal because I think it is well known and has been outlined in both our submissions and by Mr. Clarke just a minute ago.

Let me turn for just a moment to H.R. 2094, the bill that your committee or the Subcommittee on Financial Institutions has just marked up. Let me provide some observations about the treatment of uninsured depositors in H.R. 2094. This will prohibit the FDIC from protecting uninsured depositors beginning in 1995, even if it would reduce costs to the taxpayer. And while the bill was improved in subcommittee with an amendment that would preserve the Federal Reserve's current authority to address liquidity problems in undercapitalized banks, we believe that even the amended text leaves too little flexibility to address systematic risk.

We will continue to support amendments that would improve the language to address both of these problems. In conclusion, we believe that ours is the most balanced approach to the problem of protecting uninsured depositors, given the competing considerations of systematic risk, taxpayer exposure, market discipline, and fairness.

Still, as long as we have repeated instances of costly bank failures, there will still be some unfairness resulting from systematic risk considerations. What we really need to do is what I said at the outset, fix the system so that we don't continually have these costly failures.

We cannot afford to keep putting ourselves in the position of having to make the choice between protecting small banks and protecting the taxpayer. The key is to making the banking industry economically viable through comprehensive reform. Banking organizations must be able to offer a full range of services to compete with their rivals, domestically and internationally.

They must be able to locate their places of business where they choose and attract capital from financial and non-financial firms. And they must be regulated more effectively with prompt corrective action that stops smaller problems from mushrooming into large losses to the insurance fund.

H.R. 1505 addresses all of these requirements. those who suggest we must end the too-big-to-fail problem before we fix the system have got it exactly backwards, in my view. Instead, we must fix the system in order to eliminate the unfairness of too-big-to-fail. Thank you, Mr. Chairman.

[The prepared statement of Mr. Glauber can be found in the appendix.]

Chairman CARPER. Thank you, Mr. Glauber. We have been joined at the subcommittee hearing by Mr. Ridge, who is the Ranking Republican. We welcome you, Tom.

I don't know if you have a statement that you would like to offer.

Mr. RIDGE. I do have a statement, Mr. Chairman, but I would ask unanimous consent that it be considered as part of the record. People are here not to listen to my statement, but to listen to the statement of the witnesses.

Chairman CARPER. Fair enough. Without objection.

[The prepared statement of Mr. Ridge can be found in the appendix.]

Chairman CARPER. I notice the arrival of Mrs. Patterson.

We welcome you, as well. Governor LaWare, you get to be our clean-up hitter again, the second time in 2 weeks. We welcome you, and we look forward to your testimony.

STATEMENT OF JOHN LaWARE, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. LAWARE. Thank you, Mr. Chairman and members of the subcommittee.

I have submitted detailed testimony on this subject, but I would like to read into the record a brief summary of it with your permission.

The concerns encompassed by "too big to fail" are among the most important reasons why we need to reform our deposit insurance system and the broader structure of financial institutions in regulation.

I want to emphasize that the Board is extremely uncomfortable with any regulatory policy that differentiates among banks or their customers, largely on the basis of a bank's size.

Thus, the Board supports the Treasury's proposals that would enhance the accountability, of and tighten the criteria used by, regulators in resolving failed banks. However, we believe that it would be imprudent for the Congress to exclude all possibility of invoking "too big to fail" under any circumstances.

Situations may arise where uninsured liabilities of failing institutions should be protected, or normal regulatory actions delayed, in the interest of macroeconomic stability. Indeed, implicitly or explicitly, a policy of "too big to fail" is followed in most industrialized countries.

In general, it is appropriate to invoke too big to fail only in cases of clear systemic risk. By systemic risk, I mean the possibility that financial difficulties at a single very large bank or even a small number of banks could spill over to many more financial institutions. Practical situations representing true systemic risk are rare.

Unfortunately, the specific considerations relevant to such determinations vary over time with, for example, the underlying strength of the financial system itself. The board endorses reforms that would foster a stronger and more resilient banking system. The goal should be a system in which even if a very large bank failed, the strength of other institutions would be sufficient to limit the potential for systemic risk.

Thus, over the years, we have been committed to higher capital standards, to the reduction of risk in the payment system, and to improved international cooperation in the areas of payment systems and banking supervision. For the same reasons, we also support the Treasury's proposals calling for frequent, on-site examinations, prompt corrective action policies, interstate branching, and a broader range of activities for financial services holding companies that have well-capitalized banks.

Even in such an environment, it would be impossible to guarantee that systemic risk would never occur. In our view, therefore, it is essential that policymakers retain the capacity to respond quickly, flexibly and forcefully in conditions involving extensive risk to the financial system and the economy.

One of the most serious potential effects of the failure of a very large bank is an impairment of the system that is so widespread as to disrupt the economic activity of the Nation. There are several aspects to this potential problem.

First, when a bank fails, the ability of its depositors to make payments from their accounts would be severely limited were it not for government intervention designed to maintain the liquidity of insured and sometimes uninsured balances.

A second aspect of systemic risk reflects the fact that large banks are major providers of payments and other correspondent banking services for smaller depository institutions.

The loss of access to their uninsured balances at a failed correspondent could cause other financial institutions to experience liquidity and solvency problems of their own. In addition, the failure of a major correspondent bank could cause significant problems for the customers of other banks and financial institutions that ultimately depend on the correspondent for payment services.

Both of these possibilities were concerns, for example, in the 1984 failure of Continental Illinois National Bank. Some of the clearest examples of payment system-related systemic risk are associated with foreign exchange markets.

An important concern in these markets is the risk arising from the practice, due to differences in time zones, of paying out foreign currencies in settlement of foreign exchange contracts before counterpayment in U.S. dollars is fully completed.

This practice exposes participants to the risk of losing the full amount of foreign currency paid out while they are awaiting dollar payments. Failure to complete these foreign exchange transactions in a timely manner would subject counterparties to greater risk of loss and could undermine confidence in domestic and international payment systems.

Another serious aspect of systemic risk is the possibility of widespread depositor runs. Such runs could be engendered by the failure of a major bank if such a failure generated significant uncertainty regarding the health of other banks.

Widespread runs away from domestic bank deposits could seriously disrupt the process of intermediation on which many borrowers depend. We need only look at the costs imposed by the recent credit crunch to get a sense of the critical importance of credit creation by banks to the economy.

For the foreseeable future, there will always exist borrowers for whom banks serve as the primary source of funds. Widespread difficulties in the banking sector could reduce confidence in the broader financial system.

Virtually all types of financial institutions depend on the maintenance of public confidence for the successful conduct of their business. For instance, investment banks depend on commercial banks for substantial amounts of short-term credit.

A significant reduction in the supply of bank credit would reduce the ability of these institutions to provide underwriting services and liquidity support to securities markets. Furthermore, many securities are backed by bank credit guarantees or liquidity facilities.

The continued provision of credit to nonbank financial institutions was one of the Board's primary concerns in our efforts to minimize the adverse effects of the October 1987 stock market crash. Larger commercial banks are also major and direct participants in many key financial markets, including government securities, mortgage-backed securities, and foreign exchange. The collapse of a major bank's participation could, for a time, significantly impair the functioning of those markets. It is important to understand that even where too big to fail is invoked, the stockholders, bond holders, and senior management of the insolvent bank loses.

That is, even when all depositors are made whole and the bank continues in operation, senior management is replaced and the financial interests of stockholders and bond holders are extinguished.

The board believes that it should have a role in determining when systematic risk exists. As the Nation's central bank, the Federal Reserve has responsibilities for the health of the domestic and international payments and financial systems. Thus, the Federal Reserve has both the perspective and the expertise that are useful for evaluating the systemic risk implications of a given crisis or imminent bank failure.

Inevitably a determination of whether systemic risk is a substantial concern must be made on a case-by-case basis. Furthermore, the Board understands that it may be all too tempting for regulators to declare that systemic risk requires deviation from normal regulatory procedures. For these reasons, the Board supports the Treasury's proposal that both the Board and the Secretary of Treasury should jointly determine when systemic risk justifies such deviation.

In closing, I would reiterate the Board's strong support for the principle that regulatory actions should apply equally to banks of all sizes. However, a primary reason for the safety net for depository institutions is to prevent systemic risks from imposing major costs on the economy.

The broad set of financial reforms proposed by the Treasury would help to reduce the likelihood of serious systemic risks, but we should not fool ourselves into believing that an impending bank failure will never be a threat to the stability of our economy.

Therefore, the Board strongly urges Congress to continue to allow policy-makers the flexibility to intervene for the purpose of protecting against systemic destabilization.

Thank you, Mr. Chairman.

[The prepared statement of Mr. LaWare can be found in the appendix.]

Chairman CARPER. Governor LaWare, we thank you very much.

Gentlemen, I have a few questions I would like to ask. Then I will turn it over to Mr. Ridge.

There seems to be general agreement on a number of themes in your testimony. One, you seem to agree that we need strong capital standards for our financial institutions.

Two, there seems to be agreement that what we need is comprehensive reform in the delivery of financial services in our country.

The third point you seem to agree on is that—I think Mr. Glauber alluded to it, the notion that the Bank of New England's uninsured depositors are protected and at Freedom National Bank of Harlem, they are not. There is a matter of inequity or unfairness that none of us are comfortable with.

The fourth point that I seem to sense agreement on is that while the too-big-to-fail policy must be limited, you don't want the Congress to bar with a law the protection of uninsured deposits in all instances.

Those seem to be among the major points that you agreed on. I sense, at least from some of the body language I was picking up from the witnesses, there might have been one or two points that there was some disagreement on.

I recall during Mr. Glauber's testimony, I might have seen Mr. Seidman's head shaking, no, and shocking as that might be, but, Mr. Seidman, why don't you just specify what you were thinking there for us.

Mr. SEIDMAN. Well, I seldom disagree with Mr. Glauber, who I have the highest respect for, but I must say when he said that under the too-big-to fail doctrine, we protect practically all depositors in all cases, I think that would be misleading.

As I said, and he seems to disagree, we have used the essentiality provision of the statute four times in the last 5½ years. In the other cases to which I believe he was referring, we have covered all depositors, as we do both in small banks and large banks, because it has been less costly to the fund than the cost of the liquidation.

Whether that liquidation is done by a payout or by an insured deposit transfer, which is a method of pay out, makes very little difference. So I think we would be making a mistake if we look at the fact that uninsured depositors have been covered in 99 percent of all cases and say that has anything to do with too big to fail.

It has nothing to do with too big to fail. It has to do with the lowest cost way of resolving a failure. Now, the cost of the failure comes on the asset side, from the loss from the value of assets when an institution fails. It sometimes is mistakenly thought if we could just close a bank while it had 2 percent capital, there wouldn't be any loss.

Well, if we are going to liquidate that bank, I can tell you from experience that there will be a substantial loss because the assets themselves lose value when you throw them on the junk pile. I guess if there was any body English, it was that I hate to see us getting mixed up between too big to fail and least cost resolutions of failed institutions.

I think in general the provisions that the Treasury has proposed will make very little difference. We gave you the four cases where that we had actually invoked that doctrine. In every case we have been encouraged to invoke it by the Federal Reserve, and at least the Treasury has not been willing to say that they would advise us not to invoke it.

I am concerned that we look at reality here in terms of what is really going on.

Chairman CARPER. All right. Mr. Glauber, any follow up there?

Mr. GLAUBER. Well, first, let me state a bit of reality, and that is that for whatever the reason, while roughly 75 percent of deposits are insured, we have managed to cover 99½ percent of deposits in resolution. Now, the reasons we can dispute, and that is really looking backward, and I prefer not to spend a lot of time looking backward.

What is a fact is that under current law the FDIC is not required to look at all methods of resolution and determine the least cost. Under what we propose, they would be. I think that that is the way it should be.

I think it would make a difference in the future. But in any case, I think we ought to have on the books a law that requires that they use the least cost method of resolution.

Chairman CARPER. All right. Let me take a somewhat different course now. The Subcommittee on Financial Institutions met in this room on Tuesday. They marked up a bill, H.R. 2094.

I would welcome the specific responses of each of you to the action taken in that subcommittee with regards to too big to fail, your specific reactions and any specific changes that you would recommend at full committee when we take up that legislation.

Governor LaWare, why don't you lead off.

Mr. LAWARE. Well, we were very pleased that the 5-day limitation on borrowing at the Federal Reserve discount window was removed in the markup because we felt that that was much too rigid a limitation on our ability to provide emergency liquidity, that, in the final analysis was one of the principal reasons for establishing the Federal Reserve in the first place.

We are concerned that the language that remains in the bill, however, that after 1994, "too big to fail," if we can simplify the procedure in that fashion, may not be invoked, and that the FDIC may not, in fact, use any of its funds to protect uninsured depositors. That is the reason for our testimony today as much as anything, to try to persuade Congress to rethink that section of the bill.

Mr. Clarke.

Mr. CLARKE. Mr. Chairman, I agree with Governor LaWare on both counts. I think it was desirable not to limit the use of the discount window, as had been proposed. I think it is very unfortunate to completely bar the FDIC or anyone else from the ability to deal with systemic risk when it is upon us. As I have urged in my written statement and as I have urged in my opening statement this morning, it is very important that there be a mechanism that permits dealing with systemic risk. The administration's proposal provides that mechanism.

Chairman CARPER. All right.

Mr. Glauber.

Mr. GLAUBER. Mr. Chairman, we believe that under H.R. 2094 that the Fed does retain some ability to deal with systematic risk, but we don't believe it is fully adequate. We would continue to support amendments which would bring the provisions of the final legislation more closely in line with what we originally proposed.

We think it is still necessary to have some more flexibility than what is provided by H.R. 2094.

Chairman CARPER. Thank you.

Mr. Seidman.

Mr. SEIDMAN. The principal provision that we think needs further study is the limitation on paying depositors above $100,000, which comes into effect in 1994, and says even if it is less costly we want you to take the more expensive route in order to not pay insured depositors.

It seems to me that that is, you know, shooting off your own foot. It is hard for me to justify the Congress would want us to take a more expensive way of resolving institutions. Let me just take a second to explain why it is that it is often less expensive to cover all depositors.

The reason is that we are selling a bank and a bank franchise. Bankers do not want to buy an institution where their first act of buying the institution is to take their best customers and tell them that they have just lost a portion of their deposits. So bankers will pay more for an institution where all depositors can be covered than they will for one in which the best customers that they are taking over in the new institution are being penalized.

Only when they are willing to pay more can we find it to be less costly than a liquidation or an insured deposit transfer, which is a form of liquidation. So it would seem to me that it is very unwise for us to provide that even though there is a less costly way to handle matters, the fund will be prevented from doing that because we are not going to pay anybody over $100,000 in any event, no matter what.

Chairman CARPER. All right. Thank you very much.

Mr. Glauber, the last word, then I will yield to Mr. Ridge.

Mr. GLAUBER. Thank you. I would just like to seize the opportunity to agree with my friend, Chairman Seidman. On this I think absolutely the FDIC should be permitted to consider the full range of resolution methods, and pick the cheapest one, even if that includes a purchase and assumption transaction, which it would be prohibited from doing under H.R. 2094.

Chairman CARPER. OK, thank you. We welcome Mr. Vento. Thank you for coming, Mr. Ridge, you are on.

Mr. RIDGE. Thank you, Mr. Chairman.

If we check the attendance records of the full committee and the subcommittees, that the four of you have better attendance records than most of the Members. I have to tell you how much we appreciate your willingness to testify, your access, and most importantly, your time.

I think I can speak for all of my colleagues that we are very grateful for all of that. Governor LaWare, I want to follow up on some things that my colleague alluded to and that relate to the subcommittee's removal of the provision objected to by Chairman Greenspan that would have limited the Fed's ability to advance funds to institutions.

It is my understanding that the Bank of New England was lent about $2 billion by the Fed during a liquidity crisis in the spring of 1990. It seems to me that under those circumstances, and I think some of the data collected during and after that process suggested that a lot of that money was lent and went out because uninsured depositors were leaving the system.

In order to bolster up a troubled bank that is having problems, you infused substantial dollars going to potentially uninsured depositors. That obligation then becomes an secured obligation. You are then a secured party. Basically, we have a sinking ship; stowaways get off with their luggage. The rest may go down with the ship or if they survive, they don't have their luggage or their luggage gets a hair cut. The Fed is protected.

It seems to me that one of the concerns that my colleagues have is that the Fed's well-intentioned involvement ultimately can exacerbate the problem and cost the taxpayers even more money. Or cost BIF potentially more money, as well. Shall we give a hair cut to Fed advances?

Mr. LAWARE. I am not quite sure I know what you mean by a hair cut to Fed advances. Our role in the Bank of New England is the classic role of the central bank in providing emergency liquidity to an institution.

You likened it to a sinking ship. At that stage it was leaking, and the pumps were being manned and the life boats were being swung out to be lowered in case of necessity, but it was not an insolvent institution at that point. We are required to take collateral for loans that we extend under those circumstances, and I don't think that the role of the Fed was in any way improper.

I would also argue that the ultimate cost to the FDIC was probably less as result of the actions taken by the new management that was installed in the spring of 1990 significantly reduced the expenses of that institution, worked down the assets, and I believe that by June they were completely out of the Fed.

They were not borrowing from us, and the institution still had capital, not at desired levels, but they were not capital insolvent at that point. I think that role was an appropriate one and one that we are chartered to do.

Mr. RIDGE. Any body else care to comment?

Mr. Clarke, I saw you nodding in agreement.

Mr. CLARKE. I totally agree that that is the classic function of the central bank. The central bank does not lend to an institution at a point where it is deemed to be slumping, when it is insolvent, but when has a temporary need for liquidity. The management team that was put in place in the early spring of 1990 was busily downsizing the institution. They were selling assets. They were transferring assets from the holding company into the bank to try to get its capital up. They were doing all the kinds of things that you would like to see being done in an institution that is trying to save itself. I think it is very important to note that they were out of the window. Despite the fact that they borrowed substantial amounts from the Fed, they were able to pay all of those back in full and stayed out of the discount window until very close to the failure of the institution.

Mr. RIDGE. Have there been instances when, in spite of your intervention and your well-intentioned efforts as a Central Bank where these illiquid institutions eventually became insolvent?

Mr. CLARKE. Yes.

Mr. RIDGE. With what frequency has that happened, and do you have any idea what ultimately the resolution was?

Mr. LAWARE. I think that is far less frequent than instances where we have provided that liquidity.

Mr. SEIDMAN. Mr. Ridge, I think the illustration you need is not the Bank of New England, but the National Bank of Washington because that is a case where at least you can argue that the costs to the BIF fund were increased. That wasn't the intention, but that is the way it worked out, so in my view it isn't that the Fed is misguided or doing the wrong thing, but occasionally it worked out that what we thought was solvent turns out to be insolvent.

In the interim, the Fed's money has gone out either in losses or in uninsured deposits. I don't think it is wrong to say that there is a problem there that we need to look at, but I don't think the Bank of New England is a good illustration of that.

Mr. RIDGE. You said—you referred to the National Bank of Washington. You reluctantly admitted that there was an argument. My sense is you don't think there is much of an argument for the discomfort that Members of Congress have with the Fed's posture perhaps interfering with the congressional intent dealing with too big to fail?

Mr. SEIDMAN. Well, I would say that the Fed was carrying out what they believe, and I believe, is their obligation to meet liquidity problems, but presumably they are not to meet liquidity problems of insolvent institutions. When, in fact, they turn out to be insolvent, then there may be a cost to the BIF fund because they have—they and we have all misjudged the exact extent of that institution's financial problems.

Mr. CLARKE. It is interesting to point out, though, Mr. Ridge, that when the National Bank of Washington was closed, it had $25 million of equity left in it. It was technically not insolvent.

As Chairman Seidman indicated earlier, once an institution is closed and once the assets go into the FDIC receivership, the assets become of much less value and the FDIC does lose money on them. But in the case of the Fed, at such time as an institution is judged to be insolvent or unable to get itself out of the discount window, the lending stops.

Mr. RIDGE. I very much appreciate this public discussion of that role of the Central Bank because I do believe that we may revisit that issue in full committee because of the discomfort level of some Members up here.

Again, I appreciate your responses to these questions. I believe my time has expired.

Chairman CARPER. Thank you, Mr. Ridge.

The Chair notes the arrival of Mr. Hancock, Mr. Hoagland, Mr. Moran. I want to recognize Members as they have arrived.

I believe Mr. Luken is next. If I misstep, I hope that the Members will correct me.

Mr. Luken, you are recognized.

Mr. LUKEN. Thank you, Mr. Chairman.

Let me congratulate you on putting this important hearing together. It is one of the most difficult issues we face as we approach the question of bank reform. My question is maybe a little bit different. I want to address the question of what happens to small and medium-sized banks if we adopt the Treasury Department's position, and I want to raise two factors.

One is, no matter how we might argue to the contrary, clearly too big to fail provides an advantage, of what magnitude, we can argue, some advantage to banks who would be perceived as falling under that doctrine.

In addition, there are proposals that will permit interstate banking, and I understand the logic behind them, but I wonder if there is not a feeling that all of these things together might, in the long run, make it more difficult for small and medium-sized banks to exist, and particularly if we look at the history that those institutions have in investing in what we might call middle America.

The homes, the small businesses, whether or not the combined impact of this legislation doesn't have a negative impact on small and medium-sized banks and whether that is good for the United States generally.

Mr. GLAUBER. Well, let me begin. I think really quite the opposite.

I think the impact of the legislation on small and medium-sized banks is positive and not negative. First, on "too big to fail", I think the current situation is unfair, and that we have to cut back on the incidence of protecting uninsured deposits in full. We propose to do it, as I said, in several ways, most importantly by cutting down on failures, but also by making it more difficult to declare that a situation is a systemic risk situation in which we have to protect all uninsured deposits.

I think that that can only be fairer to small banks, as it should be.

As regards the other parts of the bill, I think, first of all, anything that cuts down on failures, and failures often occur to the largest banks, anything that cuts down on failures has to be fairer to small banks because they tend to be the best capitalized banks, and they shouldn't have to bear the burden of failures that can be avoided, and I think, again, the bill that we have put forward would do that.

On the issue of branching, I must tell you that I believe—and a large number of the small bankers with whom I have spoken believe, as well—that branching is not going to endanger their future. They have withstood the onslaught of branches of larger banks over and over again and done extremely well. They do well because they provide the services in the community better than any other banking company could do.

We have really run this experiment, if you want to call it that, in a number of States, when they go on to statewide branching.

California may be as good an example as any. California is as big as most countries.

California's small community banks have thrived in the face of what amounts to nationwide branching within California. The same thing is true in New York. So I don't believe that what we propose will endanger small banks.

Indeed, I think it will clearly help them, as it should.

Mr. LUKEN. Mr. Glauber, let me just follow up. Do you think after this legislation that the Treasury envisions, if it is adopted by Congress, that without regard to whether that is a good thing or a bad thing, do you project out that there will be fewer banks in this country necessarily?

Mr. GLAUBER. I think there will be. There, of course, have been fewer banks each year in this country. I will hazard a guess that if you look to see where the contraction will come, it will come as much at the end of the large banks as it will among small banks, that what we are doing in this legislation is to require that banks either be well capitalized or get out and get out usually through a merger. Since some of the larger banks are less well capitalized than the small ones, I think that you will see some of them disappearing generally through merger.

Mr. LUKEN. Thank you, Mr. Chairman.

Chairman CARPER. Thank you, Mr. Luken.

I believe that Mr. Thomas may have been here next. I will recognize you at this time.

Mr. THOMAS. Thank you, Mr. Chairman.

Due to my newness here, my questions will be a little broader, I think. First of all, I assume you know that each time we go home we hear more about taxpayers supporting failed financial institutions than almost anything else, so it is a terribly serious problem.

Mr. Seidman, you have been to Wyoming, and I appreciate that. You talk about moving towards larger banks in this whole philosophy, at least the Secretary did, and says we have to compete in the world and need larger banks, and if that is the policy direction, but then you play down at the same time this same matter of "too big to fail". I see a little conflict there. Would you comment on that, please, sir?

Mr. GLAUBER. Certainly, Mr. Thomas.

I don't think we necessarily want to move towards larger banks in particular. Indeed, I think that there are elements in the legislation we put forward that will make it possible for larger banks to be more competitive, but also for middle-sized banks and for the community banks. For middle-sized banks, branching is going to take a tremendous amount of cost out of their operations, which can only help them. Of course, with the largest banks, allowing them to compete with a range of activities which are the same as their international competitors have, ought to help them.

Our philosophy is not to try and make larger banks. Our philosophy is to take out of the system regulations which prevent the system from adjusting to the demands of the marketplace and then let the marketplace decide what it should look like so long do it is in a safe and sound way.

I don't think that we are trying to tip things towards larger banks at all. We are trying very seriously in this legislation to help community banks and to help middle-sized regional banks as well.

Mr. THOMAS. I recall the Secretary's talking about us dropping out, not being in the largest of the world banks and feeling very sorry about that.

Mr. GLAUBER. Well, Mr. Thomas, I think that is one of the segments of the banking industry, and I think we need to be competitive in that segment. We need also to have efficient, competitive banks in the middle-sized regional part of the banking system so that they can deliver their services more cheaply. I don't think you should take the Secretary's comments as focusing unduly on the largest banks.

Mr. THOMAS. Good.

Mr. Seidman, I understand that even the largest bank, I think Citibank, only represents about 3 percent of the market, really, as opposed to some of the other businesses that have been too large to fail. How do we handle other businesses? Why should we handle the banking business with that sort of concentration any differently than we do Chrysler or anyone else?

Mr. SEIDMAN. I don't think we should. I think Chrysler and Lockheed were public policy decisions made and paid for by the Treasury. I think that large banks should be treated in exactly the same way. Let me indicate, so I get it on the record, that I don't think the proposals that are now before you in the administration bill are going to make any difference in "too big to fail".

We already cut all those parties. It may make it a little easier because the parties deciding whether or not we will invoke the doctrine don't have to pay for it. At least when we invoke the doctrine, we have to pay for it.

So in my view, the proposals before you insofar as the fears of the small banks are concerned cannot be very comforting.

Mr. THOMAS. Let me—I didn't quite understand what you said. You said we have to pay for it. If you invoke the doctrine, who pays for it now?

Mr. SEIDMAN. The FDIC. Let me make it clear that we have only invoked the doctrine four times. This is not something that is happening day and night. It has happened four times.

I have been there all four times. I have spoken with all the other—well, Mr. Clarke is on our board and has been a part of it. We have always spoken with the Fed. They have attended the meetings, they have supported it all four times.

We have spoken with the Treasury about it, although they have not necessarily given us their OK. I can tell you that in the last one, the Bank of New England, I told the Treasury that if the administration believed that we should not support the Bank of New England with coverage of uninsured depositors, I would vote for that because I thought it was a public policy question that ought to be decided by the administration.

Mr. THOMAS. Who decided on Lockheed and Chrysler?

Mr. SEIDMAN. Congress. The problem with banking is you don't have time to hold hearings and go through that when you have to act. That is why I have proposed that the administration have a fund available which they can use. They have got a couple of funds around there they could use with the total fund being only a billion, you know.

They have got a lot of that laying around that they could handle it with.

Mr. THOMAS. Let me ask another naive question.

The four of you represent, I suppose, the basic regulators. All of you have talked about moving more quickly, I believe.

You use capitalization as a sign of being strong. Why don't you move more quickly? I hear you saying we need to move more quickly, we have been having failures for a long time.

Why don't you move more quickly?

Mr. SEIDMAN. Well, I am only the recipient of the move after it takes place. I guess Mr. Clarke could answer that.

Mr. THOMAS. Mr. Clarke.

Mr. CLARKE. I will be glad to tackle that one. You have correctly pointed out that the proposals that are being suggested for moving more quickly are geared to capital. We have changed our policy with respect to national banks to provide that when a bank runs out of equity capital, it is insolvent, and it is closed if the owners of the bank have no means available to recapitalize the bank. We, obviously, try to give people a fair opportunity to raise additional capital in the capital markets or sell the bank to someone else or otherwise get it recapitalized. But this policy results in a much earlier closure of institutions than formerly. We used to close them when they ran out of primary capital, which meant that the loan loss reserve also had to be fully exhausted. That meant that insolvent banks were able to stay open longer and banks that failed had had all of their loan reserves already exhausted.

I think it is important to focus also on actions that we can take at a time when everything is going great. That is the most difficult aspect of bank supervision, but something we have to come to grips with. A lot of the loans that are put on the books when all the trends are going up and all the asset values are going up and the borrowers are paying a lot of money and the banks have a lot of capital and they are earning a lot of money are the ones that ultimately cause the banks problems. Those are put on the books because the banks let their guard down; they forget that the curves will someday turn down. They lower their underwriting standards in some cases because of competitive pressures. That is the most difficult time to go into a bank and get the bank to correct its actions, because their response is, "Where are the problems? Look at all the capital we have; look at all the money we are making. Look at the way the values are going up in this particular market." The administration's proposal would give us the opportunity to move in that area with a little bit more decisiveness, and I believe you will see that happening.

Mr. THOMAS. Thank you.

I appreciate your candor, all of you. I think we all have to be very candid in addressing this problem so that we don't end up with something that we have had before.

Thank you very much, Mr. Chairman.

Chairman CARPER. Thank you, Mr. Thomas.

The Chair would now recognize Mrs. Patterson. I think you were the next to join us. Mrs. Patterson.

Mrs. PATTERSON. Thank you, Mr. Chairman.

I appreciate your holding this hearing. I regret that we had a delay in getting started. I appreciate the gentlemen appearing before us.

I know that what we have been dealing with in Subcommittee on Financial Institutions and before the committee is of interest to lots of us, but I think it is primarily interesting to the taxpayers, at least in my district it is all we talk about, bank failures and who is going to pay for them in the long run and whether the BIF is out of money or will soon be out of money, and so that really has gotten a lot of attention in my district.

The other elements of the Treasury bill may be have not gotten so much as you all would like, but this is what has gotten the attention of the media and the folks in my district. I am sure that all of you, if you were not present, had a representative present as we dealt with the mark-up this week, and I would like to ask a couple questions.

Number one, I think it has already been alluded to. I would like to hear from you how you feel about the overall bill, but then I would also like to ask each of you, and maybe, Mr. Seidman, you would be the place I should begin, during that mark-up I proposed an amendment dealing with BIF that I thought was a good amendment.

It broadened the base for the assessment. It didn't pass, but I think that is something we really do need to look at as we deal with the "too big to fail" or if you want to call it the "least cost to fail" institutions, whatever you want to call it.

I do think that broadening the assessment base is direction we should look toward. I just wondered how you feel about that and wondered how in general the rest of you felt about the bill as reported out.

Mr. SEIDMAN. Well, I think the bill as reported out is a good first step. It would be sad, however, if the subcommittee feels that by acting with respect to that narrow issue, they have dealt with the problem, so I think we have made certain comments on the bill so far, but I would be very much concerned if the subcommittee—if that is the full product of their labors. I think they have to look at the broader issues.

With respect to your proposal, we believe that the FDIC should have the authority to use a broader base if it appears appropriate. Much of that depends on whether or not "too big to fail" gets eliminated, as Chairman Gonzalez would propose, and as this bill would propose down the line or whether it becomes accepted that there is going to be that power in the Government because clearly "too big to fail" affects foreign as well as domestic deposits.

If you save an institution that has large foreign deposits, then there is certainly a basis for saying that the premiums ought to be paid on all deposits or all assets, Therefore, I would, in general, favor giving the FDIC the power to use a different base if it appears appropriate when we see how this all settles out.

Mrs. PATTERSON. I would look forward to working with you and those on your staff in relation to that. Mr. Glauber, we keep seeing body language up here. Evidently, you want to say something.

Mr. GLAUBER. No, but I am happy to respond to your question. First, on the general thrust of what the subcommittee did, I think it is quite positive. I think there may be some things we would like to see changed on some of the issues, but I would want to start by emphasizing what Chairman Seidman just did, that we think it is very important that the subcommittee go is forward as it intends to do next week and begin to treat the broader structural reform issues because we believe that any attempts simply to fund the problem, to put more money in the fund without fixing the underlying structural problems is a mistake.

On the specific issue you raise, I understand well the desire to broaden the assessment base, but in doing that, of course, it then calls into question what liabilities are assessed, and our concern is by broadening the range of liabilities that are assessed, we implicitly broaden the safety net, and we think that is a mistake. We think that we ought to, in fact, narrow what it is that we protect.

We believe that "too big to fail" should be changed to do that, and we believe we shouldn't take steps to broaden what we insure.

Mr. CLARKE. I would like to comment just on a couple of aspects of the legislation. One of the things that I would very much hope would be revisited is the absolute prohibition in the bill currently on the ability to protect uninsured deposits. I simply think you have to provide the mechanism to deal with systemic risk, as I indicated in my opening statement.

The other thing I hope everyone will please keep in mind as this legislation is looked at is the need to maintain a sufficient amount of flexibility on the part of bank supervisors to deal with problems on an individualized basis. Every problem bank has different characteristics. The administration has sought in its bill to provide balance between a triggering mechanism that give bankers an expectation of things that can happen to them when they reach certain capital levels and giving the supervisor who has to deal with the facts as he or she finds them the ability to make judgments and take actions designed to correct the problems in that particular institution. I would hope that there wouldn't be absolute required actions in all cases, regardless of what the circumstances happen to be.

Mrs. PATTERSON. I appreciate that. Let me just say to the panel, I listened with interest in some of the sections of the bill that we will be looking at next week,. in my State of South Carolina, which was in the State legislature, we dealt with the interstate banking compact, and it was a big issue. Everyone said our small banks and our community banks will die out. That was the thrust of that whole debate. For a few months, years, we did see a few of them, but in recent years, we have seen more and more thriving and new ones popping up.

I think we need to consider that when we look at that section in the big bill next week.

Mr. GLAUBER. I am very heartened by your comments.

Mrs. PATTERSON. Thank you, Mr. Chairman. I will yield back the balance of my time.

Chairman CARPER. Thank you, Mrs. Patterson.

The Chair would now recognize the gentleman from Iowa, Mr. Nussle.

Mr. NUSSLE. Thank you, Mr. Chairman.

I listened with some interest here, Chairman Seidman, when you mentioned Willy Sutton robbing banks, and that is because that is where the money is. That is probably why Bonnie and Clyde came to Iowa many years ago, because that is where the money is.

As I read in my Iowa newspaper here last week, it says that more banks in Iowa were profitable at the end of 1990 than in any other State, according to figures released Thursday. The Federal Reserve Board said 97 percent of Iowa banks recorded a profit on December 31st, so you can see where we are concerned. We are also very proud of these accomplishments because that hasn't always been the case, as you well know.

One of the questions I have and one of the assumptions that the chairman went through here early on, he said there were some things that you all agreed on. One of the things you agreed on is that every country does this, and I guess I am curious within the same period of time that we have realized four such instances of bailouts—or, not bailouts, but "too big to fail" type instances. Are there other countries that have experienced that same type of situation?

Mr. SEIDMAN. Well, there is no country that has a system like ourselves, to begin with, so we are looking at a much greater number of banks, but there have been instances in Germany and England, I think in Switzerland where there have been institutions that have had to require Government rescue, and essentially in those cases they have supported all depositors.

However, none of them have had any institution comparable to the size that we have had to deal with.

Mr. NUSSLE. You mentioned, too, the public versus private or explicit versus implicit discussion of "too big to fail". Do you think that the fact that we have a more public "too big to fail" policy—for instance, we are having a discussion here, television cameras, and so forth—do you think that has affected the way it is used in this country, as opposed to other countries that you indicated where it is a little more private?

Mr. SEIDMAN. Well, we have a tendency to deal with things in an important public way in this country. Our fellow regulators in other countries wish we would stop talking about it so much.

We usually can't accommodate them under our system. So I think it has brought it much more to the fore here, but what has really brought it to the fore here is that we have had $20 billion and $30 billion banks that were failing. Therefore, we had to make a decision very publicly and up-front what we were going to do about them.

Mr. NUSSLE. It has been mentioned Lockheed, New York City, Chrysler, in those instances it was my understanding that they were required to pay back. Do you think that there should be paybacks in instances where "too big to fail" is exercised, and how could that work if you think that would be a viable policy?

Mr. SEIDMAN. Well, I think it——

Mr. NUSSLE. Because it is my understanding that there is no payback currently.

Mr. SEIDMAN. In essence, that is true. The way you get a payback is by having the Government own all or part of the institution during the period when it is supported and ultimately recovers. The reason that Continental Illinois, the largest failure we ever had, has cost us the least by far of the major failures is because we owned it. We simply ran it until it could recover. As a result, we didn't lose the franchise value, we didn't throw the junk pile operation at it, and that institution will cost us, when we are all done, probably less than a billion dollars, whereas some of these others are going to cost us $2½ to $3 billion.

The difference is that we were willing, if you will, to nationalize those institutions and run them as government operations.

The problem in banking is that if you start in that direction, we have a great many candidates that we might end up owning. We might really move to nationalize our banking system in a way that would be very unfortunate. Therefore, we are paying for not nationalizing these institutions.

Mr. NUSSLE. OK. Mr. Clarke, I listened with interest in your frustration over maybe being able to get involved coming in sooner, so to speak, in some of these instances. Do you think we are tough enough in the legislation? I know that—I guess I am referring to early intervention, especially. Is there a way to come in even sooner than what is proposed so that we don't even have to worry about "too big to fail" in the future?

Are there ways to do that that are even tougher than what we are experiencing in the current legislation?

Mr. CLARKE. In the administration's proposal, with the early intervention stops along the way, there is a point at which there is an ability to step in and establish a conservatorship, with the conservator having the authority to sell the institution or merge it with another institution. We have that authority today, incidentally. Congress gave us in FIRREA a conservatorship authority which works. We had some conservatorship authority prior to FIRREA, but it really didn't work. We have used the new conservatorship authority in several instances.

The kind of early intervention that I was talking about earlier is the ability to step in way before you are even thinking about selling the institution, way before its capital has deteriorated, and bring about the correction of banking practices that can lead to the demise of an institution if they are not fixed. That is going to require greater acceptance on the part of the industry of the regulatory process' stepping in and assisting in those corrections. I suppose that had we done that in some instances, over the last five years, your mail and the mail of many of your colleagues would have been scorched around the edges talking about the heavy-handed regulators who were coming in, trying to run the institutions and force management to do things when there were really no problems. I think we should intervene earlier, but there is also going to have to be a greater acceptance of our doing that.

Mr. NUSSLE. I am just amazed as I travel around my district talking to bankers. I have to say that I admire Mr. Thomas' candor in saying that he is learning the issues. So am I.

I am a new member to the subcommittee, and this is not my background, so I have been talking to a number of my bankers. They tell me that they want a little stronger regulation, that they want that oversight, they are looking forward to it.

I think it is because they see themselves as being a little bit better run than some other areas, and they want, I guess, the incentive or the ability to go into other areas.

Is it capital requirements that we should look at or are there other areas?

I mean, should we just say that at a certain point capital requirements, eight, seven—I don't know—that at a certain point we come in and should we increase those? I guess that is what I am searching for.

Mr. CLARKE. We have, I believe, a very workable capital adequacy measuring stick now, the combination of risk-based capital standards, which became effective this year, with an underpinning of the leverage ratio, and the ability to increase those levels above the minimums, depending on the level of classified assets, depending on the risk that is in the institution. But, I don't believe we should just look at capital standards. Bad management practices are what ultimately bring down a bank, and it is the management practices that erode capital away no matter how much capital you have. Therefore, there has to be an opportunity to get management practices corrected.

I agree with you that the banker who has 10 percent capital, Who is making a whole bunch of money, and who realizes that this has become a dollars and cents issue for him because he is now having to pay more for deposit insurance as a result of the failure of some of these other institutions is out there cheering us on, saying we need to be more aggressive, we need to do more of these kinds of things. When that banker's capital gets down to 2 percent, or 1.5 percent, his attitude changes radically because he is a human being. We would all have the same reaction.

Mr. NUSSLE. I see my time is running out. I guess this launches us into risk-based premiums a little bit, but I will pass on that. I know there is other people that have questions.

I would be very interested in any of your comments maybe at some point on risk-based premiums as well.

Thank you, Mr. Chairman.

Chairman CARPER. Thank you, Mr. Nussle.

Now, I would like to recognize Mr. Moran. Welcome.

Mr. MORAN. Thank you, Mr. Chairman.

We thank you gentlemen for joining us this morning. I would like to focus on those four instances of "too big to fail" banks that have brought us here this morning, not because there is much to be gained by crying over spilt milk, but we may be able to examine those instances in an effort to determine how that situation might have been avoided.

First of all, I would like for you to supply for the record, unless you have the figures now, what proportion of depositors' money would have been covered with the $100,000 cap, had we been purist about it and simply restricted insurance coverage to $100,000 per account and covered it literally, what proportion of depositors' money and what number of depositors, and within that number of depositors, how many were individual accounts versus corporate or pension or whatever, non-individual accounts?

If you have information in that regard, you might supply it now. Otherwise, you could do so for the record.

Do any of the witnesses have such information?

Mr. SEIDMAN. We can supply it for the record. I don't have it with me.

Mr. MORAN. OK. Thank you. I would be interested to have those figures.

[The information referred to can be found in the appendix.]

Mr. MORAN. Now, let's just do a speculation, if you would. I appreciate the breakfast we had this morning, Mr. Seidman. One of the things that we discussed was the concept of a two-track approach within banks that would leave choice to the individual or corporate investor on the one hand, one track would have all of the deposits fully covered, and insurance premium would be assessed on all of those deposits, but the money could only be invested in what would meet strict standards of fiduciary responsibility, so there would probably be a somewhat lower proportion of real estate investments perhaps, but at least there would be balance, and those accounts would be much safer investments and much less likely to not be able to pay off whatever loans were made.

On the other hand, if people chose, they could enter into the second track, which would be investments that were not covered by insurance, which would allow the bank to make somewhat more speculative loans, to be able to pay a higher interest, and, in fact, if the private sector wished to become involved, they might very likely offer a risk-based insurance premium for those wishing to pay a portion of the additional interest on an insurance premium to cover their deposits with private insurance, but it would be up to the depositor.

With that two-track approach, what I know of the National Bank of Washington and the Bank of New England, we clearly would have prevented the situation that has led to the hearing today and has led to such a heightened concern on the part of all Americans over the viability of our banking institutions.

Now, there are obviously a lot of aspects of that proposal which would need to be further studied, but would any of you care to offer some observations on how you think that might have played out had such a system been in effect and applicable to the four major banks that have failed to date? Mr. Seidman has some receptivity to the idea, so maybe we should start with you, Mr. Chairman.

Mr. SEIDMAN. Well, Mr. Moran, I think first it should be noted that the administration's program moves in that direction because they have proposed that these newer and riskier activities be done outside of the bank in separately capitalized institutions.

They haven't proposed that they be financed through a second window in the bank, but the general approach is comparable. In my view, if we had had that kind of an approach in some of these failures and we had been willing to force the riskier kinds of lending outside of the bank, we would not be facing these problems.

I mean, I can tell you today how to cure the entire problem, and that is to make every construction and development loan by a bank money good, and we wouldn't have any bank failures.

Mr. MORAN. Clarify what you mean by "money good".

Mr. SEIDMAN. Simply that they made very risky construction and development loans. As Mr. Clarke has said, the standards fell, the standards fell right when the banks were making all the money. It is a very difficult supervisory program. If we had a two window or however you want to describe it approach, where those kinds of things simply could not be done with assured funds, we wouldn't be facing the problem we are looking at today.

Mr. MORAN. So you think that probably would have prevented perhaps some, if not all, of the failures that we have encountered?

Mr. SEIDMAN. I think it certainly would have, if properly administered, made a big difference.

Mr. MORAN. Thank you, Mr. Seidman.

Mr. Glauber.

Mr. GLAUBER. Mr. Moran, I think the general thrust of what you are suggesting, as I take it, is central, and that is we have to put the riskiest activities outside of the bank and make sure they are not funded with insured deposits. As Chairman Seidman said, we intend to do that in what we propose.

Mr. MORAN. A fire wall?

Mr. GLAUBER. That is correct. Furthermore, we say certain activities which currently go on inside the bank shouldn't—direct investment in real estate, for example, and indeed we say that activities which State banks do which go beyond what national banks are allowed should not go on inside the bank unless Mr. Seidman and the FDIC says so, so I think the general thrust of what you are saying, and that is to get very risky activities outside the bank so the insured deposit money doesn't back them is right.

Mr. MORAN. The problem with what you are suggesting, though, Mr. Glauber, is that Northern Virginia would not be as healthy as it is today if there had not been many of those commercial loans that initially might not have seemed like good investments, but, in fact, worked out. I am afraid that you are cutting off the source of capital, and what this would do is really hopefully have the best of both worlds.

It would not endanger the banking system, the insurance fund, but it would still make capital available for those who knew what they were doing, who were willing to waive the safety that is naturally assumed the bank has.

Mr. GLAUBER. I agree with you. If someone wants to invest directly in real estate, they should be allowed to, they should be encouraged to, but not with insured deposit money.

Mr. MORAN. But still through the banking system perhaps?

Mr. GLAUBER. The bank could have an affiliate, and we would be delighted for the bank to have an affiliate of a holding company that does that kind of thing, but not with insured deposits.

Mr. MORAN. Thank you.

Mr. Clarke.

Mr. CLARKE. What we are talking about, what Chairman Seidman is talking about, is quite different from direct investment in real estate or the participation in securities activities or the other things contemplated by the administration's bill. What we are talking about here is just plain lending, which can be very risk-free if it is done right and can be very risky, as we have discovered, when it is not done right. When a market gets overdone, even the loans that were made to good borrowers and on good terms and conditions can produce a lot of pain for a lot of lenders.

To accomplish what you are suggesting would mean that many of these loans would have been made in an affiliate or at a different window of the bank funded by uninsured deposits. If you could create a mechanism where you could make certain that depositors understood what they were getting and the risk they were taking and understood that there was a difference—if they got a different color certificate of deposit, a different kind of deposit slip for an unprotected instrument—perhaps it would work. But you are really talking about a fundamental change in the way the banking system in this country has operated for a number of years.

Mr. MORAN. It would also, though, have rates that would be competitive with money market funds, more competitive, and thus it is conceivable that it would, if handled right, bring more money into the banking system for those who went in with their eyes open.

Mr. CLARKE. You just said the magic words, "if handled right". I would be very complex to make that change and have everybody understand what they were really doing.

Mr. MORAN. Any comment, Mr. LaWare?

Mr. LAWARE. Well, what troubles me about the narrow banking concept is that you implied that such a narrow bank could only invest insured deposits in investments on an approved investment list, and that seems to me to be fraught with problems because who is going to determine what that list of activities is?

If you want to be perfectly safe, it would be government securities, but then you don't need insured deposits.

Mr. MORAN. No. But there are parameters of fiduciary responsibility. We have standards for people who are responsible for estate accounts and so on.

Really, it would be going back to the more traditional concepts of banking loans.

Mr. SEIDMAN. Mr. Chairman, if I might just in that regard, one of the big imprudences has been concentration, so you could simply say to an institution, all right, if you want to make loans and concentrate beyond a certain level, then you move it over to the other window.

Mr. MORAN. Diversification and balance in the saver window.

Mr. GLAUBER. I think, I believe that the regulators presently have the authority to deal with concentration issues, and as I understand it, they are discussing that, so I think a lot of that is well within the bounds of what is permissible now.

Mr. LAWARE. What we don't want to get into is allocation of credit. I think that is very dangerous, and the important thing is to have an examination and supervisory system in place that can properly identify emerging problems in banks and have the authority to insist that they be corrected.

I think it would be a grave mistake to set out ratios in any firm way that would tend to determine for a bank exactly how its loan portfolio has to be split down.

Mr. MORAN. Thank you, gentlemen.

Thank you, Mr. Chairman.

Chairman CARPER. Thank you, Mr. Moran.

The Chair will now recognize Mr. Hancock, a member of the subcommittee, and subsequent to that, Mr. McCandless, if he has questions.

Mr. HANCOCK. Thank you, Mr. Chairman.

I am a little curious about how many times the Federal Reserve makes advances in the event of liquidity problems. I know about the Bank of New England, but in the past 10 years, has the Federal Reserve had to step in with other advances?

Mr. LAWARE. Well, we have essentially three different ways of lending funds at the window. One program is for seasonal needs of banks, for example, rural banks who finance the agricultural industry have seasonal requirements for loans that generally outstrip their deposit base, and so they borrow seasonally for long periods of time, several months at a time over a planting season, let's say, to carry a larger portfolio than their ordinary deposit base will support.

That is called seasonal borrowing.

Then we have adjustment borrowing, which is done by banks on a fairly standard basis when their reserves with the Federal Reserve System fall below what is required either as required reserves against their deposits or as amounts necessary to cover their transactions, their clearings and their wire transfers and so on with the Federal Reserve. Those borrowings are called adjustment borrowings.

There is a regular pattern of that kind of borrowing. Then finally there borrowing for emergency liquidity situations, and I would say over a 10-year period we have lent for liquidity purposes dozens of times. I can get the information together for you if you want it in detail, and we can supply that information to the subcommittee.

Mr. HANCOCK. Mr. Clarke mentioned that the problem really started snowballing roughly 5 years ago. You know there were a lot of us in the private sector that predicted that the 1986 tax law was going to create a major problem.

If in your opinion, the major changes we made in the 1986 Tax Reform Act created the problem.

Should we look at the underlying cause and fix the cause before proceeding with other matters?

So what would happen now if, in fact, we would go back and take a real good look at that 1986 tax law and take a look at 18 year, 19 year depreciation on real estate, capital gains, and put back into effect the good parts that we took away in 1986? What would that do doing the next 5 years to solve the problems that we are facing now?

Mr. LAWARE. One school of thought in thinking about that whole process would say that to some extent the problem was created by the over-abundance of capital seeking real estate opportunities prior to the 1986 changes, and that then when you removed that impetus, you damaged the industry in the other way.

In other words, the feeding frenzy for real estate started because of the attractive tax opportunities, and then when they were suddenly taken away, that created a different kind of a problem, so that there wasn't much equity investment in a lot of these loans that were made after that period of time, and consequently no cushion to absorb the changes in the marketplace that have taken place since then.

So it is a chicken-and egg-kind of a proposition.

Mr. HANCOCK. Are you saying maybe that we over-corrected them in 1986?

Mr. LAWARE. Well, one man's opinion, I think so.

Mr. HANCOCK. There is another comment I would like to make that concerns me a little bit. I also have been on this subcommittee a very short time, and only in Congress a short time. Prior to that, I was in private business—a small businessman. When Mr. Clarke mentioned that we need to allow regulators flexibility to deal with the problem, I am reminded that the nature of government is its inflexibility.

How do you go about writing a manual giving people flexibility when everything they can do is written down in a little book. I am a little confused how we are going to go about giving people in the field flexibility when they have got to operate with 14,000 pages of regulations.

Mr. CLARKE. Mr. Hancock, there are undoubtedly a lot of rules and regulations that banks have to follow and that bank supervisors have to check up on, but fundamentally bank supervision in many respects is still a judgment business, just as bank management is in many respects a judgment business.We don't have a recipe that tells a banker every move he has to make. What I was suggesting to you is we want to make sure we don't do that, and we want to make sure that we don't tie the hands of banking supervisors in making judgments when certain events occur.

The administration's proposal seems to strike a balance. Banks have an expectation of what will lilely happen to them, particularly as capital levels begin to drop. That provides a powerful inducement in the first place for the bank not to let its capital level drop, and, second, it provides some predictability to the banker as to what will happen if the capital level drops. But, supervisors also have the ability to make judgments and take actions designed to correct problems in particular institutions. I would simply hate, though, for us to be in a position where when the capital level reaches a particular point we have no choice in the kind of remedies that we might apply to an institution.

Mr. HANCOCK. Well, that is the point I was trying to make. That is why, frankly, I think that you have to have that flexibility. But I don't know how to go about getting it, knowing the way the Government operates.

One final comment, and I think my time is up.

Are we getting to the point that, for the lack of fiscal resources, that we are trying to get to a time where we have absolutely no bank failures?

Is that where we are trying to head?

Mr. CLARKE. I hope not, Mr. Hancock, because in order to have a system where we have no bank failures, we would have a pretty smothered, non-competitive banking industry.

Mr. HANCOCK. Well, we will have ruined the capitalistic system when we get to the point that we say that there is no risk involved banking—in expansion and job creation. I just wanted to make sure that we recognize that it is not bad to have some banks get in trouble once in awhile, otherwise, we are being too restrictive.

Mr. GLAUBER. I just would hasten to add—and I agree with everything you have said, we have a good distance to go from where we are now to where we would be in danger of never having bank failures.

Mr. HANCOCK. Thank you.

Thank you, Mr. Chairman.

Chairman CARPER. Amen.

Mr. McCandless, we are glad you could join us today. We welcome you for some questions.

Mr. McCANDLESS. Thank you, Mr. Chairman, for the invitation to join the subcommittee. I have an idea it is because "too big to fail" is a bit issue with me, and in order to share some thoughts with the panel, we have had successful small banks, as members of the panel have stated, in California, because there is a quality in banking, and that the money from the Fed is the same price for a small bank as it is for the big bank and all of the other transactions that take place as well as the insurance.

There is a perception now, correctly or incorrectly perceived, that there is no longer equality in the banking system. To give you a couple of direct examples, in an area in my district, the Treasury of the United Way has moved that account from a small to medium-sized bank to a larger bank, and as was stated during the markup yesterday or whenever it was, there is possible personal liability if he had not done that because he had not properly attributed his responsibility as treasurer to the funding deposit institution.

Another example is one who has a brokerage insurance company and has a trust account where the money is coming and going. That individual now has moved that trust account from a very popular three deposit institution bank, three branches, to another larger institution.

Another example, a real estate resolution company has also moved its trust fund because there is a certain fidelity there that is a part of that particular organization's requirements to fulfill its obligations when it comes to the escrow process.

I took time to give you examples here because I feel that even though the language of H.R. 1505 gives what one would perceive to be proper regulatory management options in the "too big to fail" area, that the average person is going to have to look at this in a little different way because of the experience, however small in numbers it has been, and Mr. Seidman has told us that, it has been there and, therefore, there is a further perception that it is going to be there possibly in the future.

Therein lies the real problem, how do we approach that so we can get back to what the average person would call equality in banking, and therefore the way that I have outlined here to be movement of accounts.

How can we do that? I have offered an amendment which was ruled non-germane, which I will offer again this coming week, but I would be interested in any comments that you gentlemen have.

Mr. GLAUBER. Mr. McCandless, I think the issue of equality or fairness is absolutely an important one, and we have to do something to make the system be perceived as more fair. I think there are clearly some things we can do, and the first is to cut down on failures so that that depositor or those depositors you talked about don't have to worry as much as they do today about the possibility of bank failure.

Mr. MCCANDLESS. I understand that. Let me interrupt you because that has been the response that other panels have given other subcommittees and the full committee, banks will be better capitalized, banks will be better regulated, will have greater opportunities, and, therefore, "too big to fail" will not apply because these banks will be too strong to fail.

That is the answer that has been given in the past. That is not necessarily going to be acceptable to the parties in question that I have taken the time to give you examples of.

Mr. GLAUBER. I realize that. Someone has to go further, and I would propose to do so. I think we have got to cut back on the number of times that we declare there is a systemic problem, and I think we have to convince people that we are going to cut back on that.

I think the mechanism we propose would both cut back on it and make clear that we are going to cut back on it by changing where the decision is made and how the decision is made. I think we can believe that this would happen less frequently.

Once we believe it will happen less frequently, it will have to happen less frequently.

Mr. MCCANDLESS. Right, but how in the meantime do we stop this silent run that I have given you examples of?

Mr. GLAUBER. I think we do it first by assuring people that their money is safe. My bet is that each one of these people that moved their account, or at least the couple you have mentioned, had less in it than the limit on insurance, at least in many of the cases that have been told me, there have been people whose money is totally insured, and they still have taken it out.

Mr. MCCANDLESS. I happen to know the numbers, and they were in excess of $100,000.

Mr. GLAUBER. If they were, then that is the case. I think what we have to do is assure people that the system really is safe, that we are going to make it safer and not disturb them. Let's say that I cannot agree with the argument that says that because this is a tender time we should do nothing.

I think we have to fix the system, and if we wait until there are no problems, then I think my successor would be sitting here and you would say, "If it ain't broke, don't fix it."

Mr. MCCANDLESS. This is a given. I would not argue with this. Mr. Clarke, do you have a thought?

Mr. CLARKE. I would just like to make the observation that while we talk about the unfairness that sometimes can result from the application of the so-called "too big to fail" doctrine, and it undoubtedly does produce some unfair results, and may even be producing some of the results that you described in your illustrations, we should not lose sight of the fact that many smaller banks benefit when uninsured depositors are protected in an effort to deal with systemic problem. If it works, and so far, fortunately, it has, it stops drains of deposits out of those smaller institutions. When the Bank of New England was closed, we had a number of depositors withdrawing insured money from institutions all over the region because they were uncertain about whether their deposits were really protected. At the same time, remember, we had a Rhode Island deposit insurance failure, and a lot of people were concerned about whether even their insured deposits were protected. Being able to deal with Bank of New England as we did stopped that withdrawal activity and benefitted those institutions. It also benefitted the insurance fund because it may well have prevented a number of banks from failing that would not otherwise have failed.

Mr. McCandless. I understand the systemic aspect of it. Let me pose a question.

I think I have got just a little bit more time, pose a question to you. We talked about reducing the $100,000, and we talked about limiting the number of $100,000 accounts, and we have gone through a whole series of events dealing with what we are going to insure and what are we not going to insure.

Along with that, Mr. Seidman has said, well, we have been able to recover to date 88 percent of what it is that we were obligated to pay off when we have done what we have done with these institutions.

I would like to play "what if" with the panel. What if we said that the department insurance would be good up to $100,000, full face, and then we said after that because of our experience in recent years with the cost of the failures, that 85 percent of whatever the individual had in that one institution would be covered over and above the $100,000, and if the individual wanted to have insurance in excess of $100,000, 100 percent, that they would have to move to another institution and put that $100,000.

What would be the reaction there, and that this would apply irrespective of size or shape of the institution?

Mr. Seidman. That is the American Bankers Association Program, which is that we take past experience and not cover depositors above $100,000. Whatever loss there is, based on past experience, is automatic and those depositors above $100,000 find they have 15 percent less in their account.

We don't know what the effect of that will be. Will people run because they are going to lose 15 percent? I guess that so far we haven't been willing to experiment with that.

Mr. McCandless. Would this create a run on the bank?

Mr. Seidman. The runs that we have had, such as First Republic, are caused mainly by smaller banks who are using that bank as a transfer agent. It is the small banks that, when this occurs are the ones who are after us to make sure that we declare essentiality and cover all depositors.

Mr. McCandless. Because we have received up front from day one this is what is insured and this is what is not. It would appear to me that the idea of a run on a bank would not take place because the individuals automatically realize what is at risk and what isn't.

Mr. Seidman. A run takes place when people become aware that something is at risk. At First Republic, $2 billion went out of the bank in an hour and a half, transfers from small banks who panicked to get their money out when it became clear that the institution might not survive.

If they had known they were going to get 85 percent of their money back, would they have taken all their money out? We can't answer that. It is a catch 22 because as long as we agree that the government has to have some way of dealing with that, how can we protect the small banks?

My testimony has been to the effect if you are going to protect the small bank, under those circumstances you have to protect the deposit insurance side and make sure there is enough so they can compete. With too big to fail, money has not gone out of the small banks into the big banks until we started talking about reducing deposit insurance.

Mr. LaWare. It is systemic risk that fails to be controlled and stopped at the inception that is a nightmare condition that is unfair to everybody. The only analogy that I can think of for the failure of a major international institution of great size is a meltdown of a nuclear generating plant like Chernobyl.

The ramifications of that kind of a failure are so broad and happen with such lightening speed that you cannot after the fact control them. It runs the risk of bringing down other banks, corporations, disrupting markets, bringing down investment banks along with it.

That is the kind of situation in which we have to be able to intervene to protect the innocent, the people who have nothing to do with the situation that creates the collapse, but who are sucked into the maelstrom as a result of the discontinuation of that vital cog in the payment system.

I think that that is what we are all talking about. We are not talking about some of these other situations that have been used as illustrations. We are talking about the failure that could disrupt the whole system.

Mr. McCandless. The Chairman has been very kind in allocating my time.

Chairman Carper. Mr. Hoagland, who has gone to Rules to testify, asked for a comment on a question very similar to that posed by Mr. McCandless.

Mr. Hoagland offered and withdrew in subcommittee on Tuesday a proposal to provide for a-15 percent limit on deposit insurance for $100,000. He was anxious for members of this panel to comment on the merits or lack thereof of his proposal.

Mr. Glauber. Mr. Chairman, I think that proposal is a perfectly sensible approach because it provides liquidity in the system and what the administration proposed, the FDIC could implement such a program. The real question is what happens beyond that.

Do you say that is all you will do or will you allow under some extraordinary circumstance the Fed to declare that we have to protect more, that last 15 percent or 10 percent because there is a systemic risk.

I think that is the question, and do we want to go to a system that prohibits ever doing that. It is a very difficult question. I think we cannot go to a system that prohibits it flat out, but should make it as infrequent as humanly possible.

Chairman CARPER. Any other members of the panel who would like to comment on this point?

Mr. LAWARE. I don't think it solves the stability problem at all. If you have $1 million in a bank and you run the risk of losing $15,000 of it, it seems to me that that is as vital a reason for moving your deposit somewhere else or moving into liquid financial assets as it is for the man who has a $110,000 and moves it somewhere else in order to be fully protected.

It is a question of where for any individual depositor the perception of risk lies and how much that person is willing to tolerate in terms of losses in order to continue to do business there.

Chairman CARPER. In fairness to Mr. Hoagland, I am not well versed with his proposal. I believe it provides escape clauses where such a situation exists.

Mr. GLAUBER. His proposal does indeed allow for an override versus systemic risk.

Chairman CARPER. Mr. Hoagland has arrived.

We have backed your proposal——

Mr. HOAGLAND. You are very kind.

Chairman CARPER. You had asked that we submit to the panel some questions for their consideration and their thoughts on your proposal in subcommittee, which you withdrew. Their comments, I think, were constructive. I would recognize you for any further questions you might have.

Mr. HOAGLAND. Thank you, Mr. Chairman.

This is an excellent hearing. I am very pleased that you have scheduled it and arranged for these panelists. The bill that I am cosponsoring before the Rules Committee will be on the floor next Tuesday so I had to go over there, and I am sorry to have missed the comments.

But given the fact there are two more packages to go and these issues, I know having been thoroughly explored, I will look forward to reading what is in the record and please do. This has probably been said already, if you generally feel the proposal is on the right track, which I believe you do based on my review of your testimony and conversations we have had Mr. Glauber, please let us in so we can test it out and approve it for full subcommittee markup.

Chairman CARPER. Mr. Seidman, I may have misinterpreted what I thought I heard you say. Did you tell us that there have been four instances in the last 5 years where a too-big-to-fail policy was essentially implemented and followed?

Mr. SEIDMAN. There have been instances in which we have protected all depositors on the basis of essentiality, which is the provision of the statute that allows us to find an institution if you will, too big to fail.

There are only four instances. In other instances where depositors have been protected above $100,000, it is because we have determined that that is the least costly way to handle the transaction, less costly than a liquidation or an uninsured deposit transfer.

Chairman CARPER. Did I understand you to say that if the administration proposal were adopted, we would see no change in the actions taken for those four institutions?

Mr. SEIDMAN. I don't see how it makes too-big-to-fail decisions different than they have been. It makes it easier because the decision is made by the Fed and Treasury, but they can charge it to the FDIC, whereas, if we make the decision, we have to pay for it.

I find it difficult to see how in practice it will be more difficult. Beyond that, those two organizations have participated in every one of these transactions. At least the Fed in every case has advised us to use the essentiality doctrine and the Treasury has been asked whether they wished to object, In no case have they objected.

Chairman CARPER. This has been most illuminating. This is a very difficult subject. We need your help beyond today and we look forward to your cooperation as we try to come to grips with this problem.

The House is voting on a supplemental appropriation for aid to the Iraqi refugees. The subcommittee will adjourn for 10 minutes and then we will try to come together again by 12:25.

We want to thank you each for being with us today, for your testimony. We look forward to working with you in the future.

[Recess.]

Chairman CARPER. We will now reconvene.

We expect another vote in an hour. We will go ahead and get started. I want to welcome the General Accounting Office, Mr. Johnny C. Finch, Director of Planning and Reporting for the General Government Division, and I see that you are joined by two colleagues of yours.

I will ask you to introduce them. Mr. Finch, we welcome you.

STATEMENT OF JOHNNY C. FINCH, GENERAL ACCOUNTING OFFICE, DIRECTOR OF PLANNING AND REPORTING, GENERAL GOVERNMENT DIVISION; ACCOMPANIED BY CRAIG SIMMONS AND STEVE SWAIM

Mr. FINCH. Thank you, Mr. chairman.

Seated to my left is Craig Simmons. Craig is the Director who oversees all of the work we do on financial institutions. To my right is Steve Swaim. Steve is the Assistant Director who is specifically responsible for banking issues.

We appreciate this opportunity to give GAO's views on the complex issues associated with resolving large bank failures. I do have a detailed statement which I will now summarize, Mr. Chairman members of the subcommittee.

Perhaps more than any other aspect of banking, the problems and incentives associated with resolving large bank failures show the need for comprehensive reform of the deposit insurance and bank supervisory systems.

Solutions must comprehensively deal effectively and fairly with today's incentive problems, problems that make it easy for undercapitalized or risky banks of all sizes to obtain funding that is nearly always insured by the full faith and credit of the U.S. Government.

The reforms that we have recommended to deal with the incentive problems that give rise to the too-big-to-fail policy are all designed to insure industry stability through the safe and sound operation of banks instead of through deposit insurance guarantees that could result in large expenses for healthy banks and taxpayers.

Any attempts, we feel, to increase depositor discipline must be preceded by other reforms to improve the safety and soundness of banking organizations. Starting with the 1984 failure and rescue of Continental Illinois, bank regulators have preferred to err on the side of guarding confidence in the banking system when large banks fail.

FDIC has protected all deposits in the 14 failures of banks with assets over $1 billion at a cost of approximately $11.8 billion. The de facto protection provided to large banks uninsured depositors and non-deposit liabilities has successfully protected the stability of the banking system, yet it has also led to a widespread perception that some banks are too big to fail or, perhaps more accurately, too big to be liquidated.

This situation is troublesome because large banks, whose failures pose the greatest threat to FDICs finances, have fewer incentives to control risk. In addition, depositors have incentives that favor the placement of uninsured deposits in large banks, putting small banks at a competitive disadvantage.

If legal coverage limits on insured deposits or the de facto protection afforded uninsured depositors were cut back or eliminated, all banks, but especially large banks, would no doubt be operated more safely in order to win and retain depositor confidence.

But the real possibility of destabilizing bank runs cannot be ignored. Uninsured deposits and nondeposit liabilities account for over 60 percent of the funding of 10 of the top 25 banks in the country. Runs on our largest banking institutions could have significant destabilizing effects through disruptions to the settlement system, correspondent banks, or foreign and domestic confidence in the U.S. banking system, particularly if a run at one large institution becomes contagious, leading to runs at others.

The potential for such a contagion arises from a number of factors. First, uninsured depositors do not currently have options, such as purchasing additional insurance for safeguarding their deposits.

Second, it is unreasonable to expect many uninsured depositors to make informed decisions about the condition of the institutions in which they place funds. Third, the losses that would be faced by uninsured depositors must be reduced by improving bank supervision.

Losses in banking organizations closed between 1985 and 1989 averaged nearly 16 percent of the failed banks' assets. We believe this represents an unacceptably high level of loss for risk adverse depositors to accept. For these reasons, we do not believe that scaling back coverage for insured deposits or eliminating de facto protection for uninsured deposits is wise at this time.

We do believe it is possible through other means to control the ability of banks, especially those which are large and poorly managed aimed, to attract deposits, while at the same time maintaining continued market stability. We have recommended several reforms to accomplish this objective.

First, better supervision of banks is essential. Bank regulators must take prompt corrective action to stop unsafe banking activities. We have recommended that regulators be required to develop an early intervention or tripwire supervisory system that focuses enforcement actions on the earliest signs of unsafe behavior in all banks—large or small.

Implementation of the tripwire system, we propose, should help prevent poorly managed banks from offering above market interest rates to attract deposits and would lower the cost to the FDIC when banks do fail.

Second, capital requirements should be strengthened to discourage bank owners and managers from taking excessive risk and to provide a financial buffer between losses resulting from poor business decisions and the resources of the Bank Insurance Fund.

Third, disclosure policies that give depositors and the general public better information on the condition of banks must be adopted. A risk-based deposit insurance premium system that can be used as a supplement to risk-based capital requirements should be implemented. Finally, uninsured depositors should be provided the choice of insuring their deposits at an additional cost.

In the past, decisions by uninsured depositors to withdraw funds from weak banks, like the Bank of New England, forced regulators to deal with insolvent banks that probably should have been resolved earlier. If such discipline is to play an expanded role in the future, certain conditions must be met so as not to jeopardize market stability.

The banking system and the Bank Insurance Fund must be in a much sounder condition than they are today, and the near-term reforms I have discussed should be substantially implemented. Even with our recommended reforms, however, it may still be necessary for regulators to protect uninsured depositors in a failed large bank for stability reasons.

Under certain conditions—a severe recession or an unstable international environment, for example—the threat of irrational runs may be so great that it would be reasonable to protect uninsured depositors. Thus, even in the long run, a formal policy requiring the FDIC to follow a least cost resolution method and impose losses on uninsured depositors under all circumstances would not be wise.

Instead, the Federal Reserve, in conjunction with FDIC, should be given the authority to determine whether the failure of a bank would be detrimental to the stability of the U.S. financial system.

If so, such a bank could be resolved in ways that protect uninsured liabilities. We are uncertain how often such intervention would be needed. However, if all of the reforms I have mentioned are implemented, such intervention should become the exception, not the rule.

This concludes my statement, Mr. Chairman. My colleagues and I will be pleased to take questions.

[The prepared statement of Mr. Finch can be found in the appendix.]

Chairman Carper. Let me just ask, in retrospect, do you believe that systemic risk—Mr. Seidman alluded to four institutions that he and the FDIC deemed too big to fail in consultation with the Federal Reserve and with Treasury.

Do you believe that systemic risk was present in those four cases that were determined that a bank was too big to fail?

Mr. SIMMONS. We haven't studied them in any detail, Mr. Chairman.

I suspect that the determination was accurate. The principal thing that they would probably have looked at was the relationship of the four banks that he mentioned, one of which was the Bank New England, with other banks in the region or in the economy.

I suspect that other banks, many of them small, cleared through those bigger banks or had correspondent banking relationships with them, that may have been jeopardized in the event that those banks failed. All of them were pretty good sized and no doubt had correspondent banking relationships with other banks.

Chairman CARPER. The second question: What specific reactions do you have or specific recommendations for further change would you have to H.R. 2094, the legislation marked up in this room in subcommittee 2 days ago, and specifically changes in the area of too big to fail?

It is a question similar to that—I asked that same question to our first panel, and I would ask the same of you.

Mr. FINCH. As I said in my statement, Mr. Chairman, I think we have to maintain the too-big-to fail policy under certain circumstances. A problem with the bill as we see it, therefore, is that it seems to repeal too-big-to-fail altogether. We support a lot of the comments that the regulators made in terms of concerns that they had with the bill.

We do think it is a step forward, but we think there should be broader reforms. We think certainly that there should be more kinds of interventions written in for the regulators so that they can take earlier actions against unsafe practices by seemingly healthy banks. In order to do that, there also needs to be some accounting and internal control reforms so both the regulators and bank managers and directors can make more informed decisions about the conditions of the bank.

Chairman CARPER. Reforms that go beyond what is in the bill as reported out of the subcommittee?

Mr. FINCH. Yes. Also——

Chairman CARPER. Any specifics?

Mr. FINCH. Well, some of the specific recommendations in our report, like the recommendation which would set up tripwires. These would put the regulators and the banks on notice that unsafe practices such as excessive credit or poor internal control would require specific acions at that point in time.

The purpose of this is to get at the underlying causes of the problems that cause capital to deteriorate. A lot of the administration's proposal is geared towards capital as the indicator, and by the time capital starts deteriorating, it is often a little too late to reverse the situation.

Our proposals include recommendations for regulators to get in much earlier to deal with the underlying causes that ultimately result in capital deterioration.

Mr. SIMMONS. Let me just expand on that.

We did a study of 72 problem banks, and issued a report recently on the supervisory and examination histories of those banks. What we found repeatedly was that capital was the lagging indicator of more fundamental problems in a bank's management, and the fundamental problems are really what got the bank into trouble in the first place. Problems with management were cited by the examiners in the exam reports.

There is no mystery about these problems—management lack, needed expertise. The bank had a passive board of directors. There was an unwillingness or inability to address prior enforcement actions. Banks simply ignored the regulators. There was no system for ensuring compliance with laws and regulations, and the list goes on and on.

All of those relate to bad management practices that result in bad lending decisions that result subsequently in the reduced earnings, reduced capital, and ultimately failure. What we found was that the regulators weren't taking actions early enough to prevent the underlying causes from ultimately depleting capital, and our position has been that you need to start earlier than at a finding of an insufficient capital level to save a bank or to turn it around because frequently by the time capital falls below the minimum it is too late to do anything about the bank.

Chairman CARPER. If we are going to have a too-big-to-fail policy, who should pay for the cost of that policy?

Mr. FINCH. Our position, sir, all along has been that the insurance fund should pay for that.

Chairman CARPER. What is the rationale for that?

Mr. FINCH. The rationale for that is that the industry benefits, really, from the insurance fund. It is there to help the industry, and that is one rationale. The rationale is that by having a vested interest, by paying into the insurance fund, it gives the industry a greater incentive to really discipline itself, number one, and number two, to demand of the regulators that the regulators intervene when they should. So it is a better self-policing mechanism.

Chairman CARPER. There are some arguments against doing that. You may have heard some from Mr. Seidman today. How would you respond to the arguments against paying for this policy out of the FDIC.

Mr. FINCH. Against what, sir?

Chairman CARPER. You were here, I think, earlier today when Mr. Seidman, the first panel, spoke on this subject. There are some arguments against using the FDIC to pay for the cost of too-big-to-fail policy. How would you rebut those arguments?

Mr. FINCH. I guess I would use basically the same argument that I just made. The FDIC is responsible for determining, under the present procedure, the essentiality of banks and institutions, and we think that should stay, and we also really view the incentive of the industry participating in terms of paying its own way.

I think if you get beyond that, it really becomes a bailout by the taxpayers to the extent that the industry can't pay its own way.

Chairman CARPER. In your opinion has the FDIC always resolved banks in the least costly manner, or at least in recent years has the FDIC resolved banks in the least costly manner?

Mr. FINCH. I don't think we have studied all of the resolutions that FDIC has made.

Mr. SIMMONS. We have looked at some, and of course it depends on the assumptions that are made, the value of assets in liquidated institutions and how long it will take to dispose of them. But I think in the institutions that we have looked at, it is fair to say they have followed the procedures that they are supposed to follow in making the determination.

Chairman CARPER. One last question: Do you feel that the least cost provisions in H.R. 2094 are adequate?

Mr. FINCH. Well, there again, sir, our position is that there should be a too-big-to-fail relief valve, an escape valve. Now, are you talking about that, sir, or are you talking about the detailed provisions of how they go about making least cost determination?

Chairman CARPER. The latter.

Mr. FINCH. The latter.

Mr. SIMMONS. I haven't studied it.

Mr. SWAIM. In general, picking up the statement that we have made, our view is that before going to a definite least cost requirement as of a drop-dead date, in this case it would be the end of 1994, that certain reforms need to be in place and working so that we in fact have a banking system that is being operated in a safe and sound manner and has established public confidence.

We are concerned that depositors have alternatives for protecting their deposits, but 2094 makes no provision for depositors who maintain the types of accounts that Mr. McCandless was mentioning earlier this morning.

Under 2094 there would be no opportunity for the United Way or other uninsured depositors tp protect their those accounts. There are a lot of reasons why people have accounts over $100,000, and in our judgment the safety and soundness and stability of the banking system would warrant making provisions for people to make a trade off against yield to be able to protect their deposits.

The other area would be that there are no provisions in 2094 for greater disclosure about the condition of banks. It is very difficult for depositors to know the true condition of the bank under current accounting rules and disclosure requirements, so the question becomes, then, how will the depositors exercise this discipline? What they will do is at the first sign of trouble, they will remove money from the banks, so we will introduce the potential for a great deal of instability.

This is true, of course, in large banks where of the top 25 banks, ten of those have more than 60 percent of all of their assets funded with uninsured liabilities. They can run in a twinkling with electronic transfers. The $2½ billion moving out of a bank, I think in a morning was mentioned earlier.

That certainly is a realistic possibility, and in smaller banks where the uninsured deposits are not such a great percentage, nonetheless money can move very quickly at the first sign of trouble. So we feel that it is important to have this early intervention system actually operating and being able to prove to the public that banks can be closed at relatively little loss to the deposit insurance system, and that there be opportunities for protecting uninsured deposits before a drop dead date comes into effect that would require such an absolute decisionmaking process.

Chairman CARPER. Thank you.

Mr. Hoagland.

Mr. HOAGLAND. Thank you, Mr. Chairman.

Gentlemen, let me ask you about two additional proposals that have been noted to reinforce the strength of the banking system and make it less likely that we will wind up in a too-big-to-fail situation. One is a recommendation that banks, large banks, say banks with over $10 billion, I think this was your recommendation, as a matter of fact, be required to issue subordinated debt periodically, every 3 months, every 6 months.

Mr. Finch, hadn't GAO developed a proposal along those lines?

Mr. FINCH. One of our proposals is that in strengthening the economic incentives for banks to be safely and soundly managed, that capital requirements should be further strengthened after the Basel requirements go into effect..

We said that as a part of the strengthened minimum capital requirement we would recommend that part of that be subordinated debt, and the reason for that would be because of the market discipline that the holders of that debt could bring to bear in bank management.

Mr. HOAGLAND. Why don't you explain to the volunteers of this hearing what subordinated debt is and what it would do by way of injecting market discipline and market evaluation into the stability of a large bank.

Mr. FINCH. OK. I am going to defer to one of my experts.

Mr. SIMMONS. In general, subordinated debt is not protected in even large bank failures. Subordinated debt has typically been issued by a holding company, I should clarify that.

We are recommending that it be issued by the bank itself.

Mr. HOAGLAND. It is not insured. That money is completely at risk by those who choose to invest in the bank?

Mr. SIMMONS. It has been at risk in the failures that have occurred recently. The only case that I am aware of where it was not at risk was in the Continental Illinois situation.

I believe creditors, general and subordinated debt-holders were protected in that one. Since that time, I believe that they have had to get in line with others to share in losses. As a result of that, those people have an incentive to keep an eye on banking organizations and make sure they are operated safely and soundly because if the bank takes a gamble, they don't participate in the upside.

All they participate in is the losses of the institution if the gambling doesn't pay off. That is generally the reason why we support this kind of a mechanism.

Mr. HOAGLAND. These individuals you are talking about are outside investors that will buy this subordinated debt on the market?

Mr. SIMMONS. That's correct.

Mr. HOAGLAND. If the bank fails, they lose their investment entirely?

Mr. SIMMONS. They wouldn't lose it entirely. They would get in line and share in the proceeds of the bank, if it is 70 cents on the dollar or 80 cents, they would get the 70 or 80 cents on the dollar.

Mr. SWAIM. They would have also a vested interest to make sure the regulators move quickly so the value of the subordinated debt retains some value. In contrast to the uninsured depositors, these are people who are investing, knowing what risks they are taking—and they are individuals who would be as skilled as anybody could be in evaluating the condition of the banks in which they are making this investment.

Mr. HOAGLAND. So we would have an objective external market indicator of how well a bank was going, based on what people were willing to pay for that subordinated debt as they traded it among themselves or with the bank?

Mr. SIMMONS. That's right.

Mr. SWAIM. There may also be attached to the subordinated debt, some covenants that would give the subordinated debt holders certain rights to effect, perhaps, a reorganization of the Board of Directors, for example, so that before the bank actually failed and came into the government's hands there could be an opportunity for a private sector reorganization that would be triggered at a time when there was the best chance of saving the value of that bank.

Mr. HOAGLAND. Is it GAO's official position that we should place a provision like that into the American Banking Statues?

Mr. FINCH. Yes.

Mr. HOAGLAND. It is a recommendation that you have made?

Mr. FINCH. Yes.

Mr. HOAGLAND. Now let me ask you about another proposal that is being floated, that will make it less likely that we will ever be in a situation where some authority in government would have to consider paying off uninsured depositors and that is in the early intervention system, we have higher capital requirements for the large banks.

Large banks are treated differently on an early intervention system, the system is tougher on the large bank. Have you all considered that proposal?

Mr. SIMMONS. No, I haven't seen that one. I would only comment that the risk-based capital standards that were developed under the international agreements, under the Basel accord, currently treats large banks differently than small banks, because it covers off balance sheet activities.

The large banks are the banks that typically engage in off-balance sheet activities—interest rate swaps, certain foreign currency transactions, letters of credit, any number of other activities that have credit risk and interest rate risk associated with them, but don't show up on the balance sheet. So I think in a sense what we have now is a system that does treat the large banks differently, and in fact the large banks are the ones that will need to raise capital in markets or through retentions to meet the standard by the end of 1992.

Right now some of them don't. Small banks, on the other hand, are there. They have—they meet the standards right now. So I would say that right now we have a system that differentiates between large banks in terms of the standard.

Mr. FINCH. One of the things that we would suggest in addition to that, I think, or after we get some of the other controls in place, that risk-based insurance premiums would be a part of the scheme of things, which would also differentiate between the weaker banks would have to pay more.

Mr. HOAGLAND. Gentleman, with the chairman's permission, let me direct you to one third—a third and final point of inquiry, if I might, and that is that—and the chairman may have covered this in his questions. I assume all of you agree that it is not good public policy to leave in a bill that has been advanced by the Financial Institutions Subcommittee and sent to the Full Banking Committee, a provision that attempts to outlaw the reimbursement of uninsured depositors under all circumstances, no matter what the systematic risk is.

Mr. FINCH. That's right, sir.

We believe that you have to have an escape valve, that you have to have a too-big-to-fail policy in the instance of systematic risk. Our approach is to try to get the safety and soundness enhanced enough so that you really cut down the number of times that you have to invoke that particular policy, but the policy has to be there, we think.

Mr. HOAGLAND. and in that respect, you concur, then, with Chairman Seidman of the FDIC and Comptroller Clarke of the Office of the Comptroller of the Currency, Mr. Glauber of the Treasury Department, and Mr. LaWare of the Board of Governors?

You agree with the testimony they presented, this panel earlier today?

Mr. FINCH. Yes, sir, in terms of that.

I think we are all coming from the same place, that you have to be able to protect against systematic destabilization.

Mr. HOAGLAND. So this subcommittee really faces no alternative, in your opinion, but to devise an amendment—by this subcommittee, I mean the full Banking Committee, faces really no option, but to devise an amendment that instead of trying to deal with the too-big-to-fail doctrine by totally prohibiting it under all circumstances, instead channelizes it and defines it and lays the rules out in clear form and makes it as difficult as practical to apply?

Mr. FINCH. That's correct, sir.

Mr. HOAGLAND. I have no further questions, Mr. Chairman.

Thank you.

Chairman CARPER. Thank you, Mr. Hoagland.

Mr. Vento.

Mr. VENTO. Mr. Chairman, I regret that I have been absent for most of the hearing. I think it was a good hearing. I would like to have asked some questions of the panel members in the first panel. Maybe the General Accounting Office has assessed and reviewed the impact of 2094.

The assumption was made or the assertion was made by Mr. Seidman and Mr. Glauber, apparently, that they feel that the 2094 precludes purchase and assumption with regards to the least cost test.

That certainly isn't my reading of what occurs, and so I would challenge that most vigorously, Mr. Chairman, and would ask the witnesses at the table whether they have reviewed the provisions with regard to the least cost test and feel as though they are able to make any statements with regards to it.

Mr. FINCH. I don't think we have read it in that much detail yet, Mr. Vento.

We would be glad to and give you our opinion for the record.

Mr. VENTO. Mr. Chairman, I would just point out that forbearance and the too-big-to-fail issue is enormously important. We have done a little bit of a review here with regards to this in the RTC task force and have done somewhat of an analysis of it. The crux is that assumptions about the value of assets, how you value the remaining assets, is key to the cost of a purchase and assumption. Almost any premium that is paid under purchase and assumption, therefore, would render a greater benefit to the government than going into liquidation, which of course has some other problems.

But I think that the weak point in that is the assumptions on what the recovery is possible from the portfolio of bad assets. That is a key point, and the assumption is made there—in other words, if you go with an FDIC historic loss of 15 percent or 20 percent at the most, all of a sudden you render a different number than you would if you had losses higher than that.

The reason that this becomes key, and I think the reason that there was a difference to some extent between Mr. Glauber and Mr. Seidman, as you rightly pointed out, was because, I think the Treasury has made the observation that the way that his cost test works trips them over into what they would characterize as being the essentiality test. Seidman and the FDIC have said that recues of all depositors have taken place only in four instances.

They would suggest that because of the nature of the way they evaluate this, it is tripped much more frequently, and it is key because if you go into liquidation, clearly, then the obligation to limit the payment of insurance to the $100,000 limit is so much stronger, so I think that as we focus on this, and I think these hearings are useful from that particular sense.

Here are some flash points that we need to look at as we move ahead and as we effect it. Of course, Mr. Seidman's attitude is that this language will not change anything.

Well, I sure as hell hope that the language that we have will change things. I would yield on that particular point that I think it will. We hope it will. If it doesn't, then I think we ought to look at it again and make sure it does change.

Chairman Carper. Would the gentleman yield?

Mr. Vento. I would be happy to yield to the chairman.

Chairman Carper. I think his point was the language under the administration's proposal would not change things. Clearly the language under 2094 would change things.

Mr. Vento. I understand too—that is correct, Mr. Chairman.

I ran those two ideas together, but nevertheless I think we want to change things, and we obviously want to do it in a positive way. I think the question of the loss in portfolio is a loss whether it occurs in the time frame of 3 or 4 or 5 years or whether it occurs up front.

Obviously the issue of early intervention, there are many, many questions we could ask here about this.

One of them that maybe you could just refer to is the case of the Bank of New England, where we are talking about the utilization of too big to fail. There were a series of events that occurred prior to that, Mr. Chairman, and one of them was the calling in of all loans that were callable in the region, in the area, through the Bank of New England.

What effect did that have in terms of a multitude of small businesses in the process of this bank trying to come up with money?

In other words, there wasn't just the fact that we have had an open discount window, it wasn't only the fact that we dealt with this and treated this as a systematic or an essentiality test, in essence. But there are also other ramifications practicing forbearance.

I am certain there are many individuals that came to us and suggested that their loans were being called, loans in which they were current, but obviously the bank of New England and its affiliated banks, had the power to call in those loans.

I think we have to look at that in terms of the total impact. That is what we should be looking at here in answering questions with regards to economic stability.

One thing that the FDIC looks at or at least that they claim to look at is the loss to the fund, but they don't look at some of the other aspects in terms of what their conduct is in this case. Can the General Accounting Office witness, Mr. Finch, give us any insights into that particular phenomena, in terms of the calling in of loans?

Mr. FINCH. I will defer the specific question of calling in loans early to one of my colleagues, but I will comment, sir, that this ties into the point I was making earlier, Mr. Chairman, about earlier intervention, and intervention that is geared towards unsafe practices on the part of the banks that are the underlying causes of capital subsequently deteriorating.

One of the things that we think really needs to be done in the way of improvement and change and reform is some accounting and internal control reforms. One of the things that we would like to see, which gets at the asset deterioration value,. is that we would like to see banks value their problem assets on the basis of existing market conditions, and we would like to see more disclosure and more information available to both the regulators and the managers in terms of the actual condition of the banks.

Mr. VENTO. Well, I appreciate that particular response. I think that that gets into another problem in this case where they are causing assets that are really sound loans to become unsound loans by accelerating them.

Any time you have a loan, you have a depressed real estate market, and if it is a 10-year or 15-year loan, you are going to instantly recognize the loan is actually going to go into a negative evaluation, and, of course, there is a concern about how you read that and what that means in terms of actions and how the market reads it. So here is another concern that if in fact we are saying that it is all right for these loans to have that value, we don't know how the market will digest it.

Can you give us any assurances of how the market in New England, for instance, would digest a mark to market valuation of a loan portfolio at institutions that appear on paper today to be adequately capitalized, but in marking to market, they would face a rather volatile situation, would they not, Mr. Finch.

Mr. FINCH. I am sure that is true today, sir.

My point was to try to get in on the front end of the issue, before the situation deteriorates so badly.

Mr. VENTO. Yes.

Well, I think all of us agree with that, but trying to read that situation as being a loan that may be valued somewhat less now because of an aberration or a recession problem in a specific market may, in fact, be current. They may be making payments.

The business may be making profit, and if you value it in a certain way, and we had this happen repeatedly during the agriculture crisis during the 1980's in the middle West and because the acreage value had dropped, the collateral had dropped. They immediately made a call on the loan. That is what they were required to do, and of course, precipitated a lot of problems. So, again, this relates to how you evaluate this and what you do with the information.

In the case of the Bank of New England, there was no question that the loans were valid. They had the power to call these loans. That is the way they are written. That is a major issue in terms of how banks conduct themselves today.

If we wanted to provide stability and certainty, this type of question has to be addressed in terms of their conduct. The only answer they have is that they show a better balance because they got a better capital sheet, but they have almost necessarily either tripped loans over into being non-performing loans by the fact that they haven't responded to the call and/or just a bad loan in terms of valuation.

Well, I have taken enough of the subcommittee's time, but I think that it does relate to the too-big-to-fail issue in terms of liquidation versus purchase and assumption. Purchase and assumption isn't liquidation. I don't think you can sell it as liquidation, and so I think it is at the heart of how we deal with the issue of too big to fail.

Chairman CARPER. I thank the gentleman for his comments and for those questions. I am going to ask unanimous consent that the members of the subcommittee be able to submit for the record questions and ask you to respond in writing.

With that, I will excuse our witnesses from this panel. We thank you very much for being with us.

Mr. FINCH. Thank you, Mr. Chairman.

Chairman CARPER. We are probably going to have another vote within a half hour. What I would like to do is go ahead and begin our third panel. We may—I understand we have to be out of this room by 2. There is a briefing that is being held by the Financial Institutions Subcommittee.

What I may do if we have a vote in the interim, ask one of our two panel members to go vote and then return to chair while I vote, if that would be convenient.

Mr. VENTO. Mr. Chairman, if I may make a suggestion, as our witnesses—perhaps if each of the witnesses were to summarize their statement in about 5 minutes, we could try and——

Chairman CARPER. They have been doing a good job of that. We welcome you here today, and we look forward to your testimony.

Mr. Brandon, I understand you are representing the American Bankers Association. You are the President of the First National Bank of Phillips County in Helena, AR.

We welcome you. We are going to recognize you first and ask you to lead off for us. Thank you.

STATEMENT OF WILLIAM H. BRANDON, JR., PRESIDENT, FIRST NATIONAL BANK OF PHILLIPS COUNTY, HELENA, AR, AMERICAN BANKERS ASSOCIATION

Mr. BRANDON. Thank you, Mr. Chairman.

First of all, thank you for letting me come and express my views. This is a subject that is dear to all bankers' hearts. It is dear to my heart as an American. It is a very complicated, very difficult, very, very important subject.

Congressman Vento, I certainly do agree. I ought to be able to summarize this in 5 minutes. If I don't, raise your hand, and I will stop.

The reason I can summarize it in 5 minutes, is because I think that the written testimony that I have submitted thoroughly explains the ABA position and my position on too big to fail. It explains our position on several other things, as well, but primarily too big to fail.

A little background on Helena, AK. I have been in the banking business since 1964. Prior to that I was in the manufacturing business. Prior to that, I was in the Air Force. Helena, AK, is an area that if we could get to the point that we are having a mild recession like the rest of the country, we would improve dramatically.

Unemployment in our area has been over 10 percent for over 20 years. It is chronic unemployment. The only reason I say that is we are not an area that is high-flying in any way. We have to be very conservative. We think very conservatively.

Let me also explain the development of my thinking, it is directed and derived from being co-chairman of the Deposit Insurance Reform Committee for the American Bankers Association. I mention that because it was a committee of 16 people. Four of the members of that committee were money center banks. Six were banks that would be considered community banks.

The balance were banks anywhere from 1 billion to 10 billion. We came to the conclusion as a unit that too big to fail was the single biggest problem of the banking community today, and when I say that, keep in mind that four members of that committee were money center committee banks.

We came to the conclusion that was the biggest single problem. The FDIC, in our mind, if it would take care of insuring insured depositors, if it would take care of regulating and supervising the banks, and if it would take care of disposing of the assets when they were called on to dispose of the assets, and if it would not feel obligated to pay people who neither expected nor were promised nor were intended to be paid, then the system would probably dramatically improve.

Let me give you an example. There are three things wrong with too big to fail. One of them is that the cost is enormous. It is absolutely enormous. One of them is that you can have no discipline. I know people say you can't put discipline into the system. But let me tell you, as a banker, there is discipline in there, and the other is fairness.

All three of them are good issues. On the part of cost, my cost has gone up nearly 200 percent in 18 months. The increase in my bank—I am a $90-million bank—is about $145,000. If I make a .5

return on assets, that is nearly 30 percent of my return in 18 months. I have got to convert that to capital.

That is where it needs to go. Capital is what all of the previous people were telling us we need to have. It is very difficult to have capital when you can't make a decent profit. Very difficult to have capital if you are a larger bank when the capital markets feel like a subordinated debenture would be wiped away, their stock would be wiped away. It is a costly, expensive thing to do.

The second thing is fairness. It is very difficult for a depositor in a small rural town in Arkansas to feel like they are being treated as fairly as someone in New England if they know they would lose everything over their insured deposit, whereas somebody else doesn't.

That fairness drives a lot of things. If you want to have fairness, then about the only way you can do it would be to have 100 percent deposit insurance. If you have 100 percent deposit insurance, if we think too big to fail is expensive, let's try to insure everything for everybody, and in addition to that, what difference would it make if I had capital if everybody is insured and the next guy has no capital?

The money simply flows to the rate. It is just common sense. It flows to the rate. There can be no discipline in that thing. That comes to the third part of this, and that is the discipline. I have got to determine what I am going to do to make the public perceive my bank as a strong place to do business, and the only way I can do that is to make moves that make my capital in my bank stronger.

With too big to fail in there driving us toward deposits being 100 percent, I lose my discipline. The net of those three things, then, is that we feel like, as a whole, too big to fail has to go. Too big to fail has to go.

How are we doing it? Basically like the FDIC has done it in the past, with this exception, if you have got over $100,000—you all are talking about putting this in in 1995. You are not talking about putting this in tomorrow.

By 1995 people know and expect, one of the previous testifiers said that, they know what to expect, they have got plenty of time to expect it. By 1995, if you are insured and a bank fails, you are going to catch a hair cut, and that hair cut is going to be roughly what the average of the FDIC failure cost has been for the last 5 years or 10 or whatever the U.S. Congress wants to make it.

That means, then, when the assets are all sold, then the cost to the fund will be zero over time; some will be more, some will be less. There is an additional catch to that, though.

You can't simply take that much liquidity out of the system, so what we do is say 12 percent is what you are going to lose, and we will kick you back your 12 percent and we will collect ours back over time. All right, we feel like those things will work.

They talk about a systemic failure and the bank fund paying for it. Systematic failure, as the Fed described it this morning, we have a melt down of a huge nuclear reactor, a melt down, so what he is talking about is some huge bank goes down, and international implications are all over the place.

Implications of industry after industry falling, huge banks, wham, it goes down in a few cases. That fund would be gobbled up in 15 seconds. There is no way if you are going for systemic reasons to save the fund that the FDIC fund could pay, so if that is a valid thing to do, then let's find a valid way to pay for that thing.

I thank you, Mr. Chairman.

Chairman CARPER. Thank you for your testimony as well.

[The prepared statement of Mr. Brandon can be found in the appendix.]

Mr. Ely, welcome.

STATEMENT OF BERT ELY, PRESIDENT, ELY AND COMPANY, INC., ALEXANDRIA, VA

Mr. ELY. Mr. Chairman, and Members of the subcommittee, I want to thank you for inviting me to testify today about one of the most difficult and important issues in deposit insurance—"the too big to fail" policy.

Enormous and very sincere effort has been devoted in recent months by the administration and the Congress to determine how to convincingly abandon this policy. But, Mr. Chairman, the title of my testimony says it all—abandoning "too big to fail" is an impossible dream.

I will devote the rest of my time to explaining why. Abandoning the "too big to fail policy" is premised on the notion that deposit insurance reform requires more depositor discipline. Put another way, the feeling of many is that Federal deposit insurance cannot be reformed unless more depositor discipline is injected into the banking business.

I reject this premise. Depositor discipline represents the third best source of banking discipline. Stockholders represent the best source of discipline; regulators are a distant second.

Worse, depositor discipline can quickly become counterproductive and even dangerous if relied upon too much.

Depositor discipline is like a fragile bridge that cannot carry too much traffic. Overload it and it will quickly collapse.

Depositor discipline is dangerous because depositors are very risk adverse with regard to their bank and thrift deposits. Worse, they can quickly withdraw their deposits if they fear they will lose any portion of their money.

This brings us to the central reason why a distinct no "too big to fail" policy will never work. No matter how fast the regulators move to close a troubled institution, thereby sticking its insured depositors with a loss, the more sophisticated depositors will run even faster. Only the least sophisticated will suffer a loss. However, they will garner the greatest political sympathy. Freedom National is just the latest failure that teaches that lesson.

Faster, more dramatic runs will be bad for two reasons. First, a depositor run on a troubled bank greatly increases the probability that the bank will fail.

A faster run also will increase the loss that BIF will suffer when it disposes of the bankrupt institution.

Second, more frequent runs on troubled banks will increase the potential for contagious runs, by both insured and uninsured depositors, on institutions who need not fail at a loss to the BIF. As irrational as it may seem, insured depositors have very rational reasons for withdrawing their deposits from a bank they fear may be closed.

As one woman said on Monday when pulling her insured deposit from the troubled Madison National Bank here in Washington, "I just don't want the hassle if the bank fails. I know my money is insured, but that is only part of the concern."

Madison had $382 million in deposits at the end of the last year. As of last June 30, it had 47,000 deposit accounts and $74 million of uninsured deposits, an amount which undoubtedly is lower today.

Clearly, Madison is small enough to be liquidated, but imagine liquidating a bank with $10 billion in deposits and 1 billion in deposit accounts. Now we are talking about the reality of abandoning "too big to fail." And this is why abandoning "too big to fail" is an impossible dream, for when this dream clashes with the realities of the cost and complexity and the risk and danger of bank runs, reality will win out.

Those regulators who have their finger on the trigger will blink when the tough decisions have to be made, and "too big to fail" will win out again. Just yesterday former triggerman Paul Volcker declared that "too big to fail" cannot be abandoned. He spoke the truth about "too big to fail."

Deposit insurance must be reformed and more discipline must be injected into banking, but reform must be premised on strengthening the first line of defense, stockholder discipline.

Tougher regulations can't do the job because technology is rapidly and irreversibly destroying the efficacy of all forms of financial services regulations. That is why Congress has no choice eventually but to strengthen stockholder discipline over banking so there no longer is a need to rely on increasingly ineffective regulatory discipline and the potentially dangerous and destructive depositor discipline.

Unfortunately, today, stockholder discipline in banking has one major structural flaw. Once a bank, which is after all a limited liability corporation, exhausts all of its own on-balance sheet equity capital, any additional insolvency losses have to be born by uninsured depositors and taxpayers; that is, healthy banks who increasingly are over charged for their deposit insurance. Neither party is a desirable bearer of loss.

I have good news, though. This structural flaw can be fixed quite easily. The fixed—always keep someone's stockholder capital at risk in every single bank, no matter how strong or how weak it is.

This means that when a bank exhausts its own capital and therefore fails, any additional solvency loss will be borne by stockholder capital invested in other banks. One way to tap capital within the banking system to absorb bank insolvency losses is the 100 percent cross-guarantee concept. This concept is described in attachment A to my written testimony.

Essentially, cross guarantees would utilize the enormous earning power and equity capital of the banking system to construct a solvency safety-net under every single bank and thrift in this country. No longer would the Congress have to fear that taxpayers will pay for deposit insurance losses, a fear that came true in the S&L crisis, and no longer would "too big to fail" be an unsolvable dilemma. Move to cross guarantees, and the "too big to fail" issue becomes moot.

Thank you.

I welcome your questions.

[The prepared statement of Mr. Ely can be found in the appendix.]

Chairman CARPER. Thank you very much.

We look forward to offering some questions.

Before we do, let me recognize Mr. Kaufman to the subcommittee for your statement.

STATEMENT OF GEORGE G. KAUFMAN, PROFESSOR OF FINANCE AND ECONOMICS, LOYOLA UNIVERSITY OF CHICAGO, CHICAGO, IL

Mr. KAUFMAN. Mr. Chairman, I am happy to testify on the implications of continuing a "too big to fail" (TBTF) policy in banking on effective deposit insurance reform that would both strengthen the banking system and protect the taxpayer against sharing in the costs of the bank failures. I will summarize my longer statement.

TBTF is the single biggest obstacle to achieving these objectives and is the major loophole in the Treasury proposal. Indeed, in light of the recent experience in the thrift industry, the taxpayer is not safe until TBTF is buried once and for all.

As presently employed, TBTF is a policy of not asking private sector uninsured depositors to share in the losses of insolvent large or important banks. Instead, the losses are borne by the FDIC, paid for by the other banks, and if its resources are depleted, by the taxpayers as in the ongoing thrift debacle. This is significantly different than what happens in other industries.

Their losses beyond those that deplete a firm's shareholders' capital are borne totally by the firm's private creditors. TBTF is a harmful and counterproductive policy for a number of reasons: It permits banks to operate with dangerously low capital ratios and excessively risky portfolios. It is blatantly unfair to smaller banks whose larger depositors are put at greater risk.

It creates uncertainty about which banks regulators will consider "too big to fail" at which times and thereby increases bank insurance premiums and bank costs. It encourages bank management to place growth above earnings in its objectives.

By permitting "bad" near insolvent and even insolvent "zombie" institutions to continue to operate, it increases the cost of living to "good" banks by bidding up deposit rates and undercutting loan rates.

Because the larger losses may require taxpayer assistance, it is accompanied by greater government intervention and regulation than otherwise.

Why, in light of all of these adverse implications, do most regulators support continued TBTF? There are a number of reasons: Pressure from the insolvent institutions—shareholders, managers, employees, and larger borrowers—to delay resolution.

Pressure from Congress responding to the same parties as above, who are important constituents. Fear of spillover of bank failure to other banks, the financial sector as a whole and the national macro-economy.

Fear of reduction in money and credit to the community. Fear of breakdown in the payments system from defaults in clearing.

Fear of receiving a public black mark on their record for failing to maintain bank safety and fear that the public and Congress may shoot the messenger of bad news. Thus, regulators prefer to delay public recognition of failures in hope that conditions will reverse or, if not, that the failure or at least recognition of it occurs on their successors' watches.

Fear of antagonizing future potential employers. Similar to the well publicized "revolving door" in the Defense Department, many employees of bank regulatory agencies join banks and related firms after their tenure at the agency.

Last, fear of loss of discretion, which enhances the visibility, power and "fun" of the regulatory job.

As I review in my written statement, these qualifications are not desirable or persuasive. I document that systemic risk is today a phantom issue. It is a scarce tactic. If one includes the thrift debacle, bank runs, failures and depositor losses were less costly in the pre-FDIC era than they were in the last decade.

The runs on the Continental Bank in 1984, the large Texas banks in 1987-1989, and the Bank of New England in 1990-1991 were rational runs on economically insolvent institutions that moved funds not into currency to start systemic risk, but to safer banks. The delayed resolutions by the regulators did little more than increase FDIC losses substantially.

Contrary to regulators' claims at the time of the Continental rescue in 1984, the change in policy by the FDIC not to make all creditors of bank holding companies whole in 1986 and to fail banks legally in 1988 did not cause disruptions.

Continuation of "too big to fail" is a battle between bank regulators, and today I find out also the General Accounting Office, on the one side, and the bankers and taxpayers on the other.

There is hardly another issue today on which bankers are as united as on the need to end TBTF.

I recently attended a meeting of the chief executive officer's of a cross section of banks in Chicago and they unanimously voiced their opposition to TBTF. I would like to enter into the record a news release that summarizes that meeting.

[The information referred to can be found in the appendix.]

Mr. KAUFMAN. It would be different to believe in wake of the S&L debacle that taxpayers do not feel the same way. It is time to stop bowing to the regulators and heed the concerns of the people as in your bill 2094.

Thank you.

[The prepared statement of Mr. Kaufman can be found in the appendix.]

Chairman CARPER. Thank you very much.

Is it Dr. Kaufman?

Mr. KAUFMAN. Yes.

Chairman CARPER. You are a professor from Loyola in Chicago.

Mr. Ely, do you still have your firm down in Alexandria?

Mr. ELY. Yes, I do.

Chairman CARPER. Mr. Wright, I understand you are the Director of Regulatory Affairs for the Office of Financial Markets, Arthur Andersen and Co.?

Mr. WRIGHT. That is correct.

Chairman CARPER. We welcome you and recognize you at this time.

Mr. WRIGHT. Thank you.

STATEMENT OF HOWARD L. WRIGHT, DIRECTOR OF REGULATORY MATTERS, OFFICE OF FINANCIAL MARKETS, ARTHUR ANDERSON & COMPANY

Good afternoon, Mr. Chairman and Members of the subcommittee. I appreciate the opportunity to share the views of the Committee for Responsible Financial Reform regarding "too big to fail" and how this issue relates to deposit insurance reform.

The Committee for Responsible Financial Reform consists of 10 individuals who are prominent in financial circles. The committee was formally organized on February 4, 1991 to support efforts to achieve comprehensive and meaningful reform of the banking and financial system in 1991, with such reform directed at the broad public interest rather than that of any industry group.

The committee is chaired by Frederick H. Schultz, former Vice Chairman of the Federal Reserve Board. Donald P. Jacobs, Dean of the J.L. Kellogg Graduate School of Management at Northwestern University, serves as Vice Chairman. Other members of the committee are: Richard P. Cooley, retired CEO of Seafirst Bank; W. Peter Cooke, Chairman, World Regulatory Advisory Practice; Price Waterhouse, formerly Head of Banking Supervision at the Bank of England and Chairman of the Basle Committee of Banking Supervisors; Maurice R. Greenberg, CEO of the American International Group, Inc.; William M. Isaac, CEO of The Secura Group and former Chairman of the FDIC; James D. Robinson III, Chairman of the American Express Co.; Gary H. Stearn, President of the Federal Reserve Bank of Minneapolis; Thomas I. Storrs, retired Chairman of the Board of NCNB Corp.; and Howard L. Wright, Director of Regulatory Matters, Office of Financial Markets of Arthur Andersen & Co.

Clearly, "too big to fail" is the linchpin of the deposit insurance reform equation. Its elimination, to the extent possible, should be the critical centerpiece of any deposit insurance reform proposal adopted by the Congress.

We have reviewed the study submitted to the Congress by the Secretary of the Treasury and find it to be a thoughtful, comprehensive report that serves the full attention of the Congress. Meaningful reform of the Nation's banking and financial system is needed.

Not only in the interest of the financial institutions but also and much more important in the interest of the public.

While agreeing with the basic thrust and major recommendations of the Treasury report, the subcommittee finds that the report falls short in failing to recommend fundamental reform of the deposit insurance system.

It is essential that the market be restored as an important regulator of banking, and this could be accomplished only by requiring that depositors share with the government the cost of bank failure. The present policy of "too big to fail" is inequitable and costly and must be eliminated.

The report's failure to recommend fundamental insurance reform and an enhanced role for market discipline compels it to rely too heavily on expenses and potentially stifling government regulations.

Moreover, it forecloses the possibility of substantial future reductions in the cost of insurance to the banks and to the public. Clearly, market discipline can be restored only when the market is convinced that all banks can fail and, more important, that failure will imply losses for uninsured and unsecured depositors and creditors.

The subcommittee is fully aware that the prospect of eliminating "too big to fail" raises substantial concerns in the minds of many. some perceive that without "too big to fail" the temporary inaccessibility of funds in accounts over $100,000 could disrupt the payments system, money supply, and market liquidity.

These difficulties may be mitigated by changing the structure of the deposit insurance system. It is important to note that "too big to fail"and the structure of deposit insurance cannot really be separated.

Further, it is generally agreed that the elimination of "too big to fail" would represent a major change for many banks and their depositors and their creditors. Accordingly, deposit insurance reform along the lines we suggest should be enacted with a delayed effective date of at least 3 years after the adoption of the legislation. An insurance system, for example, that covered fully transactions and 90 percent or so of interest-bearing liabilities over $100,000 mitigate the concerns associated with "too big to fail."

Liabilities up to $100,000, of course, would be fully covered and subordinated debt would remain completely uncovered. Such a system of deposit insurance would fully protect small depositors and assure the functioning of the payments system. It would introduce market discipline for banks by exposing large interest-bearing accounts to a degree of risk of loss.

This approach would curtail insurance coverage only slightly from the current de facto level of 100 percent in the larger banks.

It is precisely this modest reduction in coverage that will allow for the elimination of "too big to fail." We see several advantages to the haircut approach with respect to large interest-bearing accounts. It is irresponsible to allow depositors earning rates will above these paid by conservative, well-managed institutions to escape risk under the government guarantee umbrella. Under this proposal depositors will tend to be prudent in selecting an institution.

Those in the fast lane will have their radar detectors on to avoid the speed traps. It is unfair to the sound institutions that are forced to bear the burden of high deposit insurance premiums and to the public at large who, as taxpayers, act as a back stop to the deposit insurance fund.

Weak institutions, prone to pay higher rates for deposits, will find it more difficulty to attract depositors. Thus, obtaining funds to adopt a "bet the bank" strategy, if you will, would be more difficulty.

Elimination of "too big to fail" will reduce substantially the costs of the BIF fund. The BIF's expenses will be reduced considerably because a portion of the costs of all failures will be shared by those in interest-bearing accounts over $100,000, and the market discipline so created will reduce future costs by eliminating the growth of the weak and risky institutions. Importantly, this system will eliminate the inequity between the large and small banks inherent in the "too big to fail" policy.

As you can see, the subcommittee believes it is possible to reform the deposit insurance system to mitigate the most serious systemic concerns associated with large bank failures. The question remains whether there are any circumstances under which the government must intervene to prevent losses to all depositors and general creditors.

It is difficult to imagine a situation where this would be the case, but should it arise, the question has no relevance to the deposit insurance reform. A government's right to intervene whenever a business failure threatens the national interest is absolute, whether the business is a bank or an industrial concern.

Should the government decide to intervene in the case of a bank, the decision, the form and nature of assistance, and the cost should be handled outside the deposit insurance system.

Mr. Chairman, that concludes my testimony. I would be pleased to answer any questions.

Chairman CARPER. I am going to ask that the Members of the subcommittee adhere to the 5-minute rule so we can get out of here in a timely manner and let our witnesses go on their way.

Mr. Brandon, where do you and Mr. Wright agree and where do you disagree in your statements, where do you think you agree? What are the principal differences?

Mr. BRANDON. It appears that we both agree that "too big to fail" is too expensive and it is not fair to the depositor and it needs to go.

It appears that we agree that "too big to fail," if you take it as a national interest, is not something that is a matter for the FDIC. The FDIC insures insured deposits, so we agree on those two things.

Chairman CARPER. Where do you disagree?

What are your principal disagreements?

Mr. BRANDON. I would have to read his testimony very carefully to see if there were any nuances that we disagreed on. Pretty rare that you are going to find in "too big to fail" anybody that totally agreed on anything.

Chairman CARPER. Mr. Wright, where do you see you and Mr. Brandon agreeing and disagreeing?

Mr. WRIGHT. I think the real distinction in our approach is the protection of all the payments system accounts, if you will, the non-interest bearing accounts, and I think that takes away the fear of a payment system collapse, and putting the burden for the policing on the high interest—or the high-yielding deposits of depositors seeking high yields in on deposits excess of $100,000, that will have been guaranteed irrespective of yield by the existing "too big to fail" approach.

Chairman CARPER. Dr. Kaufman, is it fair to say that you, of the witnesses we have heard from today, most agree with the action of the Financial Institutions Subcommittee, the legislation, H.R. 2094?

Dr. KAUFMAN. I haven't read it in detail. All I know is what has been reported in the press. I think it is a very good first step in stopping "too big to fail", which I have argued is very costly to the taxpayer, unfair to the banks, and I know that there was an amendment that was lost about the Federal Reserve being able to lend to banks.

I think eventually you may want to deal with that, but I would like to see us make progress, and that can only happen one step at a time, so I do agree with the thrust of the bill 2094 of stopping "too big to fail".

Chairman CARPER. All right. Mr. Ely, in the second page of your summary, of your testimony, you said "I have good news, though, this structural flaw can be fixed quite easily."

Could you just go back and sketch that for us again, please, your explanation of how this fix can occur.

Mr. ELY. There are various ways that the fundamental structural flaw of deposit insurance could be dealt with. What I talk about, and have proposed for some time, is what I call the cross-guarantee concept. It is nothing more than a self-insurance mechanism for the banking industry in which ad hoc syndicates of banks would guarantee each other's liabilities in full and not just the first $100,000 of deposit balances.

The purpose for doing this is not to improve depositor protection. That is a given in the countries of the industrialized world. The whole thrust of this proposal is to improve taxpayer protection; to, in effect, use the earning power of the banking system, and the over $200 billion of equity capital to link together all banks in constructing what I call a solvency safety net that would stand between the banking system and each bank in it on the one hand and the Treasury Department or the taxpayer on the other. Any bank insolvency loss that effectively wipes out the capital of an individual bank would be spread laterally across the banking system and not imposed upon the general taxpayer in any way. Essentially, this is the way to set up an actuarially sound deposit insurance mechanism that, among other things, would allow for risk-sensitive deposit premiums.

I think there are many in Congress today who believe there should be risk sensitivity in deposit insurance pricing, but pricing can only be done accurately in a private, competitive marketplace.

One of the reasons to move toward the cross-guarantee concept or a comparable type of insurance mechanism is to allow that pricing to take place. In all candor, the FDIC will never be able to price properly.

Coming back to the purpose of this hearing, if we establish a sound insurance mechanism that is based on the capital and earning power of the banking system, we can protect every dollar of deposit, we can get away from the notion of having depositor discipline, and "too big to fail" just disappears as an issue.

Chairman CARPER. Let me ask each of the other panelists to respond very briefly to this proposal from Mr. Ely.

Mr. BRANDON. I will start.

I have not read Mr. Ely's total plan thoroughly. I have seen his plan. I don't think that it is practical, and I don't think that it could work in a reasonable world.

I think we can't get there from here, frankly.

Chairman CARPER. All right. Dr. Kaufman.

Mr. KAUFMAN. I agree. I think in practice it would not work very well. There is not enough capital in the banking system to protect all the banks with the cross guarantee.

Second, I think that deposit insurance, up to a certain amount, $100,000, or something, is ingrained, in the public. The small depositors are the only ones you need to worry about because they are the only ones who could run into currency. The big depositors can't.

The only way that systemic risk, if there is such a thing, can occur is if there is a run on all banks into currency. So you have to worry about the small depositors. I think that they look forward to a government guarantee.

Chairman CARPER. Mr. Wright.

Mr. WRIGHT. I would share the view that the small depositor looks forward to the Government guarantee. I also believe firmly that the discipline provided by the large depositor will be very real if, in fact, it will put the large depositor at some modest degree of risk.

Chairman CARPER. OK. My time has expired. Let me yield now to Mr. Ridge for his questions.

Mr. RIDGE. Mr. Chairman, I know my colleagues, Congressmen Vento and Hoagland, have been here and they have been waiting along time. I will yield to them and I will conclude.

Chairman CARPER. Good. Thank you.

Mr. Hoagland.

Mr. HOAGLAND. I don't know where to begin because this subject is so complicated.

Each of you gentlemen has presented such interesting testimony. First, in defense of Mr. Ely's proposal, I guess Canada sort of has that, doesn't it?

Canada has six or seven big banks. Isn't that right? How many banks?

Mr. ELY. They have a number of smaller banks also, but their banking system is dominated by a handful of very large institutions.

Mr. HOAGLAND. That have Canadian-wide banking?

Mr. ELY. That is correct.

Mr. HOAGLAND. So if a branch somewhere fails, why, the rest of the bank is there to keep that branch from failing, in effect?

Mr. ELY. That is correct, and protecting depositors 100 percent.

Mr. HOAGLAND. That is right. So is that an appropriate analogy to say your system really sort of is in place in Canada?

Mr. ELY. Well, Canada also has a deposit insurance system. The Canada Deposit Insurance Corporation provides protection up to $60,000, but they have—I was just looking at their numbers the other day—probably including their trust companies, about 150 depository institutions operating in the whole country, so in some ways their problems are more manageable.

Interestingly enough, they also are thrashing around with this issue of "too big to fail". My testimony cites a $1.5 billion institution that they closed just a couple weeks ago, a trust company that is a lot like a thrift in this country, in which they have decided to liquidate the institution, but they delayed long enough that most of the uninsured deposits in the institution had fled by the time they finally closed it.

Mr. HOAGLAND. Maybe we can talk about this some more. I would like to follow up, but we are under a strict 5-minute limitation with this vote looming over and the fact that we have to give the room up in 20 minutes, so let me shift, if I can.

Mr. Brandon, the official ABA position—correct me if I am wrong—is in favor of the least cost, immediate payout resolution procedure, and otherwise not ensuring or not reimbursing uninsured depositors; is that right?

Mr. BRANDON. That is correct.

Mr. HOAGLAND. So the ABA position would concur with the current version of the bill that was reported by the subcommittee?

Mr. BRANDON. With the exception of the amendment for the Fed. As the Governor spoke this morning, he mentioned that amendment. That is a huge loophole that can end up with the Fed stepping in at the last minute, lending money to allow the uninsured deposits to flee, and the uninsured creditors to flee, taking the assets, the good assets, dumping it back on FDIC fund at the end and you have got the same result, you have got "too big to fail" all over again.

Mr. HOAGLAND. So something needs to be done with that, if possible.

Mr. BRANDON. Right.

Mr. HOAGLAND. As I read Mr. Wright's testimony, it is very similar to your testimony. You two are sort of both saying we should use that least-cost resolution system and not—how do you respond, Mr. Brandon, to the testimony from the regulators this morning and from Mr. Glauber from Treasury that somewhere in the Government there needs to reside the authority because—I think Mr. Ely said hat in his testimony. I don't believe Mr. Kaufman did, but how do you and Mr. Wright respond to the problem that there can be such severe systemic failures that somewhere in government somebody has to have the authority to step in, shouldn't be paid for by the Bank Insurance Fund, but nonetheless that authority has to reside somewhere. What is your——

Mr. BRANDON. It is interesting.

First of all, we started with a small subcommittee, but that wasn't the end of the banker involvement of whether or not "too big to fail" can go. It is our industry, it is our business, so we are paying pretty close attention to this.

But it went from there to a subcommittee of 100, it went from there to the subcommittee of 400. It went from there to the Board of Directors. It went from there to almost every State in the Union, to talk about the question of, is "too big to fail" something that can be eliminated? It is almost unanimous.

Nothing is ever unanimous, but it is almost unanimous that, yes, we don't have any choice but to do this, we have got to do this. It was also pretty well unanimous that if you did have that unusual rare systemic risk, that was outside the fund, it was a national priority, congressional priority and should be dealt with in a different way.

Mr. HOAGLAND. But you were conceding that that authority—you are essentially agreeing with Mr. Ely, that it is in the end an impossible dream, and that somewhere in government there needs to reside that authority or would you totally take out of the statutes any authority or require that a bill be brought in a la the Chrysler bailout?

Mr. BRANDON. I would be back to Mr. Wright's proposal on that. What we are saying is "too big to fail" simply means that you come in and that you pay uninsured depositors and uninsured creditors 100 percent because you think that there might be some system risk to the banking industry.

That is what you are saying. We are saying that we believe you can eliminate that, that if we go to a haircut type of approach, if we give ourselves enough time, if everybody understands the situation, then there is nowhere to go.

You have got the same thing everywhere. You simply go to the bank that you think is run the best, and you have got a market discipline that comes in there. We are not saying that under any circumstances ever there might not be something that would be in the nature of the Chrysler situation, the New York situation, the railroad situation that the Congress wouldn't have to deal with.

We are simply saying that is outside the FDIC.

Mr. WRIGHT. I would have to agree. There would have to be a catastrophe before the Government would step in in the strictest sense of the word.

The concept is if you put enough market discipline in the system, in effect, you should be able to lower premiums because the marketplace itself will help regulate the system, and only in a very, very catastrophic situation, it would have to be a Chernobyl as discussed by one of the other witnesses this morning—we haven't had one of those in this country.

Mr. HOAGLAND. Thank you, gentlemen. Your testimony has been most helpful.

Chairman CARPER. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman. I think the whole issue is whether we have got an insurance system that costs more than the banks can support. I mean, that is what the problem is, so we are trying to reallocate those costs somehow.

I guess I have got about 5 minutes before we really have to go. But the point is, if we, for instance, and I know that my good friend, Congressman Hoagland and others are advocating that we, in fact, put in place some sort of a system that would provide a haircut. Right now the FDIC could any time they want employ that particular technique. But they don't, and there are probably a lot of good reasons why they don't, one of which is they might get involved in a lot of litigation.

My concern is that if we were to do that, then we would really be extending insurance coverage. Today we do it implicitly, then we do it explicitly.

Mr. Ely, you agree, so I will ask you a little bit about it.

Mr. ELY. Well, I think that we are slowly moving in that direction, whether we like it or not, of having increasingly explicit coverage for deposit balances over $100,000.

Mr. VENTO. But this system, when the banks were profitable it was a different thing. Then we had moral hazard, Mr. Bartholomew. The point is, now the moral hazard is something we really can't afford.

There is no actuarial table, there is no way to do it. How does your proposal, Mr. Ely, really differ from raising the premiums on everyone?

Doesn't it really come back and tax everyone for the problem in a way that we say, well, this is so bad that it would cause other banks to go into default?

Mr. ELY. No, this is where you get into the area of risk-sensitive deposit insurance premiums so that in effect the drunk drivers of the banking world pay a lot more than their sober siblings for their deposit insurance. My calculations are that the riskiest banks should be paying as much as 20 times what the soundest banks ought to be paying for their deposit insurance.

We have right now a flat rate deposit insurance system where the cross subsidy that is flowing from the good banks, from Mr. Brandon's bank and others, to pay for bad banking is growing all the time.

The cross subsidy next year will be in excess of $3 billion. That is wrong. That is bad for the better banks in this country.

If we go to a system that allows for a private, competitive marketplace to engage in the assessing of risk and the pricing of risk, we will get away from the problems that we are so concerned about with Federal deposit insurance.

Just to clarify the record on that point, the cross-guarantee concept does not envision rolling back Federal deposit insurance protection one iota.

Under cross-guarantees, the Government would specify that the banking system and its capital and resources stand there first in an actuarially sound way. There is no reason why the FDIC sticker can't stay in the door and why the Government in a catastrophe, if the banking system as a whole is bankrupt, couldn't come in and protect depositors.

The thing that is interesting is that in the Depression there was, even then, enough capital in the banking system to have fully protected all depositors at that time.

Mr. VENTO. I wanted you to have an opportunity, because I knew you didn't earlier, to respond. I think the witnesses agree with regard to the essentiality test.

Mr. Seidman said it had only been employed four times. Do you agree that the "too big to fail" has only been invoked four times in that timeframe? I don't know what his timeframe was.

I think he started with Continental and ended up with Bank of New England.

Mr. BRANDON. I am eventually regulated by the FDIC, so I always agree with everything they say.

However, it would appear to me that is a rather narrow definition. We as bankers feel like it has been used one way or the other a lot more than that.

Mr. VENTO. We have all these discussions about the benefits of free enterprise, but when it really comes down to it, it sounds to me like a lot of people don't want to practice it, the downside of it.

Mr. Kaufman, do you agree with that essentiality issue?

Mr. KAUFMAN. I looked at the list Mr. Seidman presented to us, and it left out the Continental Illinois Bank. I would think any list that leaves out the Continental would not be a complete list.

Mr. WRIGHT. I think he was referring to the list while it was on his watch.

Mr. VENTO. I am sorry. I think you are probably right. I didn't know what the timeframe was.

Mr. WRIGHT. I guess the other view I would have is if you are going to have "too big to fail", in effect, you are providing funds to institutions who are too weak to go ahead and make additional loans, and that is one of the problems.

Once the institution has a bad loan, it is too late.

Mr. VENTO. Well, I agree that that is a problem, but, Mr. Wright, I was sort of fascinated by the thought that you had given to this, and of the suggestions, but is there anyone here who really thinks that the current insurance system we have is something we can afford?

Don't we really need to trim this back?

I don't know that we do it enough with the 85 percent because right now, for instance, they have discretion that they could cut way back and they don't examine that particular technique.

So if we actually say we are going to do 85 percent, you know, we are really extending or expanding it.

Mr. WRIGHT. I think the real issue is one of looking at it over time. I think you have to phase in to whatever changes you make. If you make a change immediately, you have got to provide for some transition.

Mr. VENTO. We are all for that. I appreciate it, Mr. Chairman. Thank you very much. My time has expired.

Chairman CARPER. Thank you, Mr. Vento.

For the last word, Mr. Ridge.

Mr. RIDGE. Thank you, Mr. Chairman.

Mr. Brandon, first of all, let me thank you for your testimony, all panelists, and let me also thank you for you leadership within the ABA, as well as your colleagues on your deposit insurance reform effort. I have read what you wrote.

I think it is a very good succinct primary primer of a broad range of concerns that not only Members of Congress but the panelists had, the taxpayers had in terms of identifying what the problems are, and what we should be alerted to. I think you did an excellent job, and I certainly think it was a thoughtful responsible alternative that you have offered.

I just want to thank you for the contributions of the ABA to this process. I am not sure we are going to get there from here, borrowing your words, but it was a thoughtful contribution, and I for one, appreciate it.

Perhaps, you heard this morning the discussion I had with the panelists with regard to the Fed's intervention into ailing institutions, and I used the Bank of New England, which probably wasn't the best example, and Chairman Seidman referred to National Bank of Washington, and either one is still illustrative of the concern that many Members of Congress have, that you have an early run on "X," and more often than not it is involving uninsured depositors. Because of their run, there exists a liquidity problem.

The liquidity problem is addressed by the Fed. The Fed then takes a position as a secured creditor rather than an uninsured depositor and, therefore, if that institution ultimately goes belly up, you have got an even greater insurance problem because there are now secured liabilities rather than uninsured liabilities, so my colleagues understandably have considerable discomfort that that may exacerbate the problem.

Their response, as you heard, was, well, that is what central banks do, we haven't intervened that often, and we still need the flexibility to do that.

Would you give me your thoughts on that problem and that gives some of my colleagues so much discomfort because I think we are going to have to come back and address it.

Mr. BRANDON. First, thank you for your complimentary comments. I did hear the testimony and your dialog and the questions. That is of the great concern to the ABA, it is of great concern to me. I don't know exactly what the solution is, but I do know it appears to us that as you characterize it, that is exactly what could happen.

Now, how you solve that, I am not prepared to say at this time, except that that is a huge loophole in eliminating "too big to fail" that we feel like you need to look into very strongly and very emphatically and let's see if we can't work out a solution.

Mr. RIDGE. Mr. Ely, just a quick review of your testimony.

I know that you cite many reasons for the "too big to fail" policy, and you referred to it in all kinds of ways in avoiding the wrath of depositors and, I guess, the army, the acronym used to COIA, so I think you have some feelings on this.

Would you share them with me as well as the rest of the panelists?

Mr. ELY. Well, the basic problem is that when the crunch comes it is a matter of who is going to take the loss. The regulators would prefer that the pain be diffused, and the easiest way to diffuse the pain is to have the FDIC pick up the loss because the banks finance the FDIC. In a more serious situation, the Government, and the general taxpayer will absorb the pain.

The problem that will come up is that if an attempt is made to get even more serious about imposing losses on specific depositors, then we will have some concentrated hurts, and those folks will scream bloody murder. I think the regulators want to avoid that.

We see this every time it is attempted, most recently in Freedom National. There was $11 million of uninsured deposits in that institution, a drop in the bucket compared to big institutions, and yet there have been enormous cries of pain and also suggestions that maybe in that case we ought to bend a little bit and protect some of those poor depositors that had uninsured balances in that institution.

I think the Freedom National experience is the type that stays in the minds of regulators, and tilts them towards avoiding the concentrated pain whenever a larger troubled bank situation comes up.

Mr. RIDGE. OK.

Mr. Kaufman.

Mr. KAUFMAN. I wish to disagree with Mr. Ely.

What we are talking about, what bill 2094 does, and what my colleagues here are talking about is a different system with early intervention. By the way, I would like to mention that early intervention in a structured program, such as in 2094, such as in the Treasury proposal, such as in the Gonzalez bill, is a new idea.

Three years ago, it was a radical idea when I and my co-author George Benson developed it for the American Enterprise Institute. So in 3 years it has swept in. You can do such things.

Mr. RIDGE. It is that vision thing, you had it.

Mr. KAUFMAN. With such a structure you are going to have far fewer banks that are going to go down into the lower tiers, into the lower zones which require the re-capitalization. If you pass a law, the regulators are going to stick to that law, and I think you are going to have a different banking system.

Let me remind you, when we talk about runs on uninsured institutions, look at the money market funds. They are viewed as safer than banks, yet they are not insured. People have greater faith in them because they monitor the assets. I have been trying to get a money market fund to see if they would run an experiment for me go into 30-year mortgages.

But they know better; they know there would be a run. But don't worry about runs. The threat of a potential run is a major from of market discipline.

I have studied banking history, going way back to the early 1800's, and banking history in this country was very stable. We had very few runs. The bank failure rate from 1865 to 1920 was lower than the non-bank failure rate.

Even during the Depression the losses were pretty small, because of market discipline and because we closed the institutions quickly.

If you don't have a closure rule, you can throw everything else away.

Mr. RIDGE. Mr. Wright, I am afraid my colleague and I have to leave, but I will give you the last word.

Mr. WRIGHT. One last comment. I don't doubt the sophistication and ability of the marketplace to provide discipline. I think many times the marketplace also provides better discipline than people who are trying to figure their way around whatever structural rules are imposed by regulation.

Mr. RIDGE. On that interesting and controversial note——

Chairman CARPER. Mr. Wright, Dr. Kaufman, Mr. Ely, Mr. Brandon, thank you very much for being with us today.

[Whereupon, at 2 p.m., the hearing was adjourned.]

A P P E N D I X

May 9, 1991

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED SECOND CONGRESS

SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
ROOM 140 FORD HOUSE OFFICE BUILDING
WASHINGTON, DC 20515

STATEMENT OF CONGRESSMAN THOMAS R. CARPER, CHAIRMAN
SUBCOMMITTEE ON ECONOMIC STABILIZATION
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HEARING ON
THE ECONOMIC IMPLICATIONS OF THE "TOO BIG TO FAIL" POLICY

MAY 9, 1991

I WOULD LIKE TO THANK MY FELLOW MEMBERS OF THE SUBCOMMITTEE AND OUR WITNESSES FOR JOINING ME HERE TODAY TO DISCUSS THE ECONOMIC IMPLICATIONS OF THE "TOO BIG TO FAIL" POLICY AND PROPOSED LEGISLATIVE CHANGES TO THIS POLICY.

BANK FAILURES OCCURRED AT RECORD LEVELS IN THE 1980s. IN THE LAST THREE YEARS ALONE, CLOSE TO 600 BANKS FAILED OR RECEIVED ASSISTANCE, AND THIS TREND IS NOT LIKELY TO SIGNIFICANTLY CHANGE IN THE NEAR FUTURE.

YET NOT ALL OF THESE FAILED INSTITUTIONS HAVE BEEN RESOLVED IN THE SAME MANNER. WHILE DEPOSIT INSURANCE PROTECTION HAS BEEN ROUTINELY EXTENDED TO UNINSURED DEPOSITORS WHEN LARGE BANKS FAIL, SUCH PROTECTION HAS NOT ALWAYS BEEN AFFORDED TO UNINSURED DEPOSITORS WHEN SMALL BANKS FAIL.

THIS POLICY OF PROTECTING UNINSURED DEPOSITORS IN LARGE BANK FAILURES IN ORDER TO PREVENT ADVERSE EFFECTS ON THE FINANCIAL SYSTEM AND THE MACROECONOMY IS COMMONLY REFERRED TO AS THE "TOO BIG TO FAIL" DOCTRINE. WHILE SOME ARGUE THAT THE POLICY HAS BEEN

IMPORTANT IN MAINTAINING A STABLE FINANCIAL SYSTEM IN OUR COUNTRY, IT HAS RESULTED IN INEQUITABLE TREATMENT OF DEPOSITORS AND BANKS; INCREASED COSTS TO THE BANK INSURANCE FUND; INCREASED TAXPAYER EXPOSURE; AND DISCOURAGED MARKET DISCIPLINE.

FOR THESE REASONS, THE "TOO BIG TO FAIL" POLICY IS ONE OF THE MOST CONTROVERSIAL ISSUES IN THE BANKING COMMUNITY TODAY.
IT PRESENTS MEMBERS OF THE HOUSE AND SENATE BANKING COMMITTEES WITH ONE OF OUR THORNIEST PROBLEMS TO RESOLVE AS WE DEBATE BANK REFORM. CONGRESS' ULTIMATE GOAL SHOULD BE TO REFORM THE BANKING INDUSTRY IN A WAY THAT WILL RESTORE VITALITY TO THE BANKING INDUSTRY, BENEFIT CONSUMERS AND AVOID ANOTHER TAXPAYER BAILOUT. TO REACH THAT GOAL, THE TOO-BIG-TO-FAIL ISSUE MUST BE RESOLVED.

I COMMEND CHAIRMAN GONZALEZ AND CHAIRMAN ANNUNZIO FOR BEGINNING TO ADDRESS THE TOO-BIG-TO-FAIL ISSUE IN H.R. 2094, BUT I BELIEVE THAT IMPORTANT QUESTIONS STILL REMAIN UNANSWERED. THE PURPOSE OF TODAY'S HEARING IS TO REVIEW IN DETAIL THE ECONOMIC JUSTIFICATIONS FOR A TOO-BIG-TO-FAIL POLICY, AND THE ECONOMIC IMPLICATIONS OF PROPOSED CHANGES TO THIS POLICY.

WE HAVE A FULL PLATE BEFORE US TODAY, WITH A NUMBER OF WITNESSES SCHEDULED TO TESTIFY. I'LL SAVE ALL OF YOU FROM A LONG OPENING STATEMENT. I LOOK FORWARD TO HEARING FROM OUR DISTINGUISHED PANELS OF WITNESSES.

OPENING STATEMENT
THE HONORABLE THOMAS J. RIDGE
RANKING MEMBER, SUBCOMMITTEE ON ECONOMIC STABILIZATION

Thank you, Mr. Chairman. Events have made this hearing very timely. In the Financial Institutions Subcommittee markup two days ago, Members tried but failed to begin to address this very crucial policy. I think a number of those on the Banking Committee are sympathetic to allowing the Federal Reserve and the Treasury a small window to take action to prevent systemic risk, but aside from Mr. Hoagland, they were very quiet yesterday. A significant number--and they did make themselves heard--believe any window is too large, and the risk of codifying too big to fail far outweighs any benefits of reducing current regulatory practice.

The result is the current mark of HR 2409: a simple statement preventing the FDIC from paying off uninsured depositors. That is our starting point today. The Treasury proposal allowing the Federal Reserve and the Treasury make the FDIC pay uninsured depositors is no longer in the mark. Some good ideas are out there, however, and I hope we will hear comment on these topics, as well as explore in detail the various components of systemic risk.

I do know that if we do not make progress in this area, other parts of the bill will not be agreed upon readily. Securities firms worry that large financial services holding companies will receive 100% federal backing, thus providing unfair competition to them. Small banks worry that deposit reform means cutbacks in their coverage while large banks retain full backing, leading to an outflow of funds from small communities. These groups and others will have a legitimate incentive to block needed reforms unless we resolve our dilemma.

I look forward to the testimony.

TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

THE IMPLICATIONS OF "TOO BIG TO FAIL"

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

10:00 A.M.
MAY 9, 1991
ROOM 2128, RAYBURN HOUSE OFFICE BUILDING

Mr. Chairman and members of the Subcommittee, I am pleased to appear before you today to discuss the Federal Deposit Insurance Corporation's views on the resolution of large failing banks and on proposed legislative changes to the FDIC's cost test. These issues have become known as the "too big to fail" problem. The FDIC believes that this problem needs to be addressed by Congress as it studies recapitalization of the Bank Insurance Fund and the necessary modernization of the U.S. banking industry. It also is important to address the evident unfairness in a system which seems to provide greater protection for depositors in large institutions than it does to those who place funds in smaller institutions.

We applaud your initiative which supports our view that this problem is a matter of concern to the overall economic stability of our nation, as well as to the banking agencies.

Your letter of invitation detailed several areas of interest to this Subcommittee. Before addressing those directly, I would like to provide some background information on the insurance coverage of depositors in large bank failures.

Introduction

"Too big to fail" (TBTF) is imprecise shorthand for "too big to allow uninsured depositors to suffer losses." TBTF arises when a bank fails (or may fail) and the FDIC and other federal regulators find the institution essential and thus act to prevent consequences of allowing depositors above $100,000 to sustain their proportion of the loss in the institution. In large bank failures, essentiality involves systemic instability arising from possible disruption to the payments system, fear of contagion effects on other banking organizations, or increased instability in the banking system as a whole. In small bank failures, essentiality may involve essential financial services required in the community it serves. However, it is unlikely that the failure of a small bank in a large community will meet the essentiality test.

In the bank failures where TBTF is not involved, either an insured deposit payout is used, or a failed bank is acquired by another institution in a closed-bank purchase-and-assumption (P&A) transaction. In a P&A transaction, an acquirer normally purchases some of the assets and assumes liabilities of the failed bank, and pays a premium that reflects the franchise value of the institution. The acquirer assumes both the insured and uninsured deposits, and in some cases other nondeposit liabilities of the failed bank. In some cases, a resolution is accomplished by providing direct financial assistance on an open-bank basis to facilitate a merger with a healthy institution or an acquisition by new investors. Thus, in this transaction all depositors are protected.

Prior to 1951, the P&A transaction became the most common failure-resolution method employed by the FDIC. This transaction was viewed as an efficient means of handling an insolvent bank because generally protecting all depositors resulted in fewer disruptions to banking services to the community, and the transaction provided the FDIC with maximum flexibility in the failure-resolution process.

In 1951, Congress questioned the FDIC's policy of providing de facto 100 percent deposit insurance to banks, and suggested that failures were being resolved without regard to relative cost. In response, the FDIC began to use a cost test when determining how a bank failure should be resolved. The FDIC interpreted Section 13(e) of the Federal Deposit Insurance Act of 1950 to mean that a cost test must be undertaken whenever a resolution transaction is performed to determine its cost relative to an insured-deposit payout. The Garn-St Germain Act of 1982 significantly revised Section 13 of the FDI Act, specifically mandating a cost test. Other than cases where an "essentiality" finding is made by the Board of Directors, the 1982 Act permits the FDIC to pursue an alternative failure-resolution method only in situations where the transaction is less costly than an insured-deposit payout.

The FDIC has always preferred to handle bank-failure resolution cases in the most cost-effective and least disruptive way possible. There are several important policy objectives that the FDIC has considered when determining the most appropriate failure-resolution method. These include the need to minimize cost to the insurance fund, maintain stability in the financial system, encourage market discipline, minimize disruptions to the community, and provide consistent treatment for banks of all sizes. Experience has shown that these are not always compatible goals. Nevertheless, the fact remains that there will be situations in which the need to maintain financial stability is the overriding concern. Over the past five years, the FDIC has determined that only four banks were "too big to fail" and protected all depositors. The cost of protecting the uninsured depositors of these institutions was less than one billion dollars or about 3.5 percent of the FDIC's total insurance losses over this time period. Attachment A to this testimony provides the names and asset size of these institutions.

The TBTF concept came into prominence with the 1984 assistance package arranged for Continental Illinois National Bank and Trust Company. In that case, the FDIC in conjunction with other federal regulators made an essentiality finding on the basis that a failure and statutory payout would threaten the stability of the financial system.

As is discussed more fully later, fear of adverse macroeconomic consequences or financial system instability resulting from the failure of a major bank is not a deposit insurance problem per se. Nor is the incidence of government assistance to large organizations unique to banking. During the 1970s, public-policy makers determined that certain organizations should not be reorganized under the protection of bankruptcy laws even though these laws, in general, have worked well to protect claimants and minimize disruptions when corporate firms become insolvent. Thus, for example, Lockheed Aircraft Corporation and the Chrysler Corporation were deemed "too big to fail."

Since the Continental Illinois open-bank assistance package, in which both the creditors of the holding company and the uninsured depositors and creditors of the bank itself benefitted, the FDIC has gained additional powers that have permitted us to limit coverage provided under TBTF. In subsequent cases, the FDIC has used its authority to establish bridge banks to exclude holding company creditors and equity holders in rescue efforts that provide the uninsured depositors and creditors of a subsidiary bank with protection. For example, this authority was exercised in the resolution of the Bank of New England.

Moreover, the FDIC's pro rata power -- which was legislatively endorsed in FIRREA and has been used more frequently in recent years -- enables us to distinguish between categories of uninsured depositors and creditors under all methods of resolving failing banks.

Some believe that small banks are allowed to fail and are usually resolved through a payout of insured deposits, but this is not true. Most small banks are resolved through P&A transactions in a manner identical to larger institutions. Of the 169 banks that failed in 1990, only eight were resolved through an insured-deposit payout and only 12 others were resolved through an insured-deposit transfer. The remaining failure resolutions provided full coverage to all depositors through a P&A transaction which was determined to be the least costly way to handle the failure.

The International Experience

One of the issues we were asked to address today is how the TBTF policy affects the overall soundness and competitiveness of our banking system both domestically and internationally. For several years now, the FDIC has taken an active interest in how other major countries handle bank failures. This is not an easy task because many countries either do not allow their banks to fail, or they step in and take action before a troubled bank becomes newsworthy. In any event, most other countries do not have a deposit insurance entity with powers equivalent to the FDIC. However, all other major industrial countries have reserved for themselves considerable flexibility in the handling of large bank failures. During the annual joint meeting of the World Bank and the IMF last September, representatives from the central banks, finance ministries, and national banking associations of the G-10 countries joined us at the FDIC to discuss TBTF and other issues related to the provision of financial safety nets. A summary of the proceedings of this meeting is included as Attachment B.

It was noted that the U.S. system of federal deposit insurance is virtually unique in that, although statutorily limited in the amount of coverage provided, the FDIC has authority to extend _de facto_ coverage through its powers to arrange purchase-and-assumption transactions and financially-assisted mergers, or to provide direct assistance to banks. These tools, along with the need to handle bank insolvencies in a least-costly manner and several well-publicized rescues of large banks in recent years, have contributed to a widespread belief in the U.S. that uninsured depositors will only suffer losses in the failure of small banks. This belief has raised competitive concerns among commercial banks in the U.S. and also has led to concern that equity considerations may result in the FDIC extending _de facto_ 100 percent deposit insurance coverage to all banks.

While most foreign representatives at the conference felt that the U.S. federal deposit insurance system is overly generous, it was apparent that direct comparisons of deposit insurance coverage are difficult, if not impossible, due to differences in national banking structures and safety-net arrangements. For example, unlike other nations, the U.S. does not have any government-owned banks which, by definition, cannot fail. Nor does the U.S. have a postal savings system in which the government explicitly guarantees principal and interest. Additionally, many countries tend to rely on failure-prevention methods, including direct capital injections, government acquisition of nonperforming assets, nationalization of troubled banks, provision of liquidity through central banks or with industry support ("lifeboats"), and government-assisted mergers. As a result, costs which in the U.S. are incurred by the FDIC are incurred in these countries by the central bank, the finance ministry, or a consortium of banks.

Publicly, no foreign government representative will admit that their country has a TBTF policy. Privately, conference participants acknowledged that there may be banks that are too big to fail, simply because large banks often are important components in a nation's payments system and the failure of a major bank could have adverse macroeconomic effects. Additionally, in many of these other countries a handful of banks control the majority of domestic banking assets and, therefore, an implicit assumption may exist that one of these major banks would not be allowed to fail.

Nevertheless, the conclusion with respect to TBTF was best summed up by one of our international colleagues when he said, "Too important to fail, perhaps; too big to suffer, no." The implication of this statement is that even if official support is given in a particular situation, it does not necessarily mean that a significant increase in moral hazard, or the tendency for a bank's management to increase risk-taking behavior as it approaches insolvency, is a certain result. Authorities can exact penalties for imprudent behavior by demanding the replacement of senior management, change of ownership, and a write-off of stockholders' investment. Penalties can be applied even if the deposits are fully protected.

There was less agreement among our international colleagues regarding the role and effectiveness of depositor discipline. All representatives agreed that market discipline is desirable, but none seemed willing to rely on it entirely. While some participants felt that more market discipline is needed in today's banking environment, others were skeptical about the effectiveness of expecting individual depositors to police the condition of their banks. Moreover, it was noted that in several countries, political forces are sometimes brought to bear against decisions by the central bank to allow depositors to lose money.

All representatives agreed that the focal point in failure-resolution decisions is the trade-off between maintaining public confidence in the financial system and preserving a degree of market discipline. Thus, most regulators preferred taking corrective action prior to a bank's actual insolvency so that failure-resolution decisions can be avoided entirely. It should be noted that most insolvencies or near-insolvencies in other countries have been resolved *via* bailout or merger. Liquidations typically have been limited to small, local depository institutions.

Finally, conference participants were specifically asked by the FDIC what the reaction in their countries would be if the U.S. were to impose losses on depositors in a large bank. One representative expressed skepticism that such an event would ever occur, except under the most extraordinary circumstances. Others felt that any foreign bank doing business with the failed U.S. bank should be prepared to accept the consequences of their decision. At the same time, however, participants noted that such a failure probably would cause foreign banks to re-evaluate the creditworthiness of all American banks.

We concluded from these discussions that TBTF is an issue that exists even in the absence of explicit deposit insurance programs. That is, the possible failure of a large financial organization presents macroeconomic issues that some arm of the government must be able to consider. The evaluation of the economy-wide ramifications of the demise of a large bank is a government responsibility.

FDIC's Position on TBTF

In some cases, it may be necessary to have the flexibility to resolve the failure of a large troubled bank in a manner that protects all depositors. As mentioned above, the need for this flexibility arises because of macroeconomic and financial stability considerations (systemic risk) that are much broader than those pertaining specifically to the deposit insurance safety net. The Treasury's legislative proposal provides that the decision that a bank is "too big to fail" should be made by the government agencies charged with maintaining macroeconomic stability, and not by the FDIC. However, it requires the FDIC to bear the costs associated with protecting the uninsured creditors in these situations.

The FDIC believes that decisions on TBTF should be dealt with on a public-policy basis by the administration. Funding for TBTF should come from the U.S. Treasury through funds available for that purpose. Because of the short-term nature of bank liabilities, these decisions must be made within hours. The availability of stand-by funding is essential because there simply is not time to go to Congress for an appropriation. If, as we suggest, Treasury pays for TBTF, then the decision-making authority should rest with Treasury, in consultation with the Federal Reserve Board and the FDIC. If Congress instead decides that the insurance fund should pay for TBTF, any decision to use it should be made by the FDIC with the concurrence of the Federal Reserve Board and the Treasury. If the insurance fund must bear these costs, then it is necessary that the FDIC have the authority to adjust the assessment base as may be appropriate.

If Congress makes the decision that all depositors should not be protected if a large troubled bank fails, a great deal of potential disruption to depositors can occur unless prompt information on insurance coverage is available. Thus, resolution methods are needed that can sort out the various insured and uninsured claims swiftly and accurately. This may require a "final settlement" arrangement similar to that proposed in the American Bankers Association's study of deposit insurance reform and contained in the Treasury's proposal. However, it must be recognized that this type of approach would require that the larger banks maintain systems capable of differentiating between insured and uninsured claims on a real-time basis. This will involve considerable additional costs to the institution.

Additionally, Congress may want to be mindful that the establishment of criteria authorizing the protection of uninsured depositors, only in cases of systemic risk, would exclude small and minority banks that may be essential to their communities.

In summary, Mr. Chairman, the FDIC believes that any deposit insurance reform package must adequately address the TBTF issue. Any solution should include both a source of funding and the establishment of a credible mechanism to handle large bank failures in a manner that ensures the stability of international and domestic financial markets. Proposed remedies should recognize that small banks are treated unfairly under the present system and are handicapped in competition with large institutions. If TBTF continues in some form then small banks need broad deposit insurance protection to offset the TBTF advantage.

There is no question that our TBTF system is in need of reform but unfortunately, there are no easy answers which provide both fairness and safety and soundness to the system. Our goal should be to strengthen the entire banking industry so that the question of which institutions can fail will not be of paramount concern. In the interim, we suggest that "constructive ambiguity" as to who will be too big to fail should continue, and TBTB should be administered and paid for by the Administration, after consultation with other regulators.

Attachment A

1986	First National Bank & Trust Co. Oklahoma City, Oklahoma Total Assets $1.6 billion
1988	First Republic Bank Dallas, Texas Total Assets $32.9 billion
1989	MCorp Houston, Texas Total Assets $15.8 billion
1991	Bank of New England (3 banks) Boston, Massachusetts Total Assets $22.9 billion

Attachment B

SUMMARY OF PROCEEDINGS
INTERNATIONAL CONFERENCE ON DEPOSIT INSURANCE
AND PROBLEM-BANK RESOLUTION POLICIES

by Alane K. Moysich*

This conference was convened by the FDIC on September 26, 1990, for the purpose of discussing issues related to the operation of deposit insurance systems and government policies for intervention in problem-bank situations. Officials from countries represented at the Basle Committee on Bank Supervision, the Commission of European Communities, and national banking associations were invited to share their experiences and concerns regarding the provision of national safety nets, and to consider whether there is a need to coordinate these policies on an international level.

From the U.S.'s perspective, this meeting was especially timely in light of the current debate on deposit insurance reform and restructuring of the U.S. banking industry. International bankers, in particular, were asked to share their views on the American Bankers Association's proposal to change failure-resolution procedures in the U.S. Other areas of interest included the future of deposit insurance programs and problem-bank resolution policies in the post-1992 European Community and, more generally, how national bank regulators can best maintain safe-and-sound financial systems in a global marketplace.

The conference was divided into four panel discussions. The morning session, which concentrated on government policies for problem-bank resolutions, was restricted to government officials to facilitate private dialogue. Banking industry representatives were invited to share their views during the afternoon session, which concluded with a discussion of prospective trends in deposit insurance and problem-bank resolution policies.

Panel I

The first panel discussion centered around the role that governments should play when confronted with problem-bank cases. Of particular concern was how confidence in the banking system can be maintained without unduly eroding market discipline and whether

---

*Alane K. Moysich is a financial economist in the FDIC's Division of Research and Statistics.

there are indeed banks that are "too big to fail."[1] Panel members were central bankers who have had considerable experience dealing with these issues. They included: William Taylor, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve (moderator); Johann Wilhelm Gaddum, Member of the Directorate, Deutsche Bundesbank; Tadayo Homma, Director, Financial and Payment System Department, Bank of Japan; Huib Muller, Executive Director, the Nederlandsche Bank and Chairman of the Basle Supervisors' Committee; and Brian Quinn, Executive Director, Bank of England.

There was general agreement among the panelists that bank supervision and adequate capital levels are the first lines of defense against bank failures. Some panelists expressed a desire to see capital standards increased above the current Bank for International Settlements' (BIS) guidelines which require banks to have equity capital, subordinated debt, and other reserves equivalent to eight percent of weighted-risk assets by year-end 1992. However, panelists also agreed that in free-market economies, bank failures can, and indeed should, occur. All panelists acknowledged at least several recent examples of bank failures or, in some cases, government-sponsored rescues, in their respective countries. Most insolvencies or near-insolvencies were resolved via bailout or merger; liquidations typically were limited to small, local depository institutions.

While the possibility of bank failure was viewed as a necessary market-discipline tool, panel members stressed the need to retain flexibility in resolving problem-bank cases. The prevailing view was that decisions on how to handle a particular crisis involve each situation's unique causes and effects and, therefore, cannot be prescribed in advance. One panelist noted that in his country, judgments regarding problem-bank resolutions are based on the net benefit to the community, not just on narrow financial calculations. Threats of contagion due to direct links to the failed bank, or to a general loss of confidence in institutions performing similar functions, were cited as factors favoring a decision to provide official support.

Panelists acknowledged that there may be banks that are too big to fail, simply because large banks often are important components in a nation's payments system and, thus, the failure of a major bank could tie up much of an economy's working capital. At the same time, however, panelists stressed that "too big to fail" should not be accepted as public policy. If that were the case, however, then those benefitting should be forced to pay in

---

[1] "Too big to fail" is imprecise shorthand for "too big to allow depositors to suffer losses." A situation in which a large bank fails but depositors are protected fully is thus consistent with the application of a "too big to fail" policy.

the form of more-demanding supervision or greater prudential requirements. Moreover, panelists cited cases where government rescues were mounted for nonbanking companies that were considered too big to fail, as well as for small banks that were considered too important to fail. It was noted, however, that even if support is given, penalties should be imposed on managers, owners, and investors. Thus, in the words of Brian Quinn of the the Bank of England, while a bank may be too big to fail, it is never "too big to suffer."

Panelists firmly agreed that the focal point in failure-resolution decisions is the trade-off between maintaining public confidence in the financial system and preserving a degree of market discipline; thus, most regulators preferred taking prompt corrective action prior to a bank's actual insolvency. It was noted that overly-generous deposit insurance programs give rise to the so-called moral hazard problem, or excessive risk-taking by insured financial institutions. However, there was less agreement on the effectiveness of market discipline in controlling the risk-taking activities of banks. One panelist's view was that today's markets are not fully aware of the competitive environment in which banks operate and, therefore, need to face the consequences of a failure in order to be made aware of the new risks. Another panelist argued that while market discipline should be encouraged, it cannot be relied on exclusively due to the conflicting goal of maintaining financial stability. Additionally, it was noted that political forces sometimes may be brought to bear against the decision to allow depositors to lose money.

Deposit insurance funds or guarantee programs were seen by most panel members as supplemental tools to protect the small saver and to aid general financial stability when a bank is declared insolvent. Several panelists noted that the U.S. federal deposit insurance system is far more extensive than its European or Japanese counterparts. For example, individual limits on deposit insurance coverage in Great Britain and the Netherlands are rather low, while Germany's deposit insurance fund, which covers each depositor up to 30 percent of the bank's equity capital, does not cover interbank deposits and is run entirely by the banking industry. Hence, it was suggested that in Germany the government is not perceived to be the ultimate insurer of commercial bank deposits.

Direct comparisons of deposit insurance coverage among various countries are difficult, however, due to differences in national banking structures and safety-net arrangements. For example, the U.S. does not have any government-owned banks which, by definition, cannot fail, or a postal savings system in which the government explicitly guarantees principal and interest. Additionally, many countries tend to rely on failure-prevention methods, including direct capital injections, government acquisition of nonperforming assets, nationalization of troubled banks, provision of liquidity through central banks or with industry support ("lifeboats"), and government-assisted mergers. As a result, costs which in the U.S. are incurred by the FDIC are incurred in these countries by the central bank, the finance ministry, or a consortium of banks.

The need to maintain flexibility in problem-bank resolution policies, particularly with respect to the lender-of-last-resort policies of central banks, has been referred to as "constructive ambiguity" by E. Gerald Corrigan, President of the Federal Reserve Bank of New York, who believes it is a necessary force countering the moral hazard problem inherent in the provision of financial safety nets. While panelists agreed that "constructive ambiguity" is an appropriate policy for central bankers, several expressed a desire to revisit the Basle Concordat,[2] which spells out the responsibilities for supervision of international banks and banking groups, but does not directly address policies for dealing with the resolution of international bank failures. They noted that while it might not be desirable to suggest that a particular central bank will always act as lender of last resort, it is important to determine just which central bank is responsible for deciding whether to intervene in a problem-bank situation. Several panelists suggested that a serious gap currently exists between the globalized nature of financial markets and the decentralized structure of central banks. Moves to bridge this gap during non-crisis times would save valuable time and help to ensure that financial stability is maintained in the event of an international bank failure.

Panel II

The second panel discussion focused more specifically on the role of deposit insurance programs. Panelists were asked to comment on their own country's philosophy regarding the protection of depositors and the rescue of insolvent banks, as well as the role deposit insurance plays in maintaining stability within their banking systems. This panel was moderated by Paul Fritts, Director of the FDIC's Division of Supervision. Speakers were drawn from countries that have a variety of mechanisms for dealing with deposit protection. They included: Monique Dubois, Assistant Director, Economic Studies Section, Swiss National Bank; Pierre Dubois, Director, Belgian Banking Commission; Ronald A. McKinlay, Chairman, Canada Deposit Insurance Corporation; and, Robert Ophele, Representative, Banque de France.

---

[2]In December 1975, the central bank governors of the Basle Committee on Bank Supervision approved a group of broad guidelines for the division of responsibilities among national authorities governing the supervision of foreign banking establishments. These guidelines, which were later revised in 1983, became known as the "Basle Concordat."

Of the four foreign countries represented on this panel, the government of Switzerland appeared to be the least actively involved in bank-failure resolution issues. Although regulation and supervision are the principal mechanisms to prevent bank failures, the Swiss banking industry itself plays an important role in maintaining a sound financial system by establishing codes of conduct for member banks that supplement regulations imposed by Swiss banking legislation. One example is the joint guarantee of savings deposits at insolvent institutions which was agreed upon in 1984 in lieu of a legalized deposit insurance program. This guarantee (up to 30,000 Swiss francs) supplements the Swiss depositor preference law in which certain deposits receive a priority claim in the case of bankruptcy. In the past, most failed Swiss banks were taken over by other banks; however, since the 1984 deposit guarantee agreement there have been no failures and thus, the guarantee has never been used.

The Association of French Banks (AFB) also operates a loss-sharing agreement among all commercial banks operating in France. Deposit protection is limited to approximately $75,000 per person, with a yearly cap on total industry payouts. Only personal deposits held in French francs are insured; specifically excluded are foreign-currency deposits, interbank funds, and funds with "abnormally high rates of remuneration." Losses are shared according to each bank's market share, although smaller banks pay a larger percentage of their deposit base than do larger banks. This arrangement primarily is designed to protect small banks; the yearly cap precludes payouts of even a medium-sized bank. Additionally, the governor of the Banque de France legally may request that French banks participate in assisting the rescue of a troubled institution, as was the case with the 1987 rescue of Al Saudi Bank.

In contrast to the industry-sponsored Swiss and French deposit guarantee programs, Belgium has a deposit protection fund which is managed by the Rediscount and Guarantee Institute, an organization which has close ties to the central bank. Annual contributions are 0.02 percent of covered liabilities, which are limited to deposits in Belgian francs, up to $15,000 per person. The deposit protection fund may contribute to the liquidation of an insolvent bank, to financial rehabilitation, or to the complete or partial takeover of the activities of a member bank, providing that such interventions would be less costly than a payoff. However, the fund has no receivership capacity and interventions are limited to the total amount of the fund. These constraints do not appear to concern the Belgian public, mainly because the three largest banks control 76 percent of covered deposits and thus, according to the Belgian representative, Pierre Dubois, it is perceived that they would not be allowed to fail.

Of the four countries represented on this panel, the Canada Deposit Insurance Corporation (CDIC) has powers most similar to those of the FDIC, including the ability to acquire assets from member institutions and to act as receiver of a failed bank. Additionally, the CDIC is empowered to borrow up to $3 billion from the consolidated revenue fund, if necessary. Annual premiums are currently 0.1 percent of insured deposit liabilities. Each deposit is insured up to $60,000 in Canadian funds, with maturities not exceeding five years. The CDIC has handled over 20 bank failures since its inception in 1967 and strongly favors going-concern problem-bank resolutions over more-costly liquidations. Additionally, Chairman McKinlay noted that once an institution is known to be in financial difficulty, confidence is lost and rehabilitating the institution becomes nearly impossible. Therefore, the CDIC actively is engaged in a program to develop standards of sound business and financial practices, whose purpose is to preclude problems from developing. Similar to most European countries, Canada has a highly concentrated banking system, with about ten institutions controlling over 75 percent of deposits. This high degree of concentration was cited as a significant contributing factor to the country's ability to avoid losses of the magnitude of the U.S. savings and loan crisis.

Panel III

This panel was designed as a forum for international bankers to express their views on deposit insurance and other government-sponsored safety nets. Issues addressed included the relationship between the private and public sectors in the provision of deposit insurance and decisions or actions concerning problem banks, the competitive effects of different deposit insurance systems, and the American Bankers Association's proposal (which would mandate an automatic loss for uninsured depositors) and other ideas to reform the U.S. deposit insurance system. The panel moderator was C.G. ("Kelly") Holthus, President of the American Bankers Association. The speakers included: Professor Piero Barucci, Chairman of the Italian Bankers' Association; Toru Hashimoto, Deputy President, Fuji Bank, Ltd., Tokyo; Thomas S. Johnson, President, Manufacturers Hanover Trust Company, New York; and G. Malcolm Williamson, Group Executive Director, Standard Chartered Bank, London.

Several panelists expressed the view that private banks, and their managers, play an important role in maintaining public confidence in the safety and soundness of financial systems. How this is accomplished varies from country to country and several interesting differences were apparent. For example, during Great Britain's "fringe" banking crisis in the 1970s, all banks stepped in to prevent a general loss of confidence spreading throughout the financial system. This procedure was in keeping with the informal nature of the British banking system whereby a close working relationship between bankers and their supervisors at the Bank of England takes the place of many written regulations.

Japanese bank managers also take seriously their responsibility for maintaining public confidence in the financial system. However, in contrast to Great Britain where the supervisory style was characterized as being by "hint and nod," Japanese law emphasizes the public nature of banks and supervision is very strict. Although Japan has a government-sponsored deposit insurance system, it is rarely used and problem banks are either helped financially and managerially by other banks, or sold or merged into another bank.

In Italy, political pressure, stemming from the belief that bank crises should be borne by the banking system itself, led to the creation in 1987 of the Interbank Fund for the Protection of Deposits. Membership is voluntary, and member banks are legally bound to maintain certain balance-sheet ratios. Interventions by the Fund must be approved by the central bank which is represented at its board meetings. In cases of liquidation, deposits are fully insured up to approximately $170,000 with an additional $675,000 covered at the rate of 75 percent. If less-costly than paying off deposits, the Fund also may assist in transferring the failed bank's assets and liabilities to another institution. Alternatively, the Fund may provide support to the ailing bank itself, under the following conditions: (1) the institution has been placed under special administration by the Bank of Italy; (2) the financial assistance must be less-costly than the estimated cost of paying off depositors in the event of liquidation; and, (3) there must be prospects for the bank to be restored to sound and viable condition.

There was general agreement among the foreign representatives that the current U.S. federal deposit insurance system and bank-failure resolution policies create a moral hazard problem that is not prevalent in other countries. However, most panelists agreed with the position that deposit insurance reform must extend beyond the federal safety net and address structural changes in the banking industry, particularly interstate branching laws. Several bankers noted that the ability to diversify risk geographically would enhance the efficiency and profitability of U.S. banks and, therefore, strengthen their performance at home and improve their international competitiveness. Stronger banks would attract new capital and facilitate an orderly and efficient consolidation of the U.S. banking industry.

Bankers on this panel expressed thoughts similar to those offered by government representatives during previous panels, with respect to the combined roles of market discipline and regulatory attentiveness in maintaining bank safety and soundness. Additionally, 100 percent deposit insurance coverage, either for all banks or only for those banks deemed too big to fail, was viewed by panelists as an inappropriate government policy. In general, foreign bankers agreed with the American Bankers Association's position that more market discipline is needed to minimize the potential costs of deposit insurance or other financial system safety nets.

During the ensuing discussion, some representatives expressed reservations about the ABA's proposal to treat each failed bank in a manner that automatically subjects uninsured depositors and unsecured creditors to a percentage loss based on the FDIC's average receivership loss rate. One discussant suggested that this concept was incompatible with denouncing "too big to fail," since it actually guarantees depositors more than the stated insurance limit of $100,000. In addition, the proposal's intended effect could be subverted by politicians who, in some instances, might decide to reimburse depositors in full anyway. In general, foreign bankers favored regulatory flexibility over passage of any law in their own countries that would impose fixed problem-bank resolution techniques.

Finally, panelists were queried regarding the reaction of the international financial community if the U.S. were to impose losses on depositors in a large bank. One panelist expressed skepticism that such an event would ever occur, except under the most extraordinary circumstances. Others felt that any foreign bank doing business with the failed bank should be prepared to accept the consequences of their decision. At the same time, panelists noted that such a failure probably would cause foreign banks to re-evaluate the creditworthiness of all American banks.

Panel IV

The final panel served to summarize some of the earlier discussions and to address future trends in deposit insurance and problem-bank resolution policies. In particular, panelists were asked to focus on what kinds of international coordination of safety nets will be needed in the future, and how much standardization, if any, will be necessary. The panel moderator was Paul A. Volcker, Chairman of James D. Wolfensohn, Inc. and former Chairman of the Board of Governors of the Federal Reserve. Speakers included: Masahiro Akiyama, Deputy Director General, Banking Bureau, Japanese Ministry of Finance; Paolo Clarotti, Head of Division, Banks and Financial Establishments, Commission of European Communities; Robert Glauber, Under Secretary of Finance, U.S. Treasury Department; and Harry Walsh, Under Secretary, Her Majesty's Treasury, Great Britain.

Mr. Volcker noted that while a wide diversity of banking systems and safety-net arrangements exist, a remarkable degree of agreement on the nature of the problems surrounding deposit insurance and bank-failure resolution policies was expressed by the various representatives. This common understanding, which was not evident in international settings as recently as a decade ago, was seen as one indication that alignment of the various banking systems already may be occurring. Although most representatives from outside the U.S. had expressed satisfaction with the current structure and operation of their own domestic banking systems and regulatory mechanisms, this panel speculated on how well these systems will perform in the long run.

Observing that international bank safety and soundness begins with domestic financial systems, one panelist noted that regulators in his country are closely monitoring the effect that interest-rate deregulation will have on the future stability of the domestic banking market. This uncertainty has led authorities there to focus their efforts on prevention of failures, a strategy preferred by a number of countries to contain the costs of deposit insurance. While this approach has great merit, it was recognized that the style of bank supervision of an individual country depends on a number of factors including the degree to which the financial industry is developed, its legal system, and even the social climate or national character.

It has been noted that the U.S. system of federal deposit insurance is virtually unique in that, although statutorily limited in the amount of coverage provided, the FDIC has authority to extend de facto coverage through its powers to arrange purchase-and-assumption transactions, financially-assisted mergers, or to provide direct assistance to banks. These tools, the need to handle bank insolvencies in the least-costly manner, and several well-publicized rescues of large banks in recent years have contributed to a widespread belief in the U.S. that uninsured depositors will only suffer losses in the failure of small banks. This belief has raised competitive concerns among commercial banks in the United States and also has led to concern that equity considerations may result in the FDIC extending de facto 100 percent deposit insurance coverage to all banks.

This panel suggested that there are really two issues raised by the "too big to fail" debate, only one of which can be dealt with through legislation. All panelists recognized that there are times when a particular bank failure could lead to a general loss of confidence in the system. These genuine cases of unacceptably high systemic risk, which are not limited to large banks, are the foundation for the argument in favor of "constructive ambiguity," or the maintenance of regulatory flexibility.

It is the other component which Mr. Glauber argued that the U.S. should try to change: that is, discrimination in the treatment of uninsured deposits at large versus small banks present in the current failure-resolution procedures. While the U.S. should not move towards a system where failures are prevented, it was suggested that an appropriate long-run strategy might be to restructure the relationship between the financial institution and its regulator. This would include restructuring the U.S. financial system to allow banks to adapt to new lines of business, as advocated by a number of bankers on the third panel. At the same time, appropriate firewalls should protect insured deposits from the riskiest activities and to allow supervisors to focus more attention on the bank itself, and less on the holding company structure. These measures, designed to limit the safety net, could reduce both the number of institutions requiring resolution and the number of cases where a purchase-and-assumption transaction is justified and, ultimately, return deposit insurance to its historical purpose of protecting small depositors.

Other ideas mentioned by panelists to reduce the U.S. safety net included limiting deposit insurance to natural persons rather than companies, excluding brokered deposits from insurance coverage, and reducing individual coverage limits. Risk-related deposit insurance was mentioned by one panelist, who felt it would only be marginally-effective given appropriate risk-related capital requirements and supervisory arrangements that ensure enforcement of prudential standards.

With respect to the convergence of international safety nets, the experience of the European Community (EC) provided a fruitful area for discussion. The majority of EC countries established deposit insurance programs following the Commission of European Communities' 1986 recommendation, although it was noted by Mr. Clarotti that these programs share few common characteristics. With passage of the Second Banking Directive in December 1989, it became clear that deposit insurance programs that require branches of foreign banks to join the local system are incompatible with the principle of home country control for banking superversion set forth in the Directive.

Therefore, the Commission has decided that it will establish certain basic guidelines for harmonization of the individual deposit insurance programs. It is expected that these minimum standards will not legislate uniformity among the systems, but rather allow the EC countries flexibility in deciding how their deposit insurance systems are established and operated. Panelists expressed the opinion that these different systems can co-exist successfully in the post-1992 environment if small depositors continue to use domestic banks and if protection is limited to individuals and not extended to financial institutions themselves. However, further harmonization might be required if banks begin holding foreign-currency deposits for small depositors or if the mechanics of a particular insurance program give rise to a competitive edge.

Harmonization of deposit insurance and other safety-net arrangements on a world-wide basis was not envisioned as necessary or desirable in the near future. Not only was such an attempt thought to be politically unrealistic, but also nearly impossible given the vast differences that currently exist in regulatory structures, safety-net provisions, and bankruptcy laws. However, as globalization of financial markets proceeds, panelists felt that there most likely will be further alignment by way of increased communication and cooperation among regulators. Familiarity with one another's supervisory styles was seen to be important for banks operating across borders and for regulators who will need to anticipate a given country's reaction in a crisis situation. Additionally, it was noted that the insurance status of deposits in foreign banks or branches is one area of inconsistency that should be clarified. However, the point was made that regardless of the pace or future degree of international safety-net convergence, reform of the U.S. banking industry and deposit insurance system should proceed as soon as possible.

Summary

The purpose of this meeting was to convene policy-makers and private bankers from the major industrialized nations to share their thoughts and concerns regarding financial system safety nets in the context of a global marketplace. Much was learned about the vast differences among the various banking systems, but common goals also were found to exist. Chief among these were the desire to preserve the stability and integrity of national banking systems and to provide mechanisms that protect the small, unsophisticated saver. All representatives expressed a desire to work together to ensure that these goals are met in the event of an international bank failure.

Several speakers felt that the discussions should not be limited to the "too big to fail" doctrine, or even to failure-resolution methods in general. It was noted that some portion of the value of a bank's assets is lost when the institution becomes insolvent or is known to be in trouble. Thus, a number of regulators expressed a desire to continue efforts to strengthen capital standards, while all stressed the need for strong and effective supervisory procedures to limit the number of bank failures.

One of the major themes expressed throughout the day was the need for bank regulators to have at their disposal a wide variety of mechanisms to deal with actual or potential insolvencies at financial institutions. Moreover, regulators need the flexibility to use these measures on a case-by-case basis. It may be concluded from the discussions that attempts to have bank-failure resolution policies cemented into law in the United States would not be copied by other countries.

The desire to retain a measure of "constructive ambiguity" in failure-resolution policies was prevalent in discussions on "too big to fail." While several speakers acknowledged that imposing losses on depositors in the failure of a major bank could provide a number of unacceptable public-policy choices for regulators and politicians, none was prepared to advocate a "too big to fail" doctrine, and a few speakers expressed dismay that this subject has even been discussed in public. In general, it was felt that in order to encourage market discipline, no bank should be considered too large to fail; if a situation dictates that it is in the public interest to provide official support to an ailing financial institution, then the means should be available to impose penalties on its owners, investors, and managers.

It was shown that several countries have viable deposit insurance funds or guarantee programs run entirely by the private banking sector, or in conjunction with the central bank. For the most part, however, these exist in countries where few bank failures have occurred, where penalties for mismanagement are severe, and where the banking industry is concentrated enough for banks to be diligent about self-policing. Additionally, there was the general perception that the relationship between bankers and their regulators is much closer in many countries than in the U.S. and, in some cases, independent auditors play an important examination role.

While there were some representatives who expressed a desire for increased coordination of international safety-net policies, it was generally felt that convergence of these policies is neither necessary nor desirable at this time. However, there were two areas that conference participants thought required clarification in the near future. The first was the allocation of responsibility among international financial regulators for problem-bank intervention decisions that may affect more than one country. This would include a clear understanding as to which is the lead authority in a given situation, who else may be involved, and what effects a decision will have on other countries. The second area in need of clarification is the insurance status of deposits in foreign bank subsidiaries or branches. As a result of the current disparity in deposit insurance systems, some deposits may be covered by more than one program while others remain uninsured.

In summary, this conference highlighted the need for international financial regulators to continue to communicate and to share information with each other as banking markets continue to undergo change. Each country is faced with the prospect of adapting national banking systems and supervisory styles to a globalized financial marketplace. Technological change and the trend toward multi-function financial conglomerates ensure that the need for international cooperation and coordination will become even more critical in the future.

For release:
May 9, 1991, 10:00 a.m.

TESTIMONY OF
ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY
Before the
SUBCOMMITTEE ON ECONOMIC STABILIZATION
of the
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
of the
U.S. HOUSE OF REPRESENTATIVES

May 9, 1991

Mr. Chairman and members of the Subcommittee, I am here this morning to discuss the policies of the Federal Deposit Insurance Corporation (FDIC) regarding the extension of deposit insurance coverage to uninsured depositors in large bank failures.

In discussing this topic, we need to have a clear understanding of just what the issue is. The common reference to "too-big-to-fail" policy can be misleading: the issue is not whether large insolvent banks are allowed to fail; insolvent banks of all sizes do fail. Shareholders lose their investment in the bank; subordinated debt-holders and other unsecured creditors recover their investments only to the extent that the FDIC is able to collect on the assets of the failed bank; and, in virtually every case, bank managers lose their jobs. Rather, the issue is whether it may be necessary, under certain limited circumstances, to protect uninsured depositors of large failed banks in order to preserve the stability of financial markets.

"contagious" runs on other banks, and threats to the payments system.

Contagious runs. Because depositors generally possess only limited knowledge about the financial condition of banks, they may take the failure of one bank as a sign that other banks are likely to fail. If the FDIC is prevented from offering assurances to uninsured depositors, a prominent bank failure may provoke uninsured depositors at other banks to withdraw their funds. In extreme cases, there could be a loss of confidence in the banking system in an entire region of the country, resulting in widespread disintermediation, a decline in credit availability, and substantial damage to the regional economy.

Payment System Risk. Large banks provide clearing and settlement services to smaller banks, and play a central role in organizing the markets for federal funds, government securities, mortgage-backed securities, foreign exchange, and a variety of other financial instruments. The failure of a large bank could seriously disrupt these markets.

For example, small banks typically maintain deposit accounts with a larger correspondent bank in connection with the check-collection, settlement, and other services that the correspondent bank provides. If a major correspondent bank were to fail, a large number of smaller respondent banks might lose the funds they have on deposit. These losses could result in the markets. But that does not mean that uninsured depositors at larger banks should always be protected. Three considerations argue in favor of narrowing *de facto* coverage of uninsured depositors at large banks. First, limiting coverage to insured depositors would generally (although not always) reduce the cost of failure resolution to the FDIC. Second, it would restore the balance that deposit insurance was intended to strike between protection for bank deposits and market discipline. And third, providing the same degree of coverage in large and small bank failures would be more fair.

Minimizing Resolution Costs. Current law does not require the FDIC to use the least costly method to resolve bank failures; it requires only that whatever method is used be no more expensive than liquidating the bank and paying off its insured depositors. A purchase-and-assumption can often meet this test, since bidders are generally willing to pay a premium for the franchise value of the bank, which is dissipated if the bank is liquidated.

On the other hand, a purchase-and-assumption, even if less costly than a liquidation, could be more costly than an insured deposit transfer, in which the acquiring institution assumes only insured deposits. This would tend to be the case whenever most of the failed bank's franchise value resides in the value of its "core" deposits. A purchase-and-assumption could still be cheaper, however, if it saved the FDIC substantial administrative uninsured deposits. Large banks, benefitting from the government's implicit guarantee of "uninsured" deposits, can attract these funds at interest rates much closer to the riskless interest rate. Serious questions of fairness must be raised regarding a government policy that confers valuable guarantees on some banks while withholding them from others that are equally well managed.

Determining failure resolution policies involves weighing the need to control systemic risk against the objectives of minimizing resolution cost and promoting market discipline and fairness. Eliminating the too-big-to-fail policy altogether, as some have proposed, would go too far in one direction: it would greatly increase market discipline, but at the cost of preventing bank regulators from acting in those instances when going beyond the statutory limits on insurance coverage is necessary to control systemic risk.

Eliminating too-big-to-fail protection could also place U.S. banks at a disadvantage in competing with the banks of foreign countries, which generally provide full protection to all deposits, although not necessarily through the deposit insurance system. Reducing the protection afforded to depositors could drive up the cost of funds at U.S. banks, and erode public confidence in them, compared with their overseas competitors.

A key element of the Administration proposal is the separation of the responsibility for making systemic risk determinations from the normal process of failure resolution. That separation will reinforce the presumption in favor of the least-cost method resolution, which will be reversed only in exceptional cases. The Federal Reserve Board should be involved in systemic risk determinations because it is the government agency primarily responsible for financial market stability. Since actions to protect the financial system could have profound effects on the economy and the federal budget, the Treasury Department, in consultation with OMB, should also be involved.

When Should Uninsured Depositors be Protected?

The determination that the government will satisfy the bank's liabilities to its uninsured depositors should depend in part on the size of the bank and the extent of its involvement in broader financial markets. The more extensive the bank's correspondent relationships with other banks, for example, or the greater its role as a market-maker in financial markets, the greater is the potential for systemic shock in the event the bank fails.

Systemic risk determinations should also depend on economic conditions in the markets in which the bank operates. Adverse economic conditions can make a region more susceptible to systemic shock. Thus, to take a recent example, the decision to would be published, so that uninsured depositors would know the exact extent of their potential loss.

In any particular bank failure, the FDIC might pay more, or it might pay less to uninsured depositors than they would be entitled to receive under current law. But, over time, over-payments and under-payments would tend to average out, and the FDIC would break even. This approach would enable the FDIC to provide more liquidity immediately to uninsured depositors. At present, the FDIC must be conservative in advancing liquidity to uninsured depositors, to avoid the possibility of significant losses to the insurance fund if the proceeds of a particular liquidation are smaller than expected.

Conclusions

The current deposit insurance system provides de facto coverage for virtually all bank deposits: an extension of the federal safety net that goes well beyond the original purpose of deposit insurance. Rather than extending blanket protection to uninsured deposits, the deposit insurance system should generally limit protection to insured deposits--except where more extensive coverage is less costly to the FDIC--while retaining flexibility to deal with genuine instances of systemic risk. The Administration's proposal is designed to achieve this change in policy and priority, and it has my full support.

EMBARGOED UNTIL GIVEN
EXPECTED AT 10:00 A.M.

TESTIMONY OF
THE HONORABLE ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

May 9, 1991

Chairman Carper, Mr. Ridge, and members of the Subcommittee, thank you for this opportunity to explain the Administration's proposal to roll back the Federal Deposit Insurance Corporation's "too-big-to-fail" policy, which currently results in the protection of all uninsured depositors in most bank failures, particularly larger ones. This broad expansion of the federal deposit insurance guarantee has greatly increased taxpayer exposure. It is also unfair to those smaller banks that do not receive this blanket *de facto* protection. Our proposal ends this routine protection of uninsured depositors without compromising the safety and stability of our financial system. We firmly believe that this is the most sensible way to address this very difficult problem.

Let me acknowledge at the outset that the Administration's proposal preserves the flexibility of the government to protect the nation's financial system in times of crisis. In rare cases this may result in the protection of uninsured depositors in bank failures. These rare occasions will no doubt raise some of the same questions of unfairness and taxpayer exposure as today's policy of routinely protecting most uninsured deposits. But a policy that risks our financial system to avoid an exceptional case of "unfairness" would be dangerous and irresponsible.

In the end, the only way to truly eliminate our continual confrontations with the unfairness of protecting uninsured depositors is to fix the underlying system. Other countries rarely confront the "too big to fail" issue because they rarely have bank failures. We simply must have fewer costly bank failures and fewer threats to our economy. That means comprehensive reform that results in stable and profitable banks; prompt corrective action for weak banks; streamlined supervision;

NB-1264

and a recapitalized bank insurance fund. And that, Mr. Chairman, is exactly what the Administration has set forth before Congress in H.R. 1505, the "Financial Institutions Safety and Consumer Choice Act of 1991."

With that introduction, let me now turn to the body of my statement, beginning with a description of what we do and don't mean when we use the term "too-big-to-fail."

Understanding Too-Big-to-Fail

The term "too-big-to-fail" is a misnomer. When the doctrine is invoked, the institution involved still fails -- shareholders are wiped out; subordinated debtors and unsecured creditors typically lose part of their investments; and management is replaced. There is no FDIC or taxpayer "bailout" of shareholders or managers.

Instead, "too-big-to-fail" is a part of the FDIC's current policy to routinely extend deposit insurance protection beyond the $100,000 limit to uninsured depositors. Indeed, over 99 percent of uninsured depositors have been protected in the resolution of failed banks during the last five years. In a very few of these situations, the failure to provide such protection would clearly have resulted in serious risk to the financial system. But in most cases, the protection of uninsured depositors occurred in resolutions that did not involve systemic risk through the routine use of so-called "purchase and assumption" transactions, or "P&As." Both situations are described in more detail below.

Protecting Uninsured Depositors to Prevent Systemic Risk

Protecting uninsured depositors to prevent systemic risk -- the classic "too big to fail" policy -- first gained notoriety in 1984 when the FDIC protected the uninsured depositors and other creditors of the Continental Bank of Illinois and its holding company. The policy came into sharp public focus again with the recent failure of the Bank of New England. In both of these cases it was feared that imposing losses on uninsured depositors would create genuine risk to the financial system.

What is systemic risk? Gerald Corrigan of the Federal Reserve Bank of New York described it as the danger "that failure or instability in one institution or in one segment of the financial markets can quickly be transmitted to other institutions or segments of the markets, thereby causing a more generalized crisis of confidence with all of its potential for instability in the financial and real sectors of the economy." This would include cases that threaten (1) widespread loss of consumer confidence and resulting contagious depositor runs, (2) potentially severe problems for the correspondent banking network, and (3) the breakdown of the payments system. Any or all of these events could result in major dislocations in the provision of regional or national business and trade credit, and potential disruption of domestic and international economic stability.

In the case of Continental there were significant concerns about the financial impact that bank closure and a deposit-payoff might have had on the large number of Continental's smaller, correspondent banks. Approximately 1000 banks had correspondent relationships with Continental at the time of its failure. Sixty-six of these banks had uninsured deposits exceeding 100 percent of capital, and 113 had deposits equalling 50-100 percent of capital. If Continental's uninsured depositors had not been protected, its failure would have substantially weakened a large number of its small correspondent banks with serious consequences for consumer confidence and the financial system.

More recently, the threat of systemic risk resulted in the protection of uninsured depositors of the Bank of New England. As you may recall, the situation was a tinder box. Uninsured credit unions in nearby Rhode Island had recently failed, with widespread publicity attending the inability of average depositors to withdraw their funds. As the Bank of New England teetered on the brink of insolvency, there were signs that even federally insured depositors in neighboring banks were beginning to line up for the withdrawal of their deposits. This volatile situation, along with the considerable concern over the impact closure and a deposit-payoff would have on the availability of credit in the fragile New England economy, led to the decision to protect uninsured depositors.

Much as we might not like it, the threat of systemic risk is real. While much progress has been made to reduce the threat of systemic risk in bank failures, and while more steps can and should be taken to further reduce such risk, we cannot blindly dismiss the fact that it remains with us. Indeed, to our knowledge no government has forfeited its ability and responsibility to protect the stability of its financial system, even if that means protecting uninsured depositors. None. We should not be the first to try this dangerous experiment.

Routine Protection of Uninsured Depositors in P&As

While the cases of genuine systemic risk caused by bank failures are relatively rare, the FDIC has nevertheless extended full insurance protection to virtually <u>all</u> uninsured depositors in recent years. This is so because of the almost exclusive reliance by the FDIC on purchase and assumption transactions. In P&A transactions, acquiring institutions purchase all of the assets and assume all of the liabilities -- including uninsured deposits -- of failed institutions.

How has this broad expansion of the federal safety net been justified? P&As have long been defended as less expensive to the FDIC than simply paying off insured depositors and liquidating an institution's assets. It has been argued that the cost of protecting uninsured deposits is offset by the premium paid by acquirers for core deposits and the going concern value of an intact institution. As a result, while one of every three failures -- the smallest ones -- received no FDIC coverage for uninsured depositors in recent bank failures, over ninety-nine percent of uninsured deposits have been fully protected during the record period of bank failures since 1985.

While the P&As may very well be less costly than an insured deposit payoff, they may not always be the least costly resolution method -- indeed, current law does not require the FDIC to adopt the least costly resolution method. An alternative resolution method, called an insured deposit transfer, may often be the least costly. In this method an acquirer pays a premium to acquire a failed bank's assets and only its insured deposits, not its uninsured deposits. Almost by definition, an insured deposit transfer will be less costly than a P&A whenever the failed bank's franchise value resides largely in its core deposits -- the FDIC receives essentially the same premium as it would in a P&A, but it would not incur the additional cost of protecting uninsured depositors.

Protecting uninsured depositors when it is not the least costly resolution method is an unjustified expansion of the federal deposit insurance guarantee that increases taxpayer exposure and removes market discipline from the system. It is also unfair to the smallest depository institutions that receive no such protection.

Problems from Protecting Uninsured Deposits

There are three fundamental problems arising from the current policy of routinely protecting most uninsured deposits: increased taxpayer exposure to losses; the removal of market discipline over weak and risky banks; and the unfairness of protecting some uninsured deposits but not others.

Increased Taxpayer Exposure. Increasing the scope of the federal guarantee directly increases taxpayer exposure whenever protecting uninsured deposits is not the least costly resolution method. By one estimate, protecting uninsured deposits in the six transactions involving systemic risk in the last five years cost the FDIC $883 million. In addition, the FDIC fully protected approximately $5 billion of uninsured deposits in purchase and assumption transactions where insured deposit transfers might have been a less costly resolution method.

Removal of Market Discipline. Deposit insurance is intended to provide stability to the banking system by protecting small, unsophisticated depositors. But it was never intended to cover sophisticated investors with large deposits in banks, who are an important source of market discipline on bank risk-taking. The routine extension of deposit insurance to all such investors removes this market discipline, allowing weak banks to stay in business longer and accumulate losses that will ultimately be borne by the insurance fund or the taxpayer. Such a policy also undermines the nominal statutory limits on deposit insurance coverage.

Unfairness. The protection of uninsured depositors in large banks but not small banks can give large banks an unfair funding advantage for large deposits. This unfairness was brought into sharp contrast with the recent decisions to protect uninsured depositors in the resolution of the Bank of New England, and not to protect them in the resolution of the Freedom National Bank in Harlem.

As we all know, the unfairness of protecting some uninsured depositors but not others has become the battle cry of smaller banks around the country, and with good reason. There are basically three ways to address this fairness problem.

The first is to expand the current practice even further -- that is, to simply protect all depositors, insured and uninsured, at all banks. This is the position preferred by small banks as being most fair because it would neutralize bank size as a major factor in the competition for funds. But it would not be fair to taxpayers. Their exposure could only go up. Extending the federal safety net of deposit insurance to all deposits eliminates all market discipline, even from sophisticated depositors, and that can only make the banking system more risky.

The second approach is never to protect uninsured deposits. This approach, too, would be "fair." Banks of all sizes would be treated identically and uninsured depositors would have no incentive to place funds on the basis of protection in the event of failure. But this approach creates problems of systemic risk. It is simplistic and dangerous.

We believe that the only sensible solution is a third approach that balances all of the factors involved -- one that rolls back the routine protection of uninsured depositors, preserves the government's ability to protect the financial system, and embraces new ways to reduce the systemic risk involved in bank failures.

The Administration's Proposal

In our recently completed study of deposit insurance and banking, the too-big-to-fail problem was among the most difficult addressed. We arrived at our recommendations only after a long and hard examination of the issue and considerable dialogue with the regulatory agencies, representatives of the industry, and other interested parties.

Our approach is intended to reduce taxpayer exposure and reduce unfairness to small banks. It would roll back the too-big-to-fail doctrine to true instances of systemic risk and make it the rare exception in bank failures. The routine coverage of uninsured deposits would be eliminated by demanding "least cost resolutions." The regulators would be made more visible and accountable when they do decide to protect uninsured depositors. And specific measures would directly reduce systemic risk.

Least Cost Resolution. Our legislation would amend the Federal Deposit Insurance Act to explicitly require the FDIC to choose the bank resolution method that results in the least cost to the insurance fund. While this provision does not prohibit the FDIC from using P&A transactions, we expect that it would generally lead to greater reliance on insured deposit transfers that would not protect uninsured depositors.

Systemic risk exception. While systemic risk could still be used as a reason to protect uninsured depositors, the Administration's proposal includes new procedures to make this a much more visible and accountable determination -- which we believe will help limit its use to rare instances of genuine systemic risk. The FDIC would not be permitted to factor systemic risk into its selection of a resolution method. Rather, the determination of systemic risk would be reserved to the Federal Reserve Board and the Treasury Department acting jointly, but in consultation with the Office of Management and Budget and the FDIC. Upon such a determination, these agencies could direct the FDIC to provide insurance coverage for all depositors or take other appropriate action to lessen risk to the system.

The Federal Reserve is responsible for financial market stability, and because government action could require Federal Reserve discount window loans, it ought to be formally involved in systemic risk decisions. Also, since the Administration is directly accountable to the taxpayer, the Treasury and OMB have a legitimate role to play in this determination. By broadening the decision-making in this way, both government flexibility and accountability can be achieved. Furthermore, we think that lodging this decision at the highest levels of government with high visibility will mean that uninsured depositors are protected much less often.

Proposals to Reduce Systemic Risk. Finally, our legislation would reduce systemic risk directly, which in turn will reduce the occasions when uninsured depositors need to be protected. Our principal proposal in this area is to improve the liquidity mechanism in bank failures.

Uninsured depositors that are unprotected in bank failures do not lose all their funds; instead, they typically receive a partial recovery based on their claim on bank assets. This partial recovery can be substantial, sometimes amounting to over 90 percent of the value of uninsured deposits.

The problem is that partial recovery can take long periods of time during which the value of the deposits can be tied up in a failed bank receivership. This temporary loss of liquidity magnifies the systemic risk problems associated with depositor losses, especially from the payments system and correspondent banking networks.

Our proposal authorizes a new means for the FDIC to provide immediate liquidity to uninsured depositors in bank failures based on the FDIC's average recovery experience from receiverships over a time period to be determined by the Agency. This provision in our bill, based on a proposal by the American Bankers Association, could significantly reduce the systemic risk involved in bank failures.

In addition, our legislation includes measures to reduce payments system risks, including (1) the bilateral netting of the mutual obligations of banks, (2) statutory elimination of the risk that a receiver or liquidator of a failed member of a clearing organization could negate the netting rules of the clearing organization, and (3) preemption of any injunction or similar order issued by a court or agency that would interfere with the netting procedures governed by the Act.

Indeed, our proposals build on the numerous efforts that have been made over the years to reduce the risks associated with payments, clearance and settlement arrangements. The Federal Reserve already has mechanisms in place to secure its large dollar payments system, Fedwire. These mechanisms include guaranteed final payment, bilateral caps among institutions, and real time monitoring of the flow of funds over the system. In a similar vein, the Clearing House for International Payments (CHIPS) not long ago instituted a cross guarantee arrangement among its member institutions that significantly reduces systemic risk in the event of a large bank failure.

We will continue to work to reduce threats of systemic risk based on liquidity problems and faulty payments mechanisms. By doing so we will progressively diminish the number of systemic risk situations that require uninsured depositor protection.

Paying for TBTF

The decision as to who pays for genuine systemic risk resolutions is a difficult one to make. It is argued by some that the cost should be borne by the taxpayer because of the far-reaching economic implications of a systemic breakdown. Protecting the financial system protects more than just banks, and banks should not be held uniquely accountable for the costs of maintaining stability.

On the other hand, preventing systemic risk uniquely benefits the banking industry, and not just the largest banks. Stability and depositor confidence are critical to the viability of all banks. And although the protection of large deposits in large banks clearly benefits large banks generally, it also directly benefits smaller correspondent banks and indirectly benefits all banks that are susceptible to contagious depositor runs.

On balance, because of these direct benefits, we believe that the industry should pay for the costs of preventing systemic risk. Accordingly, H.R.1505 requires the FDIC to pay for the cost of protecting uninsured depositors in the rare circumstances of systemic risk where it would be required.

H.R. 2094

Before concluding, let me provide some observations about the treatment of uninsured depositors in H.R. 2094, which was marked up in the Subcommittee on Financial Institutions last Tuesday. This bill prohibits the FDIC from protecting uninsured depositors beginning in 1995, even if it would reduce costs to the taxpayer. And while the bill was improved in Subcommittee with an amendment that would preserve the Federal Reserve's current authority to address liquidity problems in undercapitalized banks, we believe that even the amended text leaves too little flexibility to address systemic risk. We will continue to support amendments that would improve the language to address both of these problems.

Conclusion

In conclusion, we believe that ours is the most balanced approach to the problem of protecting uninsured depositors given the competing considerations of systemic risk, taxpayer exposure, market discipline, and fairness. Chairman Greenspan has said that not all large bank failures require a too-big-to-fail resolution. We agree, and we provide a specific mechanism for handling bank failures that should decrease the number of such resolutions without ignoring the dangers of genuine systemic risk situations.

Furthermore, by making the protection of uninsured depositors the rare exception, not the rule, we help to accomplish several fundamental objectives. Taxpayer exposure is reduced. Market discipline is increased, as the doctrine of "constructive ambiguity" becomes much more of a reality -- even depositors in the very largest banks will never be completely sure about whether their deposits will be fully protected, which is healthy. And small and large banks will be treated much more equally, resulting in few unfair funding advantages to large institutions.

Still, as long as we have repeated instances of costly bank failures, there will still be some unfairness resulting from systemic risk situations. What we really need to do is what I said at the outset -- fix the system so we don't continually have these costly failures. We cannot affort to keep putting ourselves in the position of having to make the choice between protecting small banks and protecting the taxpayer.

The key is to make the banking industry economically viable through comprehensive reform. Banking organizations must be able to offer a full range of services to compete with their rivals, domestically and internationally. They must be able to locate their places of business where they choose and attract capital from financial and non-financial firms. And they must be regulated more effectively with prompt corrective action that stops smaller problems from mushrooming into large losses to the insurance fund. H.R. 1505 addresses all of these requirements.

Those who suggest we must end the "too-big-too-fail" problem before we fix the system have it got it exactly backwards; instead, we must fix the system in order to eliminate the unfairness of "too-big-to-fail."

****

Mr. Chairman, that concludes my formal statement. I would now be pleased to answer any questions you or other members of the Subcommittee might have.

For release on delivery
10:00 a.m. E.D.T.
May 9, 1991

Testimony by

John P. LaWare

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Economic Stabilization

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

May 9, 1991

I am pleased to appear before this subcommittee on behalf of the Federal Reserve Board to discuss the economic implications of the so-called "too-big-to-fail" doctrine and proposed legislation dealing with this issue. The concerns encompassed by the term too-big-to-fail are among the most important reasons why we need to reform not only our deposit insurance system, but also the broader structure of financial institutions and regulation. The Board urges the Congress to view too-big-to-fail as one element of a very complex set of problems that need to be attacked on several fronts.

At the outset, I want to emphasize that the Board appreciates and is sensitive to the equity and efficiency arguments frequently advanced for eliminating too-big-to-fail policies. We are extremely uncomfortable with any regulatory policy that differentiates among banks, or their customers, largely on the basis of that institution's size. Under the too-big-to-fail doctrine, uninsured deposits at large banks typically have been protected in full -- through purchase and assumption resolution methods -- while those at smaller institutions generally face a greater risk of some loss.

Fairness alone would seem to argue that the treatment of depositors at a failed bank be independent of its size. Indeed, on many occasions the Board has indicated its view that the presumption should be that regulatory policy is equally applicable to banks of all sizes. It is desirable that no bank should assume that its scale insulates it from market or regulatory discipline, nor should the depositors with uninsured balances in a large bank assume that they face no risk of loss should that institution fail. For these reasons, the Board supports those provisions of the Treasury proposal that would enhance the accountability of, and tighten the criteria used by, regulators in resolving failed banks.

However, we believe strongly that it would be imprudent for the Congress to exclude all possibility of invoking too-big-to-fail under any circumstances. One can contemplate situations where uninsured liabilities of failing institutions should be protected, or normal regulatory actions delayed, in the interest of macro economic stability. Such a finding typically would be appropriate only in cases of clear systemic risk involving, for example, potential spillover effects leading to widespread depositor runs, impairment of public confidence in the broader financial system, or serious disruptions in domestic and international payments and settlement systems.

In practice, situations representing true systemic risk are rare. Indeed, one can envision improved circumstances in which even a very large bank could fail and not pose an inordinate risk to the economy. Unfortunately, the specific considerations relevant to such determinations are not fixed, but will vary over time with, for example, the underlying strength of the financial system and the economy.

In principle, systemic risk also could develop if a number of smaller or regional banks were to fail. Partly because such failures could potentially have severe consequences for a community or region, purchase and assumption resolutions have not only been used with large banks, but often with small institutions as well. Nevertheless, in practice systemic risks are more likely to be associated with failures of large institutions that are major participants in interbank financial markets, and in clearance and settlement systems for securities transactions.

The Board endorses reforms that would foster a stronger and more resilient banking system, one in which bank failures would be less likely and, should even a very large bank fail, the strength of other institutions would be sufficient to limit the potential for systemic risk. Thus, over the years we have been committed to higher capital standards, to the reduction of risk in the payments system, to finality criteria for clearing houses and payment systems, and to improved international cooperation in the areas of payments systems and banking supervision. For the same reason, we also support the Treasury's proposals calling for frequent on-site examinations, prompt corrective action policies, interstate branching, and a broader range of permissible activities for financial services holding companies with well-capitalized bank subsidiaries. With these changes, we believe that over time the financial system and the economy could better tolerate large bank failures, thereby minimizing the likelihood that regulators would need to invoke too-big-to-fail.

Even in such an environment, however, it would be impossible to confidently assert that a systemic risk situation involving one or more troubled banks would never occur, in large part because of varying macroeconomic and other circumstances. In our view, therefore, it is not only prudent, but essential that policy makers retain the capacity to respond quickly, flexibly, and forcefully in conditions involving extensive risk to the financial system and the economy. I would note that while there surely are elements of unfairness in too-big-to-fail policies, unfairness also would result if regulators were required to ignore systemic risks. Such a mandate could needlessly expose banks and other financial institutions, their customers, and the broader society to severe economic disruptions and hardships that were neither of their own making nor within their control.

Mr. Chairman, the remainder of my remarks today will amplify on the reasons that have led to Board to these views.

Systemic Risk

The fundamental reason why it may sometimes be necessary to protect certain uninsured creditors or delay normal regulatory actions is systemic risk. Systemic risk refers to the possibility that financial difficulties at one bank, or possibly a small number of banks, may spill over to many more banks and perhaps the entire financial system. So long as problems can be isolated at a limited number of banks, but confidence maintained in the broader banking and financial system, there is little or no systemic risk.

One of the most serious and immediate potential effects of the failure of a very large bank is an impairment of the payments system that is so widespread as to disrupt the economic activity of the nation. In modern economies, the ability of individuals and firms to make and receive payment for goods and services is usually taken for granted. But, clearly, trade and commerce would be curtailed if this ability were substantially impaired for a major portion of the economy. One aspect of the potential problem is clear: When a bank fails, the ability of its depositors to make payments from their accounts would be severely limited were it not for government intervention designed to maintain the liquidity of insured, and sometimes uninsured, balances. Recent examples of the potential hardship such disruptions could place on exposed depositors can be seen in the failures of the Ohio, Maryland, and Rhode Island deposit insurance systems. Clearly the problems could be greater in the case of the failure of a large bank, or a contagion of failures at many banks.

There is another aspect of systemic risk that is generally not as well understood. Large banks are major providers of payments and other "correspondent" banking services for smaller banks, as well as other financial institutions. Often these interbank relationships involve holdings of relatively sizable compensating or clearing balances at correspondent banks. Such interbank relationships are a key mechanism by which problems at a large correspondent bank can be transmitted to other financial institutions. There are two ways this can occur. First, the loss of access to their balances at the correspondent could cause other financial institutions to experience liquidity and solvency problems of their own. Second, the failure of a major correspondent bank could cause clearing and settlement problems for the customers of other banks and financial institutions that, ultimately, depend on the correspondent for payments services. Both of these possibilities were concerns, for example, in the 1984 failure of Continental Illinois National Bank, which was an especially important participant in interbank markets.

Some of the clearest examples of payments system-related systemic risk are associated with foreign exchange markets, which involve the largest banks from all the major industrial countries, and are closely linked to and integrated with domestic money and capital markets. On any given day, a major bank will have entered into foreign exchange contracts to be settled on a future day, typically two days hence in the case of "spot market" contracts. If for any reason exchange rates were to move in the interim, a bank failure during this period could subject its counterparties, both banks and nonbanks, to unexpected capital losses.

Usually of greater immediate concern is the settlement risk arising from the traditional practice of paying out foreign currencies in settlement of foreign exchange contracts before counter-payments in U.S. dollars are fully completed. This practice arose because European banking markets operate in time zones at least 5 or 6 hours earlier than U.S. markets, while far eastern markets operate in time zones 13 or 14 hours earlier. The result is that both U.S. and foreign banks are typically exposed to the risk of losing the full amount of foreign currency paid out while they are awaiting dollar payments. This settlement risk, although managed by banks through various techniques, may amount to substantial temporary exposures lasting for a few hours during the day. Failure to complete these transactions in a timely manner would not only subject the counterparties to risk of loss, but could undermine confidence in domestic and international payments systems, whose smooth functioning is essential to flows of goods and financial capital around the world.

To reduce systemic risks in the payments system, in recent years the Federal Reserve has worked with private payment and clearing systems to develop policies and procedures to reduce payments system risk. We believe that these initiatives have lowered the potential disruption to counterparties on large dollar networks. Still, it is the case that general instability in the banking system, such as would occur in a true systemic risk situation, could lead to multiple clearing and settlement failures. The Board believes that it is in the public interest for policy makers to have the tools and flexibility to prevent such an event.

Another serious aspect of systemic risk is the possibility of widespread depositor runs on both healthy and unhealthy banks. Such runs could be engendered by the failure of a major bank, for example, if such a failure generated significant uncertainty regarding the health of other banks. In days past, the primary concern was that depositors would run to currency, thereby causing a rapid and precipitous decline in the money supply and in the ability of banks to maintain old and make new loans. Today, while a flight to currency is not a realistic concern, in large part because of the success of the safety net, rapid and expanding runs from domestic bank deposits to government securities, other money market instruments, and foreign bank deposits could still seriously disrupt the process of intermediation on which many borrowers depend.

The process by which savings are turned into loans and other forms of financial investment is crucial to the creation of real capital in our economy, and therefore central to the means by which increased productivity and higher living standards are achieved. Banks are obviously major contributors to this process. Indeed, the primary value added of banks is their ability to attract and pool depositors' funds by issuing liquid liabilities, and then provide financing to individuals and firms for productive purposes by creating relatively illiquid loans.

A credit relationship between a borrower and a particular bank is not necessarily easily transferred to another financial institution. The unique information collected by individual banks about their customers is often expensive to acquire, and may be the result of years of close interaction. True, securitization and technological change are making it increasingly possible for many bank customers to access credit markets directly, and the resultant decline in the value of the bank franchise is one of the key issues that needs to be addressed in banking reform. But for now -- and for the foreseeable future -- there will exist a core of business and other borrowers for whom banks serve as a primary source of funds. For example, data from our 1988 National Survey of Small Business

Finances indicate that of those small businesses having a loan or lease with a financial institution, more than half obtained such financing exclusively from one depository institution; and more than 80 percent had a loan or lease with a commercial bank. Moreover, it should be recognized that many securities are backed by bank credit guarantees or liquidity facilities.

We need only look to the economic and other costs imposed by the so-called "credit crunch" to get a sense of the critical importance of credit creation by banks to the stability and growth of our economy. In addition, research on the Great Depression points to the destruction of this function, caused by widespread bank failures, as a major contributor to the severity and length of the Depression. These arguments suggest that a rapid shift of deposits from one major portion of the banking industry to another -- say from banks considered weak to those considered strong -- would seriously disrupt credit creation. Such a disruption could easily feed into the real economy.

The implications of widespread difficulties in the banking sector -- including perhaps major disruption of the payments system and extensive depositor runs on healthy banks -- are not likely to be confined to banks. In large part this is due to the interconnections that I have already described between banks, other financial and commercial firms, and households. But there are other reasons why a loss of confidence at banks could spread. For example, all types of financial institutions depend on the maintenance of public confidence in the broad financial system for the successful conduct of their business. Problems in banking could reduce confidence in this broader system.

In addition, other financial intermediaries, for example investment banks, depend on commercial banks for substantial amounts of short-term credit. A significant reduction in the supply of bank credit would reduce the ability of these institutions to provide underwriting services and liquidity support to a wide variety of securities markets, including those for stocks, bonds, and commercial paper. The resultant contraction in the availability and liquidity of such investment vehicles would tend to exacerbate the effects of a reduction of loans at banks. Indeed, the continued provision of credit to other financial intermediaries was one of the Board's primary concerns in our efforts to minimize the adverse effects of the October 1987 stock market break.

Large commercial banks are also major and direct participants in a variety of key financial markets. Examples include the markets for government securities, mortgage-backed securities, and foreign exchange. In their role as major participants and market-makers, large banks are a primary source of liquidity for these markets. For this reason alone, the collapse of a major bank's participation could, for a time, significantly impair the functioning of these markets. In short, a variety of strong arguments can be made for the need to manage carefully the withdrawal of a major bank from financial markets.

The Congress and the banking regulators should take pride in the fact that systemic risk seems today to be a somewhat remote problem. One of the fundamental purposes of our banking safety net is to prevent systemic risk from becoming an observable reality. I think there can be no doubt that over the last half century we have been extremely successful in achieving this goal. Indeed, stability in the banking system has undoubtedly contributed to the much milder contractions in the economy that we have experienced since World War II relative to earlier times. The problem is that we have also paid a price for our success. An excessive degree of moral hazard has been allowed to develop within the system. This has been manifested in various ways, including low bank capital ratios, high asset risk at many banks, reduced market discipline by depositors, and ultimately large losses by the deposit insurance funds. But reform should not deny or eliminate the benefits of our success; rather, it should attempt to maintain the benefits while minimizing their costs.

Further Actions Needed to Reduce Systemic Risk

As I noted earlier, the Board urges the Congress to view too-big-to-fail as one element in a complex set of problems that should be attacked simultaneously. In this regard, Chairman Greenspan and other Board members have argued repeatedly in favor of fundamental reform of our system of banking and financial regulation. Most recently, Chairman Greenspan testified last week before the Financial Institutions Subcommittee of the House Banking Committee on the Board's views on these issues. I shall not repeat his remarks here today except to reiterate my earlier observation that a vital component of the ultimate solution to too-big-to-fail is a stronger banking system. We should promptly adopt reforms that will achieve this goal, including greater emphasis on capital adequacy, prompt corrective action to deal with financially distressed depositories, timely on-site examinations, full interstate branching, and a broader range of permissible activities for financial services holding companies with well-capitalized banking subsidiaries. As I noted earlier, by increasing the safety and soundness of our banking system, these reforms would lessen the likelihood of a major systemic threat and a need to invoke too-big-to-fail.

A way to equalize the benefits of too-big-to-fail policies across depository institutions is to eliminate the deposit insurance limit, implying explicit 100 percent insurance for all deposits, including those in excess of $100,000. I would note that such a change in policy would further increase the degree of moral hazard in the banking system, virtually eliminate depositor discipline, and increase potential taxpayer liability. To offset these effects, much higher capital ratios and unacceptably intrusive regulation might be required.

It is important to understand that, even in a circumstance where too-big-too-fail is invoked, the stockholders, bondholders, and senior managers of the insolvent bank lose. This occurs even when all depositors are made whole and the bank continues in operation. Thus, from the point of view of the owners, bondholders, and senior managers, the application of too-big-to-fail policies still would imply de facto failure of the bank, since their financial interest in the bank would be extinguished. In this sense, too-big-to-fail implies no inequity of treatment across banks. Moreover, in the Board's view it is these very agents -- stockholders, bondholders, and senior managers -- who are in the best position to exert market discipline on the bank so as to limit the risk that the bank will ever become financially impaired.

Federal Reserve Role in Identifying Systemic Risk

The Board believes that it should have a role in determining when systemic risk exists. As the nation's central bank, the Federal Reserve has responsibilities for the health of the domestic and international payments and financial systems. Thus, the Federal Reserve has both the perspective and the expertise that are useful for evaluating the systemic risk implications of a given crisis or imminent bank failure. Our responsibilities in this regard are carried out in part through administration of the discount window, which would likely be involved in any attempt to manage the demise of a major bank in an orderly way. To carry out our responsibilities for assessing systemic risk and administering the discount window it is particularly important that we have the thorough understanding of banks and the payments system operations that we obtain through close and frequent contact with large banking organizations.

With the increasing globalization of banking, the world's central banks will need more than ever to coordinate responses to developments that may originate anywhere and may impact domestic and international payments systems and financial markets. Thus, the Board believes that it is essential that the Federal Reserve -- in order to conduct its stabilization policies, including protecting against systemic risk -- have intimate familiarity with all banking organizations having a substantial international presence.

Inevitably, a determination of whether systemic risk is a substantial concern must be made on a case-by-case basis. Furthermore, the Board understands that it may be all too tempting for regulators to declare that systemic risk requires deviation from normal regulatory procedures. For these reasons the Board supports the Treasury's proposal that both the Board and the Secretary of the Treasury, who also has major responsibilities for ensuring financial stability, as well as protecting taxpayers' funds, should jointly determine when systemic risk justifies such a deviation. Such a requirement would help to ensure that a systemic risk exemption is not abused without rendering the decisionmaking excessively cumbersome and time consuming.

Other Issues

Mr. Chairman, in your letter of invitation you inquired as to how a policy of too-big-to-fail, by which I understand you to mean a policy of protecting against systemic risk, should be funded. This is a difficult issue. On the one hand, banks, and particularly the largest banks, are clear beneficiaries of a policy that greatly reduces the likelihood of depositor runs on healthy banks. Thus, a case can be made for funding such a policy through deposit insurance premiums. On the other hand, the general public surely benefits from too-big-to-fail policy, and thus taxpayer funding may be justifiable. Moreover, the Board is concerned about the adverse impact of continued high -- let alone rising -- deposit insurance premiums on the competitiveness, size, and viability of our banking system.

Rather than focus on the relatively narrow issue of funding systemic risk, the Board would prefer to concentrate on the more general need to recapitalize the bank insurance fund. The Board believes that any plan to recapitalize BIF must provide sufficient resources without imposing excessive burdens on the banking industry in the near term. The Board also believes that loans to BIF that would be repaid with future premium revenues are the best means of striking this difficult balance. But I would stress that BIF recapitalization should be considered within the context of the broader set of reforms I described earlier. If such reforms are enacted, the Board fully expects that the probability of facing a failure with systemic implications will decline over time. Thus, in the long run, the issue may become moot.

The final aspect of a policy of ensuring against systemic risk that I would note is that it is very rare to observe large bank failures in other industrialized nations. Two important reasons for this experience include the operation of financial safety nets abroad, and the structure of foreign banking and financial markets. Indeed, many observers argue that an implicit policy of too-big-to-fail is followed in these nations.

Virtually all of the industrial countries have deposit insurance systems. Often, however, these systems do not provide the same explicit protection for depositors as the FDIC. Support for the largest banks appears most likely to be channeled through countries' tax systems. In a few nations, the direct government ownership of some banks can also be regarded as part of the banking safety net. In addition, the possibility of direct government intervention to deal with severe problems at key financial institutions is not ruled out in most countries, although such intervention has been highly unusual. The fact is that regardless of institutional structure, observers conclude that explicitly or implicitly the norm in other industrial nations is that the largest banks will not be allowed to collapse. Thus the United States is far from being alone in having policies in place to deal with systemic risk. The Board believes that the widespread adoption of such policies abroad bears witness to the possible systemic cost of the uncontrolled collapse of a major bank.

Conclusion

In closing, I would reiterate the Board's strong support for the principle that the presumption of policy should be that regulatory actions apply equally to banks of all sizes. However, one of the primary reasons why there is a safety net for depository institutions is that failure of these firms can produce systemic risks, and unchecked systemic risk can impose major costs on the entire economy. Over the last half century a fundamental, and successfully achieved, goal of policy has been to avoid systemic problems in the banking sector. In addition, the broad set of financial reforms proposed by the Treasury and supported by the Board would, in the Board's view, help further to reduce the chance that we would find ourselves in a situation of serious systemic risk. But we should not fool ourselves into believing that we can guarantee that an impending bank failure will not be a threat to the stability of our economy. Real life is never so neat and tidy, the structure of the economy is not so fixed, and our ability to understand fast-breaking developments is not so perfect that we could ever ensure that. Therefore the Board strongly urges Congress to continue to allow policy makers the flexibility to interrupt our normal regulatory and failure resolution procedures for the purpose of protecting against systemic destabilization.

* * * * * *

United States General Accounting Office

GAO Testimony

For Release
on Delivery
Expected at
10:00 a.m. EDT
Thursday
May 9, 1991

Resolving Large Bank Failures

Statement of
Johnny C. Finch
Director of Planning and Reporting
General Government Division

Before the
Subcommittee on Economic Stabilization
Committee on Banking, Finance and Urban
Affairs
House of Representatives

GAO/T-GGD-91-27

Resolving Large Bank Failures

SUMMARY OF STATEMENT BY
JOHNNY C. FINCH
Director of Planning and Reporting
General Government Division
U.S. General Accounting Office

GAO is testifying today on the issues associated with resolving large bank failures. The views presented are discussed in greater detail in GAO's recently issued reports on deposit insurance, bank supervision, and accounting reforms.[1]

Perhaps more than any other aspect of banking, the problems and incentives associated with resolving large bank failures show the need for comprehensive reform of the deposit insurance and bank supervisory systems. Solutions must comprehensively deal effectively and fairly with today's incentive problems that make it easy for undercapitalized or risky banks of all sizes to obtain funding that is nearly always insured by the full faith and credit of the U.S. government. Just reducing legal or de facto coverage of deposits, as some have proposed, would no doubt increase depositor discipline and improve bank management incentives to operate more safely and soundly. But such changes to coverage may also result in an unacceptably high level of instability in our financial system.

GAO does not believe that scaling back coverage for insured deposits or eliminating de facto protection for uninsured deposits is wise, at this time. The potential for systemic instability caused by reliance on uninsured depositors to discipline risk-taking is too high. The risk of instability is especially evident at the present time because of the weak financial condition of many banks, including some of the nation's largest, and the weak condition of BIF.

GAO recommends several reforms to control the ability of banks--especially those which are large and poorly-managed--to attract deposits, while at the same time maintaining continued market stability. First, better supervision of banks is essential. Bank regulators must take prompt corrective action to stop unsafe banking activities before capital deteriorates. Accounting, auditing and financial management reforms designed to improve information on banking organizations and internal controls are also necessary to make the system of prompt corrective action effective. Second, capital requirements should be strengthened to discourage bank owners and managers from taking excessive

---

[1]Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, March 4, 1991); Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, April 15, 1991); Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991)

risks and large banks should be required to hold subordinated debt. Third, disclosure policies that give depositors and the general public better information on the condition of banks must be adopted if uninsured depositors are to be placed at greater risk. Finally, depositors with over $100,000 should be provided the choice of insuring those deposits at an additional cost.

In the long term it may be possible to place uninsured depositors at greater risk if GAO's recommended reforms have been implemented. Nevertheless, it may still be necessary for regulators to protect uninsured depositors in a failed large bank for stability reasons.

Mr. Chairman and Members of the Subcommittee:

We appreciate this opportunity to give you GAO's views on the complex issues associated with resolving large bank failures. The views I am providing and the reforms we are recommending are discussed in greater detail in our recently issued reports on deposit insurance, bank supervision, and accounting reform[1].

Perhaps more than any other aspect of banking, the problems and incentives associated with resolving large bank failures show the need for comprehensive reform of the deposit insurance and bank supervisory systems. Solutions must comprehensively deal effectively and fairly with today's incentive problems that make it easy for undercapitalized or risky banks of all sizes to obtain funding that is nearly always insured by the full faith and credit of the U.S. government. Just reducing legal or de facto coverage of deposits, as some have proposed, would no doubt increase depositor discipline and improve bank management incentives to operate more safely and soundly. But such changes to coverage may also result in an unacceptably high level of instability in our financial system.

The reforms that we have recommended to deal with the incentive problems in banking that give rise to the "too big to fail"

---

[1]Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, March 4,1991); Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, April 15, 1991); Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991)

policy are all designed to ensure industry stability through the safe and sound operation of banks instead of through deposit insurance guarantees that could result in large expenses for healthy banks and taxpayers. Any attempts to increase depositor discipline must be preceded by other reforms to improve the safety and soundness of banking organizations.

BACKGROUND

Starting with the 1984 failure and rescue of Continental Illinois, bank regulators have preferred to err on the side of guarding confidence in the banking system when large banks fail. FDIC has protected all deposits in the 14 failures of banks with assets over $1 billion. It is important to note that while depositors in these institutions have been protected, shareholders, creditors and managers have suffered almost total losses. The cost to FDIC of resolving these banks has totalled approximately $11.8 billion.

FDIC has protected the vast majority of deposits in all banks--both large and small. About 99.6 percent of all deposits--insured and uninsured--were fully covered in bank failures from 1985 through 1989. Nevertheless, we estimate that 32 percent of the uninsured deposits in small liquidated banks suffered losses, totalling about $100 million.

The de facto protection provided to large banks' uninsured depositors and non-deposit liabilities--such as fed funds, repurchase agreements and demand notes--has successfully protected the stability of the banking system. Yet, it has also led to a widespread perception that some banks are "too big to fail"--or perhaps more accurately "too big to be liquidated." This perception has led to a belief that uninsured depositors can safely ignore the quality of a bank if it is large enough. This situation is troublesome for a number of reasons. Among others, large banks, whose failures pose the greatest threat to FDIC's finances, have fewer incentives to control risk. In addition, depositors have incentives that favor the placement of uninsured deposits in large banks, putting small banks at a competitive disadvantage.

STABILITY CONSIDERATIONS ARE IMPORTANT

If legal coverage limits on insured deposits or the de facto protection afforded uninsured depositors were cut back or eliminated, as some have proposed, all banks, but especially large banks, would no doubt be operated more safely in order to win and retain depositor confidence. However, depositors who are not fully protected will also have a strong incentive to withdraw funds at the first hint of problems. The real possibility of destabilizing bank runs cannot be ignored. Stopping bank runs that stem from loss of confidence in the banking system is one of the reasons deposit insurance was established. The reasons for being concerned about disruptive runs are as valid today as when the system was created. Uninsured deposits and nondeposit liabilities account for over 60 percent of the funding of 10 of the top 25 banks in the country. Runs on our largest banking institutions could have significant destabilizing effects, through disruptions to the settlements system, correspondent banks, or foreign and domestic confidence in the U.S. banking system, particularly if a run at one large institution becomes contagious leading to runs at others.

The potential for such contagion arises from a number of factors that must be addressed before any reduction in insurance protection--de facto or otherwise--can be contemplated. First, uninsured depositors do not currently have options--such as purchasing additional insurance--for safeguarding their deposits. Second, it is unreasonable to expect most uninsured depositors to make informed decisions about the condition of the institutions in which they place funds. Even the most sophisticated of uninsured depositors cannot be expected to accurately assess the condition of banking organizations because information on those organizations is not always available. Without such information, it is all too likely that destructive bank runs will be caused by misinformed depositors. Third, the losses that would be faced by uninsured depositors must be reduced by improving bank supervision. Losses in banking organizations closed between

1985 and 1989, averaged nearly 16 percent of the failed banks' assets. We believe this represents an unacceptably high level of loss for risk-averse depositors to accept.

For these reasons, we do not believe that scaling back coverage for insured deposits or eliminating de facto protection for uninsured deposits is wise, at this time. The potential for systemic instability caused by reliance on uninsured depositors to discipline risk-taking is too high. The risk of instability is especially evident at the present time because of the weak financial condition of many banks, including some of the nation's largest banks, and the weak condition of BIF.

A NEAR TERM APPROACH IS NEEDED THAT DOES NOT PUT DEPOSITORS AT GREATER RISK

I indicated at the outset that the most important problem needing attention involves dealing with a system in which undercapitalized and otherwise risky banks can easily obtain funding that is backed by the full faith and credit of the U.S. government. While we do not believe it is possible to rely more on uninsured depositors to help solve this problem at this time, it is possible, through other means, to control the ability of banks--especially those which are large and poorly-managed--to attract deposits while at the same time maintaining continued market stability. We recommend several reforms to accomplish this objective.

First, better supervision of banks is essential. Bank regulators must take prompt corrective action to stop unsafe banking activities. As described in our recently issued reports on deposit insurance reform and bank supervision, we have found that, although bank regulators have the authority to prevent unsafe and unsound activities, they do not always use it when they discover deficiencies. They prefer to work cooperatively with bank managers rather than take swift action to discipline unsafe banks. As a result, banks may continue to engage in risky practices that can increase BIF losses. To address such problems, we have recommended that regulators be required to develop an early intervention or "tripwire" supervisory system that focuses enforcement actions on the earliest signs of unsafe behavior in all banks--large or small. An important feature of the tripwire system is that the earliest tripwires enable regulators to take forceful action to stop risky practices in seemingly healthy banks before bank capital begins to fall. Implementation of the "tripwire" system we propose should help prevent poorly managed large banks from offering above market interest rates to attract deposits, and would lower the cost to the FDIC when banks do fail.

The success of any early intervention strategy depends on good information on the value of insured banking institutions. To provide regulators with more accurate information we have recommended a strengthening of financial and management reporting requirements for banks and their external auditors, valuing problem assets based on existing market conditions, strengthening the corporate governance mechanisms for banks, and requiring annual, full scope, on-site examinations of all banks.

Second, capital requirements should be strengthened to discourage bank owners and managers from taking excessive risks and to provide a financial buffer between losses resulting from poor business decisions and the resources of the Bank Insurance Fund. We recommend that strengthened capital requirements be phased in after the risk-based Basle capital standard is fully implemented in 1992, and that they include provisions for better controlling interest rate risk. As part of the effort to strengthen capital requirements, we recommend that large banks be required to hold a minimum level of subordinated debt so that they become subject to the market discipline associated with such debt. Because subordinated debt holders are in danger of losing their investment when a bank fails, they have a strong incentive to control bank risk-taking, imposing many of the disciplinary benefits generally believed to exist if uninsured depositors were exposed to greater losses. The costs of raising subordinated debt would increase with the riskiness of the bank, and would therefore give a clear signal to bank owners, uninsured depositors and the bank regulators of the health and perceived risk of the bank. Unacceptably high costs for such debt should force bank management to reevaluate its strategies.

Third, disclosure policies that give depositors and the general public better information on the condition of banks must be adopted. If uninsured depositors are placed at greater risk, they must have accurate and readily available information about their banks. This information could include capitalization ratios and levels, the relative performance of loan portfolios, CAMEL ratings and deficiencies noted by examiners. We have recommended that bank regulators, in consultation with industry experts, be required to develop appropriate disclosure requirements.

Fourth, a risk-based deposit insurance premium system that can be used as a supplement to risk-based capital requirements should be implemented. Such a system would provide an incentive for the owners and managers of institutions to control risk and would help regulators focus on risks incurred by the banks they are supervising.

Finally, uninsured depositors should be provided the choice of insuring their deposits at an additional cost. Options for accomplishing this result include collateralizing accounts with lower yields to reflect their comparative safety or the purchase of additional insurance protection through the FDIC. This would allow depositors to make a more rational trade-off between risk and return than is now possible and should make the banking system less susceptible to bank runs.

IN THE LONG-TERM, IT MAY BE POSSIBLE TO PLACE DEPOSITORS AT GREATER RISK

In the past, decisions by uninsured depositors to withdraw funds from weak banks--like the Bank of New England--forced regulators to deal with insolvent banks that probably should have been resolved earlier. The ambiguity present in the current system generated sufficient market discipline to finally curtail the amount of regulatory forbearance shown toward these troubled banks.

If such discipline is to play an expanded role in the future, certain conditions must be met so as not to jeopardize market stability. The banking system and BIF must be in a much sounder condition than they are today and the near term reforms I have discussed relating to bank supervision accounting and auditing standards, bank capital, improved information, risk-based insurance premiums, and alternative coverage options should be substantially implemented.

When these conditions have been met, it may be appropriate to consider requiring FDIC to resolve failed banks in ways that more frequently impose losses on uninsured depositors. While such a requirement would not automatically impose losses in every instance, we believe it could significantly increase depositor discipline at large banks.

Nevertheless, even with our recommended reforms it may still be necessary for regulators to protect uninsured depositors in a failed large bank for stability reasons. Under certain conditions--a severe recession or an unstable international environment, for example--the threat of irrational runs may be so great that it would be reasonable to protect uninsured depositors. For these reasons, we believe that even in the long-run a formal policy requiring the FDIC to follow a least cost resolution method, as some have proposed, and impose losses on uninsured depositors under all circumstances would not be wise. Instead, the Federal Reserve, in conjunction with FDIC, should be given the authority to determine whether the failure of a bank would be detrimental to the stability of the U.S. financial system. If so, such a bank could be resolved in ways that protect uninsured liabilities. We are uncertain how often such intervention would be needed. However, if all of the reforms I have mentioned are implemented, such intervention should become the exception, not the rule it is today.

The Bank Insurance Fund, not the Federal Reserve or Treasury, should continue to finance such resolutions. Requiring the industry, through its BIF premiums, to pay for large bank failures will create powerful incentives for the industry to pressure FDIC to effectively deal with problems in large banks, thereby limiting losses from those that do fail.

CONCLUSIONS

Regulatory policies for resolving large bank failures have successfully protected the stability of our financial system but have reduced the incentives for owners and managers of large institutions to operate their banks in a safe and sound manner. They have also placed small banks at a competitive disadvantage.

The reforms we have recommended to resolve these problems do not require cutting back legal or defacto deposit insurance coverage. Yet they will curtail the ability of risky banks to attract uninsured deposits. These reforms also go a long way towards reducing the disparity between large and small bank regulation. Our "tripwire" system will restrict the access poorly operated large banks have to uninsured deposits, thereby reducing the advantage they have under de facto protection of uninsured depositors. In addition, our recommendation to strengthen capital standards--particularly with respect to subordinated debt--will specifically affect larger banks. Finally, other reforms that we have recommended--such as relaxing restraints on interstate branching--not specifically designed to deal with the incentive problems of large banking organizations and depositors, might also strengthen banking organizations and reduce their probability of failure.

It would be beneficial, in the long term, to make de facto protection much less predictable for uninsured depositors. In pursuit of this goal, however, the ability of the Federal Reserve and FDIC to take whatever actions are needed to protect systemic stability should in no way be compromised.

This concludes my prepared statement. My colleagues and I will be pleased to answer any questions.

Copies of GAO reports cited in this statement are available upon request. The first five copies of any GAO report are free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877

Orders may also be placed by calling (202) 275-6241.

STATEMENT OF

WILLIAM H. BRANDON, JR.

on behalf of

THE AMERICAN BANKERS ASSOCIATION

presented to the

SUBCOMMITTEE ON ECONOMIC STABILIZATION

of the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

May 9, 1991
Washington, D.C.

TABLE OF CONTENTS

STATEMENT OF WILLIAM H. BRANDON, JR.

ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

MAY 9, 1991

INTRODUCTION

Mr. Chairman and members of the Subcommittee, I am William Brandon, President of the First National Bank of Phillips County, Helena Arkansas and Co-Chairman of the Deposit Insurance Reform Committee of the American Bankers Association. The member organizations of the American Bankers Association range in size from the smallest to the largest banks, with 85 percent of our members having assets of less than $100 million. The combined assets of our members comprise about 95 percent of the total assets of the commercial banking industry.

The issue of "too-big-to-fail", which is the subject of these hearings, is central to the debate on deposit insurance reform -- in fact, it is the single most important component of deposit insurance reform. ABA's Deposit Insurance Reform Committee spent many weeks debating this issue, and the result of those efforts was the development of a method for resolving the failure of any bank -- large or small -- without undue disruption to the financial markets. We commend you, Mr. Chairman, for holding these hearings, and we appreciate this opportunity to present our views on the economic implications of the current "too-big-to-fail" policy and to outline our Final-Settlement-Payment program.

Deposit insurance reform, as important as it is, cannot by itself guarantee the stability of the deposit insurance system. Ultimately, the health and safety of the deposit insurance fund rests squarely on the health and safety of the industry it insures. It is therefore critical that deposit insurance reform be a part of a comprehensive package of reforms which includes modernizing our financial structure to allow banking organizations to compete as equals in today's financial marketplace. If the industry remains shackled by out-dated laws which inhibit banks' abilities to meet the financial needs of customers, no amount of deposit insurance reform -- or recapitalization of the deposit insurance fund -- will be able to protect the fund or the taxpayer over the long run.

In addition, we must not ignore or underestimate the strong linkage between the banking industry and the economy. This linkage means that we must consider the economic consequences of various reform proposals. For example, pulling large amounts of capital from banks to recapitalize the Bank Insurance Fund and imposing ever-higher regulatory burdens on banking organizations will reduce banks' ability to support economic growth. If banks find themselves less able to meet the credit needs of their local economies, recovery from the current recession will be undermined.

In sum, Mr. Chairman, there are no quick fixes -- we must address each dimension of the problem, recognizing the interconnections between them, if we are to reach our goal of a safe and sound financial system. Comprehensive reform will not be easy to achieve -- but by working together, we believe it can and will be accomplished.

THE MARKET FOR FINANCIAL SERVICES HAS CHANGED DRAMATICALLY

Before I talk more fully about the too-big-to-fail problem and its solution, it is important to understand the competitive environment the banking industry currently faces.

Most of us have a sort of "conventional wisdom" view of what a "bank" is. This view has certainly changed as new products burst on the financial scene over the past ten years. But public perceptions change slowly -- far more slowly than the pace of change in financial markets. The fact is that in today's market, the line between banking firms and other financial firms, including insurance companies and securities firms, exists only in theory -- in practice, it has been overrun by market forces.

Nonbank providers of financial services do not operate under the same constraints as banks, and affiliations between securities firms, insurance companies, and real estate brokerage firms are common. Many of these firms own thrift institutions (which now call themselves banks and advertise that they are FDIC-insured) -- and many firms, ranging from Aetna Life and Casualty Company to Textron, Inc., also own banks (so-called non-bank banks). These firms are taking advantage of their greater freedom to develop and market combinations of financial products that banks cannot offer.

I would just like to highlight a couple of the financial activities of some of these firms. For example, Prudential Insurance Company (the largest life insurance company in the country), American Express (the largest domestic financial firm ranked by capital), and Merrill Lynch (the largest securities firm in the country) offer federally insured deposits, consumer loans, credit cards, commercial finance, mutual funds, securities brokerage and underwriting, insurance sales and underwriting, and a host of other financial services -- all under the same corporate umbrella.

And it is not just securities firms and insurance companies that are offering attractive combinations of financial products. Ford, General Electric and Sears, for example, began as nonfinancially-based companies. But while their public image remains associated with cars and light bulbs, the fact is that these companies -- and many other "nonfinancial" companies -- are very involved in the provision of financial products to both businesses and consumers. For example, Sears says that about one half of the corporation's revenues come from financial services, half from retailing. Even AT&T -- better known for telephones -- has become a major competitor in the consumer credit card market.

In short, the question of whether or not to mix banking with securities and insurance -- or increasingly, even banking and commerce -- is being answered by the marketplace. Moreover, it is important to note that these types of firms do not operate with the kind of "firewalls" that are often included in discussions about allowing banks to engage in a broader array of financial activities, nor are they subject to many of the "consumer" laws applicable to banks.

My purpose in citing these examples of broad-based financial companies at the beginning of this testimony is to point out that some of the questions being raised about the need to reform our banking laws seem to us to totally ignore the reality of today's marketplace. For example, questions about whether or not we should allow banking, insurance, and securities firms to be affiliated ignore the fact that these types of firms are already affiliated in major organizations involving billions and billions of dollars in assets. In fact, *any* firm, -- except a traditional commercial bank -- can combine "banks", insurance and securities through the acquisition of an S&L, which the acquirer can call a bank and advertise as being FDIC insured.

TOO-BIG-TO-FAIL MUST BE ELIMINATED

In the remainder of my testimony, I would like to detail the ABA's concerns about the too-big-to-fail problem and present our proposal for reform. Let me first summarize the ABA's position on this issue:

The most important element of deposit insurance reform must be to *end the current FDIC policy of too-big-to-fail.* The ABA strongly believes that this concept must be legislatively eliminated for three reasons:

(1) in order to ensure that market discipline is maintained in the system;

(2) in order to ensure fairness among banks of all sizes; and

(3) because the perception in the capital markets is that, as long as the banking industry is obligated to underwrite all the losses under the too-big-to-fail concept, the industry has unlimited liability.

If the final legislative product does provide some new mechanism for permitting the implementation of a too-big-to-fail policy in limited cases, *under no circumstances should the Bank Insurance Fund be required to pay the cost of implementing that policy.*

Too-Big-To-Fail is a Problem for All Banks -- Small and Large

Mr. Chairman, you have indeed picked a most important issue to be the subject of these hearings -- the economic implications of the current too-big-to-fail policies of the FDIC. There are, indeed, severe economic consequences of this policy and eliminating it as an option in the resolution of bank failures is the single most important reform that can be undertaken. One needs only to read the popular press to see the implications. For example, three weeks ago in the Washington Post Sunday Magazine, Joseph Nocera, a well-known business writer, wrote responses to commonly asked questions about finance in an article called "Fear of Finance." Asked where he would advise people to place their money, he stated:

> I tell them that the less they want to think about their money, the more it should be in a bank, even with all the banks' problems. A big bank, of course. A too-big-to-fail bank. You may not like this policy, but it's stupid not to take advantage of it.

As a community banker, I know how quickly money can flow out of an institution and out of local communities to these too-big-to-fail banks. I have no doubt about my ability to compete with my larger counterparts on the basis of quality. But I cannot even begin to compete, nor adequately service the needs of my community, if deposits are flowing to the large banks just because they are too big to fail.

But the impact of too-big-to-fail is not just a burden on small banks; it is a burden on *all* banks, since all banks must shoulder the costs of this policy. Extending *de facto* insurance to almost $900 billion in uninsured deposits creates an enormous and unnecessary liability for the FDIC. We are pleased that both Chairman Gonzalez and Chairman Riegle recognize this, and each have introduced legislation containing a January 1, 1995 deadline for phasing out the too-big-to-fail doctrine. We fully support their efforts on this issue.

Too-Big-To-Fail has Serious Economic Implications

The implications of the FDIC's ad hoc policy of 100 percent coverage are becoming clear. On the surface, it would seem that covering all depositors would be a stabilizing influence by preventing possible disruptions in deposit markets. In reality, 100 percent deposit insurance has significant adverse long-term consequences for the industry and the economy.

Protection of all deposits, whether or not they are legally entitled to insurance, creates an enormous and unnecessary liability for the FDIC and ultimately for the taxpayer. As the current policy of 100 percent protection becomes increasingly embedded in the minds of investors -- as is happening, no doubt, following the full protection afforded to depositors in the Bank of New England -- it will systematically erode the incentives of investors in large deposits to choose their banks based on the soundness of the bank, at least if the bank is large. The result is to encourage funds to flow to the highest bidder, regardless of risk. Thus, in a *de facto* 100 percent deposit insurance world, the deposit insurance funds are burdened with costs they were never intended to bear.

True deposit insurance reform must address the fundamental problem with the current system -- we simply cannot afford to continue to guarantee all deposits. We must move away from 100 percent deposit insurance and eliminate the too-big-to-fail policy. The heart of ABA's proposal for reform -- the Final Settlement Payment Approach -- is one of the approaches which could be used to do this. All of these approaches basically require that uninsured depositors share in the FDIC's losses when their depository institution fails.

Moving to a system in which uninsured depositors are truly at risk raises operational and transitional questions. The principal operational problem stems from the current lack of a framework for handling a large bank insolvency. Approaches which require uninsured depositors to share in FDIC losses can enable the regulators to handle the insolvency of any bank -- large or small -- without undue disruption to the system. They would permit uninsured depositors to receive access to most of their balances with no loss of liquidity, while at the same time sharing in the losses of the FDIC in an amount determined by the insurance agency's historical experience.

The problem of transition to a new system can be handled by establishing a credible program and announcing it well in advance of its effective date. The Gonzalez and Riegle bills do just that by setting a date of January 1, 1995, after which the FDIC could not invoke too-big-to-fail. This delayed effective date will give investors in uninsured deposits time to assess the financial condition of their depository institutions and to take whatever steps they may feel are appropriate to minimize their exposure to loss. It will also give banks the time needed to adjust their own operations to a new system in which they will be subjected to intensified competition and discipline in the markets for deposits.

The delayed effective date will also enable record keeping systems to be adjusted. It is important to understand that the current configuration of bank record keeping and reporting is, in part, a result of the FDIC's policy of *de facto* 100 percent insurance of all deposits. Since uninsured deposits are fully protected, it is not necessary to have detailed knowledge of the insurance status of individual accounts.

Certainly, determining which deposits are insured and which are not can pose important challenges. Record keeping systems in place today in many banks, especially smaller ones where uninsured deposits are relatively unimportant, might require little change. For larger banks, where the numbers and sizes of accounts tend to be larger, and the proportion of uninsured deposits to total deposits tends to be higher, substantial modifications might be required.

There is no doubt that technology makes it feasible to keep records in a manner consistent with identification of uninsured deposits in a timely manner. For those institutions with systems that require substantial modification, the delayed effective date would provide the time necessary to facilitate this transition.

Thus, the operational problems related to implementation of any one of the possible loss-sharing approaches such as the ABA final settlement payment proposal can be resolved. The problems are manageable and resolving them is not particularly complex. Moreover, the cost of modifying existing or implementing new record-keeping systems -- while not inconsequential -- are likely to be far less than the cost burden of maintaining the current too-big-to-fail policies of the FDIC. Simply because current record-keeping systems may not be fully aligned with deposit insurance needs is no reason to maintain a costly too-big-to-fail system of coverage.

Banks Should Not Underwrite Too-Big-To-Fail Policies

The banking industry strongly believes that too-big-to-fail should be eliminated. However, to the extent that some elements of the too-big-to-fail policy may be maintained, under no circumstances should the Bank Insurance Fund's resources be used to pay the extra cost of protecting uninsured depositors. There are several reasons for this position:

(1) Banks will find it extremely difficult to raise capital if markets perceive banks as having unlimited liability to underwrite all losses under the too-big-to-fail policy;

(2) If the Bank Insurance Fund continues to be used to pay the extra costs of insuring large depositors, there will be continuing incentives for those deciding how to resolve failed institutions to perpetuate the too-big-to-fail doctrine;

(3) Unless the FDIC is removed completely from the too-big-to-fail equation, the market will remain unconvinced that there has been any real change in government policy and, therefore, will not adjust. This lack of adjustment will, as a kind of self-fulfilling prophecy, make it harder for policy makers to implement a changed policy; and

(4) The too-big-to-fail doctrine is intended to avoid the potential for economic disruptions, i.e., "systemic risk"; however, the cost of dealing with such risk should not be borne by the deposit insurance system, which was not designed for that purpose. In most developed countries, "systemic risk" costs are, in fact, borne by the central bank.

ABA is concerned that the Treasury bill does not move to effectively eliminate too-big-to-fail even though it takes that decision out of the hands of the FDIC. One reason for the ineffectiveness is that the Bank Insurance Fund is still obligated to finance the too-big-to-fail policy even though the decision to protect uninsured depositors (and perhaps general creditors) was made by the Fed and the Treasury.

Protecting Every Dollar of Uninsured Deposits is Prohibitively Costly

Providing for insurance coverage on some $900 billion in uninsured deposits is not cheap. And in addition to the direct costs of providing *de facto* insurance for all deposits, there is something much more subtle and, in the long run, more costly -- the increasing risk of the whole banking system that derives from the perverse incentives created as the too-big-to-fail policy undermines market discipline. In other words, too-big-to-fail not only increases the costs of individual failures, in the long run it causes more failures.

Moreover, the too-big-to-fail policy is also unfair between banks. This fact was brought into sharp focus in the recent disparate treatment of depositors in the National Bank of Washington and the Bank of New England, where uninsured depositors were protected, and the Freedom National Bank, a small bank in Harlem where uninsured depositors were not protected. This unequal treatment of uninsured depositors results in funds flowing out of smaller banks into larger institutions where depositors believe their deposits will be fully protected.

By undermining incentives for large depositors to evaluate and monitor the financial condition of the banks in which they place their funds, 100 percent deposit insurance places the entire burden of detecting and controlling excessive risk-taking on the supervisory agencies. Given the inherent shortcomings of regulatory discipline, it would be a mistake to assume that the problems arising from full protection of uninsured deposits can be mitigated by still more regulation. It is essential to recognize the practical limitations of both the regulatory system and the system of deposit insurance, and to search for feasible opportunities to decrease the strains put upon both. Increasing incentives for holders of large deposits to assess the soundness of the banks in which they place their funds presents just such an opportunity.

The deposit insurance system must strengthen incentives of investors with substantial resources to exercise care when placing funds in a depository institution -- just as they would with any other investment. With a heightened awareness of their exposure to loss, these depositors will be inclined to choose their banks more carefully, either by shifting funds out of less well-managed banks or by demanding premium interest rates from them to compensate for their added risk. The increased cost that risky institutions would have to pay for deposits will provide them with a powerful inducement to get their houses in order.

Institutions considered by the market to be in sound financial condition and prudently managed will, over time, be able to expand their shares of the banking business. Equally important, the entire job of monitoring and controlling the risk-taking of individual institutions will not be thrown in the lap of the regulators. Tapping the resources of the private market to assist in the assessment of a bank's financial condition not only broadens the monitoring system, it also means that fewer scarce resources need to be employed to do the job. This will help contain the need for regulatory intervention, result in fewer bank failures, and put less strain on the deposit insurance fund.

Deposit Insurance Coverage On Multiple Accounts Should Not Be Changed

One of the proposals on deposit insurance receiving a great deal of attention is to place limitations on the number of insured accounts an individual may hold. First, such limitations on multiple accounts will do little or nothing to improve the system or reduce the exposure of the Bank Insurance Fund if we continue with *de facto* 100 percent coverage of all deposits.

Furthermore, to the extent that the FDIC's too-big-to-fail policy has convinced the public that large banks are safer than community banks, changes in the definition of accounts eligible for deposit insurance may cause a significant shifting of funds away from small banks into larger institutions. This potential movement of funds points up perhaps the most serious problem with proposals to limit the number of insured accounts. Until the FDIC's policy of too-big-to-fail is eliminated, smaller banks will continue to operate at a competitive disadvantage relative to large banks that have de facto 100 percent deposit insurance coverage. It would be unfair and unwise to aggravate this situation by tinkering with well established and well understood rules governing deposit insurance for individuals but to do nothing to address the real problem facing the deposit insurance system -- that is, the exposure resulting from the FDIC's too-big-to-fail policy.

Making piecemeal changes in individual account coverage is particularly inappropriate at this time. In view of the current public perception of the fragility of the financial system, restricting multiple account coverage may well cause unnecessary confusion and anxiety even among those whose accounts would be unaffected by the action, i.e. those with less than $100,000 on deposit.

THE FINAL SETTLEMENT PAYMENT METHOD SHOULD BE USED TO RESOLVE ANY FAILED INSTITUTION -- LARGE OR SMALL

Eliminating the too-big-to-fail doctrine would require that a method be in place that could resolve the failure of any institution without causing undue disruption to local and regional economies. The Final Settlement Payment approach is such a method. This approach, which was developed by a committee of bankers of the ABA, has stood the test of time since its release in March of 1990. A response to its critics is attached as an appendix to this testimony.

One of the important characteristics of the Final-Settlement-Payment method is its simplicity. Let me describe briefly how it would work:

When a bank's equity capital falls to zero --

(1) its primary regulator will declare it insolvent, and the FDIC will take control of the institution in its receivership capacity;

(2) insured accounts will be credited with 100 percent of the balance up to $100,000;

(3) holders of uninsured accounts (i.e., domestic deposits in excess of $100,000 and all foreign branch deposits) and unsecured creditors will become claimants on the receivership and their claims will be settled by a "final settlement payment" based upon an industry-wide average of the FDIC's bank receivership recovery experience and calculated in such a way that over time the FDIC receives no more or less than its legitimate claim as a general creditor, standing in place of insured deposits; and

(4) the full balance of insured deposits and the written-down portion of uninsured deposits (i.e., the final settlement payment) will be assumed by an acquiring banking institution or a "bridge bank" run by the FDIC in cases where the sale of the institution is more complicated and would require more time to complete (as would likely be the case for many larger banks). The acquiring institution or bridge bank would then immediately open for business.

It is important to note that the only difference in selling a failed institution under final settlement payment method and the current method used by the FDIC is the writedown of the balances of uninsured depositors.

In any particular bank failure, the final settlement payment may be above or below what the FDIC would have had to pay off to the general creditors of that specific bank. But over time, the over-payments and under-payments will net each other out. The FDIC's longer-term exposure will be no greater than if it had settled general creditor claims on a bank-by-bank basis. An example of how this works is contained in Exhibit 1.

The final settlement payment to general creditors disposes of their receivership interests in the FDIC's disposition of the institution. When the payment is made, investors in uninsured deposits and unsecured creditors have no further receivership claim on the failed bank or the FDIC.

The Final Settlement Payment Would be Based on the FDIC's Past Receivership Experience

The FDIC's past receivership loss experience is instructive. From discussions with FDIC staff, the asset-weighted average recovery rate from bank failures in the second half of the 1980s is about 88 percent. If this rate were used to set final settlement payments, uninsured depositors and unsecured creditors would expect to receive a settlement payment equal to 88 percent of the face value of their claims.

Under the proposed system, the bank receivership loss experience is likely to be significantly less under the final-settlement-payment procedure recommended than it has been under recent practices. Strengthening market discipline will prevent problem banks from growing as fast or as large as in the past and will cause them to be dealt with more quickly. In addition, as FDIC and other federal banking agency examination and supervisory capabilities continue to improve, problems will be identified and insolvency ascertained more promptly.

The use of a single industry-wide rate to determine final settlement payments in the event of failure is intended to meet the parallel goals of enhancing market discipline and assuring financial stability. Use of the final-settlement-payment approach alerts uninsured depositors and unsecured creditors to the fact that losses are unavoidable in a bank failure and enables them to know in advance what the magnitude of those losses will be. As distinct from traditional FDIC procedures involving 100 percent protection, the approach will drive home to the general creditors the need to pay careful attention to the behavior of the banks with which they are involved. At the same time, however, it will assure the maintenance of a high degree of depositor and creditor liquidity. The final-settlement-payment approach enables the FDIC to instantly settle creditor claims without risk of losses of its own in conducting its receivership responsibilities.

Uninsured depositors and unsecured creditors will incur losses in line with their general creditor status. Businesses, governments, and other banks, will have timely access to their deposit and creditor balances to enable them to continue essential economic activities. Potential losses in the range of five to fifteen percent will stimulate market discipline, but not endanger depositor or creditor viability.

Secondary Effects from Depositor Losses Would be Minimized

The final settlement payment is intended to minimize the secondary effects from losses to depositors and unsecured general creditors. It is the ABA's belief that the final settlement payment, which is likely to be between 85 percent and 95 percent of general creditors' claims, will not create adverse problems.

When a bank is paid off today, uninsured depositors and unsecured creditors initially get receivership certificates. Rarely are these marketable. Uninsured depositors and unsecured creditors suffer considerable uncertainty regarding their ultimate recovery and have to wait a long time before receiving any payments. It is obvious that a straight payoff of a large institution would cause considerable disruption.

The final-settlement-payment approach, on the other hand, provides instant liquidity at a level that would not cause serious disruptive effects. There is no uncertainty regarding recoveries, since the final settlement payment rate would be set and announced well in advance. Uninsured depositors and unsecured general creditors would therefore know their exposure and would seek to minimize losses by placing their funds in high-quality institutions.

The Final-Settlement-Payment Applied to the Continental Illinois Bank Failure

The most important aspect of the final-settlement-payment method is that it would be effective in resolving a large bank insolvency. Perhaps the best illustration of this is the case of Continental Illinois bank. It was believed at that time that the failure and liquidation of Continental Illinois would cause the failure of many other banks that used Continental Illinois as their correspondent bank.

Specifically, the FDIC determined that on April 30, 1984, 2,229 banks had deposits in Continental Illinois. This was just a few weeks before the FDIC's first assistance package, and two and a half months before the final assistance program was implemented. Of these 2,229 banks, 976 had an exposure in excess of $100,000. Some banks had a depositor relationship with Continental Illinois and had funds in demand accounts, time deposit accounts, or both. Other banks had sold unsecured federal funds to Continental Illinois, and many had a depositor and creditor relationship with it. In all, 65 banks had uninsured balances exceeding 100 percent of their own capital, and another 101 banks had uninsured balances between 50 and 100 percent of their capital. These 166 banks were located in Iowa, Indiana, Wisconsin, and eight other states, with the major concentration in Illinois.

If Continental Illinois had been closed on April 30, 1984 and correspondent banks had to wait for their *pro rata* share of the receivership proceeds, serious operational problems would have developed. Fear of these problems made such an alternative unacceptable. For a great many of these banks, more than the entire amount of their equity capital would have been in the form of a receivership claim on the FDIC. In addition, essential check-clearing and other services would have become suddenly unavailable.

Moreover, the large deposit customers of these banks -- in addition to the non-bank uninsured depositors of Continental Illinois -- could have had considerable difficulty in meeting their obligations to employees and creditors. This severe loss of liquidity could have potentially led to the bankruptcy of these individuals and businesses as well.

If a final-settlement-payment procedure had been available and used, correspondent banks would have continued to have essential correspondent services since Continental Illinois would have essentially remained open for business either as a bridge bank or as the subsidiary of an acquiring bank holding company. Moreover, the losses incurred by correspondent banks would have been manageable. If a final settlement payment equaling only 70 percent of general creditors' claims had been made on April 30th, just six banks would have faced a loss greater than their own capital and only 22 banks would have incurred losses between 50 and 100 percent of their capital. If a final settlement payment of 90 percent had been made -- which is more likely -- there would have been no banks with losses greater than capital and only 2 banks with losses between 50 and 100 percent of their capital.

Clearly, under the final-settlement-payment procedures, correspondent banks are not fully protected. And in our judgment they should not be. Monitoring by other commercial banks is regarded as one of the most important sources of risk-constraining market discipline.

CONCLUSION

Mr. Chairman, we must reform our deposit insurance system. The key is to eliminate the too-big-to-fail doctrine -- without dealing with this critical element, other changes will do little, or indeed will be counterproductive.

The legislative landscape ahead for major financial services reform will not be easy to traverse. But the current situation is untenable. The banking industry simply cannot continue to function effectively with an overly expensive, unfair, and ultimately unworkable deposit insurance system; with a growing body of regulations which impose increasing burdens on the banking industry -- burdens which are not borne by competitors offering virtually identical products; and with a legal structure that bears no rational resemblance to the realities of today's marketplace for financial services. Comprehensive reform is needed to deal with these critical issues.

EXHIBIT 1

FINAL-SETTLEMENT-PAYMENT (FSP) PROCEDURE

- Using an average receivership loss rate causes receivership losses to be shared between the FDIC and the general creditors
- The FDIC's receivership losses are no greater than they would be if all insolvencies were handled as insured deposit payoffs

THREE BANK RECEIVERSHIPS

Insolvent Bank	A	B	C	Average
Total Assets	$10000	$10000	$10000	$10000
Insured Deposits	8500	8500	8500	8500
General Creditors*	1500	1500	1500	1500
Capital	0	0	0	0
Receivership Loss	$500	$1000	$1500	$1000
Loss Receivership Loss	5%	10%	15%	
Average Receivership Loss				10%

P&A TRANSACTION (Protects general creditors. FDIC absorbs full loss.)

FDIC Loss	$500	$1000	$1500	$1000
Gen Crdts Loss**	0	0	0	0

DEPOSIT PAYOFF TRANSACTION (General creditors not protected. FDIC shares loss)

FDIC lOSS	$425	$ 850	$1275	$ 850
Gen Crdts Loss**	75	150	225	150

FSP TRANSACTION (General creditors not protected. FDIC shares loss.)

FDIC Loss	$350 (-75)	$ 850 (0)	$1350 (+75)	$ 850
Gen Crdts Loss**	150 (+75)	150 (0)	150 (-75)	150

(Amounts in parentheses are amounts relative to a deposit payoff transaction.)

* General creditors include uninsured depositors and unsecured creditors.
** Receivership losses incurred by the general creditors.

A RESPONSE TO THE CONCERNS ABOUT THE FINAL SETTLEMENT PAYMENT APPROACH

American Bankers Association
Washington, D.C.

A RESPONSE TO THE CONCERNS ABOUT THE FINAL SETTLEMENT PAYMENT APPROACH

INTRODUCTION

There is a consensus that deposit insurance reform must be an integral part of the overall restructuring of the financial services industry. Because of the importance of deposit insurance reform issues to its membership, the American Bankers Association (ABA) in 1989 convened a committee of 19 bankers from across the country, representing banks of various sizes operating in all types of banking markets, to study the issue and recommend needed changes. Over an extended period the Deposit Insurance Reform Committee studied the issues, heard from expert witnesses, and hammered out a program for reform to enhance the financial strength of the deposit insurance funds and enhance outside pressures on banks to manage their risks with care. Details of this program were released in March, 1990.

The key policy question is deceptively simple -- who is insured? Over the past decade, the FDIC's answer has been that all depositors are covered -- especially depositors in large banks. There have been few exceptions to this policy of *de facto* 100 percent deposit insurance, and the exceptions have all been small banks. The protection of all deposit obligations -- especially in large banks -- is sometimes called the "too-big-to-fail" policy.

The implications of the FDIC's ad hoc policy of 100 percent coverage are only now becoming clear. On the surface, it would seem that covering all depositors would be a stabilizing influence by preventing possible disruptions in deposit markets. In reality, 100 percent deposit insurance has significant adverse long-term consequences for the industry and the economy.

Protection of all deposits, whether or not they are legally entitled to insurance, creates an enormous and unnecessary liability for the FDIC and ultimately for the taxpayer. It also undermines incentives of large depositors to evaluate and monitor the financial condition of the banks in which they place their funds. The result is to encourage funds to flow to the highest bidder, regardless of risk. Thus, in a *de facto* 100 percent deposit insurance world, the deposit insurance funds are burdened with costs they were never intended to bear while the entire burden of detecting and controlling excessive risk-taking tends to be shifted to the supervisory agencies. In today's complex and fast-paced financial world, this is a Herculean task. It will require a massive increase in resources devoted to regulation, place a huge regulatory burden on the industry, and probably not achieve the desired results.

In sum, *de facto* 100 percent deposit insurance is unnecessarily risky and prohibitively expensive.

Many proposals for deposit insurance reform under discussion today attempt to "fix" the system without changing the current case resolution policy of the FDIC that results in complete protection of uninsured deposits. Some of the proposals, such as risk-based premiums and limitations on the number of insured accounts, will do little or nothing to improve the system or reduce the exposure of the BIF if we continue with *de facto* 100 percent coverage of all deposits. Other proposals, such as significantly increased capital requirements and limitations on activities (or proliferation of firewalls), may actually increase systemic risk rather than reduce it.

True deposit insurance reform must address the fundamental problem with the current system -- we simply cannot afford to continue to guarantee all deposits. We must move away from 100 percent deposit insurance and eliminate the too-big-to-fail policy. For this reason, the ABA's Deposit Insurance Reform Committee recommended a deposit insurance system that places uninsured depositors in all banks at risk of loss in the event of insolvency.

The deposit insurance system must strengthen incentives of investors with substantial resources to exercise care when placing funds in a depository institution -- just as they would with any other investment. As large depositors make more careful assessments of their exposure to loss, poorly managed institutions will be forced to pay higher interest rates to attract funds, thus limiting their ability to grow. Over time, an increasing share of the banking business will be channelled to well-managed, sound institutions. As a result, there will be fewer bank failures, and less strain on the deposit insurance fund.

Equally important, the entire job of monitoring and controlling the risk-taking of individual institutions will not be thrown in the lap of the regulators. Tapping the resources of the private market to assist in the assessment of a bank's financial condition not only broadens the monitoring system, it also means that fewer scarce resources need to be employed to do the job.

Moving to a system in which uninsured depositors are truly at risk raises operational and transitional questions, a matter that was considered with care by the ABA's Deposit Insurance Reform Committee. The principal operational problem stems from the current lack of a framework for handling a large bank insolvency. The ABA has developed a plan that will enable the regulators to handle the insolvency of any bank -- large or small -- without undue disruption to the system. This plan would call for uninsured depositors to receive access to most of their balances with no loss of liquidity, while at the same time sharing in the losses of the FDIC in an amount determined by the insurance agency's historical experience.

The problem of transition to the new system can be handled by establishing a credible program and announcing it well in advance of its effective date. This will give investors in uninsured deposits time to assess the financial condition of their depository institutions and to take whatever steps they may feel are appropriate to minimize their exposure to loss. It will also give banks the time needed to adjust their own operations to a new system in which they will be subjected to intensified competition and discipline in the markets for deposits.

The ABA proposal has received a great deal of attention since it was set forth in the March 1990 report. Much of the commentary has been favorable, but as could be expected, concerns have been raised about the desirability of undertaking such a fundamental change. The issues raised can be grouped into three general categories: (1) the possibility of undesirable side effects if uninsured depositors are truly at risk; (2) whether operational hurdles of eliminating too-big-to-fail can be overcome; and (3) potential constitutional problems with the ABA program. These issues are examined in some detail in the remainder of this paper.

The most thorough review of the ABA recommendation to require large depositors to share in the FDIC's risk was set forth by the FDIC itself, in a document published last summer. The FDIC's comments are typical of the array of arguments raised in opposition to doing away with the too-big-to-fail policy and requiring uninsured depositors to shoulder the risks now routinely absorbed by the FDIC. It will therefore be used as a basis for a response throughout much of this paper.

MARKET DISCIPLINE

Introduction

The case for market discipline by depositors is based on a simple idea: individual depository institutions should be subjected to the same kind of policing that banks and other creditors apply to those to whom they lend money. Many uninsured depositors already evaluate the condition of their banks with care. But others, comforted by the perception of total protection of uninsured deposits at large banks, devote too little attention to bank soundness. As the current policy of 100 percent protection becomes increasingly embedded in the minds of investors -- as is happening, no doubt, following the full protection afforded to depositors in the Bank of New England -- it will systematically erode the incentives of investors in large deposits to choose their banks with an eye to the risks they run, at least if the banks are large.

By undermining incentives for large depositors to evaluate and monitor the financial condition of the banks in which they place their fund, 100 percent deposit insurance places the entire burden of detecting and controlling excessive risk-taking on the supervisory agencies. Given the inherent shortcomings of regulatory discipline, it would be a mistake to assume that the problems arising from full protection of uninsured deposits can be mitigated by still more regulation. It is essential to recognize the limitations of both the regulatory system and the system of deposit insurance, and to search for feasible opportunities to decrease the strains put upon both. Increasing incentives for holders of large deposits to assess the soundness of the banks in which they place their funds presents just such an opportunity.

The heart of the ABA proposal for reform is the requirement that uninsured depositors share in the FDIC's losses when their banks fail. With a heightened awareness of their exposure to loss, these depositors will be inclined to choose their banks more carefully, either by shifting funds out of less well-managed banks or by demanding premium interest rates from them to compensate for their added risk. The increased cost that risky institutions would have to pay for deposits will provide them with a powerful inducement to get their houses in order.

Of equal importance, institutions considered by the market to be in sound financial condition and prudently managed will, over time, be able to expand their shares of the banking business, bringing more of the risks that must be managed into competent hands. This will help contain the need for regulatory intervention.

A Response to Concerns About the ABA Approach

In deliberating on its recommendations for reform, the ABA considered with care the concerns that are normally raised about proposals for ending the FDIC's too-big-to-fail policy. Not surprisingly, these concerns have surfaced in discussions of the ABA proposal, and it is useful to take a fresh look at them.

In its critique of the ABA plan, the FDIC did not defend the current practice of providing 100 percent guarantees to uninsured depositors, nor did it attempt to counter criticisms that such a policy has serious long-term consequences. It did, however, express reservations about any plan that would require investors of large deposits to share in the loses of the FDIC.

Summarizing its concerns, the FDIC stated:

> Dependance on depositor discipline to relieve the burden on the insurer can create undesirable side effects. These include: 1) an increase in systemic instability; 2) a loss of flexibility in limiting the economic damage of a major bank failure and 3) a competitive disadvantage for the U.S. economy. In addition, 4) it is unclear that the bank deposit market is well suited to imposing discipline on banks.

Each of these FDIC arguments concerning market discipline will be considered below.

Systemic Instability

The first potential undesirable side effect of market discipline cited by the FDIC is the threat of bank runs. The agency states:

> ...any time that the solvency of a bank is questioned, uninsured depositors can be expected to run. [This]... could cause an otherwise viable bank to collapse because bank assets are illiquid.

In a different section of its critique, the FDIC raised a warning that financial problems at one bank may lead to runs on other banks that are similar in outward respects but otherwise in healthy condition. The two points are closely related. Together, they constitute the very heart of the traditional view of Federal bank regulators that a too-big-to-fail policy is necessary and justified. But in its review of ABA's recommendations, the FDIC pays little attention to the enormous costs of providing total protection to all depositors, no matter how large. It is not appropriate to assess current policy as if these costs did not exist, or were not significant.

The most obvious cost of *de facto* 100 percent protection is the drain on the FDIC's financial resources from protecting uninsured deposits.

The other serious cost of using the deposit insurance system to extend protection to uninsured deposits is the destruction of incentives of investors in large deposits to choose banks with an eye to soundness. Protection of uninsured deposits actually provides support to banks that may need to be reined in.

Both types of costs are immensely important, and both figured importantly in shaping the ABA's recommendations for reform. But they were given little attention in the FDIC critique.

Moreover, the ABA recommendations take into account alternative mechanisms for dealing with bank runs, whereas the FDIC critique appears to assume that there are no such alternatives. When a run occurs, deposits withdrawn from a bank or banks would generally be moved, directly or indirectly, to other banks, rather than being transformed into currency hoards. The market for interbank loans provides a vehicle for banks experiencing deposit inflows to put the funds to work in loans to solvent banks losing deposits. The interbank market is highly developed, redistributing billions of dollars every day.

Of course, bank runs are most likely to take place in times of great uncertainty, and it is not certain that banks gaining deposits would be willing to lend to those losing them. But banks unable to replace deposits through the interbank market could and would turn to the Federal Reserve discount window, which is designed precisely for the purpose of providing liquidity to institutions that are unable to manage outflows of funds. Thus, runs by uninsured depositors and unsecured creditors might require decisive action by the Federal Reserve, but they would not endanger the banking system.

In addition, it is possible, though not likely, that holders of large deposits would withdraw completely their funds from the banking system, rather than moving them from one bank to another. In this case it would be necessary for the Federal Reserve to use open market operations to offset any adverse effect on bank reserves.

This is not to say that dealing with a major run, presumably resulting from a shock to confidence, would be easy. It is, as it always has been, important to maintain mechanisms for dealing with systemic disturbances. But it is even more essential to avoid policies that create the conditions conducive to panic -- mismanagement of risk, growth of unsound banks, and misplaced faith in the effectiveness of bank regulation. One of the greatest potential virtues of increased market discipline is that it would help prevent systemic breakdowns by encouraging prudent management of risk. Current FDIC policy works in the opposite direction because it assures even the largest depositors that they are not a risk of loss -- at least if they place their money in a large bank -- no matter how unsound that bank might be.

Regulatory Flexibility

The FDIC argues that it must have the ability to decide on a case-by-case basis whether to protect uninsured depositors from loss in bank failures. The idea is that such losses could result in unacceptable economic disruption, particularly if the failed bank is large and has very substantial uninsured deposit liabilities.

There are two reasons why the losses of uninsured depositors might lead to disruptions. The first is impaired liquidity and the second is loss of wealth. The ABA proposal provides for immediate restoration of liquidity after uninsured deposits have been written down by the loss ratio determined from FDIC experience. Historically, the losses taken by the FDIC (on a discounted present value basis) have averaged about 12 cents per dollar. Thus, under the ABA approach, uninsured depositors would have *immediate* access to about 88 cents for each dollar of uninsured funds. This protection of liquidity would help to minimize the potential for any disruptions.

The write-down is the important difference between the ABA proposal and the customary resolution of most bank failures. Under current policy, the FDIC sells the failed institution to an acquirer unless a buyer cannot be found. The same can be done under the ABA plan. In this case, however, the FDIC would transfer to the purchasing bank 100 percent of the insured accounts plus the written-down portion of the uninsured accounts.

There remains the potential threat that losses of wealth from the write-down of uninsured deposits could lead to severe economic dislocations. This is no different from the possibility that losses by investors from *any* source might lead to unacceptable disruptions. The first thing to note is that such losses generally do not lead to disasters. The second is that if losses to any group of investors or sector of the economy poses the threat of unacceptable spillover effects, government programs can be shaped to deal with them. The ABA proposal, however, would end the automatic treatment of any and every failure of a major bank *as if it did portend disaster*, and prevent the use of funds accumulated for the purpose of protecting small depositors from being dissipated in the name of too-big-to-fail.

The fact, of course, is that the FDIC is inflexible in its treatment of uninsured deposits when a sizeable bank fails. The automatic invocation of the too-big-to-fail policy represents a systematic misuse of financial resources intended for a different purpose, and encourages large investors to place their deposit balances with too little regard for risk.

The ABA proposal presents a way out of this predicament. It provides for protection of liquidity, thereby helping to minimizing the probability that losses taken by uninsured depositors will have serious repercussions. It eliminates bias against small banks and those who hold uninsured deposits issued by them. And it husbands market discipline, rather than discouraging it.

Competitive Disadvantage for U.S. Banks

The third adverse side effect raised by the FDIC concerns the competitive position of U.S. banks in international markets. The FDIC's concern is that if investors in uninsured deposits are required to share in the losses that would result if their banks failed, U.S. banks will be regarded as inferior risks, and uninsured depositors would shift their funds to banks whose countries were believed to provide "more government support."

In shaping its recommendations for deposit insurance reform, the ABA Deposit Insurance Reform Committee considered this question very carefully. While the ABA agrees that there is reason to be concerned about unequal treatment of banks from different countries that compete the same markets, we cannot accept the FDIC argument that it "would be imprudent to institute mandatory haircut proposals before international agreements are reached." It is important, of course, to participate in international efforts to improve bank regulation, and the ABA and its members stand ready to do so. The prudent course, however, is to move ahead with meaningful reforms of a deposit insurance system badly out of step with the times.

The Suitability of Bank Deposit Markets to Impose Discipline on Banks

Bank regulators tend to dismiss the idea that investors in uninsured deposits are capable of making useful judgments as to the safety of individual banks. The FDIC, in its critique of the ABA plan, sets forth three reservations about the suitability of uninsured deposit markets to play a role in policing the institutions that use them to raise funds.

First, the FDIC argues that depositor discipline cannot be effective because bank stock prices have more informational content than deposit interest rates. The reasoning is that stocks can be sold short, and there are even options markets for some stocks of banks. By way of contrast, says FDIC, "only one position [long] can be taken in a bank's certificates of deposit." From this observation the agency jumps to the conclusion that:

> A financial agent who believes that a bank has begun to pursue riskier or ill advised policies cannot affect the market for the bank's certificates.

This statement is startling and incorrect. Many investors in uninsured deposits exercise care in choosing where they put their funds. If substantial numbers of these investors believe "that the bank has begun to pursue riskier or ill advised activities" the bank will soon find out, unless the investors are confident that whatever happens to the bank they will be protected. Investors in uninsured deposits who have no interest in taking either short or long positions in a bank's equity, or in related options, can exert very powerful influences on the way risk is managed simply by placing a premium on safety. In fact, because investors in uninsured deposits focus on the risk of negative outcomes, their evaluations are particularly well suited to encouraging prudent management at banks. Moreover, private markets are well-suited to putting new information into action with minimum delay. As individual investors revise their evaluations, the amounts they are willing to invest, and the terms on which they will do so, banks are likely to change their risk-taking behavior very quickly.

Second, the FDIC argues that while analysis performed by private investors and those who advise them, including rating agencies, may offer some insight into a bank's current performance," private sector analysis based on publicly-available financial statement information "does not indicate much about a bank's prospects." In particular, the FDIC holds, analysis of a bank's loan portfolio probably cannot be "performed by agents other than bank examiners."

Examiners are, to be sure, in an advantaged position to judge the quality of individual loans, although there have been instances when the private sector was ahead of the bank examination force in spotting and acting on trouble. It is most certainly not true, however, that examiners are the only competent judges of management, liquidity, capital adequacy, or the economic environment -- all factors that are important in determining the future prospects of any bank. The private markets make these assessments all the time, for all types of creditors. The diversity of viewpoints and flexibility to recognize and correct errors that characterize private judgments are not features one would cite in a list of the virtues of bank supervision. The correct conclusion is not that market discipline is likely to be ineffective, but that it is capable of providing an immensely valuable complement to regulatory oversight as exercised by the banking agencies.

Third, the FDIC points out "there are limits" to the value of information supplied by rating firms, and that "private analysis is not a substitute for the information reflected in a market-generated price in which each analyst takes a monetary position." But advisory services are not used as substitutes for market prices. The volume of publicly-available information about banks is enormous, and for some investors, the way this information is interpreted and distilled by third-party analysts contributes to its usefulness. Ratings and other evaluations are used by investors to make more informed judgments, and these judgments determine the cost and availability of funds to banks that issue uninsured deposits.

Moreover, private analysts do have a major "monetary interest" in the evaluations of a banking company. Rating firms gain business when they do their work well. Brokerage firms provide analyses of industries and firms in them not as a courtesy, but as a way to improve the value of their services. These third-party analyses contribute significantly to the market's understanding and assessment of investment risks.

Market Discipline is a Significant Force in Reducing Systemic Risk

Holders of uninsured deposits tend to look for the same things in a depository institution that are important to regulators: good risk management, sound capital and adequate liquidity. That is why rewards and penalties doled out by discriminating investors in uninsured deposits help channel funds to banks that are best equipped to perform the intermediation function with appropriate attention to risk.

Examples of steps taken by prudent investors in uninsured deposits include the following:

> Investors evaluate the credit quality of issuing banks using a variety of information, including condition and income reports filed with the regulatory agencies, financial reports of bank holding companies, and in some cases direct contact with issuing banks.
>
> There is a substantial and profitable market for ratings of the safety of banks and the credit quality of their deposits. A number of advisory services and rating firms offer opinions in a nationwide and even international market for advice. Some of these firms specialize in larger banks, but others will provide information and advice on the financial condition of any bank in the country. Investors use such information to determine which banks' deposits they might buy, and to establish lines, or maximum investments, for each of the banks selected. It would not be possible for these firms to prosper as they do unless their clients placed substantial value on the opinions and information they offer.
>
> Managers of large blocks of deposit funds typically diversify their holdings among a number of banks on their approved lists. Diversification is a common practice by investors who seek to limit concentrations of exposure to loss.
>
> Distinctions among issuers typically sharpens during periods of financial stress, and "tiering" of rates develops. This is a typical phenomenon in other markets where risk is a factor in investment decisions. As rate differentials widen, banks singled out by the market for penalty rates have strong incentives to pull back.

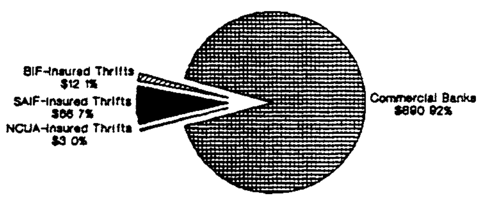
Some investors in large time deposits are quite confident that their deposits would be fully protected even if the bank that issued them failed, at least if the bank was very large. Others may be careless, which is true in any financial market. But even in the face of the disincentives created by FDIC's 100 percent protection policies, many investors in large time deposits continue to choose their banks with care. In fact, these investors exhibit the same risk-aversion as buyers of, say, commercial paper issued by finance companies and other business firms.

Market discipline, like regulatory discipline, is neither perfect nor painless. There are times when the markets for large time deposits close down for banks that appear to be in trouble. The affected banks must scale back or turn to other sources of funds, including the Fed funds market and if necessary the Federal Reserve discount window. Sometimes the alarms are false, and in these cases the difficulties pass; there is no recent record of any bank that was in sound condition being ruined by a loss of uninsured deposits. Where passage of time reveals that the affected banks are in fact deeply troubled, they may find their access to uninsured deposits and other non-guaranteed liabilities dries up.

The Size and Breadth of the Market for Uninsured Deposits Assure Broad-Based, Consensus Messages

The uninsured deposit market is well positioned to exert a restraining influence on banks that rely on it. At the end of 1989, U.S. banks and thrifts had nearly $1 trillion of uninsured deposit liabilities (see Chart 1). This was nearly one-third of all deposits. All types and sizes of depository institutions issue uninsured deposits, and significant amounts of these deposits are held by every major sector of the domestic economy as well as a variety of foreign investors (see Chart 2). The large number of uninsured deposit accounts -- well over 2 million at BIF-insured institutions alone -- is important because it assures a decentralized market that brings together evaluations made by numerous individual investors. This decentralized evaluation system nicely complements the authoritative, but ponderous, process of government regulation.

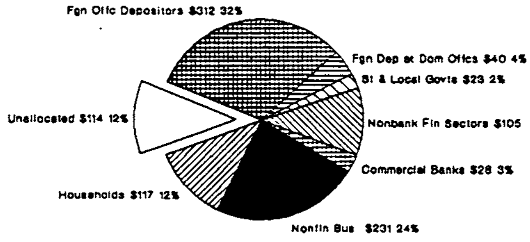
Chart 1. Estimated Uninsured Deposits by Issuer, 12/31/89
Dollar amounts in billions



Sources: Estimated from FDIC, Federal Reserve, Office of Thrift Supervision and National Credit Union Administration

The variety of types of investors is important as well (see Chart 2). It means that the disciplines exerted by uninsured depositors reflect a broad cross-section of viewpoints and approaches toward assessing and managing risk-taking. Every major sector of the domestic economy -- nonfinancial business, households, financial firms and state and local governments -- has major investments in uninsured deposits. And customers of foreign branches of U.S. banks, primarily other banks, business firms and governmental entities, held more than $300 billion, or almost a third of total uninsured deposits, at the end of 1989.

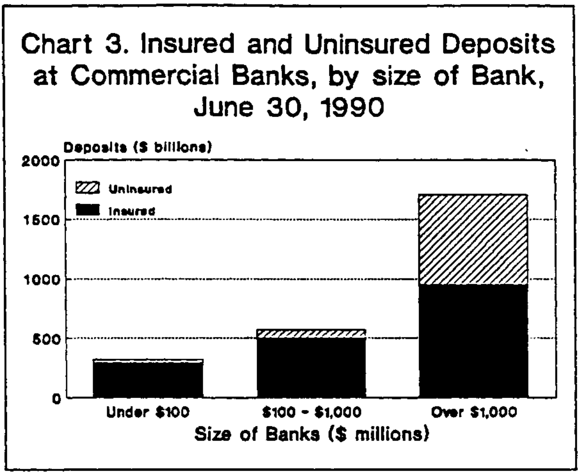
Chart 2. Estimated Uninsured Deposits by Type of Holder, 12/31/89
Dollar amounts in billions



Estimated using Federal Reserve and FDIC data

The greatest potential effects of market discipline relate to large commercial banks. Estimates based on data from the regulatory agencies indicate that commercial banks accounted for more than 90 percent of the $971 billion total uninsured deposits at U.S. financial institutions at the end of 1989 (see Chart 1). And banks with assets of more than $1 billion accounted for over 85 percent of the commercial bank total (see Chart 3).

Most uninsured deposits are in the form of large (over $100,000) time deposits. While uninsured deposits are held for a variety of reasons, it is important to note that large-denomination short-term CDs compete directly with both commercial paper and Treasury bills, and longer-dated large time deposits with a large array of private and public debt issues.



Conclusion

There are only two choices: a world where uninsured depositors are fully protected or a world where they are not. We can no longer afford the luxury of too-big-to-fail policies. They burden the deposit insurance system with unnecessary costs that were never intended and thrust the entire burden of detecting and controlling excessive risk-taking on the supervisory agencies. Market discipline, on the other hand, strengthens incentives of investors with substantial resources to exercise care when placing funds in a depository institution just as they would with any other investment. Money will flow, overtime, to well-managed, sound institutions thereby resulting in fewer bank failures and less strain on the deposit insurance fund.

OPERATIONAL CONSIDERATIONS

Introduction

The ABA proposal to do away with full protection of uninsured deposits raises two important questions of an operational nature. The first is whether it is technically feasible, at least in the case of a large bank failure, to determine rapidly which deposits are uninsured, and therefore not entitled to full protection. The second question is whether imposing losses on uninsured depositors might disrupt the operation of the payments system so seriously as to cause severe economic dislocations.

Both questions were raised in the FDIC critique of the ABA's proposal. While the FDIC does not contend that operational problems are necessarily insurmountable, neither does it conclude that they are manageable. It is, therefore, important to address the concerns the FDIC has raised.

The ABA's Deposit Insurance Reform Committee considered both the need to be able to quickly determine which deposits in a failed bank are not insured and whether the imposition of losses on large depositors would seriously upset the payments mechanism. It concluded that the first potential problem is manageable as long as every depositor is entitled to separate protection at each institution with which he banks. With respect to protecting the payments mechanism, the Committee worked carefully to fashion its proposal in a manner that would limit the loss of liquidity experienced by holders of uninsured balances in failed banks and would enable them to know in advance the proportionate losses they would face in the case of a failure.

This section considers both matters in some detail.

Determining Deposit Insurance Coverage

Determining which deposits are insured and which are not can pose important challenges. Record keeping systems in place today in many banks, especially smaller ones where uninsured deposits are relatively unimportant, might require little change. For many or most larger banks, where the numbers and sizes of accounts tend to be larger, and the proportion of uninsured deposits to total deposits tends to be higher, substantial modifications might be required.

There is no doubt that existing technology makes it feasible to keep records in a manner consistent with identification of uninsured deposits in a timely manner. But if existing systems require substantial modification, it would take time to develop and implement the needed changes. This should not pose a substantial problem, for in any event it would be necessary to give ample advance notice of a reform of current too-big-to-fail policies of the FDIC in order to permit depository institutions and their customers to make portfolio and other changes called for by the new system.

It is important to understand that the current configuration of bank record keeping and reporting is, in part, a result of the FDIC's policy of *de facto* 100 percent insurance of all deposits. Since uninsured deposits are fully protected, it is not necessary to have detailed knowledge of the insurance status of individual accounts. It is interesting to note that more than five years ago the FDIC hired an outside consulting firm to examine the possibility of effecting transfers or payoffs of insured deposits in connection with large bank failures. The general conclusions of the first phase of the study suggested that systems could be developed to handle very large bank failures, particularly if modest record keeping requirements were imposed on banks. The FDIC decided not to have such systems developed because they were not likely to be used, not because they could not be developed or would not work. Had the FDIC followed up five years ago, the state of bank record keeping and reporting as it relates to identification of insured accounts would be different today.

Once there is agreement to go ahead with the ABA proposal, technical expertise from the banking industry, the banking agencies and elsewhere can be brought to bear on development of appropriate systems and reporting requirements to implement the proposal.

To its credit, the FDIC has recently developed a system that apparently has the capability of determining insurance coverage very quickly for banks whose deposit records are in satisfactory condition, without imposing record-keeping requirements on those banks. While the FDIC has not made use of such a system in connection with any very large bank deposit transfer or payoff (there have not been any), the FDIC staff indicate that their system could handle a very large bank failure if records are in satisfactory condition. If the FDIC's newly-developed system is not sufficient, then the way banks keep deposit records will have to be modified. There is no question in the mind of the ABA that such modifications are practicable.

The discussion below suggests how certain operational problems related to the ABA proposal can be resolved. This is not to say that better systems could not be developed. Rather, the intent is to suggest that potential problems are quite manageable and resolving them is not all that complex.

Balance Aggregation

It is easy to spot some uninsured deposits using ordinary bank records, since in no case are balances in accounts of more than $100,000 insured. But other uninsured deposits are held in accounts with balances under $100,000.

If a depositor holds more than one account in any given capacity, limiting insurance protection to $100,000 may require aggregating all balances held in that capacity at the failed institution. For example, a depositor might hold $30,000 in a NOW account and $80,000 in a time deposit at the same bank, for a total of $110,000. Only $100,000, however, is insured. On the remaining $10,000, the depositor would be subject to loss.

In addition, depositors who hold accounts in different capacities (e.g. accounts held jointly with others, and IRA and Keogh accounts) are entitled to separate coverage for each eligible capacity. Aggregation of accounts must recognize this fact.

Under the ABA plan, aggregate balances held in each eligible capacity exceeding $100,000 would be written down by a percentage based upon the average historical recovery in all failed banks. Thus, depositors would receive 100 percent of balances up to $100,000 and a final settlement payment (FSP) for the percentage applied on the uninsured portion. In the example above, the depositor with $110,000 would stand to lose $1,500 if the FSP on the uninsured portion ($10,000) was 15 percent. This method of payment could be accomplished in any type of failure resolution.

The account information required to determine the amount of uninsured balances held by a depositor with more than one account or in different rights and capacities would be as follows:

- Name(s) and Social Security or Taxpayer Identification Number(s) of account owner(s);

- The capacity in which the account is held;

- For accounts held by an executor or administrator, the identity of the decedent;

- For corporate, partnership or association accounts, the identities and percentage ownership of each party to the account;

- For joint accounts, (1) the identities of each participant; (2) the percentage ownership of each, (to make things easier it could be assumed that in the absence of specific designations on file with the issuing bank, the percentage ownership shares are equal for all parties on the account); (3) proof that each owner has executed a signature card and has equal withdrawal powers;

- For trust accounts (including IRAs and Keoghs): (1) the identity of the grantor; (2) the identity of the beneficiary; (3) if the account is a qualified pension or profit-sharing plan; (4) the type of account (time or savings or demand deposit);

- For custodial accounts, the identity of the ward or minor;

- Whether the account is managed by a "deposit broker;" and

- The account balances at close of business.

Resolution of Errors

As long as a depositor does not have aggregate balances of more than $100,000 in a failed bank, there is little potential for error. But potential for error does arise if accounts are held in different capacities, since balances held in different capacities could be mistakenly aggregated and losses improperly imposed where the total exceeds $100,000.

The incidence of errors due to mistaken aggregations is likely to be small in relation to a bank's total deposits, even without any change in record keeping requirements. First, most individuals do not have deposit balances of more than $100,000, even when all accounts held in all capacities are aggregated. Federal Reserve survey data collected in the mid 1980s indicated that 98 percent of households had combined deposits of less than $40,000, with the average around $3,000. A 1985 FDIC survey of all deposit accounts in several large banks indicated that fewer than two percent of deposit accounts (including non-personal accounts) had balances in excess of $20,000. Such smaller accounts are, of course, fully insured and would not be affected by the final settlement payment for uninsured deposits contemplated in the ABA proposal.

Furthermore, since uninsured balances are credited with a final settlement payment, any dispute over insurance coverage would involve only a small fraction of the balance involved (the write-down would be about 12 percent of the uninsured portion based on the average historical loss in bank failures). For example, if two $100,000 accounts held in different capacities were mistakenly aggregated, the depositor would be short-changed by about $12,000. This error would be unlikely to cause serious disruptions, particularly if one or both of the accounts were non-transaction accounts, as would be the case with IRAs, Keoghs, or certain other types of trust accounts.

Where errors or omissions did occur, they could be rectified later. Post-transaction adjustments are a common FDIC practice in current deposit transfers and payoffs.

Of course, the best policy is to minimize the number of mistaken write-downs of insured deposits. This might require that record-keeping systems be established to permit enhanced ability to cross-reference accounts and special coding to identify account capacities. Many banks already have the capacity to cross reference accounts based on names, addresses, social security numbers, or tax identification numbers. This is done partly to meet different tax and reporting requirements for interest earning accounts. For example, under current law, social security or tax identification numbers must be referenced on interest-bearing accounts if the depositor is to avoid withholding by the bank. In addition, some banks cross-reference different accounts held by the same depositor for internal monitoring of account relationships, marketing activities, profitability analysis, and to provide customers with useful account summaries.

To handle problems raised by depositors who do not provide social security or tax identification numbers, it could be required that such information be provided by depositors to banks as a condition of deposit insurance coverage.

Reconciliation of legitimate disputes over insurance coverage could take place after the initial final settlement payment. To minimize potential confusion, it might be appropriate to require that large banks with substantial uninsured deposits periodically provide information to larger depositors on their level of insurance coverage. That way, depositors would better understand the system and have an opportunity to correct errors. This likely would be preferable to "trial runs" of the reporting system as some have suggested.

Timeliness of Account Information

A second requirement for successful implementation of the ABA final settlement payment approach is that it be possible to generate account balance information needed to determine which deposits are not insured with little delay after a bank has failed. Because account balances are updated daily, this will be possible as long as aggregation routines have been established in advance.

A related question, raised by the FDIC in its critique of the ABA plan, is the feasibility of a next-day opening of a failed bank. Obviously, the more time available, the less difficult the account reconciliation. Closing the failed bank at the end of the day on a Friday -- as is common practice -- allows extra time over the weekend for account reconciliation. With appropriate systems and coding in place, account aggregation and final settlement payments could begin immediately following the posting of transactions for the previous day. Some of the necessary work related to account aggregation and determining where uninsured deposits are present could even be done before prior-day posting has been completed. The new bank would open following the weekend with no interruption. Thus, no adverse consequences would be likely.

Check Clearing

The final settlement payment procedure is likely to cause an increase in checks drawn against insufficient funds, since it involves writing down uninsured balances. Of course, most deposit accounts are fully insured and checks in process drawn on these accounts will be unaffected.

Equally important, banks deal with overdrafts every day, so that the dishonoring of checks following a bank failure occurs frequently even when uninsured depositors are fully protected. As would be expected, the FDIC has procedures for handling such transactions, and those receiving bad checks still have a claim on the check writers.

The increase in the volume of returned checks under the ABA reform proposal will be modest, especially if appropriate procedures for minimizing it are put in place. Where depositors have several accounts, losses on uninsured balances could be applied first to non-transaction accounts, perhaps starting with the longest maturity. That would minimize the impact on transaction accounts and keep down the volume of returned checks.

In summary, the increase in returned checks from adopting the reform proposed by ABA should be modest because (1) most depositors will continue to be fully insured; (2) losses on uninsured balances could first be applied to non-transaction balances where they are present; and (3) under the proposed final settlement payment arrangement, most uninsured deposit balances would continue to be available without interruption.

The FDIC's critique of the ABA proposal expressed concern about the violation of existing time limits on reversing payments in connection with checks written with insufficient funds. It is important not to overstate this potential difficulty. Today's rules and procedures have been fashioned to work in a system where deposits are fully protected, at least if they are held in large banks. A new system will require different procedures to be sure, but it makes little sense to judge the feasibility of a reform by questioning its workability with unchanged procedures. For example, adjustments can be made to existing rules on timely notification and minimum size cutoffs for such notification, and new procedures can be established. Rules might be established to protect third parties from loss due to overdrafts traceable to bank failures.

In sum, the procedures needed to make a reformed system work properly can be implemented. What is important is that the system gets the job done, makes sense for most users, is perceived to be fair, specifies in advance where "arbitrary" rules are to be put in place, and has appropriate procedures for dealing with conflicts with minimal litigation.

Correspondent Banking

The FDIC critique expresses concern that the insolvency of a large bank might impose losses on smaller banks that hold balances with it for check clearing. The critique also states that where regional economic problems are present, small banks might be subjected to repeated losses because they could not find a safe correspondent bank in their region. The market for correspondent services, including check clearing is, however, considerably less regional in scope than is suggested in the FDIC paper, and it is hard to imagine that there would not be sound correspondent banks available.

In addition, it is likely that institution of the ABA reform would hasten the trend toward substitution of explicit fees for implicit interest on correspondent balances, an attractive alternative for a bank that wishes to minimize potential losses on balances held with other banks. Of course, banks that are not satisfied with private sector alternatives would continue to have the option of relying more heavily on the Federal Reserve system for check clearing.

Lock Box Services

The FDIC paper expresses concern that exposing depositors at large banks to losses if their banks fail will cause profitable lock box services (collecting bill payments and providing quick access to funds, particularly for large retail-oriented corporations) to shift away from the banking sector. A major reason for this concern appears to be the FDIC's desire to protect and subsidize the lock box function, which it notes is a profitable one. But protecting profits is not a legitimate function of deposit insurance. Even in today's environment, where FDIC policy protects holders of uninsured deposits in large bank failures, larger corporations are likely to exercise care in choosing among banks that offer lock box services. The encouragement of such selectivity through a reform that requires holders of uninsured deposits to share in the FDIC's risk of loss from bank failures is entirely consistent with the development of improved market discipline.

Large Transactions

The report that presented the ABA proposal devoted considerable attention to issues related to large wire-transfer transactions. The report concluded that the two major wire transfer systems, CHIPS and Fedwire, would not be seriously vulnerable to the depositor and creditor losses contemplated in the proposal.

Wire transfer systems are constantly being improved. For example, since the ABA paper was competed, additional steps have been taken to control risk and prevent disruptions of wire transfer transactions. CHIPS has moved to a system of transaction finality, eliminating the possibility that complex unwinding of past transactions might be necessary.

The CHIPS system has also recently demonstrated how banks will act to limit exposure to another bank. When a large U.S. bank that was a member of CHIPS encountered serious difficulty last year, other members, following procedures that had been established to limit risk, dramatically reduced their exposures to that bank. This made it virtually impossible for the weakened bank to effect large transactions through CHIPS. The troubled bank withdrew from the system, a move that no doubt reduced its ability to retain large deposit balances. This indirectly provided support for the ABA position that the major clearing systems will be able to handle failures of large banks that are accompanied by depositor and general creditor losses.

The FDIC paper presents little criticism of ABA's position that the reform it proposes would not result in unacceptable payment system risk. It does, however, express a concern that exposure of one bank to losses occasioned by the failure of another may be compounded because of wire transfer relationships. It appears that this concern, if it had merit when the critique was written, is no longer relevant because of the new finality of payment rules adopted by CHIPS.

Conclusion

Operational problems related to implementation of the ABA proposal can be resolved. The problems are manageable and resolving them is not all that complex. Moreover, the cost of modifying existing or implementing new record-keeping systems -- while not inconsequential -- are likely to be far less than the cost burden of maintaining the current too-big-to-fail policies of the FDIC. Simply because current record-keeping systems may not be fully aligned with deposit insurance needs is no reason to maintain a costly too-big-to-fail system of coverage.

THE CONSTITUTIONALITY OF THE FINAL SETTLEMENT PAYMENT

Introduction

A central feature of the ABA approach is that, in any bank failure, uninsured depositors (domestic or foreign branch) and unsecured creditors would receive a single payment, based on the average recovery in all failed banks. This "final settlement payment" would dispose of the receivership interests of these general creditors and they would have no further claim on the failed bank or the FDIC.

The use of an "average" figure for calculating the amount due to uninsured depositors and unsecured creditors necessarily implies that some such claimants would receive less under the ABA approach than they would have received under current law and practice. With respect to these claimants, it has been suggested that Congressional enactment of the ABA proposal into law would result in a taking of private property for public use without just compensation, in violation of the Fifth Amendment and would, therefore, be unconstitutional.

Such concerns are without merit. The concept behind the ABA proposal is by no means unprecedented. There are many programs operating in a similar fashion in other contexts which have been upheld in court.

This section reviews the key issues in determining constitutionality of the ABA approach. This review summarizes the findings of two more extensive studies that detail the legal precedent for the Constitutionality of the Final Settlement Payment approach as presented by the American Bankers Association.[1]

The Fifth Amendment

The Fifth Amendment provides in part that:

> No person ... shall be deprived of property without due process of law nor shall private property be taken for public use without just compensation.

---

[1]Mary S. Binder, esq., *Federal Deposit Insurance Reform: Final Settlement Payment*. Law Department, The First National Bank of Chicago, August 10, 1990; and American Bankers Association, *Memorandum on the Constitutionality of the ABA Deposit Insurance Reform Proposal*, Office of the General Counsel, September, 1990.

Given that a bank deposit is property protected by the Fifth Amendment,[2] the final settlement payment statute (FSP) must satisfy the due process and "taking" provisions of the Fifth Amendment.

The issues of concern are:

(1) whether a statutory waiver ("Waiver") of deposit claims in excess of the FSP ("Excess Deposits") constitutes a deprivation of property without due process of law; and

(2) whether a Waiver results in a Fifth Amendment "taking" of property.

Economic Legislation and Due Process

Economic legislation is presumptively constitutional with respect to the Fifth Amendment. Since the FSP Statute would be economic legislation designed to allocate the risk of loss of uninsured deposits between the FDIC and depositors, it too would be presumptively constitutional.

The FSP statute will, therefore, withstand a Fifth Amendment challenge unless a claimant proves that such legislation is demonstrably arbitrary, unreasonable, or unfair. A statute will be held to be non-arbitrary if the statute bears a rational relationship to a legitimate legislative objective.[3] The FSP Statute would satisfy this since it can be assumed to enhance market discipline among FDIC insured banks and to allocate the risk of loss between FDIC and depositors in a rational manner.

It is also "reasonable" and "non-arbitrary" to spread a cost or loss among those who generally profit from a certain activity. If uninsured depositors were at risk, as they would be under the FSP plan, riskier banks would have to pay more to attract deposits. Those uninsured depositors would be benefiting from the market forces created by the FSP statute. Therefore, the FSP would be considered a rational means of allocating the risk of loss among those who attempted to profit from such risk.

---

[2]This is by no means obvious. Property can include vested rights such as those arising under a valid contract. In that context, a depositor has a vested right to obtain repayment in full of all deposits placed with an FDIC bank. On the other hand, it could be interpreted that unsecured creditors and depositors have only a "claim" against a bank. In this context, the deposit in not the "property" of the depositor; it is the property of the bank. In this context, the deposit is a debtor/creditor relationship, not a bailment.

[3]Whether it in fact accomplishes Congress's stated objective is not a question of constitutional dimension.

Besides being non-arbitrary and reasonable, due process also requires that a person be provided adequate notice and an opportunity to be heard before the ultimate disposition of one's property. Constitutionally adequate notice is usually provided by the publishing of the statute and affording those within the statute's reach a reasonable opportunity to familiarize themselves with the statute and to comply with its provisions. Since the FSP Statute would be adopted with a reasonably prospective effective date, depositors would have adequate notice.

The statute would also be structured so that depositors have an opportunity to be heard. Examples of situations where a depositor may desire a hearing include a challenge to the computational accuracy of the "recovery rate" used to determine one's FSP amount or a claim of unrecorded or mis-recorded uninsured deposits.

In summary with respect to due process, a waiver of Excess Deposits would probably be held to be a non-arbitrary, rational and reasonable means of achieving market discipline among FDIC banks and allocating losses among general creditors. Since the FSP Statute would have a prospective effective date, depositors would be presumed to know the law and will therefore be aware of the risk of loss of Excess Deposits. Given this, the FSP statute would not constitute a taking of property without due process of law.

"Taking" of Property Without Fair Compensation

Even if due process requirements were satisfied, the FSP Statute would be unconstitutional with respect to the Fifth Amendment if the loss of Excess Deposits was so confiscatory as to amount to a "taking" without fair compensation. Courts will consider:

- o whether the cost or loss imposed is reasonably and fairly calculated;
- o whether the FSP constitutes a reasonable means of allocating costs to those who enjoy a benefit; and
- o whether one could have avoided loss of property by one's own actions.

Moreover, a single determining factor in establishing whether a statute effects a taking of property is whether a person has a "reasonable expectation" that a property interest will be preserved.

The recovery rate used to establish the FSP would be a historical aggregate of the results of the liquidation of failed insured banks. Historical results have been upheld as a valid and reasonable basis on which to base current recoveries. Therefore, the recovery rate would probably be held to be a reasonable means of calculating the FSP.

It is also likely to be upheld that the FSP is a reasonable means of allocating costs to those who enjoy a benefit. In fact, there is no constitutional requirement that the method be perfect, the best, or even free from error.

Depositors enter into transactions voluntarily. Knowing that they are exposed to loss in the event that their bank fails they may choose to deal with a particular bank or not as they see fit. Thus, depositors control the actual risk of loss through the selection of an insured bank and could avoid altogether any loss by investing in instruments other than uninsured deposits. Since the loss of property could be avoided by one's own actions, the waiver of Excess Deposits would not constitute a "taking."

Moreover, the certainty and immediacy of the FSP might be a valuable benefit in an uncertain investment environment. Certainty of compensation is a benefit for which one may be compelled to bear some cost. This is similar to the seminal case of constitutionality of workmen's compensation statutes. Generally, these laws disallow litigation by employees against their employers for injuries incurred on the job, make it irrelevant that the employer was not at fault for any such injury, and compensates employees for such job-related injuries, typically through a state administrative agency -- which employers are obligated to fund. Without workers compensation laws, an injured worker might, in any given case, be able to recover more in damages as a result of litigation against his employer than he or she is allowed to recover under the workers compensation law. But by the same token, the worker is guaranteed a meaningful recovery of injuries suffered, even though in any given case the worker might otherwise lose a lawsuit against the employer. The FSP Statute involves the same trade-off: an mandated certainty of remedy as a sufficient substitute for a doubtful right. Thus, the FSP Statute would not constitute a taking of property.

If one could possess a reasonable expectation that uninsured deposits would be fully protected, it would constitute a Fifth Amendment taking. After the effective date of an FSP Statute, depositors *could not* possess a reasonable expectation that Excess Deposits would be recovered upon the failure of an insured bank. In the absence of FDIC or other government guarantees on which one could reasonably rely, such expectations would be inconsistent with the provisions of an FSP Statute, legislative policy, and the market rate of interest paid on uninsured deposits. A depositor could not avoid a loss even if he had been extremely diligent in placing his deposit since more than a unilateral expectation is required.

In summary with respect to a Fifth Amendment "taking," a waiver of Excess Deposits would not be confiscatory. The recovery rate based on historical information would be a reasonable basis for setting the FSP, depositors have certainty and prompt access to the FSP in the event of a bank failure, and depositors could avoid any loss whatsoever by choosing not to invest in uninsured deposits. Additionally, after the effective date, no depositor could possess a "reasonable expectation" to recover Excess Deposits upon a failure. Therefore, a waiver of Excess Deposits would not constitute a Fifth Amendment "taking" of property.

Conclusion

Finally, the conclusion is that the FSP Statute would not be unconstitutional on Fifth Amendment grounds since the condition of due process of law would be satisfied and the waiver of Excess Deposits would not be a "taking" of property.

4/29/91

Implications of "Too Big To Fail"
For The Safety of the Banking Industry
and the Protection of the Public

Statement by

George G. Kaufman
John F. Smith Jr., Professor of Finance and Economics
Loyola University of Chicago
and
Co-Chair, Shadow Financial Regulatory Committee

Before the

Subcommittee on Economic Stabilization
of the
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
Washington, D.C.
May 7, 1991

Mr. Chairman, I am happy to testify on the implications of continuing a "too big to fail" (TBTF) policy in banking on effective deposit insurance reform that would both strengthen the banking system and protect the taxpayer against sharing in the costs of bank failures. Too big to fail is the single biggest obstacle to achieving these objectives. Indeed, in light of the recent experience in the thrift industry, the taxpayer is not safe until TBTF is buried once and for all.

As presently employed, too big to fail is a policy of not asking private sector uninsured depositors to share in the losses of insolvent large banks. Instead, the losses are borne by the FDIC, paid for by the other banks, and if its resources are depleted, by the taxpayers as in the ongoing thrift debacle. This is significantly different than what happens in other industries. There losses beyond those that deplete a firm's shareholders' capital are borne totally by the firm's private creditors.

It has been amply demonstrated in recent years that losses at insolvent banks and S&Ls that are not resolved quickly can be very large and passed through to the taxpayers. As the American Bankers Association has correctly noted recently "As long as uninsured deposits continue to be covered, recapitalizing the FDIC through increased premiums [or anything else] will be like bailing out a boat with a hole in the bottom".[1] Resolution of TBTF is also required if any legislated insurance coverage limits are to be effective.[2] Moreover, as long as TBTF is continued, banks are likely to continue to operate with dangerously low capital ratios and excessively risky portfolios because of reduced depositor concern and manager/owner belief that delayed resolution will give them additional time to regain profitability

---

1. Hobart Rowen, "Lightening Strikes Twice," Washington Post National Weekly Edition, April 8-14, 1991, p. 5. Bracketed terms added by the author.

2. A recent report by the staff of the House Banking Committee concluded that:

> Only in rare instances will the FDIC reluctantly resolve an institution in a way that results in some of the uninsured deposits not receiving coverage. Any reforms which limit the scope and amount of deposit insurance coverage will be useless unless the resolution policies of the FDIC are corrected.

Staff, Committee on Banking, Finance and Urban Affairs, Regulatory Treatment of Uninsured Deposits in Failed Institutions, September 25, 1990 in Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, Deposit Insurance Reform, September 13, 19, 25 and 26, 1990, p. 337.

and retain the bank.

But TBTF does additional damage:

- o It is blatantly unfair to smaller banks whose larger depositors are put at greater risk. The Federal Reserve Bank of San Francisco has recently documented that of the 1,086 commercial bank failures in the 1980s, 225 involved losses to depositors. Of these banks, 210, or 93 percent, had deposits of less than 100 million.[3]

- o It creates uncertainty about which banks regulators will consider too big to fail at which times and thereby increase the cost of capital to the banking industry.

- o By increasing potential bank losses to the FDIC, it increases bank insurance premiums and thereby bank costs.

- o It encourages bank management to place growth above earnings in its objectives.

- o By permitting "bad" near insolvent and even insolvent "zombie" institutions to continue to operate, it increases the cost of living for "good" banks by bidding up deposit rates and undercutting loan rates. One need only recall the recent Texas and New England deposit premiums of more than 100 basis points.

- o Because the larger losses may require taxpayer assistance, it is accompanied by greater government intervention and regulation than otherwise.

Why, in light of all of these adverse implications, do most regulators support continued TBTF? There are a number of reasons:

---

3. Kenneth H. Bacon, "Banking-Reform Proposals Are Already Rattling The System and Making Credit Crunch Worse", Wall Street Journal, April 16, 1991, p. A16. These data also indicate that TBTF has been effectively broadened to cover most banks, at least in terms of the FDIC not having uninsured depositors share in its losses. The staff of the House Banking Committee found that in 1990 as of August 8, "the FDIC has resolved 110 of the 115 bank failures by way of a P&A sale, which has resulted in billions of dollars of uninsured deposits receiving insured treatment". Staff, p. 342.

- Pressure from the insolvent institutions - - shareholders, managers, employees, and larger borrowers, who prefer to delay repayment - - to delay resolution.
- Pressure from Congress responding to the same parties as above, who are important constituents.
- Fear of spillover of bank failures to other banks, the financial sector as a whole and the macroeconomy.
- Fear of a reduction in money and credit to the community.
- Fear of a breakdown in the payments system from defaults in clearing.
- Fear of receiving a public blackmark on their record for failing to maintain bank safety and fear that the public and Congress may shoot the messenger of bad news. Thus, regulators prefer to delay public recognition of failures in hope that conditions will reverse or, if not, that it occurs on their successors' watches.
- Fear of antagonizing future potential employers. Similar to the well publicized "revolving door" in the Defense Department, many employees of the bank regulatory agencies join banks and related firms after their tenure at the agency.
- Fear of loss of discretion, which enhances the visibility, power and "fun" of the regulatory job.

These justifications do not hold up to scrutiny. A primary purpose of creating "independent" bank regulatory agencies was to insulate them from industry and political pressures. Because TBTF permits regulatory discretion, it weakens this protection. The fears of spillover damage from not making all uninsured depositors whole are greatly exaggerated. Before the FDIC era, bank failures were relatively rare up to the 1920s and the cost to depositors small. Between 1865 and 1920, the bank failure rate was below that of nonbanks and the sharp increase in failures during the 1920s was almost entirely among the very smallest banks. Losses to depositors at insolvent institutions from 1865 through 1933 averaged on by 0.20 percent of total bank deposits annually and were less than 1.0 percent annually even in crisis years such as 1929-1933. A study published in 1931 reported that losses to depositors at insolvent banks only were less than losses suffered by bondholders of nonbank firms.[4] Such losses did not create serious harm then nor will they now.

Spillover or contagion to other firms occurs for all firms and products when losses or damage of any kind occur. Thus, all headache products are temporarily boycotted by Tylenol scares and all airlines by plane crashes. What differentiates bank contagion is that it may result in a nationwide multiple reduction in money and credit that would adversely affect both the financial condition of otherwise healthy banks in greatly different geographic and product areas and national business activity across-the-board. This is a scary prospect. But both theory and history show that this is highly unlikely to happen and, when it may have occurred in U.S. history, it was more the fault of poor discretionary policy by the bank regulators, such as by the Federal Reserve in the 1930s, than that of the market place.

Depositor runs are viewed as the germs that spread contagion from sick to healthy banks. But evidence suggests that healthy,

---

4. George G. Kaufman, "Banking Risk in Historical Perspective", in George G. Kaufman, ed., Research in Financial Services, (Greenwich, CT.: JAI Press, 1989), pp. 151-164 and George J. Benston, Robert A. Eisenbeis, Paul M. Horvitz, Edward J. Kane and George G. Kaufman, Perspectives on Safe and Sound Banking (Cambridge, MA.: MIT Press, 1986).

6

economically solvent banks are generally able to withstand such runs. A study by the Comptroller of the Currency in 1938 of all national bank failures from 1865 through 1936 reported that runs were the primary cause of less than 15 percent of the 3,000 failures and accounted for less than 10 percent of the 4,500 causes of failure identified.[5] And this includes the larger banks and the 1929-33 period, when bank runs were most widespread. Runs appear to have occurred primarily on economically insolvent banks and were the result and not the cause of the insolvency. This is not much different than the runs we have observed more recently on the economically insolvent Continental Bank, the large Texas banks and the Bank of New England. Indeed, the threat of a run is a powerful force of market discipline that has over the years before deposit insurance made banks less risky and depositor fears and runs less necessary.[6]

Nor did bank runs cause national declines in money and credit. Most runs resulted in redeposits at banks considered safe either directly by the fleeing depositors or indirectly after the purchase of Treasury securities by the depositors and deposit of the proceeds by the seller. Total reserves or deposits (money) in the banking system did not change, although

---

5. J.F.T. O'Connor, The Banking Crisis and Recovery Under the Roosevelt Administration (Chicago: Callaghan, 1938), p. 90.

6. George G. Kaufman, "The Truth About Bank Runs" in Catherine England and Thomas Huertas, eds., The Financial Services Revolution (Boston: Kluwer, 1987), pp. 9-40.

they were redistributed among the banks and this undoubtedly caused temporary dislocations. Only when the depositors considered no bank in the country, or for that matter overseas, as safe and held the withdrawn funds as currency did aggregate money and credit decline. Under such conditions, runs on individual banks or groups of banks turn into runs on the banking system.

But serious runs to currency and a large number of bank failures have occurred in only two periods in U.S. history, 1893 and 1929-33. And even in these periods, the evidence suggests that the runs resulted from problems in the economy feeding back on the banks at least as often as bank runs ignited problems elsewhere. Moreover, with credible deposit insurance in force up to $100,000, small depositors, who are the only parties that can conduct business in currency and will run into currency, have no incentive to do so. Thus, nationwide systemic risk is not a viable concern today. No serious ill spillover effects occurred from the runs on the Continental Bank in 1983-84, the large Texas banks in 1987-89 and the Bank of New England in 1990-91, despite the uncertainties in the markets from the uncertainty about the regulators' closure rule. In addition, no additional adverse effects would have occurred had any of these failures been handled without TBTF by the regulators and losses to the FDIC would have been less.[7] The runs by uninsured depositors were to

7. George G. Kaufman, "Are Some Banks Too Large To Fail? Myth and Reality", Contemporary Policy Issues, October 1990, pp. 1-14; George G. Kaufman, "Too Big To Fail Has Failed Big", Biline

safe banks not to currency.[8]

When a bank, even a large one, fails it does not leave a hole in the ground. The bank is typically sold or merged and, even in the rare case when it is liquidated, other banks will enter the market area if there is sufficient demand for banking services. Indeed, it is ironic that there is concern over reductions in credit to a community from a bank failure at the same time that there also is concern over the continued viability of the banking industry in light of its secular decline in market share and inroads by nonbank financial institutions. Banks are no longer a unique source of credit and the failure of a bank is unlikely to cause greater, costlier or more lasting dislocations than the failure of any other credit supplier of similar size serving the same market.

Defaults by insolvent banks will interfere with the efficient operation of the payments mechanism and cause problems for third parties. But there are more efficient and less costly methods of preventing such losses than guaranteeing all liabilities of banks. Indeed, both the clearing houses and the Federal Reserve are limiting daylight overdrafts, which are the

---

(Chicago Clearing House Association), 1, 1991, pp. 1-3; and George J. Benston, et. al., Chapter 2. For example, despite stated fears by the regulators at the time of the Continental Bank in 1984, no adverse effects occurred when the FDIC ultimately stopped making all creditors of insolvent BHCs whole in 1986 and started legally failing insolvent banks in 1987.

8. In the 1980s, there was also a new and different kind of run from good banks to bad banks, which offered higher deposit rate on fully insured, safe deposits.

clearing only with good funds so no overdrafts occur and preclearing netting.

The best way to guarantee that systemic risk will not occur is to adopt a structure of deposit insurance that minimizes the probability of bank failures with large losses to depositors. Such a structure is incorporated to varying degrees in a number of bills currently being considered by Congress, including the Gonzalez Bill (HR 6) and the Riegle Bill (S 543). Basically, this structure centers on higher capital ratio that would prevail in the absence of deposit insurance, early discretionary and mandatory intervention by regulators when a bank's financial condition begins to deteriorate to discourage further deterioration and mandatory recapitalization by existing or new shareholders at some point before the bank's capital has been fully depleted.[9]

Resolution by recapitalization needs to be mandatory both to protect the regulators from pressures to forbear and accept larger losses and to produce greater certainty in the market. No bank would be too large or too special to avoid regulatory intervention and eventual recapitalization before losses accrue to depositors. Losses would be restricted to shareholders. There is little of any downside risk to such a system. The cost to the economy of requiring recapitalization too soon is vastly

---

9. Shadow Financial Regulatory Committee, "An Outline of a Program for Deposit Insurance and Regulatory Reform", February 13, 1989 and George J. Benston and George G. Kaufman, Risk and Solvency Regulation of Depository Institutions (New York: Salomon Brothers Center, New York University, 1988).

less than requiring it too late. The failure to provide for regulator protection and close the TBTF loophole is the major weakness of the deposit insurance reform section of the Treasury proposal. As long as TBTF persists, the U.S. banking system will be riskier and less stable than otherwise.

It is sometimes argued that TBTF is necessary in the United States because all other major countries pursue such a policy either explicitly or implicitly. But a recent GAO study suggests that this generalization may not be totally true.[10] But even if it were, if other countries wish to subsidize their banking industry or agriculture industry or any other sector it does not follow that the U.S. need to follow automatically. Moreover, to the extent that TBTF weakens U.S. banks by encouraging them to operate at a higher risk level than otherwise, U.S. banks are likely to lose large international deposits to better capitalized banks in other countries. There is no evidence that TBTF helps international competitiveness, but there is clear evidence that bank profitability and prudential capitalization does.

Continuation of TBTF is a battle between bank regulators on the one side and bankers and taxpayers on the other. There is hardly another issue today on which bankers are as united as on the need to end TBTF. Only one of the 11 financial trade associations polled by the American Banker believed that the Treasury's TBTF proposal went far enough in avoiding bailouts and

10. U.S. General Accounting Office, Deposit Insurance: Overview of Six Foreign Systems (Washington, D.C.: February 1991).

two associations did not take a position.[11] The members of both the New York and Chicago Clearing House Associations, which comprise the banks most directly favored by the current policy, have recommended its discontinuance, as have the CEOs of a cross-section of Chicago-area banks.[12] To them, the benefits are less than the costs.

It would be difficult to believe after the S&L debacle that taxpayers do not feel the same way. TBTF is too costly to preserve to please the regulators. Even if their worst fears came to pass, as is now almost impossible without a major policy error on their part, it is difficult to imagine that the costs incurred would come close to exceeding the $200 billion present value cost of the S&L rescue and any additional potential costs of further problems in the commercial banking industry under the current regulatory regime. It is time to heed taxpayers' concerns and end TBTF. The cost-benefit tradeoffs are clear.

---

11. Robert M. Garsson and James M. Pethokoukis, "Trade Group Rift May Stall Reform Bill", American Banker, March 1, 1991, pp. 1, 8, 9.

12. Chicago Clearing House Association, "Chicago Bankers Oppose Too Big To Fail", Press Release, April 26, 1991.

TESTIMONY OF

HOWARD L. WRIGHT
DIRECTOR OF REGULATORY MATTERS
OFFICE OF FINANCIAL MARKETS OF ARTHUR ANDERSEN & CO.
AND MEMBER OF
THE COMMITTEE FOR RESPONSIBLE FINANCIAL REFORM

ON

ELIMINATION OF "TOO-BIG-TO-FAIL"

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

10:00 A.M.
THURSDAY, MAY 9, 1991
ROOM 2222, RAYBURN HOUSE OFFICE BUILDING

Good afternoon, Mr. Chairman and members of the Subcommittee, I appreciate the opportunity to share the views of the Committee for Responsible Financial Reform[1] (the "Committee") regarding "too-big-to-fail" and how this issue relates to deposit insurance reform. Clearly, "too-big-to-fail" is the linchpin in the deposit insurance reform equation; its elimination, to the extent possible, should be the critical centerpiece of any deposit insurance reform proposal adopted by the Congress.

We have reviewed the study submitted to the Congress by the Secretary of the Treasury and find it to be a thoughtful, comprehensive report that deserves the full attention of the Congress. Meaningful reform of the nation's banking and financial system is

---

[1]The Committee for Responsible Financial Reform consists of ten individuals who are prominent in financial circles. The Committee was formally organized on February 4, 1991 to support efforts to achieve comprehensive and meaningful reform of the banking and financial system in 1991, with such reform directed at the broad public interest rather than that of any industry group.

The Committee is chaired by Frederick H. Schultz, former Vice Chairman of the Federal Reserve Board. Donald P. Jacobs, Dean of the J.L. Kellogg Graduate School of Management at Northwestern University, serves as Vice Chairman. Other members of the Committee are: Richard P. Cooley, retired CEO of Seafirst Bank; W. Peter Cooke, Chairman, World Regulatory Advisory Practice, Price Waterhouse, formerly Head of Banking Supervision at the Bank of England and Chairman of the Basle Committee of Banking Supervisors; Maurice R. Greenberg, CEO of the American International Group, Inc.; William M. Isaac, CEO of The Secura Group and former Chairman of the FDIC; James D. Robinson, III, Chairman of the American Express Company; Gary H. Stern, President of the Federal Reserve Bank of Minneapolis; Thomas I. Storrs, retired Chairman of the Board of NCNB Corporation; and Howard L. Wright, Director of Regulatory Matters, Office of Financial Markets of Arthur Andersen & Co.

needed, not only in the interest of financial institutions but also, and much more important, in the interest of the public.

While agreeing with the basic thrust and major recommendations of the Treasury Report, the Committee finds that the Report falls short in failing to recommend fundamental reform of the deposit insurance system. It is essential that the market be restored as an important regulator of banking and this can be accomplished only by requiring that depositors share with government the cost of bank failure. The present policy of "too-big-to-fail" is inequitable and costly, and must be eliminated.

The Report's failure to recommend fundamental insurance reform and an enhanced role for market discipline compels it to rely too heavily on extensive and potentially stifling government regulation. Moreover, it forecloses the possibility of substantial future reductions in the cost of insurance to banks and to the public.

Clearly, market discipline can be restored only when the market is convinced that all banks can fail and, more important, that failure will imply losses for uninsured and unsecured depositors and creditors. The Committee is fully aware that the prospect of eliminating "too-big-to-fail" raises substantial concerns in the minds of many.

Some perceive that without "too-big-to-fail" the temporary inaccessibility of funds in accounts over $100,000 could disrupt the payments system, money supply, and market liquidity. These difficulties may be mitigated by changing the structure of the deposit insurance system. It is important to note that "too-big-to-fail" and the structure of deposit insurance cannot be separated.

Further, it is generally agreed that the elimination of "too-big-too-fail" would represent a major change for many banks and their depositors and creditors. Accordingly, deposit insurance reform along the lines we suggest should be enacted with a delayed effective date of at least three years after the adoption of the legislation.

An insurance system, for example, that covered fully transaction accounts and 90 percent or so of interest-bearing liabilities over $100,000 would mitigate the concerns associated with "too-big-to-fail." Liabilities up to $100,000, of course, would be fully covered and subordinated debt would remain completely uncovered. Such a system of deposit insurance would fully protect small depositors and assure the functioning of the payments system. It would introduce market discipline for banks by exposing large interest-bearing accounts to a degree of risk of loss.

This approach would curtail insurance coverage only slightly from its current de facto level of 100 percent in larger banks. It is precisely this modest reduction in coverage that will allow for the elimination of "too-big-to-fail."

We see several advantages to the "haircut" approach with respect to large, interest-bearing accounts. It is irresponsible to allow depositors earning rates well above those paid by conservative, well-managed institutions to escape risk under the government guarantee umbrella. Under this proposal depositors will tend to be more prudent in selecting an institution. Those in the "fast lane" will have their "radar detectors" on to avoid the speed traps.

It is unfair to the sound institutions that are forced to bear the burden of high deposit insurance premiums and the public at large who, as taxpayers, act as a backstop to the deposit insurance funds. Weak institutions, prone to pay higher rates for deposits, will find it more difficult to attract depositors. Thus, obtaining funds to adopt a "bet-the-bank" strategy will be more difficult.

Elimination of "too-big-to-fail" will reduce substantially the costs of the Bank Insurance Fund ("BIF"). The BIF's expenses will be reduced considerably because a portion of the costs of all failures will be shared by those with interest-bearing accounts over $100,000, and the market discipline created will reduce future costs by limiting the growth of weak and risky institutions. Importantly, this system will eliminate the inequity between large and small banks inherent in the "too-big-to-fail" policy.

As you can see, the Committee thinks it is possible to reform the deposit insurance system to mitigate the most serious systemic concerns associated with a large bank failure. The question remains whether there are any circumstances under which the government must intervene to prevent losses to all depositors and general creditors. It is difficult to imagine a situation where this would be the case, but should it arise the question has no relevance to deposit insurance reform. A government's right to intervene whenever a business failure threatens the national interest is absolute, whether that business is a bank or an industrial concern. Should the government decide to intervene in the case of a bank, the decision, the form and nature of assistance, and the cost should be handled outside the deposit insurance system.

Mr. Chairman, this concludes my testimony. I would be pleased to answer any questions you may have.

Attachment

March 15, 1991

Background Memorandum

Statement on the Treasury Report by the Committee for Responsible Financial Reform

In a statement on the study and report of the Treasury Department (Modernizing the Financial System: Recommendations for Safer, More Competitive Banks), the Committee for Responsible Financial Reform compliments the Secretary of the Treasury for the thrust and scope of the Report and pledges its full support for the accomplishment of meaningful reform of the banking and financial industry. The Committee endorses the approach and many of the recommendations of the Treasury Report, but takes serious exception to the absence of sufficient recommendations to accomplish needed reform of the deposit insurance system itself. The Committee also identifies the three elements of a reform package that it believes to be of primary importance. This background memorandum provides additional information on the Committee's conclusions.

Deposit Insurance Reform

The Committee recommends that:

> No uninsured balance in an interest-bearing account, of whatever description and regardless of size of bank, should be accorded full coverage in the event of a bank failure. However, all noninterest-bearing deposit accounts should be fully covered in the event of a bank failure.

Discussion of recommendation. While the Committee agrees completely with the objective of narrowing the scope of deposit insurance, it does not believe that the Treasury Report goes far enough in this direction. The Report recommends, for example, that the number of fully insured accounts that would henceforth be available to any individual depositor in any bank be significantly restricted. The

Committee believes that this is a desirable step but does little to enhance market discipline.

The Treasury Report also recommends that an additional cost test be met by the FDIC before it may conclude that a purchase and assumption transaction is the most cost efficient way of proceeding in resolving a failing bank situation, and it would require that in cases involving systemic risk problems the Federal Reserve Board and the Treasury make a determination that protection of all depositors by the FDIC is necessary. While these recommendations clearly head in the right direction, the Committee does not believe that if implemented they would accomplish meaningful reform of the deposit insurance system.

In the unanimous view of the Committee, it is essential that market discipline play an important role in the regulation of banks and thus reduce future demands on the BIF. That discipline has been significantly eroded during the past several decades because of the policies and procedures that have been developed by the FDIC in resolving failing bank cases. As the Treasury Report points out (p.7), from 1985 through 1990, "over 99 percent of uninsured deposits have been fully protected in bank failures." It is the Committee's view that effective reform of deposit insurance and the restoration of market discipline can be obtained only through providing, unequivocally, that regardless of the type of transaction adopted by the FDIC to resolve a failing bank situation, the uninsured portion of deposits must share the cost with the government.

The Committee is particularly concerned that the policy best known as "too-big-to-fail" will remain alive if the reforms recommended by the Treasury are adopted. To be sure, it is the intention of the authors of the Treasury Report that the exercise of this power be made more difficult. More is necessary; it must be made impossible. And more than market discipline is involved here, important as that discipline is. The policy is grossly inequitable, discriminating among depositors in terms of the particular institutions with which they decide to do business. It should be abandoned. The disparate treatment of the depositors of Bank of New England and Freedom National Bank of New York is a prime example of this inequity.

It is the Committee's impression that one reason for the failure of the Treasury recommendations to go as far as would be desirable is concern over payments system implications. That is, the failure in certain instances to apply "too-big-to-fail" procedures would constitute a threat to the money supply and pose potential liquidity disruptions resulting from the temporary inaccessibility of funds in accounts with balances over $100,000. While the Committee is not entirely convinced that the payments system problems cannot be dealt with in other ways, nonetheless its recommendation mitigates that problem since noninterest-bearing deposits (i.e., checking accounts) would be fully covered. However, in no circumstance would interest-bearing accounts with balances in excess of the insurance maximum be fully protected. This would constitute a significant change in present insurance coverage.

Illustrative proposal. While the Committee has not endorsed the specifics of a deposit insurance reform proposal, an illustration may be useful for discussion purposes. Such a proposal may be outlined as follows:

> All noninterest-bearing transaction accounts would be fully insured. Interest-bearing accounts (both transaction and nontransaction) would be fully insured up to a maximum of $100,000 per account holder; in addition, 90 percent of amounts over this limit would be covered. This policy would apply to all insured depository institutions without exception.

While a 10 percent "haircut" for all interest-bearing balances above $100,000 is probably appropriate, a lower percentage might be more desirable. Over time, and after study, a "haircut" of more than 10 percent might also be feasible.

It should be noted that this illustration extends insurance coverage to all interest-bearing accounts (except those subordinated to general creditor status). This includes non-deposit accounts such as federal funds and foreign deposits, accounts not technically covered under the current system. While this will be viewed by some as an expansion in insurance coverage, the opposite is the case. Elimination of "too-big-to-fail" will reduce substantially the costs of the BIF. Not only will the BIF's expenses be reduced considerably because a portion of the costs of all failures will be shared by those with accounts over $100,000, but the market discipline created will reduce future costs by limiting the growth of weak and risky institutions.

If such an approach were to be considered, an expansion of the assessment base for insurance purposes should also be considered. The current assessment base of total domestic deposits bears no relationship to the liability base that receives full *de facto* coverage under present policies, especially with regard to large institutions.

The implementation of such a plan would represent a major change for many banks and their depositors and creditors. Accordingly, a reform along these lines should be enacted with a delayed effective date of at least three years after the adoption of the legislation.

Multi-Office Banking

The Committee recommends that:

> Federal statutes now restricting the ability of banks and bank holding companies to expand geographically (the McFadden Act and the Douglas Amendment) should be amended or repealed, as recommended by the Treasury.

The Treasury Report recommends that full nationwide banking on a holding company basis become available at the end of three years. It further recommends that the provisions of the McFadden Act which prohibit national banks from branching on an interstate basis be repealed, such that national banks may branch within the geographic areas in which interstate banking can be conducted. This means, of course, that after three years branching could be conducted nationwide. The Committee heartily endorses these recommendations.

The rationale offered in the Treasury Report for its multi-office banking recommendations is sound and need not be repeated here. The Committee simply endorses the view that there is an urgent necessity to modernize banking laws and that the recommendations relating to multi-office banking will take a long step toward assuring a more competitive and a more efficient banking system, with substantially increased benefits to the users of banking services.

Financial Services Holding Companies

The Committee recommends that:

> Financial services holding companies be authorized and empowered to engage in an appropriate variety of financial activities, including banking; and non-financial firms be allowed initially to own up to 25 percent of such companies, which limit Congress should

review and consider increasing after some experience has been gained.

The creation of financial services holding companies (FSHCs) as recommended in the Treasury Report is a useful way to encourage diversity in the banking system. Banking organizations house the expertise to provide financial services that are closely related to banking which they are currently prohibited from offering. The creation of FSHCs could be helpful if the future health of the banking system is to be maintained. It has been well recognized, as the Treasury Report points out, that market forces have been eroding the core franchise of many banking organizations. There is no reason to expect that these forces will abate; it is more likely that they will accelerate, especially if meaningful deposit insurance reform is adopted.

The Committee fully endorses the "two way" street which would be created with implementation of the Treasury Report recommendations, namely that non-bank financial firms may also affiliate with banks. The Committee did not review each of the specific financial activities for which affiliation with banks would be permissible. At a later date the Committee may comment more directly on specific activities; at this point it believes that a broad and liberal interpretation of financial activities is desirable.

There is a strong consensus within the Committee in support of the recommendation in the Treasury Report that non-financial commercial firms be permitted to own FSHCs. However, not all members of the Committee are convinced that this reform should be fully implemented. Moreover, the Committee is aware of significant opposition in many quarters to taking such a step and is concerned that this may delay the enactment of such essential reforms as the elimination of "too-big-to-fail" and the modernization of laws relating to interstate banking and product diversification. Accordingly, the Committee concluded, and so recommended, that a limited step be taken in this direction, namely, authority for commercial firms to own at least 20 percent of a FSHC and not more than 25 percent. Equity ownership of 20 percent would allow for accounting for the interest in the FSHC on the equity method, which would be important to such investors.

It is the Committee's belief that even limited investment opportunities for commercial firms will go some way toward meeting one of the Committee's basic objectives, set forth in its February 4, 1991 statement, namely, the "crucial importance of providing banks improved access to capital."

The members of the Committee also believe that the way may be open in the future for expanding the investment limits contained in its recommendation. It suggests that Congress require a study, due in 18 months, examining whether these equity limitations should be expanded or eliminated.

The Committee for Responsible Financial Reform

The Committee for Responsible Financial Reform consists of ten individuals who are prominent in financial circles. The Committee was formally organized on February 4, 1991 to support efforts to achieve comprehensive and meaningful reform of the banking and financial system in 1991, with such reform directed at the broad public interest rather than that of any industry group.

The Committee is chaired by Frederick H. Schultz, former Vice Chairman of the Federal Reserve Board. Donald P. Jacobs, Dean of the J.L. Kellogg Graduate School of Management at Northwestern University, serves as Vice Chairman. Administrative and research assistance is provided by The Secura Group, headquartered in Washington, D.C.

Members of the Committee, in addition to the Chairman and Vice Chairman, are: Richard P. Cooley, retired Chief Executive Officer of Seafirst Bank; W. Peter Cooke, Chairman, World Regulatory Advisory Practice, Price Waterhouse, formerly Head of Banking Supervision at the Bank of England and Chairman of the Basle Committee of Banking Supervisors; Maurice R. Greenberg, Chief Executive Officer of the American International Group, Inc.,; William M. Isaac, Chief Executive Officer of The Secura Group and former Chairman of the FDIC; James D. Robinson, III, Chairman of the American Express Company; Gary H. Stern, President of the Federal Reserve Bank of Minneapolis; Thomas I. Storrs, retired Chairman of the Board of NCNB Corporation; and Howard L. Wright, Director of Regulatory Matters, Office of Financial Markets of Arthur Andersen & Co.

CHICAGO CLEARING HOUSE ASSOCIATION

Organized March 3, 1865

Robert M. Fitzgerald
President
230 So. LaSalle St.
Suite 600
Chicago, IL 60604
312.408.2110
FAX: 312.427.9352

NEWS RELEASE

April 26, 1991

Contact: Thomas C. Tucker
312-408-2111

CHICAGO BANKERS OPPOSE TOO BIG TO FAIL

No commercial bank should be too big to fail and Federal Deposit Insurance coverage should, at minimum, not be increased above the current $100,000 limit per account. These were conclusions reached by a group of chief executive officers of Chicago area banks participating in a public policy conference on deposit insurance reform sponsored by the Chicago Clearing House Association on April 12, 1991. The CEOs reached their conclusions at a luncheon after listening to Senator Alan Dixon of Illinois; Silas Keehn, President of the Federal Reserve Bank of Chicago; Thomas Theobald, CEO of the Continental Bank; James Lancaster, Chairman of NBD Illinois, Inc.; Kenneth Skopec, CEO of The Mid-City National Bank of Chicago and Professors Stuart Greenbaum (Northwestern University), Edward Kane (Ohio State University) and George Kaufman (Loyola University of Chicago). Some 100 Chicagoland bankers attended the conference and 35 CEOs of banks of all sizes attended the luncheon.

Too big to fail, or TBTF, is a policy in which regulators do not require losses at insolvent large banks to be borne by uninsured depositors as they often require at smaller insolvent institutions. TBTF has been used frequently by the FDIC in recent years. Although a number of speakers, including Senator Dixon, supported regulatory discretion in continuing the TBTF policy or believed that TBTF was too ingrained to change, the Chicago bankers believed otherwise. In their opinion continuation of TBTF would:

o seriously undermine current efforts at effective deposit insurance reform,

o be unfair to smaller banks,

o not reduce the number of bank failures or the accompanying large dollar losses and thus not reduce either deposit insurance premiums or the possibility that the losses might be shared with the taxpayer,

CHICAGO CLEARING HOUSE ASSOCIATION

- o increase the cost of capital to banks by maintaining uncertainty about which banks qualify as too big and which do not,

- o justify undue government regulation and interference in banking, and

- o delay the exit of poorly capitalized or even insolvent banks thereby damaging well-managed banks by bidding up deposit rates and underpricing loans.

The last phenomenon was clearly evident in the Texas and New England deposit rate premiums of recent years brought about by zombie banks and savings and loan associations in these areas. The bank executives believed that TBTF is too costly to both banks and taxpayers to continue and urged policy makers to end its use. Uninsured depositors at all insolvent banks should be treated equally.

The bank CEOs were in less agreement about the precise limits of deposit insurance coverage. None favored increasing the amount of coverage. Some CEOs believed that coverage should be reduced both in dollar amount and in number of accounts per depositor in order to increase market discipline on banks. Others supported the proposal by the Treasury Department to effectively limit insurance to $100,000 per depositor per bank and still others preferred to maintain the existing $100,000 multiple account coverage. It was felt by some CEOs that the coverage issue would become less important if no bank was considered too big to fail, and if a system of early regulatory intervention and recapitalization of weak banks before their net worth was depleted was adopted. If successful, such a system would effectively limit losses to only bank shareholders.

Oral Statement by Bert Ely
to the
Economic Stabilization Subcommittee
May 9, 1991

ABANDONING TOO-BIG-TO-FAIL: THE IMPOSSIBLE DREAM

Mr. Chairman and members of the Subcommittee, I want to thank you for inviting me to testify this morning about one of the most difficult and important issues in deposit insurance today: The too-big-to-fail (TBTF) policy.

Enormous and very sincere effort has been devoted in recent months by the Administration and the Congress to determine how to convincingly abandon this policy. But Mr. Chairman, the title of my testimony says it all: Abandoning TBTF is an impossible dream. I will devote the rest of my time this morning to explaining why.

Abandoning the TBTF policy is premised on the idea that deposit insurance reform requires more depositor discipline. Put another way, the feeling of many is that federal deposit insurance cannot be reformed <u>unless</u> more depositor discipline is injected into the banking business. I reject this premise.

Depositor discipline represents the third-best source of banking discipline; stockholders represent the best source of discipline and regulators are a distant second. Worse, depositor discipline can quickly become counter-productive and even dangerous if relied upon too much. Depositor discipline is like a fragile bridge that cannot carry too much traffic -- Overload it and it will quickly collapse.

Depositor discipline is dangerous because depositors are very risk adverse with regard to their bank and thrift deposits. Worse, they can quickly withdraw their deposits if they fear they will lose any portion of their money. And this brings us to the central reason why a strict no-TBTF policy will never work: No matter how fast the regulators move to close a troubled institution, thereby sticking its uninsured depositors with a loss, the more sophisticated depositors will run even faster.

Only the least sophisticated will suffer a loss. However, they will garner the greatest political sympathy. Freedom National is just the latest failure that teaches that lesson. Faster, more dramatic runs will be bad for two reasons. First, a depositor run on a troubled bank greatly increases the probability that the bank will fail. A faster run also will increase the loss the BIF will suffer when it disposes of the bankrupt institution. Second, more frequent runs on troubled banks will increase the potential for contagious runs, <u>by both insured and uninsured depositors</u>, on institutions who need not fail at a loss to the BIF.

As irrational as it may seem, insured depositors have very rational reasons for withdrawing their deposits from a bank they fear may be closed. As one woman said on Monday when pulling her insured deposit from the troubled Madison National Bank here in Washington: "I just don't want the hassle if the bank fails ... I know my money is insured, but that's only part of the concern."

Madison had $382 million in deposits at the end of last year. As of last June 30, it had 47,000 deposit accounts and $74 million of uninsured deposits, an amount which undoubtedly is lower today. Clearly Madison is small enough to be liquidated. But, imagine liquidating a bank with $10 billion in deposits and one million deposit accounts! Now we are talking about the reality of abandoning TBTF.

And this is why abandoning TBTF is an impossible dream, for when this dream clashes with the realities of cost and complexity and the risk and danger of bank runs, reality will win out. Those regulators who have their finger on the trigger will blink, when the tough decisions have to be made, and TBTF will win out again. Just yesterday, former triggerman Paul Volcker declared that TBTF cannot be abandoned. He spoke the truth about TBTF.

Deposit insurance must be reformed and more discipline must be injected into banking. But, reform must be premised on strengthening the first line of defense, stockholder discipline. Tougher regulation cannot do the job because technology is rapidly and irreversibly destroying the efficacy of all forms of financial services regulation. That is why Congress has no choice eventually but to strengthen stockholder discipline over banking so there no longer is a need to rely on increasingly ineffective regulatory discipline and the potentially dangerous and destructive depositor discipline.

Unfortunately, today stockholder discipline in banking has one major structural flaw: Once a bank, which is after all a limited-liability corporation, exhausts all of its own on-balance-sheet equity capital, any additional insolvency losses have to be borne by uninsured depositors and taxpayers; that is, healthy banks who increasingly are overcharged for their deposit insurance. Neither party is a desirable bearer of loss.

I have good news, though -- this structural flaw can be fixed quite easily. The fix -- always keep someone's stockholder capital at risk in every single bank, no matter how strong or weak it is. This means that when a bank exhausts its own capital, and therefore fails, any additional insolvency loss will be borne by stockholder capital invested in other banks.

One way to tap capital within the banking system to absorb bank insolvency losses is the 100% cross-guarantee concept. This concept is described in Attachment A to my written testimony. Essentially, cross-guarantees would utilize the enormous earning power and equity capital of the banking system to construct a solvency safety net under every single bank and thrift in this country. No longer would the Congress have to fear that taxpayers will pay for deposit insurance losses, a fear that came true in the S&L crisis, and no longer would TBTF be an unsolvable dilemma. Move to cross-guarantees and the TBTF issue becomes moot.

Thank you. I welcome your questions.

TESTIMONY BY BERT ELY

to the

SUBCOMMITTEE ON ECONOMIC STABILIZATION

COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

ABANDONING TOO-BIG-TO-FAIL: THE IMPOSSIBLE DREAM

May 9, 1991

Submitted by:

Bert Ely
Ely & Company, Inc.
803 Prince Street
Alexandria, Virginia 22314

703-836-4101

ABANDONING TOO-BIG-TO-FAIL: THE IMPOSSIBLE DREAM

by Bert Ely
Ely & Company, Inc.
Alexandria, Virginia
May 9, 1991

I - INTRODUCTION

Mr. Chairman and members of the subcommittee, I am pleased to be able to testify today regarding the "too-big-to-fail" issue (TBTF). TBTF is certainly one of the thorniest, if not the thorniest issue in the area of deposit insurance reform. In fact, there can be no genuine reform of federal deposit insurance until this issue is resolved definitively and credibly. More specifically, any attempt to impose more depositor discipline on banks will not succeed until the TBTF issue is resolved convincingly. In effect, TBTF is the first hurdle that must be cleared in attempting to impose more depositor discipline on banks.

However, as the title of this testimony suggests, abandoning too-big-to-fail is an impossible dream for reasons I will present below. Further, I question the fundamental assumption of many that banking needs more depositor discipline. I recommend instead that deposit insurance be reformed in a manner that greatly strengthens stockholder discipline. If stockholder capital is always voluntarily at risk when a bank fails, then depositor discipline becomes unnecessary and TBTF becomes a moot issue.

In preparing this testimony, I have kept in mind the following questions posed to me in Mr. Carper's letter of invitation. I hope I have addressed these questions satisfactorily in the context of presenting this testimony. His questions were as follows:

1) What changes should or should not be made to the TBTF policy? Do the Treasury and other major legislative proposals to reform the financial system adequately address the TBTF issue?

2) Specifically, what systemic risk would result from depositor losses or the threat of depositor losses at a large financial institution?

3) How does the TBTF policy affect the overall stability and competitiveness of our banking system both domestically and internationally? To what extent does the current policy discourage institutional and depositor discipline?

4) How does a TBTF policy affect the stability of small institutions?

5) What are the best options for preventing large bank failures?

II - TOO-BIG-TO-FAIL: THE ISSUE

What Is TBTF? TBTF really means too big to liquidate. Thus, when the TBTF policy is invoked, *all* depositors in a failed bank are fully protected against any loss of their principal, accrued interest or withdrawal rights. The deposits protected in a TBTF situation include all deposits in foreign offices and deposits exceeding the statutory insurance limit. In other words, it's business as usual for all depositors in a failed bank.

Some have suggested that TBTF really means some banks are "too-small-to-save." That is, the statutory deposit insurance limit is enforced against all depositors in smaller failed banks. This is a fair interpretation of the TBTF policy.

Only through a formal liquidation or receivership proceeding can a bank insolvency loss be imposed on statutorily *uninsured* depositors and other creditors of a bank.[1] The liquidation of a bank can take one of two forms: The more extreme case, the payoff of insured depositors, or the less extreme case, the transfer of insured deposits to another bank. A deposit transfer has the same effect on uninsured depositors as a depositor payoff, but it may be less costly to the deposit insurer than a payoff.

When the TBTF policy is invoked, regulators effectively have decided that it is preferable for taxpayers to bear the bank's insolvency loss rather than uninsured depositors or other unsecured creditors of the failed bank. The first group of taxpayers to bear the loss are healthy banks which are overcharged for their deposit insurance. In a worst case situation, in which bank insolvency losses become so burdensome for healthy banks as to be damaging to the economy, the remaining bank insolvency losses would be borne general taxpayers. This, of course, is what happened in the S&L industry.

The Cost of TBTF. So far, banks insured by the BIF have borne the entire cost of the TBTF policy through the deposit insurance premiums, or tax they have paid. However, the deposit insurance tax they pay has been rising steadily as bank insolvency losses have skyrocketed. Bank Insurance Fund (BIF) premiums will have almost tripled in 18 months when they rise to 23 basis points on July 1. As of that date, this deposit tax will be six times higher than it was in 1980.

Higher BIF losses have driven this tax increase. For the 1988-90 period, the BIF's recorded bank insolvency losses have averaged $6.66 billion annually. By way of a very stark contrast, BIF losses in the 1970-80 period, on an inflation-adjusted basis, averaged just $45 million annually, less than one percent of the 1988-90 loss experience.

FDIC Chairman William Seidman recently testified that the TBTF policy cost $883 million in four cases where the "essentiality" test has been invoked over the last

[1] References to banks include any type of federally insured depository institution, except where the context of the testimony limits the use of the term "bank" to BIF-insured commercial and savings banks.

five years.[2] The essentiality test is the legal justification for invoking TBTF in cases where the FDIC has estimated that the liquidation of a bank would be cheaper to the Bank Insurance Fund (BIF) than protecting all depositors. The essentiality test permits the broad public policy objective of systemic financial stability to override the narrower concern of minimizing the cost of disposing of a failed bank.

Ely & Company has estimated that the TBTF policy has cost the FDIC $2-$2.5 billion, if the costs of all failed bank resolutions are distributed proportionally over insured and uninsured deposits in these banks *at the time they failed*. We are gathering additional data at this time to better estimate the cost of the TBTF policy, using this allocated cost method.

It can be argued, though, that even this cost estimate is too low because it does not include the hidden cost of TBTF, which is the steady substitution of insured for uninsured deposits in a failing bank *before* it is closed; i.e., when it is merged or liquidated with BIF assistance. In effect, pre-closure bank runs, which drag out over many months or even a few years, give more sophisticated and fleeter depositors ample time to pull their uninsured funds from the bank before the regulators act officially. Often, these pre-closure runs are partially funded with discount window loans from the Federal Reserve.

For example, the Fed lent $2 billion or more to Bank of New England (BNE) during the height of its liquidity crisis in the Spring of 1990. This liquidity crisis was caused largely by uninsured depositors making a mad dash for the door. Based on call report data, two-thirds, and perhaps more, of the $7.3 billion in deposit shrinkage in 1990 in the three BNE banks represented the flight of uninsured deposits. That is, $5 billion of BNE's deposit shrinkage represented the runoff of uninsured deposits, including a $2.9 billion shrinkage of deposits in foreign offices.

In effect, the Fed, as the nation's "lender of last resort," is a major barrier to abandoning TBTF. This is the case because the Fed provides the wherewithal to permit those who otherwise would be tapped for a loss to abandon a bank *before* losses are imposed on the uninsured saps who are caught when the bank's doors are closed. Thus, logic would dictate that the TBTF policy cannot be abandoned until such time as the Fed's power to provide emergency liquidity is limited to all but the very strongest banks; i.e., those banks where there is only a remote chance that the bank might become insolvent.

The regulators, and especially the Fed, have engaged in recent years in a policy of "constructive ambiguity," in deciding which banks are TBTF. In other words, they have been very vague about who will and who will not be assisted. One senses, though,

[2] Seidman testimony to the Financial Institutions Subcommittee of the House Banking Committee, April 30, 1991, page 15. He testified that six groups of related banks met the essentially test; today, according to an FDIC source, Chairman Seidman will testify that only four groups of related banks met this test.

42-688 0 - 91 - 8

that constructive ambiguity is nothing more than a sophisticated term for "winging it." In effect, the regulators play it case-by-case as problems arise. While the constructive ambiguity strategy may seem to be a way to reduce the scope of TBTF, this policy may in fact have the opposite outcome because in specific situations, the arguments for applying the TBTF policy far outweigh arguments to the contrary. In other words, those who have their fingers on the trigger blink when the pressure to act bears down on them.

Who Really Has Paid for the TBTF Policy? The deposit insurance tax assessments that always have been levied on explicitly *uninsured* domestic deposits (deposits over $100,000) would have paid for the entire cost of the TBTF policy even if there had been no flight of uninsured depositors from troubled banks. From 1934 to 1990, the FDIC collected $6.2 billion of deposit insurance taxes on deposits reported by banks as being uninsured. However, the total amount of deposit insurance tax collected on uninsured deposits undoubtedly has exceeded $6.2 billion because actual uninsured deposits are higher than reported. This is the case because banks do not reflect in the uninsured deposit balances they report to the FDIC the aggregation rules used to compute deposit insurance coverage in a failed bank. These rules have the effect of reducing coverage.

For the four failed bank cases mentioned above that supposedly met the essentiality test, the FDIC estimated that uninsured depositors would have lost $2.84 billion had the banks been closed as of the last call report date "... prior to a major news announcement regarding the FDIC's resolution transaction for each institution."[3] Adding in other major failed banks, notably Continental Illinois and Bank of New England, it appears likely that the maximum cost of protecting uninsured depositors in failed banks has been in the range of $5-$6 billion, slightly less than what the FDIC has collected in the deposit insurance tax on explicitly uninsured deposits. Adding in the time value of money resulting from the accumulation of this tax before large banks began failing, the BIF may actually be several billion dollars *ahead* at this time in protecting explicitly uninsured depositors.

Viewed from another perspective, it can reasonably be argued that the BIF probably would have a lower fund balance today if uninsured depositors never had been protected *and if* the BIF premium tax had never been levied on explicitly uninsured deposits. Interestingly, the Canada Deposit Insurance Corporation levies its deposit insurance tax only on explicitly *insured* deposits.

Depositor Discipline: An Argument in Favor of Abandoning TBTF. Reducing deposit insurance losses is one argument given for abandoning the TBTF policy. The real argument, though, for abandoning TBTF is to force depositors to do what stockholders and regulators increasingly have failed to do: Force failing banks to

[3] "Modernizing the Financial System," U.S. Department of the Treasury, February 1991, pg. III-30. The four banks were First City in Texas, FirstRepublic, MCorp, and Texas American Bancshares.

revitalize themselves or disappear through voluntary mergers or liquidations *before they become insolvent.*

Stockholders absorb the first dollars of loss in a failed bank and therefore supposedly have the greatest incentive to force corrective action in a troubled bank. As a practical matter, though, stockholder discipline often is ineffective. Under existing concepts of financial disclosure and corporate governance, managements of deteriorating banks are able to stay in power far too long. Perhaps stockholders leave poor management in place because the stockholders too easily become resigned to losing their investment in a failing bank. The concept of limited liability for bank stockholders, which limits their loss to their initial investment, less tax write-offs, may fuel this resignation.

This failure of stockholder discipline raises two important questions: One, why does stockholder discipline not work in some banks? Perhaps the flat-rate deposit insurance premium, coupled with inherent regulatory delay, muddy the marketplace signals that normally drive stockholder discipline. Two, is stockholder discipline weaker in banks than in organizations with uninsured liabilities? The 100% cross-guarantee concept described in Section VI of this testimony proposes one way to strengthen stockholder discipline over banks.

Regulatory discipline is supposed to be the backstop to stockholder discipline. Thus, regulatory action should force an involuntary closure or merger of a failing bank before or at the point when the bank becomes insolvent. Prompt action by regulators protects taxpayers and uninsured depositors against any loss. Increasingly, though, bank regulators are unable or unwilling to close banks as they reach insolvency. Thus, each failure of an insolvent bank raises this embarrassing question: How is the insolvency loss not allocated to protecting insured depositors supposed to be split between taxpayers and uninsured depositors and creditors?

The inability of regulators to close larger banks before insolvency occurs is not limited to the United States: The closure of the Standard Trust Company (US$1.3 billion in deposits) in Canada on April 18, nine months after reports first surfaced about its real estate problems, is perhaps the most recent example of foreign regulators asleep at the switch. The failure in Australia last July of the Pyramid building society (US$1.04 billion in deposits) is another example of delayed regulatory action.[4]

Bank Runs -- Depositor Discipline That Forces Regulators to Finally Act. The fear of bank runs is how depositor discipline really asserts itself. In effect, the fear of runs becomes a check on regulatory moral hazard; i.e., the unwillingness of regulators to act in a timely manner to close failing banks. In this way, the fear of bank runs serves as an increasingly necessary but still unfortunate backup source of discipline to regulators and stockholders. Consequently, *adopting a strict no-TBTF policy and thus*

[4] The Economist, June 6, 1990, page 80; July 7, 1990, page 76.

attempting to impose losses on uninsured depositors and creditors represents giving up on having effective stockholder or regulator discipline of banks.

Depositors are quick to run because they are highly risk-adverse with regard to their bank deposits. Many insured bank depositors are unclear about the scope of deposit insurance and therefore are unsure whether or not their deposits are in fact insured. Therefore, a run from a bank rumored to be in trouble is a very rational act, from a depositor's perspective. Better safe than sorry. Even risk-prone persons who shoot high-stake craps every weekend in Atlantic City still seek a safe haven for their bank deposits.

There are two types of bank runs -- the single shot run and the contagious run. The most feared type of run is a virulent, contagious run on many banks, some of which are very sound. Many innocent banks can be swept into insolvency by a contagious run. A nationwide contagious bank run, beginning on February 14, 1933, is what escalated into the national bank holiday President Roosevelt declared nineteen days later.

The second type of run is focused only on one or more clearly troubled institutions. While many praise this type of run as stimulating a necessary cleansing of the banking system; in fact, a run of any type is a highly *undesirable* way to rid the banking system of weak banks. Such runs needlessly rattle *insured* depositors, increasing the probability that the bank will fail, and adding to its insolvency loss. One major challenge to eliminating the TBTF policy is developing a more efficient way for reversing the decline of failing banks *and* disposing of those whose decline cannot be reversed. The cross-guarantee proposal discussed in Section VI represents one way to achieve this goal.

Regulators are afraid to impose losses on uninsured depositors when they are finally forced to close a bank which they, the regulators, have let slide into insolvency. The oft-stated reason to invoke TBTF is the fear of creating financial instability if losses are imposed on large numbers of uninsured depositors. Financial instability means that depositors in other banks get nervous and begin a supposedly irrational, contagious run from the other banks. These runs are economically damaging to the other banks and also create losses in the market value net worth of other economic actors. If broad enough, this deflationary effect can depress real economic activity. Price deflation depresses economic activity because borrowers suddenly feel more burdened by their debts, and scale back their purchases and investments largely financed by debt.

There is ample evidence of the contagion effect of bank runs. Most recently, the run in January on non-federally insured Rhode Island credit unions caused a run by federally *insured* depositors on several Bank of New England (BNE) banks that forced their closure. The run on BNE also came on the heels of a report of further losses at BNE, reports which raised fresh doubts about BNE's survivability. The run on BNE in turn triggered runs by insured depositors on some other banks. In March 1985, runs on non-federally insured Ohio S&Ls triggered scattered runs by insured depositors on some federally insured Ohio S&Ls.

Many bankers currently believe that a silent run is now underway from banks into Treasury securities, money market mutual funds, other types of investments, and possibly even into foreign banks. This run suggests a very pernicious contagion effect that is harming many innocent banks. Aggregate data displayed in **Chart 1** support this assertion. The ratio of domestic deposits in banks and thrifts (excluding credit unions) declined from 63.9% of GNP at the end of 1989 to 59.8% of GNP as of March 31 of this year. This decline of 4.1 percentage points (about $230 billion in deposits) over 15 months is quite sharp ; the decline dropped this percentage below the 1981 deposits/GNP percentage, when depository disintermediation was at a peak due to record high interest rates. Expressed another way, bank and thrift deposits declined $200 million during 1990 while nominal GNP increased $238 billion.

This decline in the deposits/GNP ratio during 1990 and early 1991 cannot be explained by interest rate controls which drove prior bouts of depository disintermediation nor can it be fully explained by deposit shrinkage in S&Ls. Its continuation could have seriously adverse consequences for banking and for credit availability.

Runs at two troubled banks on Monday of this week certainly will hasten their demise and add to BIF's eventual cost of disposing of them. According to The Washington Post on May 7, "Jittery depositors yesterday crowded Madison National Bank's branches in downtown Washington to withdraw their funds and query tellers about the bank company's future." Said one depositor, "I just don't want the hassle if the bank fails. I know my money is insured, but that's only part of the concern." The Wall Street Journal also reported on May 7 that the announcement of large loan loss provisions "... spurred significant withdrawals at First National Bank of Toms River [New Jersey] by depositors yesterday."

Bank runs are properly feared, from a public policy perspective, because bank deposits are the hazardous liabilities of a market economy. Hazardous liabilities have one of two characteristics. One, they can be withdrawn on demand or upon very short notice. Checkable deposits are hazardous liabilities as are certificates of deposit or other types of time deposits that can be withdrawn before maturity.

Two, hazardous liabilities are used to fund maturity mismatching; i.e., the assets funded by hazardous liabilities have a longer maturity or a longer time until the interest rate is reset than does the source of funding. Because debtors, on a net basis, want to fix an interest rate for a longer period of time than do creditors, there always will be, within market economies, a demand for maturity mismatching. This demand will be met by banks or by other types of organizations displaying the same financial risk characteristics as a bank.

Like hazardous chemicals, hazardous liabilities are an inescapable element of modern, market-driven economies, yet like hazardous chemicals, these liabilities can be very destructive if not handled with care. There would, however, be fewer hazardous liabilities in an economy in the absence of deposit insurance or any type of government

Bank and Thrift Deposits as a Percent of GNP

Chart 1

Note: This ratio is calculated as follows: Total deposits in all federally insured commercial banks, savings banks, and S&Ls (but not credit unions) at the end of a year were divided by the average of the GNP (annualized) for the fourth quarter of that year and the first quarter of the following year.

* = first quarter 1991

safety net. However, attempting to minimize the quantity of hazardous liabilities within an economy may impair the performance of that economy. Thus, the absence of any deposit insurance is not necessarily desirable. *An actuarially sound deposit insurance system will be far more desirable because it will permit the optimal amount of hazardous liabilities to exist within the economy while permitting the banking system to operate in a safe-and-sound manner.*

A run by the owners of hazardous liabilities (depositors) can be systemically destabilizing in several ways. Debtors funded by hazardous liabilities (banks) are forced to sell assets at fire sale prices, which lessens their net worth and may even drive some banks into insolvency. Non-bank owners of comparable assets also may be driven into insolvency because of the sudden decline in the value of their assets. These insolvencies may cause real economic activity to contract. This risk is magnified in a rigid mark-to-market accounting environment where net worth must immediately be reduced by market value losses. Banks experiencing a run or a liquidity crisis also are forced to curtail credit extensions, which can force a contraction of real economic activity.

A government lender-of-last-resort can provide liquidity to a bank experiencing a run so as to limit the economic contraction caused by the run. However, this provision of liquidity provides uninsured depositors with the escape hatch described above.

Although bank runs have enormous academic appeal, the real world seems much less enamored of them. Dwyer and Gilbert, for example, document very well the numerous steps taken repeatedly before the founding of the Federal Reserve System, usually through local bank clearinghouse associations, to mitigate the affects of runs.[5] The driving force for founding the Federal Reserve was to lessen the destructive affects of bank runs. In effect, the formation of the Fed nationalized and also knitted together the local, independent private bank clearinghouse function.

The bankruptcy laws are further evidence of a public policy distaste for sudden withdrawals of credit from a troubled business. The automatic stay provision of the Bankruptcy Code (11 U.S.C. Sec. 362) effectively prevents a run by creditors on a company that has filed for protection under the bankruptcy laws.

A Very Real Argument in Favor of a TBTF Policy: Avoiding the Wrath of Depositors. A seldom stated but very real reason that TBTF is invoked is to avoid the concentrated wrath of uninsured depositors who might otherwise suffer losses. A handful of depositors who suffer material losses will raise much more intense political hell with regulators than will the banking industry (which bears the first dollars of loss when uninsured depositors are protected) or the general taxpayer in a more severe situation.

[5] Dwyer, Gerald P., Jr., and R. Alton Gilbert, "Bank Runs and Private Remedies," Bulletin of the Federal Reserve Bank of St. Louis, May/June 1989, pp. 43-61.

The imposition of losses on depositors in the failed Freedom National Bank of Harlem is one recent incident where political scorn is dumped on regulators when they do not invoke TBTF. This scorn raises embarrassing questions about why the regulators failed to act earlier to save the bank or to close the bank before it became insolvent. Worse, the losses after closure finally occurs are suffered by less sophisticated depositors who garner the greatest political sympathy. More sophisticated and watchful depositors, of course, escape any loss because they withdraw their uninsured deposits *before* the regulators act.

In effect, abandoning the TBTF policy is premised on the idea that regulators will sneak up on a troubled bank, close it, and thereby impose losses on its least sophisticated depositors; i.e., those who were not smart enough to withdraw their uninsured deposits before the bank was closed.

Yet Another Argument in Favor of a TBTF policy: Avoiding Regulatory Accountability. Another reason regulators invoke TBTF is to avoid accountability for a decision to close a bank if that closure subsequently creates systemic instability or a painful political backlash. The regulators who actually decide to close a bank are very reluctant to take the political heat for closing a bank if that closure would create economic distress or a political uproar. A regulator does not want to go down in history as having triggered the collapse of the Western world if his or her decision to *not* invoke TBTF creates a financial panic.

FDIC Chairman Seidman expressed this sentiment very succinctly when he stated in 1988: "The bottom line [re TBTF] is that nobody really knows what might happen if a major bank were allowed to default, and the opportunity to find out is not one likely to be appealing to those in authority or to the public."[6] The strongest support for abandoning TBTF comes from those who will *not* have to pull the trigger.

It is the fear of *both* systemic instability and political wrath that causes regulators to delay closing a large, insolvent bank until such time as most uninsured depositors can beat it out the door. In effect, then, a TBTF policy greatly diffuses unhappiness over regulatory actions.

In addition to the deposit shrinkage in BNE discussed above, substantial deposit shrinkage, before closure, also occurred in other large failed banks, notably FirstRepublic and Continental Illinois. In the latter case, the Fed in 1984 provided a peak of $7.6 billion in emergency liquidity as Continental deposits plunged from $29.4 billion to $17.5 billion in the second quarter of 1984 and to $15.1 billion by the end of 1984.

It apparently was a stated policy of the Federal Home Loan Bank Board and more recently is a policy of the Resolution Trust Corporation (RTC) to actively work to

[6] Remarks by Chairman Seidman to the Garn Institute Deposit Insurance Forum, November 14, 1988.

reduce uninsured deposits in insolvent S&Ls before they are closed. The staff of the House Banking Committee provided explicit detail to the committee just last year about this policy.[7] In effect, delayed closure of a failing or insolvent bank is a backdoor way of implementing a TBTF policy.

The practice of squeezing uninsured deposits out of a troubled bank is not limited to the U.S. The same thing happened at Canada's Standard Trust Co. According to one news account, "The regulators had been discouraging the trust company from taking deposits over the insurable limit of $60,000 in recent months, and some customers had reduced their accounts below that level."[8]

The Treasury Department, through its placement of tax-and-loan deposits also occasionally provides some of the liquidity needed by a troubled bank to enable uninsured depositors to make their getaway. This allegation was made most recently in the BNE situation.[9]

Delayed closure also gives troubled banks time to liquidate assets and to sell business units to raise cash to fund deposit outflows. These forced sales of a bank's better assets is comparable in outcome to the long discredited 18th century medical practice of bloodletting. That practice, of course, killed George Washington, among many others; it also is very successful today in killing banks.

Troubled banks often become very aggressive solicitors of insured deposits to replace the departing uninsured deposits. In effect, uninsured deposits and unsecured credit are replaced by insured deposits. The regulators are empowered under FIRREA to grant a waiver to a troubled bank so that it can gather brokered, insured deposits to help maintain its liquidity. In effect, the regulators themselves abuse the often unfairly maligned brokered deposits to facilitate their efforts to protect uninsured depositors from losses.

Thus, in many failed banks, the greater amount of protection for uninsured depositors is provided *before* the regulators dispose of the bank. Unfortunately, from the regulators' perspective, not all uninsured depositors take the hint. Despite its highly publicized troubles, BNE reportedly had $2 billion of uninsured deposits at the time it was closed. Perhaps these depositors were the hard-core believers in the TBTF policy or they were persons who felt they had to support BNE to the end or they simply were naive. In any event, these depositors were winners because they were paid high rates of interest by the troubled BNE and in the end TBTF protected them from any loss.

---

[7] "Regulatory Treatment of Uninsured Deposits in Failed Institutions" in the report on Hearings before the Committee on Banking, Finance and Urban Affairs, House of Representatives, Serial No. 101-169, September 25, 1990, pp. 336-358.

[8] Howlett, Karen, "Trust's Branches Padlocked by Ottawa," Toronto Globe and Mail, April 19, 1991, page A1.

[9] The New York Times, December 13, 1990, page A1.

Despite the best efforts by the RTC to scare off uninsured depositors, there still are some uninsured deposits in S&Ls resolved by the RTC. However, many of these deposits are protected from loss when the S&L's deposits are disposed of through a "purchase-and-assumption" transaction that protects all deposits.

Thus, regulators are in an increasingly unenviable position: They are damned if they delay so that uninsured depositors can run and then they are damned whether or not they protect the uninsured depositors who did not run. On balance, regulators probably take less heat politically if they delay closure to allow the maximum runoff of uninsured deposits and then invoke TBTF once they no longer can postpone closure. This calculus reinforces why it will be extremely difficult to enforce a no-TBTF policy even if it is enacted into law. Who, for instance, will force the regulators to actually abandon TBTF? Congress? Treasury? Bankers? Also, how will enforcement be obtained? Would a banker or a member of the general public be empowered, through the right of *mandamus*, to seek a court order forcing the closure of a large, failing bank?

Regulatory delay to allow depositor flight unfortunately greatly erodes the franchise and organizational value of the insolvent bank. This erosion further adds to the deposit insurer's loss when closure finally occurs. Because intangible franchise and organizational values are not recorded as an asset of a bank, it is difficult to measure a loss in their value. However, this loss does represent the destruction of real economic resources. I have estimated that the extremely rapid shrinkage of Continental Illinois in 1984 probably added at least $100 million to the FDIC's cost of resolving that bank failure.

Thus, regulators impose great costs on a deposit insurer when they delay closure of a failing bank so as to protect fleeing uninsured depositors. However, the cost of bank failures would be *increased* if all failing banks, regardless of size, were quickly and suddenly liquidated in an effort to impose losses on uninsured depositors. This will be the case because depositors, both insured and uninsured, will be even quicker to abandon a bank merely rumored to be in trouble, thus destroying franchise value while they are running out the door. Thus, the deposit insurer loses either way when closure is delayed or when a bank is liquidated in an attempt to impose losses on uninsured depositors. Surely there must be a better way?

The debate over abandoning TBTF has had one beneficial effect: It has helped to expose the myth that federal deposit insurance exists to protect just small depositors. In reality, deposit insurance exists to promote financial stability. Because money is fungible, a $1 billion run by a few large depositors is just as destabilizing and damaging as a $1 billion run by many small depositors. Increasingly, though, runs by large depositors may be *more* destabilizing because technology, specifically wire transfers, now enables large depositors to run much more quickly than was the case a few decades ago.

III - DETERMINING WHEN A BANK IS TOO-BIG-TO-FAIL

If the TBTF policy is to be abandoned, it first is important to understand relevant characteristics of institutions that are TBTF. Below are some characteristics that Ely & Company has quantified.

The Presence of Foreign Branches. There apparently is a great fear among regulators that if a bank closure imposes losses on depositors in the foreign branches of a bank, these losses will greatly damage foreign confidence in all American banks. Because foreigners generally do not understand the irrationality of American banking policies and because foreign governments make far fewer threats to abandon TBTF, it apparently is important to protect foreigners from seeing firsthand the attempted application of depositor discipline. Thus, any bank with at least one foreign branch probably is TBTF. The importance of foreign branches in the TBTF decision-making process was demonstrated last year when the National Bank of Washington was deemed TBTF and *all* of its deposits accordingly were protected against any loss.

Size, Measured From Several Perspectives.

Total Assets. One billion dollars in total assets probably is the biggest American bank that can be liquidated without creating systemic disturbances. Therefore, banks over that size are TBTF. The largest banks that have been liquidated (and their deposits) were 1st Service Bank for Savings, Leominster, Massachusetts ($707.7 million in a deposit transfer); Yankee Bank for Finance and Savings, Boston ($475 million in a deposit transfer); and Penn Square Bank, NA, Oklahoma City ($470 million in a depositor payoff). A few larger S&Ls have been liquidated, but these were long-term basket cases in which the regulators had flushed out just about all uninsured deposits.

Standard Trust in Canada, which was closed last month with about C$1.5 billion (US$1.3 billion) in deposits, will be liquidated through a transfer of insured deposits to another institution. Standard Trust reportedly had $21 million in uninsured deposits when it was closed. Although this institution has over $1 billion in deposits, its depositors will have to wait at least a month to get their money (except in hardship cases). This is a circumstance that would be unacceptable in the U.S., as the recent Rhode Island deposit insurer failure has demonstrated.

Total Number of Deposit Accounts. The largest number of accounts handled so far in a deposit transfer was 70,000 (First American Bank for Savings, Boston). The largest depositor payoff had 30,000 accounts (Capitol Bank & Trust, Boston). There are 140,000 accounts at Standard Trust in Canada which will be transferred, but that process is taking weeks to organize.

By way of contrast, there are 38 banks and thrifts in the U.S. that have more than *one million* deposit accounts. Another 76 banks and thrifts have between 500,000 and one million accounts. The time and resources it would take to organize the transfer of just the insured portion of 500,000 or more accounts to a bridge bank would be sufficient to enable many *uninsured* depositors to beat it out the door before the transfer actually took place. Thus, from an administrative perspective alone, these banks, and those with even a few hundred thousand deposit accounts, truly are TBTF.

Because large issuers of checks tend to clear their checks through larger banks, shifting only insured deposits of a large, failed bank to a bridge bank probably would cause tens of thousands of checks to be bounced. This will occur because the aggregate amount of checks drawn on one depositor in the bridge bank would far exceed $100,000. Unless the check issuer can make rather dramatic arrangements within a few hours to feed sufficient cash into the bridge bank from sources other than the failed bank, his checks will start bouncing with possibly very widespread and damaging repercussions throughout the nation's payments system.

Number of Depositors Who Will Suffer a Loss. Based on available data, the largest number of depositors in an FDIC-insured bank in which uninsured depositors have suffered a loss was 3,888, in the Sharpstown Bank (Texas) failure in 1971. This figure suggests that the TBTF cutoff is at or above this number of depositors.

Amount of Uninsured Deposits. Based on available data, the largest amount of uninsured deposits in an FDIC-insured bank in which uninsured depositors were exposed to a loss was $35.9 million in the Western Bank-Westheimer (Texas) failure in 1987. This figure suggests that the TBTF cutoff is at or above this amount. Ely & Company has filed a freedom-of-information request with the FDIC to obtain missing data on some bank liquidations. This request may reveal larger numbers than those cited above. Freedom National, with $11 million of uninsured deposits at the time of closure, suggests that in the future banks with uninsured deposits of at least this amount may be treated as TBTF.

Substantial Amounts of Interbank Deposits. The presence of substantial amounts of interbank deposits is often given as the reason the TBTF policy was applied to Continental Illinois. The fear reportedly was that imposing large losses on these deposits would have caused the insolvency of many small banks. However, the number of failures that actually would have occurred is widely disputed.

Time Since last Embarrassing Imposition of a Large Amount of Losses on Depositors. The Herstatt failure in Germany in 1974, which imposed substantial losses on large depositors and other creditors, apparently still discourages foreign bank regulators from imposing large losses on depositors. The Johnson-Matthey failure in Britain in 1984, in which all depositors were fully protected, undoubtedly reflected the lessons of both Herstatt and Britain's Secondary Banking Crisis of the early 1970s. The uproar over the Freedom National liquidation probably has lowered the TBTF floor, at least temporarily and perhaps permanently.

Domicile of Depositors. While experience is mixed, one senses that it is easier to impose losses on foreign-domiciled depositors and creditors in a foreign-domiciled subsidiary of a failed bank. This is quite different than imposing losses on foreign-domiciled depositors or creditors in a foreign *office* of a U.S.-domiciled bank. This distinction apparently is recognized by the Basle Concordat (adopted in 1975), which provides guidance to central banks in supervising banks that operate in more than one country.

In 1982, the Bank of Italy assumed no responsibility for the insolvency of Banco Ambrosiano Holdings, a non-bank, 70%-owned Luxembourg affiliate of Italy's failed Banco Ambrosiano. Creditor losses in the Luxembourg affiliate are estimated to have totaled about $130 million[10]

However, in 1983, the German authorities went in the opposite direction and protected all the creditors of the Luxembourg subsidiary of Schroeder, Munchmeyer, Hengst & Co., a failed German bank. More recently, in 1988, the French government insisted that all foreign as well as all domestic depositors in Al Saudi Banque be reimbursed in full when it failed. Thus, one senses a shift towards protecting foreign-domiciled depositors of a failed bank *unless* those depositors are two or three levels removed from the failed parent bank.

IV - THE REALITY OF TOO-BIG-TO-FAIL MUST BE ACCEPTED FOR SEVERAL REASONS

Unilaterally Abandoning TBTF Is Not Feasible. It will be extremely difficult for the U.S. to abandon TBTF unilaterally because unilateral abandonment of TBTF will harm the domestic competitiveness of American-domiciled banks. Large depositors will be tempted to shift deposits, and related borrowing relationships, into the domestic branches of foreign-domiciled banks and into American-domiciled banks owned by foreign banks in order to better protect themselves against suffering a loss in a failed bank.

An international compact on abandoning TBTF will not be reliable either. Unlike the risk-based capital standards being implemented under the Basle accord, an international no-TBTF accord will be unenforceable since any one country could abandon this policy on a moment's notice. Because other countries have much less punitive attitudes towards large depositors in failed banks, politicians in those countries will quickly overrule their banking regulators if a large bank failure might impose losses on a substantial number of voters.

Perhaps the lower level of zeal in other countries to abandon TBTF also reflects the fact that no other country was ever invaded by the Puritans although England was their breeding ground. I say this because one senses that an almost Puritanical-like

[10] Defaulted borrowings of $400 million times a loss rate of 33%. Based on data set forth in "Modernizing the Financial System," U.S. Department of the Treasury, February 1991, pages XXI-10 and XXI-11.

desire for revenge against large depositors drives those Americans who advocate abandoning TBTF. Perhaps this drive also reflects an understanding that continued large bank insolvency losses *not* borne by depositors may eventually undermine the political support for government regulation and therefore close government control over banks. The fear is that if regulation cannot prevent large bank insolvency losses, then the political process will be forced to seek non-regulatory methods for reducing the threat bank insolvency losses increasingly pose to taxpayers/voters.

Some Hard-to-Answer Questions About Abandoning TBTF Further Illustrates the TBTF Dilemma:

- When to abandon TBTF?

- How to phase in a no-TBTF policy?

- How to credibly abandon TBTF?

- How to justify invoking TBTF, once the TBTF policy has been officially abandoned, when reality intrudes and losses really should not be imposed on uninsured depositors in an insolvent bank?

- How to reestablish the credibility of a no-TBTF policy once an exception has been made to that policy?

- What to do when credibility cannot be reestablished convincingly?

This testimony will suggest no answers to these questions because I believe that it is unwise to attempt to abandon the TBTF policy, for the following reasons.

It Will Be Impossible to Convincingly Abandon TBTF. The banking regulators and the Fed in particular want to preserve TBTF because it preserves their options and their power in dealing with banks, especially those in trouble. No matter what is done to force earlier closure, the intent of a strict no-TBTF policy will largely be defeated by the Fed's discount window lending. The only way to effectively shutter the discount window is to prohibit the Fed from lending on a collateralized basis. Then the Fed, fearful of losing taxpayer monies, will lend only to the strongest banks who are least likely to need or desire to borrow at the Fed. However, barring the Fed from making collateralized loans will effectively kill its role as lender of last resort.

Thus, illiquid banks of questionable solvency will have to look elsewhere for emergency liquidity even if they have plenty of good collateral to pledge. If they cannot find sufficient liquidity in a crunch, they will have to shut their doors and begin to liquidate. The Fed was created of course, to prevent just this type of situation. *Thus, Congress faces this dilemma: A key element that keeps the TBTF policy alive also is the mechanism for providing emergency liquidity to banks.* This conundrum reflects this dichotomy: The ultimate beneficiaries of loans made by the lender of last resort, large, uninsured bank depositors, are the same parties who benefit from the TBTF policy.

The Cost of Attempting to Abandon TBTF is Not Worth the Price. Adopting and enforcing a no-exception or very limited exception TBTF policy will not be a cost-free exercise. The number of failed banks actually may increase because an increased certainty that a troubled bank will be liquidated will trigger more quickly a broader run of both insured *and* uninsured deposits from a troubled bank than currently is the case. These runs will ensure that a higher percentage of the banks that hit the FDIC's problem bank list will fail. In effect, a heightened fear of failure may make bank failure a self-fulfilling prophecy more often.

Eliminating TBTF Actually Will Increase the Cost of Disposing of Failed Banks. Broader, quicker runs on troubled banks will more dramatically shrink the franchise or going-concern value of troubled banks, especially as departing depositors take their borrowing and other banking relationships with them to other banks. Losses in franchise value can only add to a deposit insurer's loss. Franchise value is a very real and significant banking asset. It represents the value that has been created over the years as banks have opened branches, built reputations, and created a base of customers, largely depositors. Conservatively assuming an average franchise value equal to 4% of deposits, the total amount of franchise value in BIF-insured banks exceeds $100 billion. This amount is equal to almost half of the tangible capital in the banking system.

Liquidations or insured deposit transfers of banks are even more destructive of franchise value, which further adds to the cost of disposing of a failed bank. Strict adherence to a no-TBTF policy effectively means an end to purchase-and-assumption transactions in which the buyer of a failed bank assumes liability for all deposits. These transactions now seek to minimize the deposit insurer's loss by maximizing the recovery of the failed bank's going-concern value.

V - THE CONSEQUENCES OF ABANDONING TOO-BIG-TO-FAIL

There are adverse consequences of a no-TBTF policy that must be acknowledged and addressed, specifically increased financial instability. Runs on larger banks will occur sooner than they now do; they also will sweep a larger portion of uninsured deposits out of these banks than now occurs. More dramatic runs will have at least three likely adverse consequences:

One, the Fed, through its discount window activities, will have to fund a larger portion of the run. This will be the case because the troubled bank will not have as much time to sell assets to raise cash.

Two, a troubled bank will have to sell assets at a deeper discount, thus reducing its chances for executing a turnaround and survival. As a result, its insolvency loss, should insolvency occur, will be larger than would occur if the bank experienced a slow, silent run.

Three, the regulators will have to act under greater duress to engineer a merger of the bank in order to avoid an outright closure of the bank. This duress will lower the probability of an assisted merger and therefore increase the probability that the bank will have to be closed and liquidated at a higher cost to the deposit insurer.

Even the probability of having more runs will have at least three adverse consequences on American banks, even in the absence of runs.

One, shifting deposits to uninsured depositories. The increased regulatory burden on insured depository institutions that will accompany the implementation of the no-TBTF policy will drive deposits towards explicitly uninsured firms, such as MMMFs. This shift will increase the probability of systemic financial instability. This shift will occur because the rising regulatory burden will raise the operating and capital costs of insured institutions relative to the costs of uninsured depositories such as MMMFs.

This increased cost differential will enable the MMMFs to pay even more attractive yields that will enable the MMMFs to attract more rate sensitive deposits from insured institutions. This growing cost differential explains why total MMMF deposits grew 12.8% annually from the end of 1986 to the end of last year while domestic deposits in insured banks and thrifts grew only 2.8% annually in that same four-year time period. Viewed from another perspective, general purpose MMMFs grew from 8.2% of the retail deposit market to 11.9% between December 1986 and February of this year. There is every indication that these percentages will continue to grow. However, as deposits in uninsured institutions grow, these institutions will become an increasing threat to the taxpayer-backed federal safety net.

Chart 2 illustrates how uninsured financial institutions which potentially could borrow from the Fed represent a direct threat to the general taxpayer. As this chart shows, the general taxpayer is protected from insolvency losses in federally insured banks and thrifts, to the extent that those losses do not overburden healthy institutions. No comparable insurance or guarantee mechanism exists for those presently uninsured institutions that conceivably could borrow from the Fed in a crisis situation.

Because MMMFs are not explicitly insured by the federal government, any concerns about the safety of MMMFs will cause even the smallest depositor to run from these funds if one or a few funds are rumored to be unable to redeem their shares at par. Although MMMF depositors theoretically are investors in these funds and thus are not guaranteed to always be able to redeem their shares at par value, in reality, MMMF depositors expect to get their funds back *on demand and at par value*. SEC regulations also support the policy that MMMFs maintain a stable net asset value. MMMF depositors in a troubled fund who do not run in time are subject to an immediate, automatic "haircut" in the value of their principal if their fund shares suddenly are redeemable at less than par value or they begin to carry a below-market interest rate.

Structure of Federal Safety Net

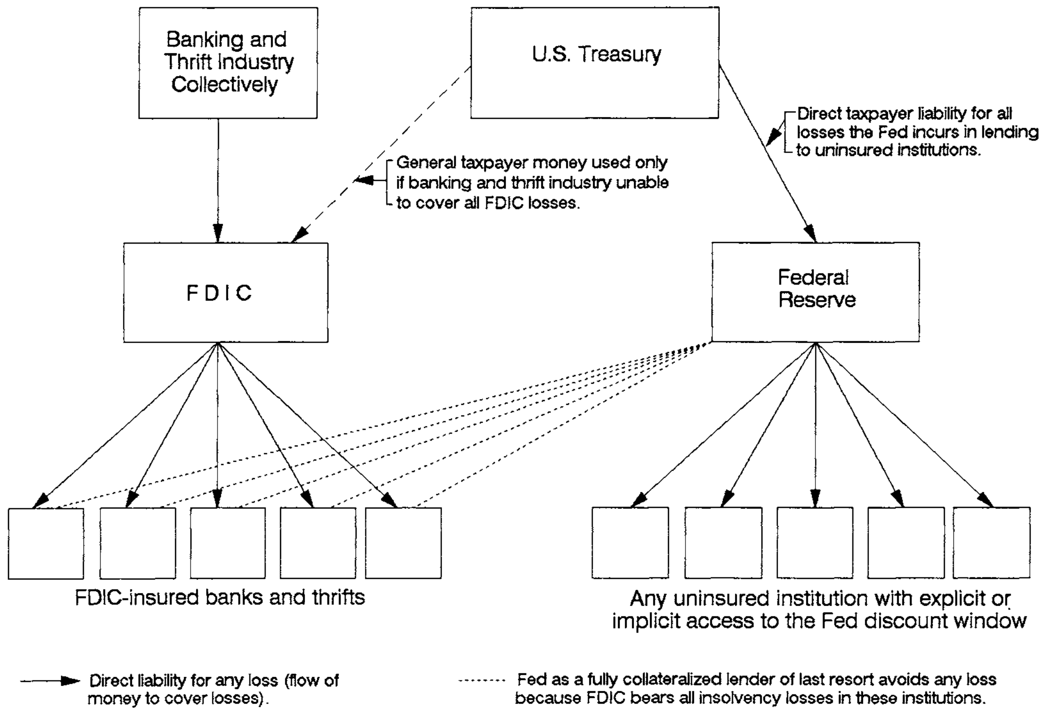


Chart 2

Because of their enormous size ($500 billion in assets on February 28, 1991) MMMFs are implicitly protected by the federal safety net. Continued growth of the MMMFs increases the probability that this safety net will be made explicit when the first wave of nervousness causes a run on MMMFs. In a few years, MMMFs could become a $1 trillion gorilla that even the Fed cannot ignore. The Fed will have no choice but to open the discount window to MMMFs if they experienced a sudden run so that the MMMFs will not have to dump securities on the market to fund deposit withdrawals. The Fed, like any other regulator, will much prefer the political heat of risking a loss to taxpayers to incurring the much more intense wrath of MMMF depositors who might suffer a loss. The provision of Fed cash to MMMFs will, of course, indirectly protect fully those MMMF depositors who run fastest.

MMMFs also may become riskier as their growth, relative to total financial assets in the economy, makes it more and more difficult for them to maintain short-term maturity *matching* within their portfolios. Thus, attempts to abandon the TBTF policy, which are in concert with efforts to shrink the size of the explicit federal safety net will have the ironic effect of *broadening* the federal safety net by forcing vast quantities of hazardous liabilities into depository institutions only implicitly backed by the federal safety net.

Two, a strict no-TBTF policy may cause higher deposit insurance losses to be imposed on a static or possibly shrinking base of deposits in explicitly insured institutions. Imposition of a strict no-TBTF policy will reduce total domestic bank deposits as a percent of GNP as deposits are driven out of the insured institutions. The dramatic shrinkage in 1990 in the deposit/GNP ratio may merely be the start of a long-term shrinkage of bank and thrift deposits. The deposit insurance tax currently is assessed on *total* domestic bank deposits, not just insured deposits.

If a strict no-TBTF policy drives deposits out of insured institutions, and weakens banks in the process, then higher bank and thrift insolvency losses, as posited above, will have to be spread over a shrinking deposit base. The resulting higher deposit insurance premiums will make insured institutions even less competitive relative to uninsured institutions such as MMMFs.

Three, the U.S. market share for American-domiciled banks will shrink because of a strict no-TBTF policy. Because moving from one bank to another is time-consuming and expensive, increasing numbers of uninsured and even insured depositors may seek to deposit and borrow from banks operating within the U.S. that are chartered by countries with a more explicit TBTF policy. Because many small businesses, non-profit groups, and retirees also at times have deposit balances over $100,000, they too would find it prudent to bank with foreign domiciled banks deemed TBTF by their regulators.

Given that international trade, including the provision of domestic services such as banking, should be governed by the rules of comparative advantage, is Congress prepared to concede a broad comparative advantage in domestic banking to other nations? In effect, are we prepared to concede that other countries are better regulators of financial institutions than U.S. regulators?

VI - ABANDONING THE CONCEPT OF DEPOSITOR DISCIPLINE MAKES THE TOO-BIG-TO-FAIL ISSUE MOOT

Accepting the reality of the TBTF policy is *not* an argument against preventing banks from failing. Instead, it is an argument over who should bear the cost of bank failures: equity capital invested in banking *or* depositors and other creditors. Extending the TBTF policy to *all* banks merely states that depositors will not bear any loss in a failed bank; a TBTF policy does not answer the crucial question of who will bear the loss, taxpayers or equity capital invested in banking. That question must be addressed separately.

Legal Challenges to the Present TBTF Policy Will Undermine Depositor Discipline. Any ambiguity about the reality of TBTF may be ended by a court decision which finds that the present TBTF policy discriminates against explicitly uninsured depositors in banks deemed too small to save. Freedom National may just be that test case. A court might rule, for example, that statutorily uninsured depositors in all banks must be treated equally; i.e., explicitly uninsured depositors must be fully protected in all bank failures or uninsured depositors in a bank of any size must share in the insolvency loss of that bank.

Such a decision would force the extension of the TBTF policy to banks of all sizes because as a practical matter, TBTF cannot be abandoned for larger banks, especially those with foreign branches. The effect of such a decision would be to explicitly extend deposit insurance to *all* deposits. This extension also would effectively end the concept of depositor discipline.

The Freedom National case raises a second, provocative question: Is it lawful for a bank regulator to knowingly permit a clearly insolvent bank (as Freedom was) to accept or renew uninsured deposits? According to its call reports, Freedom was insolvent at the end of 1989, more than ten months before it was closed. Freedom reported a positive book equity capital of $428,000 on December 31, 1989, but it also had unrecorded securities losses of $1.12 million on that date, indicating that it actually was insolvent by at least $692,000, or almost .6% of its assets. However, Freedom's call reports indicate that Freedom was accepting or renewing uninsured deposits in 1990, after the institution had clearly become insolvent.

In an interesting parallel, in some states in years past, bank directors could be held personally liable for losses suffered by depositors if the bank was insolvent at the time the deposits were accepted by the bank. Why should this concept of personal liability not be extended to those regulators who permitted an insolvent Freedom National to accept uninsured deposits.

Stockholder Discipline--The Better Option. Abandoning the concept of depositor discipline (in effect, providing 100% deposit insurance) would force public policy to rely entirely on stockholders and regulators to discipline wayward bankers. Providing 100% protection for depositors also will automatically make TBTF a moot issue. However, because electronic technology is rapidly destroying the efficacy of financial services regulation, the regulatory establishment can no longer be relied upon to protect taxpayers from escalating deposit insurance losses.[11]

Thus, establishing *effective* stockholder discipline over the activities of all banks under all economic conditions is the only way to make TBTF a moot issue. Effective stockholder discipline means that every dollar of loss within any failed bank has to be absorbed by private sector equity capital voluntarily committed to accepting the risk of bank insolvency. Ensuring that someone's equity capital always will be available to absorb all bank insolvency losses means that neither depositors nor taxpayers will ever bear a bank insolvency loss. Depositors will have no reason to panic and run from a bank and increasingly undependable regulators will not have to be relied upon to protect taxpayers from losses incurred in protecting depositors from losses.

Because banks are limited liability corporations, losses within any one bank can exhaust that bank's equity capital. However, it is highly, highly unlikely that the equity capital of the entire banking system could ever be exhausted. Thus, a deposit insurance mechanism that explicitly places the entire earning power and equity capital of the banking system behind every dollar of deposit in every bank effectively eliminates all depositor risk. TBTF then disappears as a political issue.

Even during the Great Depression, member banks of the Federal Reserve, as a whole, had positive capital and positive current earnings. In 1933, the bottom of the Depression, member banks of the Federal Reserve System had operating earnings (before loan loss provisions) of $378 million and equity capital at the end of 1933 of $4.96 billion. On June 30, 1933, Fed members held 82% of all assets owned by commercial banks. The total book capital of all commercial banks on that date was $6.2 billion, almost five times the losses depositors experienced in banks that failed in the 1930-33 period. Thus, there was enough earning power and equity capital within the banking system during the worst of the Depression to have absorbed all depositor losses in insolvent banks and still have left the banking system adequately capitalized to rebuild itself as the country pulled out of the Depression.

The 100% cross-guarantee concept, which is described in Attachment A, represents one way in which to more effectively use the earning power and equity capital of the banking system to fully protect all depositors in all banks against bank insolvency

---

[11] The witness has described in numerous forums how electronic technology is destroying the efficacy of financial services regulation, including "Technology, Regulation and the Financial Services Industry in the Year 2000," Issues in Bank Regulation, Fall 1988, pp. 13-19; "Fundamental Issues in Deposit Insurance Reform," testimony on October 3, 1990, to the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations; and "The Narrow Bank: A Flawed Response to the Failings of Federal Deposit Insurance," Regulation, The Cato Institute, Spring 1991.

losses in any adverse economic circumstance. The cross-guarantee concept also will allow for the optimal amount of maturity mismatching within the economy, within the context of safe and sound banking.

Placing the entire burden of disciplining bankers on equity capital *voluntarily* placed at risk (and properly compensated for that risk) should dramatically reduce bank insolvency losses while allowing marketplace mechanisms to bring greater efficiency to the depository intermediation business. Unlike regulators who suffer no personal financial loss when a bank fails, equity capital voluntarily placed at risk would bear the full cost of all bank insolvency losses.

VII - CONCLUSION

The TBTF policy is an inescapable reality of today's industrialized world. The various legislative remedies proposed this year to escape from TBTF will not work. Instead of continuing to fight the reality of TBTF, we must move quickly to reshape the disciplining forces that act on bankers. The notion of depositor discipline must be abandoned as the necessity of TBTF becomes more evident. Attempting today to impose losses on large numbers of depositors is increasingly counter-productive and costly. Instead, we must look to an unfailing application of stockholder discipline to bring safe, sound, and efficient banking to America. The cross-guarantee concept described in the attached appendix is one way, and perhaps the only way, to achieve that goal.

Attachment A

REFORMING DEPOSIT INSURANCE WITH 100% CROSS-GUARANTEES

How 100% Cross-Guarantees Would Work

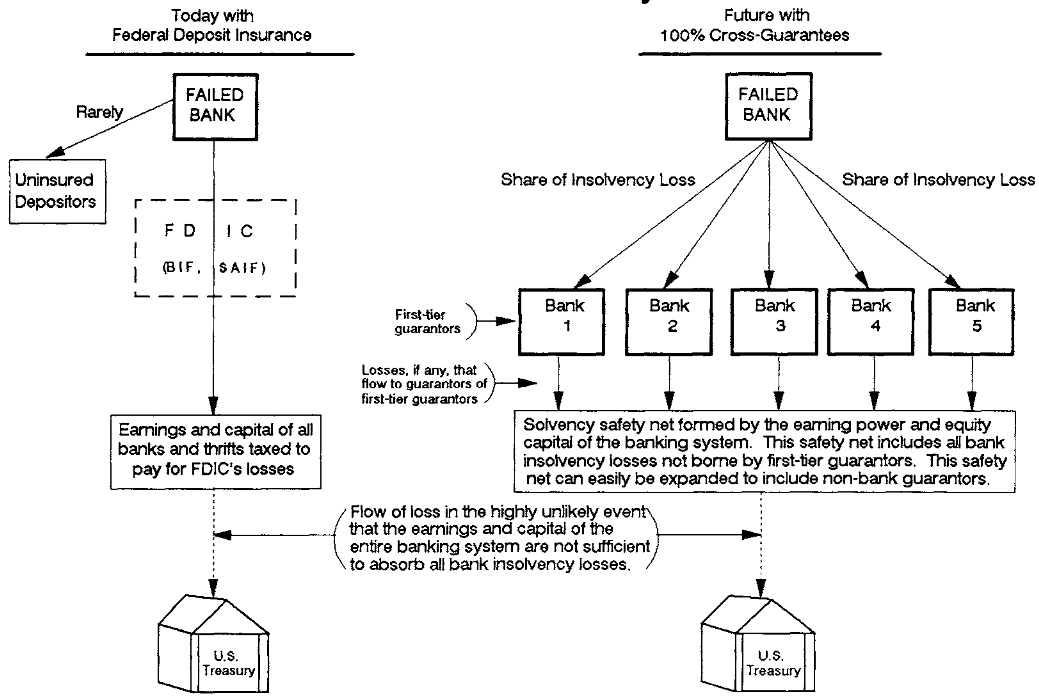
Briefly, the 100% cross-guarantee concept is an industry self-insurance mechanism which would more effectively use the earning power and the equity capital of the entire banking system to protect all deposit balances in all banks and thrifts against any loss whatsoever. The 100% cross-guarantee concept modifies the existing system of federal deposit insurance in three important, yet easily implemented ways. One, it substitutes risk-sensitive premiums established in a private, competitive marketplace for the present flat-rate deposit insurance premiums now charged by the FDIC. Two, it would insure all deposits so as to reduce insolvency losses should a bank fail. Three, the bank closure decision would effectively be shifted from government regulators to the private guarantors of a bank. **Chart 3** contrasts the present system of federal deposit insurance with the 100% cross-guarantee concept.

Under 100% cross-guarantees, individual banks would enter into a voluntary cross-guarantee contract with other banks and even other types of guarantors. This contract would protect all of a bank's deposits, including balances over $100,000, from any loss of principal, interest, or liquidity. Other liabilities of the guaranteed institution also could be protected under the contract. Each cross-guarantee contract would be issued by an ad hoc syndicate of banks called "first-tier" guarantors. Conceivably, non-bank firms and wealthy individuals also could participate as guarantors. Each guarantor bank would itself be guaranteed by a separate syndicate of guarantors. Syndicates would be organized and managed by specialized firms called syndicate agents.

Guarantors would periodically collect a risk-sensitive deposit insurance premium from each of the banks they guaranteed. Premium formulae would be negotiated solely between the guaranteed bank and its guarantors, with the riskiest banks probably charged as much as 15 or 20 times the rate charged the safest banks. The formula for each guaranteed bank would be designed to adjust the premium rate as the riskiness of that bank to its guarantors varied.

In order to reinforce depositor confidence in banks, the FDIC could continue to insure all deposits up to $100,000, in effect, forming an insured bank within a guaranteed bank as shown in **Chart 4**. However, due to the low level of insolvency losses anticipated with cross-guarantees, it is highly unlikely that the FDIC would ever suffer a loss since the bank's equity capital and the guaranteed liabilities would be the first to be wiped out in the case of a large insolvency loss.

Flow of a Bank's Insolvency Loss If It Fails



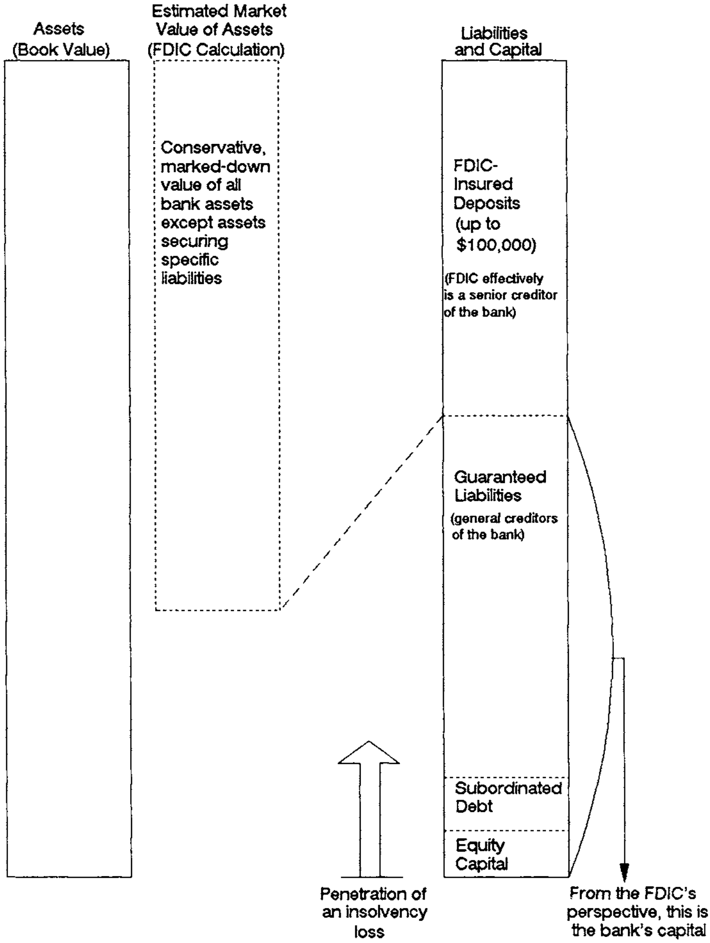
Note: Dotted line around the FDIC fund denotes the fact that this fund does not actually exist because it is incorporated in the consolidated federal budget. Losses paid by the FDIC actually count as government spending when money is disbursed.

Flow of insolvency loss

Chart 3

Chart 4

Larger Bank With Guaranteed Liabilities
"An Insured Bank Within a Guaranteed Bank"



Safeguards Built Into Cross-Guarantees

Numerous safeguards have been incorporated into the 100% cross-guarantee concept, some of which are discussed below. Working together, these safeguards would permit both the banking system and the ongoing risk syndication process to operate smoothly and efficiently while providing depositors, public officials, taxpayers, and the rest of the world unsurpassed confidence that the American banking system would function without hesitation even during times of enormous economic and financial stress.

Guarantors Must Be Guaranteed Institutions and Also Must Have "Stop-Loss" Protection. All guarantors would have to have their deposits and their cross-guarantee obligations guaranteed by yet other guaranteed institutions. This feature, plus the stop-loss feature in all cross-guarantee contracts, is perhaps the most important safeguard for 100% cross-guarantees. It is the device by which the occasional large bank insolvency loss would be spread very widely, but thinly, across the earnings and equity capital base of the entire banking system and to others who voluntarily contracted to be guarantors.

Thus, in the rare event of a large loss or concentration of losses, the "stop-loss" provision in each cross-guarantee contract would permit a portion of that loss to be passed through the guarantor banks to their own guarantors. This "stop loss" provision would, therefore, prevent any guarantor losses from driving a guarantor bank into insolvency. **Chart 5** illustrates how a very large insolvency loss would flow from tier to tier of guarantors until the loss had been fully but safely absorbed by private equity capital.

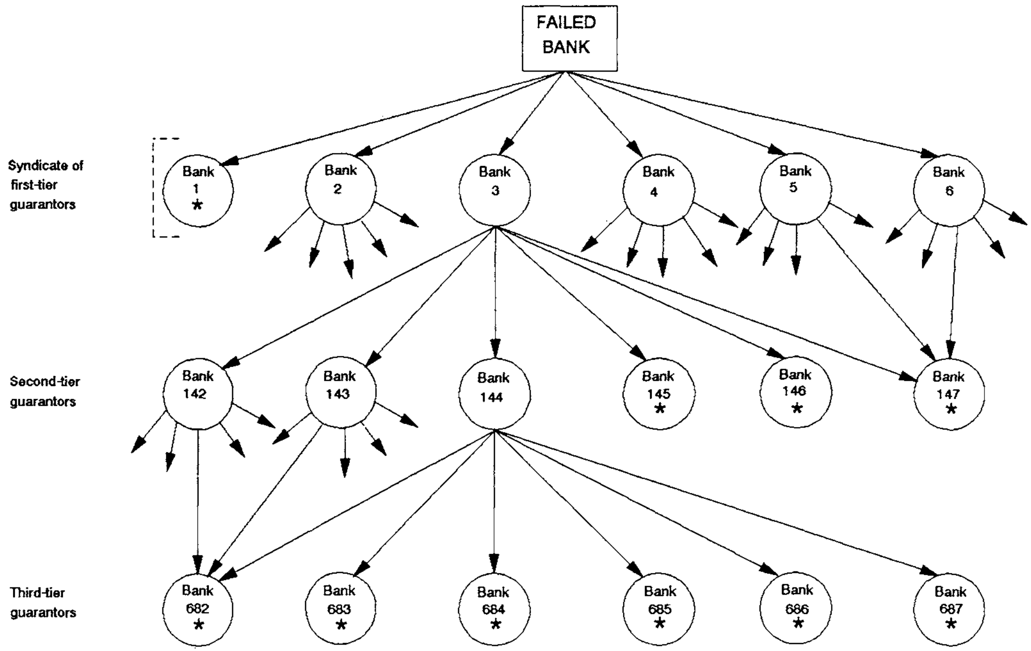
Risk Diversification Requirements Imposed on Guarantors. In order to diversify their risk as guarantors, even large guarantors could assume only a small portion of many cross-guarantee risks. Thus, a guarantor's exposure to a cross-guarantee loss in any one bank would be limited to just a small portion of the guarantor's equity capital that it could risk as a guarantor. A guarantor's aggregate cross-guarantee risk exposure also would be limited by its capital resources.

Risk Diversification Requirements for Any One Cross-Guarantee Contract. Each guaranteed bank would have to have a minimum number of guarantors, with a larger number of guarantors required for larger banks. No one guarantor could assume more than a small share of the total risk of any one cross-guarantee contract. Also, a small group of banks could not join together to cross-guarantee each other in an undiversified manner that consequently contained all or most of the risk of failure within this group of banks. The failure of one bank in this "closed loop" situation could trigger a string of domino-like failures among the other banks in the closed loop.

Bank Run Protection. Providing unlimited amounts of liquidity to a bank experiencing a run is the only effective way to stop the run. The emergency liquidity injected into a bank would let its nervous depositors protect their wealth by pulling their money out of the bank in accordance with the original terms of their deposit contract. Therefore, guarantors would be prepared to provide whatever liquidity was necessary to arrest a bank run. However, protecting every dollar of deposit, as 100% cross-guarantees would do, would, as a practical matter, eliminate bank runs. Minimizing the threat of

Chart 6

Example of How a Very Large Insolvency Loss Might Flow Through Multiple Tiers of Guarantor Banks under the Stop-Loss Reinsurance Provision of 100% Cross-Guarantee Contracts



* Four first- and second-tier guarantors (Banks 1, 145, 146, and 147) and all the third-tier guarantors have no losses flowing out of them because their share of the failed bank's insolvency loss does not reach their stop-loss reinsurance limit.

Flow of insolvency losses →

bank runs also would help to preserve the franchise value of a troubled bank which, in turn, would reduce the insolvency loss in any guaranteed bank that actually failed.

The Many Benefits of Cross-Guarantees

The 100% cross-guarantee concept would provide many benefits to the banking system, to the economy, and to the American taxpayer. Most significantly, 100% cross-guarantees would not take away any existing protection for depositors or the financial system. Instead, cross-guarantees would vastly improve taxpayer protection by absorbing bank insolvency losses within the solvency safety net constructed by the stop-loss feature.

Since private guarantors, and not the regulators, would be responsible for closure decisions, early closure of failing banks would finally become a reality. Timely takeovers of failing banks, before they became insolvent, would improve the overall efficiency of the economy by ridding the banking system of inefficient competitors.

Protecting all deposits, including balances over $100,000, would eliminate completely the need for depositor discipline. Risk assessment activities would be shifted from a highly risk-averse set of creditors (bank depositors) to that source of funds (equity capital) that is best suited to assess and price financial risks. *With full protection for all deposits, the regulatory practice of TBTF would be eliminated since large depositors would be no more exposed to loss than small depositors. By protecting all deposits in a guaranteed institution, cross-guarantees represent the only way to truly get rid of TBTF by making TBTF a moot issue.* Eliminating TBTF through 100% cross-guarantees also would greatly improve the competitiveness of community banks which in the past have been discriminated against by regulators due to the TBTF policy.

Risk-sensitive premiums would deter unwarranted risk-taking by banks and encourage wiser lending and investment practices, thus allowing banks to innovate at their own pace. Wiser lending also would lead to a more productive use of credit within the economy, which in turn would enhance GNP growth. Risk-sensitive premiums, based on leading rather than lagging indicators of banking risk, finally would force the drunk drivers of the banking world to pay for the risks they are assuming. Thus, properly priced risk-sensitive premiums would largely eliminate the cross-subsidy now flowing from good banks to bad due to flat-rate deposit insurance premiums.

Risk-sensitive premiums based on leading indicators of banking risk, such as risk mismatching, asset concentrations, and operational deficiencies, would steer most banks away from trouble long before they became insolvent. In effect, properly structured risk-sensitive premiums would provide an enormous deterrent to risky banking and wasteful extensions of bank credit. **Chart 6** illustrates how risk-sensitive premiums would work in three different situations. The actual capital in a bank is assumed to be a proxy for the riskiness of the bank.

In Bank 1 (the top bank in Chart 6), the premium rate rises as the bank's riskiness increases until finally the bank's management takes corrective action. The bank's riskiness then begins to decline and its premium rate drops accordingly. In Bank 2 (the middle bank), the bank's condition continues to decline until it is recapitalized, at which time its premium rate drops dramatically to reflect the suddenly reduced riskiness of the bank. The newly invested capital will reasonably be able to bargain to capture the lion's share of the premium savings. These savings will provide a powerful incentive to attract fresh capital to troubled banks that now is absent with the FDIC's flat-rate premiums. Bank 3 (the bottom bank) does not turn itself around nor does it attract fresh capital. It eventually is taken over by its guarantors, most likely when the premium rate hits a certain level, but before it actually becomes insolvent.

The 100% cross-guarantee concept would greatly increase financial stability within the banking system by explicitly protecting all domestic and foreign deposits of American banks. Cross-guarantees also would dramatically reverse the rapidly declining credit-worthiness of American banks because guaranteed banks would be AAA credit risks. This would make guaranteed banks much more competitive. They would not only enjoy a lower cost of funds, but properly capitalized banks also would pay far less for their deposit insurance than they now pay. In addition, there would be far fewer regulatory burdens on banks and thrifts that now add greatly to their operating expenses while limiting their activities. Thus, cross-guarantees offer the only way to integrate deposit insurance reform and the restructuring of financial services because 100% cross-guarantees would completely shift restructuring decisions and their associated insolvency risks to private sector capital.

Transition to 100% Cross-Guarantees

The transition to 100% cross-guarantees would be fairly easy and straightforward. Initially, healthy, well-capitalized banks would be permitted by enabling legislation to obtain cross-guarantees, beginning one year after the enactment of the legislation. The one-year period preceding this opt-in date would allow sufficient time for the cross-guarantee marketplace to establish itself and to begin organizing cross-guarantee syndicates. The capital requirement for banks to opt-into cross-guarantees should be lowered each year for five years, by which time uninsured liabilities in all banks should be protected by 100% cross-guarantees. A bank that could not obtain a 100% cross-guarantee contract by the end of that period effectively would be insolvent or would be in such marginal condition that the FDIC would have to liquidate or merge that bank out of existence. Mandatory deposit insurance coverage should be retained, however, to eliminate the "free-rider" problem that would arise if uninsured banks got into trouble.

Chart 6

Interaction Between a Risk-Sensitive Deposit Insurance Premium Rate and Capital Levels for Three Banks

(All three banks are declining at the same rate until they pull out, are pulled out, or do not pull out of their decline)