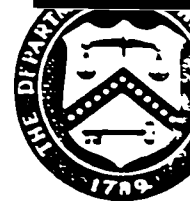


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U.S. Department of tge Treasury

PRESS RELEASES

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2000

FOR IMMEDIATE RELEASE  
January 2, 1991

CONTACT: Office of Financing  
202/376-4350

## TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately \$20,000 million, to be issued January 10, 1991. This offering will provide about \$1,300 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of \$18,696 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, January 7, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately \$10,000 million, representing an additional amount of bills dated April 12, 1990, and to mature April 11, 1991 (CUSIP No. 912794 WD 2), currently outstanding in the amount of \$19,233 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately \$10,000 million, to be dated January 10, 1991, and to mature July 11, 1991 (CUSIP No. 912794 WY 6).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of \$10,000 and in any higher \$5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing January 10, 1991. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold \$518 million as agents for foreign and international monetary authorities, and \$4,478 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).



Each tender must state the par amount of bills bid for, which must be a minimum of \$10,000. Tenders over \$10,000 must be in multiples of \$5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than \$1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of \$200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds \$200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for \$1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2

JAN 02 1991

FOR RELEASE AT 4:00 P.M.  
January 2, 1991

CONTACT: Office of Financing  
202/376-4350

## TREASURY TO AUCTION \$8,500 MILLION OF 7-YEAR NOTES

The Department of the Treasury will auction \$8,500 million of 7-year notes to refund \$5,115 million of 7-year notes maturing January 15, 1991, and to raise about \$3,375 million of new cash. The public holds \$5,115 million of the maturing 7-year notes, including \$182 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The \$8,500 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average price of accepted competitive tenders.

In addition to the public holdings, Federal Reserve Banks for their own accounts hold \$397 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders.

Details about the new security are given in the attached highlights of the offering and in the official offering circular.

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Attachment

NB-1082

HIGHLIGHTS OF TREASURY  
OFFERING TO THE PUBLIC  
OF 7-YEAR NOTES  
TO BE ISSUED JANUARY 15, 1991

January 2, 1991

Amount Offered:

To the public ..... \$8,500 million

Description of Security:

Term and type of security ..... 7-year notes  
Series and CUSIP designation .... E-1998  
(CUSIP No. 912827 ZT 2)  
Maturity date ..... January 15, 1998  
Interest rate ..... To be determined based on  
the average of accepted bids  
Investment yield ..... To be determined at auction  
Premium or discount ..... To be determined after auction  
Interest payment dates ..... July 15 and January 15  
Minimum denomination available .. \$1,000

Terms of Sale:

Method of sale ..... Yield auction  
Competitive tenders ..... Must be expressed as an  
annual yield, with two  
decimals, e.g., 7.10%  
Noncompetitive tenders ..... Accepted in full at the aver-  
age price up to \$1,000,000  
Accrued interest  
payable by investor ..... None

Payment Terms:

Payment by non-  
institutional investors ..... Full payment to be  
submitted with tender  
Deposit guarantee by  
designated institutions ..... Acceptable

Key Dates:

Receipt of tenders ..... Wednesday, January 9, 1991  
a) noncompetitive ..... prior to 12:00 noon, EST  
b) competitive ..... prior to 1:00 p.m., EST  
Settlement (final payment  
due from institutions):  
a) funds immediately  
available to the Treasury .. Tuesday, January 15, 1991  
b) readily-collectible check .. Friday, January 11, 1991



# P R E S S   R E L E A S E

DEPT. OF THE      **OVERSIGHT BOARD**

RESOLUTION FUNDING CORPORATION

FOR RELEASE AT 4:15 p.m.  
January 2, 1991  
OB 91-1

CONTACT: Felisa Neuringer  
Brian Harrington  
(202) 786-9672

## REFCORP ANNOUNCES AUCTIONS OF \$6.9 BILLION OF BONDS

The Resolution Funding Corporation will auction \$4,945,555,000 of 30 year bonds and \$2,000,000,000 of 39-1/4 year bonds on January 8, 1991 to provide funding to the Resolution Trust Corporation.

The 30 year bonds will mature on January 15, 2021, while the 39-1/4 year bonds will be a reopening of the 8-7/8% REFCORP bonds maturing on April 15, 2030. Both REFCORP bonds will be offered to the public through yield auctions conducted by the Federal Reserve Banks as fiscal agents to REFCORP. The bonds will be available in book-entry form only and in minimum denominations of \$1,000. Noncompetitive tenders must be submitted through a primary dealer or a depository institution with a book-entry account at a Federal Reserve Bank. Only commercial banks and primary dealers may submit tenders for the accounts of customers. Noncompetitive tenders will be accepted at the average price of accepted competitive tenders.

Including this sale of bonds, REFCORP will have completed its \$30 billion borrowing program authorized by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Thus, no further new offerings of bonds are planned by REFCORP.

The bonds may be stripped into their separate principal and interest components in book-entry form and may be reconstituted into whole bonds on the book-entry system maintained by the Federal Reserve.

The details on the new securities are contained in the attached highlights of the offering and in the Resolution Funding Corporation offering circular dated October 13, 1989, and offering circular supplement dated January 2, 1991.

HIGHLIGHTS OF REFCORP OFFERINGS TO THE PUBLIC  
OF 30 YEAR AND 39-1/4 YEAR BONDS TO BE ISSUED ON JANUARY 15, 1991

January 2, 1991

<u>Amount Offered to the Public</u> .....	\$4,945,555,000	\$2,000,000,000
<u>Description of Security:</u>		
Term and type of security .....	30 year bonds	39-1/4 year bonds (reopening)
Series and CUSIP designation .....	Series A-2021 (CUSIP No. 761157AG1)	Series B-2030 (CUSIP No. 761157ACO)
Maturity date .....	January 15, 2021	April 15, 2030
Interest Rate .....	To be determined based on the average of accepted bids	8- 7/8%
Investment yield .....	To be determined at auction	To be determined at auction
Premium or discount .....	To be determined after auction	To be determined after auction
Interest payment dates .....	July 15 and January 15	April 15 and October 15
Minimum denomination available....	\$1,000	\$1,000
<u>Terms of Sale:</u>		
Method of sale .....	Yield auction	Yield auction
Competitive tenders .....	Must be expressed as an annual yield, with two decimals, e.g., 7.10%	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders .....	Accepted in full at the average price up to \$1,000,000	Accepted in full at the average price up to \$1,000,000
Accrued interest payable by investor .....	None	\$22.43132 per \$1,000 (from October 15, 1990, to January 15, 1991).
<u>Payment Terms:</u>		
Payment by non-institutional investors .....	Full payment to be submitted with tender	Full payment to be submitted with tender
Deposit guarantee by designated institutions .....	Acceptable	Acceptable
<u>Key Dates:</u>		
Receipt of tenders .....	Tuesday, January 8, 1991	Tuesday, January 8, 1991,
(a) Noncompetitive .....	prior to 12:00 noon, EST	prior to 12:00 noon, EST
(b) Competitive .....	prior to 1:00 p.m., EST	prior to 1:00 p.m., EST
<u>Settlement:</u>		
Immediately available funds .....	Tuesday, January 15, 1991	Tuesday, January 15, 1991

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2

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FOR IMMEDIATE RELEASE  
January 3, 1991

CONTACT: Desiree Tucker-Sorini  
(202) 566-8773

## Treasury Announces Support for Tax Relief for Desert Shield Participants

Washington -- The Treasury Department announced today that the Administration supports legislation sponsored by Senator Robert Dole, Representative Bob Michel, Representative Dan Rostenkowski and others which will provide additional tax relief to military or civilian participants in the Desert Shield operation in the Persian Gulf area.

The legislation will extend the time period for filing federal income tax returns, paying federal income tax and taking a variety of other actions, such as filing claims for refund of federal income tax, until 60 days after the individual's participation in the Desert Shield operation comes to an end. The legislation provides that interest will not be charged on tax payments made within the extended time period. Federal income tax refunds that are due to Desert Shield participants will, however, continue to earn interest at the normal statutory rates.

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NB-1083

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2

FOR RELEASE AT 12:00 NOON  
January 4, 1991

CONTACT: Office of Financing  
202/376-4350

## TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately \$11,750 million of 364-day Treasury bills to be dated January 17, 1991, and to mature January 16, 1992 (CUSIP No. 912794 XV 1). This issue will provide about \$2,200 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of \$9,554 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Thursday, January 10, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. This series of bills will be issued entirely in book-entry form in a minimum amount of \$10,000 and in any higher \$5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing January 17, 1991. In addition to the maturing 52-week bills, there are \$19,341 million of maturing bills which were originally issued as 13-week and 26-week bills. The disposition of this latter amount will be announced next week. Federal Reserve Banks currently hold \$914 million as agents for foreign and international monetary authorities, and \$6,761 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rate of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold \$190 million of the original 52-week issue. Tenders for bills to be maintained on the book - entry records of the Department of the Treasury should be submitted on Form PD 5176-3.



Each tender must state the par amount of bills bid for, which must be a minimum of \$10,000. Tenders over \$10,000 must be in multiples of \$5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than \$1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of \$200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds \$200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for \$1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.



# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE  
January 7, 1991

CONTACT: Office of Financing  
202-376-4350

## RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for \$10,033 million of 13-week bills to be issued on January 10, 1991 and mature on April 11, 1991 were accepted today (CUSIP: 912794WD2).

### RANGE OF ACCEPTED COMPETITIVE BIDS:

	<u>Discount</u> <u>Rate</u>	<u>Investment</u> <u>Rate</u>	<u>Price</u>
Low	6.50%	6.70%	98.357
High	6.53%	6.73%	98.349
Average	6.52%	6.72%	98.352

Tenders at the high discount rate were allotted 60%.  
The investment rate is the equivalent coupon-issue yield.

### TENDERS RECEIVED AND ACCEPTED (in thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	53,555	53,555
New York	24,414,090	7,920,090
Philadelphia	54,890	54,890
Cleveland	65,285	65,285
Richmond	115,735	109,735
Atlanta	39,325	38,525
Chicago	1,488,185	303,185
St. Louis	62,340	28,340
Minneapolis	9,870	9,870
Kansas City	49,065	49,065
Dallas	27,850	27,850
San Francisco	924,040	454,040
Treasury	<u>918,120</u>	<u>918,120</u>
TOTALS	\$28,222,350	\$10,032,550
Type		
Competitive	\$24,035,110	\$5,845,310
Noncompetitive	<u>1,927,400</u>	<u>1,927,400</u>
Subtotal, Public	\$25,962,510	\$7,772,710
Federal Reserve	2,177,730	2,177,730
Foreign Official		
Institutions	<u>82,110</u>	<u>82,110</u>
TOTALS	\$28,222,350	\$10,032,550

An additional \$122,490 thousand of bills will be issued to foreign official institutions for new cash.



# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE  
January 7, 1991

CONTACT: Office of Financing  
202-376-4350

## RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for \$10,012 million of 26-week bills to be issued on January 10, 1991 and mature on July 11, 1991 were accepted today (CUSIP: 912794WY6).

### RANGE OF ACCEPTED COMPETITIVE BIDS:

	<u>Discount Rate</u>	<u>Investment Rate</u>	<u>Price</u>
Low	6.50%	6.81%	96.714
High	6.52%	6.84%	96.704
Average	6.51%	6.82%	96.709

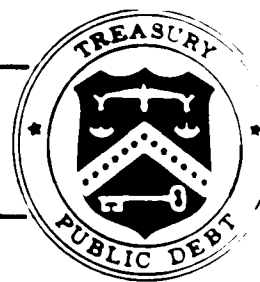
Tenders at the high discount rate were allotted 53%.  
The investment rate is the equivalent coupon-issue yield.

### TENDERS RECEIVED AND ACCEPTED (in thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	50,560	50,560
New York	25,996,340	8,630,420
Philadelphia	19,965	19,965
Cleveland	48,555	48,555
Richmond	49,185	48,245
Atlanta	34,735	33,715
Chicago	1,577,320	145,070
St. Louis	40,045	22,695
Minneapolis	8,090	8,090
Kansas City	52,100	52,050
Dallas	22,270	22,260
San Francisco	563,935	188,735
Treasury	741,530	741,530
TOTALS	\$29,204,630	\$10,011,890
Type		
Competitive	\$25,120,585	\$5,927,845
Noncompetitive	<u>1,475,155</u>	<u>1,475,155</u>
Subtotal, Public	\$26,595,740	\$7,403,000
Federal Reserve	2,300,000	2,300,000
Foreign Official Institutions	<u>308,890</u>	<u>308,890</u>
TOTALS	\$29,204,630	\$10,011,890

An additional \$446,910 thousand of bills will be issued to foreign official institutions for new cash.

# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR RELEASE AT 3:00 PM

January 7, 1991

Contact: Peter Hollenbach

(202) 376-4302

## PUBLIC DEBT ANNOUNCES ACTIVITY FOR SECURITIES IN THE STRIPS PROGRAM FOR DECEMBER 1990

Treasury's Bureau of the Public Debt announced activity figures for the month of December 1990, of securities within the Separate Trading of Registered Interest and Principal of Securities program. (STRIPS).

### Dollar Amounts in Thousands

Principal Outstanding (Eligible Securities)	\$473,539,584
Held in Unstripped Form	\$359,953,194
Held in Stripped Form	\$113,586,390
Reconstituted in December	\$5,076,440

The accompanying table gives a breakdown of STRIPS activity by individual loan description. The balances in this table are subject to audit and subsequent revision. These monthly figures are included in Table VI of the Monthly Statement of the Public Debt, entitled "Holdings of Treasury Securities in Stripped Form." These can also be obtained through a recorded message on (202) 447-9873.

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TABLE VI—HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM, DECEMBER 31, 1990  
(In thousands)

Loan Description	Maturity Date	Principal Amount Outstanding			Reconstituted This Month <sup>1</sup>
		Total	Portion Held in Unstripped Form	Portion Held in Stripped Form	
11-5/8% Note C-1994	11/15/94	\$6,658,554	\$5,567,354	\$1,091,200	- 0 -
11-1/4% Note A-1995	2/15/95	6,933,861	6,462,021	471,840	- 0 -
11-1/4% Note B-1995	5/15/95	7,127,086	5,915,886	1,211,200	\$8,400
5-1/2% Note C-1995	8/15/95	7,955,901	7,293,901	662,000	- 0 -
3-1/2% Note D-1995	11/15/95	7,318,550	6,358,550	960,000	7,200
3-7/8% Note A-1996	2/15/96	8,575,199	8,343,199	232,000	- 0 -
7-3/8% Note C-1996	5/15/96	20,085,643	19,871,243	214,400	- 0 -
7-1/4% Note D-1996	11/15/96	20,258,810	20,023,810	235,000	- 0 -
3-1/2% Note A-1997	5/15/97	9,921,237	9,848,037	73,200	- 0 -
3-5/8% Note B-1997	8/15/97	9,362,836	9,330,836	32,000	- 0 -
3-7/8% Note C-1997	11/15/97	9,808,329	9,792,329	16,000	- 0 -
3-1/8% Note A-1998	2/15/98	9,159,068	9,158,188	2,880	- 0 -
3% Note B-1998	5/15/98	9,185,387	9,135,387	30,000	- 0 -
3-1/4% Note C-1998	8/15/98	11,342,848	11,213,848	129,000	- 0 -
3-7/8% Note D-1998	11/15/98	9,902,875	9,896,475	6,400	- 0 -
3-7/8% Note A-1999	2/15/99	9,719,828	9,716,428	3,200	- 0 -
3-1/8% Note B-1999	5/15/99	10,047,103	9,178,303	868,800	- 0 -
8% Note C-1999	8/15/99	10,163,644	10,081,644	82,000	- 0 -
7-7/8% Note D-1999	11/15/99	10,773,960	10,766,960	7,000	- 0 -
3-1/2% Note A-2000	2/15/00	10,673,033	10,673,033	- 0 -	- 0 -
3-7/8% Note B-2000	5/15/00	10,496,230	10,485,030	11,200	- 0 -
3-3/4% Note C-2000	8/15/00	11,080,646	11,080,646	- 0 -	- 0 -
3-1/2% Note D-2000	11/15/00	11,519,686	11,519,686	- 0 -	- 0 -
11-5/8% Bond 2004	11/15/04	8,301,806	3,666,606	4,635,200	- 0 -
12% Bond 2005	5/15/05	4,260,758	1,530,808	2,729,950	25,000
10-3/4% Bond 2005	8/15/05	9,269,713	8,372,113	897,600	88,600
3-3/8% Bond 2006	2/15/06	4,755,916	4,755,916	- 0 -	- 0 -
11-3/4% Bond 2009-14	11/15/14	6,005,584	1,519,984	4,486,600	51,200
11-1/4% Bond 2015	2/15/15	12,867,799	2,052,439	10,815,360	62,500
10-5/8% Bond 2015	8/15/15	7,149,916	1,674,076	5,475,840	- 0 -
9-7/8% Bond 2015	11/15/15	6,899,859	2,159,059	4,740,800	- 0 -
3-1/4% Bond 2016	2/15/16	7,266,854	6,438,654	827,200	263,800
7-1/4% Bond 2016	5/15/16	18,823,581	16,842,351	2,171,230	35,200
7-1/2% Bond 2016	11/15/16	18,864,448	14,111,888	4,752,560	1,530,800
3-3/4% Bond 2017	5/15/17	18,184,189	5,882,889	12,301,299	730,800
3-7/8% Bond 2017	8/15/17	14,016,858	9,063,648	4,953,200	- 0 -
3-1/8% Bond 2018	5/15/18	8,708,639	2,855,839	5,852,800	73,800
3% Bond 2018	11/15/18	9,032,870	1,437,870	7,595,000	10,000
3-7/8% Bond 2019	2/15/19	19,250,793	5,229,983	14,020,800	704,000
3-1/8% Bond 2019	8/15/19	20,213,832	11,106,032	9,108,800	20,180
3-1/2% Bond 2020	2/15/20	10,228,868	3,987,268	6,241,600	1,003,800
3-3/4% Bond 2020	5/15/20	10,158,883	5,241,603	4,917,280	432,180
3-3/4% Bond 2020	8/15/20	21,418,556	20,508,556	910,000	80,320
Total		473,539,584	358,863,184	114,676,399	6,078,440

<sup>1</sup>Effective May 1, 1987, securities held in stripped form were eligible for reconstitution to their unstripped form.

Note: On the 4th workday of each month a recording of Table VI will be available after 3:00 pm. The telephone number is (202) 447-8873. The balances in this table are subject to audit and subsequent adjustments.

FOR IMMEDIATE RELEASE

January 8, 1991

## FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of November 1990.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled \$177.6 billion on November 30, 1990, posting a decrease of \$2.9 billion from the level on October 31, 1990. This net change was the result of a decrease in holdings of agency-guaranteed loans of \$4,549.6 million and in holdings of agency assets of \$0.2 million, while holdings of agency debt increased by \$1,631.6 million. FFB made 28 disbursements during November.

Attached to this release are tables presenting FFB November loan activity and FFB holdings as of November 30, 1990.

## FEDERAL FINANCING BANK

## NOVEMBER 1990 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi- annual)	INTEREST RATE (other than semi-annual)
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AGENCY DEBTNATIONAL CREDIT UNION ADMINISTRATIONCentral Liquidity Facility

+Note #532	11/6	\$ 7,570,000.00	2/4/91	7.434%	
+Note #533	11/16	21,790,000.00	2/14/91	7.443%	
+Note #534	11/27	10,000,000.00	2/25/91	7.381%	
+Note #535	11/28	10,000,000.00	1/28/91	7.392%	

RESOLUTION TRUST CORPORATIONNote No. 90-07

Advance #1	11/7	300,000,000.00	1/2/91	7.434%	
Advance #2	11/9	300,000,000.00	1/2/91	7.443%	
Advance #3	11/13	617,000,000.00	1/2/91	7.395%	
Advance #4	11/19	170,000,000.00	1/2/91	7.428%	
Advance #5	11/26	150,000,000.00	1/2/91	7.376%	
Advance #6	11/29	600,000,000.00	1/2/91	7.413%	

TENNESSEE VALLEY AUTHORITY

Short-term Bond #61	11/6	195,000,000.00	11/15/90	7.428%	
Short-term Bond #62	11/8	13,000,000.00	11/15/90	7.434%	
Short-term Bond #63	11/15	347,000,000.00	11/21/90	7.383%	
Short-term Bond #64	11/15	21,000,000.00	11/23/90	7.383%	
Short-term Bond #65	11/17	30,000,000.00	11/30/90	7.443%	
Short-term Bond #66	11/21	308,000,000.00	12/3/90	7.448%	
Short-term Bond #67	11/28	28,000,000.00	12/11/90	7.374%	
Short-term Bond #68	11/30	119,000,000.00	12/11/90	7.413%	

AGENCY ASSETSFARMER'S HOME ADMINISTRATION

RHIF - CBO #57548	11/25	1,155,000,000.00	11/25/05	8.453%	8.632% ann.
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+rollover



## FEDERAL FINANCING BANK

## NOVEMBER 1990 ACTIVITY

<u>BORROWER</u>	<u>DATE</u>	<u>AMOUNT OF ADVANCE</u>	<u>FINAL MATURITY</u>	<u>INTEREST RATE</u> (semi- annual)	<u>INTEREST RATE</u> (other than semi-annual)
<u>GOVERNMENT - GUARANTEED LOANS</u>					
<u>DEPARTMENT OF DEFENSE</u>					
<u>Foreign Military Sales</u>					
Honduras 10	11/29	\$ 21,999.98	11/30/94	8.003%	
<u>GENERAL SERVICES ADMINISTRATION</u>					
<u>U.S. Trust Company of New York</u>					
Advance #1	11/15	5,209,310.05	5/15/91	7.505%	
Advance #2	11/21	4,314,285.68	5/15/91	7.547%	
Advance #3	11/27	1,161,139.08	5/15/91	7.454%	
<u>DEPARTMENT OF HOUSING &amp; URBAN DEVELOPMENT</u>					
Cincinnati, OH	11/30	380,000.00	12/1/03	8.361%	8.536% ann.
<u>RURAL ELECTRIFICATION ADMINISTRATION</u>					
Brazos Electric #230A	11/1	978,000.00	1/3/22	8.857%	8.761% qtr.
Brazos Electric #332	11/1	617,000.00	12/31/19	8.844%	8.748% qtr.
Central Iowa Power #295	11/27	410,000.00	1/2/18	8.460%	8.372% qtr.
<u>TENNESSEE VALLEY AUTHORITY</u>					
<u>Seven States Energy Corporation</u>					
Note A-91-01	11/30	2,282,541.54	12/31/90	7.413%	

FEDERAL FINANCING BANK  
(in millions)

Program	November 30, 1990	October 31, 1990	Net Change 11/1/90-11/30/90	FY '91 Net Change 10/1/90-11/30/90
<b>Agency Debt:</b>				
Port-Import Bank	\$ 11,339.8	\$ 11,339.8	\$ -0-	\$ -0-
Central Liquidity Fund	74.0	87.3	-13.4	17.4
Resolution Trust Corporation	50,300.0	48,163.0	2,137.0	8,818.3
Tennessee Valley Authority	14,130.0	14,622.0	-492.0	-252.0
Postal Service	6,697.8	6,697.8	-0-	-0-
sub-total*	82,541.6	80,909.9	1,631.6	8,583.7
<b>Agency Assets:</b>				
Farmers Home Administration	52,324.0	52,324.0	-0-	275.0
HHS-Health Maintenance Org.	69.6	69.6	-0-	-0-
HHS-Medical Facilities	82.7	82.7	-0-	-0-
Rural Electrification Admin.-CBO	4,407.2	4,407.2	-0-	-0-
Small Business Administration	8.0	8.2	-0.2	-0.4
sub-total*	56,891.5	56,891.7	-0.2	274.6
<b>Government-Guaranteed Loans:</b>				
DD-Foreign Military Sales	5,279.8	9,747.3	-4,467.5	-4,475.8
Ed.-Student Loan Marketing Assn.	4,850.0	4,880.0	-30.0	-30.0
HUD-Community Dev. Block Grant	239.9	241.0	-1.1	-4.0
HUD-Public Housing Notes +	1,903.4	1,950.8	-47.4	-47.4
General Services Administration +	376.8	367.3	9.5	9.5
PI-Guam Power Authority	29.7	29.7	-0-	-0-
PI-Virgin Islands	25.3	25.3	-0-	-0-
NSA-Space Communications Co. +	1,203.2	1,203.2	-0-	107.3
ON-Ship Lease Financing	1,672.4	1,672.4	-0-	-0-
Rural Electrification Administration	18,967.8	18,965.8	2.0	-74.5
SA-Small Business Investment Cos.	340.8	354.6	-13.8	-41.8
SA-State/Local Development Cos.	735.2	738.5	-3.4	-6.4
SA-Seven States Energy Corp.	2,362.7	2,360.4	2.3	6.6
ST-Section 511	23.1	23.3	-0.3	-0.3
ST-WMATA	177.0	177.0	-0-	-0-
sub-total*	38,186.9	42,736.6	-4,549.6	-4,556.8
grand total*	\$ 177,619.9	\$ 180,538.2	\$ -2,918.2	\$ 4,301.5

Figures may not total due to rounding  
Does not include capitalized interest

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2

FOR RELEASE AT 4:00 P.M.  
January 8, 1991

CONTACT: Office of Financing  
202/376-4350

## TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately \$20,000 million, to be issued January 17, 1991. This offering will provide about \$650 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of \$19,341 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, January 14, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately \$10,000 million, representing an additional amount of bills dated October 18, 1990, and to mature April 18, 1991 (CUSIP No. 912794 WE 0), currently outstanding in the amount of \$9,982 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately \$10,000 million, to be dated January 17, 1991, and to mature July 18, 1991 (CUSIP No. 912794 WZ 3).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of \$10,000 and in any higher \$5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing January 17, 1991. In addition to the maturing 13-week and 26-week bills, there are \$9,554 million of maturing 52-week bills. The disposition of this latter amount was announced last week. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold \$723 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold \$913 million as agents for foreign and international monetary authorities, and \$6,761 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of \$10,000. Tenders over \$10,000 must be in multiples of \$5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than \$1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of \$200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds \$200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for \$1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.



# PRESS RELEASE

## OVERSIGHT BOARD DEPT. OF THE RESOLUTION FUNDING CORPORATION

FOR IMMEDIATE RELEASE  
January 8, 1991  
(OB 91-2)

CONTACT: Felisa Neuringer  
Brian Harrington  
(202) 786-9672

### REFCORP ANNOUNCES RESULTS OF AUCTION OF 30-YEAR BONDS

The Resolution Funding Corporation has accepted \$4,941 million of \$11,019 million of tenders received from the public for the 30-year bonds, Series A-2021, auctioned today.<sup>1</sup> The bonds will be issued January 15, 1991, and mature January 15, 2021.

The interest rate on the bonds will be 8-5/8%. The range of accepted competitive bids, and the corresponding prices at the 8-5/8% interest rate are as follows:

	<u>Yield</u>	<u>Price</u>
Low	8.59%	100.375
High	8.61%	100.160
Average	8.60%	100.267

Tenders at the high yield were allotted 28%.

### TENDERS RECEIVED AND ACCEPTED (In Thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	\$ --	\$ --
New York	10,307,361	4,724,641
Philadelphia	80	80
Cleveland	--	--
Richmond	13,000	13,000
Atlanta	--	--
Chicago	516,140	196,140
St. Louis	2,000	2,000
Minneapolis	--	--
Kansas City	4,060	4,060
Dallas	--	--
San Francisco	<u>176,000</u>	<u>1,000</u>
Totals	\$ 11,018,641	\$ 4,940,921

The \$4,941 of accepted tenders includes \$285 million of noncompetitive tenders.

<sup>1</sup>The minimum par amount required to strip the REFCORP bonds larger amounts must be in multiples of that



# PRESS RELEASE

## OVERSIGHT BOARD

DEPT. OF THE RESOLUTION FUNDING CORPORATION

FOR IMMEDIATE RELEASE  
January 8, 1991 (OB 91-3)

CONTACT: Felisa Neuringer  
Brian Harrington (202) 786-9672

### REFCORP ANNOUNCES RESULTS OF AUCTION OF 39-1/4 YEAR BONDS

The Resolution Funding Corporation has accepted \$2,000 million of \$6,380 million of tenders received from the public for the 39-1/4 year bonds, Series B-2030, auctioned today.<sup>1</sup> The bonds will be issued on January 15, 1991 and mature on April 15, 2030.

The interest rate on the bonds will be 8-7/8%. The range of accepted competitive bids, and the corresponding prices at the 8-7/8% interest rate are as follows:

	<u>Yield</u>	<u>Price</u> <sup>2</sup>
Low	8.48%	104.433
High	8.52%	103.963
Average	8.50%	104.197

Tenders at the high yield were allotted 84%.

### TENDERS RECEIVED AND ACCEPTED (In Thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	\$ --	\$ --
New York	5,999,214	1,863,814
Philadelphia	--	--
Cleveland	--	--
Richmond	4,000	4,000
Atlanta	--	--
Chicago	299,000	129,000
St. Louis	2,000	2,000
Minneapolis	--	--
Kansas City	--	--
Dallas	--	--
San Francisco	<u>76,000</u>	<u>1,000</u>
Totals	\$ 6,380,214	\$ 1,999,814

The \$2,000 million of accepted tenders includes \$185 million of noncompetitive tenders.

<sup>1</sup>The minimum par amount required to strip the REFCORP bonds is \$1,600,000. Larger amounts must be in multiples of that amount.

<sup>2</sup>At the auction price, accrued interest of \$22.43132



# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE  
January 9, 1991

CONTACT: Office of Financing  
202-376-4350

## RESULTS OF TREASURY'S AUCTION OF 7-YEAR NOTES

Tenders for \$8,544 million of 7-year notes, Series E-1998, to be issued on January 15, 1991 and mature on January 15, 1998 were accepted today (CUSIP: 912827ZT2).

The interest rate on the notes will be 7 7/8%. The range of accepted bids and corresponding prices are as follows:

	<u>Yield</u>	<u>Price</u>
Low	7.94%	99.656
High	7.95%	99.603
Average	7.95%	99.603

\$10,000 was accepted at lower yields.  
Tenders at the high yield were allotted 45%.

### TENDERS RECEIVED AND ACCEPTED (in thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	21,482	21,469
New York	21,269,807	7,993,351
Philadelphia	6,759	6,759
Cleveland	13,873	13,864
Richmond	29,376	20,276
Atlanta	11,936	11,808
Chicago	1,192,786	371,986
St. Louis	12,703	8,703
Minneapolis	5,649	5,649
Kansas City	17,019	15,019
Dallas	6,683	6,682
San Francisco	409,432	65,382
Treasury	3,477	3,477
TOTALS	\$23,000,982	\$8,544,425

The \$8,544 million of accepted tenders includes \$595 million of noncompetitive tenders and \$7,949 million of competitive tenders from the public.

In addition, \$165 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional \$397 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.





# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE  
January 10, 1991

CONTACT: Office of Financing  
202-376-4350

## RESULTS OF TREASURY'S AUCTION OF 52-WEEK BILLS

Tenders for \$11,767 million of 52-week bills to be issued on January 17, 1991 and mature on January 16, 1992 were accepted today (CUSIP: 912794XV1).

### RANGE OF ACCEPTED COMPETITIVE BIDS:

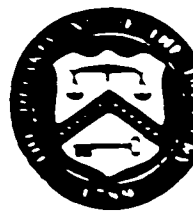
	<u>Discount Rate</u>	<u>Investment Rate</u>	<u>Price</u>
Low	6.19%	6.59%	93.741
High	6.23%	6.63%	93.701
Average	6.22%	6.62%	93.711

Tenders at the high discount rate were allotted 72%.  
The investment rate is the equivalent coupon-issue yield.

### TENDERS RECEIVED AND ACCEPTED (in thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	49,480	49,480
New York	26,925,775	10,453,135
Philadelphia	28,570	28,570
Cleveland	45,545	45,545
Richmond	46,140	46,140
Atlanta	41,650	39,970
Chicago	1,808,740	427,740
St. Louis	36,375	31,255
Minneapolis	12,495	12,495
Kansas City	53,595	53,035
Dallas	21,620	21,620
San Francisco	862,405	168,805
Treasury	388,870	388,870
<b>TOTALS</b>	<b>\$30,321,260</b>	<b>\$11,766,660</b>
<u>Type</u>		
Competitive	\$26,412,195	\$7,857,595
Noncompetitive	1,179,065	1,179,065
Subtotal, Public	\$27,591,260	\$9,036,660
Federal Reserve	2,600,000	2,600,000
Foreign Official		
Institutions	130,000	130,000
<b>TOTALS</b>	<b>\$30,321,260</b>	<b>\$11,766,660</b>

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2000

FOR IMMEDIATE RELEASE  
January 11, 1991

CONTACT: CHERYL CRISPEN  
(202) 566-5252

## UNITED STATES AND VENEZUELA TO DISCUSS A NEW INCOME TAX TREATY

The Treasury Department today announced that representatives of the United States and Venezuela will meet in Washington, January 22-25, to discuss a possible bilateral income tax treaty between their two countries. Currently, no income tax treaty is in effect between the two countries.

The negotiations will take into account the model income tax treaties published by the Organization for Economic Cooperation and Development, the United Nations, and the U.S. Treasury Department, as well as tax treaties recently concluded by the two countries with other countries, and recent changes in their respective income tax laws.

Income tax treaties provide rules for the taxation of income derived in one of the countries (the "source" country) by residents of the other. They establish when the source country may tax various classes of income and specify maximum rates of tax at source on certain items, such as dividends, interest and royalties. They also provide for administrative cooperation between the tax authorities of the two countries and guarantee non-discriminatory taxation. Treaty benefits are limited to residents of the two countries.

Persons wishing to offer comments or suggestions on the negotiations are invited to write to Philip D. Morrison, International Tax Counsel, Treasury Department, Washington, DC 20220.

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# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE  
January 14, 1991

CONTACT: Office of Financing  
202-376-4350

## RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for \$10,022 million of 13-week bills to be issued on January 17, 1991 and mature on April 18, 1991 were accepted today (CUSIP: 912794WE0).

### RANGE OF ACCEPTED COMPETITIVE BIDS:

	<u>Discount</u> <u>Rate</u>	<u>Investment</u> <u>Rate</u>	<u>Price</u>
Low	6.08%	6.26%	98.463
High	6.12%	6.30%	98.453
Average	6.12%	6.30%	98.453

\$2,450,000 was accepted at lower yields.  
Tenders at the high discount rate were allotted 95%.  
The investment rate is the equivalent coupon-issue yield.

### TENDERS RECEIVED AND ACCEPTED (in thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	76,960	76,960
New York	26,747,435	8,372,980
Philadelphia	38,110	38,110
Cleveland	75,100	75,100
Richmond	71,845	71,845
Atlanta	54,715	53,555
Chicago	1,481,740	173,990
St. Louis	62,430	20,430
Minneapolis	12,390	12,390
Kansas City	56,205	56,205
Dallas	30,090	30,090
San Francisco	1,001,055	340,055
Treasury	<u>699,815</u>	<u>699,815</u>
TOTALS	\$30,407,890	\$10,021,525
Type		
Competitive	\$26,293,170	\$5,906,805
Noncompetitive	<u>2,056,075</u>	<u>2,056,075</u>
Subtotal, Public	\$28,349,245	\$7,962,880
Federal Reserve	1,961,120	1,961,120
Foreign Official		
Institutions	<u>97,525</u>	<u>97,525</u>
TOTALS	\$30,407,890	\$10,021,525

An additional \$2,975 thousand of bills will be issued to foreign official institutions for new cash.



# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE  
January 14, 1991

CONTACT: Office of Financing  
202-376-4350

## RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for \$10,018 million of 26-week bills to be issued on January 17, 1991 and mature on July 18, 1991 were accepted today (CUSIP: 912794WZ3).

### RANGE OF ACCEPTED COMPETITIVE BIDS:

	<u>Discount</u> <u>Rate</u>	<u>Investment</u> <u>Rate</u>	<u>Price</u>
Low	6.18%	6.47%	96.876
High	6.22%	6.51%	96.855
Average	6.21%	6.50%	96.861

\$300,000 was accepted at lower yields.  
Tenders at the high discount rate were allotted 7%.  
The investment rate is the equivalent coupon-issue yield.

### TENDERS RECEIVED AND ACCEPTED (in thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	55,775	55,775
New York	24,632,430	8,503,280
Philadelphia	26,760	26,760
Cleveland	59,475	59,475
Richmond	66,075	66,075
Atlanta	48,950	45,810
Chicago	2,061,330	388,080
St. Louis	41,510	19,650
Minneapolis	14,150	14,150
Kansas City	56,035	56,035
Dallas	23,150	23,150
San Francisco	730,460	206,280
Treasury	<u>553,000</u>	<u>553,000</u>
TOTALS	\$28,369,100	\$10,017,520

<u>Type</u>	<u>Received</u>	<u>Accepted</u>
Competitive	\$23,952,955	\$5,601,375
Noncompetitive	<u>1,500,975</u>	<u>1,500,975</u>
Subtotal, Public	\$25,453,930	\$7,102,350
Federal Reserve	2,200,000	2,200,000
Foreign Official		
Institutions	<u>715,170</u>	<u>715,170</u>
TOTALS	\$28,369,100	\$10,017,520

An additional \$9,430 thousand of bills will be issued to foreign official institutions for new cash.

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2000

FOR IMMEDIATE RELEASE  
January 14, 1990

CONTACT: CHERYL CRISPEN  
(202) 566-5252

## UNITED STATES INCOME TAX TREATY WITH TUNISIA RATIFIED

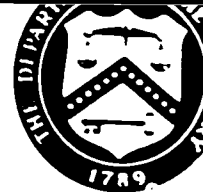
The Treasury Department announced today that instruments of ratification were exchanged with Tunisia on December 26, 1990, bringing into force the Convention between the Government of the United States of America and the Government of the Tunisian Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income. The provisions of the Convention will take effect, in the case of withholding taxes, for amounts paid or credited on or after January 1, 1991, and in the case of other taxes on income, for taxable years ending on or after December 31, 1990.

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NB-1094

# TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-20



100100004509

January 15, 1991

Contact: Cheryl Crispen  
(202) 566-5252  
or  
Robert Snow  
(202) 535-5708

## RAYMOND A. SHADDICK RECEIVES TOP GOVERNMENT HONOR FROM PRESIDENT BUSH

Raymond A. Shaddick, Assistant Director for the U.S. Secret Service in the Department of the Treasury, received the Distinguished Rank Award from President Bush at a ceremony January 9 in the White House. This \$20,000 award is one of the Presidential Rank Awards, and is the highest honor bestowed upon a member of the Senior Executive Service.

In praising Mr. Shaddick and other award winners, President Bush said, "These talented executives have performed their management duties with the highest standards of excellence and integrity. In so doing, they have upheld the public trust bestowed upon them and have enriched the lives of countless American citizens. I applaud their many achievements, and I extend my gratitude, and that of all Americans, for their contributions to our country."

Echoing the high praise by the President, Treasury Secretary Nicholas F. Brady stated, "The Treasury Department could not ask for a more dedicated individual. Ray Shaddick's efforts and diligence as the Special Agent in Charge of the Presidential Protective Division are a model for all Treasury employees."

Mr. Shaddick's award recognizes his flexible and creative management style in the U.S. Secret Service. His abilities have been tested throughout his 21 years with the Secret Service. He was Special Agent in Charge of the Honolulu office, which due to its location and high number of visiting foreign dignitaries presented unique problems which Mr. Shaddick solved. In his role as Special Agent in Charge of Presidential Protection he oversaw security for the Presidential election and subsequent transition starting in November 1988. Mr. Shaddick was recently promoted to Assistant Director for Investigations.

Mr. Shaddick, a native of California, presently lives in Centreville, Virginia.

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2000

AUG 10 20 04 54 0

January 15, 1991

Contact: Cheryl Crispen  
(202) 566-5252  
or  
Roger Busby  
(912) 230-2908

U.S. DEPARTMENT OF THE TREASURY

## CHARLES F. RINKEVICH RECEIVES TOP GOVERNMENT HONOR FROM PRESIDENT BUSH

Charles F. Rinkevich, Director of the Federal Law Enforcement Training Center in the Department of the Treasury, received the Distinguished Rank Award from President Bush at a ceremony January 9 in the White House. This \$20,000 award is one of the Presidential Rank Awards, and is the highest honor bestowed upon a member of the Senior Executive Service.

In praising Mr. Rinkevich and other award winners, President Bush said, "These talented executives have performed their management duties with the highest standards of excellence and integrity. In so doing, they have upheld the public trust bestowed upon them and have enriched the lives of countless American citizens. I applaud their many achievements, and I extend my gratitude, and that of all Americans, for their contributions to our country."

Echoing the high praise by the President, Treasury Secretary Nicholas F. Brady stated, "The Treasury Department could not ask for a more dedicated individual. Charles Rinkevich's efforts and diligence in the operation of the Federal Law Enforcement Training Center are a model for all Treasury employees."

Mr. Rinkevich's award recognizes his "aggressive leadership" in directing the Federal Law Enforcement Training Center (FLETC) in Glynco, Georgia, where he is an integral player in the President's strategy to combat crime. Since his appointment in 1983, FLETC has provided superior training for our Nation's law enforcement personnel on a continuing basis at the lowest possible cost. It serves over 60 federal agencies and graduates over 29,000 students annually.

Mr. Rinkevich received a bachelor's degree in police administration from Michigan State University, and a master's degree in public administration from Georgia State University.

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2000

January 15, 1991

Contact: Barbara Clay  
(202) 566-5252

## R. RICHARD NEWCOMB RECEIVES TOP GOVERNMENT HONOR FROM PRESIDENT BUSH

R. Richard Newcomb, Director of the Office of Foreign Assets Control in the Department of the Treasury, received the Distinguished Rank Award from President Bush at a ceremony January 9 in the White House. This \$20,000 award is one of the Presidential Rank Awards, and is the highest honor bestowed upon a member of the Senior Executive Service.

In praising Mr. Newcomb and other award winners, President Bush said, "These talented executives have performed their management duties with the highest standards of excellence and integrity. In so doing, they have upheld the public trust bestowed upon them and have enriched the lives of countless American citizens. I applaud their many achievements, and I extend my gratitude, and that of all Americans, for their contributions to our country."

Echoing the high praise by the President, Treasury Secretary Nicholas F. Brady stated, "The Treasury Department could not ask for a more dedicated individual. Rick Newcomb's efforts and diligence in the operation of the Office of Foreign Assets Control are a model for all Treasury employees."

Mr. Newcomb's award recognizes his "extraordinary leadership" which has been vital in ensuring compliance with economic sanctions and embargo programs ordered by the President. Recently, his office quickly and effectively implemented the broad economic sanctions ordered against Iraq. Under his direction, FAC has become an extremely productive and efficient organization that has achieved wide recognition for its many accomplishments.

A native of Toledo, Ohio, Mr. Newcomb received a B.A. from Kenyon College, Gambier, Ohio, and a J.D. degree from Case-Western Reserve University Law School, Cleveland, Ohio. He has been admitted to the bar in both Ohio and the District of Columbia, and is a member of the D.C. Bar Association.



**NOTE TO THE PRESS**

Due to a brief illness, Mr. Newcomb was unable to attend the ceremony at which the awards were presented. He will receive the award at a later date.

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-20

FOR RELEASE AT 4:00 P.M.  
January 15, 1991

CONTACT: Office of Financing  
202/376-4350

## TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately \$20,000 million, to be issued January 24, 1991. This offering will provide about \$2,175 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of \$17,821 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Tuesday, January 22, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately \$10,000 million, representing an additional amount of bills dated October 25, 1990, and to mature April 25, 1991 (CUSIP No. 912794 WF 7), currently outstanding in the amount of \$20,666 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately \$10,000 million, to be dated January 24, 1991, and to mature July 25, 1991 (CUSIP No. 912794 XA 7).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of \$10,000 and in any higher \$5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing January 24, 1991. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold \$591 million as agents for foreign and international monetary authorities, and \$4,858 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of \$10,000. Tenders over \$10,000 must be in multiples of \$5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than \$1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of \$200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds \$200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for \$1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2000

FOR RELEASE AT 4:00 P.M.  
January 16, 1991

CONTACT: Office of Financing  
202/376-4350

## TREASURY TO AUCTION 2-YEAR AND 5-YEAR NOTES TOTALING \$21,500 MILLION

The Treasury will auction \$12,500 million of 2-year notes and \$9,000 million of 5-year notes to refund \$10,262 million of securities maturing January 31, 1991, and to raise about \$11,250 million new cash. The \$10,262 million of maturing securities are those held by the public, including \$725 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The \$21,500 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average prices of accepted competitive tenders.

In addition to the public holdings, Federal Reserve Banks, for their own accounts, hold \$929 million of the maturing securities that may be refunded by issuing additional amounts of the new securities at the average prices of accepted competitive tenders.

Details about each of the new securities are given in the attached highlights of the offerings and in the official offering circulars.

oOo

Attachment

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC  
 OF 2-YEAR AND 5-YEAR NOTES TO BE ISSUED JANUARY 31, 1991

January 16, 1991

Amount Offered to the Public ... \$12,500 million                      \$9,000 million

Description of Security:

Term and type of security .....	2-year notes	5-year notes
Series and CUSIP designation ...	Series W-1993 (CUSIP No. 912827 ZU 9)	Series K-1996 (CUSIP No. 912827 ZV 7)
Maturity date .....	January 31, 1993	January 31, 1996
Interest Rate .....	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids
Investment yield .....	To be determined at auction	To be determined at auction
Premium or discount .....	To be determined after auction	To be determined after auction
Interest payment dates .....	July 31 and January 31	July 31 and January 31
Minimum denomination available .	\$5,000	\$1,000

Terms of Sale:

Method of sale .....	Yield auction	Yield auction
Competitive tenders .....	Must be expressed as an annual yield, with two decimals, e.g., 7.10%	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders .....	Accepted in full at the aver- age price up to \$1,000,000	Accepted in full at the aver- age price up to \$1,000,000
Accrued interest payable by investor .....	None	None

Payment Terms:

Payment by non-institutional investors .....	Full payment to be submitted with tender	Full payment to be submitted with tender
Deposit guarantee by designated institutions .....	Acceptable	Acceptable

Key Dates:

Receipt of tenders .....	Wednesday, January 23, 1991	Thursday, January 24, 1991
a) noncompetitive .....	prior to 12:00 noon, EST	prior to 12:00 noon, EST
b) competitive .....	prior to 1:00 p.m., EST	prior to 1:00 p.m., EST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury ...	Thursday, January 31, 1991	Thursday, January 31, 1991
b) readily-collectible check ...	Tuesday, January 29, 1991	Tuesday, January 29, 1991



# PRESS RELEASE

## OVERSIGHT BOARD Resolution Trust Corporation

FOR IMMEDIATE RELEASE  
January 17, 1991  
OB 91-4

Contact: Art Siddon  
Brian Harrington  
(202) 786-9672

### OVERSIGHT BOARD ADVISES RESTRUCTURING OF 1988 FSLIC DEALS

The Oversight Board for the Resolution Trust Corporation (RTC) has established guidelines for exercising the government's contractual options or for renegotiating the 1988 FSLIC agreements to achieve maximum savings for the American taxpayer.

The guidelines grant the RTC broad operating flexibility to prepay or restructure high interest FSLIC notes and yield maintenance agreements, as is allowed under the contracts, whenever the RTC determines on a case-by-case basis that such restructuring will maximize savings to the taxpayer. The RTC is also authorized to enter into negotiations to reshape the agreements in order to save money for the taxpayers.

Late in the last session, Congress appropriated \$22 billion for the 1988 Deals. The Oversight Board recently received from the RTC its recommendations to save money as well as a report on the competitiveness of the 1988 Deal bidding process.

"Given the billions of dollars to be saved," said Peter Monroe, President of the Oversight Board, "the Board has acted quickly to give policy guidance and also has granted broad operating flexibility so that RTC negotiations to save money can commence immediately."

The RTC will be responsible for the actual restructuring of the deals. However, it will report monthly to the Oversight Board regarding actions taken, amounts expended and cost savings achieved or projected as a result thereof. The RTC Inspector General also will review implementation of the policy.

With respect to the competitive bidding report, the Board authorized the RTC to take appropriate actions where fraud or other misconduct by private parties is discovered.

The Oversight Board formulates the policy, approves the funding, and provides general oversight over the RTC, the agency responsible for resolving the nation's failed thrifts. The Oversight Board includes Secretary of the Treasury Nicholas Brady as chairman, Federal Reserve Chairman Alan Greenspan, Secretary of Housing and Urban Development Jack Kemp, Philip Jackson and Robert Larson.

January 21, 1991

STATEMENT OF THE GROUP OF SEVEN

The Finance Ministers and Central Bank Governors of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States met on January 20 and 21, 1991, in New York City for an exchange of views on current international economic and financial issues. The Managing Director of the IMF participated in the multilateral surveillance discussions.

The Ministers and Governors reviewed their economic policies and prospects and reaffirmed their support for economic policy coordination at this critical time. They noted that although growth in all their economies had slowed, expansion of the world economy continues, and the pace of activity could be expected to pick up later this year. They noted that growth remains particularly strong in Germany and Japan. Implementation of sound fiscal policies, combined with stability oriented monetary policies, should create conditions favorable to lower global interest rates and a stronger world economy. They also stressed the importance of a timely and successful conclusion of the Uruguay Round.

The Ministers and Governors also discussed the situation in global financial markets in light of uncertainties arising from the Gulf war and developments in the Soviet Union. They agreed to strengthen cooperation and to monitor developments in exchange markets. The Ministers and Governors are prepared to respond as appropriate to maintain stability in international financial markets.





DEPARTMENT OF THE TREASURY

WASHINGTON

December 20, 1990

100-5310  
100-5310-4043

ASSISTANT SECRETARY

The Honorable Lloyd Bentsen  
Chairman  
Committee on Finance  
United States Senate  
Washington, D.C. 20510

Dear Mr. Chairman:

After four decades as trust territories under the stewardship of the United States, the Federated States of Micronesia ("the FSM") and the Marshall Islands concluded in 1985 an agreement with the United States giving both jurisdictions the status of freely associated states. This agreement, the Compact of Free Association (the "Compact"), was enacted as part of the Compact of Free Association Act of 1985 (the "Act").<sup>1</sup>

Section 407 of the Act directs the Secretary of the Treasury or his delegate to conduct a study of the effects of the tax provisions of the Compact (as clarified by the provisions of the Act) and to report the results of that study to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate. The date for filing that report was extended to January 1, 1991 by Section 11831 of the Revenue Reconciliation Act of 1990.

This report is submitted pursuant to that statutory directive. I am sending a similar letter to Senator Bob Packwood.

BACKGROUND

The Compact entered into force on October 21, 1986 with respect to the Marshall Islands and on November 3, 1986 with respect to the FSM. As modified by the Act, the tax provisions of the Compact included the following:

- 1) recognition of the authority of the FSM and the Marshall Islands to impose tax on the worldwide income of their residents and confirmation that the United States would allow relief from federal tax in the form of the foreign tax credit and the foreign earned income exclusion under Section 911 of the United States Internal Revenue Code (the "Code");<sup>2</sup>

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<sup>1</sup>Pub. L. No. 99-239 (1986).

<sup>2</sup>Id., Compact § 254 (as clarified by Act § 403).

- 2) continuation of eligibility of the FSM and the Marshall Islands for convention benefits under Code Section 274(h)(3)(A);<sup>3</sup> and
- 3) extension to the FSM and the Marshall Islands tax benefits under Code Section 936 as if they were U.S. possessions, so long as a tax information exchange agreement with the U.S. is in effect.<sup>4</sup>

The first of these provisions constitutes an acknowledgment that the FSM and the Marshall Islands have previously enacted their own income and business tax systems. The tax systems which were in place prior to the enactment of the Act are still in effect.

The second provision states that for purposes of Code Section 274(h)(3)(A), the term "North American area" shall include both the FSM and the Marshall Islands. Code Section 274(h) disallows deductions for expenses attributable to attendance at certain conventions held outside of North America. Inclusion of these jurisdictions in the "North American area" permits the deduction of such expenses (so long as they are otherwise allowable under Code Section 162) with respect to conventions held in the FSM and the Marshall Islands. Prior to the Act, however, the FSM and the Marshall Islands were part of the Trust Territory of the Pacific Islands, which has been included in the "North American area" since the introduction of the restrictions under Code Section 274(h). Thus the Act merely clarified that this beneficial status would continue to apply after the FSM and the Marshall Islands became freely associated states.

The third provision is the extension of Code Section 936 benefits to the FSM and the Marshall Islands in the same manner as such benefits apply to U.S. possessions. This is potentially the most significant tax provision in the Act. The tax credit available under Code Section 936 would effectively eliminate federal taxes on certain active business and investment income earned by qualifying U.S. businesses operating in these jurisdictions. However, these benefits do not apply after December 31, 1986, unless there is in effect an exchange of information agreement with the United States of the kind described in Code Section 274(h)(6)(C) (other than clause (ii) thereof). As discussed below, neither jurisdiction has yet finalized such an agreement with the United States.

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<sup>3</sup>Id., § 405.

<sup>4</sup>Id., Compact § 255 (as clarified by Act § 404).

### TAX INFORMATION EXCHANGE AGREEMENT NEGOTIATIONS

In April of 1986, representatives of the United States, the FSM and the Marshall Islands met to discuss the requirements of a tax information exchange agreement. In November of 1986, shortly after the Compact entered into force, the Department of Treasury wrote to the FSM and the Marshall Islands inviting both governments to continue discussions regarding the steps necessary to put into effect suitable agreements. A negotiating session was held in December of 1986 to discuss specific tax information exchange provisions. Draft agreements were provided to both the FSM and the Marshall Islands.

For the next two years, there was no response from the FSM with respect to our proposed agreement. In January of 1989, the FSM expressed renewed interest in continuing negotiations and requested draft legislation prepared by the Internal Revenue Service to assist countries in adopting certain laws required by tax information exchange agreements. The requested material was promptly sent to the FSM. We have not yet received a reply from the FSM with respect to its further consideration of the proposed agreement.

Significant progress has been achieved in the negotiations with the Marshall Islands. Several draft agreements have been exchanged and draft legislation and other documentation have been provided to the Marshall Islands. The negotiators have now agreed on proposed language and we are currently in the process of preparing a final agreement for execution with the Marshall Islands.

### EFFECTS OF TAX PROVISIONS

The Act directs the Department of Treasury to study the effects of the above tax provisions and to report the results of that study to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.<sup>5</sup> As discussed below, during the period that the Compact has been in force, there have been no measurable effects from these tax provisions.

With respect to their internal tax laws, both the FSM and the Marshall Islands had income tax and business tax laws in effect prior to the Act. These laws remain in effect currently and were not significantly amended as a result of the Act. In short, the Act simply acknowledged the authority of the FSM and the Marshall Islands to adopt their existing tax systems.

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<sup>5</sup>Id., § 407.

With respect to convention benefits, the Act continued the "North American area" status which had previously been available to both the FSM and the Marshall Islands. Moreover, because of their distance from the United States mainland and the limited facilities on the islands, there have been few, if any, business conventions attended by United States taxpayers in either jurisdiction.

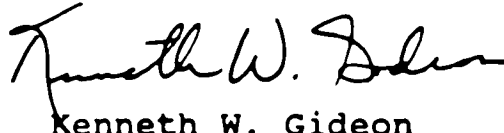
Thus the only tax provision in the Act which would produce measurable effects is the potential extension of Code Section 936 to these jurisdictions. Since neither the FSM nor the Marshall Islands has yet entered into a tax information exchange agreement, Code Section 936 was only applicable in these jurisdictions for approximately two months in 1986. We understand that no corporations claimed Code Section 936 benefits in 1986 with respect to operations in the FSM and the Marshall Islands. However, the benefits of Code Section 936 will be applicable for the Marshall Islands in the near future when its tax information exchange agreement is executed.

In conclusion, no effects are expected to arise from the tax provisions of the Compact until a tax information exchange agreement is executed with either the FSM or the Marshall Islands.

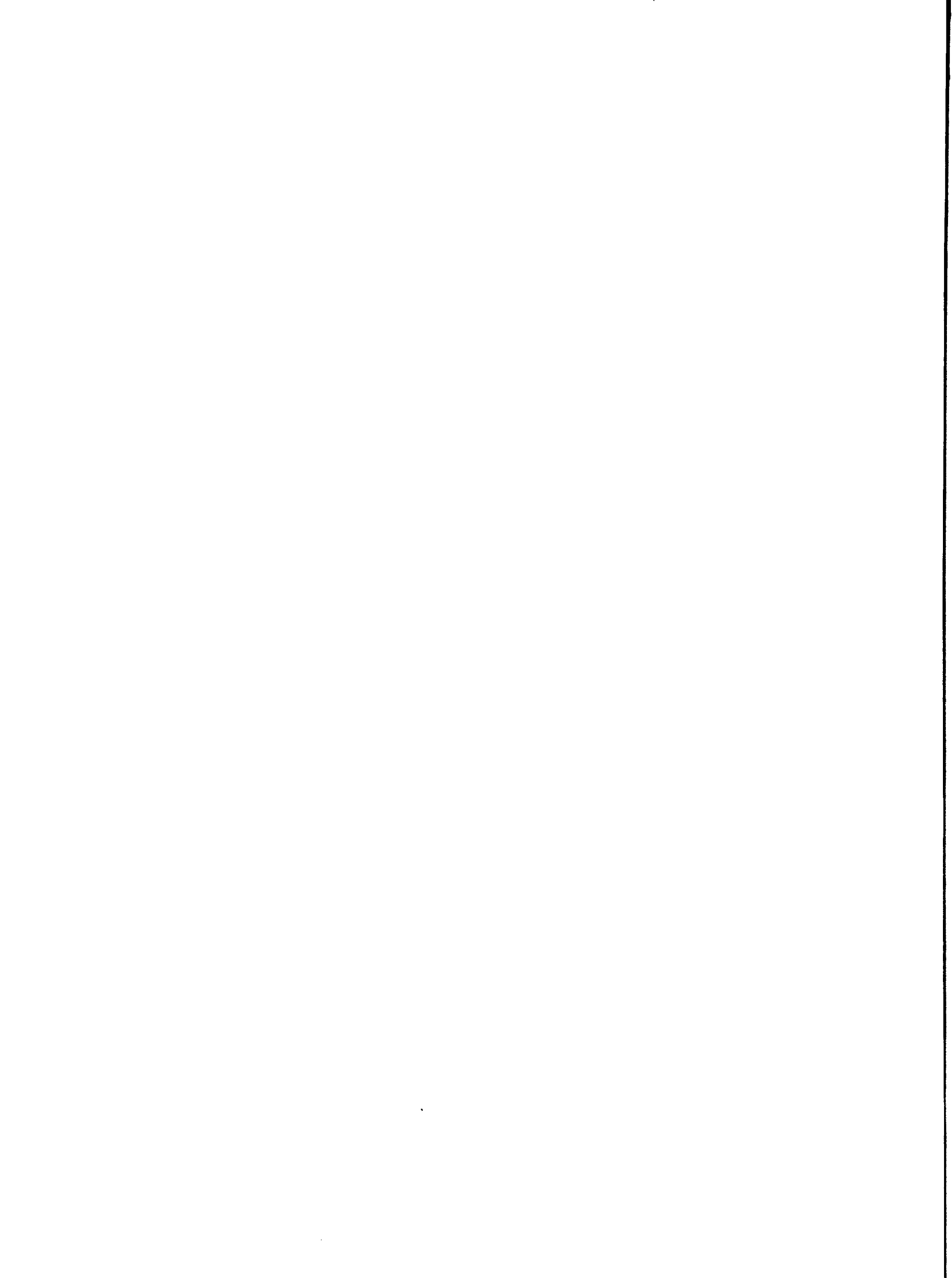
\* \* \* \*

If you have any questions concerning this matter, I would be pleased to answer them.

Sincerely,



Kenneth W. Gideon  
Assistant Secretary  
(Tax Policy)





DEPARTMENT OF THE TREASURY  
WASHINGTON

December 20, 1990

ASSISTANT SECRETARY

The Honorable Dan Rostenkowski  
Chairman  
Committee on Ways and Means  
House of Representatives  
Washington, D.C. 20515

REC-100200-1042

Dear Mr. Chairman:

After four decades as trust territories under the stewardship of the United States, the Federated States of Micronesia ("the FSM") and the Marshall Islands concluded in 1985 an agreement with the United States giving both jurisdictions the status of freely associated states. This agreement, the Compact of Free Association (the "Compact"), was enacted as part of the Compact of Free Association Act of 1985 (the "Act").<sup>1</sup>

Section 407 of the Act directs the Secretary of the Treasury or his delegate to conduct a study of the effects of the tax provisions of the Compact (as clarified by the provisions of the Act) and to report the results of that study to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate. The date for filing that report was extended to January 1, 1991 by Section 11831 of the Revenue Reconciliation Act of 1990.

This report is submitted pursuant to that statutory directive. I am sending a similar letter to Representative Bill Archer.

BACKGROUND

The Compact entered into force on October 21, 1986 with respect to the Marshall Islands and on November 3, 1986 with respect to the FSM. As modified by the Act, the tax provisions of the Compact included the following:

- 1) recognition of the authority of the FSM and the Marshall Islands to impose tax on the worldwide income of their residents and confirmation that the United States would allow relief from federal tax in the form of the foreign tax credit and the foreign earned income exclusion under Section 911 of the United States Internal Revenue Code (the "Code");<sup>2</sup>

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<sup>1</sup>Pub. L. No. 99-239 (1986).

<sup>2</sup>Id., Compact § 254 (as clarified by Act § 403).

- 2) continuation of eligibility of the FSM and the Marshall Islands for convention benefits under Code Section 274(h)(3)(A);<sup>3</sup> and
- 3) extension to the FSM and the Marshall Islands tax benefits under Code Section 936 as if they were U.S. possessions, so long as a tax information exchange agreement with the U.S. is in effect.<sup>4</sup>

The first of these provisions constitutes an acknowledgment that the FSM and the Marshall Islands have previously enacted their own income and business tax systems. The tax systems which were in place prior to the enactment of the Act are still in effect.

The second provision states that for purposes of Code Section 274(h)(3)(A), the term "North American area" shall include both the FSM and the Marshall Islands. Code Section 274(h) disallows deductions for expenses attributable to attendance at certain conventions held outside of North America. Inclusion of these jurisdictions in the "North American area" permits the deduction of such expenses (so long as they are otherwise allowable under Code Section 162) with respect to conventions held in the FSM and the Marshall Islands. Prior to the Act, however, the FSM and the Marshall Islands were part of the Trust Territory of the Pacific Islands, which has been included in the "North American area" since the introduction of the restrictions under Code Section 274(h). Thus the Act merely clarified that this beneficial status would continue to apply after the FSM and the Marshall Islands became freely associated states.

The third provision is the extension of Code Section 936 benefits to the FSM and the Marshall Islands in the same manner as such benefits apply to U.S. possessions. This is potentially the most significant tax provision in the Act. The tax credit available under Code Section 936 would effectively eliminate federal taxes on certain active business and investment income earned by qualifying U.S. businesses operating in these jurisdictions. However, these benefits do not apply after December 31, 1986, unless there is in effect an exchange of information agreement with the United States of the kind described in Code Section 274(h)(6)(C) (other than clause (ii) thereof). As discussed below, neither jurisdiction has yet finalized such an agreement with the United States.

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<sup>3</sup>Id., § 405.

<sup>4</sup>Id., Compact § 255 (as clarified by Act § 404).

### TAX INFORMATION EXCHANGE AGREEMENT NEGOTIATIONS

In April of 1986, representatives of the United States, the FSM and the Marshall Islands met to discuss the requirements of a tax information exchange agreement. In November of 1986, shortly after the Compact entered into force, the Department of Treasury wrote to the FSM and the Marshall Islands inviting both governments to continue discussions regarding the steps necessary to put into effect suitable agreements. A negotiating session was held in December of 1986 to discuss specific tax information exchange provisions. Draft agreements were provided to both the FSM and the Marshall Islands.

For the next two years, there was no response from the FSM with respect to our proposed agreement. In January of 1989, the FSM expressed renewed interest in continuing negotiations and requested draft legislation prepared by the Internal Revenue Service to assist countries in adopting certain laws required by tax information exchange agreements. The requested material was promptly sent to the FSM. We have not yet received a reply from the FSM with respect to its further consideration of the proposed agreement.

Significant progress has been achieved in the negotiations with the Marshall Islands. Several draft agreements have been exchanged and draft legislation and other documentation have been provided to the Marshall Islands. The negotiators have now agreed on proposed language and we are currently in the process of preparing a final agreement for execution with the Marshall Islands.

### EFFECTS OF TAX PROVISIONS

The Act directs the Department of Treasury to study the effects of the above tax provisions and to report the results of that study to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.<sup>9</sup> As discussed below, during the period that the Compact has been in force, there have been no measurable effects from these tax provisions.

With respect to their internal tax laws, both the FSM and the Marshall Islands had income tax and business tax laws in effect prior to the Act. These laws remain in effect currently and were not significantly amended as a result of the Act. In short, the Act simply acknowledged the authority of the FSM and the Marshall Islands to adopt their existing tax systems.

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<sup>9</sup>Id., § 407.





# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE  
January 22, 1991

CONTACT: Office of Financing  
202-376-4350

## RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for \$10,041 million of 13-week bills to be issued on January 24, 1991 and mature on April 25, 1991 were accepted today (CUSIP: 912794WF7).

### RANGE OF ACCEPTED COMPETITIVE BIDS:

	<u>Discount Rate</u>	<u>Investment Rate</u>	<u>Price</u>
Low	6.13%	6.31%	98.450
High	6.15%	6.34%	98.445
Average	6.14%	6.32%	98.448

Tenders at the high discount rate were allotted 22%.  
The investment rate is the equivalent coupon-issue yield.

### TENDERS RECEIVED AND ACCEPTED (in thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	39,595	39,595
New York	40,168,275	8,768,530
Philadelphia	34,245	34,245
Cleveland	52,950	52,840
Richmond	150,260	50,260
Atlanta	40,075	36,075
Chicago	1,538,805	56,700
St. Louis	40,305	16,305
Minneapolis	10,735	10,735
Kansas City	41,845	41,845
Dallas	22,525	22,525
San Francisco	689,090	74,090
Treasury	836,840	836,840
TOTALS	\$43,665,545	\$10,040,585
Type		
Competitive	\$39,299,525	\$5,674,565
Noncompetitive	<u>1,742,880</u>	<u>1,742,880</u>
Subtotal, Public	\$41,042,405	\$7,417,445
Federal Reserve	2,558,060	2,558,060
Foreign Official		
Institutions	<u>65,080</u>	<u>65,080</u>
TOTALS	\$43,665,545	\$10,040,585

An additional \$37,920 thousand of bills will be issued to foreign official institutions for new cash.



# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE  
January 22, 1991

CONTACT: Office of Financing  
202-376-4350

## RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for \$10,031 million of 26-week bills to be issued on January 24, 1991 and mature on July 25, 1991 were accepted today (CUSIP: 912794XA7).

### RANGE OF ACCEPTED COMPETITIVE BIDS:

	<u>Discount Rate</u>	<u>Investment Rate</u>	<u>Price</u>
Low	6.20%	6.49%	96.866
High	6.21%	6.50%	96.861
Average	6.21%	6.50%	96.861

\$2,000,000 was accepted at lower yields.  
Tenders at the high discount rate were allotted 95%.  
The investment rate is the equivalent coupon-issue yield.

### TENDERS RECEIVED AND ACCEPTED (in thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	46,705	46,705
New York	29,470,870	8,810,620
Philadelphia	19,565	19,565
Cleveland	37,705	37,705
Richmond	41,920	41,920
Atlanta	33,790	31,790
Chicago	1,481,755	141,755
St. Louis	55,450	15,450
Minneapolis	5,825	5,825
Kansas City	37,760	37,760
Dallas	17,465	17,465
San Francisco	574,885	121,385
Treasury	702,920	702,920
<b>TOTALS</b>	<b>\$32,526,615</b>	<b>\$10,030,865</b>

<u>Type</u>		
Competitive	\$28,339,205	\$5,843,455
Noncompetitive	<u>1,360,840</u>	<u>1,360,840</u>
Subtotal, Public	\$29,700,045	\$7,204,295
Federal Reserve	2,300,000	2,300,000
Foreign Official Institutions	<u>526,570</u>	<u>526,570</u>
<b>TOTALS</b>	<b>\$32,526,615</b>	<b>\$10,030,865</b>

An additional \$305,130 thousand of bills will be issued to foreign official institutions for new cash.

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2

FOR RELEASE AT 4:00 P.M.  
January 22, 1991

CONTACT: Office of Financing  
202/376-4350

## TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately \$20,000 million, to be issued January 31, 1991. This offering will provide about \$475 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of \$19,534 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, January 28, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately \$10,000 million, representing an additional amount of bills dated November 1, 1990, and to mature May 2, 1991 (CUSIP No. 912794 WG 5), currently outstanding in the amount of \$9,969 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately \$10,000 million, representing an additional amount of bills dated August 2, 1990, and to mature August 1, 1991 (CUSIP No. 912794 WS 9), currently outstanding in the amount of \$10,691 million, the additional and original bills to be freely interchangeable.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of \$10,000 and in any higher \$5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing January 31, 1991. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold \$1,393 million as agents for foreign and international monetary authorities, and \$3,955 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of \$10,000. Tenders over \$10,000 must be in multiples of \$5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than \$1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of \$200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds \$200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of competitive tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for \$1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE  
January 22, 1991

CONTACT: Office of Financing  
(202) 376-4350

## TREASURY CLARIFIES RULE ON NONCOMPETITIVE AWARDS

The Treasury today clarified its policy on noncompetitive awards. The word "competitive" has been added to the language in its offering announcements and circulars.

This change clarifies which designated closing time (either 12:00 noon for noncompetitive or 1:00 p.m., Eastern time, for competitive tenders) applies to the purchase or sale or other disposition of noncompetitive awards acquired through a Treasury auction.

Offering announcements and circulars will now read as follows:

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of competitive tenders.

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# PRESS RELEASE

## OVERSIGHT BOARD

Resolution Trust Corporation

1777 F STREET, N.W. WASHINGTON, D.C. 20232

FOR IMMEDIATE RELEASE  
January 22, 1991  
OB 91-5

CONTACT: Art Siddon  
Brian Harrington  
(202) 786-9672

### OVERSIGHT BOARD NAMES VICE PRESIDENT FOR FINANCE AND MANAGEMENT

The Oversight Board for the Resolution Trust Corporation (RTC) announced today the appointment of Lloyd B. Chaisson as vice president for finance and management, effective immediately.

Mr. Chaisson comes to the Oversight Board from the U.S. Department of Housing and Urban Development (HUD) where, as a member of Secretary Jack Kemp's principal staff, he led the implementation of the Secretary's management reform agenda. His initiatives eliminated many of the management weaknesses which crippled the department during the 1980's and resulted in billions of dollars of losses to the American taxpayer.

As vice president of finance and management, Mr. Chaisson will be responsible for measuring RTC financial performance and compliance with the Oversight Board's strategic plan. In this capacity he will be the focal point for reviewing the RTC's operating plans, assessing the loss and working capital needs of the corporation, and assessing performance against established targets.

"Mr. Chaisson's extensive experience in management reform will prove valuable to the Board as we continue to emphasize our oversight and evaluation role," said Peter H. Monroe, President of the Oversight Board. "At HUD he was instrumental in leading the effort to put in place a set of extremely successful management reforms. He will be a valuable asset to the members of the Oversight Board."

Prior to his service at HUD, Mr. Chaisson was with the McKinsey and Company, an international management consulting firm. While at McKinsey, Mr. Chaisson counseled top management on strategic, operational and organizational issues at many of this country's leading auto, aerospace, financial, and petrochemical corporations.

Mr. Chaisson holds an undergraduate degree from Dartmouth and a graduate management degree from Yale.

The Oversight Board formulates the policy, approves the  
es the general oversight of the RTC, the agency  
during the nation's failed thrift



# PRESS RELEASE

## OVERSIGHT BOARD Resolution Trust Corporation

1777 F STREET, N.W. WASHINGTON, D.C. 20232

FOR IMMEDIATE RELEASE  
January 23, 1991  
OB 91-7

Contact: Art Siddon  
Brian Harrington  
(202) 786-9672

### OVERSIGHT BOARD COMPLETES SENIOR STAFF

The Oversight Board for the Resolution Trust Corporation (RTC) announced the completion of its personnel reorganization with the appointments today of final senior staff members.

Today's staff appointments were Lloyd B. Chaisson Jr., a former management consultant with The McKinsey Company, as vice president for finance and management, and Robert Vastine, former staff director of the Senate Republican Conference, as vice president for congressional affairs.

"We now have in place a highly capable and experienced management team which will bring to the Board the expertise necessary to focus on our oversight and evaluation responsibilities," said Peter H. Monroe, president of the Oversight Board.

Monroe noted that the required critical staff skills have shifted in recent months toward management consulting, accounting, financial analysis, and legal expertise as the Oversight Board has focused more on evaluating RTC performance under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).

This has resulted in the recent appointments - in addition to Chaisson and Vastine - of:

Richard H. Farina, a specialist in corporate law and partner with the Washington law firm of Reed Smith Shaw, as general counsel.



Arthur J. Siddon, an experienced journalist and Treasury Department public affairs director, as vice president for public affairs/public liaison.

Kurt Wierschem, a 15 year veteran of the savings and loan industry who was formerly in charge of RTC conservatorships and resolutions in Florida and Puerto Rico, as vice president for evaluation and oversight.

Monroe said the Oversight Board will finalize its staffing with mid level management and support personnel primarily accountants, financial analysts, and attorneys.

The Oversight Board formulates the policy, approves the funding, and provides the general oversight of the RTC, the agency responsible for resolving the nation's failed thrifts.

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# PRESS RELEASE

## OVERSIGHT BOARD Resolution Trust Corporation

1777 F STREET, N.W. WASHINGTON, D.C. 20232

FOR IMMEDIATE RELEASE  
January 23, 1991  
OB 91- 6

CONTACT: Art Siddon  
Brian Harrington  
(202)786-9672

### OVERSIGHT BOARD NAMES VICE PRESIDENT FOR CONGRESSIONAL AFFAIRS

The Oversight Board for the Resolution Trust Corporation (RTC) announced today the appointment of Robert Vastine as vice president for congressional affairs, effective immediately.

Mr. Vastine comes to the Oversight Board from the Senate Republican Conference where, as staff director, he led the Senate leadership organization which is responsible for establishing and maintaining a forum for policy discussions and communications services for U.S. Senators.

As vice president for congressional affairs, Mr. Vastine will direct the Oversight Board's relations with Congress.

"The Oversight Board is fortunate to have obtained the services of Mr. Vastine, a multi-talented professional who has won the respect and admiration of Congressional members on both sides of the aisle," said Peter H. Monroe, President of the Oversight Board. "Mr. Vastine provides the Oversight Board with the necessary experience and expertise to ensure that our legislative goals and responsibilities are met."

Prior to his term with the Senate Republican Conference, Mr. Vastine served as legislative director to Senator John Chafee. From 1975 to 1977, he served in the Ford Administration as a Deputy Assistant Secretary for Trade Policy at the Treasury Department. Mr. Vastine was the Republican Staff Director for the Senate Committee on Government Affairs from 1971 to 1975, and represented CPC International, Inc. in Washington, as manager of national government affairs from 1969 to 1971.

A Fellow of the Institute of Politics, Kennedy School of Government at Harvard in 1977, Mr. Vastine received his undergraduate degree from Haverford College and a master's degree from John Hopkins University.

The Oversight Board formulates the policy, approves the funding, and provides general oversight of the RTC, the agency responsible for resolving the nation's failed thrifts.

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2

EMBARGOED UNTIL GIVEN  
EXPECTED AT 10:00 A.M.  
JANUARY 23, 1991

**STATEMENT OF HONORABLE NICHOLAS F. BRADY**  
**Chairman, Oversight Board of the**  
**Resolution Trust Corporation**  
**before the**  
**Senate Committee on Banking, Housing and Urban Affairs**  
**January 23, 1991, 10:00 a.m.**  
**538 Dirksen Senate Office Building**

Mr. Chairman, members of the Committee, we are pleased to be making our semiannual appearance before your Committee today. We look forward to bringing you up to date on the progress being made by the Resolution Trust Corporation (RTC) and the Oversight Board under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

I appear today in my role as Chairman of the Oversight Board of the RTC. Accompanying me are the four other members of the Board: Alan Greenspan, Chairman of the Federal Reserve Board, Philip Jackson, Jr., former member of the Federal Reserve Board and currently adjunct professor at Birmingham Southern College, Jack Kemp, Secretary of the Department of Housing and Urban Development, and Robert Larson, Vice Chairman of the Taubman Company and Chairman of the Taubman Realty Group. Also accompanying us is Peter Monroe, who is President of the Oversight Board.

We are here today to discuss RTC's funding needs as well as other issues that FIRREA requires for this semi-annual appearance.

## RTC'S FUNDING NEEDS

Mr. Chairman, my most important objective today is to state to the Committee as strongly as I can the need for additional funding for the RTC. If the RTC is to continue to carry out its Congressionally assigned mission of resolving hundreds of failed institutions and paying off their depositors without delay, then it must have additional funds as soon as possible. If the RTC fulfills its goals for January and February, and does not receive additional funds, it will have expended all available loss funds and it will be forced to stop closing and selling institutions by the end of February.

It is worth repeating that these funds are needed to protect the savings of depositors. Without these funds, RTC would have no alternative but to practice forbearance, that is, leave

insolvent institutions open to continue to lose money for which the taxpayers will ultimately be liable. RTC has estimated that forbearance for even one more quarter would cost the American taxpayers \$750-\$850 million. (These cost estimates are explained in Appendix I). This projected cost is in addition to the \$250 to \$300 million already lost due to inaction last fall. This would bring the total cost of delay to over \$1 billion.

Therefore, I urge the Congress to act on funding with dispatch.

How much will be required? Based on the RTC's draft operating plan for the nine-month period beginning January, 1991, through the end of this fiscal year, and assuming funds are provided by Congress, the RTC projects it can complete approximately 225 additional resolutions with \$145 billion in assets. To carry out the draft nine-month plan would require added loss funds of \$30 billion through the end of fiscal year 1991.

However, for a number of reasons, we should consider whether our actions should be limited just to this fiscal year's estimated needs. For one thing, the RTC may be able to exceed expectations and resolve more than its goal of 225 institutions. And together we have already said to the public that the government will do what it needs to do to protect depositors.

Insolvent institutions already have incurred losses funded primarily by insured deposits. Therefore, when these institutions are sold or closed, cash is needed to pay the difference between their deposit liabilities and the value of assets assumed by the institutions. The fact is that this is not a discretionary matter. If we do not act depositors will be left hanging.

Therefore, we believe the most sensible and appropriate way for Congress to address the funding issue is to provide RTC with the permanent funding necessary to get the whole job done. Such funding would allow RTC to pursue its mandate aggressively and without costly interruption. It should be noted that Congress can responsibly provide such permanent funding without diminishing its authority to oversee the clean-up process. The RTC and the Oversight Board appear before Congress regularly and submit annual and semiannual reports.

I am afraid that if the Congress imposes on itself the burden of repeated votes on funding, the result will be a start and stop cleanup process that produces further delays, substantial additional costs to taxpayers, and confusion and fear in the minds of depositors.

In June, 1990, at our semi-annual appearance, we estimated that the final cost of the S&L cleanup would be in the range of \$90 to \$130 billion in 1989 present value terms. As we explained at the time, the actual cost is subject to a great deal of uncertainty -- the number of cases, losses on assets, interest rates, the condition of real estate markets, and the general condition of the economy. Now, the economy has entered a downturn and the crisis in the Persian Gulf has increased the hesitance of potential buyers to make investment commitments. All these factors are interrelated and make predictions hazardous.

Although the most likely cost scenario has probably moved to the higher end of our original range, it nevertheless remains within that range. In other words, we still believe that the upper-end-of-the range estimate of \$130 billion in 1989 present value terms remains valid. However, as has been mentioned numerous times, no one can guarantee any estimate based on such volatile variables. We will continue to monitor this situation closely.

Our loss estimates are based on a cash flow model that permits us to vary a number of assumptions to take into account their effect on the RTC's ultimate costs. This range is based on the resolution of from roughly 700 to just over 1000 thrifts. A more detailed explanation of our methodology can be found in Appendix II to this testimony.

#### RTC WORK IN GETTING THE JOB DONE

Given the size and complexity of the problem with which we are dealing, the Board believes that the RTC has made progress.

When President Bush announced his proposed solution to the savings and loan crisis soon after taking office, he established four principles which continue to guide us.

- o First, protect the insured deposits of the millions of men and women who acted in trust by putting their savings in federally insured savings and loans.
- o Second, restore the safety and soundness of the savings and loan industry so that a similar crisis can not reoccur.
- o Third, clean up the S&L overhang so we get the problem behind us, and do it at the least cost to the taxpayer.
- o Finally, aggressively pursue and prosecute the crooks and fraudulent operators who helped create the problem.

Mr. Chairman, FIRREA gave RTC day-to-day operational responsibility to resolve insolvent thrifts and sell assets. The Oversight Board's responsibility is to set overall strategy, policy and goals for the RTC, approve funding, and provide oversight. Let me turn now to matters that are required by law to be addressed in our semi-annual report, and other matters of interest to the Committee.

As required by FIRREA, our testimony will cover the six-month period from April 1 through September 30, 1990. In addition, we will report on some of the key events occurring since the end of that reporting period. My presentation is supplemented by a more detailed response, contained in Appendix III, to several of the specific information requirements set forth in FIRREA for this semiannual appearance.

### Progress in Resolutions

From its inception on August 9, 1989, through December 31, 1990, RTC seized 531 thrifts, and resolved 352 of them. That left the RTC, as of January 1, 1991, in control of 179 conservatorships.

The RTC has achieved its resolution pace by setting and achieving goals. For example, for the three month period ending June 30, the RTC's goal was the resolution of 141 institutions. The RTC actually resolved 155. During the next quarter, the RTC's goal was the resolution of 77 institutions and it achieved 80 resolutions.

For the 6-month period from October 1, 1990, to March 31, 1991, the RTC had expected to resolve 192 thrifts. As a result of Congressional inaction on funding, RTC was forced to revise its goal to resolve 97 thrifts. As of December 31, 1990, RTC had resolved 66 of its revised goal, and expects to meet its goal of 97 institutions by the end of February.

### The New Accelerated Resolution Program (ARP)

Last summer the RTC began a pilot project, called the Accelerated Resolution Program (ARP), to lower the cost of thrift resolutions by pre-selling troubled institutions before they are put in conservatorship. Such pre-sales should reduce the deterioration in franchise value and core deposits that can result from placing an institution in conservatorship. ARP is a cooperative effort between the RTC and the Office of Thrift Supervision (OTS) in which the OTS, in consultation with the RTC, identifies which thrifts are ARP candidates. Then the OTS and RTC establish a supervisory and regulatory framework within which the institutions will operate while in ARP.

Nine institutions were selected for the ARP pilot project. They were chosen on the basis of: 1) bidder interest, 2) management-led investor proposals, and/or 3) demonstrated franchise value. The OTS and RTC selected thrifts in different geographic areas and of varying sizes ranging from \$100 million to more than \$3 billion in assets.

In order to ensure open and competitive bidding, the standard RTC bidding process has been followed. As a result, more than 1,300 potential bidders from the RTC qualified bidders list were notified by mail for each of the nine thrifts.

Sales have closed on seven of the nine institutions, and the OTS and RTC have begun a review of this demonstration program. Some valuable information already has been learned. In all nine thrifts, there has been virtually no deposit runoff, management has remained intact, and the institutions have remained stable.

OTS has begun to review its Group IV thrifts to identify candidates for the next phase of the program should the RTC Oversight Board approve expansion beyond the pilot project. The Board's decision will depend on the RTC's evaluation of the pilot project.

#### Status of the RTC Conservatorship Program

As of January 1, there were 179 thrifts in conservatorship. In addition, the most likely candidates for new conservatorships are in OTS's Group IV, which also contained 179 thrifts. There are another 356 thrifts in OTS's Group III for which the future is uncertain.

The advantages of placing an institution in conservatorship are that the RTC can stem losses, stabilize the institution, and halt practices which may have contributed to insolvency. Conservatorship also helps the RTC prepare the institution for resolution by reducing its assets by means such as securitization and by reducing the institution's high cost deposits. The disadvantage of conservatorship is that conservatorship can contribute to an erosion of franchise value. Skilled staff often begin to leave in anticipation of a possible liquidation of the institution, and depositors tend to accelerate their withdrawal of funds. The Accelerated Resolution Program is intended to avoid these disadvantages.

#### Progress in Asset Disposition

In addition to resolving insolvent institutions, the RTC must dispose of their assets, whether in conservatorship, at

resolution, or out of receivership. During the April through September period covered by our semi-annual report, receivership and conservatorship assets were reduced by \$66.8 billion in book value.

However, from its inception through December 31, 1990, the RTC has seized thrifts with over \$273 billion in initial assets. Through a combination of resolutions, asset sales and note collections, it has reduced assets held by over \$127 billion, and continues to hold assets of about \$146 billion.

Even though RTC has made progress, the Oversight Board and RTC are concerned that RTC has not been able to sell more assets. Therefore, the Oversight Board has over the past six months focused on developing policies - securitization, seller financing and affordable housing - that should enable the RTC to accelerate asset sales.

At our Board meeting last week, however, Chairman Seidman told us that there is a new road block that will further delay asset sales. The RTC Board has been advised that potential personal liabilities may be imposed upon directors, officers, and employees of the RTC and the Oversight Board in connection with the RTC's securitization program as well as in connection with RTC's other asset disposition activities. Chairman Seidman indicated that a legislative solution to the problem is needed and that his staff is currently drafting proposed legislation to address the matter. The Administration is reviewing this issue.

#### RTC Use of Private Sector to Aid Asset Sales

FIRREA mandates that the RTC make maximum delegation of asset management and sales functions to the private sector. To implement that, the RTC has adopted a Standard Asset Management and Disposition Agreement, or SAMDA program.

The RTC has already placed over \$10 billion in real estate and delinquent mortgages under SAMDA contracts. Bids have already been received to place another \$10 billion under SAMDA. Accordingly, most REO and delinquent mortgages in receivership will soon be under SAMDA contracts. The RTC is also proceeding to place all such conservatorship assets under SAMDA contracts.

Private sector contractors will be paid fees for managing the properties as well as incentives to accelerate sales and maximize the return to the RTC. While these contracts provide fair returns for property management, the incentive fees will be given for turning properties into cash rather than encouraging managers to collect their management fees while they wait for the real estate markets to improve.



There are incentives for selling at prices equal to or greater than the RTC's estimates of recovery. There is a 20% incentive payment for selling in the first year and 10% for selling in the second year. Actual holding costs are deducted from the sales price to encourage efficient management.

We believe the program is promising, but we recognize the difficulty of selling these assets in the current real estate market.

### Progress toward Minority Outreach

The RTC Minority and Women Outreach Program seeks to encourage minority participation in the award of RTC contracts. The RTC has conducted seminars throughout the country to inform minority and women owned businesses of the many contractor opportunities with the RTC and the registration and bidding process. Advertisements are placed in minority print media to publicize the program. As of November, 1990, RTC informs us that over 3,500 minority-owned firms, over 4,500 majority women-owned firms, and approximately 900 minority women-owned firms were registered as potential asset managers, brokers, lawyers and other RTC contractors. Over 900 contracts for such work, or about 20% of total awards, have been awarded to minority and women owned businesses.

FIRREA also directs the RTC to give preference in purchasing thrifts to bids from investors with the same ethnic identification as that of the failed thrift. As of November, the RTC had resolved 14 minority owned institutions; 3 were liquidated, 8 were acquired by buyers of the same ethnic identification, and 3 were sold to other buyers.

The Oversight Board continues to monitor this effort by RTC to preserve minority-owned institutions and promote greater awareness by minority and women-owned businesses of these excellent business opportunities.

### ENHANCED LAW ENFORCEMENT

Let me say a few additional words about some new enforcement tools. As you know, in June 1990, President Bush announced a package of legislative and administrative initiatives designed to intensify the fight against fraud in our nation's financial institutions. Most of these legislative initiatives were embraced in a bi-partisan manner by the Congress and enacted as the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990.

The new law provides an array of additional powers to the

Justice Department, bank regulators, the FDIC and the RTC, particularly provisions which:

- o Provide authority to freeze or appoint a receiver for the assets of fraudulent operators;
- o Enhance civil and criminal forfeiture authority;
- o Protect victims of fraud by closing loopholes in the bankruptcy laws that have in the past enabled some executives to evade financial responsibility for their misdeeds;
- o Allow the Justice Department to accept without reimbursement the services of federal attorneys, law enforcement personnel, and other employees;
- o Direct U.S. courts to give cases brought by the FDIC and the RTC priority consideration and to establish procedures for expedited appeals;
- o Give law enforcement authorities a needed tool: the ability to request the use of wiretaps for bank fraud and related offenses.

In conjunction with the authorities provided in FIRREA, we now have an effective arsenal of legal weapons available to combat fraud and to recover assets. Using these authorities, federal law enforcement agencies are gaining ground against fraudulent thrift officials. Of 566 defendants charged in savings and loan cases from October 1988 through the end of 1990, 403 have been convicted and only 18 acquitted. Prison sentences have been dealt totalling 768 years, and \$231.8 million in restitutions have been ordered. Of those convicted, substantial numbers have been savings and loan chief executive officers, chairmen, presidents, directors, and other officers.

#### RECENT OVERSIGHT BOARD ACTIONS

Let me turn now to the key areas of Oversight Board activity over the last six month period. First, I will discuss the importance of asset sales and three Oversight Board actions in this area: securitization, seller financing and affordable housing. Next, I will describe the Oversight Board's developing oversight and evaluation role including its management planning procedures and the relationship between the Board and the RTC Inspector General.

Finally, I will describe the Board's role in developing policy for restructuring the 1988 Deals.

## Revision of Asset Sales Strategies

As I said earlier, the increased number of resolutions handled by the RTC makes it very important to accelerate its asset sales. The Oversight Board is in the process of performing an overall strategic review of RTC asset sales programs. Our goals are to increase both the sales pace and the return on asset sales. Acquisition of this inventory is funded by working capital borrowed by RTC from the Federal Financing Bank (FFB). These borrowings grew to \$53 billion by December 31, 1990, and are projected to reach \$76 billion in February. The RTC estimates they may increase to over \$100 billion by the end of fiscal year 1991.

In developing asset sales policies, the Oversight Board received valuable advice from the National Advisory Board and the six regional boards established by FIRREA. Because the board members know local economic conditions and are composed of community leaders in the real estate, banking, housing, legal and accounting professions, they have provided useful recommendations for the Oversight Board.

## The Need for Securitization

The Oversight Board recently directed the RTC to increase its use of securitization as a means to speed the sale of performing financial assets. Securitization means the pooling of financial assets with a positive cash flow and converting the pool into one or more securities collateralized by the assets in the pool.

The policy applies to all securitizable financial assets held by the RTC including mortgage loans, high-yield securities, and any loans originated by the RTC under seller financing. Approximately 25% of all RTC assets are securitizable. The Board believes that securitization should aid the RTC to sell these assets more quickly, thus improving its cash flow position. This, in turn, should materially lessen the pressures for working capital borrowings through the FFB. Progress in the securitization area depends on the personal liability protection I discussed earlier.

## The New Seller Financing Policy

While securitization is one method to help the RTC sell its performing financial assets, the RTC has informed the Board that certain financial assets as well as real estate and delinquent mortgages are not securitizable and cannot be sold because commercial financing is not available.

Accordingly, in December, the Oversight Board expanded its seller financing policy to provide the RTC greater flexibility in its asset sales program.

This program provides \$7 billion in seller financing authority for assets that can't be sold at acceptable prices because of inadequate commercial financing. As a result of such sales, the RTC generally will receive an initial 15% downpayment, and receive the balance in installments over time. If buyers in such sales do not fulfill their commitments, the RTC still comes out ahead: it has the 15% downpayment, it may have received a number of installment payments, it has shifted the asset's operating costs to the private sector for a time, and it will repossess the asset if necessary. It is important to remember that the RTC has already paid for these assets so that the sale can only reduce Treasury borrowings. Importantly, under this policy a minimum of \$250 million is reserved solely for the financing of affordable housing to qualifying low- and moderate-income buyers.

This \$7 billion program will be measured, monitored and evaluated for effectiveness by the Oversight Board. The Board has also directed the Inspector General to perform a front end risk assessment of the program and conduct periodic audits of its implementation.

### Affordable Housing

Since we last appeared before this Committee, the Oversight Board has adopted new policies regarding the Affordable Housing Disposition Program. We believe the RTC is making progress in responding to the FIRREA mandate in the area of affordable housing for moderate-and lower-income persons.

On August 15, 1990, the Oversight Board approved a final rule allowing for a number of marketing initiatives to expedite the sale of properties. The rule encourages the RTC to use bulk sales and special marketing events such as home fairs, open houses, and auctions to make qualified organizations and individuals more aware of available properties.

Chairman Seidman has proposed a new program to sell to eligible buyers during the clearinghouse period, the bulk of RTC's single family affordable housing in a no reserve auction and sealed bid process. We have requested Chairman Seidman to provide more information on this initiative which the Oversight Board clearly supports in principle.

The Oversight Board also approved a policy allowing the RTC to accept offers from qualified buyers for single family

properties at prices as low as 80% of the market value. The policy augmented an active RTC program to increase the opportunities for low- and moderate- income buyers who are at or below 80% of the local median income.

I have already mentioned the minimum amount of \$250 million in seller financing which the Oversight Board made available to the affordable housing program. The RTC is establishing guidelines for the implementation of seller financing. The Oversight Board previously authorized the RTC to pay up to \$6 million to purchase forward mortgage revenue bond (MRB) commitments to be exclusively reserved for the RTC affordable program. One hundred eighty-nine million dollars has already been reserved under this program which when combined with the \$250 million revolving affordable seller financing program provides a minimum of \$439 million of financing for affordable housing.

The Oversight Board has also encouraged the RTC to take advantage of the Federal National Mortgage Corporation's and the Federal Home Loan Mortgage Corporation's demonstrated capabilities in housing finance. Programs utilizing their expertise in structuring and servicing seller financed mortgage loans, including delegating the origination and servicing to designated lenders with prudent underwriting, are now under consideration.

As a result of some of these new developments and the growing experience of the program and staff, we can report that property sales increased. Through December 31, 1990, the program had accepted approximately \$108 million of contracts on 2,737 properties, and of these, 1,507 properties had closed. The average sales price was \$38,442 for single family homes and \$936,000 for the nine multi-family developments on which the RTC had accepted offers. RTC advises that the average income of purchasers under the affordable program is less than 80% of national median income.

Although properties in conservatorship are by statute not subject to the 90-day marketing period, both the seller financing and MRB programs are available for conservatorship properties. The RTC is encouraging non-profit organizations, as well as individuals, to make offers for conservatorship properties.

With the final rule in place, emphasis is switching to the marketing of multi-family properties. The RTC has had some serious expression of interest in bulk packages of multi-family affordable housing and its National Sales Center is currently marketing its first bulk package of multi-family properties consisting of three Florida developments with 590 units.

One key to the progress in the affordable housing program

thus far has been the assistance of clearinghouses and technical assistance advisors. The RTC has established 30 clearinghouse agreements with state housing finance agencies including one with the Federal Housing Finance Board with the participation of the 12 district Federal Home Loan Banks.

### The Board's Role in Oversight and Evaluation

Under the Oversight Board's management planning procedures the RTC is asked to set goals which it believes are attainable. This is the best way to assure that RTC management is committed to achieving these goals. The Board then evaluates the RTC's performance against the goals.

For example, the Board has suggested improvements in RTC planning and performance measurement through the operating plan process. As mentioned earlier, the Board and RTC are working to develop a final operating plan for fiscal 1991, rather than the 3 month plans submitted previously. Longer planning periods more accurately reflect the time horizon needed by the RTC for proper goal setting. The nine month plan will be monitored monthly and performance forecasts against goals will be provided quarterly together with explanations of variances from plan. RTC will be asked to submit a one year plan for fiscal year 1992.

The operating plan process provides a vehicle for setting program goals and also funding needs. Funding needs for both loss funds and working capital are constantly updated for the Board and compared to statutory constraints.

For example, with each FFB funding draw the RTC must certify to the Board that it is in compliance with all statutory funding constraints after taking into consideration all contingent liabilities -- notably "asset puts". Asset puts represent the right of thrift buyers to "put" purchased assets back to the RTC. The Board has required the RTC to provide a detailed monthly analysis of such asset puts as to amount, term and characteristics.

The RTC also must supply a weekly update of its rolling six-week schedule of anticipated FFB borrowings.

In the area of accounting, the Oversight Board's CPA as well as the Inspector General are reviewing the loss recognition process used by the RTC. While the Board has received the RTC's unaudited financial statements for the period ending December 31, 1989, the Board continues to press the RTC for audited financial statements covering this period.

As a part of the Board's responsibility to attempt to eliminate potential fraud, waste, and abuse in RTC operations, it has been working closely with the RTC Office of Inspector General to set an aggressive audit and investigation agenda.

Weekly meetings have been held with the IG on investigative and audit activities. The meetings focus on spotting areas of vulnerability and correcting problems before they occur. The IG has been directed by the Oversight Board to undertake audits in the highest risk areas. He has also been directed to audit a sample group of completed resolutions and executed contracts. As mentioned earlier, the Oversight Board has directed the IG to undertake a front end risk assessment of the seller financing program and to periodically audit it and the 1988 Deal restructurings.

The IG has opened 15 investigative cases and closed 6 to date. It has begun 15 audits and issued 6 reports. It has identified 36 major areas on which it is planning to focus in fiscal 1991. Currently at the level of 100, the IG plans a staff of about 350 by fiscal year 1992. The Oversight Board considers it essential that an aggressive auditing program be pursued. In addition, at the Board's direction, the IG has provided the Board its detailed audit and investigation plan for the balance of this fiscal year.

#### Progress in Renegotiating 1988 Deals

In September, the RTC reported to the Oversight Board on its FIRREA mandated review of the assistance transactions entered into by the Federal Savings and Loan Insurance Corporation (FSLIC) prior to the passage of the Act. From its review, the RTC concluded that a restructuring of some of the so-called "88 Deals" could result in a savings of approximately \$2 billion to the taxpayers over the term of the loans but would require a current appropriation of approximately \$20 billion.

On October 18, Congress appropriated \$22 billion for the FSLIC Resolution Fund (FRF) to pay obligations arising in FY 1991 as well as "permit the prepayment of certain higher interest rate obligations and thus realize a savings of approximately \$2 billion".

Under FIRREA, the Oversight Board has the responsibility to establish overall strategies, policies and goals for restructuring the 1988 FSLIC assisted transactions.

Therefore, the Oversight Board has adopted a policy statement to guide the RTC in restructuring the FSLIC Assistance Agreements (see Appendix IV). The policy statement provides a

series of guidelines for such restructurings and directs the RTC to use Treasury borrowings efficiently so as to maximize overall cost savings for the government with respect to the 1988 Deals as a whole.

The important point here is that we must immediately begin the restructuring process and use this fiscal year's appropriations to save taxpayer dollars. Accordingly, we have ordered the RTC to start negotiations consistent with this policy statement.

### CONCLUSION

In closing, let me reiterate what we said at the beginning of our statement. The job is getting done, but we still have a long way to go. This is a task the government cannot escape if we are to honor the promise to the American people to make good on federal deposit insurance.

Immediate Congressional action to provide additional loss funds is essential. I repeat that without such action the RTC's resolution process will halt and the taxpayers' costs will increase. As discussed earlier, we believe the most sensible and appropriate way for Congress to address the funding issue is to provide RTC with the permanent funding necessary to get the whole job done. Let me say again that without permanent funding the result could be a start and stop cleanup process that produces further delays, substantial additional costs to taxpayers, and confusions and fear in the minds of depositors.

We will be glad to respond to your questions.




# RTC

Resolution Trust Corporation

January 10, 1990

**MEMORANDUM TO:** Peter H. Monroe  
President, RTC Oversight Board

**FROM:** David C. Cooke   
Executive Director

**SUBJECT:** Cost of Delaying Resolutions

You have asked that we update our memorandum of November 1, 1990 on the cost of delaying resolutions. Assuming that additional funds are not available until late February or early March, the RTC will have fallen approximately one quarter behind in the resolution process. We estimate the present value cost of this delay at \$250 million to \$300 million. These estimates exclude three nonquantifiable factors: asset deterioration or other losses that might occur in understaffed or undermanaged institutions awaiting resolution, deterioration of franchise value, and the effect that competing with insolvent institutions has on the cost of funds of marginally solvent institutions possibly causing additional failures.

If additional funding for the RTC is delayed beyond the very beginning of March, the cost of delay begins to go up exponentially. Thus, we estimate that an additional quarters delay would cost an additional \$750 million to \$850 million in present value terms, or an average \$250 million to almost \$300 million per month. (In actuality, since the cost of delay grows exponentially, the cost of delay at the beginning of the second quarter is somewhat less than \$250 million per month while the cost of delay at the end of the second quarter is somewhat greater than \$300 million.)

The reason that the estimated cost of a second quarter's delay is roughly triple that of a single quarter's delay is that the longer the delay, the longer it takes to make-up for the time lost to delay. It takes twice as long to make-up for a two quarter delay as a one quarter delay. For example, if the number of resolutions were increased by 50 percent to make-up for lost time, it would take 6 months to make-up for a one quarter delay and a year to make-up for a two quarter delay. Moreover, it is not realistic to assume a 50 percent increased resolution rate can be sustained much longer than 6 months. If there was a two quarter delay, a 25 percent increase in the quarterly pace of resolutions is probably the most that is feasible beyond the initial 6 months push. Thus, it could take a year and a half to completely make-up for a two quarter delay.

As previously noted, our estimates do not take into account three factors: asset deterioration or other losses that might occur in understaffed or undermanaged institutions awaiting resolution, deterioration of franchise value, and the effect that competing with insolvent institutions has on the cost of funds of marginally solvent institutions possibly causing additional failures. However, it would not be unreasonable to assume that these factors might increase the cost of an additional quarter delay by at least 10 percent.

## APPENDIX II

### Methodology for Estimating RTC Losses

In order to make our estimates for our previous testimony, we developed a cash flow model for the RTC that gives us the ability to vary a number of assumptions for their effect on the RTC's ultimate costs. As we have discussed before, our low estimate assumed a population of about 700 institutions, which included those already resolved, those in conservatorship, and all institutions classified as Group IV thrifts by the OTS. Our high estimate assumed a population of just over 1000 thrifts, which included the 700 institutions in the low estimate, plus all institutions classified as Group III thrifts by the OTS.

It should be noted that our cash flow model does not deal with individual institutions. Rather, total assets for individual thrifts are divided into 14 different asset types and then aggregated into tranches representing conservatorships, Group IV and Group III thrifts. The RTC's pace of resolution is selected not by choosing individual thrifts each quarter, but by choosing a volume of total assets in thrifts that are to be resolved each quarter.

The losses to be experienced by the RTC are estimated by applying a loss estimate, or "haircut" to each of the 14 different asset types, and adding that to the negative tangible net worth and accumulated operating losses prior to receivership of the resolved institutions. In making estimates, we used three different sets of haircuts. The medium haircuts were based upon the FDIC's Division of Research bank failure cost model, while the other two sets were assumed to be higher and lower. The average aggregate haircut for these three scenarios ranged from about 14 to 25 percent.

Our cash flow model allows us to choose what percentage of resolved institutions are resolved in whole bank, clean bank and liquidation transactions, and to define each of these transaction types in terms of what percentage of each asset type gets passed to an acquirer. Our model also allows us to vary the pace of sale of receivership assets by estimating what percentage of each of the 14 asset types is sold each quarter until all are sold.

The estimates in our previous testimony were based upon year-end 1989 data, with the OTS Group III and Group IV classifications as of the end of April 1990. As OTS has released new data and thrift classifications, we have incorporated this information into the cash flow model. Our latest estimates, upon which the President's budget numbers are based, use data as of June 1990. OTS has only recently released September 1990 data and new Group IV and Group III classifications; based upon our preliminary analysis, it appears that this new data will not substantially change our current estimates.

## APPENDIX III

### **Requirements Established in FIRREA for Semi-Annual Appearances**

- I Report on the progress made during the 6-month period covered by the semi-annual report in resolving cases involving institutions insured by the FSLIC prior to FIRREA, and for which conservator or receiver has been appointed (from 1/89 to the 3 year period beginning 8/89). These institutions are referenced below as those described in subsection (b) (3) (A).
  
- II Provide an estimate of the short-term and long term cost to the United States Government of obligations issued or incurred during such period.

### **Comments**

Detailed discussion is included in the testimony section entitled "Case Resolutions". During the six month period, the RTC resolved 235 institutions, exceeding its goal of 218 institutions. During the same period, conservatorship and receivership assets were reduced by \$66.8 billion in book value.

We interpret this requirement to address RTC short-term borrowings from the Federal Financing Bank ("FFB") and long-term borrowings from Resolution Funding Corporation ("REFCORP").

During the reporting period, the RTC had issued and outstanding about \$53.0 billion in obligations in the form of short-term working capital borrowings from the FFB. Approximately, \$900 million in interest expenses were incurred in connection with the issuance of these obligations during such period. These borrowings are fully collateralized by assets having an estimated fair market value substantially in excess of the borrowed amount. Accordingly, we expect that the U.S. government ultimately will not incur any cost in connection with these short-term obligations.

REFCORP issued \$8.5 billion of obligations during the reporting period, with \$3.5 billion having a term of forty years, and the balance having a term of thirty years. The yield on each issue was 8.88%. Total interest expense is expected to be a nominal \$25.8 billion. Annual fixed interest expenses of \$755 million will be incurred in connection with these obligations. Under FIRREA, interest on all REFCORP obligations is funded jointly by the Federal Home Loan Banks (FHLBs) and the Treasury, with the FHLB contribution limited to a maximum of \$300 million per year.

As of January 1991, REFCORP had outstanding the full \$30 billion of obligations authorized by FIRREA, with average maturities of 33 years and average yields of 8.76%. Total interest on REFCORP obligations is expected to be a nominal \$87.9 billion. The Treasury share of this interest is expected to be a nominal \$78 billion.

**requirements Established in FIRREA for  
Semi-Annual Appearances**

**III Report on the progress made during such period in selling assets of institutions described in subsection (b) (3) (A) and the impact such sales are having on the local markets in which such assets are located.**

**IV Describe the costs incurred by the Corporation in issuing obligations, managing and selling assets acquired by the Corporation.**

**Comments**

Detailed discussion is included in the testimony section entitled "Asset Disposition". It is too early in the process to assess the impact of RTC real estate sales on the local markets. To date, there is no evidence that RTC sales have had an adverse impact on local real estate markets. The RTC's National Advisory Board reports that the sale of RTC assets has not adversely affected local real estate markets to date and this observation is consistent with independent reports. The RTC will, however, monitor the impact of its sales activities in local markets through the input of its Regional Advisory Boards. The Regional Advisory Boards will receive analytical support from economists at the Federal Reserve to track and measure the impact of RTC sales on local market conditions. In particular, the new nationwide auction program will be carefully monitored.

We have interpreted this requirement to address the assets of receiverships and conservatorships which are under the management of the RTC.

Costs in the range of \$250-\$300 thousand were incurred during the period in connection with the issuance of obligations by the Corporation.

The total amount paid to private contractors during the April - September period was \$99 million, of which \$18 million represents fees paid under receivership asset management contracts.

After the appointment of RTC as conservator, association employees continue to perform asset management functions under the supervision of the RTC Managing Agent. These staff are already supplemented by outside contractors hired and paid for by the institution for services for which the institution would typically contract in normal course of business. Accordingly, we have excluded such costs for the purposes of this calculation.

**Requirements Established in FIRREA for  
Semi-Annual Appearances**

- V Provide an estimate of income of the Corporation from assets acquired by the Corporation.**
- VI Provide an assessment of any potential source of additional funds for the Corporation.**
- VII Provide an estimate of the remaining exposure of the United States Government in connection with institutions described in subsection (b) (3) (A) which, in the Oversight Board's estimation, will require assistance or liquidation after the end of such period.**

**Comments**

In its corporate capacity, the RTC's only "income" is interest on advances made by the Corporation to conservatorships and receiverships. The RTC received \$588 million of interest income on advances and loans to conservatorships and receiverships in the six months ended September 30, 1990. Dividends are not included in income because they are a reduction in RTC's claims against the assets of the receiverships, a return of capital, and not income. However, dividends received by the RTC during the period totalled \$1 billion.

The only remaining sources of additional funds to the Corporation are the secured borrowings for working capital from the FFB and the \$5 billion line of credit from the Treasury provided in FIRREA. There are no other funds currently available to the RTC.

The estimate of the total resolution cost to be borne by the RTC in connection with those institutions described in subsection (b) (3) (A) is projected to be in the range of \$90 to \$130 billion (present value). The RTC has expended approximately \$37 billion for estimated losses from inception through December 31, 1990.

## POLICY STATEMENT NO. 16

**Oversight Board Policy Concerning RTC  
Restructuring of FSLIC Assistance Agreements  
("1988 Deals")**

**1. Purpose and Statutory Background**

This policy statement establishes guidelines for the RTC with respect to the restructuring of the FSLIC agreements ("1988 Deals") referred to in Section 21A(b)(11)(B) of the Federal Home Loan Bank Act, as amended by Section 501 of FIRREA. Pursuant to the requirements of that law, and in accordance with the guidance provided by this policy statement, RTC "shall exercise any and all legal rights to modify, renegotiate, or restructure such agreements where savings would be realized by such actions." FIRREA also instructs RTC to operate in a manner that "makes efficient use of funds obtained from the Funding Corporation or from the Treasury."

**2. Restructuring Policies**

With respect to the 1988 Deals:

(A) RTC shall make efficient use of Treasury funds appropriated from time to time for the purpose of lowering the government's overall cost of the 1988 Deals.

(i) RTC shall expend appropriated funds in a manner designed to maximize government cost savings with respect to the 1988 Deals as a whole. RTC need not expend any particular amount of appropriated funds in any specific transaction.

(ii) RTC need not expend all appropriated funds but should be willing to do so as necessary to achieve cost savings.

(iii) RTC may expend appropriated funds to prepay notes, purchase assets, mark down assets, or otherwise exercise the government's rights and options under the existing terms of 1988 Deals. RTC may renegotiate terms of a transaction instead of, or in combination with, such use of appropriated funds.

(iv) Except for the expenditure of appropriated funds to make scheduled payments under the existing terms of the 1988 Deals, the Oversight Board considers all expenditures of appropriated funds to constitute "restructuring" of the 1988 Deals.

(v) In determining how and when to expend appropriated funds, RTC shall take into consideration all relevant factors including, but not limited to:

(a) savings and projected savings that may be achieved through prepayments and exercise of other government rights under the 1988 Deals;

(b) savings and projected savings that may be achieved through renegotiation of the terms of 1988 Deals;

(c) projected increases or decreases in government tax revenues; and

(d) projected costs of thrift failures resulting from exercise of government rights under 1988 Deals.

Projected savings and projected costs shall be considered with due regard for the probability with which they can be expected.

(B) Where RTC seeks to renegotiate the terms of 1988 Deals, it shall seek to improve incentives for effective management and disposition of assets in a manner consistent with the concepts employed by RTC in its Standard Asset Management and Disposition Agreements.

(C) RTC shall employ uniform criteria for its decisions and actions concerning the so-called "stabilized" deals and the other 1988 Deals. With respect to any of the "stabilized" or other 1988 Deals, RTC may renegotiate terms so as to continue yield maintenance, asset loss coverage, and other forms of continuing assistance, where doing so is consistent with the goal of reducing the government's overall cost of the 1988 Deals, notwithstanding the Oversight Board's general policy against the use of such ongoing assistance with respect to RTC thrift resolutions apart from the 1988 Deals.

(D) RTC may seek to avoid government undertakings where fraud or other misconduct by persons contracting with the government provides a legal basis to do so. Where fraud or other criminal conduct appears, RTC shall refer the matter for prosecution.

### 3. Execution

In restructuring 1988 Deals:

(A) RTC may employ whatever resources it deems reasonable and appropriate, including FDIC personnel and outside contractors. RTC, however, remains responsible for the overall plan of the effort, for the methods used and results achieved, and for reporting to Congress, the Oversight Board, and the public.

(B) RTC shall thoroughly and completely document its procedures, decisions, and actions (and shall require the same by its agents and contractors) in a manner so as to facilitate detailed auditing and investigation by RTC's Inspector General.

### 4. Performance and Monitoring

RTC shall report monthly to the Oversight Board regarding actions taken, amounts expended or to be expended, and cost savings achieved or projected as a result thereof. Reports shall be made with respect to the 1988 Deals individually and in the aggregate and shall include such detail, data, and explanations as the Chairman or the President of the Oversight Board may from time to time request.



### **3. Immediately Effective**

This policy statement supersedes the Oversight Board's request for recommendations from the RTC as set out in the resolution adopted by the Oversight Board on September 20, 1990. Accordingly, this policy statement is immediately effective and RTC may begin immediately to restructure the 1988 Deals as provided herein.



# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE  
January 23, 1991

CONTACT: Office of Financing  
202-376-4350

## RESULTS OF TREASURY'S AUCTION OF 2-YEAR NOTES

Tenders for \$12,619 million of 2-year notes, Series W-1993, to be issued on January 31, 1991 and mature on January 31, 1993 were accepted today (CUSIP: 912827ZU9).

The interest rate on the notes will be 7 %. The range of accepted bids and corresponding prices are as follows:

	<u>Yield</u>	<u>Price</u>
Low	7.08%	99.853
High	7.09%	99.835
Average	7.09%	99.835

\$100,000 was accepted at lower yields.  
Tenders at the high yield were allotted 60%.

### TENDERS RECEIVED AND ACCEPTED (in thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	54,670	54,670
New York	36,929,735	11,255,235
Philadelphia	27,140	27,140
Cleveland	69,720	49,720
Richmond	188,425	143,025
Atlanta	48,880	42,880
Chicago	1,715,270	353,270
St. Louis	83,020	67,020
Minneapolis	28,360	28,360
Kansas City	93,500	91,500
Dallas	19,980	19,980
San Francisco	500,995	110,995
Treasury	<u>375,425</u>	<u>375,425</u>
TOTALS	\$40,135,120	\$12,619,220

The \$12,619 million of accepted tenders includes \$1,329 million of noncompetitive tenders and \$11,290 million of competitive tenders from the public.

In addition, \$690 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional \$729 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-204

PREPARED REMARKS FOR  
SECRETARY NICHOLAS F. BRADY  
DELIVERED BY DEPUTY SECRETARY JOHN ROBSON TO THE  
U.S. SAVINGS BONDS VOLUNTEER COMMITTEE  
WEDNESDAY, JANUARY 23, 1991  
WASHINGTON, D.C.

Thank you. It is a great pleasure to welcome all of you to the 29th Annual Meeting of the U.S. Savings Bonds Volunteer Committee. This is an important meeting to honor the people who make Savings Bonds a success. Today, we're here to thank Allen Jacobson and his entire leadership group for their outstanding job last year. Allen will be passing the chairmanship to Ed Hennessy this year, and I'm certain Ed's group will do a great job for Savings Bonds in 1991.

Before turning to the subject of today's meeting, I'd just like to take a moment to pay tribute to the brave men and women in the Persian Gulf. They are constantly in our thoughts and prayers, and I know you join me in supporting them.

Today, we are celebrating the 50th anniversary of U.S. Savings Bonds. President Roosevelt issued the first Series E Savings Bond in 1941. Since then, it's become the most widely-held security of all time. This is an important program, and the people behind Savings Bonds have proven their ability to make it work for all Americans.

I'd like to express my appreciation for the Volunteer Committee's outstanding efforts on behalf of our nation. We've always been able to depend on your commitment to excellence, and we look forward to your continued success.

This year, our annual Volunteer Committee meeting is a special one. 1991 is the first year we've included in our meeting the leaders of company payroll savings campaigns from throughout the country. And that's appropriate, because you are the volunteers who make the Savings Bonds Program the remarkable success it is today, and I'm confident your hard work will carry on that tradition.

We are coming off a great campaign year. In 1990, Allen Jacobson led the Committee to \$8 billion in sales and 1.6 million new or increased savers. That's a real victory for the Savings Bonds Program, and it proves that our message of thrift and fiscal responsibility still hits home with the American people.

Savings Bonds are strong investments that work for everybody. They offer considerable benefits to payroll savers, companies offering the Payroll Savings Plan, and the United States.

For savers, the Bonds offer a unique combination of benefits, including market-based interest and freedom from state and local taxes. Savings Bonds also are backed by the full faith and credit of the United States -- making them the safest savings instrument available.

For the United States, bond sales save the nation millions of dollars in debt costs each year.

Finally, and most importantly, Savings Bonds are an important part of the nation's saving ethic. A saving economy is a strong economy, and Savings Bonds can help Americans attain a savings rate that will buttress our economic strength.

That's why your job is so important. Through your leadership and commitment, Savings Bonds have become an integral part of the savings and investment fabric of our nation.

Of course, as business professionals, the Savings Bonds Campaign is only one of your many responsibilities. President Bush recognized this in a letter written to your Committee in August, when he wrote:

"Throughout our country's history, the American character has been marked by a willingness to volunteer one's service for the public good. Your efforts to promote the sale of Savings Bonds exemplify that spirit."

Clearly, this Committee is in tandem with the President's commitment to community service at all levels. And to all of you joining Ed Hennessy as members of the 1991 Savings Bonds Volunteer Committee, I look forward to working with you in your upcoming mission. Your personal leadership will come a long way toward ensuring success.

To those members of the 1990 Committee, you have my sincere thanks and the thanks of all Americans for your work. You have made a positive contribution to your companies, your co-workers and to the nation.

Thank you.

SECRETARY NICHOLAS F. BRADY  
REMARKS FOR THE PRESENTATION OF AWARDS  
U.S. SAVINGS BONDS VOLUNTEER COMMITTEE  
JANUARY 23, 1991  
WASHINGTON, D.C.

The strength of any nation resides in its people and in their willingness to work for the common good. Clearly, the U.S. Savings Bonds Volunteer Committee has made many great contributions to our nation, and in your honor, I have a few awards to present:

First, I would like to recognize all the members of the 1990 Committee for their distinguished service to the Savings Bonds Program. Donald Heim [HIME] is with us on behalf of the 1990 Committee, and I am presenting the Treasury's Medal of Merit. Please come on up, Donald.

We greatly appreciate the outstanding service all the 1990 Committee members have given to the Bond Program. Thank you.

Ed Hennessy, please join me at the podium. It is now time to make your official appointment as 1991 National Chairman.

I am delighted to present you with this certificate appointing you as National Chairman of the 1991 U.S. Savings Bonds Volunteer Committee. Good luck to you and your group this year.

Allen Jacobson, will you please join me at the podium? I have two awards for you.

It is an honor to present to you this framed parchment citation and this gold medal of merit in recognition of the great value of your volunteer service to the Bond Program. We want you to know how much we appreciate your leadership of the 1990 National Bond Campaign.

Thank you, Allen, and congratulations to all the members of the 1990 and 1991 Committees. Your contributions are part of an important effort to keep our nation strong, and I appreciate all you are doing.

Once again, thanks to all of you.

###

**ACTION  
RESULT**

# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE  
January 24, 1991

CONTACT: Office of Financing  
202-376-4350

## RESULTS OF TREASURY'S AUCTION OF 5-YEAR NOTES

Tenders for \$9,035 million of 5-year notes, Series K-1996, to be issued on January 31, 1991 and mature on January 31, 1996 were accepted today (CUSIP: 912827ZV7).

The interest rate on the notes will be 7 1/2%. The range of accepted bids and corresponding prices are as follows:

	<u>Yield</u>	<u>Price</u>
Low	7.60%	99.590
High	7.63%	99.468
Average	7.62%	99.509

\$10,000 was accepted at lower yields.  
Tenders at the high yield were allotted 23%.

### TENDERS RECEIVED AND ACCEPTED (in thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	16,571	16,571
New York	23,153,394	8,381,904
Philadelphia	9,224	9,224
Cleveland	22,499	22,499
Richmond	235,246	76,626
Atlanta	19,393	17,853
Chicago	1,293,241	308,861
St. Louis	20,179	16,179
Minneapolis	7,150	7,150
Kansas City	26,373	26,373
Dallas	7,717	7,717
San Francisco	612,430	140,330
Treasury	<u>3,582</u>	<u>3,582</u>
TOTALS	\$25,426,999	\$9,034,869

The \$9,035 million of accepted tenders includes \$543 million of noncompetitive tenders and \$8,492 million of competitive tenders from the public.

In addition, \$180 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional \$200 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

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**SECRETARY OF THE TREASURY  
NICHOLAS F. BRADY**

**G-7 PRESS CONFERENCE**

1/21/91  
Stanhope Hotel, New York City

1           \_\_\_: Good afternoon, ladies and gentlemen.  
2 Thank you very much for your patience. I know that this  
3 has been difficult logistics for each of you. We  
4 sincerely appreciate your cooperation.

5           Secretary Brady will be glad to respond to your  
6 questions. Obviously, we're on the record this afternoon.  
7 We would ask that we embargo the contents of the briefing  
8 until 15 minutes after the close of the briefing. Thank  
9 you very much. Secretary Brady.

10           SECRETARY BRADY: Thank you, Roger.

11           The communique from this G-7 meeting is  
12 greatly foreshortened, and since the two paragraphs that  
13 are operative are very short, I just thought I would read  
14 it. I will take a minute.

15           The ministers and governors reviewed their  
16 economic policies and prospects and reaffirmed their  
17 support for economic policy coordination at this critical  
18 time. They noted that although growth in all our  
19 economies had slowed, expansion of the world economy  
20 continues and the pace of activity could be expected to  
21 pick up later this year.

22           He noted that growth remains particularly strong  
23 in Germany and Japan. Implementation of sound fiscal  
24 policies combined with stability oriented monetary  
25 policies should create conditions favorable to lower



1 global interest rates and a stronger world economy. They  
2 also stress the importance of a timely and successful  
3 conclusion of the Uruguay rounds.

4 The second paragraph reads. The ministers and  
5 governors also discussed the situation in global financial  
6 markets in light of uncertainties arising from the Gulf  
7 war and developments in the Soviet Union. They agreed to  
8 strengthen cooperation and to monitor developments in  
9 exchange markets. The ministers and governors stand ready \*  
10 to respond as appropriate to maintain stability in  
11 international and financial markets.

12 I would be glad to answer any questions you  
13 might have.

14 \_\_: Mr. Secretary, do you agree on any formula  
15 to pay for the war effort among the various countries?

16 SECRETARY BRADY: Well, those discussions which  
17 I did have with ministers from Japan and Germany did not  
18 go on into G-7 meetings. But I did have discussions.

19 \_\_: Can you tell us what conclusion you reached  
20 with them?

21 SECRETARY BRADY: Yes. I can tell you first of  
22 all that we had an extensive discussion with Japan about  
23 global developments in the Gulf and the burden sharing  
24 that would come about as a result of those developments.

25 I could only say -- because I am not going to

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\* Communique language reads "...governors are prepared to..."  
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22 all that we had an extensive discussion with Japan about  
23 global developments in the Gulf and the burden sharing  
24 that would come about as a result of those developments.

25 I could only say -- because I am not going to

1 get into numbers -- it was very constructive. The  
2 Japanese said that they would do their share, and that  
3 they would be making an announcement sooner rather than  
4 later.

5           \_\_: What about the Germans?

6           SECRETARY BRADY: The Germans I had a discussion  
7 with as well. The discussions in previous talks on burden  
8 sharing have gone on between Secretary Gentcher and  
9 Secretary Baker, and although I talked in broad outlines  
10 about the situation as it was expanded by developments in  
11 the Gulf, again further information on that particular  
12 discussion will come after Secretary Baker and Secretary  
13 Gentcher -- foreign minister Gentcher have a chance to  
14 talk.

15           \_: Mr. Secretary, in view of the reference to  
16 the last two paragraphs that you read, how do you attend  
17 to strengthen cooperation beyond what you already have  
18 been doing?

19           SECRETARY BRADY: Well, I think that's a good  
20 question. We discussed it quite fully, and I think that  
21 you could characterize it by saying the telephones will  
22 remain open. In other words, we have historic  
23 developments going on in the Gulf. We have historic  
24 developments going on in the Soviet Union.

25           So far the reaction in the financial markets,

1 particularly currency markets has been one of stability.  
2 And as long as that stability continues, we're not going  
3 to act in any way that would create problems where none  
4 exist. But should for some reason unforeseen at this time  
5 that a need for ministers to get together on the telephone  
6 and discuss appropriate actions, we're ready to do that.

7 We have got a two-day meeting. We all know what  
8 each other thinks. We know how to get ahold of each  
9 other, and we would be prepared to discuss any changes in  
10 the basic pattern of stability that might arise.

11 \_\_: But were there any specific changes you  
12 agreed on at this meeting?

13 SECRETARY BRADY: Not really.

14 \_\_: Mr. Secretary, with reference to the Gulf  
15 concerns though, there's also longer term considerations,  
16 aren't there? You have a divergence of economic and  
17 monetary policies. Isn't that something also that you are  
18 concerned about?

19 SECRETARY BRADY: Well, I think the pattern that  
20 we have seen so far is one of relative stability. Changes  
21 on a daily basis but not changes of great magnitude. I  
22 think while you could say that while there were reasons  
23 for the dollar to weaken, there were also reasons for it  
24 to strengthen.

25 Certainly any resurgence in our own economy

1 during the latter part of this year could be one.  
2 Obviously, when there are concerns in other parts of the  
3 world, the dollar is strengthened as a result of those  
4 concerns. So I don't think anybody is smart enough to  
5 know exactly -- be able to predict exactly which way it is  
6 going to go.

7 We just want to make sure that if it does take  
8 unusual jumps and turns, that we're ready to do something  
9 about it if that's what's called for.

10 \_\_: Mr. Secretary, what can you tell us about  
11 the discussions in terms of the Soviet Union, as far as  
12 the Soviet Union is concerned?

13 SECRETARY BRADY: Well, the situation in the  
14 Soviet Union was discussed, and as you know, in this  
15 country, President Bush is studying the situation  
16 carefully. That things are on hold until he gets a better  
17 idea and his advisors get a better idea of what might be  
18 forthcoming.

19 And until that time, I think everybody is  
20 withholding judgment. And I would say, either plus or  
21 minus, is the result of other ministers as well.

22 \_\_: Mr. Secretary, a two-part question. If you  
23 expect economic activity to pick up later this year, does  
24 it mean we should expect the economy to pick up?

25 SECRETARY BRADY: Well, I think that Chairman

1 Greenspan has said that he expects that in the middle of  
2 this year, economic activity could resume a positive  
3 growth pattern. My reading of the so-called blue chip  
4 economists in this country would indicate that most feel  
5 that particular way. Some don't, but most do.

6 I think we have had an unusual circumstance  
7 before us in this country. I can't imagine it should be a  
8 mystery to anybody why consumers are hesitant to make  
9 purchases. We have had a possibility of a war and now a  
10 war takes place. The first time in many, many years.

11 It's no surprise to me that people wanted to  
12 curb their purchases, either in looking at buying a car or  
13 taking a trip so that the automobile industry in December  
14 did badly. I can understand that. Credit card companies  
15 tell me that charges to credit cards are down. I can  
16 understand that.

17 I think any family would want to take a wait and  
18 see posture. So I believe as something that is very  
19 complex, very hard to understand for the average American.  
20 As it begins to unfold, we are getting an explanation of  
21 it hour by hour on television, everybody will understand  
22 it. It looks as though things are going according to plan  
23 now, and I expect that to release a significant amount of  
24 energy into our economy.

25 \_\_\_: Mr. Brady, it sounds like the comments of

1 the Germans may not have been as forthcoming as the  
2 Japanese in their version.

3 SECRETARY BRADY: That's not really the case.  
4 The discussions as you remember were Jim Baker and I split  
5 up the world in terms of raising money concerning the  
6 sharing. I went to the Far East and France and England.  
7 Jim went to the Gulf and Germany and some of the EC  
8 countries.

9 So it's just a question of it following  
10 channels. I couldn't characterize it the way you have at  
11 all. I think it's way too early for that.

12 \_\_: Sir, was that issue discussed and what was  
13 the result?

14 SECRETARY BRADY: Well, we did have a discussion  
15 of debt. What part of the world are you talking about?

16 \_\_: Brazil, Poland --

17 SECRETARY BRADY: Okay. I've got it. We did  
18 have our usual discussion on debt with particular  
19 reference to Poland and Egypt where in the case of Egypt,  
20 as I'm sure you are well aware, the United States has  
21 forgiven \$7 billion with the foreign military sales. We  
22 talked about that. We talked about the United States'  
23 initiative to forgive debt to Poland.

24 And we discussed that among all of the G-7  
25 countries. All countries want to do something for Poland.

1 It's a question of how do you contain it. In other words,  
2 how wide of a program of debt reduction do you go? If you  
3 forgive debt for one country, what do you say about  
4 another one?

5 And I think that you have to make your  
6 distinction for these two countries. President Bush has  
7 talked about a new world order, and certainly, that is  
8 something that we all now contemplate. One of the  
9 foundation stones of the coalition in the Gulf with Egypt,  
10 they made an unusual contribution there. And so the debt  
11 negotiations with regard to that country follow on from  
12 that.

13 In the case of Poland, they've been a leader in  
14 the movement from Eastern Europe to free markets. They  
15 were the early country to do that and they have also been  
16 the one that has had the most ambitious program. So it  
17 makes sense in our view to take these two countries as  
18 distinctive cases and work on their particular problems.

19 \_\_: Mr. Secretary, you talked about the debt.  
20 Did you package that all -- (inaudible).

21 SECRETARY BRADY: Well, not in any particular  
22 detail and that program as I'm sure you are well aware is  
23 still going together in Washington.

24 \_\_: Did you talk to them about the apparent --  
25 by the Administration of not letting the capital gains



1 tax?

2 SECRETARY BRADY: Strange as it may seem, they  
3 had no interest in capital gains.

4 \_\_: I know you can't talk about the amounts  
5 that Germany may contribute. Can you talk about the form  
6 their help would take? Straight cash or other forms?

7 SECRETARY BRADY: Again, I don't want to  
8 characterize the particulars of either one of the  
9 discussions. With regard to the Japanese discussions  
10 which fall into my purview, I will say to you that they  
11 understand the problem completely. They made the  
12 statement they want to do their share.

13 They're going to get about it quickly. You  
14 can't run an army, a military campaign on materials which  
15 aren't needed. So the discussion did contain the idea  
16 that most of this would be in direct cash assistance.

17 \_\_: How much is the fair share for Japan?

18 SECRETARY BRADY: As I said at the beginning,  
19 I'm not going to get into figures. I think it's only  
20 appropriate that after having had the chance to discuss  
21 the matter with us, that the Japanese make their own  
22 announcement on this particular amount.

23 \_\_: But, sir, do you expect so far are  
24 operations of the war running according to projections, or  
25 above or below projections so far?

1           SECRETARY BRADY: Well, you know, projections as  
2 to what? You know, you are in a war, you do what is  
3 necessary. So we can have preliminary estimates of what  
4 an operation like Desert Storm would cost, and we do. And  
5 those estimates are estimates which for the moment are  
6 going to be private. But obviously, they vary between  
7 various different scenarios as to how that war would be  
8 carried out.

9           If it's a war like is going on now, it's one  
10 thing. If it's one that's combined with land operations,  
11 it's another. So there isn't any way of being totally  
12 precise about it at this time. It changes on a daily  
13 basis.

14          \_\_: Mr. Secretary, as regards a sound fiscal  
15 policy, what does that mean in regards to the U.S. budget  
16 deficit? Your reference to leading the way. Are you  
17 anticipating that the U.S. will take the lead in that  
18 process?

19          SECRETARY BRADY: Well, this is a subject over  
20 which there has been much discussion, but I consider that  
21 the budget agreement was arrived at with a great deal of  
22 discussion, argument, and some hard, hard negotiations  
23 last fall.

24          Now, obviously, because the economy has slowed,  
25 our budget deficit has gone down, but I consider that that

1 budget agreement is tough. It will restrain spending. I  
2 think in years to come people will see that it is a system  
3 whereby we can begin to start to control spending in this  
4 country, and for that reason, it is extraordinarily  
5 significant and does work towards providing fiscal  
6 restraint.

7 \_\_\_: Mr. Secretary, you have identified now  
8 communiques with Germany and Japan. (inaudible)

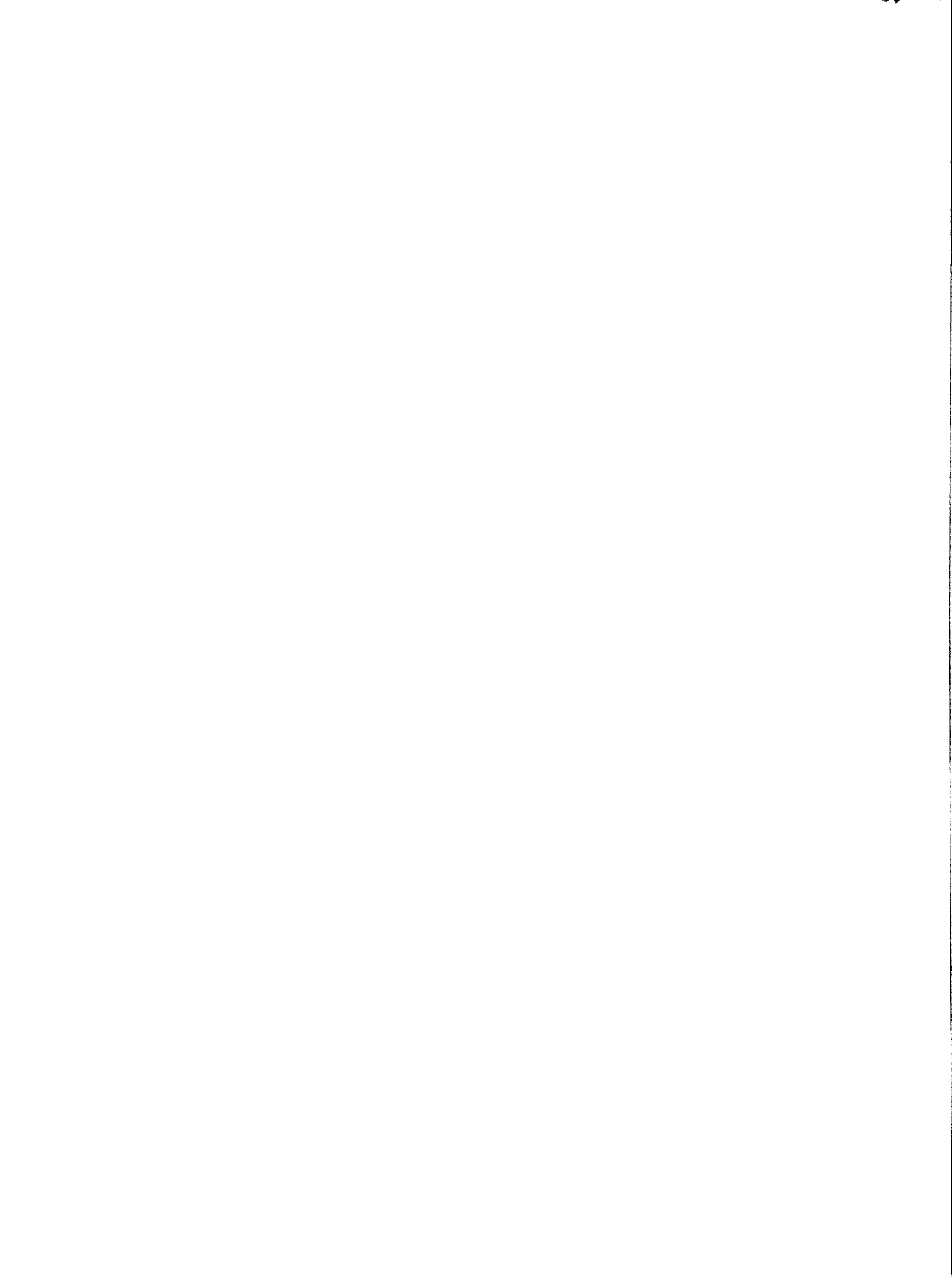
9 SECRETARY BRADY: Well, I think we have to see  
10 what announcements are made from those two countries. As  
11 I said to you a minute ago, the Japanese said that they  
12 would do their full share. The Germans the same.

13 I certainly feel that with regard to both  
14 discussions, there was no drawing back. A full  
15 understanding of how important it is to the people of this  
16 country that burden sharing be part of our operations in  
17 the Gulf and a full understanding on their part that it  
18 was important that they do it as well.

19 \_\_\_: Mr. Secretary, how much is the total amount  
20 that the United States is seeking to raise?

21 SECRETARY BRADY: As I said, I'm not going to  
22 come up with any specific figures today.

23 \_\_\_: Mr. Secretary, did any of the other nations  
24 express concern to you about the possible cost of  
25 extending the war?



1           SECRETARY BRADY: No. I can tell you that from  
2 every single one of the six other ministers, there was an  
3 appreciation of the job that the Allies have done in the  
4 Gulf, the leadership of President Bush and the forces that  
5 have exhibited out there.

6           There was no questioning of what had been done.  
7 No suggestions of what might be done. Just a strong  
8 feeling as I have mentioned to you that they want to do  
9 their share, and every single one of them at one time or  
10 another expressed their full support.

11           \_\_\_: Can I have your follow-up on what I asked  
12 before though. I mean you have given out numbers on what  
13 kind of contributions have been given out. Can you give  
14 that amount?

15           SECRETARY BRADY: No, I can't.

16           \_\_\_: And what period of time are we talking  
17 about?

18           SECRETARY BRADY: What I have said to you is  
19 that unfortunately you are just going to have to be  
20 patient. I am not going to add any numbers or any time  
21 periods at this time. Both the Germans and the Japanese  
22 understand the dimensions of what's going on in the Gulf,  
23 and they have said that they expect to do their full  
24 share.

25           Let's go all the way back.

1           \_\_\_: Is the Soviet situation in the Balkans put  
2 international institutions on hold? (inaudible)

3           SECRETARY BRADY: Well, I would take my cues on  
4 that matter from the President who I believe has said that  
5 those matters are on hold until everybody gets a better  
6 idea of exactly what is going on in the Baltic States with  
7 respect to their relationship with the Soviet Union.

8           So I think this is a question of making an  
9 appraisal and one that you shouldn't make after one or two  
10 days' events.

11          \_\_\_: (inaudible)

12          SECRETARY BRADY: No, there wasn't.

13          \_\_\_: Mr. Secretary, has there been any  
14 intervention in the foreign exchange markets since the war  
15 began? Has there been any intervention to calm the market  
16 so far?

17          SECRETARY BRADY: Not that I know of.

18          \_\_\_: But not at all?

19          SECRETARY BRADY: Not that I know of. I mean  
20 there may have been minor balancing of accounts  
21 somewheres, but nothing which the United States was part  
22 of or nothing that was brought to our attention.

23          \_\_\_: Would you approach the Soviet --  
24 (inaudible).

25          SECRETARY BRADY: Well, I think that what we

1 ought to do is what I stated to you before. These events  
2 are fast moving. They are changing daily, and it's a  
3 matter of consultation with our Allies. As you know, the  
4 President proposed earlier in the year special status for  
5 the Soviets so that they could take advantage of technical  
6 assistance to help them with their economy.

7           There is a meeting to be held by the President,  
8 and Secretary Gorbachev in the not too distant future, and  
9 I think you'll just have to wait as events unfold to see  
10 where we are. I don't think it's going to be complicated,  
11 but I think it's a question of looking at what's  
12 happening, not reacting just the first time you see  
13 something. Coming to a considered judgment and making a  
14 determination.

15           \_\_\_: Did everybody agree to keep it on hold?

16           SECRETARY BRADY: I would say that there was  
17 nobody rushing to make a statement from the situation in  
18 the Soviet Union for any number of reasons, but primarily,  
19 particularly those from Europe who are closest to the  
20 situation felt that the thing was so fast moving and  
21 changing daily that it didn't make any sense to put  
22 forward changes at this particular time.

23           \_\_\_: Just take two more questions.

24           \_\_\_: You mentioned a fiscal policy in your  
25 statement. In your discussions, what Germany's mix would

1 be of taxation involved and so on, in other words, to help  
2 in this process of bringing down the interest rate  
3 structure. Can you say something about that?

4 SECRETARY BRADY: Yes, I can, but I would refer  
5 you to Minister Vigel and Krowlato Pearl. They said that  
6 they felt there was a delicate balance between monetary  
7 policy and fiscal actions which would have to carry the  
8 German program. They felt that they were up to that task,  
9 and that they could continue on the path that they were on  
10 now which was interest rate levels as we see them, and  
11 fiscal response as it was necessary in the next months  
12 ahead.

13 \_\_: Last question.

14 \_\_: Mr. Secretary, you said that you were ready  
15 to take action if there were any unusual jumps or turns in  
16 the market. (inaudible)

17 SECRETARY BRADY: No. What it is is pretty much  
18 as I described it which is -- the best I can give you a  
19 mental picture of it is open telephones. In other words,  
20 you had a good thorough discussion in the last few days.  
21 Everybody understands what the other minister has said  
22 during that period of time.

23 If developments take place in the next several  
24 weeks or several months, there is unusual turns in the  
25 market and movements in one direction or the other which





1 are out of character with the basic strengths of the  
2 currencies, then the ministers will get on the phone and  
3 talk about and perhaps do something about it.

4 Let me discuss again I think it's important for  
5 everybody to focus on. We have had an unusual pattern of  
6 stability. Here we have a war in the Gulf of historic  
7 proportions and yet currencies are fluctuating less than  
8 they do on some days for rumors of the most unfounded  
9 basis. So I think that that's what we are striving for.  
10 I'm very pleased that over the past several months we have  
11 got stability and all of the ministers felt that if we  
12 could continue that kind of a relationship between  
13 markets, that was what the world needed at this particular  
14 time.

15 \_\_: Thank you.

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# PRESS RELEASE

## OVERSIGHT BOARD, 2054086

Resolution Trust Corporation

1777 F STREET, N.W. WASHINGTON, D.C. 20132

FOR IMMEDIATE RELEASE  
January 24, 1991  
OB 91-8

Contact: Brian P. Harrington  
(202) 786-9675

### RTC REGION 1 ADVISORY BOARD TO HOLD OPEN MEETING

The members of the New York-based Region 1 advisory board will hold their quarterly open meeting in Boston, Mass. on January 29, 1991, from 10:30 a.m. to 3:30 p.m.

The meeting, open to all members of the public and press, will be in the auditorium at the Federal Reserve Bank of Boston, 600 Atlantic Avenue in Boston.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) required that the Oversight Board establish six regional advisory boards to provide advice to the Resolution Trust Corporation (RTC) on the policies and programs for the disposition of real estate of the nation's failed thrifts.

The board includes Henry Berliner of Annapolis, Md., as chairman; Charles Kopp of Philadelphia, Pa.; Mirian Saez of Cambridge, Ohio; and Walter Terry of Baltimore, Md.

Discussions at the meeting will center on the activities of Region 1 as related to the RTC's affordable housing disposition, pricing policies, private sector contracting and administration of delinquent real estate mortgages. In addition, there will be a regional real estate market report by a Federal Reserve Bank economist. Time also will be reserved for members of the public to address the board with their comments concerning the RTC's disposition of real estate.

The Region 1 Advisory Board represents the states of Connecticut, Delaware, Kentucky, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, Vermont, Virginia, West Virginia, and the District of Columbia.

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# PRESS RELEASE

## OVERSIGHT BOARD Resolution Trust Corporation

1777 F STREET, N.W. WASHINGTON, D.C. 20232

FOR IMMEDIATE RELEASE  
January 25, 1991  
OB 91-9

Contact: Brian P. Harrington  
(202) 786-9672

### RTC REGION 2 ADVISORY BOARD TO HOLD OPEN MEETING

The members of the Atlanta-based Region 2 Advisory Board will hold their quarterly open meeting in Miami on Friday, February 1, 1991, from 10 a.m. to 3:30 p.m.

The meeting, open to all members of the public and press, will be at Miami-Dade Community College, Wolfson Campus, Room 1101, Building 1, in Miami.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) required that the Oversight Board establish six Regional Advisory Boards to provide advice to the Resolution Trust Corporation (RTC) on the policies and programs for the disposition of real estate of the nation's failed thrifts.

The five-member board includes Philip Searle of Naples, Fla., as acting chairman; G. Lindsay Crump of Savannah, Ga.; Alpha Johnson of Mobile, Ala.; Stanley Tate of North Miami, Fla.; and Ralph Thayer of New Orleans, La.

Discussions at the meeting will center on the activities of Region 2 as related to the RTC's affordable housing disposition program, pricing policies, private sector contracting and administration of delinquent real estate mortgages. In addition, there will be a regional real estate market report by a Federal Reserve Bank economist. Time also will be reserved for members of the public to address the Board with their comments concerning the RTC's disposition of real estate.

Region 2 represents the states of Alabama, Florida, Georgia, Louisiana, Mississippi, South Carolina and Tennessee.

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# PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239



FOR IMMEDIATE RELEASE  
January 28, 1991

CONTACT: Office of Financing  
202-376-4350

## RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for \$10,006 million of 13-week bills to be issued on January 31, 1991 and mature on May 2, 1991 were accepted today (CUSIP: 912794WG5).

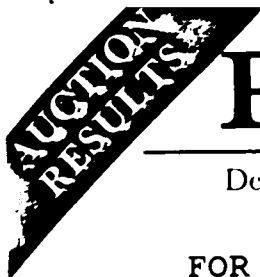
### RANGE OF ACCEPTED COMPETITIVE BIDS:

	<u>Discount Rate</u>	<u>Investment Rate</u>	<u>Price</u>
Low	6.20%	6.39%	98.433
High	6.22%	6.41%	98.428
Average	6.22%	6.41%	98.428

\$1,000,000 was accepted at lower yields.  
Tenders at the high discount rate were allotted 96%.  
The investment rate is the equivalent coupon-issue yield.

### TENDERS RECEIVED AND ACCEPTED (in thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	52,945	52,945
New York	26,076,210	8,693,630
Philadelphia	33,155	33,155
Cleveland	68,840	68,840
Richmond	191,990	114,590
Atlanta	36,750	36,750
Chicago	1,705,130	295,330
St. Louis	64,525	34,125
Minneapolis	8,890	8,890
Kansas City	45,590	45,590
Dallas	26,920	26,920
San Francisco	718,290	213,290
Treasury	<u>382,370</u>	<u>382,370</u>
TOTALS	\$29,411,605	\$10,006,425
Type		
Competitive	\$26,101,080	\$6,695,900
Noncompetitive	<u>1,344,725</u>	<u>1,344,725</u>
Subtotal, Public	\$27,445,805	\$8,040,625
Federal Reserve	1,855,200	1,855,200
Foreign Official Institutions	<u>110,600</u>	<u>110,600</u>
TOTALS	\$29,411,605	\$10,006,425



# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE  
January 28, 1991

CONTACT: Office of Financing  
202-376-4350

## RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for \$10,030 million of 26-week bills to be issued on January 31, 1991 and mature on August 1, 1991 were accepted today (CUSIP: 912794WS9).

### RANGE OF ACCEPTED COMPETITIVE BIDS:

	<u>Discount</u> <u>Rate</u>	<u>Investment</u> <u>Rate</u>	<u>Price</u>
Low	6.26%	6.55%	96.835
High	6.28%	6.58%	96.825
Average	6.28%	6.58%	96.825

\$2,000,000 was accepted at lower yields.  
Tenders at the high discount rate were allotted 35%.  
The investment rate is the equivalent coupon-issue yield.

### TENDERS RECEIVED AND ACCEPTED (in thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	44,215	44,215
New York	26,950,395	8,767,775
Philadelphia	17,425	17,425
Cleveland	49,100	49,100
Richmond	57,615	57,615
Atlanta	42,640	42,640
Chicago	1,454,140	209,140
St. Louis	45,810	32,560
Minneapolis	6,355	6,355
Kansas City	53,470	52,170
Dallas	17,505	17,505
San Francisco	581,395	128,395
Treasury	604,760	604,760
<b>TOTALS</b>	<b>\$29,924,825</b>	<b>\$10,029,655</b>

<u>Type</u>		
Competitive	\$25,614,785	\$5,719,615
Noncompetitive	<u>1,346,640</u>	<u>1,346,640</u>
Subtotal, Public	\$26,961,425	\$7,066,255
Federal Reserve	2,100,000	2,100,000
Foreign Official		
Institutions	<u>863,400</u>	<u>863,400</u>
<b>TOTALS</b>	<b>\$29,924,825</b>	<b>\$10,029,655</b>

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.  
January 29, 1991

CONTACT: Office of Financing  
202/376-4350

## TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately \$20,000 million, to be issued February 7, 1991. This offering will provide about \$775 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of \$19,228 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, February 4, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately \$10,000 million, representing an additional amount of bills dated May 10, 1990, and to mature May 9, 1991 (CUSIP No. 912794 WH 3), currently outstanding in the amount of \$20,171 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately \$10,000 million, to be dated February 7, 1991, and to mature August 8, 1991 (CUSIP No. 912794 XB 5).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of \$10,000 and in any higher \$5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing February 7, 1991. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold \$1,053 million as agents for foreign and international monetary authorities, and \$4,758 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of \$10,000. Tenders over \$10,000 must be in multiples of \$5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than \$1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of \$200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds \$200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of competitive tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.



Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for \$1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-204

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE  
January 30, 1991

CONTACT: Office of Financing  
202/376-4350

## TREASURY FEBRUARY QUARTERLY FINANCING

The Treasury will raise about \$17,175 million of new cash and refund \$17,335 million of securities maturing February 15, 1991, by issuing \$12,500 million of 3-year notes, \$11,000 million of 10-year notes, and \$11,000 million of 30-year bonds. The \$17,335 million of maturing securities are those held by the public, including \$1,431 million held, as of today, by Federal Reserve Banks as agents for foreign and international monetary authorities.

The three issues totaling \$34,500 million are being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average prices of accepted competitive tenders.

In addition to the public holdings, Federal Reserve Banks hold \$1,944 million of the maturing securities for their own accounts, which may be refunded by issuing additional amounts of the new securities at the average prices of accepted competitive tenders.

The 10-year note and 30-year bond being offered today will be eligible for the STRIPS program.

Details about each of the new securities are given in the attached highlights of the offering and in the official offering circulars.

oOo

Attachment

**HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC  
FEBRUARY 1991 QUARTERLY FINANCING**

January 30, 1991

Amount Offered to the Public . . . .	\$12,500 million	\$11,000 million	\$11,000 million
<b>Description of Security:</b>			
Term and type of security . . . . .	3-year notes	10-year notes	30-year bonds
Series and CUSIP designation . . . .	Series R-1994 (CUSIP No. 912827 ZW 5)	Series A-2001 (CUSIP No. 912827 ZX 3)	Bonds of February 2021 (CUSIP No. 912810 EH 7)
CUSIP Nos. for STRIPS Components . .	Not applicable	Listed in Attachment A of offering circular	Listed in Attachment A of offering circular
Issue date . . . . .	February 15, 1991	February 15, 1991	February 15, 1991
Maturity date . . . . .	February 15, 1994	February 15, 2001	February 15, 2021
Interest rate . . . . .	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids
Investment yield . . . . .	To be determined at auction	To be determined at auction	To be determined at auction
Premium or discount . . . . .	To be determined after auction	To be determined after auction	To be determined after auction
Interest payment dates . . . . .	August 15 and February 15	August 15 and February 15	August 15 and February 15
Minimum denomination available . . .	\$5,000	\$1,000	\$1,000
Amount required for STRIPS . . . . .	Not applicable	To be determined after auction	To be determined after auction
<b>Terms of Sale:</b>			
Method of sale . . . . .	Yield auction	Yield auction	Yield auction
Competitive tenders . . . . .	Must be expressed as an annual yield with two decimals, e.g., 7.10%	Must be expressed as an annual yield with two decimals, e.g., 7.10%	Must be expressed as an annual yield with two decimals, e.g., 7.10%
Noncompetitive tenders . . . . .	Accepted in full at the average price up to \$1,000,000	Accepted in full at the average price up to \$1,000,000	Accepted in full at the average price up to \$1,000,000
Accrued interest payable by investor . . . . .	None	None	None
<b>Payment Terms:</b>			
Payment by non-institutional investors . . . . .	Full payment to be submitted with tender	Full payment to be submitted with tender	Full payment to be submitted with tender
Deposit guarantee by designated institutions . . . . .	Acceptable	Acceptable	Acceptable
<b>Key Dates:</b>			
Receipt of tenders . . . . .	Tuesday, February 5, 1991	Wednesday, February 6, 1991	Thursday, February 7, 1991
a) noncompetitive . . . . .	prior to 12:00 noon, EST	prior to 12:00 noon, EST	prior to 12:00 noon, EST
b) competitive . . . . .	prior to 1:00 p.m., EST	prior to 1:00 p.m., EST	prior to 1:00 p.m., EST
Settlement (final payment due from institutions):			
a) funds immediately available to the Treasury . . . . .	Friday, February 15, 1991	Friday, February 15, 1991	Friday, February 15, 1991
b) readily-collectible check . . . . .	Wednesday, February 13, 1991	Wednesday, February 13, 1991 .	Wednesday, February 13, 1991

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-20

EMBARGOED UNTIL GIVEN  
EXPECTED AT 10:00 A.M.  
JANUARY 31, 1991

**STATEMENT OF HONORABLE NICHOLAS F. BRADY**  
**Chairman, Oversight Board of the**  
**Resolution Trust Corporation**  
**before the**  
**House Committee on Banking, Finance and Urban Affairs**  
**January 31, 1991, 10:00 a.m.**  
**2128 Rayburn House Office Building**

Mr. Chairman, members of the Committee, we are pleased to be making our semiannual appearance before your Committee today. We look forward to bringing you up to date on the progress being made by the Resolution Trust Corporation (RTC) and the Oversight Board under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

I appear today in my role as Chairman of the Oversight Board of the RTC. Accompanying me are the four other members of the Board: Alan Greenspan, Chairman of the Federal Reserve Board, Philip Jackson, Jr., former member of the Federal Reserve Board and currently adjunct professor at Birmingham Southern College, Jack Kemp, Secretary of the Department of Housing and Urban Development, and Robert Larson, Vice Chairman of the Taubman Company and Chairman of the Taubman Realty Group. Also accompanying us is Peter Monroe, who is President of the Oversight Board.

We are here today to discuss RTC's funding needs as well as other issues that FIRREA requires for this semi-annual appearance.

## RTC'S FUNDING NEEDS

Mr. Chairman, my most important objective today is to state to the Committee as strongly as I can the need for additional funding for the RTC. If the RTC is to continue to carry out its Congressionally assigned mission of resolving hundreds of failed institutions and paying off their depositors without delay, then it must have additional funds as soon as possible. If the RTC fulfills its goals for January and February, and does not receive additional funds, it will have expended all available loss funds and it will be forced to stop closing and selling institutions by the end of February.

It is worth repeating that these funds are needed to protect the savings of depositors. Without these funds, RTC would have no alternative but to practice forbearance, that is, leave insolvent institutions open to continue to lose money for which the taxpayers will ultimately be liable. RTC has estimated that forbearance for even one more quarter would cost the American taxpayers \$750-\$850 million. (These cost estimates are explained in Appendix I). This projected cost is in addition to the \$250 to \$300 million already lost due to inaction last fall. This would bring the total cost of delay to over \$1 billion.

Therefore, I urge the Congress to act on funding with dispatch.

How much will be required? In my letter to the Chairman dated October 10 last year, I projected that "forty billion dollars ... beyond currently authorized spending should be sufficient to fund the losses in RTC case resolutions through the end of fiscal year 1991."

Based on the RTC's draft operating plan, additional loss funds of \$30 billion will be required through the end of fiscal year 1991. This number is \$10 billion less than my October projection. The RTC needs \$10 billion less of loss funds because, due to the funding delay, it will be unable to resolve all the institutions it had planned to resolve.

The \$30 billion of additional funds, when combined with \$17.7 billion of already available loss funds, will cover RTC's estimated total FY 1991 operating losses of \$47.7 billion.

For working capital, the RTC estimates in its draft operating plan that its working capital borrowings for the nine-month period ending September 30 will be \$47 billion. This would bring total working capital borrowings for fiscal year 1991 to \$54.2 billion.

Provided that \$30 billion in added loss funds are provided on or before March 1, the RTC projects in its draft operating plan that it can complete approximately 225 additional resolutions with \$145 billion in assets by the end of fiscal year 1991.

While the RTC's draft operating plan calls for new loss funds of \$30 billion, we should consider whether our actions should be limited just to this fiscal year's estimated needs.

Full funding sufficient to resolve all failed thrifts, would allow RTC to pursue its mandate aggressively and without costly interruption. It would even permit the RTC to exceed expectations and resolve more than its goal of 225 institutions for the fiscal year. It should be noted that Congress can responsibly provide

full funding without diminishing its authority to oversee the RTC's operations. The RTC and the Oversight Board are required to appear before Congress at least twice a year and they must submit annual and semiannual reports. From October 4, 1989, to the present, officers of the Board, RTC and Treasury have testified to Congressional committees 48 times.

I worry that if the Congress imposes on itself the burden of repeated votes on funding, the result will be a start and stop cleanup process that produces further delays, substantial additional costs to taxpayers, and fear in the minds of depositors that the government will not meet its stated commitments.

The fact is that funding is not a discretionary matter. The losses we are talking about today have already taken place. When institutions are sold or closed, cash is needed to pay the difference between their deposit liabilities and the value of their assets. If we do not act depositors will be left hanging. Together we have already said to the public that the government will do what it needs to do, to protect them.

Ultimately, I believe that the government will fulfill its commitment to depositors and cover RTC losses in full. Thus, the question becomes whether to provide full or short-term funding. We believe full funding is clearly least costly to the taxpayer, and the least disruptive method of funding.

In June, 1990, at our semi-annual appearance, we estimated that the final cost of the S&L cleanup would be in the range of \$90 to \$130 billion in 1989 present value terms. Some have asked why the range of estimates is so wide. There are a number of reasons: uncertainties about the number of cases, losses on assets, interest rates, the condition of real estate markets, and the general condition of the economy. Now, the economy has entered a downturn and the uncertainty caused by the crisis in the Persian Gulf has increased the hesitance of potential buyers to make real estate investment commitments. All these interrelated factors create uncertainty and make predictions imprecise.

To oversimplify, the range of losses the government will have to face is directly related to movements in the real estate market. In turn, this affects both the number of institutions that will fail and the loss taken on assets acquired in resolution. No one can predict with exactitude where real estate markets will be in six months.

Although the most likely cost scenario has probably moved to the higher end of our original range, it nevertheless remains within that range. In other words, we still believe that the upper-end-of-the range estimate of \$130 billion in 1989 present

value terms remains valid. However, as has been mentioned numerous times, no one can guarantee any estimate based on such volatile variables. We will continue to monitor this situation closely.

In April of 1990, the Oversight Board completed the development of a cash flow model which projects RTC's sources and uses of funds on a quarterly basis through 1996. This cash flow model gives the Oversight Board the ability to vary a number of assumptions to estimate the effect on the Resolution Trust Corporation's (RTC's) need for loss funds and working capital. A more detailed explanation of our methodology can be found in Appendix II to this testimony.

### RTC WORK IN GETTING THE JOB DONE

Given the size and complexity of the problem with which we are dealing, the Board believes that the RTC has made progress.

When President Bush announced his proposed solution to the savings and loan crisis soon after taking office, he established four principles which continue to guide us.

- o First, protect the insured deposits of the millions of men and women who acted in trust by putting their savings in federally insured savings and loans.
- o Second, restore the safety and soundness of the savings and loan industry so that a similar crisis can not reoccur.
- o Third, clean up the S&L overhang so we get the problem behind us, and do it at the least cost to the taxpayer.
- o Finally, aggressively pursue and prosecute the crooks and fraudulent operators who helped create the problem.

Mr. Chairman, FIRREA gave RTC day-to-day operational responsibility to resolve insolvent thrifts and sell assets. The Oversight Board's responsibility is to set overall strategy, policy and goals for the RTC, approve funding, and provide oversight. Let me turn now to matters that are required by law to be addressed in our semi-annual report, and other matters of interest to the Committee.

As required by FIRREA, our testimony will cover the six-month period from April 1 through September 30, 1990. In addition, we will report on some of the key events occurring since the end of that reporting period. My presentation is supplemented by a more detailed response, contained in Appendix

III, to several of the specific information requirements set forth in FIRREA for this semiannual appearance.

### Progress in Resolutions

From its inception on August 9, 1989, through December 31, 1990, RTC seized 531 thrifts, and resolved 352 of them. That left the RTC, as of January 1, 1991, in control of 179 conservatorships.

The RTC has achieved its resolution pace by setting and achieving goals. For example, for the three month period ending June 30, the RTC's goal was the resolution of 141 institutions. The RTC actually resolved 155. During the next quarter, the RTC's goal was the resolution of 77 institutions and it achieved 80 resolutions.

For the 6-month period from October 1, 1990, to March 31, 1991, the RTC had expected to resolve 192 thrifts. As a result of Congressional inaction on funding, RTC was forced to revise its goal to resolve 97 thrifts. As of December 31, 1990, RTC had resolved 66 of its revised goal, and expects to meet its goal of 97 institutions by the end of February.

### The New Accelerated Resolution Program (ARP)

Last summer the RTC began a pilot project, called the Accelerated Resolution Program (ARP), to lower the cost of thrift resolutions by pre-selling troubled institutions before they are put in conservatorship. Such pre-sales should reduce the deterioration in franchise value and core deposits that can result from placing an institution in conservatorship. ARP is a cooperative effort between the RTC and the Office of Thrift Supervision (OTS) in which the OTS, in consultation with the RTC, identifies which thrifts are ARP candidates. Then the OTS and RTC establish a supervisory and regulatory framework within which the institutions will operate while in ARP.

Nine institutions were selected for the ARP pilot project. They were chosen on the basis of: 1) bidder interest, 2) management-led investor proposals, and/or 3) demonstrated franchise value. The OTS and RTC selected thrifts in different geographic areas and of varying sizes ranging from \$100 million to more than \$3 billion in assets.

In order to ensure open and competitive bidding, the standard RTC bidding process has been followed. As a result, more than 1,300 potential bidders from the RTC qualified bidders list were notified by mail for each of the nine thrifts.



Sales have closed on seven of the nine institutions, and the OTS and RTC have begun a review of this demonstration program. Some valuable information already has been learned. In all nine thrifts, there has been virtually no deposit runoff, management has remained intact, and the institutions have remained stable.

OTS has begun to review its Group IV thrifts to identify candidates for the next phase of the program should the RTC Oversight Board approve expansion beyond the pilot project. The Board's decision will depend on the RTC's evaluation of the pilot project.

### Status of the RTC Conservatorship Program

As of January 1, there were 179 thrifts in conservatorship. In addition, the most likely candidates for new conservatorships are in OTS's Group IV, which also contained 179 thrifts. There are another 356 thrifts in OTS's Group III for which the future is uncertain.

The advantages of placing an institution in conservatorship are that the RTC can stem losses, stabilize the institution, and halt practices which may have contributed to insolvency. Conservatorship also helps the RTC prepare the institution for resolution by reducing its assets by means such as securitization and by reducing the institution's high cost deposits. The disadvantage of conservatorship is that conservatorship can contribute to an erosion of franchise value. Skilled staff often begin to leave in anticipation of a possible liquidation of the institution, and depositors tend to accelerate their withdrawal of funds. The Accelerated Resolution Program is intended to avoid these disadvantages.

### Progress in Asset Disposition

In addition to resolving insolvent institutions, the RTC must dispose of their assets, whether in conservatorship, at resolution, or out of receivership. During the April through September period covered by our semi-annual report, receivership and conservatorship assets were reduced by \$66.8 billion in book value.

However, from its inception through December 31, 1990, the RTC has seized thrifts with over \$273 billion in initial assets. Through a combination of resolutions, asset sales and note collections, it has reduced assets held by over \$127 billion, and continues to hold assets of about \$146 billion.

Even though RTC has made progress, the Oversight Board and RTC are concerned that RTC has not been able to sell more assets. Therefore, the Oversight Board has over the past six months focused on developing policies - securitization, seller financing and affordable housing - that should enable the RTC to accelerate asset sales.

At our Board meeting on January 16, however, Chairman Seidman advised us of a new road block that will further delay asset sales. The RTC Board has been advised that potential personal liabilities may be imposed upon directors, officers, and employees of the RTC and the Oversight Board in connection with the RTC's securitization program as well as in connection with RTC's other asset disposition activities. Chairman Seidman indicated that a legislative solution to the problem is needed and that the RTC is developing proposed legislation for consideration by Congress.

### RTC Use of Private Sector to Aid Asset Sales

FIRREA mandates that the RTC make maximum delegation of asset management and sales functions to the private sector. To implement that, the RTC has adopted a Standard Asset Management and Disposition Agreement, or SAMDA program.

The RTC has already placed over \$10 billion in real estate and delinquent mortgages under SAMDA contracts. Bids have already been received to place another \$10 billion under SAMDA. Accordingly, most REO and delinquent mortgages in receivership will soon be under SAMDA contracts. The RTC is also proceeding to place all such conservatorship assets under SAMDA contracts.

Private sector contractors will be paid fees for managing the properties as well as incentives to accelerate sales and maximize the return to the RTC. While these contracts provide fair returns for property management, the incentive fees will be given for turning properties into cash rather than encouraging managers to collect their management fees while they wait for the real estate markets to improve.

There are incentives for selling at prices equal to or greater than the RTC's estimates of recovery. There is a 20% incentive payment for selling in the first year and 10% for selling in the second year. Actual holding costs are deducted from the sales price to encourage efficient management.

We believe the program is promising, but we recognize the difficulty of selling these assets in the current real estate market.

## Progress toward Minority Outreach

The RTC Minority and Women Outreach Program seeks to encourage minority participation in the award of RTC contracts. The RTC has conducted seminars throughout the country to inform minority and women owned businesses of the many contractor opportunities with the RTC and the registration and bidding process. Advertisements are placed in minority print media to publicize the program. As of November, 1990, RTC informs us that over 3,500 minority-owned firms, over 4,500 majority women-owned firms, and approximately 900 minority women-owned firms were registered as potential asset managers, brokers, lawyers and other RTC contractors. Over 900 contracts for such work, or about 20% of total awards, have been awarded to minority and women owned businesses.

FIRREA also directs the RTC to give preference in purchasing thrifts to bids from investors with the same ethnic identification as that of the failed thrift. As of November, the RTC had resolved 14 minority owned institutions; 3 were liquidated, 8 were acquired by buyers of the same ethnic identification, and 3 were sold to other buyers.

The Oversight Board continues to monitor this effort by RTC to preserve minority-owned institutions and promote greater awareness by minority and women-owned businesses of these excellent business opportunities.

## ENHANCED LAW ENFORCEMENT

Let me say a few additional words about some new enforcement tools. As you know, in June 1990, President Bush announced a package of legislative and administrative initiatives designed to intensify the fight against fraud in our nation's financial institutions. Most of these legislative initiatives were embraced in a bi-partisan manner by the Congress and enacted as the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990.

The new law provides an array of additional powers to the Justice Department, bank regulators, the FDIC and the RTC, particularly provisions which:

- o Provide authority to freeze or appoint a receiver for the assets of fraudulent operators;
- o Enhance civil and criminal forfeiture authority;

- o Protect victims of fraud by closing loopholes in the bankruptcy laws that have in the past enabled some executives to evade financial responsibility for their misdeeds;
- o Allow the Justice Department to accept without reimbursement the services of federal attorneys, law enforcement personnel, and other employees;
- o Direct U.S. courts to give cases brought by the FDIC and the RTC priority consideration and to establish procedures for expedited appeals;
- o Give law enforcement authorities a needed tool: the ability to request the use of wiretaps for bank fraud and related offenses.

In conjunction with the authorities provided in FIRREA, we now have an effective arsenal of legal weapons available to combat fraud and to recover assets. Using these authorities, federal law enforcement agencies are gaining ground against fraudulent thrift officials. Of 566 defendants charged in savings and loan cases from October 1988 through the end of 1990, 403 have been convicted and only 18 acquitted. Prison sentences have been dealt totalling 768 years, and \$231.8 million in restitutions have been ordered. Of those convicted, substantial numbers have been savings and loan chief executive officers, chairmen, presidents, directors, and other officers.

#### RECENT OVERSIGHT BOARD ACTIONS

Let me turn now to the key areas of Oversight Board activity over the last six month period. First, I will discuss the importance of asset sales and three Oversight Board actions in this area: securitization, seller financing and affordable housing. Next, I will describe the Oversight Board's developing oversight and evaluation role including its management planning procedures and the relationship between the Board and the RTC Inspector General.

Finally, I will describe the Board's role in developing policy for restructuring the 1988 Deals.

#### Revision of Asset Sales Strategies

As I said earlier, the increased number of resolutions handled by the RTC makes it very important to accelerate its asset sales. The Oversight Board is in the process of performing an overall strategic review of RTC asset sales programs. Our goals are to increase both the sales pace and the return on asset

sales. Acquisition of this inventory is funded by working capital borrowed by RTC from the Federal Financing Bank (FFB). These borrowings grew to \$53 billion by December 31, 1990, and are projected to reach \$76 billion in February. The RTC estimates they may increase to over \$100 billion by the end of fiscal year 1991.

In developing asset sales policies, the Oversight Board received valuable advice from the National Advisory Board and the six regional boards established by FIRREA. Because the board members know local economic conditions and are composed of community leaders in the real estate, banking, housing, legal and accounting professions, they have provided useful recommendations for the Oversight Board.

### The Need for Securitization

The Oversight Board recently directed the RTC to increase its use of securitization as a means to speed the sale of performing financial assets. Securitization means the pooling of financial assets with a positive cash flow and converting the pool into one or more securities collateralized by the assets in the pool.

The policy applies to all securitizable financial assets held by the RTC including mortgage loans, high-yield securities, and any loans originated by the RTC under seller financing. Approximately 25% of all RTC assets are securitizable. The Board believes that securitization should aid the RTC to sell these assets more quickly, thus improving its cash flow position. This, in turn, should materially lessen the pressures for working capital borrowings through the FFB. Progress in the securitization area depends on the personal liability protection I discussed earlier.

### The New Seller Financing Policy

While securitization is one method to help the RTC sell its performing financial assets, the RTC has informed the Board that certain financial assets as well as real estate and delinquent mortgages are not securitizable and cannot be sold because commercial financing is not available.

Accordingly, in December, the Oversight Board expanded its seller financing policy to provide the RTC greater flexibility in its asset sales program.

This program provides \$7 billion in seller financing authority for assets that can't be sold at acceptable prices because of inadequate commercial financing. As a result of such sales, the RTC generally will receive an initial 15% downpayment, and receive the balance in installments over time. If buyers in such sales do not fulfill their commitments, the RTC still comes out ahead: it has the 15% downpayment, it may have received a number of installment payments, it has shifted the asset's operating costs to the private sector for a time, and it will repossess the asset if necessary. It is important to remember that the RTC has already paid for these assets so that the sale can only reduce Treasury borrowings. Importantly, under this policy a minimum of \$250 million is reserved solely for the financing of affordable housing to qualifying low- and moderate-income buyers.

This \$7 billion program will be measured, monitored and evaluated for effectiveness by the Oversight Board. The Board has also directed the Inspector General to perform a front end risk assessment of the program and conduct periodic audits of its implementation.

### Affordable Housing

Since we last appeared before this Committee, the Oversight Board has adopted new policies regarding the Affordable Housing Disposition Program. We believe the RTC is making progress in responding to the FIRREA mandate in the area of affordable housing for moderate-and lower-income persons.

On August 15, 1990, the Oversight Board approved a final rule allowing for a number of marketing initiatives to expedite the sale of properties. The rule encourages the RTC to use bulk sales and special marketing events such as home fairs, open houses, and auctions to make qualified organizations and individuals more aware of available properties.

Chairman Seidman has proposed a new program to sell to eligible buyers during the clearinghouse period, the bulk of RTC's single family affordable housing in a no reserve auction and sealed bid process. The Oversight Board clearly supports this initiative.

The Oversight Board also approved a policy allowing the RTC to accept offers from qualified buyers for single family properties at prices as low as 80% of the market value. The policy augmented an active RTC program to increase the opportunities for low- and moderate- income buyers who are at or below 80% of the local median income.

I have already mentioned the minimum amount of \$250 million in seller financing which the Oversight Board made available to the affordable housing program. The RTC is establishing guidelines for the implementation of seller financing. The Oversight Board previously authorized the RTC to pay up to \$6 million to purchase forward mortgage revenue bond (MRB) commitments to be exclusively reserved for the RTC affordable program. One hundred eighty-nine million dollars has already been reserved under this program which when combined with the \$250 million revolving affordable seller financing program provides a minimum of \$439 million of financing for affordable housing.

The Oversight Board has also encouraged the RTC to take advantage of the Federal National Mortgage Corporation's and the Federal Home Loan Mortgage Corporation's demonstrated capabilities in housing finance. Programs utilizing their expertise in structuring and servicing seller financed mortgage loans, including delegating the origination and servicing to designated lenders with prudent underwriting, are now under consideration.

As a result of some of these new developments and the growing experience of the program and staff, we can report that property sales increased. Through December 31, 1990, the program had accepted approximately \$108 million of contracts on 2,737 properties, and of these, 1,507 properties had closed. The average sales price was \$38,442 for single family homes and \$936,000 for the nine multi-family developments on which the RTC had accepted offers. RTC advises that the average income of purchasers under the affordable program is less than 80% of national median income.

Although properties in conservatorship are by statute not subject to the 90-day marketing period, both the seller financing and MRB programs are available for conservatorship properties. The RTC is encouraging non-profit organizations, as well as individuals, to make offers for conservatorship properties.

With the final rule in place, emphasis is switching to the marketing of multi-family properties. The RTC has had some serious expression of interest in bulk packages of multi-family affordable housing and its National Sales Center is currently marketing for April sale its first bulk package of multi-family properties consisting of three Florida developments with 590 units.

One key to the progress in the affordable housing program thus far has been the assistance of clearinghouses and technical assistance advisors. The RTC has established 30 clearinghouse agreements with state housing finance agencies including one with

the Federal Housing Finance Board with the participation of the 12 district Federal Home Loan Banks.

### Environmental MOU

I would also like to address briefly the issue of the RTC's environmental responsibilities.

FIRREA requires the RTC to identify properties with natural, cultural, recreational or scientific significance. However, the FIRREA conference report made clear that this reporting provision was not intended to impose any duty with respect to such properties or create any liabilities for the RTC in connection with such properties.

The Oversight Board felt that it was inappropriate to delegate these responsibilities to individual special purpose public or private agencies. Rather, it was the Board's judgment that the RTC should address this issue through a strengthened internal identification capacity, combined with the procurement, as necessary, of the best available services from both the public and private sectors. Appropriate agencies would include the Fish and Wildlife Service, the EPA, and many other private and public sector agencies.

I assure you that the Oversight Board intends that the RTC fully comply with this important identification function, including the proper notification to interested parties, consistent with realizing the best sales proceeds for properties.

### The Board's Role in Oversight and Evaluation

Under the Oversight Board's management planning procedures the RTC is asked to set goals which it believes are attainable. This is the best way to assure that RTC management is committed to achieving these goals. The Board then evaluates the RTC's performance against the goals.

For example, the Board has suggested improvements in RTC planning and performance measurement through the operating plan process. As mentioned earlier, the Board and RTC are working to develop a final operating plan for fiscal 1991, rather than the three and six month plans submitted previously. Longer planning periods more accurately reflect the time horizon needed by the RTC for proper goal setting. The nine month plan will be monitored monthly and performance forecasts against goals will be provided quarterly together with explanations of variances from plan. RTC will be asked to submit a one year plan for fiscal year 1992.



The operating plan process provides a vehicle for setting program goals and also funding needs. Funding needs for both loss funds and working capital are constantly updated for the Board and compared to statutory constraints.

For example, with each FFB funding draw the RTC must certify to the Board that it is in compliance with all statutory funding constraints after taking into consideration all contingent liabilities -- notably "asset puts". Asset puts represent the right of thrift buyers to "put" purchased assets back to the RTC. The Board has required the RTC to provide a detailed monthly analysis of such asset puts as to amount, term and characteristics.

The RTC also must supply a weekly update of its rolling six-week schedule of anticipated FFB borrowings.

In the area of accounting, the Oversight Board's CPA as well as the Inspector General are reviewing the loss recognition process used by the RTC. While the Board has received the RTC's unaudited financial statements for the period ending December 31, 1989, the Board continues to press the RTC for audited financial statements covering this period.

As a part of the Board's responsibility to attempt to eliminate potential fraud, waste, and abuse in RTC operations, it has been working closely with the RTC Office of Inspector General to set an aggressive audit and investigation agenda.

Weekly meetings have been held with the IG on investigative and audit activities. The meetings focus on spotting areas of vulnerability and correcting problems before they occur. The IG has been directed by the Oversight Board to undertake audits in the highest risk areas. He has also been directed to audit a sample group of completed resolutions and executed contracts. As mentioned earlier, the Oversight Board has directed the IG to undertake a front end risk assessment of the seller financing program and to periodically audit it and the 1988 Deal restructurings.

The IG has opened 15 investigative cases and closed 6 to date. It has begun 15 audits and issued 6 reports. It has identified 36 major areas on which it is planning to focus in fiscal 1991. Currently at the level of 100, the IG plans a staff of about 350 by fiscal year 1992. The Oversight Board considers it essential that an aggressive auditing program be pursued. In addition, at the Board's direction, the IG has provided the Board its detailed audit and investigation plan for the balance of this fiscal year.

## Progress in Renegotiating 1988 Deals

In September, the RTC reported to the Oversight Board on its FIRREA mandated review of the assistance transactions entered into by the Federal Savings and Loan Insurance Corporation (FSLIC) prior to the passage of the Act. From its review, the RTC concluded that a restructuring of some of the so-called "88 Deals" could result in a savings of approximately \$2 billion to the taxpayers over the term of the loans but would require a current appropriation of approximately \$20 billion.

On October 18, Congress appropriated \$22 billion for the FSLIC Resolution Fund (FRF) to pay obligations arising in FY 1991 as well as "permit the prepayment of certain higher interest rate obligations and thus realize a savings of approximately \$2 billion".

Under FIRREA, the Oversight Board has the responsibility to establish overall strategies, policies and goals for restructuring the 1988 FSLIC assisted transactions.

Therefore, the Oversight Board has adopted a policy statement to guide the RTC in restructuring the FSLIC Assistance Agreements (see Appendix IV). The policy statement provides a series of guidelines for such restructurings and directs the RTC to use Treasury borrowings efficiently so as to maximize overall cost savings for the government with respect to the 1988 Deals as a whole.

The important point here is that we must immediately begin the restructuring process and use this fiscal year's appropriations to save taxpayer dollars. Accordingly, we have ordered the RTC to start negotiations consistent with this policy statement.

### CONCLUSION

In closing, let me reiterate what we said at the beginning of our statement. The job is getting done, but we still have a long way to go. This is a task the government cannot escape if we are to honor the promise to the American people to make good on federal deposit insurance.

Immediate Congressional action to provide additional loss funds is essential. I repeat that without such action the RTC's resolution process will halt and the taxpayers' costs will increase. As discussed earlier, we believe the most sensible and appropriate way for Congress to address the funding issue is to provide RTC with the full funding necessary to get the whole job done. Let me say again that without full funding the result

could be a start and stop cleanup process that produces further delays, substantial additional costs to taxpayers, and confusions and fear in the minds of depositors that the government will not meet its stated commitments.


We will be glad to respond to your questions.

# RTC

Resolution Trust Corporation

January 10, 1990

**MEMORANDUM TO:** Peter H. Monroe  
President, RTC Oversight Board

**FROM:** David C. Cooke   
Executive Director

**SUBJECT:** Cost of Delaying Resolutions

You have asked that we update our memorandum of November 1, 1990 on the cost of delaying resolutions. Assuming that additional funds are not available until late February or early March, the RTC will have fallen approximately one quarter behind in the resolution process. We estimate the present value cost of this delay at \$250 million to \$300 million. These estimates exclude three nonquantifiable factors: asset deterioration or other losses that might occur in understaffed or undermanaged institutions awaiting resolution, deterioration of franchise value, and the effect that competing with insolvent institutions has on the cost of funds of marginally solvent institutions possibly causing additional failures.

If additional funding for the RTC is delayed beyond the very beginning of March, the cost of delay begins to go up exponentially. Thus, we estimate that an additional quarters delay would cost an additional \$750 million to \$850 million in present value terms, or an average \$250 million to almost \$300 million per month. (In actuality, since the cost of delay grows exponentially, the cost of delay at the beginning of the second quarter is somewhat less than \$250 million per month while the cost of delay at the end of the second quarter is somewhat greater than \$300 million.)

The reason that the estimated cost of a second quarter's delay is roughly triple that of a single quarter's delay is that the longer the delay, the longer it takes to make-up for the time lost to delay. It takes twice as long to make-up for a two quarter delay as a one quarter delay. For example, if the number of resolutions were increased by 50 percent to make-up for lost time, it would take 6 months to make-up for a one quarter delay and a year to make-up for a two quarter delay. Moreover, it is not realistic to assume a 50 percent increased resolution rate can be sustained much longer than 6 months. If there was a two quarter delay, a 25 percent increase in the quarterly pace of resolutions is probably the most that is feasible beyond the initial 6 months push. Thus, it could take a year and a half to completely make-up for a two quarter delay.

As previously noted, our estimates do not take into account three factors: asset deterioration or other losses that might occur in understaffed or undermanaged institutions awaiting resolution, deterioration of franchise value, and the effect that competing with insolvent institutions has on the cost of funds of marginally solvent institutions possibly causing additional failures. However, it would not be unreasonable to assume that these factors might increase the cost of an additional quarter delay by at least 10 percent.

## Appendix II

### METHODOLOGY FOR ESTIMATING RTC LOSSES

In April of 1990, the Oversight Board completed the development of a cash flow model which projects RTC's sources and uses of funds on a quarterly basis through 1996. This cash flow model gives the Oversight Board the ability to vary a number of assumptions to estimate the effect on the Resolution Trust Corporation's (RTC's) need for loss funds and working capital.

#### Assumptions for Number of Failed Institutions

The Oversight Board's current low estimate assumes a population of about 700 failed institutions, which includes those already resolved, those in conservatorship, and all institutions classified as Group IV thrifts by the Office of Thrift Supervision (OTS). The high estimate assumes a population of just over 1000 thrifts, which includes the 700 institutions in the low estimate, plus all institutions classified as Group III thrifts by the OTS.

#### Assumptions for Pace of Resolution

The cash flow model does not deal with individual institutions. Rather, total assets for individual thrifts are divided into 14 different asset types and then aggregated into tranches representing conservatorships, Group IV and Group III thrifts. The RTC's pace of resolution is selected not by choosing individual thrifts each quarter, but by choosing a volume of total assets in thrifts that are to be resolved each quarter. For the \$90 to \$130 billion range, it was assumed that the RTC would resolve \$40 billion of assets per quarter.

#### Assumptions Behind Losses on Assets

The 14 asset types are: cash; government and agency securities; mortgage-backed securities; high yield bonds; other investment securities; mortgage derivatives; performing permanent mortgages on 1-4 family residences; other performing mortgage loans; consumer loans; all other loans; other owned real estate (ORE); other delinquent assets; service subsidiaries; and other assets.

The losses to be experienced by the RTC are estimated by applying a loss estimate, or "haircut" to each of the 14 different asset types, and adding that to the negative tangible net worth and accumulated operating losses (prior to receivership) of the resolved institutions. In making estimates, three different sets of haircuts were used. The medium haircuts were based upon the FDIC Division of Research's bank failure cost model, and, thus, were based on the actual loss experience of the FDIC. The other two sets of haircuts were assumed to be higher

and lower, depending on the estimated effect of changes in interest rates, the condition of real estate markets and the general condition of the economy. The weighted average haircuts for these three scenarios ranged from about 13 to 25 percent, as follows:

**Three Haircut Scenarios:**

	<u>Low</u>	<u>FDIC Model</u>	<u>High</u>
Weighted Avg.*	13-14%	16-18%	22-25%

- \* Weighted average haircuts are given as ranges because they vary depending upon the asset mix of the particular population estimated to fail. These ranges are for the Oversight Board's low and high population estimates. The Oversight Board has preferred not to disclose the haircuts on individual asset types out of concern that they could be used by buyers against the RTC during negotiations.

Present Value Estimates

In the May/June testimony, the Oversight Board estimated that the cost of resolving all institutions that will come to the RTC would be in the range of \$90 billion to just over \$130 billion, in present value terms.

Our current estimates suggest that the RTC's ultimate costs are still in this range. These estimates use a discount rate of 7.38%, which was the rate the RTC paid for working capital funds from the Federal Financing Bank during late-1990 (when these estimates were originally made).

Data Used

The estimates in the May/June testimony were based upon year-end 1989 data, with the OTS Group III and Group IV classifications as of the end of April 1990. As OTS has released new data and thrift classifications, this information has been incorporated into the cash flow model. The latest estimates, upon which the President's budget numbers are based, use June 1990 data. OTS has only recently released September 1990 data and new Group IV and Group III classifications; based upon preliminary analysis, it appears that this new data will not substantially change current estimates.

### Assumptions for Assets Passed to Acquirers

The cash flow model allows the Oversight Board to change the percentage of institutions that are resolved in whole bank, clean bank and liquidation transactions, and to define each of these transaction types in terms of the percentage of each asset type that is passed to an acquirer. The Oversight Board's current estimates assume that the RTC will pass an average of about 32% of all assets to acquirers.

### Assumptions for Pace of Asset Sales

The model also allows the Oversight Board to vary the pace of sale of receivership assets by estimating the percentage of each of the 14 asset types that is sold each quarter until all are sold.

	1st Half Yr. 1	2nd Half Yr. 1	Yr. 2	Yr. 3	Yr. 4	Yr. 5	Yr. 6+
Cash	100%						
Govt/agency	90%	10%					
MBS	60%	30%	10%				
Perf Perm 1-4s	25%	15%	20%	20%	20%		
Othr Perf Mtgs	7%	4%	14%	20%	20%	20%	15%
Consum Lns	15%	10%	40%	30%	5%		
All Othr Lns	7%	4%	14%	20%	20%	20%	15%
Junk Bonds	15%	10%	30%	30%	15%		
Othr Invest Sec	25%	20%	35%	20%			
ORE	0%	4%	14%	20%	20%	20%	22%
Oth Delinq Asst	0%	4%	14%	20%	20%	20%	22%
Service Subs	0%	10%	25%	40%	20%	5%	
Derivatives	25%	20%	35%	20%			
Othr Assets	10%	10%	25%	30%	20%	5%	
Weighted Avg.	19.4%	11.0%	18.3%	19.5%	16.0%	8.6%	7.2%



## Effect of Interest Rates

No specific interest rate assumptions were used. It is extremely difficult to estimate with any precision what effect a change in interest rates may have on the value of any given asset type. For example, if everything else were held equal, a decline in interest rates would increase the value of some assets held by the RTC, such as securities, mortgage loans, etc. However, as interest rates have declined, other economic factors which influence RTC asset values have also changed. If real estate values fell at the same time as interest rates fell, the effect on the value of RTC assets could go either way.

Because the effect of these factors is virtually impossible to accurately predict, the Oversight Board estimates are for ranges of both the number of institutions and the losses on those institutions' assets. Ultimately, the RTC's actual experience must act as a guide for any estimates. The RTC's recent experience suggests that the downturn in the economy may increase the RTC's costs. It appears at this time, however, that the RTC's costs still appear to be within our original present value estimates (though perhaps somewhat higher within this range).

## RTC Projections

The Oversight Board staff developed a cash flow model in order to perform sensitivity analyses, to make cost estimates, and, perhaps most importantly, to render an independent judgement regarding RTC projections of funding needs. In other words, the Oversight Board does not simply accept RTC requests for funds without questioning the assumptions implied in these requests. Likewise, of course, the RTC does not depend upon the Oversight Board for its projections of funding needs. Rather, the RTC makes its own independent estimates based upon market conditions and the institutions likely to be resolved during a particular period of time.

The projections contained in this testimony and in the President's budget reflect what the Oversight Board, the Administration and the RTC, in consultation, believe are reasonable estimates, given that the RTC receives additional funds to cover losses in a timely manner.

## APPENDIX III

### Requirements Established in FIRREA for Semi-Annual Appearances

- I Report on the progress made during the 6-month period covered by the semi-annual report in resolving cases involving institutions insured by the FSLIC prior to FIRREA, and for which conservator or receiver has been appointed (from 1/89 to the 3 year period beginning 8/89). These institutions are referenced below as those described in subsection (b) (3) (A).
  
- II Provide an estimate of the short-term and long term cost to the United States Government of obligations issued or incurred during such period.

### Comments

Detailed discussion is included in the testimony section entitled "Case Resolutions". During the six month period, the RTC resolved 235 institutions, exceeding its goal of 218 institutions. During the same period, conservatorship and receivership assets were reduced by \$66.8 billion in book value.

We interpret this requirement to address RTC short-term borrowings from the Federal Financing Bank ("FFB") and long-term borrowings from Resolution Funding Corporation ("REFCORP").

During the reporting period, the RTC had issued and outstanding about \$53.0 billion in obligations in the form of short-term working capital borrowings from the FFB. Approximately, \$900 million in interest expenses were incurred in connection with the issuance of these obligations during such period. These borrowings are fully collateralized by assets having an estimated fair market value substantially in excess of the borrowed amount. Accordingly, we expect that the U.S. government ultimately will not incur any cost in connection with these short-term obligations.

REFCORP issued \$8.5 billion of obligations during the reporting period, with \$3.5 billion having a term of forty years, and the balance having a term of thirty years. The yield on each issue was 8.88%. Total interest expense is expected to be a nominal \$25.8 billion. Annual fixed interest expenses of \$755 million will be incurred in connection with these obligations. Under FIRREA, interest on all REFCORP obligations is funded jointly by the Federal Home Loan Banks (FHLBs) and the Treasury, with the FHLB contribution limited to a maximum of \$300 million per year.

As of January 1991, REFCORP had outstanding the full \$30 billion of obligations authorized by FIRREA, with average maturities of 33 years and average yields of 8.76%. Total interest on REFCORP obligations is expected to be a nominal \$87.9 billion. The Treasury

**Requirements Established in FIRREA for  
Semi-Annual Appearances**

**III Report on the progress made during such period in selling assets of institutions described in subsection (b) (3) (A) and the impact such sales are having on the local markets in which such assets are located.**

**IV Describe the costs incurred by the Corporation in issuing obligations, managing and selling assets acquired by the Corporation.**

**Comments**

Detailed discussion is included in the testimony section entitled "Asset Disposition". It is too early in the process to assess the impact of RTC real estate sales on the local markets. To date, there is no evidence that RTC sales have had an adverse impact on local real estate markets. The RTC's National Advisory Board reports that the sale of RTC assets has not adversely affected local real estate markets to date and this observation is consistent with independent reports. The RTC will, however, monitor the impact of its sales activities in local markets through the input of its Regional Advisory Boards. The Regional Advisory Boards will receive analytical support from economists at the Federal Reserve to track and measure the impact of RTC sales on local market conditions. In particular, the new nationwide auction program will be carefully monitored.

We have interpreted this requirement to address the assets of receiverships and conservatorships which are under the management of the RTC.

Costs in the range of \$250-\$300 thousand were incurred during the period in connection with the issuance of obligations by the Corporation.

The total amount paid to private contractors during the April - September period was \$99 million, of which \$18 million represents fees paid under receivership asset management contracts.

After the appointment of RTC as conservator, association employees continue to perform asset management functions under the supervision of the RTC Managing Agent. These staff are already supplemented by outside contractors hired and paid for by the institution for services for which the institution would typically contract in normal course of business. Accordingly, we have excluded such costs for the purposes of this calculation.

**Requirements Established in FIRREA for  
Semi-Annual Appearances**

**V Provide an estimate of income of the Corporation from assets acquired by the Corporation.**

**Comments**

In its corporate capacity, the RTC's only "income" is interest on advances made by the Corporation to conservatorships and receiverships. The RTC received \$588 million of interest income on advances and loans to conservatorships and receiverships in the six months ended September 30, 1990. Dividends are not included in income because they are a reduction in RTC's claims against the assets of the receiverships, a return of capital, and not income. However, dividends received by the RTC during the period totalled \$1 billion.

**VI Provide an assessment of any potential source of additional funds for the Corporation.**

The only remaining sources of additional funds to the Corporation are the secured borrowings for working capital from the FFB and the \$5 billion line of credit from the Treasury provided in FIRREA. There are no other funds currently available to the RTC.

**VII Provide an estimate of the remaining exposure of the United States Government in connection with institutions described in subsection (h) (3) (A) which, in the Oversight Board's estimation, will require assistance or liquidation after the end of such period.**

The estimate of the total resolution cost to be borne by the RTC in connection with those institutions described in subsection (h) (3) (A) is projected to be in the range of \$90 to \$130 billion (present value). The RTC has expended approximately \$37 billion for estimated losses from inception through December 31, 1990.

POLICY STATEMENT NO. 16

Oversight Board Policy Concerning RTC  
Restructuring of FSLIC Assistance Agreements  
("1988 Deals")

1. Purpose and Statutory Background

This policy statement establishes guidelines for the RTC with respect to the restructuring of the FSLIC agreements ("1988 Deals") referred to in Section 21A(b)(11)(B) of the Federal Home Loan Bank Act, as amended by Section 501 of FIRREA. Pursuant to the requirements of that law, and in accordance with the guidance provided by this policy statement, RTC "shall exercise any and all legal rights to modify, renegotiate, or restructure such agreements where savings would be realized by such actions." FIRREA also instructs RTC to operate in a manner that "makes efficient use of funds obtained from the Funding Corporation or from the Treasury."

2. Restructuring Policies

With respect to the 1988 Deals:

(A) RTC shall make efficient use of Treasury funds appropriated from time to time for the purpose of lowering the government's overall cost of the 1988 Deals.

(i) RTC shall expend appropriated funds in a manner designed to maximize government cost savings with respect to the 1988 Deals as a whole. RTC need not expend any particular amount of appropriated funds in any specific transaction.

(ii) RTC need not expend all appropriated funds but should be willing to do so as necessary to achieve cost savings.

(iii) RTC may expend appropriated funds to prepay notes, purchase assets, mark down assets, or otherwise exercise the government's rights and options under the existing terms of 1988 Deals. RTC may renegotiate terms of a transaction instead of, or in combination with, such use of appropriated funds.

(iv) Except for the expenditure of appropriated funds to make scheduled payments under the existing terms of the 1988 Deals, the Oversight Board considers all expenditures of appropriated funds to constitute "restructuring" of the 1988 Deals.

(v) In determining how and when to expend appropriated funds, RTC shall take into consideration all relevant factors including, but not limited to:

(a) savings and projected savings that may be achieved through prepayments and exercise of other government rights under the 1988 Deals;

(b) savings and projected savings that may be achieved through renegotiation of the terms of 1988 Deals;

(c) projected increases or decreases in government tax revenues; and

(d) projected costs of thrift failures resulting from exercise of government rights under 1988 Deals.

Projected savings and projected costs shall be considered with due regard for the probability with which they can be expected.

(B) Where RTC seeks to renegotiate the terms of 1988 Deals, it shall seek to improve incentives for effective management and disposition of assets in a manner consistent with the concepts employed by RTC in its Standard Asset Management and Disposition Agreements.

(C) RTC shall employ uniform criteria for its decisions and actions concerning the so-called "stabilized" deals and the other 1988 Deals. With respect to any of the "stabilized" or other 1988 Deals, RTC may renegotiate terms so as to continue yield maintenance, asset loss coverage, and other forms of continuing assistance, where doing so is consistent with the goal of reducing the government's overall cost of the 1988 Deals, notwithstanding the Oversight Board's general policy against the use of such ongoing assistance with respect to RTC thrift resolutions apart from the 1988 Deals.

(D) RTC may seek to avoid government undertakings where fraud or other misconduct by persons contracting with the government provides a legal basis to do so. Where fraud or other criminal conduct appears, RTC shall refer the matter for prosecution.

### 3. Execution

In restructuring 1988 Deals:

(A) RTC may employ whatever resources it deems reasonable and appropriate, including FDIC personnel and outside contractors. RTC, however, remains responsible for the overall plan of the effort, for the methods used and results achieved, and for reporting to Congress, the Oversight Board, and the public.

(B) RTC shall thoroughly and completely document its procedures, decisions, and actions (and shall require the same by its agents and contractors) in a manner so as to facilitate detailed auditing and investigation by RTC's Inspector General.

### 4. Performance and Monitoring

RTC shall report monthly to the Oversight Board regarding actions taken, amounts expended or to be expended, and cost savings achieved or projected as a result thereof. Reports shall be made with respect to the 1988 Deals individually and in the aggregate and shall include such detail, data, and explanations as the Chairman or the President of the Oversight Board may from time to time request.

5. Immediately Effective

This policy statement supersedes the Oversight Board's request for recommendations from the RTC as set out in the resolution adopted by the Oversight Board on September 20, 1990. Accordingly, this policy statement is immediately effective and RTC may begin immediately to restructure the 1988 Deals as provided herein.



# PRESS RELEASE

## OVERSIGHT BOARD

Resolution Trust Corporation

1777 F STREET, N.W. WASHINGTON, D.C. 20232

FOR IMMEDIATE RELEASE  
January 31, 1991  
OB 91-10

Contact: Brian P. Harrington  
(202) 786-9675

### RTC REGION 3 ADVISORY BOARD TO HOLD OPEN MEETING

The members of the Kansas City-based Region 3 Advisory Board will hold their quarterly open meeting in Little Rock, Ark. on February 6, 1991, from 12:30 to 4:00 p.m.

The meeting, open to all members of the public and press, will be in the Fulton Room at the Statehouse Convention Center, Three Statehouse Plaza, in Little Rock.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) required that the Oversight Board establish six Regional Advisory Boards to provide advice to the Resolution Trust Corporation (RTC) on the policies and programs for the disposition of real estate of the nation's failed thrifts.

The Board includes Donald Jacobs of Evanston, Ill., as chairman; Evelyn Carroll of Minneapolis, Minn.; Emery Fager of Topeka, Kansas; Ritch LeGrand of Sioux City, Iowa; and Layne Morrill of Kimberling City, Mo.

Discussions at the meeting will center on the activities of Region 3 as related to the RTC's affordable housing disposition program, pricing policies, private sector contracting procedures and administration of delinquent real estate mortgages. In addition, there will be a regional real estate market report by a Federal Reserve Bank economist. Time also will be reserved for members of the public to address the board with their comments concerning the RTC's disposition of real estate.

The Region 3 Advisory Board represents the states of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, South Dakota, and Wisconsin.

###



FEB 5 1991

DEPT. OF THE TREASURY

FOR IMMEDIATE RELEASE

February 1, 1991

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of December 1990.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled \$179.1 billion on December 31, 1990, posting an increase of \$1.5 billion from the level on November 30, 1990. This net change was the result of a decrease in holdings of agency-guaranteed loans of \$1,199.7 million and in holdings of agency assets of \$0.2 million, while holdings of agency debt increased by \$2,662.9 million. FFB made 38 disbursements during December.

Attached to this release are tables presenting FFB December loan activity and FFB holdings as of December 31, 1990.

## FEDERAL FINANCING BANK

## DECEMBER 1990 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi- annual)	INTEREST RATE (other than semi-annual)
<u>AGENCY DEBT</u>					
<u>EXPORT-IMPORT BANK</u>					
Note #92	12/3	\$ 166,000,000.00	12/1/98	8.039%	7.96% qtr.
Note #93	12/3	16,000,000.00	12/1/06	8.405%	8.582% ann.
Note #94	12/3	578,000,000.00	6/3/91	7.487%	
<u>NATIONAL CREDIT UNION ADMINISTRATION</u>					
<u>Central Liquidity Facility</u>					
+Note #536	12/3	15,000,000.00	1/2/91	7.365%	
Note #537	12/6	2,500,000.00	1/4/91	7.350%	
Note #538	12/26	5,000,000.00	1/28/91	6.857%	
<u>RESOLUTION TRUST CORPORATION</u>					
<u>Note No. 90-07</u>					
Advance #7	12/4	200,000,000.00	1/2/91	7.395%	
Advance #8	12/10	400,000,000.00	1/2/91	7.229%	
Advance #9	12/17	2,100,000,000.00	1/2/91	7.187%	
<u>TENNESSEE VALLEY AUTHORITY</u>					
Short-term Bond #69	12/3	256,000,000.00	12/17/90	7.380%	
Short-term Bond #70	12/7	30,000,000.00	12/11/90	7.350%	
Short-term Bond #71	12/11	177,000,000.00	12/24/90	7.229%	
Short-term Bond #72	12/17	221,000,000.00	12/31/90	7.170%	
Short-term Bond #73	12/24	141,000,000.00	1/8/91	6.877%	
Short-term Bond #74	12/31	239,000,000.00	1/15/91	6.793%	
<u>GOVERNMENT - GUARANTEED LOANS</u>					
<u>DEPARTMENT OF DEFENSE</u>					
<u>Foreign Military Sales</u>					
Morocco 9	12/7	58,625.79	3/31/94	7.791%	
Morocco 13	12/7	20,169.00	5/31/95	7.914%	

+rollover

## FEDERAL FINANCING BANK

## DECEMBER 1990 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi- annual)	INTEREST RATE (other than semi-annual)
<u>GENERAL SERVICES ADMINISTRATION</u>					
<u>U.S. Trust Company of New York</u>					
Advance #4	12/28	\$ 1,204,246.99	5/15/91	6.963%	
<u>RURAL ELECTRIFICATION ADMINISTRATION</u>					
Old Dominion Electric #267	12/7	534,873.00	12/31/92	7.612%	7.541% qtr.
S. Mississippi Electric #330	12/10	296,000.00	12/31/19	8.185%	8.103% qtr.
United Power Assoc. #159A	12/17	340,000.00	12/31/19	8.204%	8.122% qtr.
*Associated Electric #328	12/31	3,730,321.80	12/31/92	7.370%	7.303% qtr.
*Cajun Electric #197A	12/31	38,153,846.11	1/2/18	8.316%	8.231% qtr.
*Colorado-Ute Electric #96A	12/31	1,076,972.57	12/31/92	7.370%	7.303% qtr.
*Colorado-Ute Electric #96A	12/31	1,293,697.82	12/31/92	7.370%	7.303% qtr.
*Colorado-Ute Electric #203A	12/31	1,922,345.76	12/31/92	7.370%	7.303% qtr.
*Colorado-Ute Electric #203A	12/31	6,882,930.83	12/31/92	7.370%	7.303% qtr.
*Colorado-Ute Electric #203A	12/31	1,037,819.17	12/31/92	7.370%	7.303% qtr.
*Cooperative Power Assoc. #156A	12/31	7,464,070.81	12/31/92	7.366%	7.299% qtr.
*N.C. Central Electric #278	12/31	99,357.12	12/31/92	7.366%	7.299% qtr.
*Old Dominion Electric #267	12/31	3,197,137.76	12/31/92	7.369%	7.302% qtr.
*Oglethorpe Power #320	12/31	15,150,942.15	12/31/92	7.367%	7.300% qtr.
*Oglethorpe Power #320	12/31	9,348,066.10	12/31/92	7.367%	7.300% qtr.
*Oglethorpe Power #335	12/31	4,792,000.00	12/31/92	7.375%	7.308% qtr.
*S. Mississippi Electric #330	12/31	510,789.92	12/31/19	8.304%	8.220% qtr.
*United Power Assoc. #67A	12/31	5,734,059.43	12/31/13	8.259%	8.175% qtr.
United Power Assoc. #159A	12/31	1,575,000.00	12/31/19	8.304%	8.220% qtr.
<u>TENNESSEE VALLEY AUTHORITY</u>					
<u>Seven States Energy Corporation</u>					
Note A-91-02	12/31	577,524,522.09	3/29/91	6.797%	

\*maturity extension

FEDERAL FINANCING BANK  
(in millions)

Program	December 31, 1990	November 30, 1990	Net Change 12/1/90-12/31/90	FY '91 Net Change 10/1/90-12/31/90
<b>Agency Debt:</b>				
Export-Import Bank	\$ 11,370.2	\$ 11,339.8	\$ 30.4	\$ 30.
NCUA-Central Liquidity Fund	81.5	74.0	7.5	24.
Resolution Trust Corporation	53,000.0	50,300.0	2,700.0	11,518.
Tennessee Valley Authority	14,055.0	14,130.0	-75.0	-327.
U.S. Postal Service	6,697.8	6,697.8	-0-	-0-
sub-total*	85,204.5	82,541.6	2,662.9	11,246.
<b>Agency Assets:</b>				
Farmers Home Administration	52,324.0	52,324.0	-0-	275.
DHHS-Health Maintenance Org.	69.6	69.6	-0-	-0-
DHHS-Medical Facilities	82.7	82.7	-0-	-0-
Rural Electrification Admin.-CBO	4,407.2	4,407.2	-0-	-0-
Small Business Administration	7.8	8.0	-0.2	-0.
sub-total*	56,891.3	56,891.5	-0.2	274.
<b>Government-Guaranteed Loans:</b>				
DOD-Foreign Military Sales	5,244.1	5,279.8	-35.7	-4,511.
DEd.-Student Loan Marketing Assn.	4,850.0	4,850.0	-0-	-30.
DHUD-Community Dev. Block Grant	233.0	239.9	-7.0	-11.
DHUD-Public Housing Notes +	1,903.4	1,903.4	-0-	-47.
General Services Administration +	477.4	376.8	100.5	110.
DOI-Guam Power Authority	29.7	29.7	-0-	-0-
DOI-Virgin Islands	25.3	25.3	-0-	-0-
NASA-Space Communications Co. +	32.7	1,203.2	-1,170.5	-1,063.
DON-Ship Lease Financing	1,672.4	1,672.4	-0-	-0-
Rural Electrification Administration	18,889.6	18,967.8	-78.2	-152.7
SBA-Small Business Investment Cos.	325.1	340.8	-15.7	-57.4
SBA-State/Local Development Cos.	729.8	735.2	-5.4	-11.8
TVA-Seven States Energy Corp.	2,375.0	2,362.7	12.4	.
DOT-Section 511	22.9	23.1	-0.1	.
DOT-WMATA	177.0	177.0	-0-	.
sub-total*	36,987.2	38,186.9	-1,199.7	-5,77.
grand total*	\$ 179,083.0	\$ 177,619.9	\$ 1,463.0	\$ 5,76.

\*figures may not total due to rounding  
+does not include capitalized interest

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-204

FOR RELEASE AT 12:00 NOON  
February 1, 1991

FEB 5 1991 CONTACTS

Office of Financing  
202/376-4350

DEPT. OF THE TREASURY

## TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately \$11,750 million of 364-day Treasury bills to be dated February 14, 1991, and to mature February 13, 1992 (CUSIP No. 912794 XZ 2). This issue will provide about \$2,150 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of \$9,594 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Tuesday, February 12, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. This series of bills will be issued entirely in book-entry form in a minimum amount of \$10,000 and in any higher \$5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing February 14, 1991. In addition to the maturing 52-week bills, there are \$19,601 million of maturing bills which were originally issued as 13-week and 26-week bills. The disposition of this latter amount will be announced next week. Federal Reserve Banks currently hold \$1,131 million as agents for foreign and international monetary authorities, and \$7,477 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rate of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold \$170 million of the original 52-week issue. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-3.

Each tender must state the par amount of bills bid for, which must be a minimum of \$10,000. Tenders over \$10,000 must be in multiples of \$5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than \$1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of \$200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds \$200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of competitive tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.

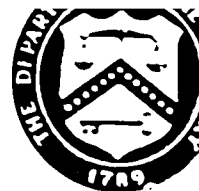
Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for \$1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-20

EMBARGOED UNTIL GIVEN  
EXPECTED AT 10:00 A.M.  
FEBRUARY 4, 1991

REPT. THE TREASURY

Remarks to the Press by  
Secretary of the Treasury  
Nicholas F. Brady  
Fiscal Year 1992 Budget

Good morning, ladies and gentlemen. This morning, the President transmitted to the Congress his budget for fiscal year 1992. The President's proposal builds on last year's budget agreement and continues to restrain spending and encourage economic growth.

Mike Boskin will comment on the economic forecast and Dick Darman will discuss the budget itself. Then we'll be glad to answer your questions.

As Mike will discuss, the economy is in a recession, but we expect that it will be of short duration. Obviously, we want the economy to get back on the growth path. Growth is the key to increased jobs and rising living standards for all Americans.

From a policy standpoint, there are a number of points concerning this budget. First, reducing the budget deficit by controlling spending must remain our number one priority. As Dick will indicate, this budget does just that.

The budget agreement we reached with Congress last fall meets the fundamental test of providing real, enforceable budget deficit reduction, and the President's 1992 budget is an important step in implementing that agreement. Over the next five years, our government will borrow in the credit markets a half trillion dollars less than it would have borrowed in the absence of the budget agreement.

As the President has said, the budget agreement will transform spending debates in Washington into a battle of ideas, not a bidding war. And the President's 1992 budget holds the growth of spending to less than the rate of inflation in order to continue progress in reducing the budget deficit with no new taxes.

NB-1111



The President's budget again supports economic growth in various ways, including Family Savings Accounts, a capital gains reduction, a permanent extension of the research and experimentation tax credit, early IRA withdrawals for first-time homebuyers and Enterprise Zones.

Finally, our prospects for long-term economic growth will be improved if we modernize our financial system to make banks safer and more competitive. The rules governing our financial system must deal with the reality that new technology and innovation is sweeping the financial services industry. Tomorrow, we will propose reforms that will protect depositors and taxpayers, while improving the international competitiveness of our entire economy.

Now, I'd like to turn first to Mike Boskin and then to Dick Darman for their comments.

###

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

## MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS

FEBRUARY 5, 1991

### FACT SHEET

#### The Need for Reform

It is time to modernize our financial system to make banks safer and more competitive:

- o We must modernize our banking system, updating outmoded laws that date back to the 1930s.
- o Banks must be sound to protect depositors and taxpayers.
- o A strong, internationally competitive banking system is essential to a strong, growing economy.

#### The Banking System is Under Stress

- o Technology has revolutionized the way financial institutions do business, but our banks are hampered by out-of-date rules.
- o Weak banks shrink lending when the economy slows, hurting businesses and costing jobs.
- o Our banks are falling behind international competitors: Only one of the 30 largest banks in the world is American, compared to nine of 30, including the top three, just 20 years ago.

## The Benefits of Reform

A modern, safe and internationally competitive banking industry will protect depositors and taxpayers, serve consumers, benefit workers and businesses, and strengthen our nation.

### Protect depositors and taxpayers:

Depositor confidence and taxpayer protection will result from:

- A safe, competitive, well-capitalized banking system;
- limitations on taxpayer exposure to losses from bank failures;
- and a strong, well-capitalized insurance fund.

### Serve consumers:

An efficient, integrated financial services system will mean:

- Consumers will have access to a wider range of services at the least possible cost.
- Consumers also will enjoy the convenience of nationwide access to services.

### Benefit workers and businesses:

A healthy banking system with strong, competitive banks will ensure:

- Jobs are preserved because loans are not called at the first sign of economic downturn.
- Small businesses that lack access to securities markets can count on banks in bad times as well as good.

### Strengthen the nation:

A world-class financial services system provides a foundation for a world-class economy:

- International economic leadership in the 21st century will require an internationally competitive financial services system.

### The Principles Governing Reform

First, we will preserve deposit insurance for small savers while protecting taxpayers by reducing the overextended deposit insurance system. Deposit insurance, originally intended to protect small depositors who could not protect themselves, has been expanded so that large, sophisticated investors receive unneeded protection. This reform will restore market discipline over risky activities that have increased the possibility of taxpayer exposure to losses in the banking system.

Second, we will make banks stronger and safer by strengthening the role of capital -- not by raising capital standards, but with a plan to attract capital to the banking industry. This will include rewarding well-capitalized banks with new activities that will attract still further capital, and taking prompt corrective action to address under-capitalized banks.

Third, we will make banks more competitive by modernizing outdated laws. Technological advances and other innovations in financial markets have put banks at a competitive disadvantage -- at home and abroad -- that has weakened the system and hurt the economy. Changes will allow banks to engage in a broader range of financial services and to operate nationwide.

Fourth, we will strengthen the banking system by making the regulatory structure more efficient. Currently, overlapping regulatory responsibilities lead to confusion and uneven results.

## RECOMMENDATIONS

### **PART ONE: DEPOSIT INSURANCE AND BANKING REFORM**

The Administration's deposit insurance recommendations go well beyond the narrow issue of deposit insurance and encompass the entire range of safety, soundness and competitiveness issues facing the banking system. They form a balanced, integrated package that must be considered as a whole. No single recommendation will be effective by itself, and indeed, could be counterproductive if adopted in isolation.

#### **I. Strengthen the Role of Capital**

The single most powerful tool to make banks safer is capital. Capital standards need not be raised, but the role of capital can be strengthened. This will discourage excessive risk-taking, reduce the possibility of bank failure, and provide a cushion to absorb losses ahead of the insurance fund and, ultimately, the taxpayer.

Well-capitalized banks are better able to keep lending, rather than shrinking loans to build capital ratios, during economic declines. And they are better able to meet competitive challenges and to take advantage of new opportunities.

#### **Specific Recommendations:**

Capital-based supervision, capital-based deposit insurance premiums and capital-based expanded activities (each described further in other sections of the report) will provide incentives for banks to build and maintain strong capital bases and make bank franchises more attractive. In addition, interest rate risk will be added to credit risk as a criterion for risk-based capital standards.

#### **II. Reduce the Overextended Scope of Deposit Insurance**

Deposit insurance, originally intended to protect small depositors who could not protect themselves, has been expanded so that large, sophisticated investors receive unneeded protection. This has increased the exposure of taxpayers to possible losses and decreased market discipline on risky banks.

By returning deposit insurance to its original purpose, we

can reduce the possibility that taxpayer funds will be needed to cover depositor losses, while simultaneously reintroducing market discipline that will help curb excessive risk.

#### Specific Recommendations:

##### Insured deposits:

"Pass-through" coverage of many types will be eliminated, reducing government protection for large, sophisticated institutional investors.

Brokered insured deposits will be eliminated, ending a practice that has given banks access to large pools of below-market-rate funds that are deposited without concern on the part of the depositor about the safety of the investment.

Individual insurance coverage will be limited to \$100,000 per institution after a two-year phase-in period, plus another \$100,000 per institution for a retirement account. This change will reduce taxpayer exposure to losses from coverage for wealthier individuals with multiple accounts, including individual, joint and revocable trusts, in a single failed institution.

The FDIC will be required to undertake an 18-month study of the costs and benefits of moving toward a systemwide \$100,000 per person insurance limitation. This would more effectively limit taxpayer exposure to losses resulting from coverage of multiple accounts, but should not be implemented until it can be shown that the benefits would outweigh the potentially large administrative costs.

##### Uninsured deposits:

The government must preserve its ability to protect the banking system and the economy in genuine systemic risk circumstances. But protection of uninsured deposits as a matter of course both expands taxpayer exposure and encourages excessive risk-taking by banks. To limit coverage of uninsured depositors, the FDIC will be permitted to cover uninsured deposits only if that would be the least costly approach. To protect the system in rare instances of systemic risk, the Treasury and Federal Reserve could step in and order that uninsured deposits be covered. This policy would be implemented after three years to allow for an appropriate transition.

##### Non-deposit creditors:

While protecting uninsured deposits should be the rare exception, coverage of non-deposit creditors should be eliminated.

### III. Risk-Based Deposit Insurance

Flat-rate premiums subsidize high-risk, poorly run institutions at the expense of well-run institutions and the taxpayer. There is a perverse incentive to take risks because there is no cost to offset the upside potential.

#### Specific Recommendations:

First, in the short-term, premiums based on capital levels will reward institutions that build capital to act as a buffer ahead of the insurance fund. In the longer term, a demonstration project may lead to premiums set by private insurance.

### IV. Improved Supervision

Even with deposit insurance limits, the insurance fund and the taxpayer remain exposed to possible bank losses. Effective bank supervision can help. Capital standards need not be increased. But because well-capitalized institutions are the safest, regulation should be reoriented towards a system of capital-based supervision that provides rewards and penalties that encourage banks to hold adequate capital.

The rewards of capital-based supervision would be much greater regulatory freedom for well-capitalized banks to expand and engage in new financial activities. The sanctions of capital-based supervision would involve "prompt corrective action" to address problems as capital levels decline, well in advance of insolvency.

#### Specific Recommendations:

Capital-based supervision would establish five zones for banks based on their capital levels. Those with capital in excess of minimum requirements will be eligible to engage in a broad range of new financial services. Those with less than minimum capital would be subject to increasingly stringent corrective action -- including dividend cuts or even forced sale of the bank -- aimed at preventing failure.

### V. Restrictions on Risky Activities

State-chartered banks with federal deposit insurance may be authorized by charter to engage in risky activities that are precluded for national banks. It is important to protect federal taxpayers from such excessive risks while maintaining state regulatory responsibilities under the dual banking system.

### Specific Recommendations:

Federal deposit insurance qualifications would prohibit direct investment activities by state banks and limit activities not permitted for national banks.

## VI. Nationwide Banking and Branching

Nationwide banking and branching would lead to safer, more efficient and more competitive banks, decreasing taxpayer exposure to losses. The U.S. is the only major industrialized country without a truly national banking system. After 1992, members of the European Community will permit international banking throughout the EC. Not only do we put our banks at an international competitive disadvantage, but we also forego significant safety, efficiency and consumer benefits.

Already, 33 states permit nationwide banking and another 13 permit regional banking. Only four prohibit all interstate banking. So the trend is clearly toward interstate banking. Yet there is almost no authority for interstate branching. Given the cost savings and efficiency arguments for interstate branching, the advantages to consumers and taxpayers of interstate branching are clear.

### Specific Recommendations:

Full nationwide banking will be authorized for bank holding companies following a three-year delay. Interstate branching will be authorized for national banks in any state in which the bank's holding company could acquire a bank. Thus, after the three-year delay, full nationwide branching will be permitted.

## VII. Modernized Financial Services Regulation

Banks are no longer the protected and steadily profitable businesses they once were. Technological advances and innovations by competing financial services providers have ended their monopoly on transaction accounts and certain types of business credit. They no longer enjoy protected access to low-cost funds from interest rate controls. And old laws that once protected them from competition have become barriers that impede banks from responding to changing market conditions. The result has been declining profitability and increasing bank failures. The losers are not just banks, but also depositors, taxpayers and the overall strength of the economy.

Out-of-date laws must be adapted to permit well-capitalized banks to reclaim the competitive opportunities they have lost to changing markets. Banks with expertise in other financial



services should be allowed to provide them for consumers, and other financial services companies with natural synergies with banking should be allowed to invest in banks. This will provide new sources of capital for the banking system and help promote safe, strong, well-capitalized banks.

The proposed changes will be accompanied by safeguards to prevent exposure of the federal deposit insurance fund to these new activities.

#### Specific Recommendations:

In order to strengthen the banking system, new rules will permit financial affiliates for well-capitalized banks. A new financial services holding company structure will permit a single company to own affiliates engaging in banking, securities, mutual funds and insurance. The new rules will allow commercial firms to own financial services holding companies.

To protect the deposit insurance fund and the taxpayer, only well-capitalized banks will be permitted to engage in new financial activities. Only the bank will have access to deposit insurance, strict regulation will be focused on the bank, and the new financial activities will be in separately capitalized affiliates.

#### VIII. Credit Union Reforms

The law required a study of adequacy of capital in the credit union industry and insurance fund and of the regulatory structure governing the credit union industry.

#### Specific Recommendations:

To ensure adequate capitalization of the credit union insurance fund, the double counting of fund assets will be eliminated over 12 years. To provide Administration accountability for credit union regulation, the federal banking regulator will serve on the National Credit Union Administration Board.

### **PART TWO -- REGULATORY RESTRUCTURING**

The current regulatory structure is complicated, overlapping and confusing. Individual institutions often are supervised by several regulators, and bank holding companies rarely have the same regulator as their subsidiary banks.

A redesigned structure should reduce duplication and

improve consistency, accountability and efficiency. It should also separate the insurer from the regulator.

Specific Recommendations:

The present four-regulator model (the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and Office of Thrift Supervision) will be simplified to two, with the same regulator responsible for a bank holding company and its subsidiary bank.

The Federal Reserve will supervise all state-chartered banks and their holding companies. A new Federal Banking Agency under Treasury will supervise all national banks and their holding companies. When a holding company owns both state-chartered and national banks, jurisdiction over the entire organization will go to the charterer of the largest subsidiary bank. The Federal Banking Agency will take over OTS responsibilities on the date it completes assigning thrifts to the RTC.

The FDIC will be focussed on insurance and resolution of failed institutions.

**PART THREE -- RECAPITALIZATION OF THE BANK INSURANCE FUND**

The Bank Insurance Fund (BIF) has experienced losses in each of the last three years due to increasing numbers of bank failures. FDIC projects additional losses over the next two years that, under the most pessimistic assumptions, could exhaust the fund's net worth. The FDIC must exercise the authority given to it in the FDIC Assessment Rate Act of 1990 to recapitalize the BIF fund in the near term. Because the FDIC has the authority and because industry participation is essential, a plan to recapitalize the fund ought to be worked out with the industry by the FDIC within the following parameters:

Goals of Recapitalization

1. The plan should provide sufficient resources.
2. It should take into account any impact on the health of the banking system.
3. It should rely on industry funds.
4. It should use generally accepted accounting principles.

**AUCTION  
RESULTS**

# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE  
February 4, 1991

CONTACT: Office of Financing  
202-376-4350

## RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for \$10,058 million of 26-week bills to be issued on February 7, 1991 and mature on August 8, 1991 were accepted today (CUSIP: 912794XB5).

### RANGE OF ACCEPTED COMPETITIVE BIDS:

	<u>Discount Rate</u>	<u>Investment Rate</u>	<u>Price</u>
Low	5.91%	6.18%	97.012
High	5.94%	6.21%	96.997
Average	5.94%	6.21%	96.997

Tenders at the high discount rate were allotted 61%.  
The investment rate is the equivalent coupon-issue yield.

### TENDERS RECEIVED AND ACCEPTED (in thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	39,430	39,430
New York	30,123,930	8,785,225
Philadelphia	25,260	25,260
Cleveland	40,160	40,160
Richmond	47,745	42,745
Atlanta	31,230	29,060
Chicago	1,789,930	60,180
St. Louis	38,250	19,300
Minneapolis	6,900	6,900
Kansas City	51,825	51,825
Dallas	17,995	17,995
San Francisco	560,185	197,335
Treasury	742,430	742,430
<b>TOTALS</b>	<b>\$33,515,270</b>	<b>\$10,057,845</b>
<u>Type</u>		
Competitive	\$28,740,075	\$5,282,650
Noncompetitive	1,406,430	1,406,430
Subtotal, Public	\$30,146,505	\$6,689,080
Federal Reserve	2,450,000	2,450,000
Foreign Official Institutions	918,765	918,765
<b>TOTALS</b>	<b>\$33,515,270</b>	<b>\$10,057,845</b>

An additional \$455,035 thousand of bills will be issued to foreign official institutions for new cash.

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE

February 4, 1991

## Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of December 1990.

As indicated in this table, U.S. reserve assets amounted to \$83,340 million at the end of December, up from \$83,059 million in November.

### U.S. Reserve Assets (in millions of dollars)

End of Month	Total Reserve Assets	Gold Stock <u>1/</u>	Special Drawing Rights <u>2/3/</u>	Foreign Currencies <u>4/</u>	Reserve Position in IMF <u>2/</u>
<u>1990</u>					
November	83,059	11,059	11,059	52,070	8,871
December	83,340	11,058	10,989	52,217	9,076

1/ Valued at \$42.2222 per fine troy ounce.

2/ Beginning July 1974, the IMF adopted a technique for valuing the SDR based on a weighted average of exchange rates for the currencies of selected member countries. The U.S. SDR holdings and reserve position in the IMF also are valued on this basis beginning July 1974.

3/ Includes allocations of SDRs by the IMF plus transactions in SDRs.

4/ Valued at current market exchange rates.

**General Explanations**  
of the  
**President's Budget Proposals**  
**Affecting Receipts**



Department of the Treasury  
February 1991

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## CAPITAL GAINS TAX RATE REDUCTION FOR INDIVIDUALS

The Budget again includes a reduction of the capital gains tax rate for individuals on long-term investments. The Budget provides for a 10, 20, or 30 percent exclusion for long-term capital gains on assets held by individual taxpayers for one, two or three years, respectively. The three-year holding period requirement will be phased in over three years.

In his State of the Union Address on January 29, 1991 the President asked Congressional leaders to cooperate with the Administration in a study led by Federal Reserve Chairman Alan Greenspan to sort out technical differences over the distributional and economic impacts of a capital gains reduction.

A reduction in capital gains taxes should benefit all Americans by providing incentives for saving and investment that would result in higher national output and more jobs.

### Current Law

Under current law, the full amount of capital gains income is generally taxable but the rate on such gains is capped at 28 percent. Capital gains are generally subject to 15 percent or 28 percent statutory tax rates. When capital gains taxes interact with other provisions in the income tax code, however, the actual tax cost of an asset sale can be significantly higher. Interacting provisions include the requirement that itemized deductions for medical and miscellaneous expenses exceed a percentage of adjusted gross income, the phase-outs with increasing income of IRA deductions, passive activity loss limitations, and the phase-out of personal exemptions and the three percent floor on itemized deductions enacted in 1990.

While the Tax Reform Act of 1986 eliminated the capital gains exclusion of prior law, it did not eliminate the legal distinction between capital gains and ordinary income, or between short-term and long-term capital gains. These distinctions currently serve to identify those transactions eligible for the 28 percent maximum rate and subject to the limitations on deduction of capital losses. Capital assets effectively include all property except inventories or other items held for sale in the ordinary course of business and certain other listed assets. Examples of capital assets include corporate stock, a home, a farm or business, real estate, and antiques. Gains or losses from the sale or exchange of capital assets held for one year or longer are classified as long-term capital gains or losses.

Individuals with capital losses exceeding capital gains may generally deduct up to \$3,000 of such losses against ordinary income. A net capital loss in excess of the deduction limitation may be carried forward. Special rules allow individuals to treat losses of up to \$50,000 (\$100,000 on a joint return) with respect to stock in certain small business corporations as ordinary losses.

Depreciation recapture rules recharacterize a portion of capital gains on depreciable property as ordinary income. These rules vary for different types of depreciable property. For personal property, all previously allowed depreciation not in excess of the realized capital gain is generally recaptured as ordinary income. For real property using straight-line depreciation, there is no depreciation recapture if the asset is held at least one year. For real property acquired before 1987, generally only the excess of the depreciation claimed in excess of straight-line depreciation is recaptured as ordinary income. There are also recapture rules applicable to the disposition of depletable property and to certain other assets.

Capital gains and losses are generally taken into account when "realized" upon the sale, exchange, or other disposition of the asset. Certain dispositions of capital assets, such as transfers by gift, are not generally realization events for income tax purposes. In general, in the case of gifts the donor does not realize gain or loss, and the donor's basis in the property carries over to the donee. In certain cases, such as the gift of a bond with accrued market discount or of property that is subject to indebtedness in excess of the donor's basis, the donor may recognize ordinary income upon making a gift. The capital gain in a charitable contribution of appreciated property (other than tangible personal property donated in 1991) is included as a preference item in calculating the alternative minimum tax. Gain or loss is not realized on a transfer at death, and the beneficiary's basis in the inherited asset is generally the fair market value of the asset at (or near) the date of death.

### Reasons for Change

Restoring a capital gains tax rate differential is important to restore economic growth and competitive strength by promoting savings, entrepreneurial activity, and risky investment in new products, processes, and industries. At the same time, investors should be encouraged to extend their horizons and search for investments with longer-term growth potential. The future competitiveness of this country requires a sustained flow of capital to innovative, technologically advanced activities that may generate minimal short-term earnings but promise strong future profitability. A preferential tax rate limited to longer-term commitments of capital will encourage business investment patterns that favor innovation and long-term growth over short-term profitability. The resulting increase in national output will benefit all Americans by providing jobs and raising living standards. In addition to the improvements in productivity and economic growth, a lower rate on long-term capital gains will also improve the fairness of the individual income tax by providing a rough adjustment for the taxation of inflationary gains that do not represent any increase in real income.

Incentives for Longer-Range Investment. A capital gains preference has long been recognized as an important incentive for capital investment. The first tax rate differential for capital gains in this country was introduced by the Revenue Act of 1921. For the next 65 years there was always some tax rate differential for long-term capital gains. The preferential treatment for capital gains has taken various forms, including an exclusion of a fixed portion of the nominal gains, an exclusion that depended on the length of time a



taxpayer held an asset, and a special maximum tax rate for capital gains. But at no time between 1921 and 1987 were long-term capital gains ever taxed at the same rates as ordinary income. In 1990, Congress set the maximum marginal tax rate on capital gains at 28 percent, or three percentage points below the maximum marginal rate on ordinary income. Nevertheless, as shown in Figure 1, the average effective tax rate on realized capital gains is currently substantially higher than it has been in the past.

By eliminating the capital gains exclusion and lowering tax rates on ordinary income, the 1986 Act increased the incentives for short-term trading of capital assets. This occurred because the tax rate on long-term capital gains was increased while the tax rate on short-term capital gains was reduced. By providing for a sliding scale exclusion that provides full benefits only for investments held at least three years after a phase-in period, the Budget proposal would increase the incentive for longer term investing.

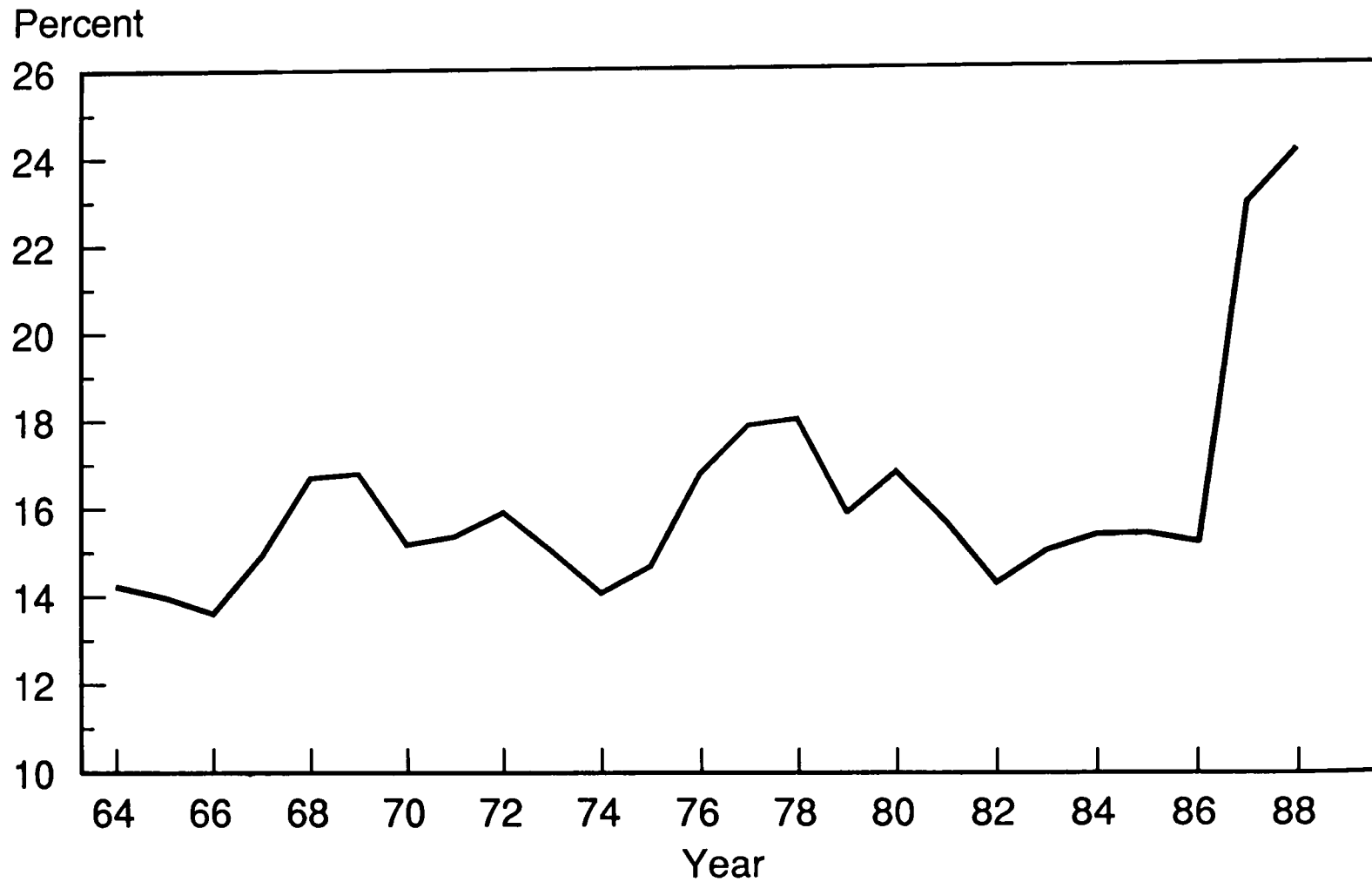
The Cost of Capital and International Competitiveness. The capital gains tax is an important component of the cost of capital, which measures the pre-tax rate of return required to induce businesses to undertake new investment. Evidence suggests that the cost of capital in the United States is higher than in many other industrial nations. While not solely responsible for the higher cost of capital, high capital gains tax rates hurt the ability of U.S. firms to obtain the capital needed to remain competitive. By reducing the cost of capital, a reduction in the capital gains tax rate would stimulate productive investment and create new jobs and growth.

Our major trading partners already recognize the economic importance of low tax rates on capital gains. Virtually all other major industrial nations provide much lower tax rates on capital gains or do not tax capital gains at all. Canada, France, Germany, Japan, the Netherlands, and the United Kingdom, among others, all treat capital gains preferentially.

The Lock-In Effect. Under a tax system in which capital gains are not taxed until realized by the taxpayer, a substantial tax on capital gains tends to lock taxpayers into their existing investments. Many taxpayers who would otherwise prefer to sell their assets to acquire new and better investments may instead continue to hold onto the assets rather than pay the current high capital gains tax on their accrued gains.

This lock-in effect of capital gains taxation has three adverse effects. First, it produces a misallocation of the nation's capital stock and entrepreneurial talent because it distorts the investment decisions that would be made in the absence of the capital gains tax. For example, the lock-in effect reduces the ability of entrepreneurs to withdraw from an enterprise and use the funds to start new ventures. Productivity in the economy suffers because entrepreneurs are less likely to move capital to where it can be most productive, and because capital may be used in a less productive fashion than if it were transferred to other, more efficient, enterprises. These effects can be especially critical for smaller firms which may not have good access to capital markets and where ownership and operation frequently go together. Second, the lock-in effect produces distortions in the investment portfolios of individual taxpayers. For example, some individual investors may be induced to

# FIGURE 1. AVERAGE EFFECTIVE TAX RATE ON CAPITAL GAINS 1964-1988



Department of the Treasury  
Office of Tax Analysis  
January 1991

assume more risk or hold a different mix of assets than they desire because they are reluctant to sell appreciated investments to diversify their portfolios. Third, the lock-in effect reduces government receipts. To the extent that taxpayers defer sales of existing investments, or hold onto investments until death, taxes that might otherwise have been paid are deferred or avoided altogether. Therefore, individual investors, the government, and other taxpayers lose from the lock-in effect. The investor is discouraged from pursuing more attractive investments and the government loses revenue.

Substantial evidence from more than a dozen studies demonstrates that high capital gains tax rates in previous years produced significant lock-in effects. The importance of the lock-in effect may also be demonstrated by the fact that realized capital gains were 16 percent lower under the high tax rates in 1987 than under the lower rates in 1985, even though stock prices had risen by approximately 50 percent over this period. The high tax rates on capital gains under current law imply that the lock-in effect is greater than at any prior time.

Penalty on High-Risk Investments. Full taxation of capital gains, in combination with limited deductibility of capital losses, discourages risk taking. It therefore impedes investment in emerging high-technology and other high-risk firms. While many investors are willing to take risks in anticipation of an adequate return, fewer are willing to contribute "venture capital" if a significant fraction of the increased reward will be used merely to satisfy higher tax liabilities. A tax system that imposes a high tax rate on gains from the investment reduces the attractiveness of risky investments, and may result in many worthwhile projects not being undertaken.

In particular, it is inherently more risky to start new firms and invest in new products and processes than to make incremental investments in existing firms and products. It is therefore the most dynamic and innovative firms and entrepreneurs that are the most disadvantaged by high capital gain tax rates that penalize risk taking. Such firms have traditionally been contributors to America's edge in international competition and have provided an important source of new jobs.

Double Tax on Corporate Stock Investment. Under the U.S. income tax system, income earned on investments in corporate stock is generally subjected to two layers of tax. Income on corporate investments is taxed first at the corporate level at a rate of 34 percent. Corporate income is taxed a second time at the individual level in the form of taxes on capital gains and dividends at rates ranging from 15 to 31 percent. The combination of corporate and individual income taxes thus can produce effective tax rates that are substantially greater than individual income tax rates alone. To the extent the return to the investor is obtained through appreciation in the value of the stock (rather than through dividend income), a reduction in capital gains tax rates provides a form of relief from this double taxation of corporate income. While a lower capital gains tax rate reduces the cost of capital for both corporate and noncorporate business, the greater liquidity of shares in publicly-traded companies suggests that the overall effect would be to reduce the bias towards noncorporate business that results from our dual-level tax system.

## Description of Proposal

General Rule. The capital gains tax rate would be reduced by means of a sliding-scale exclusion. Individuals would be allowed to exclude a percentage of the capital gain realized upon the disposition of qualified capital assets, and would apply their current marginal rate on capital gains (either 15 or 28 percent) to the reduced amount of taxable gain. The amount of the exclusion would depend on the holding period of the assets. Assets held three years or more would qualify for an exclusion of 30 percent. Assets held at least two years but less than three years would qualify for a 20 percent exclusion. Assets held at least one year but less than two years would qualify for a 10 percent exclusion. For example, individuals subject to a 28 percent tax on capital gain (i.e., taxpayers in the 28 and 31 percent tax brackets for ordinary income) would pay rates of 25.2, 22.4, and 19.6 percent for assets held one, two, or three years, respectively. The corresponding figures for individuals subject to a 15 percent rate would be 13.5, 12.0, and 10.5 percent.

Qualified assets would generally be defined as any assets qualifying as capital assets under current law and satisfying the holding period requirements, except for collectibles. Collectibles are assets such as works of art, antiques, precious metals, gems, alcoholic beverages, and stamps and coins. Assets eligible for the exclusion would include, for example, corporate stock, manufacturing and farm equipment, a home, an apartment building, a stand of timber, or a family farm.

Phase-in Rules and Effective Dates. The proposal would be effective generally for dispositions of qualified assets after the date of enactment. For the balance of 1991, the full 30 percent exclusion would apply to assets held at least one year. For dispositions of assets in 1992, assets would be required to have been held for two years or more to be eligible for the 30 percent exclusion, and at least one year but less than two years to be eligible for the 20 percent exclusion. For dispositions of assets in 1993 and thereafter, assets would be required to have been held at least three years to be eligible for the 30 percent exclusion, at least two years but less than three years for the 20 percent exclusion and at least one year but less than two years for the 10 percent exclusion.

Additional Provisions. In order to prevent taxpayers from benefitting from the exclusion provision for depreciation deductions that have already been claimed in prior years, the depreciation recapture rules would be expanded to recapture all prior depreciation deductions. All taxpayers would be able to benefit from the proposed exclusion to the extent that a depreciable asset has increased in value above its unadjusted basis. The excluded portion of capital gains would be added back when calculating income under the alternative minimum tax, however, the special rule relating to contributions of tangible personal property in 1991 would not be modified. Installment sale payments received after the effective date will be eligible for the exclusion without regard to the date the sale actually took place. For purposes of the investment interest limitation, only the net capital gain after subtracting the excluded amount would be included in investment income. The 28 percent limitation on capital gains not eligible for the exclusions would be retained.

## Examples of the Effects of Proposal

Example A. Taxpayer A is a single individual earning \$16,000 whose mutual fund investments have a reported long-term capital gain of \$500 in late 1991.

Under current law, her tax on the \$500 capital gain would be 15 percent of the full \$500 gain, or \$75.

Under the proposal, her tax would be reduced to \$52.50, which is 15 percent of \$350 (\$500 less the 30 percent exclusion).

Example B. Example B is a two-earner couple with combined taxable income other than capital gains of \$40,000. In 1993, they sell corporate stock realizing a \$1,500 capital gain on stock held 15 months and a \$2,500 capital gain on stock held 5 years.

Under current law both gains would be subject to taxation at a tax rate of 28 percent. Tax on the \$1,500 gain would be \$420, and tax on the \$2,500 gain would be \$700, for a combined tax of \$1,120.

Under the proposal, the gain from the sale of stock held 15 months would be eligible for a 10 percent exclusion and the gain on the stock held 5 years would be eligible for a 30 percent exclusion. The tax on the stock held 15 months would be \$378 and the tax on the stock held 5 years would be \$490, for a combined tax of \$868, which would be 22 percent lower than their liability under current law.

Example C. Taxpayer C is the founder of a five year old computer software company who would like to sell the company in order to start a new company making a new product. Taxpayer C has a salary of \$380,000 and \$20,000 in dividend and interest income. Taxpayer C sells the stock in the computer software company for \$2 million, resulting in a capital gain of \$1.8 million after deduction of his \$200,000 cost basis.

Under current law, Taxpayer C would pay a capital gains tax of about \$523,840 (depending on the level and composition of his itemized deductions), leaving him with net proceeds of \$1,476,160 from the sale of the company.

Under the proposal, the capital gains tax, including the alternative minimum tax, would be about \$427,915 (again, depending on the level and composition of his itemized deductions). The net proceeds from selling the company would now be about \$1,572,085. Thus, Taxpayer C would have about \$95,925 of additional funds that could be invested in the new business.

## Revenue Estimates

Capital gains realizations are highly responsive to changes in stock prices and general economic conditions as well as to capital gains tax rates. Furthermore, taxpayers may adjust their purchases and sales of capital assets and their other income sources and deductions in response to new tax rules. Since 1978, Treasury revenue estimates of capital gains have taken into account expected changes in taxpayer behavior.

These behavioral effects are the subject of continued empirical research. Treasury's Office of Tax Analysis (OTA) incorporates all effects believed to be important and presents its best estimate of the expected effects. The proposal is expected to increase Treasury receipts as compared to current law receipts due to increased realizations. The revenue estimates noted below assume a February 15, 1991 effective date. The increase in revenues is expected to be greatest in fiscal year 1992, due to the unlocking of existing capital gains, and smaller thereafter. The expected changes in revenues are modest in comparison to the magnitude of the expected total amount of revenues from the capital gains tax (in excess of \$40 billion per year).

### Details of Revenue Estimates

The details of the revenue estimates are shown in Table 1. Line I of Table 1 shows the revenue loss that results from a flat 30 percent exclusion on the amount of capital gains that would be realized at current law tax rates; *i.e.*, "baseline" realizations that would have occurred without a change in tax rates. This loss is what a "static" revenue estimate for a 30 percent exclusion would show. This "static" revenue loss is estimated to be \$11.3 billion in fiscal year 1992, gradually increasing to about \$18 billion by 1996.

Line II of Table 1 shows the estimated revenue from additional realizations that would be induced by a flat 30 percent exclusion. These induced gains arise from several sources. They represent realizations accelerated from future years, realizations due to portfolio shifting, or realizations that would otherwise have been tax-exempt because they would have been held until death, donated to charity, or not reported. As indicated by a comparison of line I and II, revenues from induced realizations are estimated to be sufficient to offset the static revenue loss on current gains for several years, but not in the long run. This conclusion is based on Treasury's analysis of the findings of numerous statistical studies of the responsiveness of capital gains to lower tax rates, and is consistent with the revenue experience of previous capital gains tax rate changes.

Line III shows the revenue effects of limiting the exclusion to 20 percent for assets held two years and 10 percent for assets held one year, and the phase-in of these holding period limitations. The estimates reflect a reduction in static revenue losses, the effects of induced realizations, and the effects of deferring realizations of assets not yet qualifying for the full 30 percent exclusion. These provisions, which are aimed at promoting a longer-term investment horizon, produce revenue gains in the long run, although a small net revenue loss over the budget period.

TABLE 1

REVENUE EFFECTS OF THE PRESIDENT'S CAPITAL GAINS PROPOSAL

Item	Fiscal Year (\$ Billions)						1991-96
	1991	1992	1993	1994	1995	1996	
I. Static effect of 30% exclusion	-1.7	-11.3	-13.0	-14.6	-16.2	-18.0	-74.7
II. Effect of taxpayer behavior 1/	2.3	14.9	15.1	14.7	15.1	16.3	78.3
III. Effect of the 3-year holding period	0.0	-0.1	-0.8	-0.8	0.3	0.3	-1.1
IV. Effect of full depreciation recapture	0.0	-0.2	0.4	1.0	1.5	1.7	4.2
V. Effect of treating excluded gains as a preference item for AMT purposes	-0.1	-0.5	0.1	0.8	1.2	1.4	2.7
VI. Effective date of proposal 2/	0.0	0.3	0.0	0.0	0.0	0.0	0.3
VII. Total revenue effect of proposal	0.4	3.0	1.7	0.9	1.8	1.7	9.5

Department of the Treasury  
Office of Tax Analysis

January, 1991

Note: Details may not add to total due to rounding.

1/ This line reflects an estimate of the net effect of an increase in budget receipts attributable to taxpayer decisions to realize more capital gains, and a decrease in receipts resulting from conversion of ordinary income into capital gains and deferral of short-term gains as a result of lower tax rates.

2/ Lines I-V reflect January 1, 1991 effective date. Line VI represents an adjustment to these lines to reflect an assumed effective date of February 15, 1991.

Lines IV and V show the revenue effects of expanded depreciation recapture and treating excluded capital gains as a preference item for purposes of the alternative minimum tax. These two provisions are critical to turning the proposal from one that would otherwise probably lose revenue in the long run to one that is revenue-raising even beyond the budget period. Over the budget period, these two provisions raise \$6.9 billion in revenue. The full depreciation recapture proposal means that if a depreciable asset is sold, the exclusion will apply only to the amount by which the current selling price is higher than the original cost. Treating excluded gains as a preference item for purposes of the alternative minimum tax primarily affects high-income individuals and raises \$2.7 billion over the budget period. Line VI shows the revenue effect of making the effective date of the proposal February 15, 1991.

The total revenue effect of the proposal is shown in line VII. The proposal is expected to raise revenue in every year and \$9.5 billion over the budget period. Treasury's estimates indicate that the Administration proposal would produce increased revenues not only throughout the budget period, but for the foreseeable future.\*

These estimates do not include the effects of potential increases in long-run economic growth expected from a lower capital gains tax rate. This conforms to the standard budget and revenue estimating practice of assuming that the macroeconomic effects of revenue and spending proposals are already included in the economic forecast.

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\* Because the methodological differences between OTA, Congressional estimators, and outside experts have not yet been resolved, the Budget reflects the deficit impact of the Administration's Pay-As-You-Go proposals with the Administration's estimates and with a zero (neutral) entry for capital gains rate reduction (see Table II-8, Part One, p. 18, of the Budget of the U.S. Government, Fiscal Year 1992).



## FAMILY SAVINGS ACCOUNTS

### Current Law

Taxation of Investment Income and Saving. Investment income earned by an individual taxpayer is generally subject to tax. The funds saved out of each year's income, which are used to make additional deposits to savings or other investment accounts, additional purchases of stocks or bonds, or to acquire other investments, are generally not deductible in calculating taxable income. The major exception is the tax treatment of retirement savings under certain tax-favored retirement savings arrangements, contributions to which are generally deductible and investment earnings of which are generally excludable from gross income. These investments are generally taxed when the amounts contributed and earned are later distributed.

Individual Retirement Accounts. The current law for Individual Retirement Accounts (IRAs) generally grants married taxpayers who do not participate in a qualified retirement plan or who have adjusted gross incomes (AGI) below \$50,000 the right to make deductible contributions to an IRA. There is a lower income threshold of \$35,000 if the taxpayer is unmarried. The deductibility of contributions for taxpayers participating in a qualified retirement plan is phased out as their AGI increases from \$10,000 below the income threshold up to the threshold. Taxpayers who do participate in a qualified retirement plan and who have adjusted gross incomes above these thresholds may make only nondeductible contributions to an IRA. Both deductible and nondeductible IRA contributions are limited to the lesser of \$2,000 or the individual's compensation for the year.

Married individuals who both work and otherwise qualify may each contribute to an IRA, so if each spouse has compensation of \$2,000 or more, each may contribute \$2,000. If only one spouse works, qualifying married individuals also have the opportunity to contribute an additional \$250 to an IRA for the nonworking spouse. The limit on deductible contributions to the IRA of a nonworking spouse is proportionately reduced for adjusted gross incomes in the applicable phase-out ranges.

Withdrawals from an IRA prior to age 59-1/2 are generally subject to a 10 percent additional tax. Except for distributions of amounts which were not deductible when contributed, IRA withdrawals are subject to regular income tax, and withdrawals must begin by age 70-1/2.

In economic terms, deductible IRAs effectively exempt investment income from taxation. (The income tax imposed on withdrawals merely recaptures the tax saved from deducting the contribution, plus interest on that tax savings; the investment income itself is effectively exempt from tax.) This favorable tax treatment provides an incentive to save; IRAs are designed to provide this incentive specifically for retirement savings. The tax exemption of investment income is also a feature of section 401(k) and other tax-qualified retirement arrangements. Nondeductible IRAs allow only a deferral of taxes on investment income, not an exemption.

## Reasons For Change

There is general concern that the rate of national saving and investment is too low relative to that needed to sustain future growth and to maintain our relative economic position in comparison with the performance of other industrial nations. Addressing this problem requires that both public dissaving (the budget deficit) be reduced, and that private saving be increased. Incentives provided by the proposed Family Savings Accounts will provide an important incentive to encourage private saving.

The availability of savings accounts in the form of IRAs was sharply curtailed by the Tax Reform Act of 1986, which resulted in a large decline in IRA participation. Prior to the Act, any individual under the age of 70-1/2 could make deductible contributions, up to the current limits, to an IRA. One of the goals of the current proposal is to expand the availability and attractiveness of tax-exempt saving to a large segment of the population.

An additional goal of the current proposal is to expand savings incentives to income that is saved for other than retirement purposes, while not eroding incentives for retirement saving. The proposal recognizes that individuals save for many reasons: for down-payments on homes, for educational expenses, for large medical expenses, and as a hedge against uncertain income in the future.

## Description of Proposal

The Family Savings Account (FSA) differs from a deductible current-law IRA in two respects: the contributions are not deductible, but if the account is maintained for at least seven years, neither the contributions nor the investment earnings are taxed when withdrawn. As in the case of IRAs, the economic effect of an FSA is to exempt investment income from taxation. The proposal would allow individuals (other than dependents) to make nondeductible contributions to an FSA up to the lesser of \$2,500 or the individual's compensation for the year. Contributions would be allowed for single filers with adjusted gross income (AGI) no more than \$60,000, for heads of households with AGI no more than \$100,000, and for married taxpayers filing joint returns with AGI no more than \$120,000. Contributions to FSAs would be allowed in addition to contributions to current-law qualified pension plans, IRAs, 401(k) plans, and other tax-favored forms of saving.

Earnings on contributions retained in the FSA for at least seven years would be eligible for full tax exemption upon withdrawal. However, withdrawals of earnings allocable to contributions retained in the FSA for less than three years would be subject to both a 10 percent additional tax and regular income tax. Withdrawals of earnings allocable to contributions retained in the FSA for three to seven years would be subject only to regular income tax. The proposal would be effective for years beginning on or after January 1, 1991.

Effects of Proposal

The proposal would increase the total amount of individual saving that can earn tax-free investment income. Generally, individuals would be able to contribute to FSAs, IRAs, 401(k) plans, and similar tax-favored plans, and would receive tax exemption on the investment income from each source.

The ability to contribute to an FSA would significantly raise the total amount of allowable contributions to tax-favored savings accounts. The contribution limit is \$5,000 for joint return filers as compared to the \$4,000 IRA limit for a working couple. These higher total contribution limits for FSAs will provide additional marginal incentives for personal saving. The higher eligibility limits on FSAs also expand the incentives to more taxpayers.

Despite the difference in structure, the value of the tax benefits in present value of an FSA per dollar of contribution is equivalent in terms of its tax treatment to the value of current-law deductible IRAs, assuming that tax rates are constant over time. Both FSAs and deductible IRAs effectively exempt all investment income from tax. The contributions to FSAs are not deductible, but the income tax imposed on withdrawals from an IRA effectively offsets the tax savings from the deduction of the contribution (plus interest on the tax savings). Individuals who expect higher tax rates when the funds are withdrawn would generally prefer the tax treatment offered in an FSA to that in an IRA. Conversely, individuals who expect lower future tax rates would generally prefer an IRA as a vehicle for retirement savings. However, the FSA offers more flexibility, because full tax benefits are available seven years after contribution and the account need not be held until retirement. This gives individuals an added degree of liquidity.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
Family savings accounts:	-*	-.3	-.8	-1.3	-1.8	-2.3	-6.5

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\* Revenue loss of less than \$50 million.

## **PENALTY-FREE IRA WITHDRAWALS FOR FIRST-TIME HOME BUYERS**

### Current Law

Married taxpayers who do not participate in a qualified retirement plan or who have adjusted gross incomes below \$50,000 generally may make deductible contributions to an Individual Retirement Account (IRA). There is a lower threshold of \$35,000 for unmarried taxpayers. The deductibility of contributions for taxpayers participating in a qualified retirement plan is phased out over the last \$10,000 below the income threshold for each income tax filing status. Taxpayers who do participate in a qualified retirement plan and who have adjusted gross incomes above these thresholds may make only nondeductible contributions to an IRA. Both deductible and nondeductible IRA contributions are limited to the lesser of \$2,000 or the individual's compensation for the year. Married individuals generally may contribute an additional \$250 to an IRA for a nonworking spouse.

Withdrawals from IRAs must begin by age 70-1/2. IRA withdrawals, except those from nondeductible contributions, are subject to income tax. In general, withdrawals from an IRA prior to age 59-1/2 are subject to a 10 percent additional tax.

### Reasons For Change

The intent of this proposal is to expand savings incentives to income that is saved for first-time home purchases. Increased flexibility of IRAs would help to alleviate the difficulties that many individuals have in purchasing a new home.

The attractiveness and eligibility of IRAs for many taxpayers was sharply curtailed by the Tax Reform Act of 1986. This resulted in a large decline in IRA participation. Prior to the 1986 Act, any individual under the age of 70-1/2 could make deductible contributions, up to the current limits, to an IRA. The current proposal is designed to enhance the attractiveness of deductible IRAs by making them more flexible. This increased flexibility would provide an incentive for more taxpayers to save for the purchase of their first home.

### Description of Proposal

The proposal would allow individuals to withdraw amounts of up to \$10,000 from their IRAs for a "first-time" home purchase. The 10 percent additional tax on early withdrawals would be waived for eligible individuals. Eligibility for penalty-free withdrawals would be limited to individuals who did not own a home in the last three years and are purchasing or constructing a principal residence that costs no more than 110 percent of the median home price in the area where the residence is located. The proposal would be effective for years beginning on or after January 1, 1991.

Effects of Proposal

This proposal will help encourage individuals to save for the purchase of a first home.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
Penalty-free IRA withdrawals for first time home buyers:	-*	.1	-.1	-.1	.1	-.1	-.4

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-\* Revenue loss of less than \$50 million.

## PERMANENT RESEARCH AND EXPERIMENTATION TAX CREDIT

### Current Law

Present law allows a 20 percent tax credit for a certain portion of a taxpayer's "qualified research expenses." The portion of qualified research expenses that is eligible for the credit is the increase in the current year's qualified research expenses over its base amount for that year. The base amount for the current year is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. A taxpayer's fixed-base percentage generally is the ratio of its total qualified research expenses for the 1984-88 period to its total gross receipts for this period. Special rules for start-up companies provide a fixed-base percentage of 3 percent. In no event will a taxpayer's fixed-base percentage exceed 16 percent. A taxpayer's base amount may not be less than 50 percent of its qualified research expenditures for the current year.

In general, qualified expenditures consist of (1) "in-house" expenditures for wages and supplies used in research; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) certain time-sharing costs for computers used in research. Restrictions further limit the credit to expenditures for research that is technological in nature and that will be useful in developing a new or improved business component. In addition, certain research is specifically excluded from the credit, including research performed outside the United States, research relating to style, taste, cosmetic, or seasonal design factors, research conducted after the beginning of commercial production, research in the social sciences, arts, or humanities, and research funded by persons other than the taxpayer.

The credit is available only for research expenditures paid or incurred in carrying on a trade or business of the taxpayer. A taxpayer is treated as meeting the trade or business requirement with respect to in-house research expenses if, at the time such in-house research expenses are incurred, the principal purpose of the taxpayer in making such expenditures is to use the results of the research in the active conduct of a future trade or business of the taxpayer or certain related taxpayers.

Present law also provides a separate 20 percent tax credit ("the university basic research credit") for corporate funding of basic research through grants to universities and other qualified organizations performing basic research. The university basic research credit is measured by the increase in spending from certain prior years. This basic research credit applies to the excess of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research over (2) the sum of a fixed research floor plus an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period (adjusted for inflation). A grant is tested first to see if it constitutes a basic research payment; if not, it may be tested as a qualified research expenditure under the general R&E credit.

The R&E credit is aggregated with certain other business credits and made subject to a limitation based on tax liability. The sum of these credits may reduce the first \$25,000 of regular tax liability without limitation, but may offset only 75 percent of any additional tax liability. Taxpayers may carry credits not usable in the current year back three years and forward 15 years.

The amount of any deduction for research expenses is reduced by the amount of the tax credit taken for that year.

The R&E credit in the form described above is in effect for taxable years beginning after December 31, 1989. However, the credit will not apply to amounts paid or incurred after December 31, 1991.

### Reasons for Change

The current law tax credit for research provides an incentive for technological innovation. Although the benefit to the country from such innovation is unquestioned, the market rewards to those who take the risk of research and experimentation may not be sufficient to support the level of research activity that is socially desirable. The credit is intended to reward those engaged in research and experimentation of unproven technologies.

The credit cannot induce additional R&E expenditures unless its future availability is known at the time firms are planning R&E projects and projecting costs. R&E activity, by its nature, is long-term, and taxpayers should be able to plan their research activity knowing that the credit will be available when the research is actually undertaken. Thus, if the R&E credit is to have the intended incentive effect, it should be made permanent.

### Description of Proposal

The R&E credit would be made permanent.

### Effects of Proposal

Stable tax laws that encourage research allow taxpayers to undertake research with greater assurance of the future tax consequences. A permanent R&E credit (including the university basic research credit) permits taxpayers to establish and expand research activities without fear that the tax incentive would not be available when the research is carried out.

### Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
Permanent R&E tax credit:	0	-0.5	-1.0	-1.3	-1.6	-1.8	-6.2

## RESEARCH AND EXPERIMENTATION EXPENSE ALLOCATION RULES

### Current Law

The tax credit allowed for payments of foreign tax is limited to the amount of U.S. tax otherwise payable on the taxpayer's income from foreign sources. The purpose of this limitation is to prevent the foreign tax credit from offsetting U.S. tax imposed on income from U.S. sources. Accordingly, a taxpayer claiming a foreign tax credit is required to determine whether income arises from U.S. or foreign sources and to allocate expenses between such U.S. and foreign source income.

Under the above limitation rules, an increase in the portion of a taxpayer's income determined to be from foreign sources will increase the allowable foreign tax credit. Therefore, taxpayers generally receive greater foreign tax credit benefits to the extent that their expenses are applied against U.S. source income rather than foreign source income.

Treasury regulations issued in 1977 described methods for allocating expenses between U.S. and foreign source income. Those regulations contained specific rules for the allocation of research and experimentation (R&E) expenditures, which generally required a certain portion of R&E expense to be allocated to foreign source income. Absent such rules, a full allocation of R&E expense to U.S. source income would overstate foreign source income, thus allowing the foreign tax credit to apply against U.S. tax imposed on U.S. source income and thwarting the limitation on the foreign tax credit.

Since 1981 these R&E allocation regulations have been subject to seven different suspensions and temporary modifications by Congress. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) adopted allocation rules which were in effect for only four months. For 20 months following the period when the TAMRA rules were in effect, R&E allocation was controlled by the 1977 Treasury regulations. The Budget Reconciliation Act of 1989 subsequently reintroduced the TAMRA rules, once again on a temporary basis. These rules were extended to taxable years beginning on or before August 1, 1991 by the Omnibus Budget Reconciliation Act of 1990.

Under the R&E allocation rules enacted by TAMRA (and temporarily recodified in 1989 and 1990), a taxpayer must allocate 64 percent of R&E expenses for research conducted in the United States to U.S. source income and 64 percent of foreign-performed R&E to foreign source income. The remaining portion can be allocated on the basis of the taxpayer's gross sales or gross income. However, the amount allocated to foreign source income on the basis of gross income must be at least 30 percent of the amount allocated to foreign source income on the basis of gross sales.



## Reasons for Change

As evidenced by its continued support for a R&E credit, the Administration believes in the provision of tax incentives to increase the performance of U.S.-based research activities. The allocation rules in this proposal provide such an incentive. Although the proposal benefits only multinational corporations that are subject to the foreign tax credit limitation, it will provide an effective incentive with respect to such entities. By enhancing the return on R&E expenditures, the proposal promotes the growth of overall R&E activity as well as encouraging the location of such research within the United States.

## Description of Proposal

The proposal would extend for one year the R&E allocation rules that were first enacted by TAMRA and were re-enacted on a temporary basis in 1989 and 1990. The proposal would be effective for all taxable years beginning after August 1, 1991 and ending on or before August 1, 1992.

## Effects of Proposal

Under the proposal, the automatic allocation of 64 percent of U.S.-performed R&E to U.S. source income generally permits a greater amount of income to be classified as foreign source than the rules applicable under the 1977 regulations. As discussed above, this will increase the benefits of the foreign tax credit for many taxpayers.

The operation of these rules is best illustrated through an example. Assume that an unaffiliated U.S. taxpayer has \$100 of expense from research performed in the United States, that 50 percent of relevant gross sales produce foreign source income, and that 30 percent of the taxpayer's gross income is from foreign sources. Subject to certain limitations not applicable to these facts, the 1977 regulations would have required the taxpayer to allocate at least \$30 of R&E expense to foreign source income ( $\$100 \times 30\%$  gross income from foreign sources).

Under the proposal \$64 is automatically allocated to U.S. source income based on the place of performance ( $\$100 \times 64\%$ ). The remaining \$36 may be allocated either on the basis of gross sales or on the basis of gross income (subject to the limitation described below). A gross sales apportionment of the remainder would result in \$18 ( $\$36 \times 50\%$ ) being allocated to foreign source income, while a gross income apportionment would result in \$10.80 ( $\$36 \times 30\%$ ) being allocated to foreign source income.

The amount allocated to foreign source income using the gross income method must be at least 30 percent of the amount so allocated using the gross sales method. That limitation will not affect the result here since the \$10.80 apportioned to foreign source income under the gross income method is greater than \$5.40 ( $\$18$  apportioned under gross sales  $\times 30\%$  limitation).

As a result of the allocation rules in the proposal, the taxpayer in this example must allocate at least \$10.80 of U.S.-performed R&E expense to foreign source income, compared to the \$30 required to be so allocated under the 1977 regulations.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
One year extension of R&E expense allocations:	0	.3	-.3	0	0	0	-.6

## ENTERPRISE ZONE TAX INCENTIVES

### Current Law

Existing Federal tax incentives generally are not targeted to benefit specific geographic areas. Although the Federal tax law contains incentives that may encourage economic development in targeted economically distressed areas, the provisions generally are not limited to use with respect to such areas.

Among the existing general Federal tax incentives that aid economically distressed areas is the targeted jobs tax credit. This credit provides an incentive for employers to hire economically disadvantaged workers and often is available to firms located in economically distressed areas. A Federal tax credit also is allowed for certain investment in low-income housing or the rehabilitation of certain structures that may be located in economically distressed areas. Another Federal tax incentive permits the deferral of capital gains taxation upon certain transfers of low-income housing. In addition, tax-exempt state and local government bonds may be used to finance certain activities conducted in economically distressed areas.

### Reasons for Change

To help economically distressed areas share in the benefits of economic growth, the Administration proposes to designate Federal enterprise zones which will benefit from targeted tax incentives and regulatory relief. The tax incentives and regulatory relief provided by this proposal will stimulate government and private sector revitalization of the areas.

### Description of Proposal

The proposed enterprise zone initiative would include selected Federal income tax employment and investment incentives. These incentives will be offered in conjunction with Federal, state, and local regulatory relief. Up to 50 zones will be selected over a four-year period.

The incentives are: (i) a 5 percent refundable tax credit for qualified employees with respect to their first \$10,500 of wages earned in an enterprise zone (up to \$525 per worker, with the credit phasing out when the worker earns between \$20,000 and \$25,000 of total annual wages); (ii) elimination of capital gains taxes for tangible property used in an enterprise zone business and located within an enterprise zone for at least two years; and (iii) expensing by individuals of contributions to the capital of corporations engaged in the conduct of enterprise zone businesses (provided the corporation has less than \$5 million of total assets and uses the contributions to acquire tangible assets located within an enterprise zone, and limiting the expensing to \$50,000 annually per investor with a \$250,000 lifetime limit per investor).

The willingness of states and localities to "match" Federal incentives will be considered in selecting the special enterprise zones to receive these additional Federal incentives.

Effects of Proposal

Enterprise zones would encourage private industry investment and job creation in economically distressed areas by removing regulatory and other barriers inhibiting growth. They would also promote growth through selected tax incentives to reduce the risks and costs of operating or expanding businesses in severely depressed areas. A new era of public/private partnerships is needed to help distressed cities and rural areas help themselves.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
Enterprise zone incentives:	0	-0.1	-0.2	-0.3	-0.5	-0.8	-1.8

## SOLAR AND GEOTHERMAL ENERGY CREDITS

### Current law

A tax credit is allowed for investment in solar or geothermal energy property. The amount of the credit is 10 percent of the investment. Solar property is equipment that uses solar energy to generate electricity or steam or to provide heating, cooling, or hot water in a structure. Geothermal property consists of equipment, such as a turbine or generator, that converts the internal heat of the earth into electrical energy or another form of useful energy. The credits for solar and geothermal property have been scheduled for expiration a number of times in recent years, but have been extended each time. The credits are currently scheduled to expire on December 31, 1991. A number of other energy credits, such as the credits for ocean thermal and wind energy property, have expired in recent years.

### Reasons for Change

The geothermal and solar credits are intended to encourage investment in renewable energy technologies. Increased use of solar and geothermal energy would reduce our nation's reliance on imported oil and other fossil fuels and would improve our long-term energy security. Use of geothermal and solar energy resources also reduces air pollution.

### Description of Proposal

The solar and geothermal credits would be extended through December 31, 1992.

### Revenue Estimate

	Fiscal Years						<u>1991-96</u>
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	
	(Billions of Dollars)						
One year extension of solar and geothermal energy credits:	0	-*	-*	*	*	*	-*

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\* Revenue gain of less than \$50 million.

-\* Revenue loss of less than \$50 million.

## TARGETED JOBS TAX CREDIT

### Current Law

The targeted jobs tax credit (TJTC) is available on an elective basis for hiring individuals from nine targeted groups. The targeted groups are: (1) vocational rehabilitation referrals; (2) economically disadvantaged youths aged 18 through 22; (3) economically disadvantaged Vietnam-era veterans; (4) Supplemental Security Income (SSI) recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students aged 16 through 19; (7) economically disadvantaged former convicts; (8) eligible work incentive employees; and (9) economically disadvantaged summer youth employees aged 16 or 17. Certification of targeted group membership is required as a condition of claiming the credit.

The credit generally is equal to 40 percent of the first \$6,000 of qualified first-year wages paid to a member of a targeted group. Thus, the maximum credit generally is \$2,400 per individual. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 40 percent of up to \$3,000 of wages, for a maximum credit of \$1,200.

The credit is not available for wages paid to a targeted group member unless the individual either (1) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees), or (2) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summer youth employees). Also, the employer's deduction for wages must be reduced by the amount of the credit claimed.

The credit is available with respect to targeted-group individuals who begin work for the employer before January 1, 1992.

### Reasons for Change

The TJTC is intended to encourage employers willing to hire workers who otherwise may be unable to find employment. Job creation incentives are required in the current economic climate.

### Description of Proposal

The TJTC would be extended for one year. The credit would be available with respect to targeted-group individuals who begin work for the employer before January 1, 1992.

Revenue Estimate

	Fiscal Years						<u>1991-96</u>
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	
	(Billions of Dollars)						
One year extension of targeted jobs tax credit:	0	-.1	-.1	-.1	-*	-*	-.3

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-\* Revenue loss of less than \$50 million.

## DEDUCTION FOR SPECIAL NEEDS ADOPTIONS

### Current Law

Expenses associated with the adoption of children are not deductible under current law. However, expenses associated with the adoption of special needs children are reimbursable under the Federal-State Adoption Assistance Program (Title IV-E of the Social Security Act). Special needs children are those who by virtue of special conditions such as age, physical or mental handicap, or combination of circumstances, are difficult to place for adoption. The Adoption Assistance Program includes several components. One of these components requires States to reimburse families for costs associated with the process of adopting special needs children. The Federal Government shares 50 percent of these costs up to a maximum Federal share of \$1,000 per child. Reimbursable expenses include those associated directly with the adoption process such as legal costs, social service review, and transportation costs. Some children are also eligible for continuing Federal-State assistance under Title IV-E of the Social Security Act. This assistance includes Medicaid. Other children may be eligible for continuing assistance under State-only programs.

### Reasons for Change

The Tax Reform Act of 1986 (the 1986 Act) repealed the deduction for adoption expenses associated with special needs children. Under prior law, a deduction of up to \$1,500 of expenses associated with the adoption of special needs children was allowed. The 1986 Act provided for a new outlay program under the existing Adoption Assistance Program to reimburse expenses associated with the adoption process of these children. The group of children covered under the outlay program is somewhat broader than the group covered by the prior deduction. The prior law deduction was available only for special needs children assisted under Federal welfare programs, Aid to Families with Dependent Children, Title IV-E Foster Care, or Supplemental Security Income. The current adoption assistance outlay program provides assistance for adoption expenses for these special needs children, as well as special needs children in private and State-only programs.

Repeal of the special needs adoption deduction may have appeared to some as a lessening of the Federal concern for the adoption of special needs children.

An important purpose of the Adoption Assistance Program is to enable families in modest circumstances to adopt special needs children. In a number of cases the children are in foster care with the prospective adoptive parents. The prospective parents would like to formally adopt the child but find that to do so would impose a financial hardship on the entire family.

While the majority of eligible expenses are expected to be reimbursed under the continuing expenditure program, the Administration is concerned that in some cases the limits may be set below actual cost in high-cost areas or in special circumstances. Moreover, inclusion in the tax code of a deduction for special needs children may alert families who are hoping to adopt a child to the many forms of assistance provided to families adopting a child with special needs.



Description of Proposal

The proposal would permit the deduction from income of expenses incurred that are associated with the adoption of special needs children, up to a maximum of \$3,000 per child. Eligible expenses would be limited to those directly associated with the adoption process that are eligible for reimbursement under the Adoption Assistance Program. These include court costs, legal expenses, social service review, and transportation costs. Only expenses for adopting children defined as eligible under the rules of the Adoption Assistance Program would be allowed. Expenses which were deducted but reimbursed would be included in income in the year in which the reimbursement occurred. The proposal would be effective January 1, 1992.

Effects of Proposal

The proposal when combined with the current outlay program would assure that reasonable expenses associated with the process of adopting a special needs child do not cause financial hardship for the adoptive parents. The proposed deduction would supplement the current Federal outlay program. In addition, the proposal highlights the Administration's concern that adoption of these children be specially encouraged and may call to the attention of families interested in adoption the various programs that help families adopting children with special needs.

There is currently uncertainty regarding whether Federal and State reimbursements are income to the adopting families. The proposal would clarify the treatment of reimbursements by making them includable in income but also deductible, up to \$3,000 of eligible expenses per child. Additionally, qualified expenses up to this limit would be deductible even though not reimbursed.

While the costs of adoption of a special needs child are only a small part of the total costs associated with adoption of these children, the Administration believes that it is important to remove this small one-time cost barrier that might leave any of these children without a permanent family.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
Deduction for special needs adoption:	0	-*	-*	-*	-*	-*	-*

---

\* Revenue loss of less than \$50 million.

## LOW-INCOME HOUSING TAX CREDIT

### Current Law

A tax credit is allowed for certain expenditures with respect to low-income residential rental housing. The low-income housing credit generally may be claimed by owners of qualified low-income buildings in equal annual installments over a 10-year credit period as long as the buildings continue to provide low-income housing over a 15-year compliance period.

In general, the discounted present value of the installments may be as much as 70 percent of eligible expenditures. Eligible expenditures include the depreciable costs of new construction and substantial rehabilitations. They also include the cost of acquiring existing buildings which have been substantially rehabilitated so long as they have not been placed in service within the previous 10 years and are not already subject to a 15-year compliance period. The basis of property is not reduced by the amount of the credit for purposes of depreciation and capital gain.

The annual credit available for a building cannot exceed the amount allocated to the building by the designated State or local housing agency. As originally enacted, the total allocations by the housing agency in a given year could not exceed the product of \$1.25 and the State's population. A State credit allocation is not required, however, for certain projects financed with tax-exempt bonds subject to the State's private activity bond volume limitation.

States could not originally allocate the low-income housing credit after 1989. The Omnibus Budget Reconciliation Act of 1989 extended each State's allocation authority through 1990, but at a reduced annual level of \$0.9375 per state resident. The Omnibus Budget Reconciliation Act of 1990, however, increased the allocation authority for 1990 to \$1.25 per State resident and extended allocation authority through 1991 at the same annual level.

### Reasons for Change

The low-income housing credit encourages the private sector to construct and rehabilitate the nation's rental housing stock and to make it available to the working poor and other low-income families. In addition to tenant-based housing vouchers and certificates, the credit is an important mechanism for providing Federal assistance to rental households.

### Description of Proposal

The proposal would extend the authority of States to allocate the credit through 1992 at an annual level of \$1.25 per State resident.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
One year extension of low-income housing tax credit:	0	-0.1	-0.2	-0.3	-0.3	-0.3	-1.3

## HEALTH INSURANCE DEDUCTION FOR THE SELF-EMPLOYED

### Current Law

Current law generally allows a self-employed individual to deduct as a business expense up to 25 percent of the amount paid during a taxable year for health insurance coverage for himself, his spouse, and his dependents. The deduction is not allowed if the self-employed individual or his or her spouse is eligible for employer-paid health benefits. Originally, this deduction was only available if the insurance was provided under a plan that satisfied the non-discrimination requirements of section 89 of the Code. Section 89 has since been repealed retroactively, however, and no non-discrimination requirements currently apply to such insurance. The value of any coverage provided for such individuals and their families by the business is not deductible for self-employment tax purposes. The deduction is scheduled to expire after December 31, 1991.

### Reasons for Change

The 25 percent deduction for health insurance costs of self-employed individuals was added by the Tax Reform Act of 1986 because of a disparity between the tax treatment of owners of incorporated and unincorporated businesses (e.g., partnerships and sole proprietorships). Under prior law, incorporated businesses could generally deduct, as an employee compensation expense, the full cost of any health insurance coverage provided for their employees (including owners serving as employees) and their employees' spouses and dependents. By contrast, self-employed individuals operating through an unincorporated business could only deduct the cost of health insurance coverage for themselves and their spouses and dependents to the extent that it, together with other allowable medical expenses, exceeded 5 percent of their adjusted gross income. (Coverage provided to employees of the self-employed, however, was and remains a deductible business expense for the self-employed.) The special 25 percent deduction was designed to mitigate this disparity in treatment. Further, the Tax Reform Act of 1986 raised the floor for deductible medical expenses (including health insurance) to 7.5 percent of adjusted gross income.

### Description of Proposal

The proposal would extend the 25 percent deduction through December 31, 1992.

### Effects of Proposal

The proposal will continue to reduce the disparity in tax treatment between self-employed individuals and owners of incorporated businesses, compared to prior law.

Revenue Estimate

	Fiscal Year						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
One year extension of health insurance deduction for the self-employed:	0	-.1	-.2	0	0	0	-.4

## **EXTEND TAX DEADLINES FOR DESERT SHIELD/STORM PARTICIPANTS**

### Current Law

Section 7508 of the Internal Revenue Code generally suspends the time for performing various acts under the internal revenue laws, such as filing tax returns, paying taxes or filing claims for refund of tax, for any individual serving in the Armed Forces of the United States or in support of the Armed Forces in an area designated as a combat zone. The designation of a combat zone must be made by the President of the United States by Executive Order.

The suspension of time provided by section 7508 (prior to its recent amendment, discussed below) covers the period of service in the combat zone, including any period during which the individual is a prisoner of war or missing in action, any period of continuous hospitalization outside the United States as a result of injuries suffered in such service, and the next 180 days thereafter. The spouse of a qualifying individual is generally entitled to the same suspension of time, regardless of whether a joint return is filed. No interest is charged during the suspension period on underpayments of tax, and (prior to the recent amendment, discussed below) no interest is credited during the suspension period on overpayments of tax. Special rules apply if the collection of tax is in jeopardy.

On January 21, 1991, the President signed Executive Order 12744, designating as a combat zone the Persian Gulf, the Red Sea, the Gulf of Oman, a portion of the Arabian Sea, the Gulf of Aden, and the total land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar and the United Arab Emirates. This designation is retroactive to January 17, 1991 (January 16 in the United States), the date specified as the commencement of combatant activities. As a result of this action, qualifying individuals serving in the combat zone will have the benefit of section 7508 beginning on January 17, 1991. Under regulations, members of the Armed Forces serving outside the combat zone in direct support of military operations in the combat zone, under conditions qualifying for compensation under 37 U.S.C. § 310 (relating to duty subject to hostile fire or imminent danger), are also entitled to the benefit of section 7508.

On January 30, 1991, the President signed into law legislation (P.L. 102-2) which amends section 7508 in several respects, effective August 2, 1990. First, it extends the coverage of section 7508 to include individuals serving in the Armed Forces or in support of the Armed Forces in the "Persian Gulf Desert Shield area" (to be designated by Executive Order) at any time during the period beginning August 2, 1990 and ending on the date on which any part of the area is designated by the President as a combat zone. As under current law, relief also extends to spouses of qualifying individuals. Second, the Desert Shield legislation reverses the prior rule in section 7508 regarding interest on overpayments of tax, so that interest is generally credited during the suspension period. Finally, the Desert Shield legislation extends the suspension period to include periods of continuous hospitalization in (as well as outside of) the United States. Not more than five years of hospitalization in the United States can be taken into account for this purpose, however, and hospitalization in the United States is not taken into account in determining the suspension period for the individual's spouse.

Reasons for Change

At the time the proposal was developed, the Persian Gulf area was not a combat zone and the Desert Shield legislation had not been enacted. There was accordingly a need to extend the coverage of section 7508 to individuals participating in the Desert Shield operation, many of whom were sent to the Middle East on short notice with little time to make provision for the filing of tax returns and payment of taxes.

Description of Completed Action

Enactment of the Desert Shield legislation and the promulgation of Executive Order 12744 have implemented the proposal discussed in the Budget.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
Extend tax deadlines for Desert Shield/Storm participants	-*	*	*	0	0	0	-*

\* Revenue gain of less than \$50 million.

-\* Revenue loss of less than \$50 million.

Note: This revenue estimate was prepared prior to the designation of the Persian Gulf area as a combat zone and the enactment of the Desert Shield legislation. Because this proposal is now a feature of current law, the revenue loss is zero, but the baseline receipts forecast must be adjusted by a corresponding amount.

## MEDICARE HOSPITAL INSURANCE (HI) FOR STATE AND LOCAL EMPLOYEES

### Current Law

State and local government employees hired on or after April 1, 1986, are covered by Medicare Hospital Insurance and their wages are subject to the Medicare tax (1.45 percent on both employers and employees). Unless a State or local government had a voluntary agreement with Social Security, employees hired prior to April 1, 1986, are not covered by Medicare Hospital Insurance nor are they subject to the tax.

### Reasons for Change

State and local government employees are the only major group of employees not assured Medicare coverage. One out of six State and local government employees are not covered by voluntary agreements or by law. However, an estimated 85 percent of these employees receive full Medicare benefits through their spouse or because of prior work in covered employment. Over their working lives, they contribute on average only half as much tax as is paid by workers in the private sector. Extending coverage would assure that the remaining 15 percent have access to Medicare and would eliminate the inequity and the drain on the Medicare trust fund caused by those who receive Medicare without contributing fully.

### Description of Proposal

As of January 1, 1992, all State and local government employees would be covered by Medicare Hospital Insurance.

### Effects of Proposal

An additional two million State and local government employees would contribute to Medicare. Of these, roughly 300,000 employees would become newly eligible to receive Medicare benefits subject to satisfying the minimum 40 quarters of covered employment.

### Revenue Estimate\*

	Fiscal Years						<u>1991-96</u>
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	
	(Billions of Dollars)						
Extend Medicare hospital insurance coverage to State and local employees:	0	1.1	1.5	1.5	1.5	1.5	7.3

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\* Net of income tax offset.



## MOTOR FUELS EXCISE TAX

### Current Law

The Omnibus Budget Reconciliation Act of 1990 raised the motor fuels excise tax by 5.1 cents from 9 to 14.1 cents a gallon on motor gasoline and from 15 to 20.1 cents a gallon on diesel fuel. One-tenth of a cent is deposited into the Leaking Underground Storage Tank Trust Fund, and half of the remaining 5 cent increase is deposited into the General Fund. The remaining 2.5 cents are deposited into the Highway Trust Fund. The General Fund and Highway Trust Fund portions of the tax are scheduled to expire at the end of fiscal year 1995.

Current services forecasts incorporate extension of the trust fund portions of the tax at their current rates through the end of the budget period, but provide that the General Fund portion of the tax expires as scheduled at the end of the fiscal year 1995. Thus, the highway portion of the motor fuels excise tax rates in fiscal year 1996 underlying the current services forecasts are 11.5 cents per gallon on gasoline and 17.5 cents per gallon on diesel fuel.

### Reasons for Change

The current motor fuels excise taxes expire at the end of fiscal 1995. While the current services forecasts incorporate extension of the highway portion of the motor fuels tax at their current rates of 11.5 cents for gasoline and 17.5 cents for diesel fuel, the Administration Budget proposal incorporates extension in 1996 at the prior rates of 9 cents for gasoline and 15 cents for diesel fuel. The lower rates in 1996 will be sufficient to finance the Administration's proposed increase in highway and transit programs.

### Description of Proposal

In contrast to the current services forecasts, under the Administration's proposal the portion of the motor fuels excise taxes which is dedicated to the Highway Trust Fund will be extended for fiscal year 1996 at the level of 9 cents per gallon on gasoline and 15 cents per gallon on diesel fuel.

### Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
Limited extension of motor fuels excise taxes:	0	0	0	0	0	-2.7	-2.7

## INCREASE IN IRS FY 1992 ENFORCEMENT FUNDING

### Current Law

The IRS currently allocates substantial resources to direct enforcement of the tax laws. Direct enforcement encompasses activities designed to encourage accurate reporting of taxable income and to assess or collect taxes, penalties, and interest which are owed but not paid. In allocating resources to these activities, the IRS does not simply seek to collect the maximum amount of taxes through direct enforcement activities; the additional objective is to increase tax revenues indirectly by encouraging and enhancing voluntary compliance.

### Reasons for Changes

The IRS has identified a number of enforcement areas in which specific problems exist that could be resolved by the application of additional resources. In addition, the gap between taxes owed and taxes voluntarily paid contributes to the Federal deficit and undermines the system of voluntary compliance.

### Description of Proposal

The proposal calls for additional IRS funding for tax law enforcement, and for the collection of delinquent taxes, penalties, and interest. The specific programs, new budget authority, and estimated FY 1992 receipts are as follows:

- o Examination Field Audit Initiative--An additional 94 staff years are to be applied to income tax audits. Total budget authority for the initiative for FY 1992 is \$6.0 million.
- o Collection of Accounts Receivable--This initiative will apply an additional 671 staff years with total FY 1992 budget authority of \$34.0 million, to the accounts receivable inventory.

### Effects of Proposal

All affected activities are in the area of direct enforcement. Consequently, the proposal should enhance the level of revenue collection, encourage taxpayers to correctly report their income for tax purposes, and expedite the collection of past due taxes.

Revenue Estimate

	Fiscal Years						
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1991-96</u>
	(Billions of Dollars)						
Increase in IRS FY 1992 enforcement funding:	0	*	0.1	0.2	0.2	0.2	0.7

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\* Revenue gain of less than \$50 million.

## MISCELLANEOUS PROPOSALS AFFECTING RECEIPTS

### Description of Proposals

Extend abandoned mine reclamation fees. The abandoned mine reclamation fees, which are scheduled to expire on September 30, 1995, would be extended. Collections from the existing fees of 35 cents per ton for surface mined coal and 15 cents per ton for under ground mined coal are allocated to States for reclamation grants. Extensive abandoned land problems are expected to exist in certain States after all the money from the collection of existing fees is expended.

Improve retail compliance with the special occupation taxes. To increase compliance rates and revenues, wholesalers would be required to ensure that their retail customers pay the special taxes in connection with liquor occupations that are levied on retailers. The proposal would be effective beginning October 1, 1991.

Increase HUD interstate land sales fee. The Interstate Land Sales Full Disclosure Act gives HUD the responsibility of registering certain subdivisions that are sold or leased across state lines. A fee is charged when a developer files a statement of record about the subdivision with HUD. The fee charged cannot exceed \$1,000 for any one developer. The fees collected cover only a portion of administrative costs. The proposal would remove the \$1,000 fee limitation to help fully offset the direct administrative costs of the program.

Amend railroad unemployment insurance (UI) status. Under present law, all railroads, including Amtrak and other public commuter railroads, make experience-rated UI contributions that are based partly on industry-wide unemployment costs and partly on their own line's unemployment costs. To prevent public subsidies from being diverted to pay for the high unemployment cost of the private sector railroads, public commuter railroads were exempt from the full railroad unemployment tax rate in 1990. Instead, they reimbursed the UI trust funds for the actual unemployment and sickness insurance costs of their employees. Under the proposal, Amtrak and other public commuter railroads would reimburse the trust funds for the actual unemployment costs of their employees after January 1, 1991.

Revenue Estimate

	Fiscal Year						<u>1991-1996</u>
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	
	(Billions of Dollars)						
Extend abandoned mine reclamation fees:	0	0	0	0	0	.3	.3
Improve retail compliance with liquor occupation taxes:	0	*	*	*	*	*	.1
Increase HUD interstate land sales fee:	*	*	*	*	*	*	*
Amend railroad UI status:	-*	*	*	*	-*	-*	*

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\* Revenue gain of less than \$50 million.

-\* Revenue loss of less than \$50 million.

**Department of the Treasury**  
**Washington, D.C. 20220**

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# TREASURY NEWS



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TESTIMONY OF SIDNEY L. JONES  
DEPT. OF THE TREASURY  
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY  
OF THE HOUSE BANKING COMMITTEE  
U.S. HOUSE OF REPRESENTATIVES  
FEBRUARY 5, 1991

Mr. Chairman and Members of the Committee, I am pleased to meet with you to discuss the general economic outlook. My comments will concentrate on reviewing current economic conditions and the Administration's economic forecasts published in the President's FY 1992 budget.

## CURRENT ECONOMIC CONDITIONS

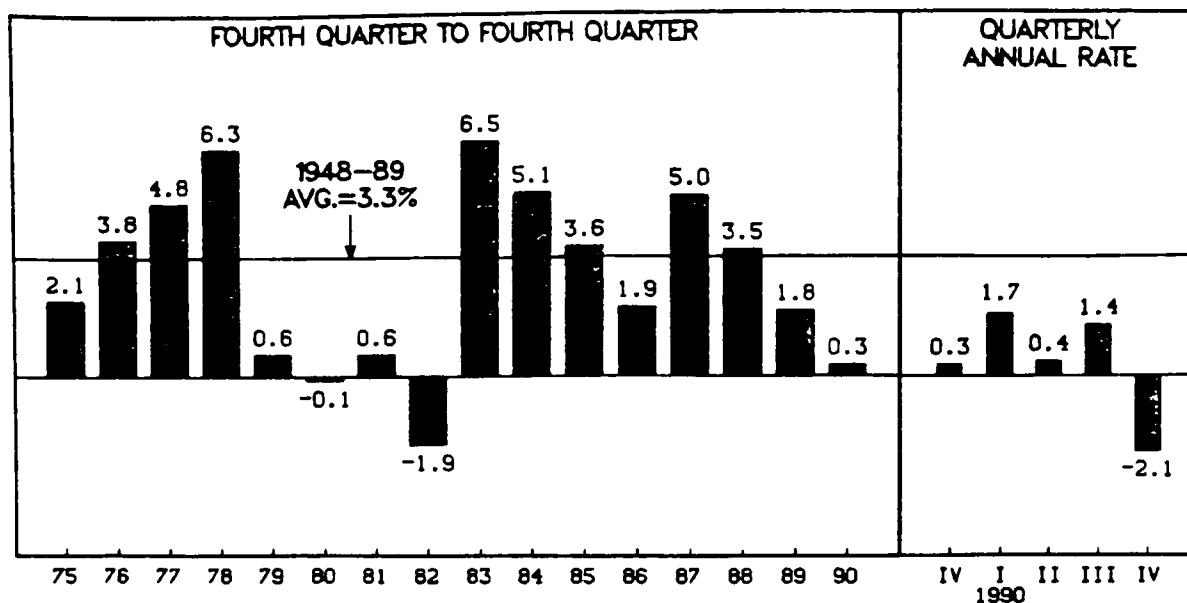
During the 1980s, rapid changes occurred throughout the world economy leading to structural reforms in Western and Eastern Europe and the continued emergence of new economic forces in the Pacific Basin and Latin America. In the United States, the cyclical expansion that began in November 1982 created almost eight years of sustained economic growth, relatively stable inflation, and the addition of more than 20 million jobs. The U.S. economy grew at an average rate of 3.6 percent from the fourth quarter of 1982 through the third quarter of 1990, a record peacetime expansion. This sustained growth is even more impressive when compared with the stagflation that preceded it -- a combination of sluggish economic activity, double-digit inflation rates, chronic unemployment problems, and unusually high interest rates.

From early-1989 through the third quarter of 1990, however, the pace of economic activity in the United States slowed to an average annual real GNP growth rate of 1.2 percent. During the last three months of 1990 the real output of goods and services declined at a 2.1 percent annual rate according to the preliminary GNP figures. The negative fourth quarter estimate reduced the 1990 annual growth rate to only 0.3 percent from the 1.8 percent pace reported during 1989. The GNP price deflator rose 4.0 percent in 1990, slightly more than the 3.7 percent increase in 1989, and the unemployment rate moved up from the 5.3 percent level reported during the first half of the year to 6.1 percent by December 1990.



# GROWTH OF REAL GNP

PERCENT CHANGE



The disruptive effects of the oil price shock beginning last August eroded consumer and business confidence at a time when economic activity already had slowed. Consumer spending, which accounts for two-thirds of the GNP, had been soft for many months, particularly the purchases of automobiles and other durable goods. Residential building had been in decline since the mid-1980s and new housing starts had fallen to the low level last reported during the 1981-82 recession. Business investment in new plant and equipment had contracted and surveys of future plans had become more pessimistic. Government spending had responded to fiscal pressures, particularly the restraint of defense spending. The creation of new jobs had decelerated in manufacturing, construction, and some service industries.

The combination of marketplace forces, particularly the distorting effects of inflation and the collapse of confidence caused by oil and war shocks, disrupted the U.S. economy. During the last quarter of 1990, widespread declines occurred in consumer spending, particularly for durable goods, business fixed investment, residential construction, and inventory investment.

Partially offsetting these declines were strong improvement in the net export balance, increasing State and local government spending, and a large rise in Federal defense outlays. Real final sales for the fourth quarter remained flat and the overall decline in the quarterly GNP reflects the rundown of inventories. Businesses reduced their inventories by more than \$16 billion in real terms during the fourth quarter following an increase of about \$5 billion in the third quarter, a swing of \$21 billion dollars of inventories.

Despite the negative fourth quarter result, most analysts believe that the current downturn will be relatively brief and mild. The major arguments supporting this consensus outlook include:

- o Stocks of inventories remain low relative to current sales and have been declining for several months rather than rising as typically occurs during the early stages of an economic downturn. The aggregate inventory-sales ratio actually declined in the fourth quarter. But the liquidation of inventories does not appear to be gathering downward momentum. This suggests that production activity to replenish inventory stocks may respond quickly when consumer and business spending resumes. For example, auto inventories are at relatively low levels because of cutbacks in production during the fourth quarter of 1990. Orders placed with durable goods manufacturers also have held up well.
- o Exporting industries continue to register strong sales. Merchandise exports grew in real terms at a strong 15 percent annual rate during the final quarter of last year. For all of 1990, merchandise exports were up 7-1/2 percent while real nonpetroleum merchandise imports increased only 2-1/4 percent during the year. Further declines in the U.S. dollar since mid-1990 have improved the competitive position of American farmers and companies in foreign markets. Export sales should remain strong despite the slowdown of economic activity in some countries, the disruptive oil and war shocks, and the disappointing delay in completing the important Uruguay Round of multilateral trade negotiations.
- o The surge of inflation linked to the runup of oil prices appears to be moderating. The implicit GNP price deflator, which is affected by shifts in the composition of output, increased by only 2.8 percent in the fourth quarter, down from a low 3.7 percent pace during the third quarter. Continued easing of price pressures will help restore purchasing power and confidence needed to stimulate personal consumption and business spending.
- o Business investment in new plant and equipment is expected to remain flat during 1991 according to recent surveys. There does not appear to be any widespread erosion of spending plans.
- o The rapid growth of Federal government spending in FY 1991, for both defense and non-defense programs, will contribute to sustaining economic activity. State and

local government spending also has continued despite the growing size of their budget deficits.

- o Economic activity should be stimulated by the large reduction in interest rates that has occurred. Since their late summer highs, Treasury 3-month bill interest rates have declined approximately 150 basis points to the 6 percent zone and Treasury 30-year bond interest rates have dropped 65 basis points to the 8-1/4 percent zone.
- o The Fed has eased policy by:
  - oo Reducing the target for the Federal funds rate from 8 percent in August to 7 percent by the end of the year and to 6-3/4 percent in early January.
  - oo Eliminating reserve requirements on nonpersonal time and Euro-dollar liabilities on December 4.
  - oo Cutting the discount rate from 7 to 6-1/2 percent on December 18. On February 1 the discount rate was cut to 6 percent.
- o We share Chairman Greenspan's concern about the sluggish growth of the money supply in recent months and support his increased emphasis on monitoring the growth of money and credit in the formulation of monetary policy.
- o The Treasury Department has tried to serve as a "catalyst" by encouraging banks to grant loans to worthy borrowers. Officials have met frequently with bank regulators to encourage them to be more sensitive to tight credit conditions.

In summary, the decline in real output during the fourth quarter of 1990 does not appear to be turning into a cumulative downturn. The decline in payroll jobs in January demonstrated that the pattern of recovery will not be a simple upward trend line, but the fundamental factors needed for resuming economic growth are in place.

ECONOMIC ASSUMPTIONS USED IN PREPARING  
THE FY 1992 BUDGET

Current events -- particularly the oil and war shocks and uncertainty about resolving structural weaknesses in domestic financial institutions -- make economic forecasting unusually difficult. Nevertheless, there is widespread agreement with the Administration's recent forecast published in the FY 1992 budget that the current downturn is likely to be relatively mild and brief. For Calendar 1991, the Congressional Budget Office (CBO),

Blue Chip Consensus (an average of approximately fifty private economic forecasters), and several private econometric models agree that moderate growth will be registered for the entire year. There is further agreement that the upturn will continue in 1992.

Outlook for Real GNP Growth		
(Percent, 4th qtr. to 4th qtr.)		
	<u>1991</u>	<u>1992</u>
Administration (Troika)	0.9	3.6
CBO (1/91)	1.3	3.4
Blue Chip (1/91)	0.9	2.8
Data Resources (1/91)	1.0	3.7
Meyer & Assoc. (1/91)	0.5	3.3
Wharton (1/91)	2.2	2.6

The CBO and Blue Chip Consensus estimates also agree with the Administration's view that positive economic growth will begin during the second quarter of this year. Of the private forecasters participating in the Blue Chip panel, 70 percent the downturn to end by June.

Quarterly Pattern of Forecasts of Real Growth					
(Percent Change, Annual rate)					
	<u>1991</u>				<u>Decline Peak to Trough*</u>
	<u>I</u>	<u>II</u>	<u>III</u>	<u>IV</u>	
Administration (Troika)	-1.3	0.3	2.0	2.8	-1.2
CBO (1/91)	-1.7	0.8	2.3	3.9	-1.0
Blue Chip (1/91)	-1.4	0.3	2.0	2.7	-1.0
Data Resources (1/91)	-2.1	-0.4	3.0	3.6	-1.4
Meyer & Assoc. (1/91)	-2.1	-1.1	2.4	2.9	-1.6
Wharton (1/91)	-0.9	2.3	4.1	3.3	-0.8

\*Including decline in 1990-IV. Total decline not at annual rate.

As to the possible depth of the current downturn, the Administration estimates a decline of 1.2 percent from the cyclical peak in the third quarter of 1990 to the trough in the first quarter of 1991. The Blue Chip Consensus and CBO both project a similar decline of 1.0 percent. The average decline during the previous eight post-war recessions has been 2.6 percent. Therefore, the current cyclical downturn is expected to be relatively mild.

Turning to the Administration's intermediate-range economic projections, we anticipate a return to more normal growth rates following the current downturn. A moderate snapback of activity is expected in 1991 leading to a sustained period of expansion, improving inflation and unemployment rates and lower short- and long-term interest rates. The annual figures prepared by the Administration for the five-year budget estimates are summarized below.

#### Summary of Administration Economic Assumptions

	<u>Actual</u>	<u>Preliminary</u>	<u>Short-term Forecast</u>		<u>Longer-term projections</u>			
	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>
			<u>Percent change, 4th qtr. to 4th qtr.</u>					
Nominal GNP	5.6	4.3	5.3	7.5	7.1	6.8	6.5	6.4
Real GNP	1.8	0.3	0.9	3.6	3.4	3.2	3.0	3.0
GNP deflator	3.7	4.0	4.3	3.8	3.6	3.5	3.4	3.3
Consumer price index	4.6	6.3	4.3	3.9	3.6	3.5	3.4	3.3
			<u>Percent, average for calendar year</u>					
Total unemployment rate	5.2	5.4	6.7	6.6	6.2	5.8	5.4	5.1
3-mo. Treas. bill rate	8.1	7.5	6.4	6.0	5.8	5.6	5.4	5.3
10-yr. Treas. notes	8.5	8.5	7.5	7.2	6.8	6.6	6.4	6.3

# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

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Contact: Cheryl Crispen  
202-566-2041

**SECRETARY NICHOLAS F. BRADY  
REMARKS TO THE PRESS  
FINANCIAL SERVICES REFORM  
TUESDAY, FEBRUARY 5, 1991**

One of the key goals of the Treasury is to ensure that we have a strong economy in order to maintain and improve the standard of living for all Americans, and also so we can compete effectively in an increasingly global economy. So the issue today is not banking reform per se, but rather a significant step in achieving this more fundamental objective.

Today, our banking system is under stress. Technology is changing the way financial institutions do business, but our banks are hampered by out-of-date laws. The laws that govern financial services should deal with the real world in which banks and other financial institutions must operate.

American families look to banks, thrifts and credit unions to finance homes and cars and to save for their children's education and their own retirement. American businesses look to these same institutions for funds to expand and create jobs. And a strong, internationally competitive U.S. financial system is essential to a strong, growing economy.

This chart shows that the major laws governing banking in this country date back to the thirties and forties. Yet the seventies and eighties have produced stunning technological changes and other innovations that have changed the face of the financial system.

Bank credit cards, ATM cards and the 800 number allow people to access banking services across state lines and around the world, but banks themselves are constrained by outmoded rules. Bank competitors can offer innovations, such as money market funds and commercial paper, that put banks at a competitive disadvantage at home and abroad.

Today, as this chart shows, only one of the 30 largest banks in the world is American. Just 20 years ago, the three largest and nine of the top 30 banks were American.

NB-1116

We must modernize our banking laws to deal with the reality of the marketplace, not just for the banks, but for the country. A weak banking system hurts the economy, particularly during difficult economic times. Weak banks are forced to pull back just when their good customers need them most. When loans stop at the first sign of an economic downturn, jobs are lost. Businesses must be able to count on banks in bad times as well as good.

There can be no doubt that fundamental reform is needed. The banking system is safe, but it is not as efficient and competitive as it ought to be. If we expect to exert world economic leadership in the 21st century, we must have a modern, world-class financial services system in the U.S.

First, the Administration's plan will preserve basic deposit insurance protection for every small saver in America. There will always be a safe place for Americans to invest for the future. But the plan will limit taxpayer exposure to possible losses by reducing the overexpansion of deposit insurance.

Originally intended to protect small depositors who could not protect themselves, deposit insurance has expanded to cover large, sophisticated investors who are able to evaluate investments and protect themselves.

This chart shows the growth of insured deposits and therefore increasing exposure of the insurance fund to possible losses. One bank recently advertised that a family of three could receive \$1.2 million of insured deposits in one institution by using their system of multiple accounts.

To address this, the Administration's plan will prevent multiple accounts in a single institution. It will end pass-through coverage for institutional investors. It will eliminate brokered deposits which are used by weak banks to avoid a marketplace test in raising funds from depositors. And it will limit protection of uninsured depositors to genuine cases of systemic risk.

Second, the plan will make banks stronger and safer by strengthening the role of capital -- not by raising capital standards, but with a plan to attract capital to the banking industry. This will discourage excessive risk-taking, reduce the possibility of bank failure, and provide a cushion to absorb losses ahead of the insurance fund.

Improved and more frequent supervision will be based on capital levels, with rewards for well-capitalized banks and prompt corrective action when capital falls below minimum levels. And risk-based deposit insurance premiums will be phased in as a further incentive to build capital.

Well-capitalized banks are better able to keep lending during economic declines, and they are better able to meet competitive challenges and take advantage of new opportunities.

Third, the Administration's plan will make banks more competitive by modernizing outdated laws like the one that restricts interstate banking and branching. A California bank can open a branch in Birmingham, England, but not in Birmingham, Alabama. And after 1992, English and German banks will be able to move freely back and forth within the European Community. But American banks can't even branch across state lines.

This map shows that 33 states now permit interstate banking -- meaning a bank holding company from out-of-state can own a bank through a subsidiary in these states. Another 13 states permit regional banking. Only four states totally prohibit interstate banking.

So the trend in the states is clearly to permit interstate banking. It has become a question not of whether, but of how. The plan will permit interstate banking and branching because there are substantial cost savings and efficiencies that will benefit taxpayers, consumers and depositors.

Similarly, laws must be changed to permit banks to reclaim the profit opportunities they have lost to changing markets. The plan will allow banks to affiliate, on a two-way street basis, with a broad range of financial firms through the formation of financial services holding companies.

To protect the deposit insurance fund and the taxpayer, only companies that own well-capitalized banks will be permitted to engage in new financial activities. In addition, only the bank will have access to deposit insurance, strict regulation will be focused on the bank, and the new financial activities will be in separately capitalized affiliates with no access to the federal safety net.

Fourth, the plan will strengthen the banking system by making the regulatory structure more efficient. The current regulatory structure is complicated, overlapping and confusing. Individual institutions often are supervised by several regulators, and are governed by conflicting regulations. And bank holding companies rarely have the same regulator as their subsidiary banks.



The current four-regulator structure will be simplified to two, with the same regulator responsible for a bank holding company and its subsidiary bank. The Federal Reserve will supervise all state-chartered banks and their holding companies. The Comptroller of the Currency and the Office of Thrift Supervision will be combined under Treasury and will supervise all national banks and all thrifts and their holding companies.

Finally, the Treasury report includes principles which should govern the FDIC's efforts to recapitalize the Bank Insurance Fund. The FDIC is working with the industry on a plan under the authority given to FDIC in the FDIC Assessment Rate Act of 1990.

All in all, these changes and reforms are essential to the future. They will address the reality of the modern financial marketplace and create a U.S. banking and financial system that is internationally competitive, that will protect depositors and taxpayers, serve consumers, and strengthen the economy.

Now, I'll be glad to take your questions.

###

**AUCTION RESULTS**

# PUBLIC DEBT NEWS



Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE  
February 5, 1991

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CONTACT: Office of Financing  
202-376-4350

## RESULTS OF TREASURY'S AUCTION OF 3-YEAR NOTES

Tenders for \$12,648 million of 3-year notes, Series R-1994, to be issued on February 15, 1991 and mature on February 15, 1994 were accepted today (CUSIP: 912827ZW5).

The interest rate on the notes will be 6 7/8%. The range of accepted bids and corresponding prices are as follows:

	<u>Yield</u>	<u>Price</u>
Low	6.97%	99.747
High	6.98%	99.720
Average	6.98%	99.720

Tenders at the high yield were allotted 61%.

### TENDERS RECEIVED AND ACCEPTED (in thousands)

<u>Location</u>	<u>Received</u>	<u>Accepted</u>
Boston	32,440	32,420
New York	39,145,230	12,040,150
Philadelphia	26,475	26,475
Cleveland	44,210	44,210
Richmond	61,040	38,040
Atlanta	31,985	26,580
Chicago	1,365,775	183,020
St. Louis	47,015	34,235
Minneapolis	19,225	19,195
Kansas City	48,730	46,730
Dallas	14,935	14,935
San Francisco	566,175	61,675
Treasury	79,845	79,845
<b>TOTALS</b>	<b>\$41,483,080</b>	<b>\$12,647,510</b>

The \$12,648 million of accepted tenders includes \$769 million of noncompetitive tenders and \$11,879 million of competitive tenders from the public.

In addition, \$1,212 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional \$1,644 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.



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# TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2000

FOR RELEASE AT 4:00 P.M. FEBRUARY 5, 1991

CONTACT: Office of Financing  
202/376-4350

## DEPT. OF THE TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately \$19,200 million, to be issued February 14, 1991. This offering will result in a paydown for the Treasury of about \$400 million, as the maturing bills are outstanding in the amount of \$19,601 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, Monday, February 11, 1991, prior to 12:00 noon for noncompetitive tenders and prior to 1:00 p.m., Eastern Standard time, for competitive tenders. The two series offered are as follows:

91-day bills (to maturity date) for approximately \$9,600 million, representing an additional amount of bills dated November 15, 1990, and to mature May 16, 1991 (CUSIP No. 912794 WJ 9), currently outstanding in the amount of \$10,550 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately \$9,600 million, to be dated February 14, 1991, and to mature August 15, 1991 (CUSIP No. 912794 XC 3).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of \$10,000 and in any higher \$5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing February 14, 1991. In addition to the maturing 13-week and 26-week bills, there are \$9,594 million of maturing 52-week bills. The disposition of this latter amount was announced last week. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold \$811 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold \$981 million as agents for foreign and international monetary authorities, and \$7,477 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of \$10,000. Tenders over \$10,000 must be in multiples of \$5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than \$1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of \$200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds \$200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of competitive tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for \$1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

# MODERNIZING THE FINANCIAL SYSTEM

RECOMMENDATIONS

for

SAFER, MORE COMPETITIVE BANKS



February 1991





# MODERNIZING THE FINANCIAL SYSTEM

RECOMMENDATIONS  
for  
SAFER, MORE COMPETITIVE BANKS



February 1991





THE SECRETARY OF THE TREASURY  
WASHINGTON

February 5, 1991

The Honorable J. Danforth Quayle  
President of the Senate  
United States Senate  
Washington, DC 20510

Dear Mr. President:

I am pleased to transmit our final Report on the federal deposit insurance system, entitled Modernizing the Financial System: Recommendations for Safer, More Competitive Banks. Section 1001 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (Pub. L. No. 101-73) directed the Treasury Department to produce this Report in consultation with the depository institution regulatory agencies and others, including the public.

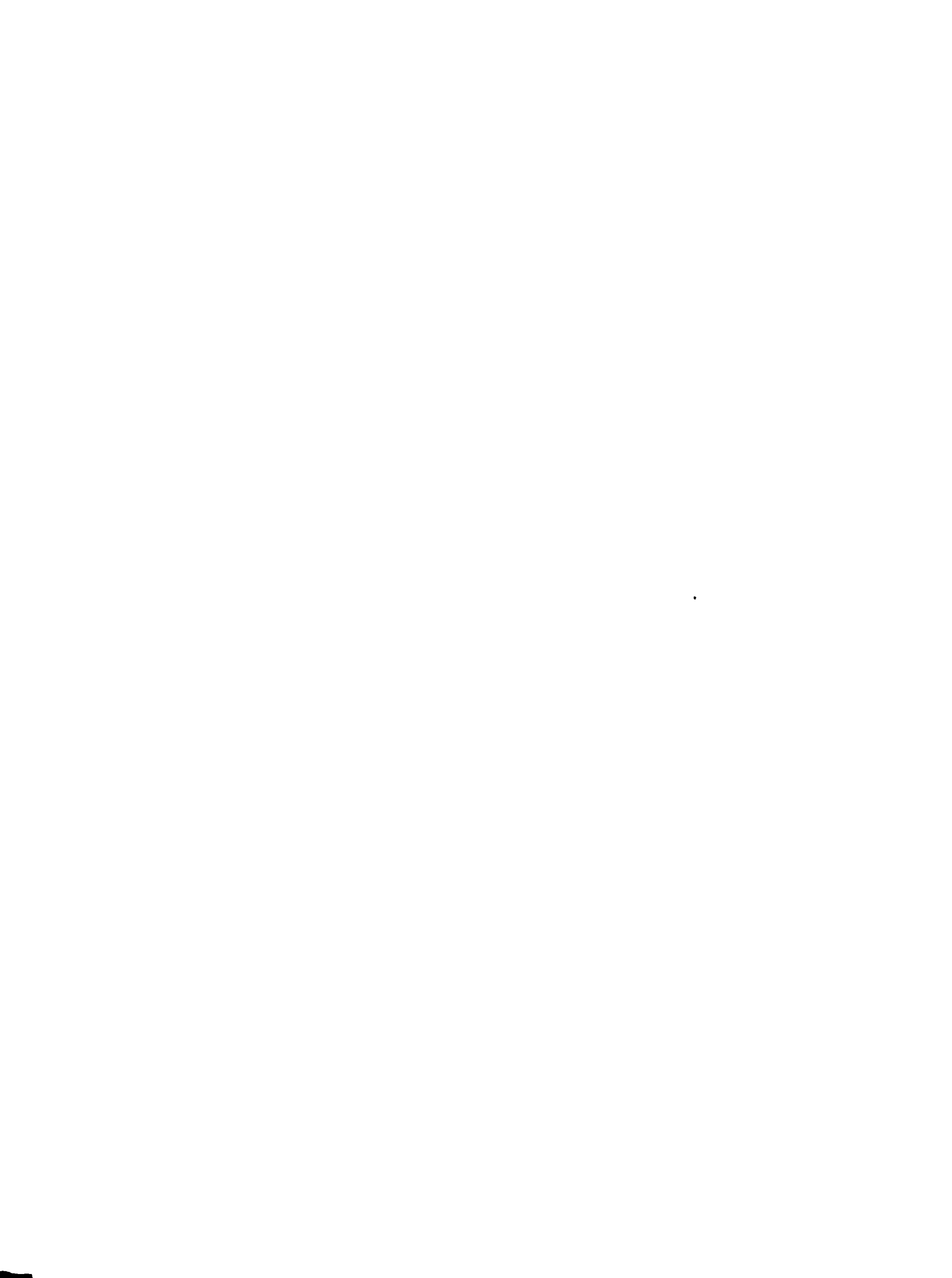
For more than a year, the study group reviewed recommendations from its member agencies and the public. Our goal has been to develop practical proposals to reform and strengthen the federal deposit insurance system; modernize our financial system to make banks safer and more competitive, both domestically and internationally; and streamline the bank regulatory structure.

The public would significantly benefit from legislative enactment of the Report's recommendations. I therefore urge Congress to give high priority to the passage of the Administration's legislative proposal implementing the Report's recommendations, which we will submit shortly.

I am also transmitting the Report to the Speaker of the House of Representatives.

Sincerely,

Nicholas F. Brady





THE SECRETARY OF THE TREASURY  
WASHINGTON

February 5, 1991

The Honorable Thomas S. Foley  
Speaker of the House  
House of Representatives  
Washington, DC 20515

Dear Mr. Speaker:

I am pleased to transmit our final Report on the federal deposit insurance system, entitled Modernizing the Financial System: Recommendations for Safer, More Competitive Banks. Section 1001 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (Pub. L. No. 101-73) directed the Treasury Department to produce this Report in consultation with the depository institution regulatory agencies and others, including the public.

For more than a year, the study group reviewed recommendations from its member agencies and the public. Our goal has been to develop practical proposals to reform and strengthen the federal deposit insurance system; modernize our financial system to make banks safer and more competitive, both domestically and internationally; and streamline the bank regulatory structure.

The public would significantly benefit from legislative enactment of the Report's recommendations. I therefore urge Congress to give high priority to the passage of the Administration's legislative proposal implementing the Report's recommendations, which we will submit shortly.

I am also transmitting the Report to the President of the Senate.

Sincerely,

A handwritten signature in cursive script that reads "Nicholas F. Brady".

Nicholas F. Brady



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## EXECUTIVE SUMMARY

A sound, internationally competitive banking system is critical to the Nation's economic vitality and the financial well-being of our citizens. Banks provide a safe place for savers to keep their funds. Bank lending has been an important engine for economic growth. Federal deposit insurance and other parts of the "federal safety net" are designed to facilitate these crucial roles for banks.

But this federal safety net has been overextended, and taxpayers are now exposed to substantial losses through federal deposit insurance. We can and should place prudent limits on taxpayer exposure by returning the scope of deposit insurance to its historical purpose -- protecting small, unsophisticated savers. But this alone will not be enough.

In the end, the most effective way to minimize taxpayer exposure is through a strong, competitive, well-capitalized banking system. Deposit insurance reform must therefore bolster the safety and soundness of the U.S. banking system and enhance the competitiveness of the industry -- both aspects of reform are crucial.

**Four-Part Problem.** Reforms must address four interrelated parts of the current problem: (1) reduced bank competitiveness and financial strength, caused by outdated legal restrictions that have prevented banking organizations from responding to the evolution of financial markets and technology; (2) the overextension of deposit insurance, resulting in excessive exposure for taxpayers and weakened market discipline for banks; (3) a fragmented regulatory system that has created duplicative rules and has often failed to produce decisive remedial action; and (4) an undercapitalized deposit insurance fund.

First, the competitiveness of the banking industry has been undercut by our failure to adapt our banking laws to the evolution of financial markets, which has brought vigorous new competition to markets traditionally served by banks. Advances in technology and information processing, for example, have spurred innovative competitors to develop products that are sometimes superior substitutes for traditional bank products. Consumers have clearly benefitted. But archaic restrictions on both geographic location and financial activities have constrained banks' ability to follow evolving markets, serve customers, and compete effectively.

Having lost traditional customers to new competitors, banks have increased their concentration on remaining customer segments. Weaker banks with virtually unlimited access to federally guaranteed funds have chased too few good lending opportunities, which has created problems for healthier banks: underpriced loans, narrowed spreads, eroded underwriting standards, and incentives to reach for riskier loans within the range of traditional bank activities. The result is diminished profitability, which has undercut the safety and soundness of the banking system.

At the same time, our hamstrung banking organizations have become much less competitive internationally. Twenty years ago, we had eight banks among the top 25 in the world. Now we have none. As our foreign competitors are expanding all over the world, U.S. banks are steadily retreating from the international marketplace.

Second, deposit insurance coverage has expanded well beyond its original purpose of protecting small unsophisticated depositors. It now guarantees the deposits of wealthier individuals, corporations, and large institutional investors. This overextension of deposit insurance has dramatically increased taxpayer exposure.

Overextended deposit insurance has also removed market discipline that should have constrained the increased riskiness of weak banks. Depositors should have shifted funds away from unprofitable, undercapitalized, and risky banks, forcing them to shrink or decrease risk. But with expanded federal insurance and no risk of loss, depositors have been more than willing to supply funds to weaker banks engaged in activities that produce inadequate returns and excessive risk. With so little to lose, these weak, undercapitalized banks have had a perverse incentive to take excessive risk -- the "moral hazard" problem -- exposing the taxpayer to even greater losses.

Third, bank regulation and supervision helps provide a substitute for the market discipline removed by deposit insurance. But in the face of the problems discussed above, our fragmented and archaic regulatory system has not been successful in stemming the weakening of the banking industry. In recent years, banks have experienced record loan losses and failures that are rapidly depleting the deposit insurance fund. There has not always been a satisfactory regulatory mechanism for promptly correcting banking problems. Moreover, with as many as four banking regulators involved in the affairs of a single banking organization, no single regulator has had either the full information or the clear authority and responsibility for the decisive, timely action necessary to deal with weak institutions.

Fourth, the Bank Insurance Fund (BIF) is at its lowest level in history as a percentage of insured deposits. It is projected to decline still further over the next two years. Without an infusion of funds, the Federal Deposit Insurance Corporation (FDIC) could face the problems that plagued the Federal Savings and Loan Insurance Corporation -- too little cash, too many incentives for forbearance, and possible exposure for the taxpayer.

**Four Fundamental Reforms.** The Administration recommends four fundamental reforms to ensure a safer, more competitive banking system that will continue its role as an engine for productive investment and economic growth. First, to increase bank competitiveness, the proposal would authorize nationwide banking, new financial activities, and commercial ownership of banking organizations -- provided these new owners are willing to maintain well-capitalized banks that protect the taxpayer. Second, to reduce taxpayer exposure and address the loss of market discipline, the proposal would rein in the overexpanded scope of deposit insurance; improve supervision by strengthening the role of capital; and assess risk-based premiums. Third,

our fragmented regulatory system would be streamlined. Finally, industry funds would recapitalize the BIF.

**Restoring Competitiveness.** Nationwide banking and branching will make banks safer through diversification and more efficient through substantially reduced operating costs. But banking organizations must also be allowed to use their expertise to participate in the full range of financial services -- but to do so outside the bank and outside the federal safety net. While appropriate safety and soundness limitations will be needed, the taxpayer can no longer afford the artificial restrictions that constrain a bank's ability to make maximum use of its resources and expertise in serving customers. At the same time, financial and commercial firms must be allowed to affiliate with banks to create a strong, diversified financial services system that can compete head-to-head with diversified financial firms around the world.

**Reducing Overextended Insurance Coverage.** Overextended insurance coverage must be reined in without reducing the basic protection for small depositors and without losing the benefits of economic stability. Narrowing coverage would reduce the exposure of the taxpayer and reintroduce an important level of market discipline by sophisticated depositors. This limited additional amount of direct market discipline would help deter banks from pursuing risky activities and would direct funds toward sound and profitable banks.

Additional market discipline by itself cannot resolve the problem, however, because deposit insurance will still protect -- and should protect -- a substantial part of each bank's funding base. It is therefore critical to strengthen the role of capital and improve supervision as strong supplements for market discipline. Capital is the single most important protection for the taxpayer. It reduces the incentive of a bank to take excessive risk and absorbs losses ahead of the deposit insurance fund. The proposal would improve supervision by creating a system of rewards and incentives for banks that build and maintain capital -- with prompt corrective action for those that do not. Moreover, permitting financial and commercial companies to own banks will both increase the value of the bank franchise and tap a vast new reservoir of capital for investment in banks.

Finally, assessing risk-based premiums would be another important supplement to direct market discipline. Premiums would vary according to levels of capital, because capital is a crucial measure of risk and because firms should be rewarded with lower premiums for maintaining higher capital. In addition, an FDIC demonstration project would test the feasibility of using private reinsurers to provide market pricing for risk-based premiums.

**Streamlined Regulatory System.** A streamlined, efficient regulatory system would further supplement market discipline and apply prompt, decisive corrective action to weak and unsound institutions. In addition, for a given banking organization, one federal regulator should have basic regulatory authority, responsibility, and accountability for fundamental banking activities. A simplified and effective regulatory structure is necessary to reduce the taxpayers' exposure through deposit insurance.

**BIF Recapitalization.** The Bank Insurance Fund must be recapitalized. The FDIC is meeting with industry groups to develop a plan for recapitalization. This Report sets forth objectives that such a plan must satisfy. The Fund must have sufficient resources so that the FDIC can do its job of resolving failed institutions. The Fund should be recapitalized with industry funding. But the recapitalization plan should avoid imposing unnecessary stresses on the banking system in the near term.

All four components of reform are needed to revitalize the nation's banking system. Reining in the overextended scope of deposit insurance, improving regulation, and recapitalizing BIF are insufficient. In the long run, the competitiveness of banking and financial organizations both at home and abroad depends on allowing them to compete efficiently nationwide and in related financial activities. A banking system that is both sound and competitive is crucial to the health of this nation's economy.

## SUMMARY OF RECOMMENDATIONS

The Recommendations of this Report are summarized below. Where appropriate, brief explanations are included.

### **PART ONE -- DEPOSIT INSURANCE AND BANKING REFORMS**

#### **I. Strengthened Role of Capital**

Capital is a crucial tool for making banks safer. The role of capital in the supervisory system would be strengthened through four separate reforms:

- A. Capital-Based Supervision:** Well-capitalized institutions would undergo less intrusive regulation, while undercapitalized institutions would be subject to increasingly stringent restrictions.
- B. Capital-Based Insurance Premiums:** Premiums would be assessed based on an institution's level of risk-based capital.
- C. Capital-Based Expanded Activities:** Well-capitalized institutions would be allowed to engage in newly permitted financial activities through separately capitalized affiliates.
- D. Capital Adjusted for Interest Rate Risk:** Interest rate risk would be included in risk-based capital standards.

#### **II. Reduction of Overextended Scope of Deposit Insurance**

Deposit insurance has been extended well beyond its original purpose of protecting small savers. The following reforms are needed to restore coverage to reasonable limits.

- A. Reduce Coverage of Multiple Insured Accounts:** In the short term, depositors would be limited to \$100,000 per institution for individual accounts and \$100,000 per institution in retirement accounts. The long term goal is limited coverage per depositor across all depository institutions.
- B. Eliminate Certain "Pass-Through" Coverage:** Pass-through coverage would be eliminated for deposits by professionally managed pension plans and for Bank Investment Contracts.

- C. Eliminate Coverage of Brokered Deposits**
- D. Eliminate Coverage of Non-Deposit Creditors**
- E. Limit Coverage of Uninsured Depositors**
  - 1. Require Least Costly Resolution Method:** The FDIC will not protect uninsured depositors unless it is cheaper to do so.
  - 2. Systemic Risk Exception:** The Treasury and the Federal Reserve Board will retain the flexibility, in cases where they jointly find systemic risk, to fully protect uninsured depositors.
  - 3. Improved Liquidity Mechanism:** To improve liquidity when banks fail, uninsured depositors will receive a "final settlement payment" immediately after a failed bank is resolved, rather than waiting for receivership distributions.
  - 4. Methods to Reduce Systemic Risk:** Technical proposals to reduce systemic risk will be included in the Administration's legislative package.
  - 5. Three-Year Transition:** To enable the system to adjust gradually, these new policies will be phased in after a three-year delayed effective date.
- F. No Assessments on Foreign Deposits**

### **III. Risk-Based Deposit Insurance**

- A. Premiums Based on Capital Levels**
- B. Premiums Set by Private Reinsurers (Demonstration Project):** The FDIC will conduct a demonstration project to determine the feasibility of using the private insurance sector to help set risk-based premiums.

### **IV. Improved Supervision**

- A. Capital-Based Supervision**
  - 1. Rewards for Well-Capitalized Banks**
  - 2. Prompt Corrective Action for Undercapitalized Banks:** Progressively stronger supervisory actions triggered by declines in capital.

3. **Early Resolution for Failing Banks:** Banks resolved before capital is completely exhausted.
4. **Improved capital measurement**
  - a. **Annual on-site examinations**
  - b. **Accurate reserving for loan losses**
  - c. **Increased market value reporting:** More market value disclosure would be required, but market value accounting is inappropriate at this time.

**B. Improved Reporting from Independent Auditors**

**V. Restrictions on Risky Activities**

**A. Restrictions on Risky Activities of Federally Insured State-Chartered Banks**

1. **Prohibition of Direct Investment Activities:** Direct equity investment in real estate and other commercial ventures, which is already prohibited for national banks, would be prohibited for state banks as well.
2. **Limit Activities Not Permitted for National Banks:** Federally insured state chartered banks would generally be prohibited from engaging in activities not permitted for national banks, unless the state bank is fully capitalized and the FDIC finds that the activities do not create a substantial risk of loss to the insurance fund.
3. **No Limits on Riskless Agency Activities**

**VI. Nationwide Banking and Branching**

**A. Full Nationwide Banking Authorized for Holding Companies in 3 Years**

**B. Interstate Branching Authorized for Banks**

1. **National Bank Interstate Branching:** Permitted immediately wherever interstate banking is permitted, but no preemption of intrastate branching restrictions.
2. **State Bank Interstate Branching:** Authorized but not required for all states.



## **VII. Modernized Financial Services Regulation**

- A. Permit Well-Capitalized Banks to Have Financial Affiliates**
  - 1. Includes Securities, Mutual Funds, and Insurance**
  - 2. Allow Financial Companies to Own Well-Capitalized Banks**
- B. Commercial Ownership of New Financial Holding Companies**
- C. Safeguards: To protect the insured depository from risks from new activities and to prevent it from subsidizing those activities.**
  - 1. Only for Well-Capitalized Banks**
  - 2. Safety Net Confined to Bank**
  - 3. Strict Regulation Focused on Bank**
  - 4. Financial Affiliates Separately Capitalized**
  - 5. Functional Regulation of Affiliates**
  - 6. Funding and Disclosure Firewalls**
  - 7. Umbrella Oversight**

## **VIII. Credit Union Reforms**

- A. Changed Accounting Treatment of Insurance Fund**
  - 1. Eliminate as Asset on Credit Union Balance Sheets**
  - 2. Gradually Expensed Over Twelve Years**
- B. Reorganized Board of National Credit Union Administration**
  - 1. Representative Included from New Federal Banking Agency**

## **IX. Other Deposit Insurance Recommendations**

- A. No Assessments on Collateralized Borrowing**
- B. Uniform Bankruptcy Exemptions**

## **PART TWO – REGULATORY RESTRUCTURING**

- A. A Single Federal Regulator for Each Banking Organization**
- B. Federal Reserve to Regulate All State Banking Organizations**
- C. New Federal Banking Agency Under Treasury to Regulate All National Banking Organizations and All Thrifts**
- D. FDIC to Function Solely As Insurer**

## **PART THREE -- RECAPITALIZATION OF THE BANK INSURANCE FUND**

The Bank Insurance Fund is under stress and must be recapitalized. The recapitalization should meet these four tests:

- A. It should provide sufficient resources.**
- B. It should take into account any impact on the health of the banking system.**
- C. It should rely on industry funds.**
- D. It should use generally accepted accounting principles.**



## STUDY PARTICIPANTS

Title X of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) directed the Treasury Department to conduct this study of federal deposit insurance and related issues in consultation with the Comptroller of the Currency, the Federal Reserve Board, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of Management and Budget. The Council of Economic Advisors and the Office of Policy Development within the Executive Office of the President participated as well.

FIRREA also directed the Treasury to obtain the participation of the public. To this end, the Treasury issued a Federal Register notice on December 6, 1989, in which it solicited public comments until March 9, 1990. During this period, more than one thousand public comments were received from individuals, depository institutions, trade associations, government agencies, consultants, academics, and others. These comments as well as those of the participating agencies have been reflected both in the Discussion Chapters that analyze individual issues, and in the Administration's Conclusions and Recommendations based on these Chapters.

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# CONCLUSIONS AND RECOMMENDATIONS

## Introduction

The taxpayer has become too exposed to losses through the federal deposit insurance system. This Report provides recommendations to reduce this exposure while strengthening the banking system's ability to play its crucial role in our economy.

In the long run, the only real protection for taxpayers is a banking system that is **safe, sound, and competitive**; a regulatory system that is **strong, efficient, and streamlined**; and a deposit insurance fund that is **well-capitalized** with industry funds. The three parts of this Conclusions and Recommendations Section address each of these issues.

- o **Part One** sets forth deposit insurance recommendations for a **safer, more competitive** banking system -- including a reduction in the overexpanded scope of deposit insurance coverage; a stronger role for capital; improved supervision; nationwide banking and branching; and new financial activities for companies that own well-capitalized banks.
- o **Part Two** sets forth regulatory reform recommendations to **streamline** and **consolidate** our fragmented regulatory system -- which will strengthen bank supervision.
- o **Part Three** sets forth objectives to be met in shoring up the Bank Insurance Fund.

Before describing specific recommendations, it is important to set forth in detail the need for reform. The following discussion draws on Discussion Chapter I, History of Deposit Insurance. (References to Discussion Chapters are included throughout this Conclusions and Recommendations Section.) For the sake of convenience, the term "bank" is generally used to apply to all federally insured depositories.

## Need for Reform

**History.** Deposit insurance was a direct response to the banking crisis of the 1930s. More than 5,000 banks had failed from 1930 to 1932, resulting in losses to depositors of almost \$800 million -- or more than \$6 billion in 1990 dollars. Another 4,000 banks failed in 1933. The banking system was on the verge of collapse.

The Federal Reserve's actions during this period to ease the liquidity problems of troubled banks through the discount window -- its "lender of last resort" function -- were ineffective. The money supply contracted, with ensuing deflation and a worsening depression. Depositor losses from bank failures also created a chain reaction of losses in other parts of the economy. Bank runs were widespread.



There was, in short, a crisis of confidence in the banking system when Franklin Roosevelt took office in March 1933. The nation's banks were already closed because of the declaration of bank holidays in all 48 states. President Roosevelt's emergency declaration of a nationwide bank holiday was merely a stopgap measure by the federal government to continue the status quo.

The times required dramatic action to restore confidence in the system, and one result was federal deposit insurance. This became the third leg of the so-called "federal safety net" protections for banks, along with the Federal Reserve's discount window lending and its guarantee of the large-dollar payments system.

Proponents of deposit insurance argued that it would stop depositor runs, protect small depositors from losses, and help restore the stability and confidence necessary to carry out basic banking functions. It was also intended to help prevent systemwide bank failures.

Critics -- including President Roosevelt -- argued that the cost of deposit insurance would be exorbitant and would require the use of tax revenues. Another criticism was that deposit insurance would remove market discipline and penalties for bad management, thus subsidizing poorly-run banks.

In the end, both sides proved correct. For many years the benefits of deposit insurance far outweighed the costs. But the scope of deposit insurance expanded greatly during the same period, weakening market discipline at the same time that banks began to lose some of their best customers to new markets and new nonbank competition.

The combination of these two factors has been a recipe for substantial losses. Constrained by outdated laws from competing in new markets, banks have reached for riskier traditional lending opportunities without appropriate discipline from the marketplace. At the same time, our fragmented regulatory system has not always been able to check increased risk with early and decisive action.

Changes must be made. But understanding these changes requires an understanding of the important role that deposit insurance continues to serve -- protecting small depositors and helping to prevent bank runs and systemic risk.

**Depositor Runs.** Banks provide a number of important functions for the economy that involve the use of liquid bank deposits. One basic function is to provide a safe place for small, unsophisticated depositors to store liquid assets. Another important function is to provide a safe payments system for checking and other transaction accounts, which is of incalculable value to the economy.

A third important function of banks is the "intermediation" of the liquid deposits of small savers into specialized, illiquid loans, particularly for borrowers who do not have access to the securities markets. The relative volume of this type of intermediation has decreased over time

with increasing nonbank competition and the increasing level of direct access by borrowers to the securities markets. For certain types of credit, there is no longer a need for bank intermediation. As Figure 1 shows, the percentage of financial assets held by depository institutions has declined significantly in recent years. Nevertheless, bank intermediation remains crucial to the economy, deploying resources in productive investments that might not otherwise be made.

Each of these important banking functions involves the use of liquid bank deposits, or extremely short-term liabilities that are often withdrawable on demand. At the same time, bank assets are concentrated in highly illiquid loans, which cannot be sold quickly without a loss in value. The combination of these two factors makes banks inherently susceptible to depositor runs, or panic withdrawals of deposits.

Runs are a destructive form of "market failure" in which unfettered market forces are unable to achieve the most efficient use of resources. A sustained withdrawal of funds itself creates losses because a bank must sell illiquid assets at fire-sale prices to meet the demands for cash. Sooner or later, a run will itself cause a bank to fail, regardless of the bank's actual condition at the time the run began. As a result, a depositor has an incentive to run if he believes that others will run, regardless of the bank's actual condition -- those at the beginning of the withdrawal line lose nothing, while those at the end risk losing everything. This is the psychology that can create panic withdrawals, absent deposit insurance.

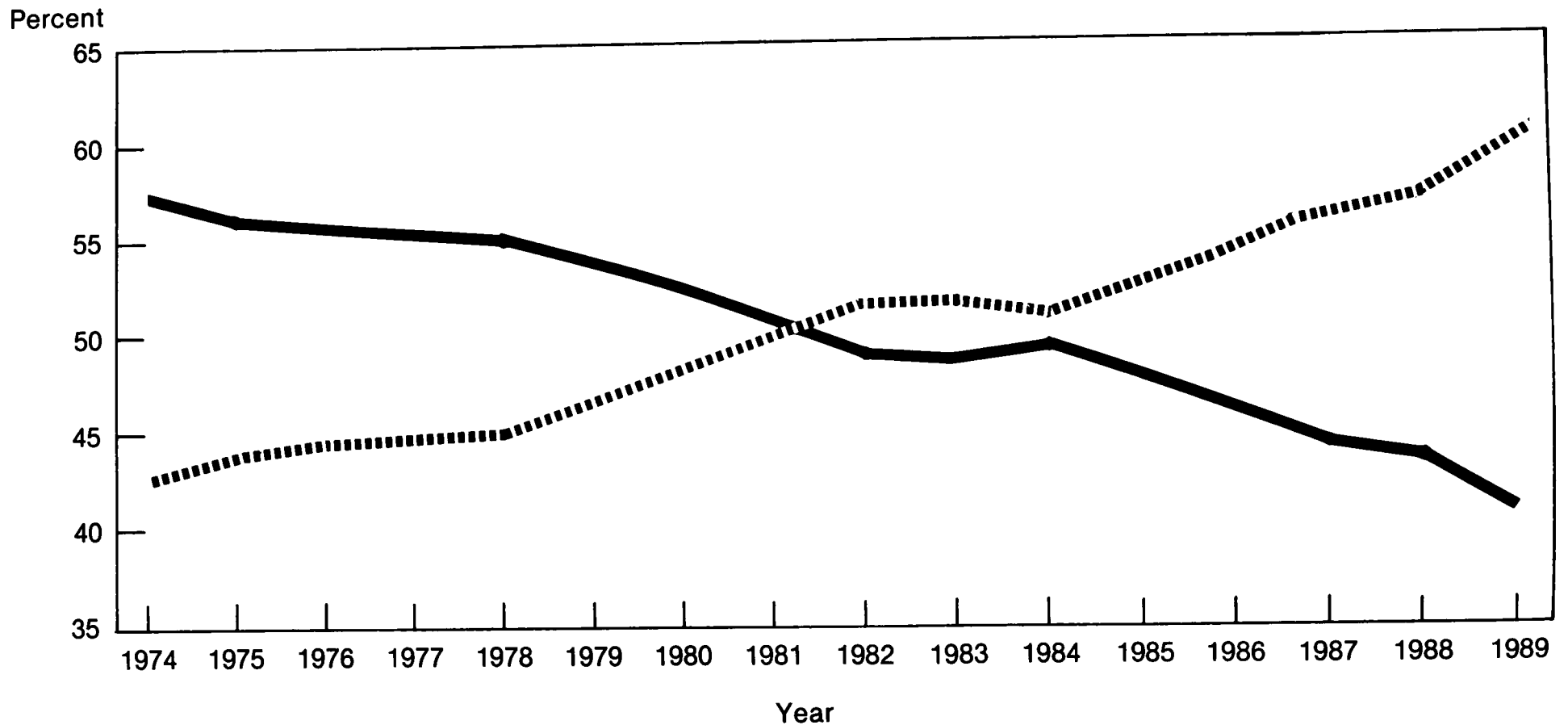
Compounding this problem is the difficulty of determining the riskiness of a bank, precisely because it invests in illiquid assets requiring individualized credit judgments. Professional analysts are often wrong about the condition of a troubled bank, which means it is that much more difficult for the average depositor to assess. This perpetual uncertainty about a bank's actual condition also helps create incentives for runs at the first sign of trouble.

**Systemic Risk.** In addition to individual bank runs, the larger problem associated with depositor losses in bank failures is systemic risk, or the likelihood that trouble in one bank will spread to other banks or other parts of the economy. The three types of systemic risk most often discussed are contagious runs, correspondent banking problems, and payments system problems.

Contagious runs occur when a run on one bank generates a run on another, unrelated institution. For example, a depositor could well assume that a problem in one bank is due to regional economic conditions that are likely to affect all neighboring banks (as in Texas during the 1980s). Given the uncertainty described above in evaluating bank risk, the fear that others will panic, and the low cost of withdrawing funds, systemwide panic withdrawals could ensue in the absence of deposit insurance. This in turn can feed on itself to create further runs.

Significant depositor losses can also create direct losses to other banks if, for example, the depositor who loses funds in one bank can no longer make good on mortgage payments to another bank. Resulting loan losses can cause additional bank failures.

Figure 1  
**Financial Assets Held by Depository Institutions  
 As a Percentage of Total Financial Sector  
 1974 - 1989**



Depository Institutions



All Other:



- Pension and Retirement Funds
- Insurance Companies
- Agencies and Mortgage Pools
- Mutual/Money Market Funds
- Monetary Authority

Source: FRB Annual Statistical Digest.

The failure of a large bank with a correspondent banking system can also create systemic failures. The resolution of Continental Illinois in 1984 is a good example. Nearly 1000 banks had deposits at Continental at the time it failed. Sixty-six of these banks had uninsured deposits exceeding 100 percent of capital, and another 113 had deposits equalling 50-100 percent of capital. If uninsured depositors in Continental had not been protected, its failure would have significantly weakened a number of these other banks.

Finally, in the absence of a federal safety net, depositor losses could spread quickly to other banks through the payments system, especially the large-dollar payments system. Default in large payments to one party can in turn create defaults on other obligations, with the process spreading quickly through a chain reaction.

In the end, while relying on some market discipline from depositors is important, relying too heavily on such discipline can be extremely costly. Small, unsophisticated depositors can lose their funds. The runs that result can bankrupt healthy banks and increase losses at insolvent ones. Systemwide losses become a real possibility. Moreover, substantial depositor losses undermine the important functions of banks described above, all of which depend critically on depositor confidence.

**Benefits of Deposit Insurance.** Deposit insurance was designed to stop runs, maintain confidence in the banking system, and prevent small depositor losses. It has been remarkably successful in achieving these goals even in the worst of times. For example, during the worst period of bank and thrift failures in Texas, there were few instances of actual losses to depositors and few bank runs. This is the type of stability and depositor confidence that prevents disruption of important banking functions, such as the payments system and the intermediation process.

Indeed, for nearly 50 years, deposit insurance seemed to provide nothing but benefits to the economy. It did remove an important degree of market discipline that would otherwise check excessive risk-taking by bank managers. But some market discipline from large, sophisticated investors remained intact. In addition, the government system for supplementing market discipline -- primarily supervision and examination -- appeared to be adequate.

Perhaps most important, banks had a very stable and profitable franchise. Traditional bank lending was the primary source of commercial credit in the economy. Funding costs were low and stable, because banks had a legal monopoly on demand deposits that could not pay interest by law, and other deposits were subject to interest rate controls. While banks were prevented from competing in other financial businesses like securities and insurance, they were also shielded from meaningful competition in their basic businesses of transaction accounts and corporate lending. Because of these advantages, bank stocks, like public utilities, were once thought to be among the safest, most conservative investments -- federally regulated companies with high dividend payments.

In this environment, both small and large banks prospered and grew. Banks and bank branches proliferated domestically, and money center banks expanded aggressively all over the

world. The industry was stable and profitable, and there was widespread confidence in the system.

Perhaps the key statistic was the decline in the number of bank failures. These decreased from 4,000 in 1933 to 370 during the period 1934 through 1941 and declined still further from 1942 through 1980, when the total number was 198, and the greatest number of failures in any one year was 20. See Figure 2.

**Problems with Deposit Insurance.** This situation changed dramatically in the late 1970s and the 1980s. The failure of hundreds of S&Ls caused the insolvency and reorganization of the Federal Savings and Loan Insurance Corporation, and many more of these S&Ls have yet to be resolved. Nine of the ten largest bank holding companies in Texas were reorganized with FDIC or other outside assistance. From 1987 through the end of 1990, the FDIC fund declined from over \$18 billion to approximately \$9 billion.

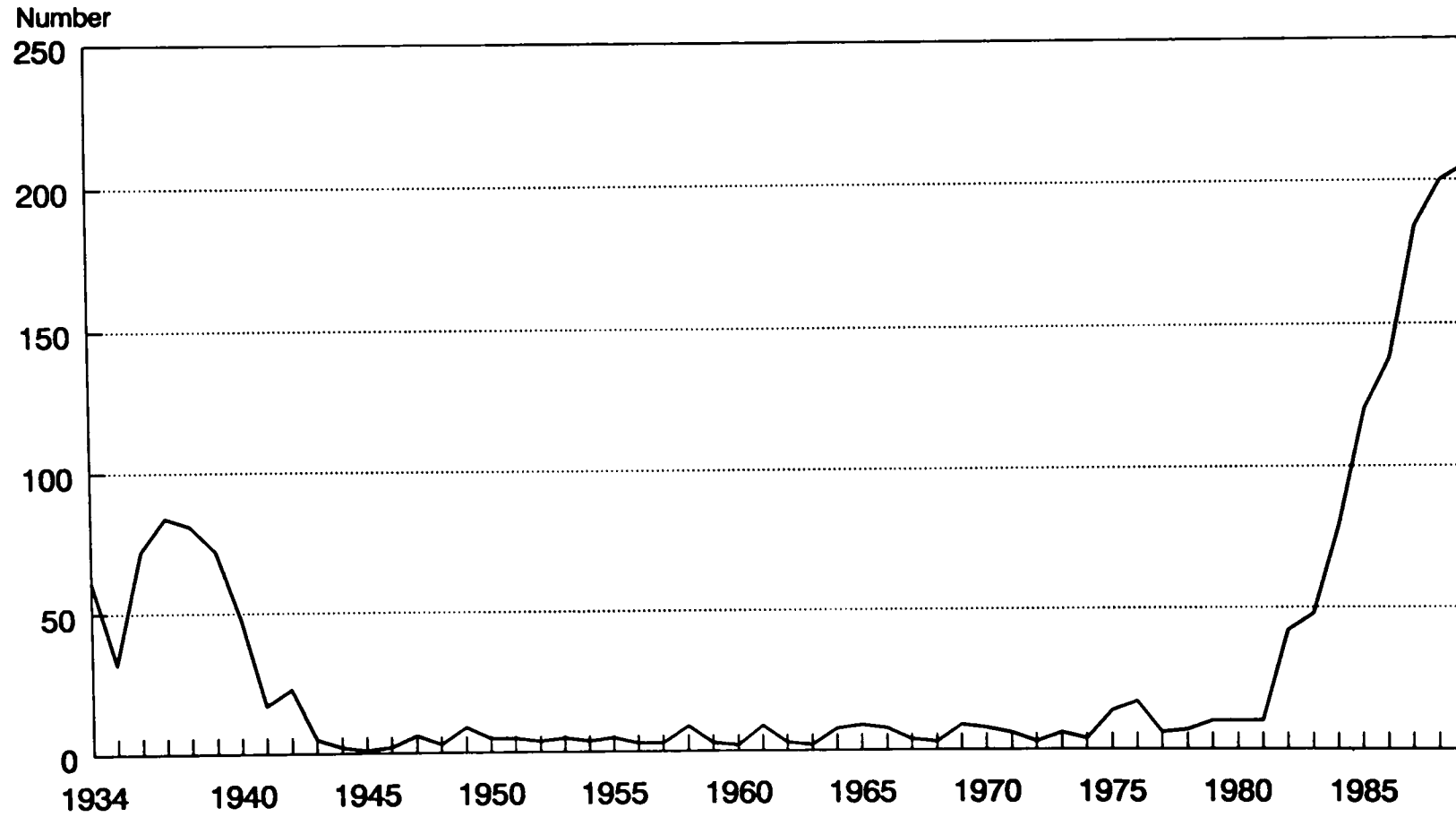
Looking ahead, the situation remains troubled. A substantial minority of the S&L industry does not meet the new and higher capital standards. At the same time, commercial banks' loan charge-off ratios and nonperforming loan ratios (including repossessed real estate) are at their highest levels since banks began using the reserve method of accounting in 1948. See Figure 3.

Events have thus demonstrated that the criticisms leveled in the 1930s against the idea of federal deposit insurance had considerable merit. While there has been stability, deposit insurance and the other two components of the federal safety net have permitted weak, poorly-managed institutions to stay in business too long -- aggravating losses and misallocating resources to unproductive investments. The resulting costs have been borne by well-run institutions and taxpayers.

There are three fundamental and interrelated reasons why these costs have escalated. First, the traditional bank franchise has eroded through competition and outdated restrictions on the ability of banks to serve customers in new financial markets; profits have decreased, losses have increased, and capital levels have declined. Second, the scope of deposit insurance has dramatically expanded, increasing taxpayer exposure and further removing market discipline at a time when weaker banks have reached for more risk. Third, government attempts to supplement market discipline -- capital requirements and supervision, for example -- have not been adequate to check new problems in the industry. Each of these fundamental problems is discussed below.

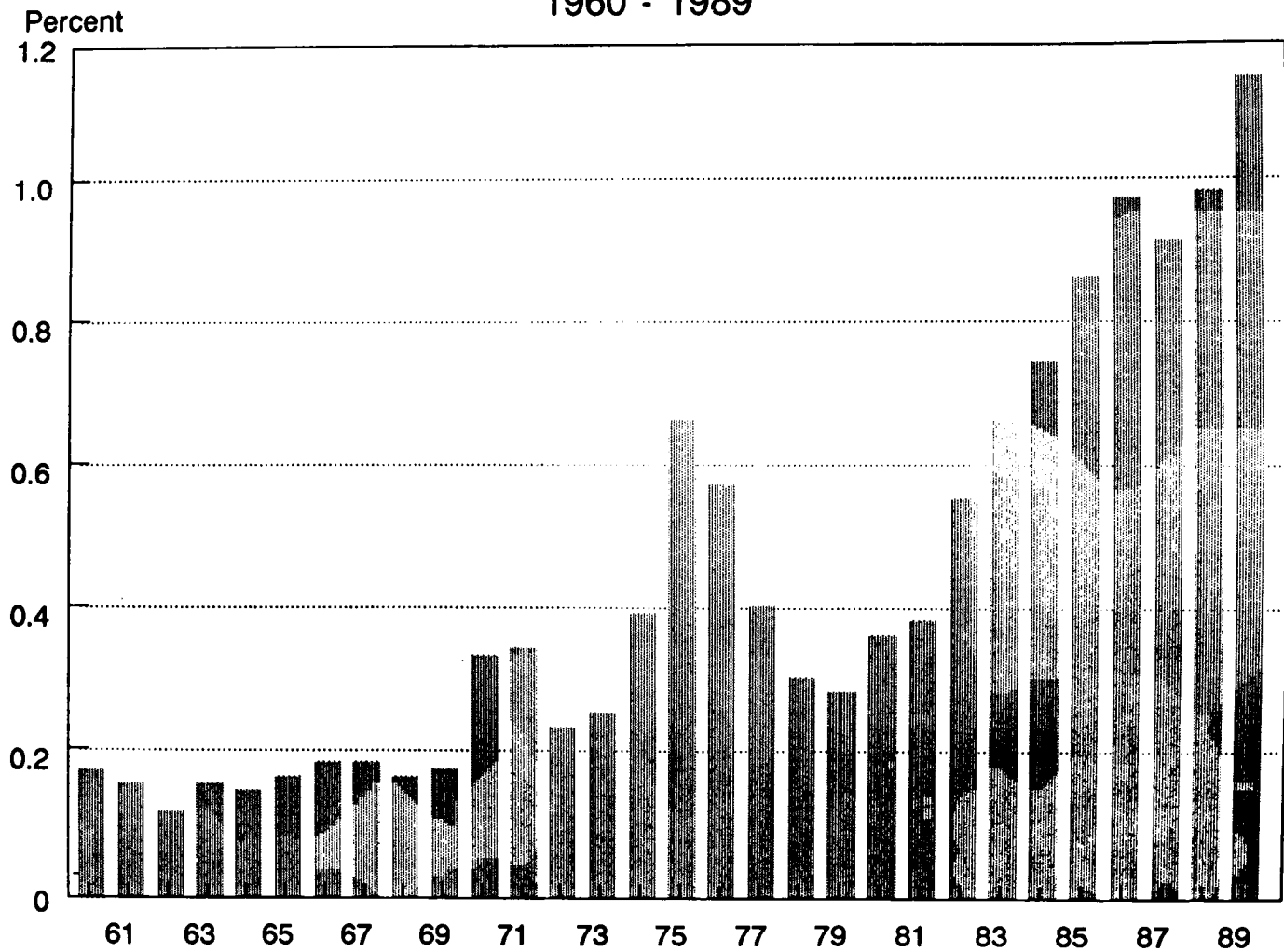
1. **Less Competitive Banks.** The erosion of the traditional bank franchise is well-documented both in Congressional testimony and by Discussion Chapter XVIII, Financial Services Modernization. Banks are no longer the protected and steadily profitable businesses they once were. Old laws designed to "protect" banks from competition have become barriers that impede banks from adapting to changed market conditions. The result has been financial fragility and losses.

Figure 2  
Number of Failed Banks by Year  
1934 - 1989



Source: FDIC Annual Reports and Statistics on Banking.

Figure 3  
Net Charge-Offs to Total Loans  
Insured Commercial Banks  
1960 - 1989



Source: FDIC Annual Reports and Statistics on Banking.

For example, because of marketplace innovations, banks no longer have protected sources of low cost funds. Uninsured money market funds developed to allow consumers to capture market rates of return. This eventually resulted in the elimination of interest rate controls and banks' monopoly on transaction accounts -- both for the benefit of consumers.

Likewise, banks have lost their near monopoly on certain types of business and consumer credit because of the development of the commercial paper market, securitization, and trade credit, as well as vigorous nonbank competition from securities, insurance, and finance companies. (Figure 4 demonstrates the dramatic expansion of the commercial paper market in comparison with commercial and industrial loans.) Similarly, thrifts have lost their leading role in the home mortgage business, due in part to the development of mortgage securitization, which facilitates mortgage origination by other types of financial institutions. See Figure 5.

In short, banks and thrifts have often been unable to provide new forms of credit to their best, most creditworthy customers. Not surprisingly, these customers have frequently turned elsewhere to meet their credit needs.

Banks have responded in several ways. On the positive side, they have been innovative in developing certain new businesses, such as credit cards, automatic teller machines, mortgage banking, and financial advisory work. They have been less successful in expanding into securities, insurance, and other financial activities because of the outdated legal restrictions of the Glass-Steagall Act and the Bank Holding Company Act of 1956 -- even though banks have natural expertise in these areas and even though natural synergies exist. Even in such activities as discount brokerage and commercial paper, where banking organizations have made some headway, the regulatory approval process and litigation costs have made these activities less efficient and less profitable.

Moreover, as traditional lending opportunities have decreased, the supply of bank deposits has grown in part through the expansion of federal deposit insurance. Weaker banks with virtually unlimited access to federally guaranteed funds have bid up deposit rates and chased too few good lending opportunities, which have created problems for healthier banks: underpriced loans, narrowed spreads, eroded underwriting standards, and incentives to reach for riskier loans within the range of traditional bank activities. Commercial real estate loans are only the most recent example of a series that includes regionally concentrated energy and agricultural loans, loans to developing countries, and loans in highly leveraged transactions. The result has been poor earnings and a resulting decline in industry capital.

Meanwhile, diversified financial and commercial companies have recognized the synergies involved in providing banking and other financial services to consumers. They provide a ready source of capital for investment in banks. But despite aggressive efforts to expand into banking they have been only partly successful.

This is unfortunate. Outside capital has proved to be a crucial source of strength for other financial industries, including both the securities and insurance industries. Even the thrift



Figure 4

### The Growth of the Commercial Paper Market Ratio of Bank C&I Loans to Commercial Paper Outstanding 1960 - 1989

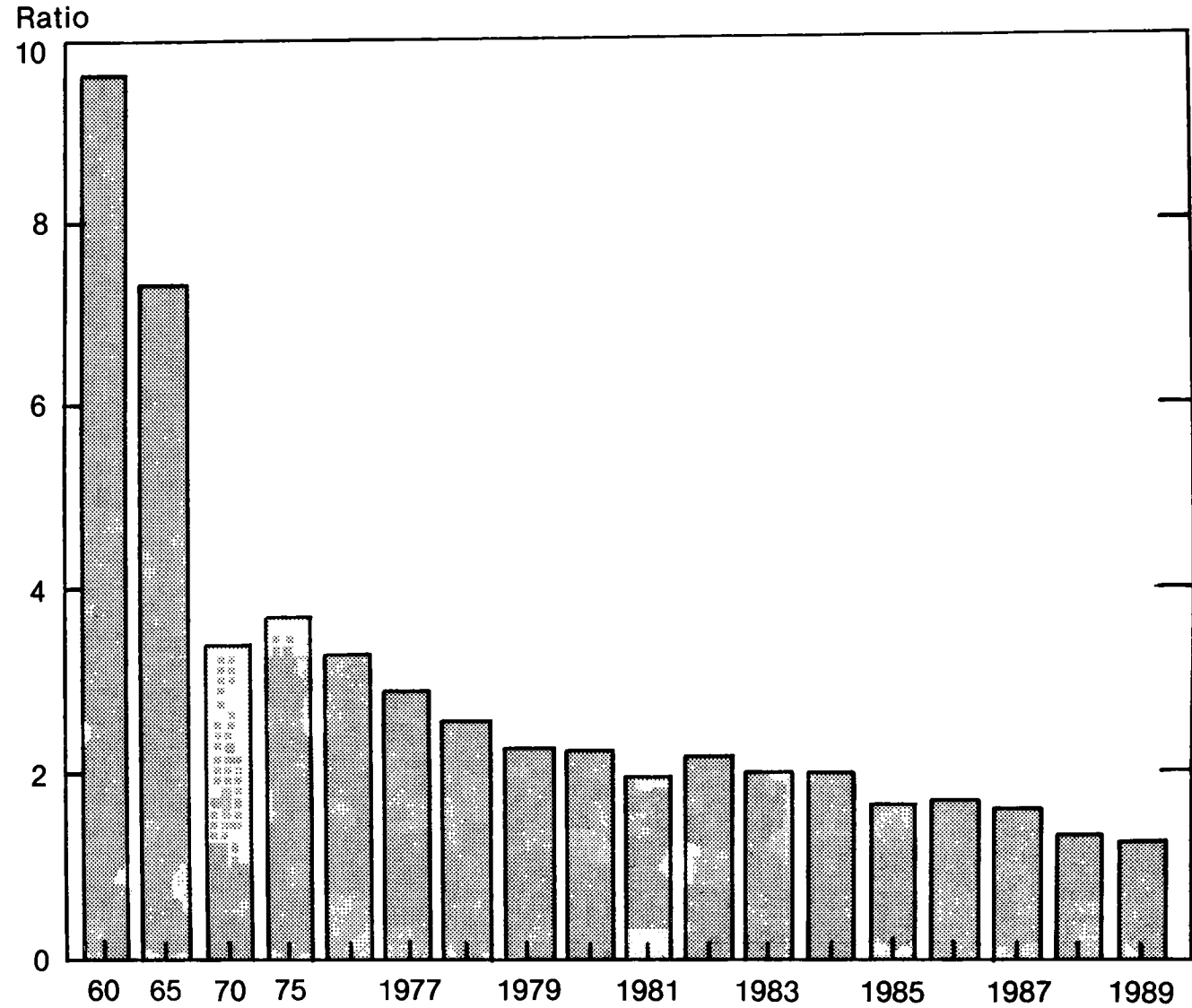
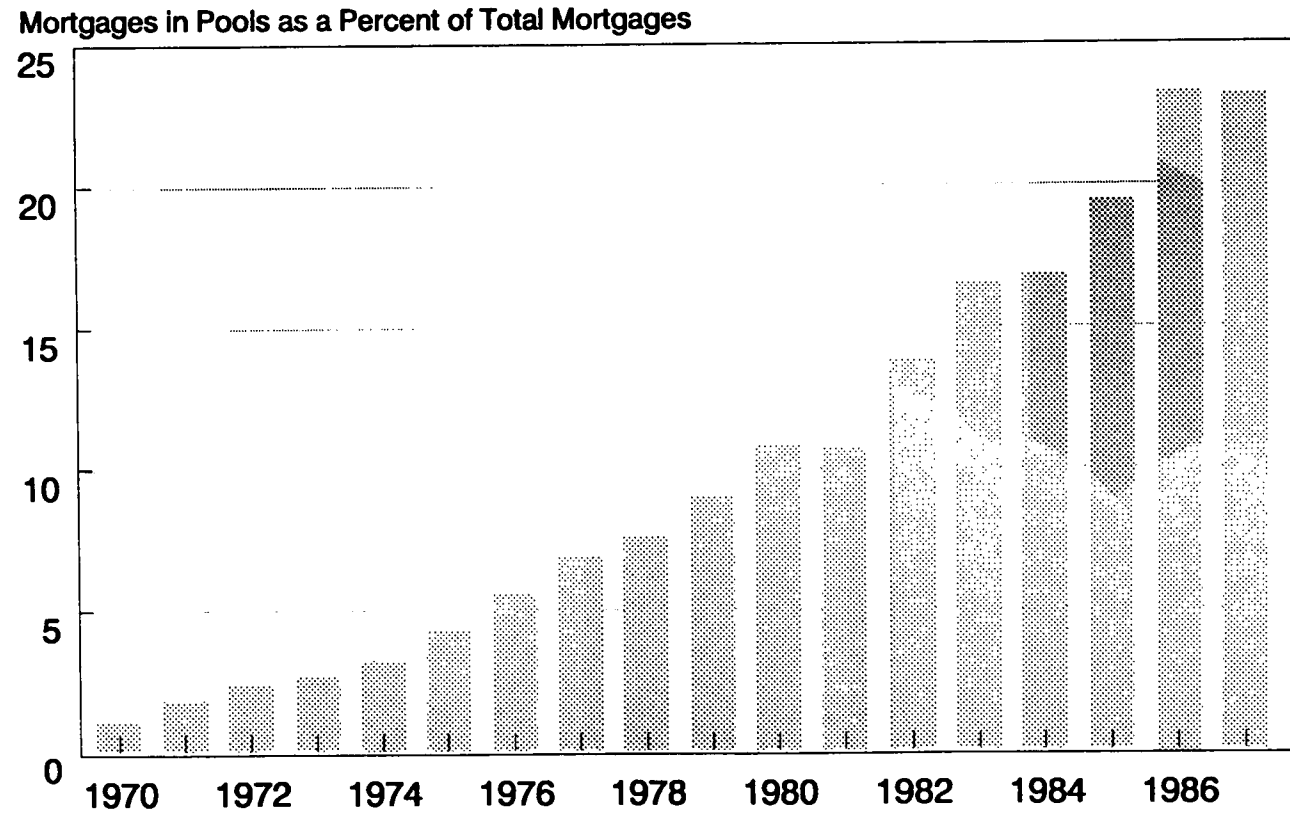


Figure 5  
The Growth of Mortgage Pools  
1970 - 1987



Source: U.S. Department of Commerce and Statistical Abstract of the United States.

industry has benefitted, where, despite numerous restrictions, non-thrift companies have purchased and supported their thrift subsidiaries. Indeed, thrifts affiliated with diversified companies have simply failed less often than thrifts unaffiliated with such companies, and, in the few instances of failure, the diversified parents provided additional funds to their failed subsidiaries to lessen the cost to the federal government.

Similarly, banks have operated under extremely inefficient and costly restrictions on geographic diversification. Interstate banking was prohibited until recently; interstate branching remains virtually prohibited; and even in-state branching continues to be restricted in a number of states. Critics argue that the inability to expand efficiently within the United States helped create incentives for banks to stretch for riskier profit opportunities and more volatile funding sources.

At the same time, banks confined to local markets have been particularly susceptible to deeper and more frequent regional recessions. Texas is a classic example, where banks were battered by the sharp downturn in the energy industry. In the late 1970s, Texas banks were confined by state laws to Texas, but were considered among the best-capitalized, most profitable banks in America. Ten years later, nine of the top ten Texas bank holding companies had been reorganized with FDIC or other outside assistance. Of the nine, the only ones that avoided FDIC assistance were those that were purchased by out-of-state bank holding companies through a special exception to state restrictions on interstate banking (e.g., the acquisition of Texas Commerce by Chemical Bank).

Through state action, interstate banking has finally become a reality. Thirty-three states - two-thirds of the country -- have voted to permit nationwide interstate banking, while another 13 states permit regional interstate banking. Only four states continue to prohibit interstate banking altogether. Intrastate branching restrictions have eroded as well.

Yet the system continues to impose costly and needless burdens on banks that choose to expand, because interstate branching is generally prohibited. Branching is often a more efficient form of interstate expansion that creates immediate cost savings, such as consolidated management and more efficient data processing systems. These savings go right to the bottom line to build both profits and capital, thereby enhancing safety and soundness. Yet despite these benefits, interstate branching is virtually prohibited.

In short, unable to adapt and follow their best customers into related lines of businesses, banks have become steadily less competitive in their traditional activity of lending. Likewise, there have been costly barriers to efficient geographical diversification through interstate branching. Losses have increased and capital has decreased. Taxpayers have become more exposed.

The eroding competitiveness of commercial banks in the domestic market has been mirrored in the international marketplace. As recently as 1983, three U.S. commercial banks were among the world's top twenty in asset size; by year-end 1988, no U.S. bank was ranked

among the world's top twenty. In addition, of the world's top fifty banks in market capitalization in 1988, only two were U.S. banks.

Moreover, while U.S. banks are rapidly withdrawing from foreign markets, foreign banks are strengthening their position in the U.S. For example, both the number and assets of the overseas branches of U.S. banks peaked in the mid-1980s, but have trended downward since then.

U.S. banking organizations can be expected to encounter even greater international competitive pressures in coming years. Most industrialized countries outside the United States permit their banks to engage in a wide range of activities, including combinations of banking, securities, and insurance. In this respect, the most important recent international development for U.S. banking organizations is the European Community's 1992 program, which is expected to allow for "universal banking" Community-wide.

**2. Overexpansion of Deposit Insurance.** At the same time that a number of banks were becoming weaker, the scope of deposit insurance was expanding -- increasing taxpayer exposure and further eroding market discipline. In the late 1930s, deposit insurance began to expand to cover uninsured depositors in bank failures. This occurred in so-called "purchase and assumption" transactions, or P&As, in which acquiring institutions purchase all of the assets and assume all of the liabilities -- including uninsured deposits -- of failed institutions. This practice directly shifted losses from uninsured depositors to the FDIC. While this may have been less disruptive to the community and to the banking system, the practice further reduced market discipline in the system and increased taxpayer exposure.

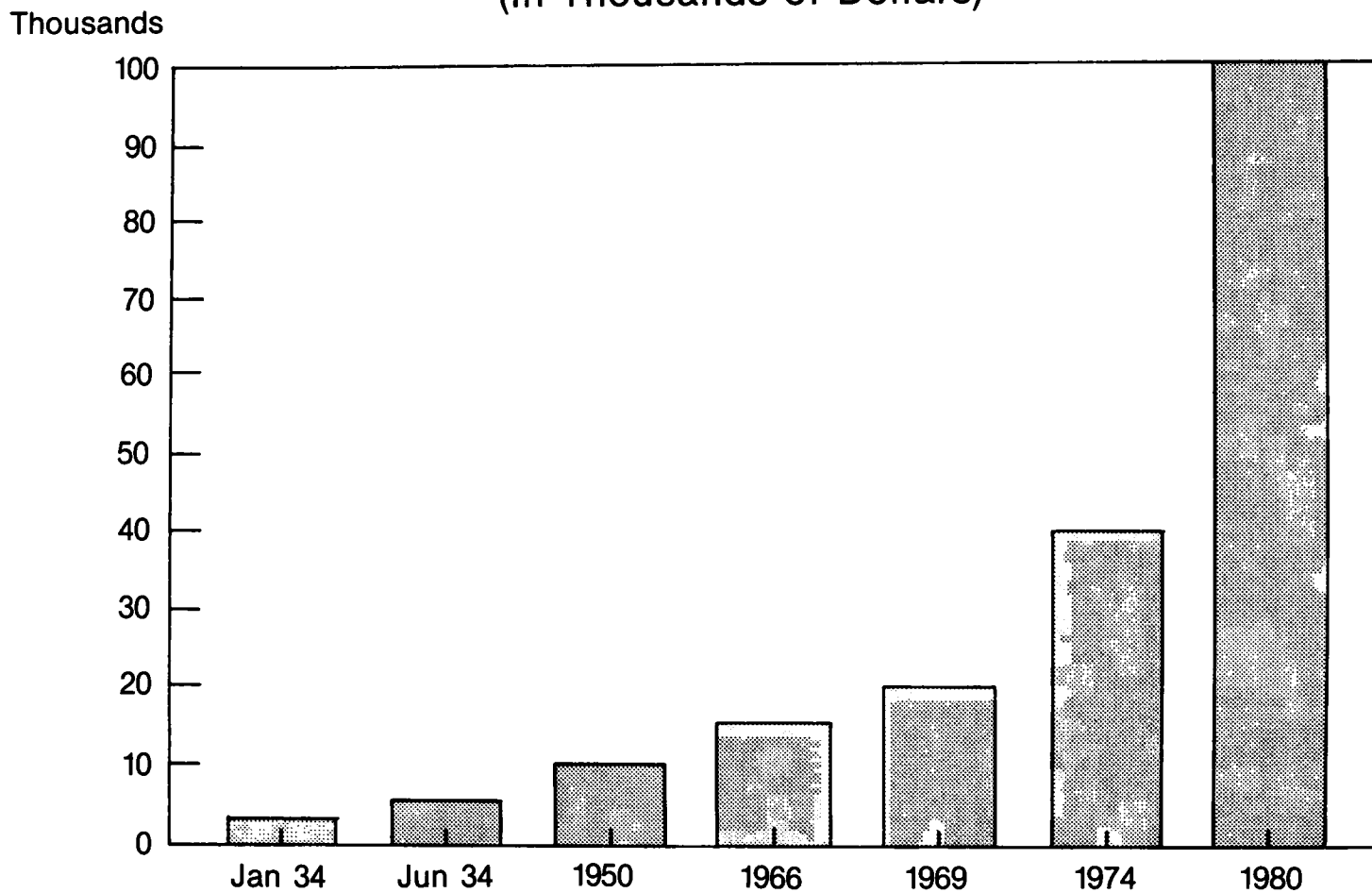
In response to Congressional concern, the FDIC temporarily shifted away from this practice in the late 1950s and early 1960s. But the practice resumed and expanded in the 1970s and 1980s, when it was argued that P&As were less expensive than paying off individual depositors. By the mid-1980s, however, it became clear that P&As were not necessarily cheaper than other resolution methods in which uninsured depositors would have suffered losses. Nevertheless, from 1985 through 1990 -- the period of the highest number of bank failures since the 1930s -- over 99 percent of uninsured deposits have been fully protected in bank failures.

Similarly, until recently, bank creditors have typically been fully protected, and this same total protection has sometimes extended even to the holding company creditors of failed banks. Such blanket protection has further eroded market discipline and increased taxpayer exposure.

At the same time, the scope of insured deposit coverage dramatically expanded. The amount insured per depositor increased from \$2,500 initially to \$100,000, a four-fold rise after adjusting for inflation (see Figure 6); the number of separate depositor "capacities" that could be insured up to \$100,000 in each bank increased substantially through regulatory interpretations; and new insurance-expanding techniques developed, such as brokered deposits and "pass-through" coverage.

Figure 6

### Growth of Deposit Insurance Coverage (In Thousands of Dollars)



Source: Federal Deposit Insurance Corporation.

Banks and thrifts took advantage of this expanded coverage to grow by using the government's guarantee to attract deposits, rather than to rely on the strength of their own balance sheets to raise funds. This is demonstrated by Figure 7, which shows the substantial increase over time of the ratio of insured deposits to total deposits. The result has been increased taxpayer exposure and decreased market discipline, enabling weak banks and thrifts to grow and proliferate.

**3. Inadequate Government Supplements to Market Discipline.** Faced with an eroded bank franchise and overexpanded insurance coverage, the government system for supplementing market discipline has become increasingly inadequate. First, capital requirements have been effectively weakened as banks have reached for off-balance sheet activities and higher leverage to increase profitability. Recently adopted risk-based capital standards are an improvement, yet they fail to take interest rate risk into account. Moreover, capital adjustment methods, such as reserving for anticipated loan losses, have not always resulted in reported capital levels that reflect economic reality.

Second, the flat-rate system of deposit insurance pricing has compounded the problem by failing to penalize institutions that assumed more risk. This is a luxury we can no longer afford.

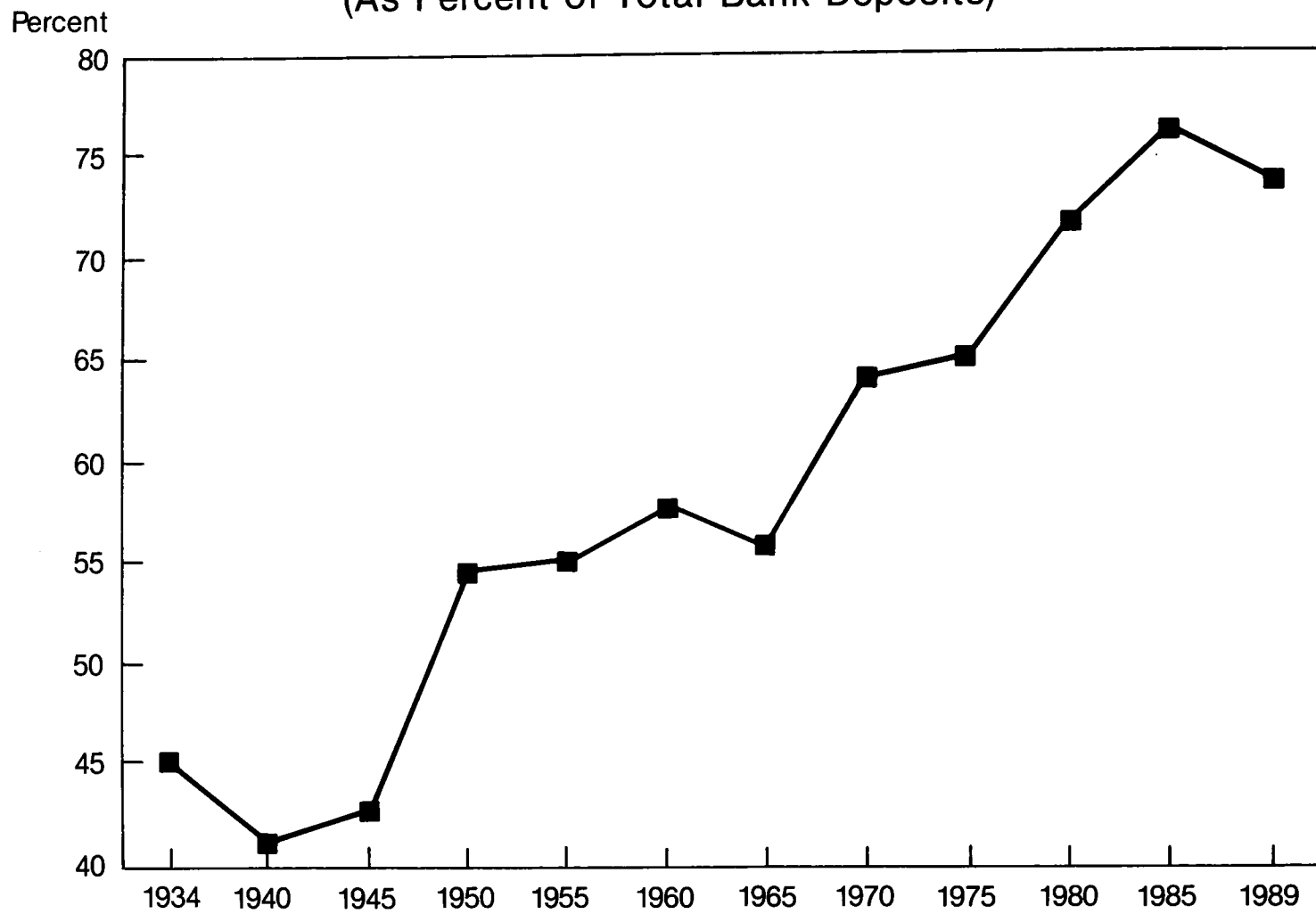
Third, states sometimes authorized federally insured, state-chartered thrifts and banks to engage directly in high-risk activities far beyond those permitted for national banks and federally-chartered thrifts. The results in the thrift industry, particularly with direct commercial real estate investment, have been disastrous. While the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) stopped much of this for thrifts, a number of states continue to permit these direct investment activities for banks.

Finally, supervisory and regulatory policies need to be modified and strengthened. Insolvent thrifts were often allowed to stay open far too long, thereby compounding losses. While some institutions were forced to cut or eliminate dividends, regulators sometimes waited too long to require cuts, thereby reducing the capital cushion available to protect the insurance funds. Critics have also argued that the absence of firm, uniform regulatory rules has created near-total regulatory discretion, which has made regulatory action more difficult as a practical matter.

The difficult job of regulation has not been made easier by our regulatory system. We have been unsuccessful in restraining the deterioration of the bank and thrift industries despite the presence of more bank examiners than any country in the world. The system is fragmented and needlessly complex. With as many as four federal regulators involved in the affairs of a single banking organization, in many cases no one regulator has the full information, responsibility, and accountability for dealing decisively with troubled firms. Moreover, the system has been too susceptible to occasional bouts of bureaucratic infighting and inconsistent standards.

Figure 7

### Growth of FDIC-Insured Deposits (As Percent of Total Bank Deposits)



Source: Federal Deposit Insurance Corporation.

**Excessive Taxpayer Exposure.** In sum, the combination of an overexpanded insurance coverage, the erosion of bank profitability, and inadequate government substitutes for market discipline has produced a predictable result: the taxpayer is exposed to unacceptable losses through federal deposit insurance. There is no better evidence for this than the increasing number and cost of failures, which have skyrocketed in the 1980s.

Part of the explanation for these statistics is no doubt the natural shakeout and consolidation of an industry that has finally become subject to competition after a long period of protection and indirect subsidy by the federal government. But losses are too high. The taxpayer is too greatly exposed, and the frequency of costly failures has even had some negative impact on depositor confidence -- which is the very thing that deposit insurance was intended to enhance.

It is time to adopt a series of reforms to make banks safer and more competitive.





## **PART ONE: DEPOSIT INSURANCE AND BANKING REFORMS**

The Administration's recommendations for deposit insurance and banking reforms fall into nine categories, all designed to strengthen the safety, soundness, and competitiveness of the banking system:

- I. Strengthened Role of Capital
- II. Reduction of Overextended Scope of Deposit Insurance
- III. Risk-Based Deposit Insurance
- IV. Improved Supervision
- V. Restrictions on Risky Activities
- VI. Nationwide Banking and Branching
- VII. Modernized Financial Services Regulation
- VIII. Credit Union Reforms
- IX. Other Deposit Insurance Recommendations

Each of these categories represents a different approach to strengthening the banking system. Some focus on stronger market discipline; others on improved supplements to market discipline; and still others on a healthier, more competitive banking system. Taken together, they form a balanced, integrated package that must be considered as a whole. No single recommendation will be fully effective by itself, and indeed, some could be counterproductive if adopted in isolation. For example, piling on restrictions in the name of safety and soundness without addressing bank competitiveness is an invitation to greater taxpayer exposure.

In addition, there must be appropriate transition periods for many of the recommended changes. A number represent fundamental reforms that will require considerable time for the banking system to adjust. They are not short-term, "quick fixes," but long-term proposals for enhancing the strength of the industry. Specific transition proposals are therefore included where appropriate.

## **I. Strengthened Role of Capital**

### **List of Recommendations**

- A. Capital-Based Supervision**
- B. Capital-Based Insurance Premiums**
- C. Capital-Based Expanded Activities**
- D. Capital Adjusted for Interest Rate Risk**

### **Reasons for Recommendations**

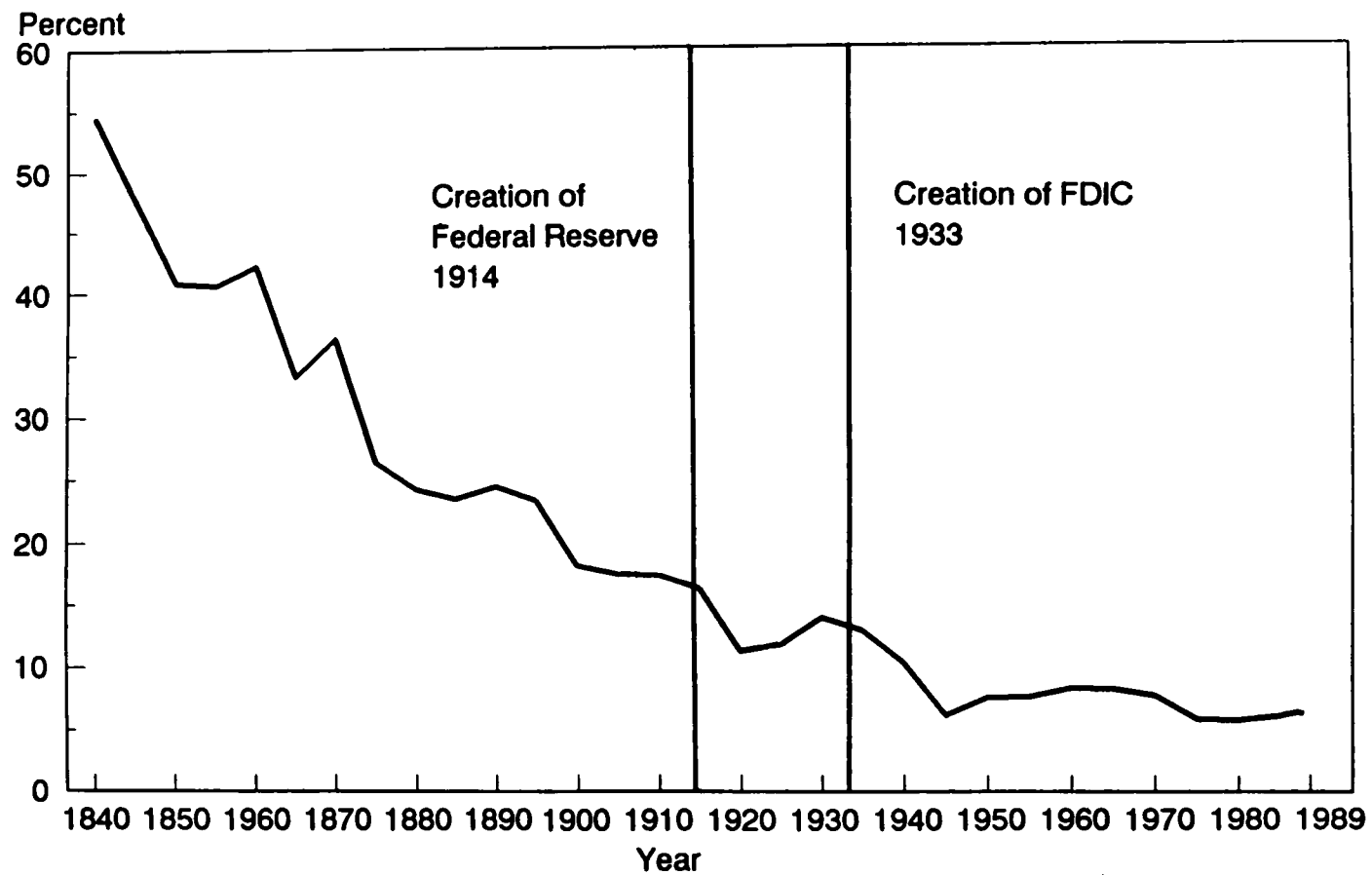
The single most powerful tool to make banks safer is capital. It is an "up-front" cushion to absorb losses ahead of the taxpayer, and banks are less likely to take excessive risk when they have substantial amounts of their own money at stake. Yet the safety net has permitted banks to have lower capital ratios than other financial companies. The bank regulatory system is not adequately focused on the crucial importance of capital. Capital standards should not be raised, but the role of capital must be strengthened -- regulation should be redesigned to provide more incentives for banks to maintain strong levels of capital. The discussion below draws on Discussion Chapter II, Capital Adequacy.

**The Low Capital Ratios of Banks.** The safety net appears to have allowed banks to run their capital ratios down to extremely low levels. As Figure 8 shows, over the last 150 years the ratio of aggregate capital to total assets of the banking system has generally declined from a high of over 50 percent in the 1840s to its current levels of well under 10 percent. Contemporary levels are one-sixth the level of the mid-1800s, and less than one-half the level of 50 years ago.

Much of this decline no doubt reflects the increasing efficiency of the U.S. financial system. But there were particularly sharp declines in capital ratios after the creation of the Federal Reserve in 1913 and the FDIC in 1933, the two safety net institutions. Moreover, it is difficult to believe that the market would allow banks to operate in recent years with such a small capital buffer were it not for a perception of federal government protection.

This point is highlighted by Figure 9, which shows dramatically that large financial institutions covered explicitly or implicitly by a government safety net -- banks and government-sponsored enterprises (GSEs) -- have much lower capital ratios than unprotected financial institutions. (Indeed, bank capital ratios might even be at the lower GSE level were it not for the minimum capital requirements established by bank regulators.) In short, banks are among

Figure 8  
Equity as a Percent of Assets  
For All Insured Commercial Banks\*  
1840 - 1989

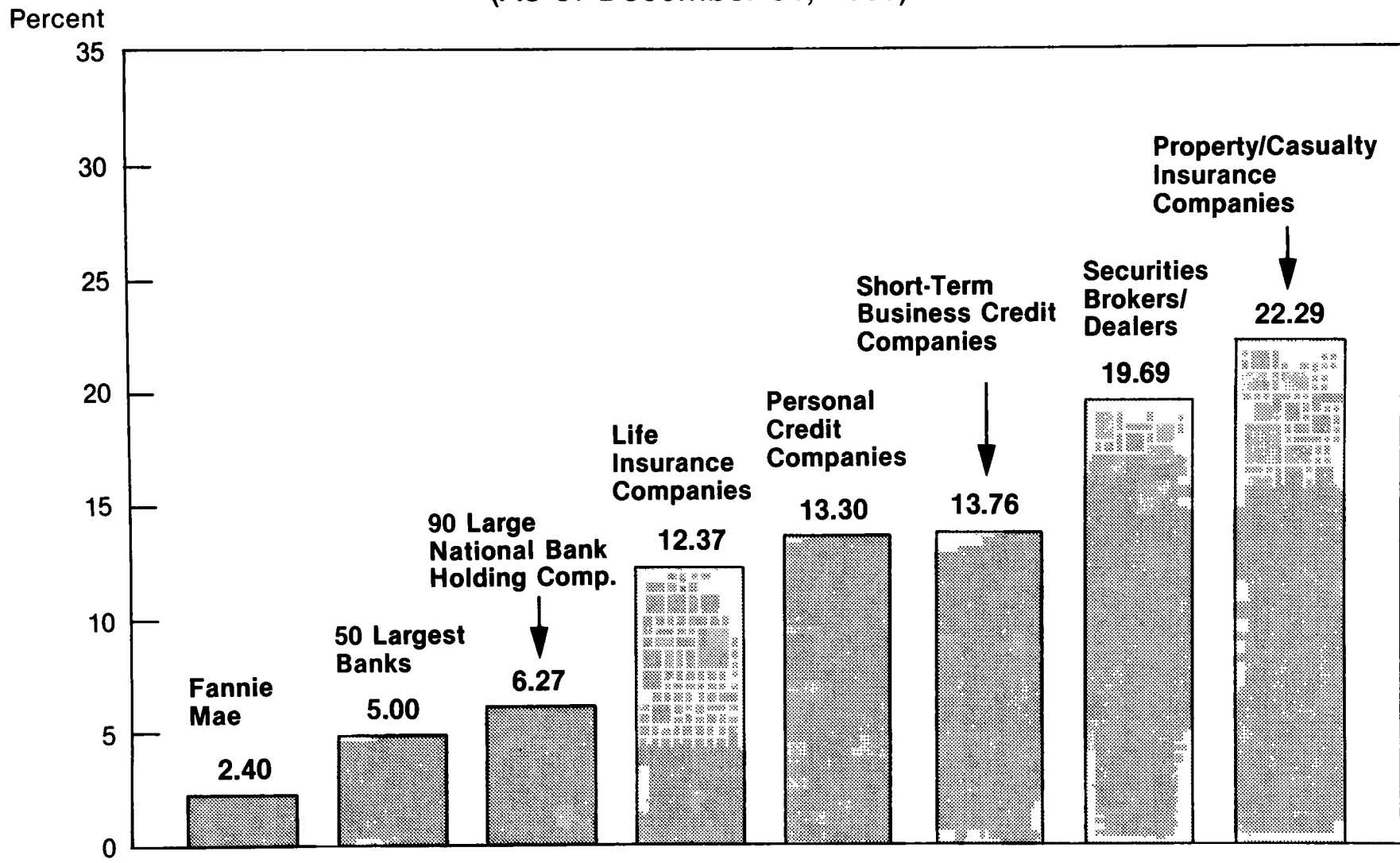


\*Ratio of aggregate dollar value of bank book equity to aggregate dollar value of bank book assets.

Source: Statistical abstract through 1970.  
Report of condition thereafter.

Figure 9

### Financial Institution Capital Levels Median Equity Capital-To-Total Assets Ratios (As of December 31, 1989)



Sources: Bank Call Reports and Standard and Poor's Compusat Service, Inc.

the most highly-leveraged non-government companies in the country.

The particular benefits of capital are described below.

**Lower Probability of Bank Failure.** Almost by definition, adequate capital decreases the likelihood of failure and therefore makes banks safer. The more capital a bank has, the more it can withstand unexpected losses without becoming insolvent. The capital "cushion" buys time for a bank and its regulator to work through problems.

**Less Incentive to Take Excessive Risk.** The combination of low capital and federally insured deposits creates the "moral hazard" problem. Owners with little at stake have an incentive to take excessive risk with a virtually unlimited supply of funds. This gambling with other people's funds creates the classic "heads I win, tails you lose" situation, with gains kept by owners and losses put to the FDIC or the taxpayer. Higher capital requires owners to put more of their own money at stake, which creates a powerful incentive to control excessive risk-taking -- making banks safer.

**Buffer in Front of the Taxpayer.** When banks do fail, every dollar in losses absorbed by capital is one less dollar absorbed by the FDIC or the taxpayer. From the perspective of the insurer, capital serves as a "deductible" for bank owners to absorb losses first, just as a car owner absorbs losses on his deductible before the insurance company pays.

**Less Misallocation of Credit.** With low levels of capital, the incentive for bank management to take excessive risk can result in a misallocation of resources to risky investments. If the number of weak institutions is large, interest rates will be too low for loans to finance these risky investments, and too high for loans to finance less risky investments. With a sufficient amount of competition from poorly capitalized banks, even well capitalized banks must accept these skewed rates of interest. Critics argue that this is exactly what has occurred in certain commercial real estate markets, with overbuilding eventually causing severe economic downturns -- which in turn has resulted in bank failures.

**Helps Avoid "Credit Crunches."** In an economic downturn, a poorly-capitalized bank that suffers losses is likely to be forced to restrict credit in an effort to shrink assets and build capital ratios. A well-capitalized bank can afford more losses and yet continue to lend in the same circumstances. Adequate capital thus helps keep credit available even in hard times.

**Increases Long-Term Competitiveness.** As discussed above, adequate capital helps ensure the long-run viability of a bank, which helps it to develop and maintain long-term customer relationships. Adequate capital also helps provide the time (by absorbing losses) and the financial resources to respond to both positive and negative changes in its environment. For example, a well-capitalized bank has much more flexibility to expand to take advantage of new opportunities than a poorly-capitalized bank.

Over the long run, a strong capital position is likely to make banks stronger and more profitable. Indeed, often the most nationally and internationally competitive U.S. banking organizations are also the best capitalized. There is also evidence that the best-capitalized banks tend to earn the highest returns on equity, notwithstanding the argument that increasing capital for a given firm should theoretically reduce its return on equity.

In sum, it is crucial to strengthen the role of capital in the bank regulatory system. The regulatory focus should be reoriented without losing the key protections of the current system. There should be rewards for firms that build and maintain strong levels of capital, and prompt corrective action for firms that fail to do so. There should be new opportunities for banks to build and attract capital, and improved measurement of capital in relation to risk. Over time this should result in a strong, well-capitalized banking system -- the best protection for the taxpayer.

### **Specific Recommendations**

#### **A. Capital-Based Supervision**

This system would gear supervision to levels of capital. As capital declines below minimum levels, the system would provide for prompt and increasingly strong corrective action. Conversely, as capital increases above minimums, a banking organization would have additional authority to engage in new financial activities and to receive less intrusive regulation. Again, these new supervisory actions based on capital levels would not replace the current regulatory system; instead, they would supplement and strengthen supervision. Capital-based supervision is described in more detail in Section IV, Improved Supervision.

#### **B. Capital-Based Insurance Premiums**

Deposit insurance premiums should be assessed on the basis of risk, and a bank's risk-based capital should be the measure used for risk. The more risk-based capital a bank has, the lower the premiums it should pay (just as a car insurer permits lower premiums with higher deductibles). This will create yet another incentive to build and maintain strong capital. The specific proposal is discussed in more detail in Section III, Assessment of Risk-Based Premiums.

#### **C. Capital-Based Expanded Activities**

Section VII sets forth recommendations for a new financial services holding company (FSHC), which would permit banking organizations to engage in new financial activities in affiliates outside of the federal safety net. FSHCs with well-capitalized banks could take advantage of these new activities, providing another incentive to build and maintain capital in

the bank. At the same time, commercial companies could own FSHCs, tapping an important new source of capital for banks.

This system will not only help firms that already own well-capitalized banks. In addition, firms with undercapitalized banks will be able to attract the necessary new capital to engage in new financial activities, either from the financial markets or from diversified financial and commercial companies. A more attractive franchise will attract more capital.

#### **D. Capital Adjusted for Interest Rate Risk**

The current risk-based capital standards are based primarily on credit risk, not interest rate risk. As a result, there is some incentive for banks to shift into assets that are more sensitive to interest rate risk. Until recently, there has been no systemwide method for bank regulators to monitor interest rate risk and no established method for adjusting capital to reflect that risk. The Office of Thrift Supervision has recently proposed an interest rate risk capital rule, and that is an innovative step forward.

The bank regulators should do likewise, and a system should be established to reflect interest rate risk in risk-based capital. International participants in the Bank of International Settlements, including the United States, are currently developing such a proposal. This process should be encouraged, but the issue is too important to wait for a new international agreement. U.S. bank regulators should develop a reporting system here within one year, which would form the basis for a system to adjust capital for interest rate risk.



## **II. Reduction of Overextended Scope of Deposit Insurance**

### **List of Recommendations**

- A. Reduce Coverage of Multiple Insured Accounts**
  - 1. Limit Individual Coverage to \$100,000 Per Institution**
    - a. Two-year transition period**
  - 2. Separate \$100,000 Coverage of Retirement Savings**
  - 3. Set Goal of \$100,000 Per Capacity Systemwide**
    - a. Eighteen-month FDIC feasibility study**
- B. Eliminate Certain "Pass-Through" Coverage**
  - 1. Eliminate Coverage for Certain Pension Plans**
    - a. Exception for self-directed plans**
  - 2. Eliminate Coverage for Bank Investment Contracts**
- C. Eliminate Coverage of Brokered Deposits**
  - 1. Two-Year Phase-In**
  - 2. Exception for Resolution Trust Corporation**
- D. Eliminate Coverage of Non-Deposit Creditors**
- E. Limit Coverage of Uninsured Depositors**
  - 1. Require Least Costly Resolution Method**
  - 2. Systemic Risk Exception**
  - 3. Improved Liquidity Mechanism**
  - 4. Methods to Reduce Systemic Risk**

## 5. Three-Year Transition

### F. No Assessments on Foreign Deposits

#### Reasons for Recommendations

Deposit insurance was intended to protect small, unsophisticated depositors who could not be expected to protect themselves. It was not intended to offer full protection to wealthier and sophisticated investors, and it certainly was not intended to extend to every uninsured depositor and to bank creditors. Yet this is precisely the expansion of coverage that has occurred in recent years -- directly increasing taxpayer exposure and directly decreasing market discipline on risky banks. (There has recently been some reduction in the coverage of non-deposit creditors.)

The time has come to reverse this trend. The Administration recognizes that deposit insurance has helped provide crucial confidence in the banking system and that exclusive reliance on depositor discipline cannot work. The federal government must stand behind this country's banking system. But taxpayers are becoming alarmed that they might be called on to cover the losses of sophisticated depositors and creditors when there is no genuine threat to the system.

Moreover, the expansion of deposit insurance coverage has taken place at the same time that failures and losses have increased geometrically. This is almost certainly not mere coincidence. The removal of market discipline as a check on excessive risk is a likely contributor to the problem.

Indeed, it appears that as coverage increased in recent years, no judgment was made about either the increase of the taxpayer's exposure or the ability of the government to control increased risk caused by the reduction in market discipline. The dramatic rise in costly failures suggests that risk did increase and that the government response was indeed inadequate.

Accordingly, the recommendations to reduce the scope of coverage are two-fold: to reduce the taxpayer's liability for losses sustained by large and sophisticated depositors; and to return the system to a level of coverage that preserves stability, while obtaining an important level of market discipline from these same sophisticated investors. For the reasons discussed below, overextended coverage should be reduced for both insured and uninsured depositors and creditors -- but only with appropriate transition periods to prevent abrupt changes to the system. The conceptual framework for these recommendations is included in Discussion Chapter III, Scope of Deposit Insurance.

Insured Deposit Coverage. Over the years, the explicit coverage of deposit insurance has dramatically expanded through the use of loopholes, legislative changes, and regulatory policy. The amount covered in each insured account has jumped from \$2,500 in 1934 to \$100,000 today -- a four-fold rise after adjusting for inflation -- with the largest single increase occurring in 1980, just over 10 years ago. See Figure 6. Regulatory policy permits numerous separately

insured accounts within a single institution through separate insured "capacities" (e.g., joint accounts, trust accounts, individual retirement accounts, etc.). And wealthier depositors can acquire an unlimited amount of deposit insurance by opening up separately insured accounts in different depository institutions. The brokerage of insured deposits has expedited this process. Meanwhile, "pass through" insurance has allowed institutional investors to take advantage of increasingly larger amounts of deposit insurance.

While the taxpayer's exposure has thus increased, troubled banks have been able to turn to these new sources of insured deposits for funding when markets would otherwise impose higher funding costs -- appropriately -- to reflect greater bank risk. Indeed, there has been a pronounced shift in bank funding from uninsured deposits to insured deposits, as discussed above.

Critics argue that reversing this trend will have little effect in an era when government policy has resulted in the protection of virtually all uninsured deposits, as well as insured deposits. This is wrong for two reasons. First, as recommended below, the government policy for routinely protecting all uninsured deposits should end.

Second, even if there was no reduction in the current de facto protection of uninsured depositors, it would still make sense to reduce explicit insurance coverage. Even today, uninsured depositors exercise a greater degree of market discipline than insured depositors because of the uncertainty about whether the government will change its voluntary policy of usually providing full protection. This "constructive ambiguity" has often resulted in uninsured depositors either demanding higher risk premiums or withdrawing funds from a risky bank; insured depositors in the same circumstances have been largely indifferent to the bank's risk.

**Uninsured Depositor Coverage.** It would seem obvious -- indeed, very nearly a tautology -- that deposit insurance coverage should not extend to uninsured deposits and other liabilities. Those with deposits over \$100,000 should be able to protect themselves without government guarantees; they make their large deposits with full knowledge that the funds have no insurance; there is no reason why the taxpayer should be exposed to their losses; and such depositors are likely to be in a better position to monitor excessive risk-taking by bank managers.

Yet, the preferred FDIC practice in recent years has been to fully protect uninsured depositors. This is not merely true of so-called "too big to fail" situations, which are discussed more fully below. FDIC policy has resulted in the protection of over ninety-nine percent of uninsured deposits during the record period of bank failures occurring since 1985.

Indeed, the current coverage policy seems exactly contrary to logic. One would expect a policy that protects only insured depositors, with an occasional extension of coverage in rare circumstances to uninsured depositors. Instead, the policy has been to protect uninsured depositors whenever possible, with exceptions occurring only in those few instances when the FDIC cannot find an acquirer for the failed institution.

There are a number of reasons why the FDIC has adopted this policy of blanket protection, including the following: (1) it is sometimes the least expensive resolution method; (2) it can maintain stability and avoid the systemic risk problems associated with large bank failures; (3) it avoids disruptions to the community; (4) it appears more equitable to smaller banks, because they believe that larger banks will always be protected under the "too big to fail" doctrine; and (5) the immediate institutional pressures are likely to favor protecting all depositors, rather than inflicting widespread losses.

As discussed below, the Administration believes that some of these concerns are legitimate, but that the pendulum has swung too far. The current system makes it far too easy to protect too many uninsured depositors and creditors; the taxpayer is effectively underwriting too many depositors that do not need protection; too much market discipline has been removed; and the result has been too much bank risk with too many costly failures.

### Specific Recommendations

#### **A. Reduce Coverage of Multiple Insured Accounts**

The Administration recommends reining in the overexpansion of deposit insurance coverage to multiple insured accounts. This type of proposal has obvious merits. Today's coverage of multiple accounts seems excessive by almost any definition. While the popular perception is that deposit insurance is already limited to \$100,000 per person, the reality is much different -- depositors can have multiple accounts insured up to \$100,000 each within a single institution, and an unlimited number of insured accounts across different institutions. Both practices should either be eliminated or sharply reduced.

For example, current FDIC rules permit an individual depositor at a single institution to have separate \$100,000 coverage for his or her individual account, joint account, revocable trust account for family members, individual retirement account, Keogh account, "pass-through" pension fund accounts, unincorporated business account, and others. (These separately insured types of accounts are otherwise known as separately insured "capacities.") Banks and thrifts take advantage of this overextension of the federal guarantee to expand their non-market funding base. For example, a recent advertisement proudly proclaimed that a family of three could acquire as much as \$1.2 million in insurance coverage from a single depository institution through the use of these types of accounts. See Figure 10.

An individual can receive this same coverage of multiple accounts at any other federally insured institution, making the total potential coverage infinite. Deposit insurance was not intended to provide such unlimited coverage. Accordingly, the Administration recommends significant reductions in this overexpansion of the federal safety net.

Figure 10

## The Expanded Scope of Deposit Insurance Coverage

Here's how a family of three - husband, wife, and one child - can increase their coverage to \$1,200,000 in a single depository institution (this example assumes that each individual holds no other account with the institution):

<b>Individual Accounts:</b>		
Husband	\$	100,000
Wife	\$	100,000
Child	\$	100,000
<b>Joint Accounts:</b>		
Husband and Wife	\$	100,000
Husband and Child	\$	100,000
Wife and Child	\$	100,000
<b>IRA/Keogh Accounts:</b>		
Husband	\$	100,000
Wife	\$	100,000
<b>Revocable Accounts:</b>		
Husband as Trustee for Wife	\$	100,000
Husband as Trustee for Child	\$	100,000
Wife as Trustee for Husband	\$	100,000
Wife as Trustee for Child	\$	100,000
<b>Total Insurance Coverage:</b>		<b>\$ 1,200,000</b>

Source: Recent depository institution advertisement.

## **1. Limit Individual Coverage to \$100,000 Per Institution**

The FDIC should generally roll back coverage at each institution to \$100,000 per individual. There is no clear reason why a depositor should receive an additional \$100,000 in coverage for a joint account -- half of the joint account should be aggregated with the depositor's individual account for the purposes of the \$100,000 coverage. Likewise, separate coverage for revocable trust accounts for family members should be eliminated, with deposited amounts aggregated with the depositor's individual account.

Separate insurance for other insured capacities, such as escrow accounts and sole proprietorship accounts, may present closer questions. Nevertheless, with the exception noted below for retirement savings, the Administration believes that separate capacities should be eliminated unless the FDIC makes a new determination that separate insurance is appropriate.

### **a. Two-year transition period**

The Administration recommends that the proposed elimination should take effect within two years from the date of enactment of legislation to give institutions time to adjust. However, the FDIC may determine within one year, after reviewing each capacity individually, that separate insurance coverage is consistent with both the fundamental purpose of deposit insurance to protect small depositors and the need to limit the expansion of deposit insurance coverage.

## **2. Separate \$100,000 Coverage of Retirement Savings**

Notwithstanding the proposal to limit the number of separately insured capacities, the Administration believes that a single, separate \$100,000 capacity per institution is appropriate for retirement savings to encourage long-term savings and investment. This would require aggregating the separate insured capacities for Keogh accounts, individual retirement accounts, and those pension fund accounts that continue to "pass through" to individual depositors under the recommendations set forth below. As with the basic \$100,000 coverage for individuals, the consolidation of retirement savings into one capacity should not occur until two years from the date of enactment of legislation.

## **3. Set Goal of \$100,000 Per Capacity Systemwide**

In addition to limiting the number of separately insured capacities within depository institutions, the Administration believes that limiting deposit insurance coverage to \$100,000 per capacity systemwide is an appropriate long-term goal. For example, deposits in an individual's own capacity in all insured accounts in all banks, thrifts, and credit unions would receive no more than \$100,000 of coverage. Such a limitation would have no effect on the overwhelming majority of depositors in America. According to preliminary estimates from the 1989 Survey

of Consumer Finances, less than six percent of households have more than \$100,000 in total deposits in insured depositories, while over 87 percent have less than \$50,000 in total deposits. (These data reveal the pattern of household deposits, not individual deposits, which is the ultimate concern.)

Although this goal will be difficult to achieve because of administrative complexities, the Administration believes it may be attainable over a five-year period. It will not be necessary to constantly monitor the account balances in every account in America. Nor will it be necessary to put in place an elaborate system to avoid delaying the resolution of a failing bank until the insured status of every depositor is determined.

For example, it may be possible to put the rule in place and selectively audit for compliance after the resolution of a failed bank. Most depositors would pay attention to the rule simply because it has been enacted into law -- few people will be indifferent to the potential effect on their bank deposits, even if they believe the rule is difficult to enforce.

Moreover, as the Administration recommends in Section VII, banks would be able to offer depositors the alternative of safe, uninsured money market accounts that might invest only in full faith and credit government securities. This would provide conservative depositors with a convenient, protected method of leaving funds in excess of \$100,000 with a depository institution.

Nevertheless, the FDIC has recently informed the Treasury that it is strongly opposed to any such systemwide limitation, even if phased-in over a long period of time. One of the FDIC's fundamental objections is the administrative cost that might be associated with such a system, citing preliminary estimates of more than \$1 billion over five years under certain circumstances.

**b. Eighteen-month FDIC feasibility study**

Such estimated costs are indeed substantial, but so is the exposure to the taxpayer of bailing out large depositors who have more than \$100,000 in federally insured accounts. A systemwide limitation demands a detailed, technical analysis of the costs and benefits associated with the least expensive, yet feasible, way to implement such a system. This would include an examination of the data systems that would be required; the reporting burden on individual banks; the interface with existing data processing systems maintained by banks; and data on the systemwide pattern of individual deposits.

The FDIC should carry out this detailed cost-benefit analysis within eighteen months, using appropriate outside consultants and technical experts. The Administration believes that, in the end, the ultimate costs may prove to be far less than the benefits. Nevertheless, Congress should determine this only after it receives the feasibility report. If the report is positive,

appropriate legislation could then be enacted to reduce taxpayer exposure by limiting insurance coverage per capacity on a systemwide basis.

## **B. Eliminate Certain "Pass-Through" Coverage**

So-called "pass-through" deposit insurance enables banks to raise large amounts of funds from institutional investors on a fully-insured basis. (Data are provided in Discussion Chapter V, Pass-Through Insurance.) This practice removes market discipline from some of the very participants who would be the best able and most likely to provide it.

Pass-through insurance occurs when a fiduciary deposits funds for a large number of beneficiaries, with \$100,000 of deposit insurance "passing through" to each of the beneficiaries. In cases where the funds are not used for investment purposes or where the trustee is not a sophisticated investor, it may be appropriate for deposit insurance to pass through to the unprotected beneficiaries. For example, escrow accounts established by either lawyers for clients or landlords for tenants would appear to be a prudent use of pass-through insurance. The same would be true of escrow accounts maintained to facilitate mortgage servicing for homeowners and check processing for consumers.

But there is no reason to expand the taxpayer's exposure through pass-through insurance for brokered deposits and certain institutional pension fund deposits. Because the general topic of brokered deposits is addressed separately below, this subsection focuses on the use of pass-through insurance by pension plans.

### **1. Eliminate Coverage for Certain Pension Plans**

Pass-through insurance applies to certain depositors that are also institutional investors, such as pension funds, the managers of which earn substantial fees to invest participants' and beneficiaries' funds prudently. The behavior of pension fund fiduciaries is governed by a strict set of criteria under trust and federal pension law designed to protect the best interests of their beneficiaries.

Indeed, for purposes of deposit insurance, there is very little difference between a professional investor who manages money for a pension fund and one who manages money for either a money market mutual fund or an employee health and welfare plan. Each is paid to invest other people's money; each is required to invest prudently; and each invests substantial sums in bank deposits. The difference is that the pension fund's deposits are generally covered by deposit insurance, while the deposits of the money market fund and employee health and welfare plans are not. The sophisticated pension fund manager may therefore exercise less market discipline over bank investments than the sophisticated managers of money market funds and employee health and welfare plans. This differential treatment makes little sense.



**Defined Benefit Plans.** Moreover, there are even greater levels of beneficiary protection available to defined benefit pension plans. The sponsor of a defined benefit plan has a commitment to pay benefits to plan participants based on established formulas involving such factors as years employed, age, and salary earned. The sponsor bears all of the investment risk from plan funds and typically employs a professional investment manager. Participants in defined benefit plans are protected from risky banks not only by prudent professional management, but also by a separate "safety net" -- in the event of bank failure, the plan's sponsor (and control group) and the Pension Benefit Guaranty Corporation (PBGC) are liable to pay for any losses that would otherwise accrue to beneficiaries. These protections make pass-through deposit insurance unnecessary and inappropriate for defined benefit plan deposits in banks.

**Defined Contribution Plans.** The other major category of pension plans that receives pass-through deposit insurance coverage is defined contribution plans. Many defined contribution plans stipulate a percentage of each participant's earnings to be contributed to the plan by the employer. Others provide for an election by each participant to defer a percentage of pre-tax earnings, which is often matched by employer contributions. In either case, investment risk remains with the participant. Participants in these plans do not receive the same "safety net" protections as participants in defined benefit plans, that is, loss protection from plan sponsors and PBGC. Nevertheless, the plans do have similar investment rules and many are professionally managed. With the exception noted below, these plans should not receive pass-through deposit insurance treatment.

**a. Exception for self-directed plans**

Pass-through insurance should continue to apply to self-directed defined contribution plans. Unlike plans where an institutional investor makes investment decisions on behalf of beneficiaries, self-directed plans give beneficiaries the discretion to choose such investments as bank deposits. When these beneficiaries make such a choice, they should be eligible for the same deposit insurance treatment as individual savers who do not participate in such plans.

At the same time, consistent with FDIC action to roll back the number of separately insured capacities, pension fund deposits receiving pass-through coverage should be aggregated with the beneficiary's other retirement savings for purposes of applicable \$100,000 limitations. While this proposal may require some changes to various rules and practices under the Employee Retirement Income Security Act of 1974, it would not create substantial new administrative burdens because the FDIC already requires the necessary recordkeeping as a condition to receiving pass-through coverage.

## **2. Eliminate Coverage for Bank Investment Contracts**

Finally, pass-through insurance can create competitive inequities. Insurance companies have offered so-called Guaranteed Investment Contracts, or "GICs," to retirement fund investors since the beginning of the 1980s. GICs permit these investors to deposit funds with the insurance company over time with a guaranteed interest rate for the term of the contract. GICs are obviously not covered by federal deposit insurance.

In recent years, banks have begun to offer a product similar to GICs called Bank Investment Contracts, or "BICs," which explicitly take advantage of pass-through deposit insurance as a marketing tool. While BICs may have a greater degree of interest rate risk than bank deposits, it appears that this risk can be effectively managed through contract limitations and hedging strategies.

The problem remains, however, that BICs are fully insured by the government. This provides banks with a new opportunity to attract large deposits by expanding the use of the government's guarantee. Meanwhile, insurance companies offering GICs totally outside of the safety net do not have this competitive advantage. Banking organizations should be permitted to offer BICs to pension fund managers, but not with federal deposit insurance.

### **C. Eliminate Coverage for Brokered Deposits**

The brokerage of insured deposits has expanded the scope of deposit insurance coverage for wealthier depositors. According to the preliminary results of the 1989 Survey of Consumer Finances, households with more than \$100,000 in depository institutions hold almost three-quarters of the insured brokered deposits held by all households. There is no clear public policy reason why the taxpayer should routinely protect these wealthier depositors from losses. Such depositors do not need deposit insurance to find safe ways to invest their funds.

The use of brokered insured deposits also increases the ability of depository institutions to avoid a marketplace test in raising funds from depositors. FIRREA corrected the worst abuses of brokered deposits by curtailing their use by weak banks and thrifts. But the fact remains that brokered deposits allow even healthy institutions to expand their sources of government-guaranteed funding. As set forth in Discussion Chapter IV, Brokered Insured Deposits, expanding the ability of firms to use the government's credit, rather than their own financial condition, to raise funds is an invitation for increased risk and an increased misallocation of resources.

Critics will argue that deposit brokerage helps provide a more even distribution of funds in the system, with deposits flowing more easily to institutions with greater lending opportunities. The problem is that today these deposits are insured, rather than uninsured, which means that there is no market discipline involved in sending these funds to distant parts of the country to unknown banks and thrifts. Other mechanisms have long existed to even out credit flows with

uninsured funds, such as the federal funds market, correspondent banking networks, and the Federal Home Loan Bank System. The brokerage of uninsured deposits could be a useful addition to these mechanisms, but the expansion of government-guaranteed credit is not an appropriate way to accomplish this objective.

**1. Two-Year Phase-In**

Accordingly, the brokerage of insured deposits should be eliminated over a two-year period, although obviously all brokered deposits previously sold would remain subject to current insurance rules until maturity.

**2. Exception for Resolution Trust Corporation**

The prohibition on the use of brokered insured deposits should not apply to institutions in conservatorship with the Resolution Trust Corporation (RTC) or the FDIC. As governmental entities, the RTC and the FDIC should have the ability to temporarily use government-guaranteed credit for liquidity purposes if the practice would lower resolution costs for the taxpayer. The problems associated with issuing brokered insured deposits -- decreased market discipline, for example -- are not an issue when the government is operating and closely supervising a failed institution.

**D. Eliminate Coverage of Non-Deposit Creditors**

There are sometimes good reasons for the FDIC to protect uninsured depositors in bank failures, but there are very seldom good reasons for protecting other kinds of bank creditors. General, subordinated, and holding company creditors do not have the same characteristics as the most liquid forms of bank deposits. Failing to protect these non-deposit creditors in bank failures does not pose the same degree of systemic risk as failing to protect depositors. The taxpayer should not be exposed to the cost of bailing out these creditors.

Moreover, as discussed below, uninsured depositors will receive government protection from losses in circumstances involving systemic risk. It is therefore that much more critical for other creditors and shareholders to monitor and discipline the risky behavior of bank managers. Government protection undermines this discipline.

Accordingly, the Administration strongly endorses the current FDIC policy of allowing non-deposit creditors to suffer losses in bank failures. Indeed, in FIRREA the Administration proposed and Congress enacted a provision that facilitated the ability of the FDIC to implement this policy. The so-called "pro rata" provision allows the FDIC to expose creditors to their normal pro rata bankruptcy losses even if uninsured depositors are made whole. The FDIC has already taken advantage of this authority in several instances.

Likewise, the current FDIC policy of leaving holding company creditors unprotected has provided important market discipline. These creditors were fully protected in the failure of Continental Illinois, but since then it has been rare for the FDIC to provide such full protection. For example, holding company creditors were not protected in the recent resolution of the Bank of New England. While some bank holding companies have at times had funding problems as a result, those are the necessary consequences of a free market.

#### **E. Limit Coverage of Uninsured Depositors**

The government must always maintain the flexibility to protect the banking system and the economy in circumstances of genuine systemic risk. At times, this policy has led to the protection of uninsured depositors, just as it has in other countries around the world. (See Discussion Chapter XXI, Foreign Deposit Insurance Systems.) The resolution of the Bank of New England is the most recent example.

But this does not mean that uninsured depositors should always be protected, which is essentially the current policy. This overexpansion of insurance coverage creates enormous exposure for the taxpayer, while at the same time shielding banks from important market discipline. The priority of FDIC policy should therefore be changed: rather than seeking to extend protection to uninsured depositors whenever possible, it should seek to limit its protection to insured depositors whenever possible. The Administration's recommendations are designed to achieve this change in policy and priority, fully recognizing the need to make a change of this nature only after a substantial transition period and to retain flexibility to protect against systemic risk.

##### **1. Require Least Costly Resolution Method**

The first recommendation is that the FDIC should be required to use the least expensive resolution method unless the Treasury and the Federal Reserve Board determine that systemic risk requires otherwise. Contrary to widespread perception, current law does not require the FDIC to choose the least costly resolution method. As a result, sometimes the blanket protection of uninsured depositors is a by-product of the least costly resolution method; many other times it may not be. Either way, the misperception that such blanket protection is always the result of the least expensive resolution method makes it much easier to provide insurance coverage to uninsured depositors.

It is true that sometimes the least costly method of resolving a failed bank will require protecting uninsured depositors. For example, a bidder may pay a substantial premium to acquire the total franchise of a failed bank, purchasing all of its assets and assuming all of its liabilities. This "purchase and assumption" resolution method can have the additional benefit of saving FDIC administrative costs associated both with sorting out insured from uninsured depositors and taking on additional assets for resale and liquidation. It is possible that the

premium and administrative savings could offset the additional cost of preventing uninsured depositors from suffering losses.

On the other hand, a purchase and assumption transaction will often be more costly than an alternative resolution method known as an "insured deposit transfer," where an acquirer assumes only insured deposits and purchases only some of the failed bank's assets. The premium paid by an acquirer in an insured deposit transfer is likely to be similar to the premium paid in a purchase and assumption transaction. This is true because much of the franchise value of a failed bank attaches to its small, core deposits, which are insured, rather than to the large deposits that are uninsured. Yet, the insured deposit transfer method does not require the FDIC to assume the cost of protecting uninsured depositors, as is the case with the purchase and assumption method.

How does the law permit the FDIC to choose the more costly resolution method? The answer is that the chosen resolution method only needs to be less expensive than liquidating the bank and paying off its insured depositors -- it does not need to be the least costly resolution method. The current legal standard is therefore inconsistent with the Administration's goal of minimizing the cost to the insurance fund of resolving failed banks. The perfectly legitimate claim that a purchase and assumption transaction is "cheaper than a liquidation" helps perpetuate the misperception that it is in fact the "cheapest" resolution method. This misperception makes it easier to justify protecting uninsured depositors in a particular case.

The legal standard should be changed to specifically require the least costly resolution method. This change is likely to result in more losses for uninsured depositors and less exposure for the taxpayer. However, if the least costly method would result in full protection for uninsured depositors in a given case, then it should be permitted.

## **2. Systemic Risk Exception**

In a given case, the presence of systemic risk could require a decision to protect uninsured depositors, even if it is not the least costly resolution method. The FDIC usually has not make this decision alone, and indeed, its practice is to consult the Federal Reserve and the Treasury. A finding demands a broader government consensus that systemic risk exists and requires extraordinary government action.

Because the Federal Reserve is responsible for financial market stability, and because government action could require Federal Reserve discount window loans, the Federal Reserve should be formally involved in the systemic risk determination. Likewise, since the Administration is more directly accountable to the taxpayer than the Federal Reserve, the Treasury Department should also be involved.

Accordingly, the Administration recommends that (1) any determination to protect uninsured depositors on the basis of systemic risk should be made jointly by the Federal Reserve

and the Treasury Department; (2) the extra cost incurred from protecting uninsured depositors should be advanced to the FDIC by the Federal Reserve; and (3) the FDIC should repay the advance with industry funds.

By broadening the decision-making in this manner, government flexibility would be maintained, but would be difficult to exercise without an appropriate level of accountability. The intended result is that the extraordinary step of covering uninsured deposits would not be taken except in situations where systemic risk is truly present.

At the same time, the recommendation provides more flexibility for the Federal Reserve to provide bridge liquidity to protect the system. The industry would remain liable, as it should, to repay this bridge liquidity.

### **3. Improved Liquidity Mechanism**

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 the uninsured deposits.

The problem is that partial recovery can take long periods of time during which the full value of the deposits can be tied up in a failed bank receivership. This temporary loss of liquidity magnifies all of the problems associated with depositor losses, including systemic risk problems through the payments system and correspondent banking networks. If FDIC policy changes to produce more losses to uninsured depositors, then mechanisms for dealing with this liquidity problem must be developed and refined.

The most promising approach is the "final settlement payment" proposed by the American Bankers Association (ABA). In resolutions where uninsured depositors were not fully protected, the FDIC would make an immediate payment equal to the weighted average recovery of the FDIC standing in the shoes of depositors in past bank receiverships. (In recent years, the weighted average recovery rate has been over 80 percent.) The recovery rate would be posted in advance so that uninsured depositors would be on notice concerning the exact extent of their potential loss.

In any particular bank failure, the FDIC might have to pay either more or less to uninsured depositors than they would be entitled to receive under current law. But over time, the over-payments and under-payments should cancel each other out so that the FDIC should break even. The advantage of this approach is that it makes liquidity immediately available without exposing the FDIC to significant losses over time.

There are technical problems that need to be resolved with the final settlement payment approach, particularly for larger banks. (These are set forth in Discussion Chapter III, Scope

of Deposit Insurance.) There is also a legal question involved in paying individual depositors less in a particular case than their pro rata share of actual recoveries from the bank receivership. While these problems must be addressed, the FDIC should be given the authority to use this approach if the problems are resolved. At the very least, a "modified payout" approach should be adopted to provide immediate liquidity based on individual cost estimates in particular resolutions.

One final point should be made to avoid confusion. The Administration only endorses the liquidity aspect of the ABA's final settlement payment approach. There is no endorsement of an "automatic haircut" of all uninsured depositors in all bank failures. For the reasons discussed above, uninsured depositors may sometimes be protected if (1) it is genuinely the least costly way to resolve the institution; (2) it is necessary to protect against systemic risk; or (3) to do so is essential to provide depository services to the community.

#### **4. Methods to Reduce Systemic Risk**

The general thrust of the Administration's recommendations is to reduce the number of occasions that require full protection of uninsured deposits, recognizing the exception for instances involving genuine systemic risk. At the same time, more must be done directly to reduce the systemic risk involved in bank failures. This in turn will reduce the number of occasions that uninsured depositors must be protected.

Much significant progress has already been made. For example, the Clearing House for Interbank Payments System (CHIPS) has recently adopted an interbank netting system that has substantially reduced the systemic risk that would be caused by a large bank failure. The clearing organizations for securities and derivative instruments have also made significant improvements since the market break in October of 1987 (as recommended by the Presidential Task Force on Market Mechanisms in 1988).

Nevertheless, additional improvements can and should be made. The "Group of 30," a non-partisan consulting group on international economic policy, has made recommendations to significantly reduce clearing and settling times, which could indirectly reduce the systemic risk caused by a large bank failure. There are a number of other, technical proposals designed to reduce systemic risk that ought to be considered as part of any legislative proposal.

#### **5. Three-Year Transition**

Finally, the recommendations, if adopted, could result in substantial changes to the banking system. These changes should not be made abruptly. As with other recommendations, significant changes to the de facto policy of protecting uninsured deposits should be phased in. The Administration recommends a three-year delayed effective date.

## **F. No Assessments on Foreign Deposits**

Beginning with the Banking Act of 1933, Congress has consistently excluded deposits in foreign offices of U.S. banks from both insurance coverage and insurance assessments. (The legislative history is set forth in more detail in Discussion Chapter VI, Insurance Treatment of Foreign Deposits.) For the reasons set forth below, this long-standing policy should continue.

Like other uninsured deposits, foreign deposits have been protected by the FDIC in resolving failed banks -- particularly larger banks, where foreign deposits are concentrated. This protection has prompted smaller banks to argue that foreign deposits should be treated just like domestic deposits, with insurance up to \$100,000 and assessments for the full amount. It is unfair, they argue, that smaller banks have to pay premiums on their entire domestic funding base, while the very largest banks can escape premiums on a substantial part of their funding base by taking deposits overseas.

Despite this appearance of unfairness, foreign deposits should not be assessed for three fundamental reasons. First, it would signal a broad expansion of the federal safety net and the government's liabilities at a time when exposure should clearly be reduced. The FDIC's decision to protect uninsured foreign deposits has been voluntary; it has not been required by law. As discussed above, the Administration believes that the FDIC should reduce its blanket coverage of all uninsured depositors, whether foreign or domestic. This reduced coverage is important both to increase market discipline and to reduce the government's liability.

The proposal to assess foreign deposits directly undermines the thrust of the Administration's recommendation. With assessments, the FDIC is much more likely to fully protect foreign deposits in all cases. It is a signal to expand insurance coverage when we should be taking steps to reduce it. We should not expand our deposit insurance liabilities.

Second, as Congress has repeatedly recognized, assessing foreign deposits would directly impair the international competitiveness of U.S. banks. This is particularly true in the highly competitive interbank and wholesale loan market, where spreads have been extremely narrow. For example, it is estimated that foreign branches of U.S. banks raise between two-thirds and three-quarters of their funds in the interbank deposit market, where spreads have averaged approximately 12 basis points over the last two years. Adding the current 19.5 basis point assessment would obviously make this unprofitable.

The third reason is fairness. It is true that the assessment base for the largest banks is a much smaller percentage of their total deposits than the assessment base for smaller banks. This seems to imply that large banks are paying much less than their fair share for deposit insurance. In fact, historical data show that just the opposite is true: during the period of record bank failures in 1985-89, large banks more than paid for their own failure costs, and in fact subsidized the failure costs of smaller banks. See Table 1. (The inclusion of resolution costs of Continental Illinois in 1984 and Bank of New England in 1991 do not change this result.)



Finally, the revenue effect is uncertain because assessing foreign deposits is likely to reduce the amount of such deposits. According to several published estimates, the effect of increased costs from increased assessments is likely to reduce the amount of foreign deposits anywhere from 37 percent to more than 50 percent. In addition, it is unclear how many banks will merely restructure their branches as foreign subsidiaries in order to avoid assessments, further decreasing potential revenue to the FDIC.

Table 1

Distribution of Resolution Costs by Bank Size Failures of FDIC-Insured Banks and Savings Banks, 1985-89

Asset size of bank	Percent of total costs	Percent of total assessments
Less than \$30 million .....	11.8	2.6
\$30-\$100 million .....	16.5	8.8
\$100-\$500 million .....	16.0	13.3
\$500 million-\$1 billion .....	3.8	4.6
Greater than \$1 billion.....	51.5	70.7

Note: There were 750 failures of banks with less than \$1 billion in total assets, and nine failures of banks with more than \$1 billion in total assets during this period. The total cost of these failures was about \$16 billion.

Source: Federal Reserve Board.



### **III. Risk-Based Deposit Insurance**

#### **List of Recommendations**

##### **A. Premiums Based on Capital Levels**

- 1. Risk-Based Capital Used as Standard**
- 2. FDIC Discretion to Adjust**
- 3. Two-Year Phase-In**

##### **B. Premiums Set by Private Reinsurers**

- 1. Demonstration Project**

#### **Reasons for Recommendations**

The current flat-rate system of deposit insurance pricing actually rewards firms for taking more risk because there is no additional premium expense. The results are likely to be more numerous and more costly bank failures than if premiums varied with risk. Moreover, flat-rate premiums subsidize high-risk, poorly-run institutions at the expense of well-run institutions and the taxpayer (although this effect is somewhat mitigated by risk-based capital).

This pricing system is perverse. A private insurance company would always charge higher premiums to riskier firms, with insurance firms competing to set the appropriate price. The ideal result would be firms "paying their own way" for their own levels of risk; a continually solvent insurance fund; and a better allocation of economic resources to productive firms and productive investments.

As a practical matter, it is unlikely that a risk-based premium system could achieve this ideal result by itself. For example, it could be difficult to price individual bank risk correctly before problems occur, and because bank failures are so unevenly distributed over time, it is difficult to set long-run revenues to cover long-run costs.

There is also an important constraint on the level of premiums that can be charged to undercapitalized banks. It cannot be so large as to threaten the viability of an otherwise sound institution. For example, large increases in premiums during an economic downturn could further aggravate banking problems even though a bank's weakened capital position might not

be the result of poor management decisions. These and other problems are discussed in more detail in Discussion Chapter VIII, Risk-Related Premiums.

In short, risk-based premiums should be viewed as a complement to, rather than a substitute for, other methods of checking excessive risk-taking, including risk-based capital requirements; direct market discipline; strong supervision; and direct restraints on risky activities. Accordingly, the Administration recommends two risk-based premium proposals. The first, for the short-term, would authorize the FDIC to establish risk-based premiums as a private insurer would, with capital levels used as the fundamental measurement of bank riskiness. The second, for the longer-term, would establish a demonstration project to introduce the private insurance market into the process for pricing bank insurance premiums. Both proposals are generally consistent with the FDIC's separate recommendations to Congress in its risk-based premium study required by FIRREA.

### Specific Recommendations

#### **A. Premiums Based on Capital Levels**

Capital should be used as the primary measure for risk in adjusting premium levels. As discussed in Section I above, capital is the single most important protection against excessive bank risk. While both capital and the insurance fund absorb losses ahead of the taxpayer, capital has one distinct advantage -- it makes banks less likely to fail. In addition, capital is a straightforward, visible way to measure risk, and indeed, empirical evidence shows that low capital levels are a good advance indicator of banks' likely failure.

Using capital makes good insurance sense from another perspective, which is the role it plays as a "deductible." Every dollar in bank losses absorbed by capital is one less dollar absorbed by the insurer, just as every dollar in loss paid for by a car owner on his or her deductible is one less dollar for the car insurer to pay.

Finally, tying premiums to capital gives bank owners an added incentive to maintain strong levels of capital. As discussed above, this type of incentive is part of the Administration's overall proposal to strengthen the role of capital.

##### **1. Risk-Based Capital Used as Standard**

The Administration believes that the specific capital measure most appropriate for risk-based premiums would be the combination of Tier 1 and Tier 2 capital currently used for risk-based capital. This measure accounts for off-balance sheet risk, which is appropriate. In addition, Tier 2 capital includes subordinate debt, and for a variety of reasons set forth in Discussion Chapter II, institutions should be encouraged to hold more subordinated debt.

However, unlike the FDIC, the Administration recommends that the correct capital ratio is the proportion of Tier 1 and Tier 2 capital to risk-weighted assets, not total assets. This would reinforce the risk-based concept for capital, which U.S. supervisors have adopted within the guidelines established by the Basle Committee on Bank Supervision. By contrast, using the capital-to-total-assets ratio (or "leverage ratio") would appear to blunt the primary importance now attached to risk-based capital standards.

Moreover, the FDIC's current proposal would use a new definition of capital for premium purposes based on adjustments to bank loan loss reserves. While the intent is apparently to remedy inaccuracies in the reserving system, the proposal would create yet another capital standard for banks to satisfy. This seems unnecessarily complicated. Problems with the reserving system should be corrected for all measures of capital, not merely the one related to setting risk-based premiums.

## **2. FDIC Discretion to Adjust**

It is important that the FDIC maintain the discretion necessary to adjust and refine the risk-based premium standard. Over time, the standard may include factors other than capital, although it is strongly recommended that capital remain the dominant factor for the near term.

## **3. Two-Year Phase-In**

The capital-based premium proposal should be approached carefully and only after public comment, as the FDIC has already suggested. A two-year phase-in would be appropriate to allow institutions to adjust.

## **B. Premiums Set by Private Reinsurers**

The second method for assessing risk-based premiums is to involve the private market in a more direct way, on the theory that markets should be better able to assess and price bank risk than a government agency. The most feasible approach appears to be an integration of primarily government insurance and just enough private reinsurance to serve as an overall price-indicator for the FDIC. The details of one such approach are set forth below, which would have to be further refined in an FDIC demonstration project before it could be considered for enactment into law on a systemwide basis.

**Shared Liability.** An integrated approach would require private reinsurers to face the same risks as the FDIC, but on a smaller scale. For example, the FDIC could reinsure (*i.e.*, purchase coverage for) a small pro rata fraction of its risk that a covered bank would fail -- the private reinsurers would cover perhaps five percent of potential depositor losses at a given bank, with the FDIC covering the remainder. The proportion insured should be large enough to

warrant careful monitoring by the insurer, but small enough to attract a wide pool of potential insurers. (This type of approach was included in legislation introduced in the Senate in 1989, the "Deposit Insurance Reform Act of 1990" (S. 3040).)

**Reinsurers Set Premiums.** But the FDIC would not negotiate the price of the risk with the reinsurer. Instead, the reinsurer would negotiate directly with the covered bank to determine the premium that the reinsurer would charge. The FDIC would take the reinsurer's premium into account in setting its premium.

**Eligibility Requirements.** Such a system could very well entail eligibility requirements for private reinsurers, which would likely include capital requirements. Insurance companies would obviously be eligible, and banking organizations could be permitted to establish reinsurance affiliates, so long as these affiliates did not reinsure affiliated banks. Reinsurers could act individually or in a consortium, the latter being the most likely means of insuring the deposits of large banks.

**Contract Terms.** It would be necessary for reinsurance agreements to have limited duration, and they could not allow the reinsurer unilaterally to cancel the policy and avoid liability for preexisting losses. Periodic premium adjustments would be permissible. There would be flexibility for the bank to terminate a reinsurer's coverage provided that another reinsurer was found.

**Potential Problems.** The private reinsurance system could produce better pricing and earlier detection of problems than the current system. At the same time, there are numerous practical difficulties. There may be problems involved in governmental monitoring of a large group of private insurers, although to the extent that private reinsurers are part of banking organizations, there would be some cost economies in monitoring. There may also be instances where the objectives of the public insurer may conflict with those of the private insurer, particularly in the areas of closure and failure resolution policies. In addition, the cost-benefit implications of the extensive regulatory framework that might be required to administer this system would have to be carefully weighed.

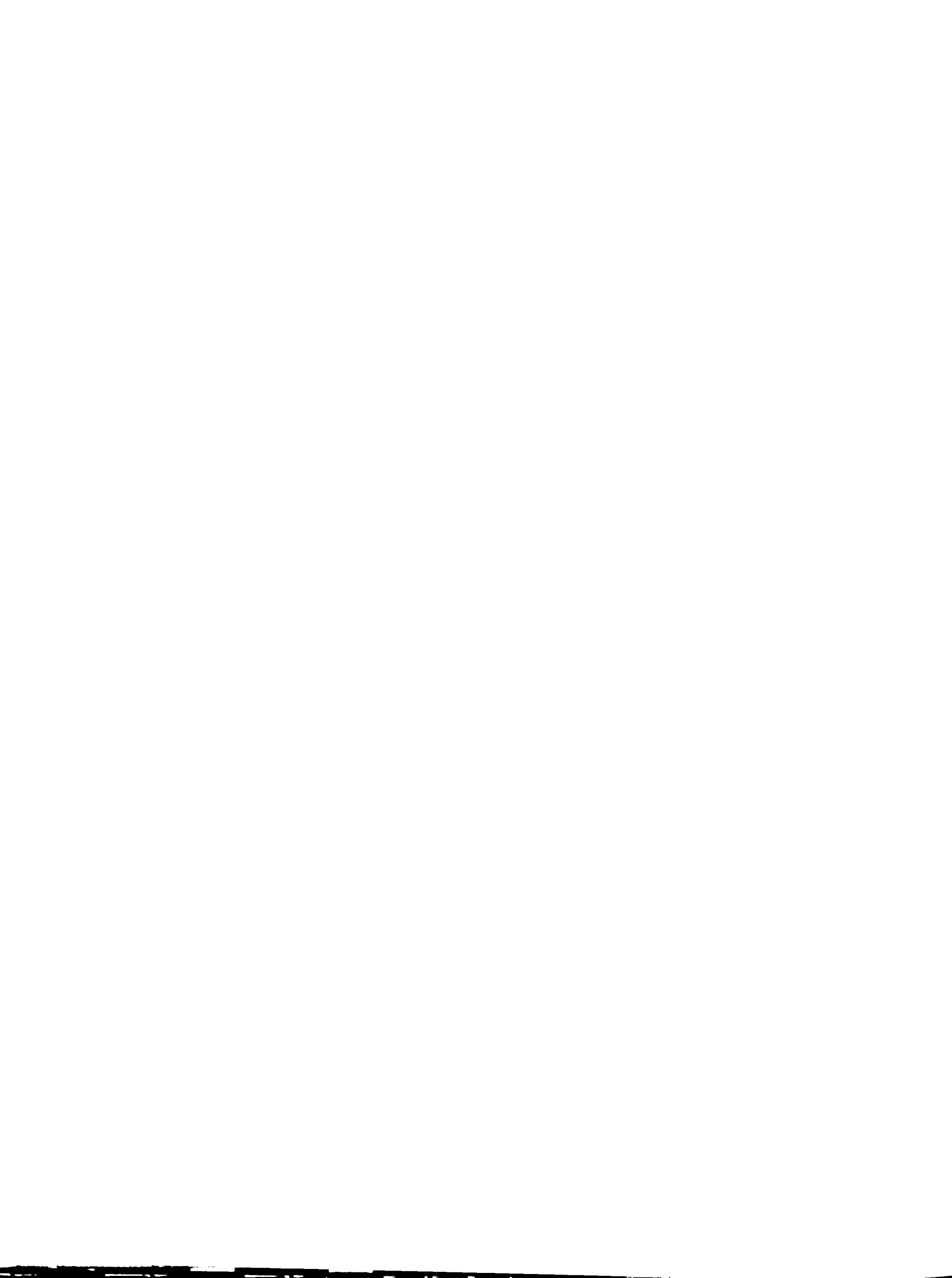
The extent to which private insurers would be willing to provide such insurance under terms consistent with public policy objectives is unclear. It may be necessary, for instance, for a private insurer to have the right either to compel closure of a bank that is no longer insurable in the private market or, if public policy considerations require the bank to remain open, to transfer the entire insurance burden to the public insurer (while retaining liability for latent losses up to the time of transfer). There are also systemic risk issues, with the potential for problems of the banking industry spreading to the insurance industry, and vice versa. Finally, another concern is that publicized premium changes could trigger adverse market reactions and runs among uninsured depositors and creditors.

## **1. Demonstration Project**

For all of these reasons, the Administration recommends that the FDIC adopt a demonstration project to determine the feasibility of using the private sector to help price risk-based premiums. While no market for this product exists today, there have been numerous indications of interest in recent months by both private firms and private industry groups. This interest must be tested and explored before such a substantial change is considered for adoption on a systemwide basis.

The demonstration project should consist of the FDIC enlisting a sampling of private reinsurers and banks to simulate a reinsurance arrangement. The participating insurers would be asked to simulate the actions they would take under actual reinsurance. These would include producing the contracts that would exist between the insurer and both the banks and the FDIC; setting the pricing structure; and obtaining the information necessary for the insurers to evaluate and monitor the risks in the subject banks. The simulation should be "real" enough so that it reflects how the system would actually work. The program would also involve actual reinsurance transactions, if possible.

The demonstration project could be conducted within one year, with the results reported back to Congress by the study participants including, but not limited to, the FDIC. The purpose would be to establish whether reinsurance is feasible; whether private participants are sufficiently interested and have the capacity to make the system work; whether public policy goals can be satisfied by a system that relies heavily on private sector participation; and what additional changes in the regulatory structure would facilitate the development of a private reinsurance system.





## **IV. Improved Supervision**

### **List of Recommendations**

#### **A. Capital-Based Supervision**

- 1. Rewards for Well-Capitalized Banks**
- 2. Prompt Corrective Action for Undercapitalized Banks**
- 3. Early Resolution for Failing Banks**
- 4. Three-Year Transition Period**
- 5. Improved Capital Measurement**
  - a. Annual on-site examinations**
  - b. Accurate reserving for loan losses**
  - c. Increased market value reporting**

#### **B. Improved Reporting from Independent Auditors**

### **Reasons for Recommendations**

Bank supervision is critical to reducing taxpayer exposure to losses from bank failures. Part Two of this study sets forth recommendations for streamlining our fragmented and complex regulatory structure. This section provides recommendations for improvements to specific types of supervision, with a particular focus on capital. The current approach to such supervision is set forth in Discussion Chapter IX, Risk Management Techniques; and the particular supervisory issues related to troubled institutions are set forth in Discussion Chapter X, Prompt Corrective Action.

As discussed in Section I above, minimum capital standards should not be raised across the board. But because of the crucial protections provided by capital, regulation should be reoriented toward a system of capital-based supervision. This system would provide well-defined regulatory rewards to firms that maintain high levels of capital, and well-defined sanctions to

those that do not. The intended result is that banks will have strong incentives to hold adequate amounts of capital at all times.

The rewards of capital-based supervision would be greater regulatory freedom for well-capitalized banks to expand and engage in new financial activities. Not only would this provide an incentive for banking organizations to maintain capital, but it would also provide the means to help build capital.

The sanctions of capital-based supervision would be designed to help correct supervisory problems early, before they grow into much larger problems. Such "prompt corrective action" would address a fundamental criticism of the regulatory response to the savings and loan problem. This criticism is that regulators waited too long to act, and much longer than the market would have tolerated in the absence of deposit insurance and the federal safety net.

This failure to take prompt corrective action may have allowed some institutions to fail that could have been saved. Other firms with low capital took excessive risks in an effort to recover -- the moral hazard problem -- and created much larger losses than were necessary. The proposal for prompt corrective action would address these problems by creating a system of specific corrective actions as the level of a firm's capital declines to particular trigger points.

This new system of capital-based supervision depends critically on accurate, up-to-date measurements of capital. Recommended improvements, as discussed below, include annual on-site examinations; more accurate reserving for loan losses; and increased market value reporting. Finally, improved reporting from independent auditors would also help strengthen supervision.

It is important to emphasize one additional point. The proposal does not make capital the only supervisory tool available to bank regulators; it merely recognizes the crucial role that capital plays. Other supervisory tools unrelated to capital would still be in place if the proposal were adopted. Capital-based supervision would simply provide regulators with more ability to act promptly and decisively to correct supervisory problems -- and make such actions more likely to occur.

## **Specific Recommendations**

### **A. Capital-Based Supervision**

Capital-based supervision would establish "zones" for banks based on their particular levels of capital. Those with the highest levels of capital would be in Zone 1, while those with the lowest levels would be in Zone 5. Rewards and supervisory remedies would depend on the particular zone into which each bank falls.

## **1. Rewards for Well-Capitalized Banks**

Banks in Zone 1 would realize the most regulatory freedom. To achieve Zone 1 status, a bank would have to maintain risk-based capital significantly above its minimum capital requirements. While the exact amount would be left to the banking regulators to define by regulation, it is important that banks have incentives to maintain additional levels of both equity capital and subordinated debt.

The most important reward for a Zone 1 bank would be the ability to engage in a broad range of new financial activities through a new FSHC. The Administration's proposal for establishing these new financial services holding companies is set forth in Section VII below. Other regulatory rewards include expedited procedures -- elimination of the cumbersome "applications" process -- for all of the following: opening new branches; acquiring new banking and nonbanking affiliates; and engaging in the newly authorized activities.

Zone 2 banks would be ones that satisfy their minimum capital requirements, but do not have the additional equity capital to qualify for Zone 1. In most ways, these banks would be treated much as they are under current law. Generally, they would not reap all the benefits accruing to Zone 1 banks, although they could take advantage of new financial activities if they could demonstrate both (1) substantial progress towards meeting Zone 1 requirements; and (2) the financial and managerial resources necessary to conduct the new activities. But they would generally not be subject to any of the corrective actions that would apply to banks in Zones 3, 4, and 5.

In sum, capital-based expanded activities will make the bank franchise considerably more attractive for firms that own either well-capitalized banks or undercapitalized banks. By expanding their ability to affiliate, firms with undercapitalized banks will be able to attract the necessary new capital to engage in new financial activities, either from the financial markets or from diversified financial and commercial companies.

## **2. Prompt Corrective Action for Undercapitalized Banks**

Banks in Zones 3, 4, and 5 would be ones that fail to meet their minimum capital requirements by progressively larger amounts; these banks would be subject to the new system of prompt corrective action. Banks in Zones 3 and 4 would be subject to dividend restrictions, growth constraints, and other supervisory actions. Banks in Zone 5, having virtually no prospect of recovery, would be promptly placed into conservatorship for subsequent sale or liquidation.

The key factor to the success of prompt corrective action is that both stockholders and management believe that the preannounced steps will in fact occur if capital declines. Only with such expectations will stockholders and management behave prudently. But a supervisory policy that is inflexible, rule-oriented, and mechanistic can raise costs by forcing actions in circumstances that call for patience.

Prompt corrective action therefore blends rules and flexibility by creating a presumption that certain corrective actions will occur, with enhanced discretion for other corrective actions. The strength of the presumptive supervisory actions increases as the degree of undercapitalization intensifies. The primary supervisory agency may grant relief from presumptive actions only if it believes and specifically finds that an exception is in the public interest.

While more specific details will be provided in the Administration's legislative proposals, a general description of the series of prompt corrective actions that would be taken is set forth below.

Zone 3 banks would be ones with capital below any of the minimum capital requirements but not so far deficient as to require drastic supervisory actions. Presumptive sanctions would include the filing of an acceptable capital plan that would promptly restore the bank to Zone 1 or Zone 2; and a prohibition on expansion by acquisition unless it was part of a plan to improve capital. In addition, the FSHC that owns the bank would become subject to consolidated capital requirements unless it divested or recapitalized the bank, and the umbrella supervisor would have the authority to examine unregulated affiliates of the bank. (The issue of consolidated capital requirements is described in more detail in Section VII, Modernization of Financial Services Regulation.)

Discretionary tools for Zone 3 banks would include restrictions on dividends and asset growth; restrictions on risky activities of the bank or affiliates that threaten the bank; the ability to remove management; and other supervisory actions. Of course, all restrictive supervisory remedies would end if the bank were recapitalized into Zone 2.

Zone 4 banks would be ones with capital substantially below any minimum capital standard, as defined by the regulator, and would be one step from mandatory conservatorship. Presumptive sanctions would include a prohibition on dividends; the filing of an acceptable capital plan that would either feasibly restore the bank to Zone 2 or result in the sale of the bank; growth restrictions; and other supervisory sanctions. Optional tools would include all those authorized for Zone 3 banks, plus the ability to order the sale of the bank or to place it in conservatorship. Again, all sanctions would be avoided or would end if the bank were recapitalized into Zone 2.

### **3. Early Resolution for Failing Banks**

Finally, Zone 5 banks would be ones with capital below a "critical level." The presumptive sanction would be early resolution through conservatorship or receivership, with the subsequent sale or liquidation of the bank unless it was recapitalized into a higher zone.

Supervisory relief for Zone 5 banks would require the concurrence of the FDIC and the appropriate federal banking regulator. If no exception is granted, early resolution might nevertheless require extended conservatorship, during which the bank would be scaled back i

anticipation of either sale to the private sector or longer-term liquidation. The objective in such cases would be, as it is with all of the proposed steps, to impose costs on management and stockholders for excessive risk-taking while protecting against systemic risk and strictly limiting the potential for taxpayer loss. Early resolution may or may not ultimately lead to cessation of operations, but it would concentrate the risk of failure on equity holders, lead to the replacement of senior management, and limit losses. No entity would be too large to be subject to such steps.

**Adequate Legal Authority.** Finally, the success of prompt corrective action and early resolution depends on the authority to act swiftly. In general, regulators currently have ample authority to require institutions to take corrective action as their condition declines (e.g., dividend restrictions, growth restrictions, management changes, etc.). But they are not always able to exercise such authority promptly. A number of regulatory steps depend upon a showing of "unsafe or unsound conditions" or a violation of law, and the time needed for implementation of a supervisory remedial action, such as issuance of a cease and desist order, can be greatly protracted when the bank contests the regulator's determination.

This process should be expedited consistent with due process protections for bank owners and managers. The prompt corrective action proposal would preserve the right to challenge an examiner's determination of an institution's particular capital zone. But once the zone is appropriately determined, there would be only very limited ability to challenge any corrective action taken by the regulator and authorized for that zone. This expedited process would produce greater consistency in supervisory actions; place investors and managers on notice regarding the presumed supervisory response to falling capital levels; and reduce the likelihood of protracted administrative challenges to the regulator's actions.

There is a related issue that will also require new regulatory authority. This is the ability of the bank regulator to place a Zone 5 institution into conservatorship while it still has some low level of positive book capital. Although this last resort in the prompt corrective action system could sometimes occur quickly, in general it would occur only after a bank had failed to meet capital plans; gone through Zones 3 and 4 with unsuccessful remedial actions; and finally reached the stage where the probability of its continued success had declined to an unacceptably low level.

Such early resolution would clearly save substantial resolution costs that would otherwise be borne by the FDIC. Nevertheless, it has been argued that it might be an unconstitutional "taking" to close an institution that still had positive book capital. For the reasons set forth in Discussion Chapter X, Prompt Corrective Action, legal issues associated with early resolution can be addressed. Accordingly, it is appropriate to provide early resolution authority in order to avoid losses to the Bank Insurance Fund and the taxpayer.

#### **4. Three-year transition period**

Prompt corrective action includes fundamental changes to the supervisory system. The banking system should have three years to adjust to the new rules, with one exception: FSH with well-capitalized bank subsidiaries in Zones 1 and 2 that take advantage of new financial activities would become subject immediately to the prompt corrective action system.

#### **5. Improved Capital Measurement**

Finally, capital-based supervision obviously depends directly on the accurate measurement of capital. If poor quality assets are carried at book value, capital is erroneously measured and corrective actions are delayed. The Administration therefore recommends several methods for improved measurement. These include annual on-site examinations; appropriate loan loss reserving; and increased market value reporting.

##### **a. Annual on-site examinations**

In general, annual on-site examinations are critical to appropriate capital measurement. On-site examinations provide data that are valuable in identifying current and potential problem institutions. This is supported by the experience of the federal regulatory agencies and by statistical research, which indicates that data regarding troubled loans are among the most useful indicators of a bank's future performance. When examiner classifications and other troubled loan data result in appropriate loan charge-offs and in adequate levels of loan losses, capital levels are conservatively measured and institutions needing regulatory resolution are more easily identified.

However, examination information relating to asset quality can quickly become stale. Accordingly, the Administration recommends thorough on-site examinations each year. Exceptions might be appropriate for smaller institutions -- those having less than \$1 billion in assets -- provided they are well-capitalized. This recommendation may require the dedication of significant additional resources to examination.

##### **b. Accurate reserving for loan losses**

Prompt and accurate reserving for loan losses is also designed to assure a more accurate measure of capital. Most bank loans are nontraded assets without ready market values, but examiners have considerable experience in anticipating probabilities of repayment of individual loans and of classifying loans on the basis of that probability. It may be possible to supplement such judgment with statistical procedures that would also provide more uniformity of treatment. Efforts to develop such guides are in process.

Accordingly, it is essential that banks take charges against earnings sufficient to maintain

their loan loss reserves at least equal to estimates of future loan loss based on annual examiner evaluations. This would assure a "truer" measure of equity capital, which again, is critical to prompt corrective action.

**c. Increased market value reporting**

Under Generally Accepted Accounting Principles (GAAP), assets and liabilities generally are carried on the balance sheet based on their historical costs, with subsequent changes in market values not recognized unless items are sold or settled. Critics have sharply criticized this practice as leading to discrepancies between accounting and economic measures of income and net worth, thus impeding accurate assessments of the true condition of depository institutions. Market Value Accounting (MVA) has been proposed as a means of improving the quality of financial information about depository institutions. A detailed analysis of the issues involved in MVA is set forth in Discussion Chapter XI, Market Value Accounting.

Under comprehensive MVA, assets and liabilities would be carried on the balance sheet at their estimated fair market values. Advocates of MVA contend that this would provide economically more meaningful measures of capital, enabling regulators to better identify problem banks and thrifts. In addition, by making the actual performance and condition of firms more transparent to private investors, proponents suggest that MVA would enhance the accountability of managers. A particular aim of MVA is to discourage transactions, such as "gains trading," that are motivated by accounting, rather than by economic, considerations.

Despite its theoretical appeal, comprehensive MVA has a number of problems that argue against its adoption at this time. Because active trading markets do not exist for the bulk of the assets and liabilities of depository institutions, many note that, under MVA, fair market values would have to be estimated using some form of discounted cash flow analysis. The subjectivity inherent in such procedures would reduce the comparability of fair market value estimates across institutions and render it difficult to verify valuations through audits and examinations. Such reliability problems would make financial statements more prone to manipulation, thus increasing uncertainty about the true conditions of depository institutions, whose viability is heavily dependent on public confidence. Although it is possible that reasonably specific standards could be developed to provide the basis for appropriate accounting and auditing practices in this area, such a process is likely to require considerable time.

A second concern is the cost of developing and implementing a comprehensive MVA system. Such costs could be substantial, and would likely fall disproportionately on smaller banks and thrifts. Care must be taken to recognize these costs in setting accounting standards. However, hard estimates of the incremental costs of comprehensive MVA are not available, precluding a formal cost-benefit analysis at this time.

Given the above drawbacks, it would be premature to impose comprehensive MVA on banks and thrifts. An often-mentioned alternative would be to adopt MVA only for those assets

that have clear secondary market values, such as marketable securities and certain residential mortgages. However, recording some balance sheet items at market and others at historical cost would fail to reflect certain hedging positions undertaken to minimize interest rate sensitivity. As a consequence, the partial MVA approach could result in volatility and distortion in reported income and capital that are misleading indicators of a firm's true financial condition. Adoption of the partial MVA approach would appear premature at this time, as well.

An alternative change in accounting standards would be to require for the present that insured depository institutions provide estimates of the fair market values of their assets and liabilities through supplemental disclosures in financial statements and regulatory reports, such as footnotes and memoranda items. Such an approach would not affect the earnings and capital of institutions reported in the main bodies of their financial statements.

The disclosure approach has a number of advantages relative to adoption of comprehensive MVA. First, market value disclosures would be substantially less costly to implement than comprehensive MVA. In addition, the disclosure approach would provide flexibility and time for accounting bodies, preparers, and users of financial reports, including regulators, to assess the reliability and cost of market value information. Thus, the disclosure approach could lead to the development and eventual adoption of comprehensive MVA, deemed appropriate. More detailed disclosures should initially be required only of large institutions, which could be given latitude to develop their own cost-effective methodologies for estimating market values. If these methodologies prove to be useful, they could then form the basis for accounting standards applicable to all depository institutions.

## **B. Improved Reporting from Independent Auditors**

The final recommendation for improving supervision concerns the relationship between banking regulators and independent auditors, which is described in detail in Discussion Chapter XII, Role of Auditors. It is not recommended that all banks be subject to a mandatory audit since virtually all of the larger banks that pose the greatest risk to the system are already audited (all but two banks with over \$1 billion in consolidated assets), and the costs appear to exceed the benefits for the smaller banks that are not currently audited.

Nevertheless, the Administration does recommend two changes that could provide significant benefits at very little cost. As described in Discussion Chapter XII, these recommendations expand on reporting requirements that the regulatory agencies, including the Securities and Exchange Commission, already require of certain financial institutions.

First, auditors or banks should be required to provide a copy of audit reports, management letters, and other reports or correspondence directly to regulators soon after they are provided to client banks. When audits take place between regulatory examinations, providing audit reports directly to regulators could provide them with important new information.



Second, banks should provide prompt notification to appropriate regulators of changes in auditors and qualifications of audit reports. This would improve the quality of information available to regulators, because changes in auditors and qualifications in audit reports can indicate problems at institutions. It could also reduce "opinion shopping" (i.e., the practice of banks searching for auditing firms to give them favorable audit opinions and accounting guidance). It should be noted that the agencies already require banks and thrifts that are subject to the reporting requirements of the Securities and Exchange Act of 1934 to report changes in auditors directly to the institution's appropriate federal regulator.

Finally, existing statutes and practices already address other proposals specifically mentioned in FIRREA that would affect the communication between auditors and the banking regulators. Similarly, as set forth in detail in Discussion Chapter XII, many of the auditing provisions of the United Kingdom's 1987 Banking Act, which are also mentioned in FIRREA, are generally duplicative of U.S. banking regulators' existing supervisory authority.

## **V. Restrictions on Risky Activities**

### **List of Recommendations**

#### **A. Restrictions on Risky Activities of State-Chartered Banks**

- 1. Prohibition of Direct Investment Activities**
- 2. Limit Activities Not Permitted for National Banks**
- 3. No Limits on Riskless Agency Activities**

### **Reasons for Recommendations**

A fifth approach to reducing taxpayer exposure to bank losses is to limit directly the riskiness of bank activities. This is a traditional approach that has been used for many years by both the states and the federal government to confine banks to "the business of banking." Banks are generally not allowed to invest insured deposits directly in commercial enterprises, and other well-known laws restrict bank activities even in closely related financial lines of business like securities and insurance. Banks therefore confine most of their direct activities to traditional business and consumer lending.

Yet such restrictions on bank activities have not avoided substantial bank losses (indeed, some argue that the lack of diversification has contributed to losses). Recent problems in the banking industry are not the result of exotic new activities; instead, they are the product of traditional bank lending to traditional customers.

Advocates of activities restrictions argue that even such traditional bank activities are inherently risky, requiring new limitations. The extreme position is that insured deposits should only be invested in virtually riskless investments, such as short-term government securities or highly-rated commercial paper -- the so-called "narrow bank" or collateralized deposit approach. The less extreme view is that the government should begin prohibiting particular types of traditional bank loans as too risky, such as commercial real estate loans or loans in highly leveraged transactions.

Neither approach appears to be a practical solution to today's banking problems. As set forth in Discussion Chapter VII, Alternatives to Federal Deposit Insurance, the narrow bank proposal raises questions about whether nonbanking firms would provide appropriate levels of

financial intermediation to the economy, and whether they could operate without the threat of economically damaging runs. In any event, formidable transition problems alone cast substantial doubt on the feasibility of this approach.

Prohibiting particular types of bank loans is also problematic. Categories of loans singled out for prohibition are usually yesterday's problem, with overreactions to practices that the market has already corrected. Commercial real estate lending is a good example. The market and the regulators have already stopped banks from making the most speculative types of commercial real estate loans that have created so many losses -- to the point now where some are concerned that there is too little commercial real estate lending. Statutory prohibitions would only exacerbate this problem.

A second problem with singling out categories of loans is the potential for deliberate policies of government credit allocation. In the name of safety and soundness, some types of credit would be prohibited, while others would be permitted. Over time, such picking and choosing by the government could result in credit allocation based on social policy rather than market forces. Such a policy could create serious long-term economic problems.

Excessive State Powers. There is, however, one area of bank activities that does require limitations. This is the ability of federally insured state-chartered banks to engage in certain kinds of activities not permitted for national banks, particularly equity or direct real estate investment. States should not have unlimited authority to provide risky powers to state banks that are federally insured. The federal government has too much exposure to loss with too little ability to control risk. This was one painful lesson of the thrift crisis, in which federally insured state-chartered thrifts racked up huge losses through a wide range of non-traditional direct investments, including shopping centers, windmill farms, fast food franchises, and stud farms.

At the same time, the dual banking system has produced a number of important innovations and benefits for banking consumers, including Negotiable Order of Withdrawal accounts (NOW accounts) and adjustable rate mortgages. The so-called "laboratory of the state" should be permitted to continue as a source of innovation, but federal limits must be imposed to prevent the kind of "nuclear meltdown" that occurred with federally insured state-chartered thrifts.

In FIRREA, the Administration and Congress struck an appropriate balance between the competing interests for federally insured state-chartered thrifts. The legislation did not eliminate the differences between state and federal thrifts, but it did impose limitations on the states' ability to authorize risky thrift activities. The Administration recommends that similar limits apply to federally insured state-chartered banks.

In providing these recommendations, it is important to recognize that state-chartered banks have not yet caused the same kind of losses as state-chartered thrifts. Indeed, many state-chartered banks have exercised their broader authorities both prudently and profitably.

Nevertheless, because of the enormous exposure of the federal insurance funds and the federal taxpayer, a certain level of federal involvement is clearly appropriate.

## Specific Recommendations

### **A. Restrictions on Risky Activities of State-Chartered Banks**

#### **1. Prohibition of Direct Investment Activities**

National banks are not permitted to make direct equity investments with insured deposits in commercial real estate and other commercial enterprises, although some states permit state-chartered banks to conduct such activities. While state banks have been more limited and prudent about this authority than state thrifts, direct equity investment remains a greater risk to the federal deposit insurance fund than traditional bank loans that have a more senior claim on assets.

Just as FIRREA prohibited such investments for federally insured thrifts, so should they be prohibited for federally insured banks, subject to an appropriate transition rule (perhaps as long as five years). Moreover, certain types of new financial activities should be reserved for nonbanking subsidiaries of FSHCs described in Section VII; they should not be conducted directly by the bank or a subsidiary of the bank.

#### **2. Limit Activities Not Permitted for National Banks**

There are other instances in which state-chartered banks are permitted to engage directly in activities not permitted for national banks. In general, these activities do not pose unusual risk to the deposit insurance fund. Nevertheless, there may be instances where unusual or significant additional risk is present that creates federal exposure. To guard against this risk, state banks must satisfy two conditions to engage in activities not permitted for national banks: they must satisfy their capital requirements, and they must receive a determination from the FDIC that the activities do not create a significant risk of loss to the insurance fund.

#### **3. No Limits on Riskless Agency Activities**

Finally, as in FIRREA, the new federal restrictions on activities would not apply to agency activities authorized by the states for state banks. As Congress recognized in FIRREA, agency activities present virtually no risk to the insurance fund. The federal government should therefore not intrude on the ability of states to authorize their state banks to engage in any agency activity.

## **VI. Nationwide Banking and Branching**

### **List of Recommendations**

- A. Full Nationwide Banking Authorized for Holding Companies**
  - 1. Three-Year Delayed Effective Date**
- B. Interstate Branching Authorized for Banks**
  - 1. National Bank Interstate Branching**
    - a. Permitted wherever interstate banking is permitted**
    - b. No preemption of intrastate branching limitations**
  - 2. State Bank Interstate Branching**
    - a. States determine whether to authorize**
    - b. Barriers to out-of-state banks removed**
    - c. Branches of out-of-state banks may not engage in activities prohibited for in-state banks**
    - d. National treatment for foreign banks**
    - e. Immediate effective date**

### **Reasons for Recommendations**

Nationwide banking and branching would lead to safer, more efficient, and more competitive banks, directly decreasing taxpayer exposure to losses. Yet the United States is the only major industrialized country in the world that does not have a truly national banking system. While much progress has been made toward national banking in recent years, we still have a cumbersome system for geographic expansion and diversification that imposes needless costs on banks throughout the system.

There are two potential methods for banking organizations to expand across state lines. First, bank holding companies could purchase or charter separate banks in separate states, with separate management, separate capital structures, and separate regulation. Second, a bank located in one state could simply branch across state lines into another state.

Through state action, nationwide banking through the bank holding company method is very nearly a reality. Thirty-three states have passed laws to permit nationwide banking through bank holding companies; 13 states permit regional banking; and only four states continue to prohibit all forms of interstate banking. The trend toward full nationwide banking is unmistakable.

Nationwide branching is a different story. With few exceptions, there is almost no authority for either state or national banks to branch across state lines. Given the clear cost savings that branching would provide to banks' bottom lines, not to mention the additional services that would become available to the consumer, restrictions on interstate branching make no sense.

The continuing usefulness of branching restrictions is particularly questionable, given the already broad expansion of banking organizations through the cumbersome, less efficient holding company method. The issue is no longer whether there should be nationwide geographic expansion, but how. The Administration believes that banks should make this decision for themselves, rather than have the government make their decision for them through artificial and inefficient constraints. Interstate branching would promote safety and soundness; provide immediate cost savings; and increase consumer benefits.

**Safety and Soundness.** As set forth in Discussion Chapter XVII, Interstate Banking and Branching, branch banks have historically had a better safety record than unit banks, which have no branches. This is not surprising, since geographic diversification protects banks from failure caused by localized problems. For example, during the 1970s, Texas banks were confined by state laws to a single full-service location, but were considered among the best-capitalized, most profitable banks in America. Ten years later, after severe problems with the energy economy, nine of the top ten had been reorganized with FDIC or other outside assistance. Appropriate regional diversification might have prevented some of these failures.

**Efficiency.** Interstate expansion through branching is likely to be much more efficient than acquiring or chartering separate banks in each different state. Such branching would save costs, increase profits, and help build and attract capital into the industry. Under the current system of expansion through separately acquired banks, there are numerous parallel and unnecessary costs that must be incurred in each state. These include separate boards of directors and management; separate regulatory reports; separate examinations; separately audited financial statements; separate support and control functions; and separate computer systems.

In addition, each bank must satisfy capital requirements separately, which creates complex treasury exercises of balancing capital among subsidiaries. There are also cost allocation

problems, and transfers of funds between subsidiaries is more cumbersome and costly between branches. In sum, the current system amounts to nothing more than a set of arbitrary roadblocks to efficient, consolidated management.

**Consumer Benefits.** Finally, interstate branching will create important convenience for consumers, particularly those who frequently cross state lines for work or other reasons. To a customer with a bank account in one state typically cannot get full-service banking services from an affiliated bank in another state without opening a separate account; there would be no such problem with interstate branching. An interstate branching network will also make cash banking services more available to travelers.

In sum, it is time to adopt an efficient nationwide banking system.

### **Specific Recommendations**

#### **A. Full Nationwide Banking Authorized for Holding Companies**

##### **1. Three-Year Delayed Effective Date**

Now that thirty-three states have adopted nationwide banking, it is time to move the entire country to the same system. The Douglas Amendment to the Bank Holding Company Act should be repealed. However, because this would be a substantial change for state banking systems that do not permit interstate banking, there should be a three-year delayed effective date.

#### **B. Interstate Branching Authorized for Banks**

The rules would initially be different for national and state banks, because Congress generally provides affirmative authority only to the banks it charters. However, given the strong incentive to shift to national charters to avoid state branching restrictions, over time the branching authority of state and national banks is likely to converge.

##### **1. National Bank Interstate Branching**

###### **a. Permitted wherever interstate banking is permitted**

Congress should authorize a national bank to branch into any state in which the bank's holding company could acquire a bank, which would effectively end the branching restrictions of the McFadden Act. This could be accomplished by converting an existing affiliated bank into

a branch; acquiring an existing bank and converting it into a branch; or branching de novo. At the end of three years, when the repeal of the Douglas Amendment becomes effective, the result would be nationwide branching for national banks. In the interim, interstate branching by national banks would be governed by the same geographic limits as apply to interstate expansion through holding companies.

**b. No preemption of intrastate branching limitations**

The proposal would not preempt state laws that limit branching within a particular state. The McFadden Act would continue to apply to intrastate branching by national banks. While state laws restricting intrastate branching are inefficient and anticompetitive, they are still properly within the purview of state legislatures. Thus, a national bank could branch into a state with county-wide branching, and continue to branch within one county. But to go beyond county lines would require the establishment or acquisition of a separate institution through a holding company. Further branching would not be permitted. (Only 10 states still have intrastate branching restrictions.) In addition, courts have upheld the authorization by the Office of the Comptroller of the Currency for national banks to branch to the extent state law permits thrifts to branch in several of these states.

**2. State Bank Interstate Branching**

As mentioned above, the branching rules would be different for state banks because Congress typically provides affirmative new authority only to the banks whose charter it defines (i.e., national banks). It typically does not provide direct new authority to state banks, which are the province of state legislatures.

**a. States determine whether to authorize**

Each state would have to determine for itself whether to authorize interstate branching power for its own state banks. Given the grant of such authority to national banks, there would obviously be strong competitive pressure to do so.

**b. Barriers to out-of-state banks removed**

A state would not be able to limit the ability of an out-of-state bank to branch inside its borders (except during the three-year period when states could still restrict certain out-of-state holding companies from acquiring in-state banks). This removal of barriers would apply to out-of-state branches of both state and national banks.



c. **Branches of out-of-state banks may not engage in activities prohibited for in-state banks**

Activities of a national bank would continue to be defined by federal law. A different problem arises with state banks. When a state bank that is permitted to engage in one set of activities in its "home state" branches into a "host state" that permits a different set of activities, which law applies to the branch? The Administration recommends that the host state's law should apply. There should be no regulatory incentive to charter a bank in the state with the most liberal activities rules and then branch into fifty other states. Each state should have the appropriate authority to govern the activities of state banks operating within its borders.

d. **National treatment for foreign banks**

Consistent with the policy of affording foreign banks national treatment, foreign bank organizations should have the same opportunity to engage in interstate branching and banking as U.S. banks.

e. **Immediate effective date**

Because interstate branching could only occur in states that have already authorized interstate banking, and because of the potential for immediate and significant cost savings, the new interstate branching rules should become effective immediately upon enactment of the legislation. Interstate branching in states that do not now permit interstate banking would become effective with the lapse of the Douglas Amendment after three years.

## **VII. Modernized Financial Services Regulation**

### **List of Recommendations**

- A. Permit Well-Capitalized Banks to Have Financial Affiliates**
  - 1. Includes Securities, Mutual Funds, and Insurance**
  - 2. Allow Financial Companies to Own Well-Capitalized Banks**
- B. Commercial Ownership of Financial Services Holding Companies**
- C. Safeguards**
  - 1. Only for Well-Capitalized Banks**
  - 2. Safety Net Confined to Bank**
  - 3. Strict Regulation Focused on Bank**
  - 4. Financial Affiliates Separately Capitalized**
  - 5. Functional Regulation of Affiliates**
  - 6. Funding and Disclosure Firewalls**
    - a. State law standard for insurance sales**
    - b. Consumer disclosure firewalls**
  - 7. Umbrella Oversight**

### **Reasons for Recommendations**

The nation's banks must be economically viable and competitive to protect the taxpayer. The erosion of the traditional bank franchise is well-documented, both in Congressional testimony and by Discussion Chapter XVIII, Financial Services Modernization. Banks are no longer the protected and steadily profitable businesses they once were. Old laws designed to

"protect" banks from competition have become barriers that impede banks from adapting to changed market conditions. The result has been financial fragility and losses, as set forth in detail in the Need for Reform discussion above.

The time has come for change. Laws must be adapted to permit banks to reclaim profit opportunities they have lost to changing markets. Where banking organizations have natural expertise in other lines of business, they should be allowed to provide it for the benefit of the consumer. Likewise, where other financial companies have natural synergies with banking, they should be allowed to invest in banks. New sources of capital must be tapped.

Put another way, protecting the taxpayer demands a well-capitalized banking system. For a banking organization must be competitive to build, attract, and maintain capital in its bank. Simply piling on restrictions in the name of safety and soundness will not achieve this end. Adapting to market innovation is critical.

Accordingly, as set forth below, the Administration proposes to allow banks to affiliate with a broad range of financial firms through the formation of financial services holding companies (FSHCs). Commercial companies would in turn be permitted to own these new FSHCs (see Figure 11). This proposed structure would create a level playing field that permits banking, financial, and commercial companies to affiliate with each other on fair terms. In taking this long overdue step, three points are paramount.

First, the proposed changes will not be a panacea for banking problems, particularly in the short-term. But in the long run, without increasing their costs materially, banking organizations will be able to earn incremental profits by applying their expertise and resources in related financial activities. This blending of banking, finance and commerce will create a stronger, more diversified financial system that will provide important benefits to the consumer and important protections for the taxpayer.

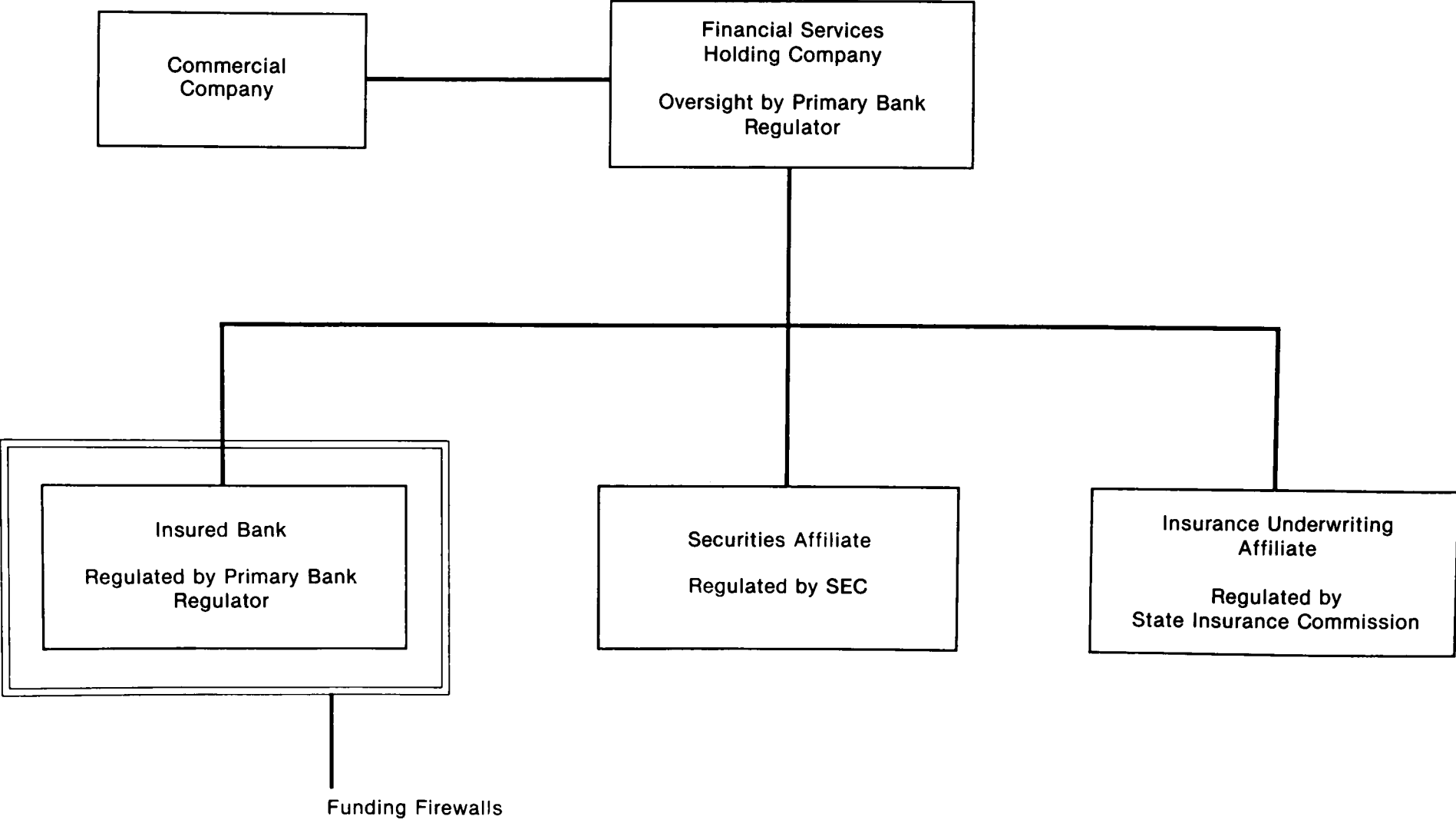
Second, the proposal will benefit firms that own undercapitalized banks, as well as firms that own well-capitalized banks. Firms with undercapitalized banks will be able to attract new capital to engage in new financial activities either from the financial markets or from diversified financial and commercial companies. A more attractive franchise will attract more capital.

Third, the proposal includes crucial safeguards to prevent an expansion of deposit insurance and the federal safety net to cover new activities. In combination with other deposit insurance reforms, this will allow banking organizations to increase profitability and attract capital without exposing the taxpayer to greater risk.

### Specific Recommendations

The Administration's recommendation to establish FSHCs is outlined below. Additional details will be provided in the Administration's legislative proposal.

Figure 11  
Proposed Financial Structure



## **A. Permit Well-Capitalized Banks to Have Financial Affiliates**

### **1. Includes Securities, Mutual Funds, and Insurance**

FSHCs with well-capitalized banks would be allowed to earn incremental revenue from financial activities related to banking. The current bank holding company structure would be replaced with the new financial services holding company. Well-capitalized banks that form FSHCs would be rewarded with the ability to engage in a broad new range of financial activities through separate holding company affiliates. These new financial affiliates could engage in a broad range of financial activity, including full-service securities, insurance, and mutual fund activities (but not real estate activities). (Because of their special ownership characteristics, mutually-owned insurance companies affiliated with banks would be permitted to engage in insurance activities directly from the holding company, rather than through affiliates.)

### **2. Allow Financial Companies to Own Well-Capitalized Banks**

By the same token, securities, insurance, and mutual fund companies could generally affiliate with well-capitalized banks. This "two-way" street is expressly intended to provide for competition among firms engaged in the financial services business.

Moreover, as set forth below, FSHCs could be owned by commercial companies, with strong firewalls between the bank and its commercial affiliates. However, FSHCs would themselves be permitted to engage in commercial activities. There would be exceptions for financial firms that engage in a limited amount of such activities at the time that legislation is enacted. Similarly, a limited amount of nonfinancial activities would be permissible for securities and insurance affiliates that engage in commercial activities in the ordinary course of business (e.g., merchant banking activities by securities firms, and passive investments by insurance companies).

## **B. Commercial Ownership of Financial Services Holding Companies**

Commercial firms should be permitted to own FSHCs, although stronger firewalls must be established between a bank and its commercial affiliates than between a bank and its financial affiliates. Allowing only indirect commercial ownership of a bank through an FSHC, rather than direct ownership, facilitates the enforcement of stronger firewalls.

The time is right to permit broader combinations of banking and commerce. Commercial companies have been an important source of capital, strength, management expertise, and strategic direction for a broad range of non-banking financial companies as well as their institutions.

More important, banks need capital, and commercial companies constitute almost 80 percent of the capital of U.S. businesses. A number of commercial companies have been and will continue to be interested in owning banks. Indeed, many of the large financial companies that might be most interested in bank ownership already have broad commercial affiliations, including nine of the 15 largest securities companies.

Critics argue that it would be more difficult to regulate banks if they were owned by commercial companies, and that there might be biased allocations of credit and inappropriate concentrations of economic power. While these concerns are legitimate, there are ways to address such problems without the total prohibition on affiliation. Indeed, none of the hypothetical problems of combining banking and commerce has been evident among the commercial companies that currently own depository institutions (thrifts, nonbank banks, and industrial banks).

Finally, while it is true that few other countries permit exactly this form of affiliation, there are significant combinations of banking and commerce in our most formidable trading partners, Germany and Japan. Moreover, if the safety net is confined to the bank in the new financial services holding company structure so as not to spread to financial affiliates, it should be feasible to keep it from spreading to commercial affiliates. Indeed, one model to accomplish this could be based on the oversight approach adopted in last year's "Market Reform Act of 1990" for securities firms owned by commercial companies.

The case for allowing combinations of banking and commerce is particularly compelling in the context of permitting commercial firms to acquire failed banks. In some circumstances, substantial losses to the government from a failed bank might be avoided only by allowing a commercial firm to purchase the failed bank. In particular, the pool of available buyers for a large failed bank may be very small if it is limited only to financial services companies.

### **C. Safeguards**

Authorizing new financial affiliations for banks will enhance the competitiveness of both banks and the banking system -- and a strong banking system is the most important protection for the taxpayer. But there must be appropriate safeguards to ensure that the federal safety net does not cover these new activities and expose the taxpayer to undue risk. These safeguards must also ensure that funding advantages of insured depositories are not used to subsidize new financial activities to compete unfairly with nonbank financial firms. Accordingly, the Administration proposes the following safeguards for engaging in new activities.

#### **1. Only for Well-Capitalized Banks**

Only well-capitalized banks would be rewarded with the ability to engage in new financial activities through FSHCs. This makes sense for several reasons. First, financial companies

would have a strong incentive to build and maintain bank capital at high levels, providing the most important single protection for the taxpayer. Second, the ability to engage in new activities could be a new source of earnings that would help build and attract new capital that could be allocated to the bank. Finally, additional capital at the bank would be an added protection against any additional risks associated with any new activities.

While the level of additional bank capital should be set by the banking regulator, it should be significant, and banks should be encouraged to hold higher levels of both subordinated debt and equity. In addition, banks meeting their minimum capital requirements and demonstrating an upward trend toward satisfying the additional amount would be eligible for new financial affiliations on a more closely supervised basis.

## **2. Safety Net Confined to Bank**

Only the bank would have access to deposit insurance, the Federal Reserve's discount window, or the federal payments system. Financial affiliates and the FSHC itself would have no such access. This principle is critical. The federal safety net cannot be extended to these entities without eroding market discipline, exposing the taxpayer to additional losses, and unfairly subsidizing the activities of financial affiliates. The corollary, of course, is that creditors of FSHC or financial affiliates should receive no federal protection in the event of FSHC insolvency. While the federal safety net should not be extended beyond the bank, this should not suggest that regulators should be unconcerned about the stability of our financial system more generally.

## **3. Strict Regulation Focused on Bank**

Regulation would be focused on protecting the bank, which has access to the federal safety net, rather than on protecting its holding company, which has no such access. The system of capital-based supervision, described above, would provide direct safeguards for the exercise of new activities. For example, an FSHC with a bank falling into Zone 2 -- one that only meets minimum capital requirements -- would have a choice: infuse capital to restore the bank to Zone 1 within one year, or divest the new financial affiliates. This is a powerful incentive to maintain adequate bank capital. It also helps prevent new activities from creating problems for anything but a well-capitalized bank.

## **4. Financial Affiliates Separately Capitalized**

As mentioned above, new activities would be carried out in separately capitalized affiliates of the bank. As a result, the affiliates could fail without affecting the capital of the bank. (Restrictions on loans from a bank to its affiliates, described below, maintain this independence.) Activities would be carried out in affiliates rather than subsidiaries because of the perception

greater distance from the bank -- and therefore greater distance from the likelihood of safety net protection.

## **5. Functional Regulation of Affiliates**

Financial activities would generally be regulated by function, rather than by institution: banking activities by the banking regulator; securities activities by the SEC; insurance activities by the state insurance commission; and so on (see Figure 11). For example, the SEC would generally regulate banks' issuance of their own securities. Banks' pooled investment activities would be regulated in a manner more similar to investment companies. And banks with new securities affiliates would transfer much of their current securities activities out of the bank. Functional regulation is likely to be more efficient and more effective than having multiple agencies each regulating essentially the same activity.

## **6. Funding and Disclosure Firewalls**

Funding firewalls would be required to contain the safety net within the insured bank. The transfer of funds between a bank and its affiliates or holding company presents two potential problems. The safety net could be exposed to losses from affiliates; and the bank's funding advantages from the safety net could "leak" into affiliated financial activities. The Administration's proposed restrictions on these transactions -- so-called "funding firewalls" -- are designed to address both concerns.

First, Section 23A of the Federal Reserve Act would apply, as it does today, to require that bank loans to affiliates would be fully collateralized and to limit strictly the amount of such loans to any one affiliate and in aggregate to all affiliates. This provision would be strengthened to apply to other types of affiliate transactions, including tax-sharing arrangements, fees, and management contracts.

Second, Section 23B of the Federal Reserve Act would continue to require that transactions between a bank and its affiliates be conducted on an arms-length basis.

Third, the FSHC would be required to provide prior notice to the bank regulator of unusually large transfers of funds between the bank and any affiliate.

Fourth, stringent dividend restrictions would apply to undercapitalized banks, as set forth above in the discussion of prompt corrective action. This would help prevent FSHCs from "milking" the assets of their subsidiary banks.

Fifth, the regulator would have the authority to prohibit or restrict certain transactions between the bank and its securities affiliate or certain customers of the securities affiliate. These discretionary funding firewalls would be similar to several of the Federal Reserve's so-called



"Section 20" firewalls for bank holding companies engaged in certain securities activities. firewalls are intended to prevent undue exposure of the bank's credit in securities transactions. It is critical to maintain regulatory discretion in setting these firewalls because of their evolving nature, rather than codifying inflexible restrictions in statutory language.

Finally, firewalls should not restrict or impede operational, managerial, or market synergies between a bank and its financial affiliates. Such restrictions defeat the very purpose of permitting affiliations between banks and financial companies -- to capture synergies and efficiencies for the benefit of the consumer. Thus, there would be no limitation on share management, employees, officers, or directors. There would also be no general limitation on the ability of a bank and its affiliates to market each other's products (except for strict disclosure requirements, as discussed below).

**a. State law standard for insurance sales**

Although there should generally be no cross-marketing firewalls, an exception is appropriate for the cross-marketing of bank and insurance products. It is true that there are obvious synergies between banking and insurance, as consumer groups and the General Accounting Office have both recognized. Seventeen states permit their banks to sell insurance and the sale of life insurance in savings banks in New England has generally been recognized as a boon for consumers. It is also true that insurance agency sales pose no risk to the deposit insurance funds, as Congress recognized in FIRREA. Such sales could provide a virtually riskless stream of income to banks throughout the country.

Nevertheless, the manner in which insurance is sold by banks has generally been regulated at the state level, which is consistent with the McCarran-Ferguson Act's restrictions on the role of the federal government in regulating insurance activities. While there is much discussion now of increasing the federal government's regulation of the insurance industry, that has not occurred. Accordingly, unless greater federal regulation of insurance is sought, the federal government should generally defer to the states on the manner in which banks are permitted to sell insurance products of either affiliated or unaffiliated companies.

At the same time, however, the Administration recommends that national banks be permitted to sell insurance products of affiliated or unaffiliated companies in states that permit such activities for their own banks. This is consistent with the concept of generally leaving the issue of bank insurance marketing to state law.

**b. Consumer disclosure firewalls**

Consumers will clearly benefit from the convenience and availability of more financial products in banks, such as money market accounts. But there must be rigorous disclosure requirements to prevent customer confusion between federally insured deposits and other financial

products that are not insured. Recent celebrated cases of abuse in failed banks and thrifts underscore this need. The Administration's legislative proposal will include such requirements.

## **7. Umbrella Oversight**

As discussed above, bank regulation should be focused on protecting the bank, which has access to the federal safety net, not on protecting its holding company or financial affiliates. At the same time, certain "umbrella oversight" of the FSHC by the bank regulator is necessary to protect the insured depository from affiliate risk. Umbrella oversight is designed to identify problems in the holding company or affiliates that are likely to cause difficulties for the insured bank, and to apply remedial action. The sole, guiding principle of umbrella oversight is to protect the insured bank. This oversight would include:

- The ability to examine the FSHC and bank, and also to examine any nonbank affiliate which poses a risk to the bank. (The regulator, if any, of the nonbank affiliate would have reciprocal examination rights.)
- The ability to require sale of a nonbank affiliate if such affiliate poses a clear threat to the bank.
- For banks that fall below minimum capital standards, the ability to require that the parent company either: (1) bring bank capital back to minimum standards; (2) sell or otherwise divest the bank; or (3) become subject to bank capital standards and other holding company regulations to be applied to the entire organization on a consolidated basis.

These and other similar protections for the bank will be included in the Administration's proposal. Unlike current law, however, there would be no cumbersome, bank-like regulation of the FSHC for the following reasons. First, such holding company regulation risks implicit government backing of the FSHC by the government, increasing the taxpayer's exposure -- where there is federal regulation, there is likely to be federal protection.

Second, full holding company regulation deters investment in banks. While non-banking companies are interested in owning banks, they will not be if the price is government regulation by bank supervisors of all non-banking activities.

Finally, it is practically infeasible for a bank supervisor to effectively regulate a complex and diverse range of businesses. Bank regulation should be concentrated on the bank, which can be effectively regulated, and not on protecting a diversified FSHC that should be subject to normal market discipline.

## **VIII. Credit Union Reforms**

### **List of Recommendations**

- A. Changed Accounting Treatment of Insurance Fund**
  - 1. Eliminated as Asset on Credit Union Balance Sheets**
  - 2. Gradually Expensed Over Twelve Years**
- B. Reorganized Board of National Credit Union Administration**
  - 1. Includes Representative From New Federal Banking Agency**

### **Reasons for Recommendations**

FIRREA requires an evaluation of "the adequacy of capital of insured credit unions and the National Credit Union Share Insurance Fund, including whether the supervision of such fund should be separated from the other functions of the National Credit Union Administration." These issues are set forth in detail in Discussion Chapter XIII, Credit Unions.

**Capital Adequacy.** In general, both the credit union industry and the National Credit Union Share Insurance Fund (NCUSIF) appear to have adequate capital. The ratio of equity capital to total assets of the credit union industry was higher than the same ratio for the banking industry as of year-end 1989 (although the ratio was lower for credit unions below \$100 million in assets). Using the banks' risk-based standard, aggregate union capital was even higher -- core capital of 11 percent to risk-weighted assets.

Likewise, the capital of the NCUSIF is substantial. The approximately \$2 billion in the Fund creates a reserve-to-insured deposit ratio of 1.28 percent, which is substantially higher than the same ratio for either banks or thrifts.

The problem, however, is the double counting of assets in both the insurance fund and on credit union balance sheets. The credit unions' contribution of one percent of assets to recapitalize the deposit insurance fund in 1985 is still counted as an asset by both credit unions and the deposit insurance fund. This practice increases the exposure of the taxpayer for two reasons.

First, unlike bank deposit insurance, credit union deposit insurance provides only one layer of protection between the taxpayer and credit union losses. This is credit union capital since most of the assets of the credit union insurance fund also count as industry capital. Unlike bank deposit insurance, the taxpayer has two layers of protection: bank capital and the FDIC Insurance Fund, which have no overlapping accounting treatment.

Second, the current system creates systemic risk problems. Whenever the credit union insurance fund dips below one percent, credit unions must begin expensing the losses on their own books simultaneously. As a result, any systemwide downturn could cause a reduction in credit union capital at the very time it was most needed, creating even more failures and more deductions to credit union capital. This cycle could feed on itself.

**Separation of Insurer from Regulator.** Credit union regulation and credit union deposit insurance are essentially combined in the National Credit Union Administration (NCUA), much as thrift regulation and deposit insurance were formerly combined in the Federal Home Loan Bank Board. Because of perceived conflicts of interest between these two functions, FIRREA separated thrift insurance from thrift regulation. The insurance function was then consolidated with bank insurance under the FDIC, and the regulation function was moved under the Treasury Department, alongside the Office of the Comptroller of the Currency -- in part to create consistent rules for banks and thrifts.

In theory, the same criticisms that applied to the combination of thrift insurance and regulation apply to credit union insurance and regulation. Similar potential conflicts exist when the charterer, regulator, and insurer are housed in one agency, and the lack of "constructive friction" between an independent insurer and an independent regulator could lead over time to more complacent supervision.

In practice, however, there is no evidence that credit union regulation and insurance have been susceptible to the same kind of regulatory lapses as thrift regulation and insurance. To date, the problems of the two industries have not been comparable.

But there does remain one serious area of concern for the taxpayer. The full faith and credit of the United States government stands behind federally insured deposits in all federally insured institutions -- banks, thrifts, and credit unions. Despite our fragmented regulatory system, there is some uniformity and consistency of rules for banks and thrifts through a single deposit insurer. More important, the Executive branch of government has direct accountability to the taxpayer for bank and thrift regulatory policy through the Secretary of the Treasury; the Office of the Comptroller of the Currency; and the Office of Thrift Supervision. No such direct accountability exists for credit union regulation and insurance.

## **Specific Recommendations**

### **A. Changed Accounting Treatment of Insurance Fund**

#### **1. Eliminated as Asset on Credit Union Balance Sheets**

The double counting of insurance fund assets as credit union assets should be eliminated. This would create an additional layer of protection for the taxpayer in the event of substantial credit union losses, with its use creating no immediate impact on industry capital. While such losses seem remote now, the thrift industry experience shows how quickly taxpayer losses can become a reality through federal deposit insurance. Taxpayer exposure must be reduced.

#### **2. Gradually Expensed Over Twelve Years**

To prevent abrupt losses to the industry, a twelve-year transition period for expensing the double-counted assets appears appropriate. The annual expense rate would be roughly comparable to the current growth adjustment rate that credit unions pay annually. This phase-in is reasonable because it will give credit unions time to build capital at the same time as they expense the one percent deposit.

### **B. Reorganized Board of National Credit Union Administration**

Because credit union regulation and insurance shows none of the same signs of problems as thrift regulation in the 1980s, it is not necessary to separate the two functions at this time. However, it is important to ensure that there is some nexus for consistent treatment (but not uniform treatment) of all federally insured depository institutions. It is also important that the Executive branch have a certain level of accountability and responsibility for credit union regulation because of taxpayer exposure through deposit insurance.

#### **1. Includes Representative from New Federal Banking Agency**

Accordingly, the Administration recommends that the Board of Directors of NCUA be reorganized. One of the two positions not occupied by the Chairman should be filled with a federal regulator that has responsibility for a broad range of federally insured depository institutions. While this could be a member of the board of FDIC, the Administration prefers that the position be filled with the Treasury Department's top banking regulator. Under the proposal set forth in Part Two of this Report, this regulator would be the director of the new Federal Banking Agency. This reorganization provides an important nexus between the Administration and the regulation of all federally insured institutions. It would also help ensure consistent regulatory policy among banks, thrifts, and credit unions.

## **IX. Other Deposit Insurance Recommendations**

### **List of Recommendations**

- A. No Assessments on Collateralized Borrowing**
- B. Uniform Bankruptcy Exemptions**

### **Reasons for Recommendations**

FIRREA requires recommendations on two other deposit insurance issues: (1) feasibility of adding collateralized borrowing to the deposit insurance base; and (2) possible changes to bankruptcy exemptions. The recommendations below are based on the issues set forth in Discussion Chapter XIV, Collateralized Borrowing, and Discussion Chapter XX, Bankruptcy Exemptions.

### **Specific Recommendations**

#### **A. No Assessments on Collateralized Borrowing**

Collateralized borrowing, which is a source of funds for depository institutions, includes repurchase agreements, loans from the Federal Reserve discount window, Federal Home Loan Bank advances, and other secured borrowing arrangements. While collateralized borrowings are not insured, the standard practice of overcollateralization generally provides full recovery for most secured creditors.

Collateralized borrowing can be costly to the insurance fund in two ways. First, to the extent it replaces uninsured deposits which would have suffered losses, the resolution cost of the institution is increased. Second, when a depository institution shifts its funding from deposits to collateralized borrowing, its insurance fund loses a source of premium income. However, because collateralized borrowing does not represent a substantial proportion of overall funding for depository institutions, the actual costs to the FDIC are limited.

Despite potential costs to the FDIC, collateralized borrowing should not be included in the deposit insurance assessment base for the following reasons: (1) it would increase the cost of secured borrowing for banks and thrifts; (2) it would put banks that are government securities dealers at a competitive disadvantage with non-bank government securities dealers; and (3) it could discourage the use of longer-term Federal Home Loan Bank advances, which are

important tool for managing interest rate risk. (Discussion Chapter XV, Federal Home Loan Bank System Subsidies, examines the use of Federal Home Loan Bank advances for managing interest rate risk.)

## **B. Uniform Bankruptcy Exemptions**

The magnitude of losses incurred in failed banks and thrifts has increased the importance of the FDIC's ability to maximize recoveries on acquired assets. However, bankruptcy exemptions limit the amount of a debtor's property available to satisfy debts owing to the FDIC and other creditors. Although the FDIC has not been able to measure the amount of its losses resulting from bankruptcy exemptions, the amount is believed to be significant based on combined FDIC and RTC experience in certain states with broad bankruptcy exemptions.

FIRREA requires this Report to consider the impact on the deposit insurance funds of varying state and federal bankruptcy exemptions and the feasibility of (a) uniform exemptions; (b) limits on exemptions when necessary to repay obligations owed to federally insured depository institutions; and (c) requiring borrowers from federally insured depository institutions to post a personal or corporate bond when obtaining a mortgage on real property.

Based on the considerations set forth in Discussion Chapter XX, the Administration continues to support uniform bankruptcy exemptions (as it did in the Federal Debt Collection Procedures Act of 1990). Uniform federal exemptions would minimize the loss to the deposit insurance funds resulting from borrowers of insured depository institutions declaring bankruptcy and exempting assets. The current widely divergent state bankruptcy exemption statutes result in adverse collection actions and unfairly disparate treatment of debtors based solely upon their domicile.

However, this option was considered by Congress in 1990 for debts owed to the United States and rejected. The next most effective way to protect the deposit insurance funds would be to set limitations on bankruptcy exemptions based on the conduct of the debtor. Such limitations could be used to permit certain exempt property to be liable for debts arising from the misuse of loan proceeds or from the misuse of bankruptcy planning devices.

## **PART TWO: REGULATORY RESTRUCTURING**

A major element of strengthened regulation and supervision of insured depositories is the restructuring of the current regulatory system for banks and thrifts. (Regulation is the establishment of rules, and supervision is the enforcement of those rules through examination of a depository's operations.) The present complicated structure for bank and bank holding company (BHC) regulation and supervision is divided among the Federal Reserve, the OCC, the FDIC, and state banking agencies. The OTS focuses on thrifts. (See Figure 12.)

### **Need For Regulatory Restructuring**

The result is too many regulators with overlapping responsibilities. The consequence is less accountability, as well as duplication of effort, with consumers bearing the additional cost. For example, a BHC with a state-chartered non-member bank subsidiary would be supervised by the Federal Reserve, the FDIC, and its state regulator. Furthermore, BHCs rarely have the same regulator as their subsidiary bank(s). The result is a regulatory framework that has been able neither to foster consistent regulation across banking organizations, nor to address as promptly and efficiently as necessary the many supervisory needs of the banks. (For a more detailed discussion of the need for regulatory reform and historical recommendations, see Discussion Chapter XIX, Reform of The Regulatory Structure.)

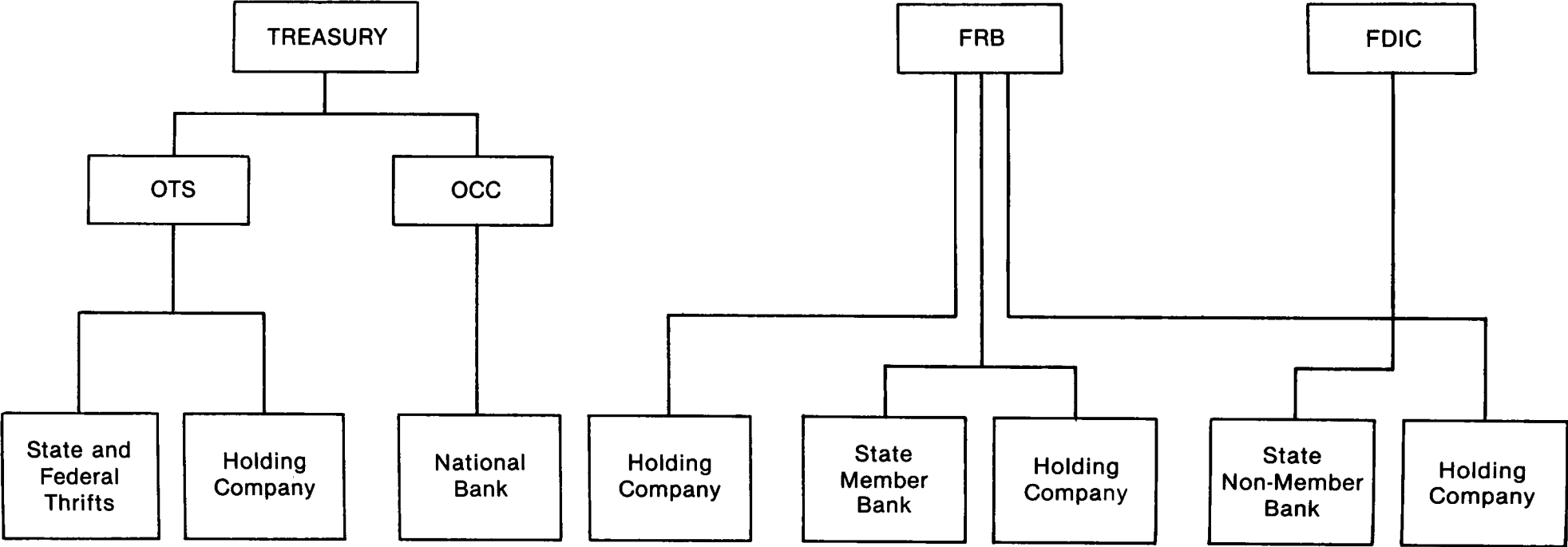
No one creating a regulatory system today from scratch would design the current structure. It effectively began with the establishment of the OCC in 1863 under President Lincoln, other component parts were added in the early 20th century, and it was largely completed with the Bank Holding Company Act in 1956. It has never been comprehensively overhauled, even though technology, information flows, global competition, private sector innovation, and consumer sophistication have completely transformed the world of financial services from the time of the Great Depression.

It is clearly desirable to move to a simplified, streamlined regulatory structure, such as the one discussed below. However, this restructuring should be implemented only after other elements of the Administration's comprehensive proposal are in place. It should also be implemented gradually over time to avoid disruption of the financial system.

A redesigned regulatory structure should achieve the following objectives compared to the current system: greater accountability, efficiency, and consistency of regulation and supervision, through a reduction in the number of regulators; improved consumer benefits from the reduced duplication and overlap; and the separation of the regulator from the insurer. In attaining these goals, significant roles for the Treasury, the Federal Reserve, and the FDIC should be retained.



Figure 12  
Current Federal Regulation and Supervision of Banks and Thrifts  
and their Holding Companies



## **Recommendations**

### **A. Two Federal Regulator Approach (Federal Reserve, Federal Banking Agency)**

Two specific recommendations, strongly reflecting the proposals of the 1984 Report of the Task Force on Regulation of Financial Services (see Discussion Chapter XIX), would help achieve these goals. First, the present four federal regulator banking model (i.e., Federal Reserve, OCC, FDIC, and OTS) would be simplified to two, and the same federal regulator would be responsible for a BHC and its subsidiary bank(s). The Federal Reserve would be responsible for all state-chartered banks and their BHCs. Those regulatory functions currently performed by the FDIC with regard to state-chartered non-member banks would be transferred to the Federal Reserve. In addition, a new federal regulator, the Federal Banking Agency (FBA), would be created under Treasury, and would be responsible for all national banks and their BHCs. The functions of the OCC and those regulatory responsibilities presently carried out by the Federal Reserve for the BHCs of national banks would therefore be transferred to the FBA. The FBA would also take responsibility for the affairs of OTS at the date it completed assigning thrifts to the RTC. (See Figure 13.) When a BHC contains both state-chartered and national banks, jurisdiction over the entire organization would go to the charterer of the largest subsidiary bank. The Federal Reserve and the FBA would mutually agree on BHC regulatory policies and practices.

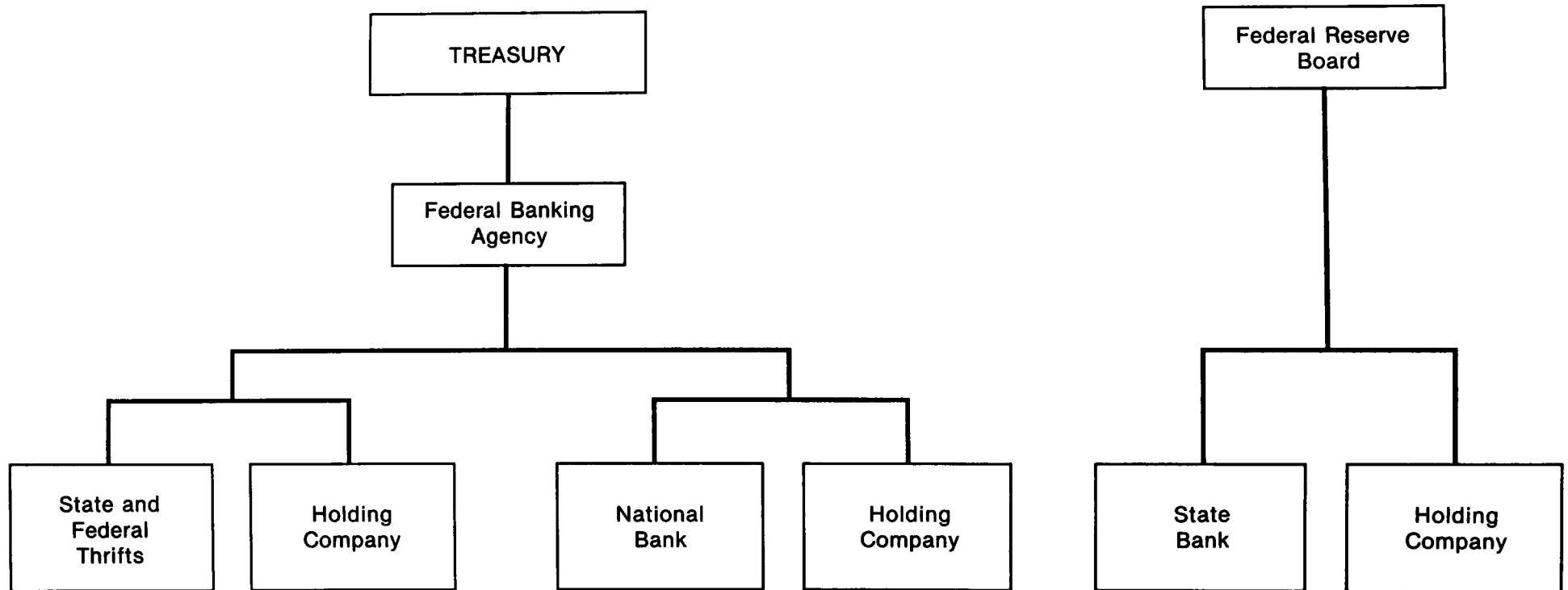
Such consolidated regulation would clearly promote the goals of regulatory accountability, efficiency, consistency and consumer benefits enumerated above. Accountability would be enhanced, as responsibility for bank regulatory matters would be focused in only two entities, the Federal Reserve and the FBA. Efficiency would be improved by having the same federal regulator/supervisor for each BHC and subsidiary bank. Consistency would be achieved by having questions concerning bank regulation and BHC/bank supervision decided by the Federal Reserve and the FBA together. Consumers would expect to benefit from the harmonized bank regulation and supervision through reduced BHC/bank paperwork time and cost. Finally, the federal regulator (Federal Reserve or FBA) would be different from the insurer (FDIC).

Joint decision-making by the Federal Reserve and the FBA would ensure that their insights on policy were obtained and their respective interests were considered. (The states would offer a counterpoint to the two federal regulators by continuing to charter, regulate, and supervise state banks.) The Federal Reserve's ability to carry out monetary policy and discount window activities would be preserved, as would its capacity, in concert with the Treasury, to make the important systemic risk ("too big to fail") judgments.

The sharing of BHC supervisory responsibilities with the Treasury through the FBA would ensure that there was regulatory accountability in the Administration. This is wholly appropriate in that the Administration bears responsibility for the successful functioning of the U.S. economic and financial system. This is also in keeping with the prominent role finance ministries play abroad, in countries such as Japan and Germany, in bank regulatory matters.

Figure 13

Proposed Federal Regulation and Supervision of Banks  
and Thrifts and Their Holding Companies



## **B. FDIC Focused On Insurance and Resolution**

The second change would be to consolidate all insurance and resolution programs for banks and thrifts in the FDIC. It would no longer supervise banks, but it would administer the deposit insurance system, protect the safety and soundness of its insurance funds, and manage any resulting bank resolutions (as it does thrift resolutions through the current RTC). The FDIC would receive copies of all bank call reports to be able to monitor banks' performance and could examine troubled banks with the approval of the Federal Reserve or the FBA. It could also take enforcement actions it deemed necessary against unsafe and unsound banks if either federal regulator, upon its request, failed to act.

Focusing the FDIC's duties solely on insurance and problem bank/thrift resolution offers an appropriate complement to the consolidated regulatory structure and a recognition of the importance of these activities. The FDIC would also need to continue its surveillance of state-chartered bank activities to decide whether those that exceed activities permitted for national banks should properly benefit from federal deposit insurance. (Otherwise, the state-chartered bank would have to engage in such an activity in a separately established and capitalized affiliate.) Given the Administration's intention to narrow the scope of the safety net, the proper location of such activities -- inside or outside the insured depository -- is of great significance.

In addition, a significant number of banks may fail in the coming years, although the proposed early intervention system of prompt corrective action should help to reduce that number over time. Timely resolution of these problem banks is necessary to avoid assets overhanging the market and weakening the earning potential of the remaining banks. The FDIC's recent and ongoing experience in its work with the RTC will provide important benefits in dealing promptly with the assets of problem banks that purchasers of those banks do not want.

## **PART THREE: RECAPITALIZATION OF THE BANK INSURANCE FUND**

The Bank Insurance Fund (BIF) is the FDIC fund that insures deposits in commercial banks and some savings banks. The Fund has declined substantially since 1987, and needs to be recapitalized with industry funds in the near term. In October 1990, the Congress passed an Administration sponsored bill, the FDIC Assessment Rate Act of 1990, which gave the FDIC the additional authority it needed to implement a recapitalization plan for BIF.

### **The Need for Recapitalization**

The predecessor to the BIF was created in 1933 by the Federal Deposit Insurance Act. The Fund was initially capitalized by a contribution of \$150 million from the Treasury and \$139 million from the Federal Reserve System; these amounts were fully repaid in the 1940s. At the Fund's inception, deposits were insured up to \$2,500, which represents about \$25,000 in 1990 dollars.

From its beginning in 1934 until 1988, the Fund experienced a decline in its net worth only once -- in 1947, when the Fund returned to the Treasury the funds contributed in 1933 to capitalize it. As Table 2 shows, the Fund always held equity of substantially more than \$1.00 for every \$100 in insured deposits. As recently as year-end 1987, the Fund's net worth was \$18.3 billion, or \$1.10 for every \$100 in insured deposits.

Since 1987, however, the Fund has incurred sizable losses, reducing its net worth by more than 50 percent. Each of the last three years has produced a new record low in the Fund's level relative to the amount of insured deposits.

**Net Worth Projections.** According to current estimates by FDIC Chairman L. William Seidman, the Fund sustained a net loss of approximately \$4.7 billion in 1990, subject to an audit by the General Accounting Office. Over 80 percent of this loss represents reserves for failures expected in 1991. These losses have reduced the Fund's net worth to approximately \$8.5 billion, or only \$0.44 per \$100 in insured deposits.

The FDIC's most recent baseline projection is that, assuming that the current recession is a moderate one of about six months duration, BIF's net worth will decline to approximately \$3.9 billion by the end of 1991. For 1992, the FDIC's baseline projection is for a further decline to \$2.4 billion. Under more pessimistic assumptions, the FDIC projects that the Fund would decline to \$0 by year-end 1991, and fall further to negative \$5.8 billion in 1992.

Various other private and public sector studies have also projected that the Fund will experience another substantial decline in the next two years, particularly if economic conditions are unfavorable.

Table 2

## Insured Deposits and the Deposit Insurance Fund, 1934-1989

(In millions of dollars)

Year (December 31)	Insurance coverage	Deposits in insured banks <sup>1</sup>		Percentage of insured deposits	Deposit insurance fund	Ratio of deposit fund to
		Total	Insured			Total deposits
1989.....	100,000	2,465,922	1,873,837	76.0	13,209.5	.54
1988.....	100,000	2,330,768	1,750,259	75.1	14,061.1	.60
1987.....	100,000	2,201,549	1,658,802	76.9	18,301.8	.83
1986.....	100,000	2,167,596	1,634,302	75.4	18,253.3	.84
1985.....	100,000	1,974,512	1,503,393	76.1	17,956.9	.91
1984.....	100,000	1,806,520	1,389,874	76.9	16,529.4	.92
1983.....	100,000	1,690,576	1,268,332	75.0	15,429.1	.91
1982.....	100,000	1,544,697	1,134,221	73.4	13,770.9	.89
1981.....	100,000	1,409,322	988,898	70.2	12,246.1	.87
1980.....	100,000	1,324,463	946,717	71.6	11,019.5	.83
1979.....	40,000	1,226,943	808,555	65.9	9,792.7	.80
1978.....	40,000 <sup>6</sup>	1,145,835	760,706	66.4	8,796.0	.77
1977.....	40,000 <sup>5</sup>	1,050,435	692,533	65.9	7,992.8	.76
1976.....	40,000	941,923	628,263	66.7	7,268.8	.77
1975.....	40,000	875,985	569,101	65.0	6,716.0	.77
1974.....	40,000	833,277	520,309	62.5	6,124.2	.73
1973.....	20,000	766,509	465,600	60.7	5,615.3	.73
1972.....	20,000	697,480	419,756	60.2	5,158.7	.74
1971.....	20,000	610,685	374,568	61.3	4,739.9	.78
1970.....	20,000	545,198	349,581	64.1	4,379.6	.80
1969.....	20,000	495,858	313,085	63.1	4,051.1	.82
1968.....	15,000	491,513	296,701	60.2	3,749.2	.76
1967.....	15,000	448,709	261,149	58.2	3,485.5	.78
1966.....	15,000	401,096	234,150	58.4	3,252.0	.81
1965.....	10,000	377,400	209,690	55.6	3,036.3	.80
1964.....	10,000	348,981	191,787	55.0	2,844.7	.82
1963.....	10,000	313,304 <sup>2</sup>	177,381	56.6	2,667.9	.85
1962.....	10,000	297,548 <sup>3</sup>	170,210	57.2	2,502.0	.84
1961.....	10,000	281,304	160,309	57.0	2,353.8	.84
1960.....	10,000	260,495	149,684	57.5	2,222.2	.85
1959.....	10,000	247,589	142,131	57.4	2,089.8	.84
1958.....	10,000	242,445	137,698	56.8	1,965.4	.81
1957.....	10,000	225,507	127,055	56.3	1,850.5	.82
1956.....	10,000	219,393	121,008	55.2	1,742.1	.79
1955.....	10,000	212,226	116,380	54.8	1,639.6	.77
1954.....	10,000	203,195	110,973	54.6	1,542.7	.76
1953.....	10,000	193,466	105,610	54.6	1,450.7	.75
1952.....	10,000	188,142	101,841	54.1	1,363.5	.72
1951.....	10,000	178,540	96,713	54.2	1,282.2	.72
1950.....	10,000	167,818	91,359	54.4	1,243.9	.74
1949.....	5,000	156,786	76,589	48.8	1,203.9	.77
1948.....	5,000	153,454	75,320	49.1	1,065.9	.69
1947.....	5,000	154,096	76,254	49.5	1,006.1	.65
1946.....	5,000	148,458	73,759	49.7	1,058.5	.71
1945.....	5,000	157,174	67,021	42.4	929.2	.59
1944.....	5,000	134,662	56,398	41.9	804.3	.60
1943.....	5,000	111,650	48,440	43.4	703.1	.63
1942.....	5,000	89,869	32,837	36.5	616.9	.69
1941.....	5,000	71,209	28,249	39.7	553.5	.78
1940.....	5,000	65,288	26,638	40.8	496.0	.76
1939.....	5,000	57,485	24,650	42.9	452.7	.79
1938.....	5,000	50,791	23,121	45.5	420.5	.83
1937.....	5,000	48,228	22,557	46.8	383.1	.79
1936.....	5,000	50,281	22,330	44.4	343.4	.68
1935.....	5,000	45,125	20,158	44.7	306.0	.68
1934.....	5,000 <sup>4</sup>	40,060	18,075	45.1	291.7	.73

<sup>1</sup> Deposits in foreign branches are omitted from totals because they are not insured. Insured deposits are estimated by applying to deposits regular Call dates the percentages as determined from the June Call Report submitted by insured banks.

<sup>2</sup> December 20, 1963.

<sup>3</sup> December 28, 1962.

<sup>4</sup> Initial coverage was \$2,500 from January 1 to June 30, 1934.

<sup>5</sup> \$100,000 for time and savings deposits of in-state governmental units provided in 1974.

<sup>6</sup> \$100,000 for individual Retirement accounts and Keogh accounts provided in 1978.

Source: FDIC Annual Reports.

**Borrowing Constraints.** The FDIC uses its borrowing authority to finance its working capital -- the assets that are retained in resolving failed institutions. The Fund faces constraints on the use of this borrowing authority in the near term.

By law, the Fund may have outstanding liabilities at any time no greater than nine times its net worth. (The Fund also has a \$5 billion line of credit from the Treasury that is not subject to this limitation.) The Fund is currently well within this limitation on borrowing. However, because of this limitation, the Fund could run out of borrowing authority, and thus be unable to resolve institutions, before it could exhaust its net worth. The liquidity constraints faced by BIF reinforce the need to address the condition of the Fund as soon as practicable.

**Why the Fund is Depleted.** The depletion of BIF's resources is a direct result of the heightened pace of bank failures that began in the late 1980s. In some measure, these failures are the result of the failure to adapt our outdated banking laws and regulatory practices to the changing financial marketplace. In prior eras, this regulatory system served us well. Now it prevents efficient geographic diversification, limits the range of permitted activities, and renders our banks unable to compete effectively on the world financial scene.

In addition, our system has sometimes failed to produce timely intervention by regulators in deteriorating institutions. In some cases, earlier intervention could have reduced or minimized losses to the Fund.

Finally, the Fund is under stress because the federal deposit insurance safety net has been extended well beyond its original purposes. It now protects almost all depositors -- insured as well as uninsured -- and permits individuals and corporations to have essentially unlimited insurance coverage.

Recapitalization of the Fund -- while necessary -- will not by itself contain the long-term exposure of the taxpayer to bank losses. In the end, only a safe, profitable, competitive, modernized banking system can do that. Our outdated banking laws prevent the achievement of this goal. This Report proposes reforms that are designed to eliminate underlying structural flaws in our banking and supervisory system. In addition, the Report includes proposals designed to rein in the overextended scope of federal deposit insurance, and to return federal deposit insurance to its original purpose of protecting small savers. It is critical that these reforms be enacted to ensure the success of any plan to recapitalize the Bank Insurance Fund.

## **Goals of Recapitalization**

A plan to recapitalize BIF should be designed to meet these objectives:

1. It should provide sufficient resources.
2. It should take into account any impact on the health of the banking system.
3. It should rely on industry funds.
4. It should use generally accepted accounting principles.

These criteria are discussed below.

### **1. Sufficiency**

The plan must provide sufficient resources for BIF to meet its needs. There are a number of perspectives from which to evaluate these needs.

**The Ideal Level of the Fund.** The Fund must have resources that are adequate to meet its needs. Beyond that truism, there is no known scientific means of deriving an "optimal level" for the Fund. Ultimately, a judgment must be made as to the contingencies the Fund should be expected to handle.

Based on prior law and a review of historical Fund levels, FIRREA affirmed a "designated reserve ratio" for BIF of 1.25 percent of insured deposits. With insured deposits today of roughly \$2 trillion, a Fund of \$25 billion would be necessary to meet that goal. The FDIC Assessment Rate Act of 1990 gave the FDIC the authority to vary the designated reserve ratio to take into account expectations as to the Fund's anticipated needs, and to raise or lower premiums accordingly.

Over time, it might be desirable to return the Fund to the 1.25 percent target, and to maintain it at that level or higher. Immediate achievement of that goal, however, would require a special assessment of roughly \$20 billion on the banks in 1991, in addition to regular assessments of over \$5 billion. This would be detrimental to the health of the banking industry and could increase losses to the FDIC.

**FDIC Projections.** The FDIC believes that it can foresee losses over a one-to-two year period with some degree of accuracy, but does not attempt to project losses beyond two years because it has little confidence in the results. As noted above, the FDIC's baseline projections for the next two years indicate that, if there is a moderate recession of about six months duration, the Fund's net worth will decline to \$2.4 billion by the end of 1992. Based on assumptions the FDIC considers pessimistic, including a recession more than a year in duration, the FDIC projects that the Fund would decline to \$0 in 1991 and to negative \$5.8 billion in 1992.



**1992 Budget Projections.** The 1992 Budget is required to project BIF outlays over a five-year period. Assuming a moderate recession and no change in current law, the current baseline projections are that the net worth of the Fund will be negative \$2.2 billion by the end of Fiscal Year 1992, and will decline to negative \$22.2 billion by the end of Fiscal Year 1996.

**CBO Projections.** The Congressional Budget Office's (CBO's) most recent baseline projections show the Fund declining to negative \$2.8 billion at year-end 1992, remaining marginally negative through 1994, and increasing to positive \$4.2 billion in 1996. These projections assume that the recession ends by mid-1991. CBO also projects better results for a milder recession, and worse results for a longer, more severe one.

**Conclusion.** The projections set forth above include varying assumptions about premium rates and failures. However, they point to a common conclusion -- it is quite possible that further losses will eliminate the remainder of the Fund's equity over the next two years. Beyond the next year or so, however, the size of the Fund's losses is highly uncertain.

The future state of the economy will be the single most important factor in determining losses, and that is obviously not knowable today. In addition, the Administration's banking reform proposals, if adopted, should make banks stronger and less likely to fail. This should have a substantial positive effect on the Fund over time. However, this effect is difficult to quantify with precision.

In light of this uncertainty, it would be wise to adopt a flexible recapitalization plan that clearly meets the near-term needs of the Fund, and that can expand (or contract) to meet the future needs of the Fund as they become clearer.

## **2. Impact on the Banking System**

With over \$200 billion in equity and average annual after-tax earnings of roughly \$18 billion during 1985-89, the banking system appears to have the capacity to finance a substantial, multi-year recapitalization of BIF. However, a recapitalization could produce incremental strains on the system at a time when failures and losses are already at an all-time high. It is desirable to recapitalize the Fund in a manner that satisfies BIF's needs, without materially increasing bank failures or reducing the availability of credit to the economy.

There are two important ways in which a recapitalization could be counterproductive. First, if funds are withdrawn from the banking system too suddenly, with no opportunity for the banks to plan or to spread the costs over time, the recapitalization could cause substantial incremental failures and losses to the Fund. Second, a recapitalization could negatively affect credit availability, given the increased evidence of a "credit crunch." It should be possible to minimize the negative impact of the plan on credit availability, however, by stretching out its implementation over time and by placing clear limits on the banks' obligations.

### **3. Use of Industry Funds**

Banking leaders have expressed confidence that the industry can provide a private sector solution to the recapitalization of the Fund. In addition, the FDIC has recently stated that it believes that the Fund's resources are sufficient to handle the losses it now foresees, although it may require additional funds for liquidity.

Since the Fund was initially capitalized in 1933, the banking industry has fully borne the burden of paying for bank losses. Industry leaders express confidence that this record can be continued. However, others have questioned whether the industry can fully fund losses under more pessimistic scenarios.

### **4. Use of Generally Accepted Accounting Principles**

Confidence in the recapitalization plan and in the banking system will be strengthened if the plan is straightforward and easily understood. Reliance on non-standard accounting techniques will undermine support for any plan.

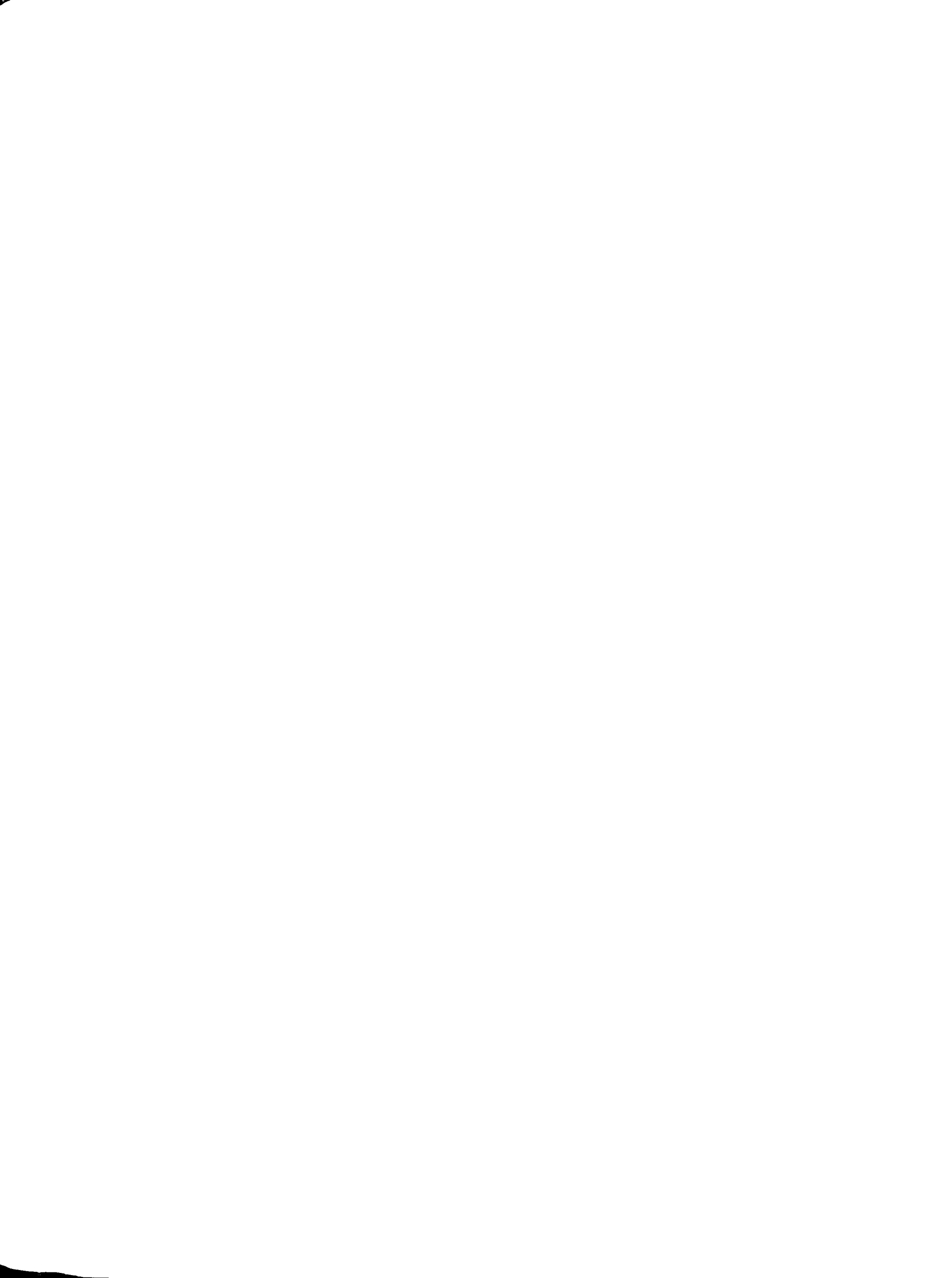
### **Conclusion**

The Administration will submit proposals as part of its comprehensive deposit insurance and banking reform legislation, to the extent any changes in law are required to implement the terms of the plan.

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## DISCUSSION CHAPTERS

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## DISCUSSION CHAPTERS

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## **Chapter I**

### **HISTORY OF DEPOSIT INSURANCE**

#### **A. Introduction**

Federal deposit insurance was established in 1933 in response to the worst economic crisis in U.S. history, the Great Depression. Unemployment stood at record levels, bank failures were widespread, panic withdrawals of deposits were commonplace and public confidence in the banking system was nonexistent. Many small savers suffered substantial losses. The dismal condition of our nation's financial system called for decisive action.

A federal guarantee of the safety of small deposits was implemented with the creation of the Federal Deposit Insurance Corporation (FDIC) in 1933 and the Federal Savings and Loan Insurance Corporation (FSLIC) in 1934. That guarantee has remained in effect to this day. Federal deposit insurance has been highly effective in achieving its fundamental goal, that of eliminating almost all panic deposit withdrawals.

For many years deposit insurance appeared to be an unmitigated success. Prior to 1980, bank and thrift failures were relatively rare and deposit insurance costs were small. The deposit insurance funds grew steadily as investment income and insurance premiums received from banks and thrifts consistently exceeded insurance expenses. No taxpayer funding was required. This was in part due to the relatively predictable financial environment in which banks and thrifts operated. Insured depositories served fairly well-defined market niches free of the degree of competition from foreign and nonbank financial firms which exists today. By the standards of the 1980s, interest rates were stable, enabling most institutions to avoid wide swings in economic net worth due to interest rate movements.

During the decade of the 1980s, commercial bank deposit insurance became much more expensive and risk exposure increased; thrift deposit insurance suffered a financial calamity requiring hundreds of billions of dollars of taxpayer money. As discussed in this chapter, reasons for this dramatic increase in insurance costs include economic downturns in oil, agriculture and real estate, increased interest-rate volatility, fundamental changes in the financial marketplace which have led to increased competition from foreign and nonbank financial intermediaries, and inadequate supervision of undercapitalized institutions.

It is possible that recent insurance losses are simply the result of an exceptionally unfavorable confluence of events, rather than the result of some inherent weakness in the deposit insurance system. The magnitude and scope of insurance losses over the last ten years, however, have led many observers to claim that the risk exposure of the deposit insurance funds is out of control. According to this view there are serious flaws in the deposit insurance system which create incentives for excessive risk-taking by insured institutions. If this view is correct, bank regulators, Congress, and insurers should say with Shakespeare's Cassius, "The fault, dear Brutus, is not in our stars, but in ourselves ..."<sup>1</sup>

This chapter is organized as follows: Section B briefly reviews how the deposit insurance system came into being in the 1930s. Section C discusses the purpose and benefits of federal deposit insurance. This is followed in Section D with a summary of the concerns and criticisms that have been leveled against the deposit insurance system. The evolution of the financial performance of federally insured institutions, and the risk exposure of the deposit insurance funds, is discussed in Section E. Section F provides information on the operation of the U.S. deposit insurance system, and Section G provides a detailed discussion of how the FDIC has handled bank failures.

## **B. Origins of the Current Deposit Insurance System**

When Franklin D. Roosevelt was sworn in as the 32nd President of the United States in March of 1933, the nation's banking industry was at its nadir. The nation's banks were closed, banking holidays having been declared by authorities in all 48 states. One of the new president's first official acts was to have the federal government take charge of the situation: he proclaimed a nationwide bank holiday to commence on March 6 and to last for four days. Administration officials quickly drafted legislation to legalize the holiday and to begin the resolution of the banking crisis.

That crisis had been developing for some time. During the comparatively prosperous years of the 1920s, banks failed at the rate of more than 600 per year.<sup>2</sup> Most of these banks were small, poorly capitalized Midwestern institutions serving agricultural markets, and their demises had little direct impact on the national economy. A look at these pre-Depression failures, however, serves to emphasize two points.

First, banks<sup>3</sup> are dependent on the confidence of depositors. The nature of the banking business is to fund relatively long-term illiquid assets with relatively short-term liabilities. If a number of depositors lose confidence in a bank and seek to withdraw their deposits, the bank might not be able to liquidate

assets quickly enough to satisfy all withdrawal requests in a timely manner. If there is no deposit insurance system, depositors in a bank about which rumors of troubles are heard are motivated to be at the head of the withdrawal line. One result can be a "run" as depositors inundate the bank with demands for their money. Unable to satisfy the demands, the bank, absent outside aid, is forced to close.

A second point that the bank failures of the 1920s serve to emphasize is the unusual structure of the U.S. banking system, a structure that still exists to a considerable extent today. Many banks in the United States were small and undiversified. They were prevented from expanding geographically by restrictive state branching laws. Consequently, they had little way of avoiding or mitigating the impact of local economic difficulties on their financial conditions.

With the onset of the Depression, the rate and significance of bank failures increased substantially. More than 5,000 banks failed during the three-year period from 1930 through 1932, resulting in losses to depositors of almost \$800 million (or more than \$6 billion in 1990 dollars). Another 4,000 banks failed in 1933.<sup>4</sup>

Some economic historians believe that actions by the Federal Reserve System to ease the liquidity problems of banks during these early years of the Depression were ineffectual. The central bank failed to adopt an aggressive stance with respect to either open market purchases of securities or discount window operations. Several reasons have been cited for this lack of response, among them being a general belief that bank failures were an outgrowth of bad management, that many troubled banks were not members of the Federal Reserve System, and a preoccupation at certain times with international monetary difficulties.<sup>5</sup>

Thus the possible collapse of the nation's banking system was among the most pressing problems facing Franklin Roosevelt when he took office on March 4, 1933. His declaration of a nationwide bank holiday and the quick enactment by Congress of emergency banking legislation restored a degree of order, but a longer-term solution was needed. Deposit insurance was potentially one such solution.

The concept of deposit insurance was not new. Between 1886 and the establishment of the Federal Deposit Insurance Corporation in 1933, 150 deposit insurance or guaranty proposals were introduced in Congress.<sup>6</sup> Moreover, fourteen states had tried insurance or guaranty programs for their banks, beginning with New York in 1829. None of these programs was in existence in 1933, however.

Six pre-Civil War programs had for the most part been successful but had lost participants as a result of (1) the "free banking" movement that began in the 1830s and (2) the establishment of the national bank system in 1863. And the eight programs that had been adopted--mainly in farming states--during the first two decades of the 20th Century had failed to survive the economic troubles of the agricultural industry in the 1920s.

The demise of these earlier state programs was used in 1933 as one argument against a federal deposit insurance program. Opponents also feared that the cost of deposit insurance would be exorbitant and would require the use of tax revenues. Another argument was that deposit insurance would remove penalties for bad management, thus subsidizing poorly run banks.

A number of factors combined to overcome these arguments, however. Chief among them was the nation's grave economic condition. Section 8 of the Banking Act of 1933, which was signed by President Roosevelt on June 16, 1933, established the Federal Deposit Insurance Corporation and provided for a temporary insurance plan to be initiated on January 1, 1934. A permanent plan did not come into being until the Banking Act of 1935 was adopted. That law became effective on August 23, 1935. Deposit insurance for savings and loan associations was provided for in the National Housing Act of 1934 with the creation of the Federal Savings and Loan Insurance Corporation.

### **C. Benefits and Purpose of Federal Deposit Insurance<sup>8</sup>**

The most important social benefits associated with insuring bank deposits are the provision of a safe haven for small depositors and the prevention of widespread deposit runs and the damage they cause.

#### **1. Protection of Small Depositors**

Government action often is triggered by the desire to help a particular group that is perceived to be disadvantaged in some way. In the case of deposit insurance, the argument is that there are people who are relatively unsophisticated financially who should have easy access to a safe means for both making payments and for storing wealth. If this were the sole reason for government intervention, it would seem that the current system provides far more insurance coverage than necessary, and that either lower deposit insurance coverage or a more limited alternative form of protection would be appropriate.

#### **2. Prevention of Bank Runs**

The primary purpose of deposit insurance is to promote financial stability by preventing destructive bank deposit runs.

Bank runs are caused by a combination of two factors. First, loans, the primary bank asset, are illiquid in that they can not be sold quickly without a loss in value. Second, most depositors have the ability to withdraw their deposits either on demand or on short notice. These two factors virtually guarantee that a bank will be unable at any time to fulfill its potential obligation to convert all or most of its liabilities to cash. Of course, under normal circumstances a bank will not be called upon to fulfill all of its obligations on short notice; this is what allows a bank to invest in illiquid assets.

If there is no deposit insurance and a depositor believes that heavy withdrawal demand may soon make a bank unable to meet its deposit obligations, that depositor will have the incentive to withdraw his or her funds. Once a bank has depleted its inventory of liquid assets, it must begin to sell illiquid assets to meet further withdrawal demands. By definition, each such sale means a bank is realizing a liquidation loss on the asset. At some point a bank will have suffered enough losses to render it unable to fulfill its obligation to the remaining depositors. Note, it is the "first come, first served" nature of the process that gives depositors the incentive to run. Those depositors at the beginning of the withdrawal line lose nothing, while those at the end lose everything. A depositor who merely suspects that other depositors are going to run will get in line whether he or she desires liquidity at that time or not. This leads to "panic" runs. Since the failure of one bank may affect how depositors view other banks, bank runs may be contagious. It is this contagion effect of bank runs that deposit insurance was designed to alleviate.

One of the functions of the system of Federal Reserve Banks is to serve as a "lender of the last resort;" that is, to extend credit to economically solvent banks which are experiencing liquidity difficulties. In theory, a lender of the last resort could prevent runs on solvent banks as well as deposit insurance could. The most important difference between the two in terms of run prevention is that deposit insurance works automatically while the lender of the last resort has discretion over whether to extend credit. The other important difference is that the lender of the last resort does not attempt to prevent depositors in insolvent banks from suffering losses.

A lender of the last resort may not be as effective in preventing runs on healthy banks as is deposit insurance. Suppose a run develops on an economically solvent bank. In order to function as a true "lender of the last resort," the Federal Reserve would have to make a quick judgment, perhaps that very day, regarding whether or not the bank is indeed solvent or has sufficient collateral. In practice, the Fed's loans must all be collateralized, making it less important from the Fed's perspective whether the bank is solvent. However, it would be



difficult for anyone to predict whether the Federal Reserve would decide to extend credit in any particular case. Given this uncertainty, depositors may still have incentive to run. In addition, banks may have incentive to hold excessive liquidity to avoid the threat of runs.

### **3. The Cost of Runs on Banks**

Bank runs can impose substantial "external" costs. In the case of contagious bank runs such costs include disruption of the money supply process, the payments system and financial intermediation. Individual bank runs also can cause systemic problems by disrupting the payments system, thus imposing third-party costs. Where bank runs force the fire-sale liquidation of assets, costs must be incurred by buyers in evaluating the quality of banks' non-marketable assets; from the standpoint of economic efficiency these costs are simply wasted resources. In addition, the threat of bank runs may induce bankers to adopt unduly conservative lending practices which reduce the funds available for productive investment.

#### **Contractionary Effect on the Money Supply**

This argument for deposit insurance focuses on the banking industry's role in the money supply process. The system of fractional reserve banking enables banks to lever the stock of high-powered money (cash and reserves at the Federal Reserve) into a stock of money several times larger. This enables the banking industry to be the major conduit through which the Federal Reserve can control the money supply. Bank runs, especially if they are widespread, have the potential to sharply curtail the money supply. If depositors who withdraw their funds do not redeposit their funds in other banks, then, barring any offsetting government action, bank reserves will be reduced and the banking system's ability to create money will be diminished. The resulting reduction in the money supply may lead to deflation and recession.

In the absence of a mechanism to prevent or stop bank runs, financial crises in the form of systemic or contagious bank runs can cause economic disruptions. However, in terms of protecting the money supply, isolated runs or runs that involve a flight of funds from some banks to other banks in the system should not be a concern, since little or no money would be withdrawn from the system.

#### **Disruption of the Payments System**

While nonsystemic bank runs do not threaten the money supply, they do pose a threat to the payments system. Deposit insurance may be justified to prevent individual bank runs in order to provide a safe payments system. The existence of a

smoothly functioning payments system is of incalculable value. Part of this value is simply in minimizing the real resources devoted to making payments. As an economy develops, the essential medium in making payments evolves from commodity to paper to electronics. Banks have been an integral part of this development, as evidenced by their role in checking services, credit cards, and electronic transfers of funds.

In addition to economizing on resources, a well functioning payments system has many of the characteristics of a "public good" such as national defense or environmental cleanup. That is, the benefits of a payments system in which market participants can make transactions quickly, easily and with confidence accrue to all members of society. Government often plays a role in ensuring adequate provision of public goods, and in the case of the payments system that role has typically involved providing resources to facilitate the mechanism (e.g., clearinghouse services) and eliminating risk to participants.

Bank runs pose a risk to the payments system because a bank facing a run may be unable to meet its obligations to the other participants in the system. Such disruptions will interfere with the smooth workings of the system. To the extent that this threat can be removed by deposit insurance, the fluidity of the payments system and the functioning of the economy can be improved. A more detailed discussion of the adverse effects of an individual large bank failure is contained in the next section.

### **Interference with Financial Intermediation**

In addition to posing a threat to the money supply and the payments system, bank runs can impose social costs by interfering with the credit-allocation role of banks. Bank runs are costly, it is argued, in part because runs can disrupt or destroy an important conduit of investment funds in the economy.<sup>9</sup> This argument for deposit insurance therefore focuses on the role of banks as intermediaries in the economy.

Investment is necessary for an economy to grow, and savings are necessary to provide the resources for that investment. Because the people who want to save are not necessarily the people who have investment projects, the need for borrowing and lending arises. A saver is willing to lend under certain terms, and in fact prefers certain lending arrangements to others. Likewise, investors prefer some borrowing contracts to others. Direct financing occurs to the extent that borrowers and lenders who prefer the same arrangements can find one another without incurring significant search costs. If they cannot find one another, or if there are lenders who prefer arrangements that borrowers are unwilling to accept (or vice versa), then there is a role for financial intermediaries. These institutions provide

a real service to the economy: investment and output will be greater, and this should translate into enhanced social welfare.

Financial intermediaries improve the allocation of credit by reducing the search and information costs of bringing borrowers and lenders together. In addition to this brokerage function, financial intermediaries perform a portfolio transformation function by modifying the attributes of the financial securities that pass between the borrowers and lenders. Two important attributes that are altered by this process are the risk and maturity of the instruments.

Savers would like to hold portfolios which include a broad range of investments to avoid wide swings in wealth. To achieve this directly, savers would need to find many borrowers and lend small amounts to each. An intermediary can pool the savings of a large number of lenders and provide the funds to many borrowers. This allows lenders to achieve a more certain return than they could otherwise obtain through direct financing.

With direct financing, the maturity of the instrument is the same for the borrower and the lender. Because people face uncertainty as to when they will desire funds with which to conduct transactions, they may be unwilling to commit funds over long periods, and, as a result, less investment will be funded. Intermediaries can issue debt that is short-term or that is easily callable in order to provide lenders with some protection against this uncertainty. Intermediation thus reduces the need for maturity matching and allows long-term investment to be funded with short-term lending.

Banks are intermediaries whose assets have tended to be specialized in loans to borrowers for whom "public information on the economic condition and prospects ... is so limited and expensive that the alternative of issuing marketable securities is either nonexistent or unattractive."<sup>10</sup> Because these borrowers cannot easily convey information about their own creditworthiness to lenders (or conversely, because lenders cannot easily ascertain the creditworthiness), there are information costs associated with the borrowing and lending arrangements available to them. Banks alleviate these costs by specializing in evaluating and monitoring this class of borrowers. This allows banks to find profitable investment opportunities in essentially nonmarketable assets.

Part of the social cost of bank runs is that they force the liquidation of these nonmarketable assets. Buyers of these assets must incur substantial evaluation costs, since the bank experiencing the run possesses specialized information about the quality of its assets that cannot be quickly or easily transferred. In addition, creditworthy borrowers may lose financing (often for extended periods, given the information

costs noted), production may be interrupted, and consumption plans may be frustrated.

The mere possibility of bank runs also may impose substantial indirect social costs. As previously noted, in the absence of deposit insurance, the belief that a panic run will occur is self-fulfilling. In the face of the threat of runs, depositors would require banks to hold more liquid assets in order to protect them against losses in a panic run. This would reduce the amount of funds available for long-term investment. On the other hand, as will be discussed in the next section, deposit insurance may have the effect of channeling excessive funds to the banking industry.

It is important to emphasize that bank runs are a type of market failure. "Market failure" is a term used by economists to denote situations in which unfettered market forces are unable to achieve the most efficient use of resources. In our context, the "market" may participate in a panic-induced run which imposes substantial real resource costs on the economy. A banking system which is subject to runs does provide a check on risk-taking by banks, but this is not without cost: if the run is on a solvent bank, the run is unnecessary and costly. If the bank is insolvent, the insolvency could have been handled in a more orderly manner with a much lower net cost to society.

#### **4. Systemic Effects of Runs on Individual Large Banks**

As discussed in the previous section, contagious bank runs can impose significant costs upon the economy as a whole. It can be argued, however, that the collapse of a large bank may, in and of itself, have a serious impact on the entire system even if the problem does not spread. There are two major components to this argument. First, there may be a disruption of the payments system, and second there may be "ripple effects" felt by other banks which maintain deposits at the failed institution.

##### **Disruption of the Payments System**

There are two important elements of the payments system at risk from a large bank failure: (1) large-dollar electronic funds transfer systems, and (2) check clearance.

Most of the dollar value of all electronic funds transfers is concentrated in two electronic systems used principally to transfer large-dollar payments between banks, Fedwire and Clearing House Inter-bank Payments System (CHIPS). CHIPS, which is used mostly for the settling of transactions involving foreign exchange, international investment, and trade activity, has in place a variety of safeguards. These include bilateral credit limits, as well as aggregate net debit caps which limit any one participant's total exposure. Also, if a bank does fail, and is

unable to fund its obligations, the other participants must take on that obligation, with each assuming a proportional amount of the defaulting participant's debt.

However, it is possible that banks could be unable to meet these new, unexpected obligations; if this were the case more failures among these banks could ensue. Furthermore, these additional obligations would be partially collateralized; once this collateral has been sold to meet part of the obligation, the CHIPS system would be hampered until new collateral could be secured.

The check-clearing networks are the other part of the payments system potentially at risk. A large bank failure could adversely affect check collection in two ways. First, checks drawn on the failed bank may be dishonored, and if other banks have accepted these, they may have provided their customers the funds before being notified of the failure. If the money has by now left the bank accepting the check, that bank may end up absorbing the loss.

The second consequence lies in the check clearing services many large banks provide for smaller ones. The failure of a large institution could impose serious hardships on these correspondent banks as is discussed below.

#### **Loss to Correspondent Banks**

Large banks tend to be net borrowers from smaller banks. These moneys originate from correspondent banking activity, such as the check clearing services described above. Depending upon the method of resolution of the large bank, many smaller banks could suffer direct losses. In the extreme case, these losses could threaten the capital position of the smaller institutions. However, even in less severe instances, this could damage the liquidity of the correspondent banks, and impair their ability to provide payments to, or on behalf of their customers. Finally, other local banks would suffer financial loss as it would take longer for them to convert check deposits into good funds.

The situation at Continental Illinois Bank in April of 1984 is an example of how correspondent banks could be put at risk if a large bank fails. Approximately 2,299 banks had funds invested in Continental. Of these, 976 had funds in excess of \$100,000 invested. In all, 66 banks had more than 100 percent of their capital in funds at Continental and another 113 had between 50 percent and 100 percent.

A large bank failure can have additional ramifications as well; for example, many large banks provide custodial services to smaller institutions, holding securities for them or their customers. The collapse of the large bank can impose costs on

these holders, particularly if the failure occurs at the time transactions are being settled. While these problems are not as important as disruptions to the payment system, or losses in wholesale banking activity, they are not trivial. To the extent that deposit insurance can prevent the disorderly exiting from the system of large institutions, it can contribute significantly to the improved functioning of the economy.

## 5. Summary

Deposit insurance provides important economic benefits which the market could not achieve on its own: the protection of small depositors and the prevention of widespread bank runs. Bank runs are costly because they interfere with the money supply process, the payments system, and with banks' intermediary role of supplying credit to productive but illiquid investment projects. Deposit insurance achieves these benefits by protecting all deposits below a certain size and thus removing the incentive for these deposits to participate in a bank run.

### D. Concerns Raised by the Existence of Deposit Insurance

During the 1980s it became increasingly apparent that deposit insurance had the potential to impose enormous costs on society. The failure of hundreds of S&Ls caused the insolvency and reorganization of the FSLIC. Nine of the ten largest bank holding companies in Texas were reorganized with FDIC or other outside assistance. From 1987 through the end of 1990, the FDIC fund will have declined from over \$18 billion to about \$9 billion.

Currently, a substantial segment of the S&L industry does not meet the capital standards recently imposed by the Office of Thrift Supervision; and commercial banks' loan charge-off ratios and nonperforming loan ratios are at their highest levels since banks began using the reserve method of accounting in 1948. Data on the growth of FDIC and FSLIC insurance outlays are presented in Tables 1 and 2.

Events have thus demonstrated that some of the criticisms leveled in the 1930s against the idea of federal deposit insurance had considerable merit. The system has subsidized highly risky, poorly managed institutions. These institutions have exploited the federal safety net by funding speculative projects with insured deposits. The resulting costs have been borne by well-run institutions and by the taxpayers.

The risk-exposure of the deposit insurance fund naturally is influenced heavily by national and regional economic performance. Critics argue, however, that the escalating cost of deposit insurance can be blamed in large part on serious flaws in the way

Table I

## Loss By The Federal Deposit Insurance Corporation For Protection of Depositors, 1934—1989

(In millions of dollars)

Year <sup>2</sup>	All cases		Deposit payoffs		Deposit Assumptions <sup>3</sup>		Assistance transactions	
	Number of Banks	Losses <sup>1</sup>	Number of Banks	Losses <sup>1</sup>	Number of Banks	Losses <sup>1</sup>	Number of Banks	Losses <sup>1</sup>
1934-1939 .....	312	18	207	13	105	5		0
1940-1949 .....	99	6	38	1	61	5		0
1950-1959 .....	28	3	12	0.6	16	2.4		0
1960-1969 .....	43	5.3	27	5	16	0.4		0
1970-1979 .....	76	107	23	3.4	53	103.6		0
1980 .....	10	31	3	2	7	29		0
1981 .....	10	588	2	1	5	2		3
1982 .....	42	1,297	7	70	26	25		9
1983 .....	48	1,522	9	26	36	1,443		3
1984 <sup>5</sup> .....	80	1,906	16	110	62	447		2
1985 .....	120	877	29	116	87	537		4
1986 .....	145	1,815	40	429	98	1,229		7
1987 .....	203	2,147	51	758	133	1,222		19
1988 <sup>6</sup> .....	221	6,022	36	470	123	2,076		62
1989 .....	207	6,090	32	817	129	1,269		46
Total .....	1,644	22,434	532	2,823	957	8,396	155	117

<sup>1</sup>Includes estimated losses in active cases. Not adjusted for interest or allowable return, which was collected in some cases in which the disbursement was fully recovered.

<sup>2</sup>No cases in 1962 required disbursements.

<sup>3</sup>Deposit assumption cases include \$347.6 million of disbursements for advances to protect assets and liquidation expenses which had been excluded in prior years.

<sup>4</sup>Assistance transactions include: a) Banks merged with financial assistance from FDIC to prevent failure through 1988; b) \$2.3 billion of receivables liabilities at book value payable over future years.

<sup>5</sup>Includes CIBB Assistance Agreement which had been previously excluded.

<sup>6</sup>Assistance losses in 1988 and 1989 include estimated costs payable in future years.

Source: Federal Deposit Insurance Corporation.

**Table 2**  
**Attrition Among FSLIC-Insured Institutions, 1934-1988**

Year	Number of failed institutions									Total	All		
	FSLIC assistance involved						No FSLIC assistance involved				Total	Total number	Total assets (in billions of dollars)
	Liquidations			Mergers and other types of assisted resolutions			Management consign- ment cases	Supervi- sory mergers	Non- failed attrition of institu- tions				
	Number	Total assets (in millions of dollars)	Total cost <sup>1</sup> (in millions of dollars)	Number	Total assets (in millions of dollars)	Total cost <sup>1</sup> (in millions of dollars)							
1934-1979.....	13	348.8	15.7	130	4,109.5	290.4	0	N/A	N/A	143	N/A	N/A	
1980.....	0	0.0	0.0	11	1,457.6	166.6	0	21	63	95	3,998	621	
1981.....	1	88.5	30.4	27	13,819.7	728.3	0	54	215	297	3,757	659	
1982.....	1	36.1	2.9	62	17,626.0	800.4	0	184	215	462	3,295	700	
1983.....	5	262.6	60.6	31	4,368.5	214.1	0	34	83	153	3,146	819	
1984.....	9	1,497.7	583.3	13	3,582.5	159.3	0	14	31	67	3,136	978	
1985.....	9	2,141.3	630.1	22	4,227.0	391.5	23	10	47	111	3,246	1,070	
1986.....	10	583.8	253.7	36	11,871.3	2,811.3	29	5	45	125	3,220	1,164	
1987.....	17	3,043.8	2,277.5	30	7,616.6	1,426.1	25	5	74	151	3,147	1,251	
1988.....	26	2,965.2	2,831.7	179	97,694.7	28,347.8	18 <sup>2</sup>	6	25	254	3,001	1,334	
<b>Total.....</b>	<b>91</b>	<b>10,967.9</b>	<b>6,685.9</b>	<b>541</b>	<b>166,373.4</b>	<b>35,335.8</b>	<b>95</b>	<b>333</b>	<b>798</b>	<b>1858</b>	<b>N/A</b>	<b>N/A</b>	

<sup>1</sup> These figures represent the estimated present value cost of resolution.

<sup>2</sup> Stabilizations with a total cost of about \$7 billion.

Source: Barth and Bradley (1989).



banks are supervised and insured. Concerns have been raised about the scope of deposit insurance coverage, the rules governing insurance premiums and about many aspects of bank supervision as well. These include closure policy, capital and accounting standards, the powers and activities available to banks, and rules governing banks' affiliations and transactions with other entities. The most important criticisms are summarized in this section.

### 1. Moral Hazard

The current debate regarding deposit insurance reform focuses on what has become known as the moral hazard problem.<sup>11</sup> The scenario is as follows. To the extent that bank creditors are protected by the deposit insurance system, there is no incentive for them to be concerned with the condition of the financial institution. In fact, their incentive is to seek the highest return without having to be concerned with the risk/-return trade-off typical of other investments. Further, without any market penalties for assuming more risk, the incentive for bank management is to assume a higher risk profile than would be consistent with safe-and-sound operations. Because the FDIC has handled most bank failures, and all failures of large institutions, in a way that protects virtually all depositors and other general creditors of the bank,<sup>12</sup> it is alleged that the operation of market forces which would otherwise constrain bank risk-taking is inadequate.

Market discipline is provided by equity holders, who stand to lose their investment in a bank failure, and also by holding company creditors, subordinated bank creditors and other general creditors who may not be certain of full recovery (see footnote 12). These other sources of market discipline notwithstanding, the moral hazard argument is simply that the bank's depositors (at least) do not penalize bank risk-taking, so that risk will be greater than if depositors did penalize bank risk-taking.

To put the matter another way, a system in which banks pay flat rates for deposit insurance and in which some or all bank depositors perceive themselves to be fully protected can be alleged to allow banks to increase risk without fully "internalizing" the cost of this risk. It follows that banks will take too much risk, and the result will be the financing of economically inefficient projects and high deposit insurance costs.

Another formulation of the moral hazard problem is often used to describe the incentives facing undercapitalized banks. As a bank approaches insolvency, it has less and less to lose from pursuing speculative projects. If the gamble succeeds, the bank may be restored to profitability. If the gamble fails, the bank loses little since it may have been headed for failure

anyway. "Heads the bank wins, tails the FDIC loses," has become a cliché to describe the moral hazard problem in this case.

## 2. Concerns about Insurance Coverage and Pricing

To the extent depositors are fully protected by the FDIC, they will not demand higher deposit rates from riskier banks. To the extent uninsured depositors believe themselves to have de facto coverage, they will not demand deposit rates which fully compensate for risk. Given that depositors will not sufficiently discipline banks against risk-taking, it is argued that banks will take undue risks--the moral hazard problem described above.

If this story accurately portrays the real world, the logical conclusion is that increasing the risk of loss to large depositors, or otherwise reducing the scope of insurance coverage, will reduce risks in the system. Thus, it is argued by those concerned with the scope of insurance coverage that depositors should have greater incentive to monitor the condition of banks in which they place funds and to exert discipline on more-risky banks by either withdrawing funds or demanding a higher return to compensate for increased risk. Apart from the supposed effect on bank behavior, it is also argued that reducing the scope of coverage would translate directly into lower FDIC costs in handling bank failures.

Another frequently expressed concern is that a bank's insurance premium does not depend on its condition or its risk exposure. Instead, banks are assessed a flat percentage of deposits, with possible rebates based on the insurer's aggregate loss experience. By tending to insulate a bank's deposit costs from its condition, this contributes to banks' incentives to undertake high-risk activities. Critics recommend making premiums depend either on some a priori measure of each bank's risk exposure, or on some measure of each bank's current condition.

Some observers have a more fundamental concern with the pricing of deposit insurance, namely that a deposit insurance system based on bureaucratically determined premiums must invariably misprice risk, with substantial adverse ramifications for credit allocation. In this view, the deposit insurance system could be improved by utilizing the private sector in insuring bank deposits. There are several proposals along these lines which vary considerably in the manner in which the private sector would be utilized.

## 3. Concerns about Bank Supervision

The FDIC's risk exposure can depend on the extent of deposit insurance coverage and the method of pricing it. The FDIC's risk exposure can also be influenced through supervision of insured

banks. For purposes of this chapter, "supervision" will be taken to encompass the establishment of rules and regulations, the process of enforcing those rules and, more generally, the evaluation of bank safety and soundness.

The problems facing the S&L industry have brought considerable prominence to concerns about the perceived ill effects of supervisory forbearance. "Supervisory forbearance" is a decision by supervisors to refrain from formal enforcement actions, generally because the supervisor has confidence in management's intention and ability to correct problems without formal action. Supervisors tend to see such discretion as normal and desirable flexibility. In less savory usage, "forbearance" connotes ignoring or bending rules, or weakening rules to make it easier for banks to comply with them. It is generally accepted that a great deal of forbearance of both types was granted to the S&L industry in the 1980s. The free reign given to insolvent and undercapitalized institutions to "grow out of their problems" contributed importantly to the cost of the S&L problem. Similarly, as discussed below, there are those who are concerned that supervisors are not sufficiently aggressive towards undercapitalized commercial banks.

Generally speaking, the most strenuous critics of forbearance argue that supervisors have too much discretion and should instead be bound by rules requiring them to take specified actions against undercapitalized institutions. Supervisors are alleged to be too heavily influenced by the regulated industry or by elected officials who are in turn influenced by the industry. Because of these forces, it is argued, the exercise of supervisory discretion tends to lead to too much forbearance.

A primary focus of bank supervision is to ensure that banks maintain an adequate level of capital, and some prominent observers of the banking industry contend that many banks do not have adequate capital levels.<sup>13</sup> Capital acts as a buffer to absorb losses that the FDIC would otherwise have incurred. By giving bank owners something to lose, capital mitigates the moral hazard problem described above. The continued operation and speculative investment strategies of hundreds of insolvent S&Ls during the past decade dramatically illustrates the importance of capital adequacy in controlling deposit insurance costs.

A related concern is that bank capital is not measured correctly. Some critics of the current rules have repeatedly called for a requirement that banks use some form of market-value accounting.<sup>14</sup> There are a variety of proposals along these lines, which vary according to what would be marked-to-market, how, and how often, but all of them are motivated by a desire to improve the criteria by which regulators may intervene in the affairs of a troubled bank. It is sometimes suggested, for example, that some institutions have exploited current rules

regarding the accounting for marketable securities to, in effect, "recognize all gains and defer all losses."

As important as the statutory capital requirements are the manner in which they are enforced. Some critics of the supervisory system have concerns about how institutions are supervised as they approach and reach the point of insolvency. One set of concerns relates to whether solvent but undercapitalized institutions are being adequately supervised; the other relates to whether economically insolvent institutions are being closed or reorganized in a timely manner.

There are several reform proposals which would attempt to reduce insurance costs by eliminating supervisory forbearance and closing non-viable banks in a timely manner. Some of these proposals would require supervisors to close or reorganize a bank when its capital ratio falls below some positive number. Other proposals would establish mechanisms under which a bank would automatically be closed when some market-determined event occurred--for example, if a bank could not roll over subordinated debt. One can also regard depositor discipline proposals as types of "timely closure" proposals, since, absent support from the lender of last resort, runs by uninsured depositors could force regulators to close a bank.

The manner in which solvent but undercapitalized banks are supervised also can have substantial effects on deposit insurance costs. One purpose of supervision is to counteract the incentives undercapitalized banks have to increase risk-taking, and to prevent inappropriate fund transfers from the bank to its owners. Those concerned about how undercapitalized institutions are supervised advocate remedies ranging from outright seizure of institutions which fall below some positive capital-to-asset ratio, to restrictions on growth and activities, and limits on dividend payments and other transfers out of the bank.

A concern sometimes expressed by bank supervisors is that they have insufficient authority to require exceptionally risky banks to hold more capital.<sup>15</sup> They contend that the litigious nature of U.S. business coupled with the standards of evidence required in administrative law proceedings make it almost impossible to impose any penalties on banks whose activities are both legal and profitable. That is, the mere potential to suffer losses through, for example, excessive concentration in commercial real estate may not be sufficient grounds to sustain a supervisory order to increase capital. Only actual losses are grounds to sustain such an order, and by that time it may be too late to avoid insurance losses. Some supervisors go so far as to say that this is the problem which has caused insurance costs to go out of control.

Finally, there is an important set of proposals which are motivated by the desire to limit the activities which can be funded with insured deposits. Supporters of these proposals contend that the deposit insurance safety net is spread too wide. There are many proposals along these lines which vary according to what activities can be funded with insured deposits, what activities are permissible to bank holding companies, and what restrictions should exist on transactions between banks and their affiliates or subsidiaries.

#### **4. Concerns about the Competitiveness of the Banking Industry**

A concern which has gained increasing prominence in recent years is that the U.S. has forced its insured depositories into an increasingly untenable competitive position. Layer upon layer of piecemeal regulation dating back to the 1927 McFadden Act, coupled with recent changes in financial markets, are alleged to have created a situation in which bank and thrift franchise values are inexorably declining. With less and less to lose, the argument goes, banks have increasing incentives to take risks and mounting insurance costs are inevitable.

Profit margins available to banks have been narrowed by a variety of forces including increased competition from foreign and nonbank providers of financial intermediary services, the growth of securitization, and a growing ability of former prime bank customers to access capital markets directly. It is argued that the U.S. regulatory structure has prevented banks from adapting effectively to these changes.

Banks in the U.S. are restricted by both the Glass-Steagall Act and the Bank Holding Company Act from affiliating with nonfinancial firms,<sup>16</sup> and the activities allowed to bank holding companies (BHCs) and their affiliates are limited to those "closely related to banking." The determination of what constitutes acceptable BHC activities, intra-BHC transactions, and consolidated BHC capitalization rests with the Federal Reserve Board (FRB), which is the federal regulator of BHCs. Intrastate and interstate bank expansion, both through branching and acquisitions by holding companies, are severely restricted by a labyrinth of state and federal statutes. Thrift institutions are required to hold 70 percent of their assets in mortgages and mortgage-related assets.

It is alleged that these restrictions make it difficult for banks, banking organizations and thrift institutions to attract capital, respond to market forces, and diversify appropriately. These concerns are heightened by the coming deregulation of European banking in 1992,<sup>17</sup> which may further weaken the competitive position of U.S. banks in the world financial market.

There are numerous proposals for improving the health of the banking industry. Most such proposals advocate a complete elimination of branching restrictions. Others advocate eliminating the Qualifying Thrift Lender Test, which would largely eliminate the distinction between thrifts and commercial banks. Many proposals would more or less completely eliminate restrictions on the types of entities with which banks could affiliate and the activities permissible to BHCs. These proposals vary considerably in terms of the types of activities which could be funded with insured deposits and how the new powers would be supervised.

## E. Historical Background

The preceding sections discussed on a conceptual level the purposes, goals and concerns with federal deposit insurance. We now turn to a brief review of the performance of commercial banks and thrifts, and the recent changes in the financial marketplace in which these institutions operate.

### 1. The Period 1934 to 1942

The early years of the FDIC's existence were a period of relatively conservative bank behavior.<sup>18</sup> Bankers who survived the Depression were extremely cautious. Legislation enacted in the 1930s limited bank behavior, essentially to insulate banks from competing with one another too aggressively. Entry was limited by cautious behavior on the part of regulators and by a still-depressed economy.

With the exception of the recession years of 1937-1938, the economy expanded throughout the 1930s from the low point reached in 1933. Nevertheless, the FDIC handled 370 bank failures from 1934 to 1942. Most of these were small banks, with the FDIC realizing an aggregate book loss of only about \$23 million as a result of these failures.

The introduction of federal deposit insurance may have increased the ability of small and undiversified banks to attract deposits. Thus, deposit insurance may have tended to perpetuate a banking structure characterized by the existence of many very small firms, and may have indirectly encouraged retention of restrictive state branching laws. It had been recognized for some time that a branch banking system potentially was more stable than unit banking because it allowed banks to diversify geographically. As the failure rate began to increase during 1929, many states moved to liberalize branching restrictions; from 1929 to the enactment of the Banking Act of 1935, 13 states enacted laws providing broader branching powers for banks.<sup>19</sup> After 1935, it was almost 30 years before any state again liberalized branching.

## **2. The Period 1942 to 1972**

During World War II, government financial policies and private-sector restrictions produced an expanding, liquid banking system. Bank failures declined significantly; only 28 insured banks failed in the period 1942-1945. Banks emerged from World War II in very liquid condition. Loan losses were practically nonexistent. In fact, many banks experienced sizable recoveries on previously charged off loans.

During the three decades from 1942 to 1972 banking behavior continued to be very conservative. In general, economic performance was favorable, with recessions reasonably mild and short in duration, and the number of business failures and the volume of loan losses at low levels. This was a period of general prosperity, with a secularly increasing GNP, generally low levels of unemployment and, beginning in the early 1950s, a relatively stable price level. Until about 1960, banks continued to operate in an insulated, safe environment. Gradually, banks began to change the way they operated, and some of the restrictions began to be dismantled. The Depression experience ceased to be a dominant force influencing bank management. Still, during these 30 years, there were only 109 failures of FDIC-insured banks.

It would be an oversimplification to think of this period as being uniform. Banking changed substantially in this 30-year period. Beginning in the early 1960s, some states started to liberalize branching laws. Additionally, the bank holding company vehicle was used increasingly to enter new product markets and circumvent branching restrictions, and the appearance of negotiable certificates of deposit represented a dramatic shift in bank-funding strategies.

## **3. The Period 1972 to 1980**

Banking behavior began to change in many respects during the 1970s. From a performance standpoint, earnings became more volatile. Loan losses rose dramatically, and even in some very good years (1977-1978) they never returned to the low 1960s levels. More and more bank funding involved purchased money, even for moderate-sized banks, and demand balances became relatively less important. Banks entered new product markets, geographic expansion possibilities broadened, and traditional banking services began to be offered by some financial conglomerates. Some of these developments occurred suddenly while others reflected a changing regulatory and competitive environment.

The performance of the economy during this period was not very strong. Real growth was sluggish and the economy experienced a severe recession. The economy also was subjected

to various shocks that affected banking and business in general. The effects of the rapid increase in oil prices beginning in 1973, and the ensuing deflation in oil prices, caused loan problems for banks heavily exposed to certain energy-related credits.

The economy experienced a serious shock in October 1979 when the Federal Reserve embarked on a program designed to reduce inflation. One component of the Federal Reserve's inflation-fighting strategy was the decision to allow interest rates to fluctuate more freely. High and volatile interest rates soon resulted, to the particular detriment of thrift institutions.

#### 4. The Period 1980 to the Present

##### SAIF-Insured Savings Associations

The S&L<sup>20</sup> industry experienced considerable financial difficulties throughout the 1980s, and its problems have received much attention. The industry's current plight can be traced, in part, to the extraordinarily high interest rates of the early 1980s. The nature of the S&L business makes the industry's earnings very sensitive to changes in interest rates, and this was especially true before the widespread use of adjustable-rate mortgages. S&Ls' balance sheets traditionally consisted primarily of long-term, fixed-rate mortgages funded by savings and time deposits. Interest rates paid on these deposits were constrained by Regulation Q. Whenever market interest rates rose above regulated rates, S&Ls faced deposit outflows.

In part to help S&Ls cope during these periods of disintermediation, which became especially troublesome during the inflationary environment of the 1970s and early 1980s, the regulators and Congress took steps to deregulate deposit interest rates. In 1978, S&Ls were authorized to offer a six-month money-market certificate of deposit which paid a market-related interest rate, and within a year this instrument accounted for 20 percent of S&Ls' deposits.<sup>21</sup> The Depository Institutions Deregulation and Monetary Control Act of 1980 established a committee to phase out all deposit interest-rate ceilings by March 1986, and allowed S&Ls (and banks) nationwide to offer interest-paying consumer transactions accounts, Negotiable Order of Withdrawal (NOW) accounts. In a further attempt to help them "keep up" with rising interest rates, in 1981 the Federal Home Loan Bank Board (FHLBB) authorized federally chartered S&Ls to offer adjustable-rate mortgages.

These developments reduced disintermediation but did not mitigate the overall impact of rising interest rates on the S&L industry. S&Ls' average cost of funds rose from about seven percent in 1978 to over 11 percent in 1982, and exceeded the average return on mortgages during 1981 and 1982.<sup>22</sup> This led to



large operating losses, illiquidity and extensive insolvencies throughout the industry. It has been estimated that by 1982 virtually the entire S&L industry would have been insolvent by about \$100 billion if marked-to-market.<sup>23</sup> As a result of these developments, 470 S&Ls failed from 1980 through 1983, as compared with 226 failures from 1934 through 1979.

The regulatory response to these problems was based in large part on a lack of adequate resources to deal with the situation and a belief that conditions would improve when interest rates declined to normal levels. This response included shoring up industry earnings and net worth with a variety of accounting changes which, while not improving the real economic position of the industry, avoided (at least technically) insolvencies and bought time for interest rates to decline.<sup>24</sup>

In addition to a more lenient definition of capital, less "regulatory" capital was required of S&Ls. Minimum regulatory capital requirements were reduced from five percent of liabilities to four percent in 1980, and to three percent in 1982.<sup>25</sup> S&Ls were permitted to expand rapidly, and many did just that. For example, S&L assets in Texas grew from \$38 billion to \$85 billion between year-end 1982 and year-end 1985. Moreover, many institutions took advantage of liberal new asset powers (particularly in Texas and California) to expand into nontraditional, higher-risk lines of business in which they had little or no experience. These new powers had been granted by Congress and certain states in an attempt to give S&Ls alternative earnings sources. Capital requirements which had been inadequate to cushion traditional S&L risks were certainly inadequate to cushion these new higher risks.

The combination of undercapitalized growth into high-risk activities, particularly speculative real estate lending and direct investment, an extremely severe regional economic depression in the Southwest, and instances of insider abuse and fraud has resulted in financial difficulties for a substantial segment of the S&L industry. As of September 30, 1990, there were 206 S&Ls with \$98.8 billion in assets under RTC conservatorship<sup>26</sup>. The remainder of the industry consisted of 2,389 S&Ls with \$1.0 trillion in assets. Four hundred nineteen of these private sector (nonconservatorship) S&Ls, with \$246 billion in assets, do not meet the capital requirements established under FIRREA effective December 7, 1989. Eight hundred thirty private sector S&Ls with \$586 billion in assets would fail the fully phased-in requirements<sup>27</sup> if they were currently in effect.

Some of the S&Ls not meeting their capital requirements will fail; others will survive. The savings and loan system is entering a transitional period which will determine the fate of the undercapitalized segment of the industry. Table 3 provides a

Table 3

Distribution of FSLIC/SAIF-Insured Thrift Institutions by Tangible Capital-to-Assets Ratio, 1985-1990

(In millions of dollars)

	Tangible capital-to-assets less than 0%		Tangible capital-to-assets 0-3%		Tangible capital-to-assets 3-6%		Tangible capital-to-assets greater than 6%	
	Number of thrift institutions	Total assets	Number of thrift institutions	Total assets	Number of thrift institutions	Total assets	Number of thrift institutions	Total assets
1990*	395	\$213,524	324	\$283,077	823	\$468,909	1155	\$199,767
1989	530	288,586	362	275,006	815	468,494	1171	202,568
1988	508	283,002	441	425,106	864	418,220	1136	195,865
1987	672	335,795	471	339,201	891	355,566	1113	188,429
1986	672	324,399	581	335,335	995	315,938	972	156,261
1985	705	335,017	726	347,512	1009	258,647	806	95,775

\* As of June 30, 1990. All other years are as of December 31.

Source: Office of Thrift Supervision.

description of the S&L industry's capital-to-asset ratio distribution from 1985 through June of 1990. The number of institutions with negative capital was significantly reduced in 1990, due to resolutions of insolvent institutions by the Resolution Trust Corporation (RTC). Figure 1 illustrates the dramatic decline of aggregate net income in the industry from 1984 through June of 1990. The ability of the S&L industry to attract capital will be contingent on the behavior of interest rates, the condition of local real-estate markets and the economy generally, and other factors influencing the value of an S&L charter.

### **BIF-Insured Savings Banks**

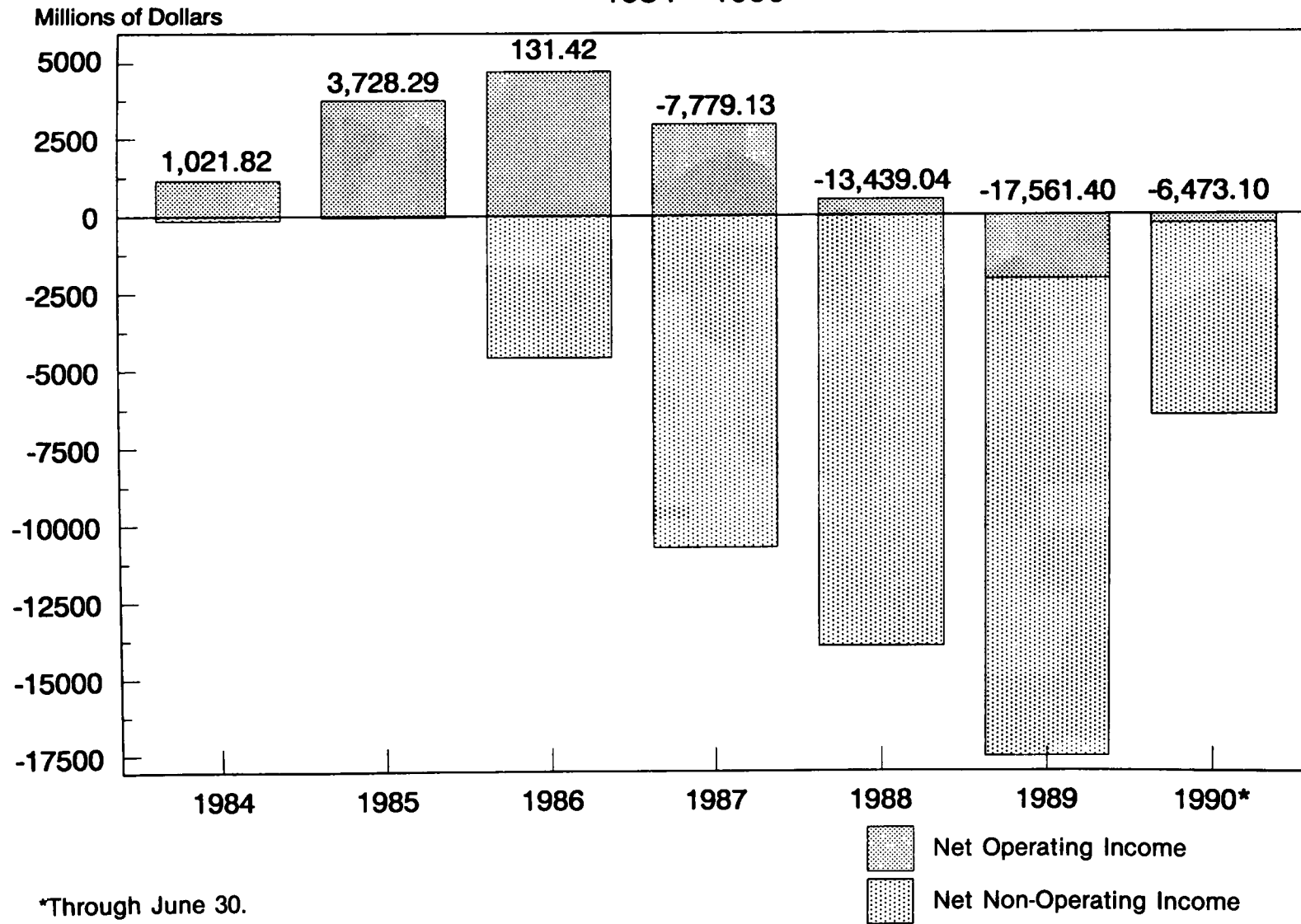
At year-end 1989 there were 489 BIF-insured savings banks with \$280 billion in assets. These institutions generally are "qualified thrift lenders." That is, they invest predominantly in mortgages and mortgage-related products. Of these 489 institutions, 469 with \$241 billion in assets are state-chartered and supervised by the FDIC, and 20 with \$39 billion in assets are federally chartered and supervised by the Office of Thrift Supervision.

When interest rates rose dramatically in 1979-1980 and again in 1981-1982, most FDIC-insured savings banks found themselves locked into long-term, low-yield assets (primarily mortgages) while their deposit costs rose substantially. Between 1978 and 1983, interest and fees on savings banks' real-estate loans fluctuated between \$7.94 and \$8.97 per hundred dollars of such loans. Meanwhile, interest and dividends on savings and time deposits rose from \$6.22 to \$9.66 per hundred dollars of such deposits. As a result, savings banks' return on average assets fell from 0.59 percent to a negative 0.93 percent, and the industry-wide equity-to asset ratio fell from 6.8 percent to 4.8 percent.<sup>28</sup> 14 FDIC-insured savings banks with \$17,421 million in assets received some form of FDIC assistance during this time (excluding the use of net worth certificates).

The mid- to late 1980s were generally more favorable for FDIC-insured savings banks. Interest rates fell from their high levels of the early part of the decade. Savings banks generally avoided rapid asset growth into new high-risk activities, so that credit quality problems were for the most part not serious. In addition, most FDIC-insured savings banks were located in New England, which did not suffer any substantial real-estate downturns for most of the decade of the 1980s. Between 1984 and 1988 only four savings banks received assistance from the FDIC (not including those with ongoing assistance agreements entered into before 1984).

More recently, many savings banks insured by the Bank Insurance Fund (BIF) have experienced considerable difficulties

Figure 1  
**Net Income of FSLIC/SAIF-Insured Institutions**  
 1984 - 1990



resulting from problems in real-estate loan portfolios and, in some instances, losses on securities activities. Most of these savings banks are located in the Northeastern U.S. Only 16 institutions with \$12.1 billion in assets--less than five percent of the industry's assets--are located in other regions.

Information on the equity-to-assets ratios of BIF-insured savings banks is presented in Table 4. The data in Table 4 indicate that as of mid-1990, 16 savings banks with assets of \$1 billion reported equity ratios less than three percent, and 44 savings banks with assets of \$64 billion reported equity ratios of three percent to six percent. These data, however, probably understate the severity of the problems facing the savings bank industry, as can be seen from further inspection of other financial data.

As indicated in Figure 2, the net income of all BIF-insured savings banks has declined four consecutive years beginning in 1986. For the first six months of 1990, 29 percent of all savings banks were unprofitable and the industry lost a combined \$443 million (a return on assets of -0.33 percent). These losses are caused primarily by weaknesses in real estate loan portfolios, which make up a substantial fraction of savings bank assets (Figure 3). Noncurrent real estate loans at state-chartered BIF-insured savings banks have grown more than 500 percent since 1986 (Figure 4). As a percentage of total assets, noncurrent real estate loans grew from one percent to 4.2 percent from 1986 to mid-1990.

Capital adequacy must be evaluated in light of savings banks' real estate loan exposure. At mid-year 1990, ten state chartered savings banks, with \$5.6 billion in assets, had levels of noncurrent loans plus foreclosed real estate more than double their total capital and reserves (Table 5). Another 32 state-chartered savings banks, with assets of \$34.9 billion, had noncurrent loans plus foreclosed real estate that exceeded their capital and reserves. The growth of problem assets relative to the capital cushion has been dramatic. A year ago, only two savings banks with assets of \$594 million had noncurrent loans plus foreclosed real estate more than twice the amount of their capital and reserves.

### **Commercial Banks**

The high interest rates of the late 1970s and early 1980s which adversely affected thrift institutions were a product of an inflationary economy; the inflation rate as measured by the annualized growth rate of the Consumer Price Index had been as high as 16.8 percent in the 1st quarter of 1980. By 1986, however, the inflation rate had fallen to 1.1 percent. This moderation of price increases lowered interest rates and created a more favorable environment for thrifts, but deflationary

Table 4

Distribution of FDIC/BIF-Insured Savings Banks By Equity-to-Assets Ratio, 1985-1990

(In millions of dollars)

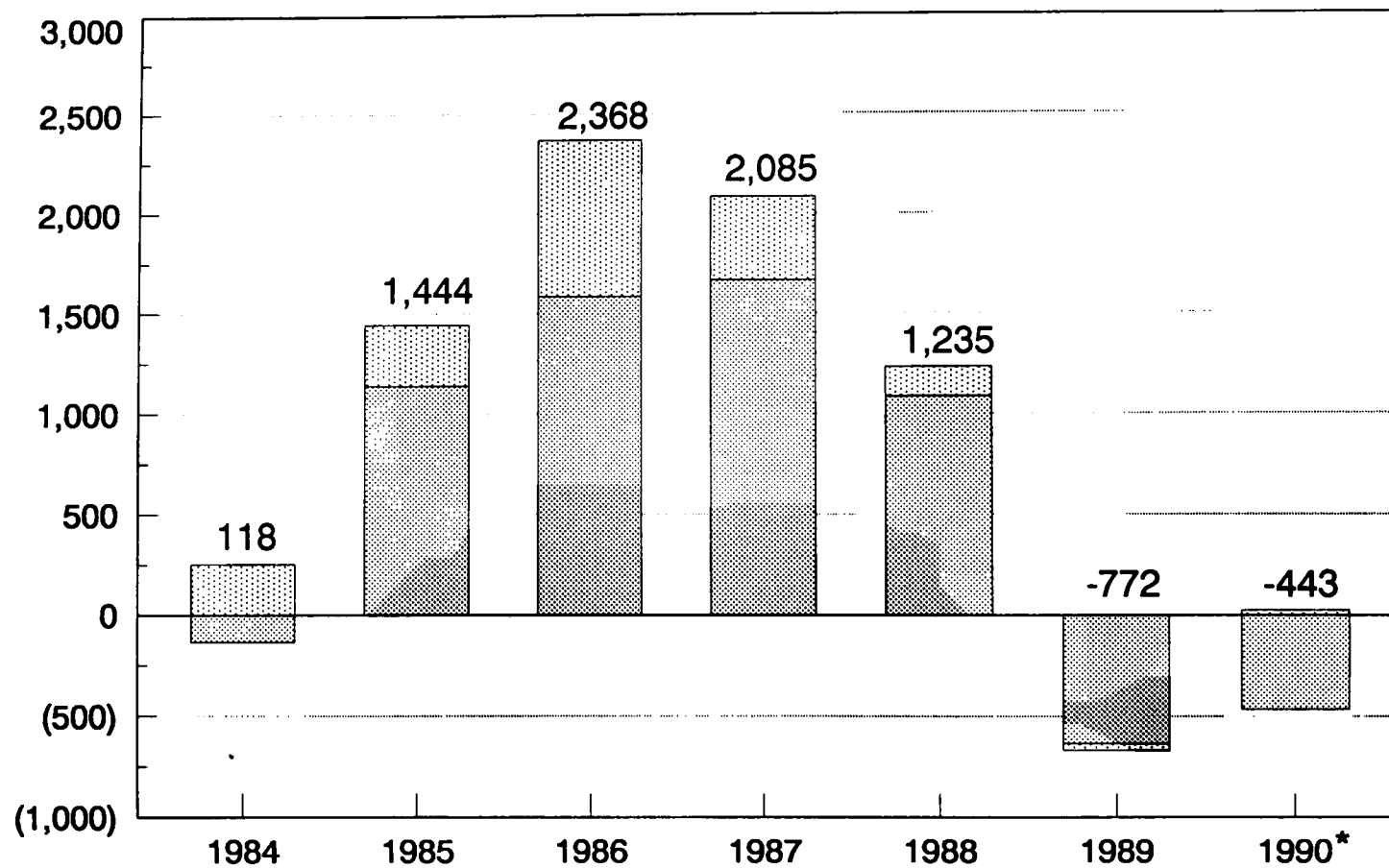
	Equity-to-assets less than 3 percent		Equity-to-assets 3 to 6 percent		Equity-to-assets greater than 6 percent		Failed 1985 through Sept. 14, 1990	
	Number of savings banks	Total assets	Number of savings banks	Total assets	Number of savings banks	Total assets	Number of savings banks	Total assets
1990*	16	\$19,008	44	\$63,666	418	\$183,547	7	\$4,258
1989	13	22,153	43	73,131	432	184,191	1	855
1988	5	20,268	38	62,124	447	206,618	0	0
1987	4	1,516	39	80,722	442	179,896	2	1,766
1986	10	13,961	58	70,366	405	151,743	1	32
1985	25	39,255	79	70,397	290	94,849	2	5,691

\*As of June 30; all other years are as of December 31, unless otherwise noted.

Source: Federal Deposit Insurance Corporation.

Figure 2  
 Net Income of FDIC-Insured Savings Banks  
 1984 - 1990

Millions of Dollars



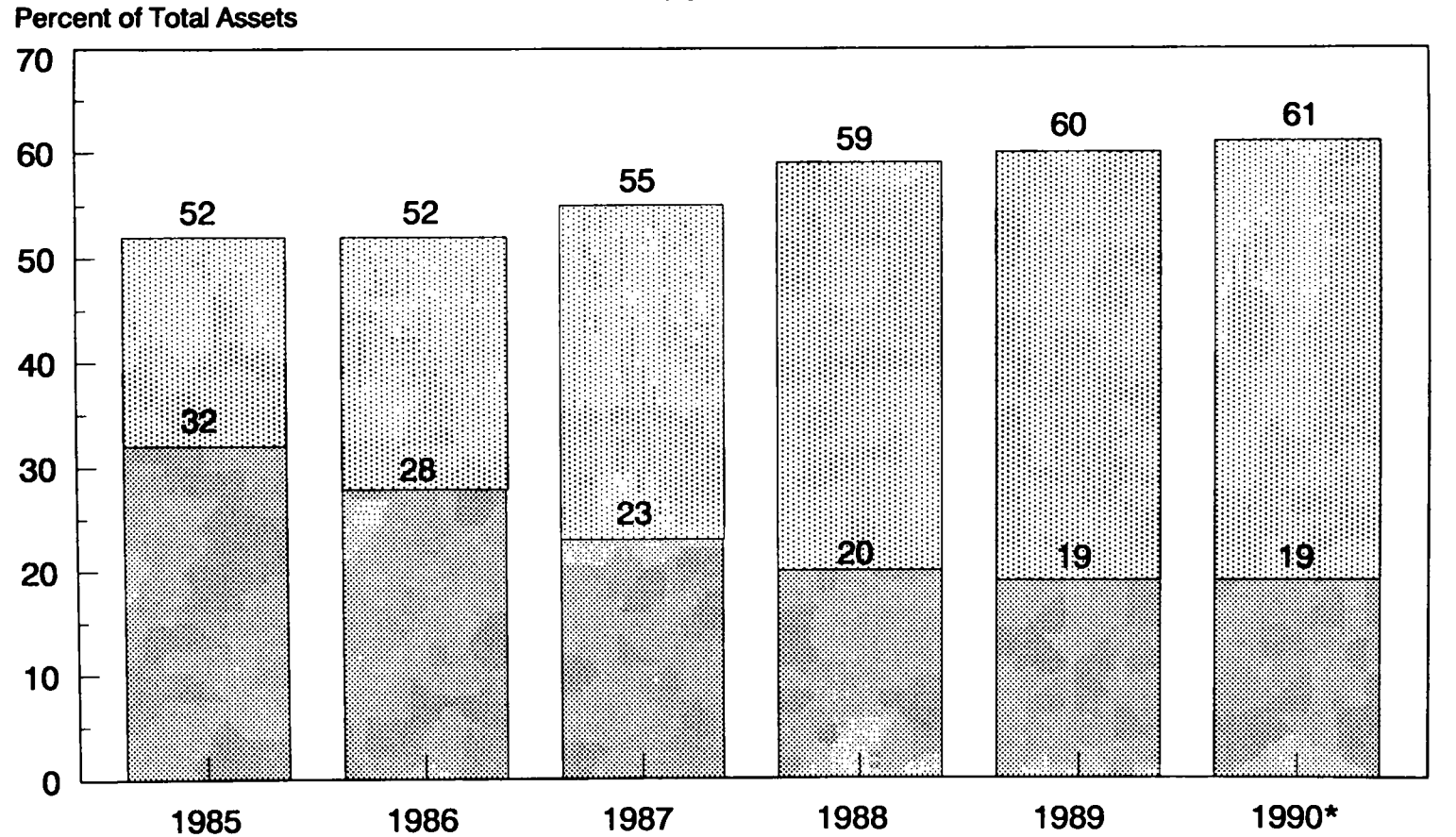
\*As of June 30.

Source: Federal Deposit Insurance Corporation.

 Securities and Other Gains  
 Net Operating Income

Figure 3

Real Estate Loans as a Percent of Total Assets  
State Chartered FDIC-Insured Savings Banks  
1985 - 1990



\* Through June 30.

Source: Federal Deposit Insurance Corporation.



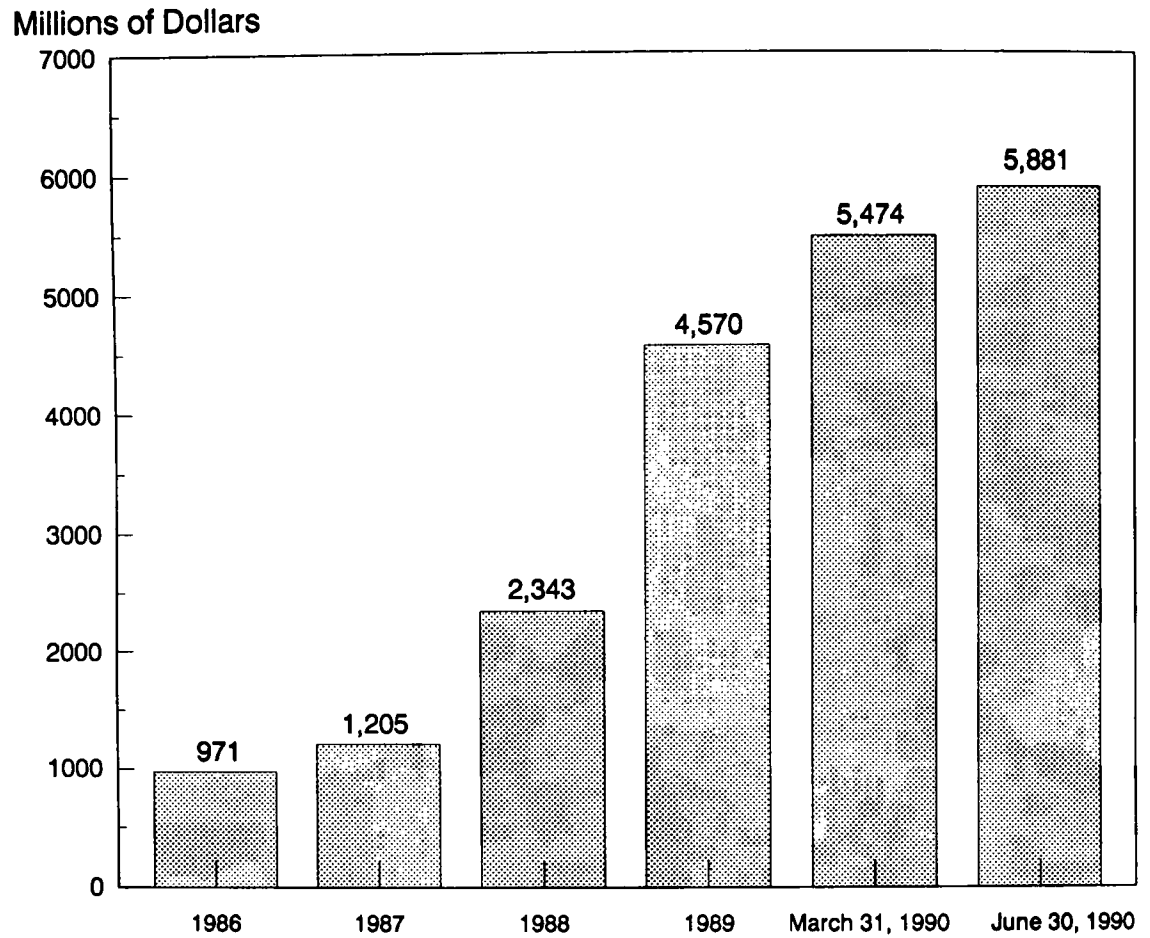
 Total Real Estate Loans  
 Fixed-Rate Real Estate Loans



Figure 4  
**Noncurrent Real Estate Loans\***  
**State Chartered FDIC-Insured Savings Banks**  
**1986 - 1990**



\* Includes Real Estate Loans 90 Days Past-Due and in Nonaccrual Status.

**Noncurrent Real Estate Loans as a  
Percent of Total Real Estate Loans**

Year-end 1986	Year-end 1987	Year-end 1988	Year-end 1989	March 31, 1990	June 30, 1990
1.02%	1.01%	1.67%	3.16%	3.81%	4.16%

Source: Federal Deposit Insurance Corporation.

**Table 5**

**Troubled Assets Relative to Capital and Reserves  
State-Chartered BIF-Insured Savings Banks,  
June 1989–June 1990**

(In millions of dollars)

Noncurrent loans plus repossessed real estate	June 1990		June 1989	
	Number of banks	Assets	Number of banks	Assets
More than 200% of Cap- ital and Reserves .....	10	\$5,579	2	\$595
Between 100% and 200% of Capital and Reserves...	32	34,946	6	15,007
Between 50% and 100% of Capital and Reserves...	65	48,165	25	11,995
Less than 50% of Capital and Reserves .....	354	143,688	437	210,110

Source: Federal Deposit Insurance Corporation.

pressures in some sectors of the economy put pressure on borrowers, resulting in credit-quality problems for many commercial banks.

The agricultural sector was particularly hard hit. During the 1970s farm exports had grown at record levels, rising from \$10 billion in 1970 to \$41 billion in 1980. It was generally believed that American agriculture was in a unique position to benefit from an inability of foreign food production to keep pace with population. Government officials and agricultural researchers expounded on the need to expand production and more extensively capitalize the production process. Farm debt rose in lock step with real-estate values even though farm income was often insufficient to support the debt.<sup>29</sup>

Demand and supply conditions shifted unfavorably for American agriculture in the late 1970s and early 1980s. High domestic production, unfavorable exchange rates, debt problems in countries that had previously imported substantial amounts of American farm products, and increases in foreign food production combined to lower the prices received by American farmers. As a result, real farm income declined, highly leveraged producers experienced severe cash flow problems, and farm real estate values declined. In the major grain producing areas of the Midwest and Northern Plains States, farm real estate values fell by as much as 50 percent between 1981 and 1986.

As a result of these developments, 204 "agricultural banks" (those with at least 25 percent of their loans to agricultural borrowers) failed between 1984 and 1987. This represented 37 percent of all bank failures that occurred during this period. These were generally small banks with assets less than \$50 million.

Even more severe was the sectoral deflation experienced in the energy-producing states. The price of oil had risen dramatically during the 1970s as a result of the behavior of the Organization of Petroleum Exporting Countries (OPEC) cartel. From its peak of \$40 per barrel in 1981, the price of West Texas Intermediate crude oil declined steadily to about \$31 in November, 1985 before falling to less than \$12 in July, 1986. Service industries that had supported the oil industry in these states suffered severe downturns. In Texas, reduced demand for office space at the time large quantities of commercial real estate were being completed resulted in difficulties for construction and related service industries. Real-estate values fell sharply; office vacancy rates in Dallas, Houston and Austin exceeded 30 percent in 1987. In the fourth quarter of 1987 the annualized rate of residential mortgage foreclosures in Texas was 15 percent of mortgages outstanding.<sup>30</sup>

The depression in the energy belt has resulted in a large number of bank failures. Defaulted energy loans played an important role in the collapse in 1984 of Continental Illinois National Bank, the largest bank to receive FDIC assistance. Between 1985 and 1989, there were 486 bank failures in Texas, Louisiana, and Oklahoma, or 54 percent of all bank failures during that time. Nine of the ten largest Texas bank holding companies were reorganized with FDIC or other outside assistance. This includes banking subsidiaries of MCorp, First Republic Bank Corporation, First City Bancorporation and BancTEXAS. The cost to the FDIC of resolving the difficulties of these four banking organizations is estimated at about \$6.7 billion.

Money-center banks' large portfolios of loans to less-developed countries (LDCs) also have been a source of concern to bank regulators and the FDIC since the mid-1980s. While losses on LDC loans have not been a primary factor in any bank failures, such losses have reduced the capital available to cushion the FDIC against loss and have increased the fragility of the banking system.

Not all the blame for bank failures can be attributed to macroeconomic events. A substantial role is played by mismanagement and, in some cases, fraud. An OCC study examined the causes of 171 bank failures that occurred during the period 1979 through 1987. The study found that "self-dealing, undue dependence on the banks for income or services by a board member or shareholder, inappropriate transactions with affiliates, or unauthorized transaction by management officials was a significant factor leading to failure in 35 percent of the failed banks. About a quarter of the banks with significant insider abuse also had significant problems involving material fraud." Material fraud, in fact, played a significant role in 11 percent of the failures. During their decline, 24 percent of the rehabilitated banks experienced significant insider abuse, but none were seriously affected by material fraud.<sup>31</sup>

There were 12,706 FDIC-insured commercial banks in operation at the end of 1989, with assets of \$3.3 trillion. These institutions had an aggregate equity capital to asset ratio of 6.2 percent, and an aggregate return on assets of 0.52 percent.

There are aspects of current bank performance that are of concern to bank supervisors and the FDIC. Two-hundred six banks failed or received assistance during 1989, fifteen less than the record of 221 set in 1988. Although the number of banks on the FDIC's "problem" list declined during 1989 by 300 to 1,093 at year-end, net charge-off rates for the banking industry for 1989 were the highest since banks began reporting the data in 1948. Five of the ten largest U.S. banks reported losses in 1989, as did one-fourth of all U.S. banks with assets over \$10 billion. These losses generally reflected problems in real-estate loan

portfolios and, in the largest banks, the effect of reserving against losses on loans to LDCs.

## **5. Changes in the Financial Marketplace Affecting Banks**

What banks and other depository institutions do, who they compete with, and the nature of the environment within which they operate, all change over the years. These changes can affect the profitability of banking and consequently the health of the banking industry.

In an accompanying series of tables and graphs, three significant interrelated trends concerning banking are isolated: banking has become a riskier, more volatile business; banks are encountering greater degrees of competition; and the banking business itself is changing.

### **Banking Is Riskier**

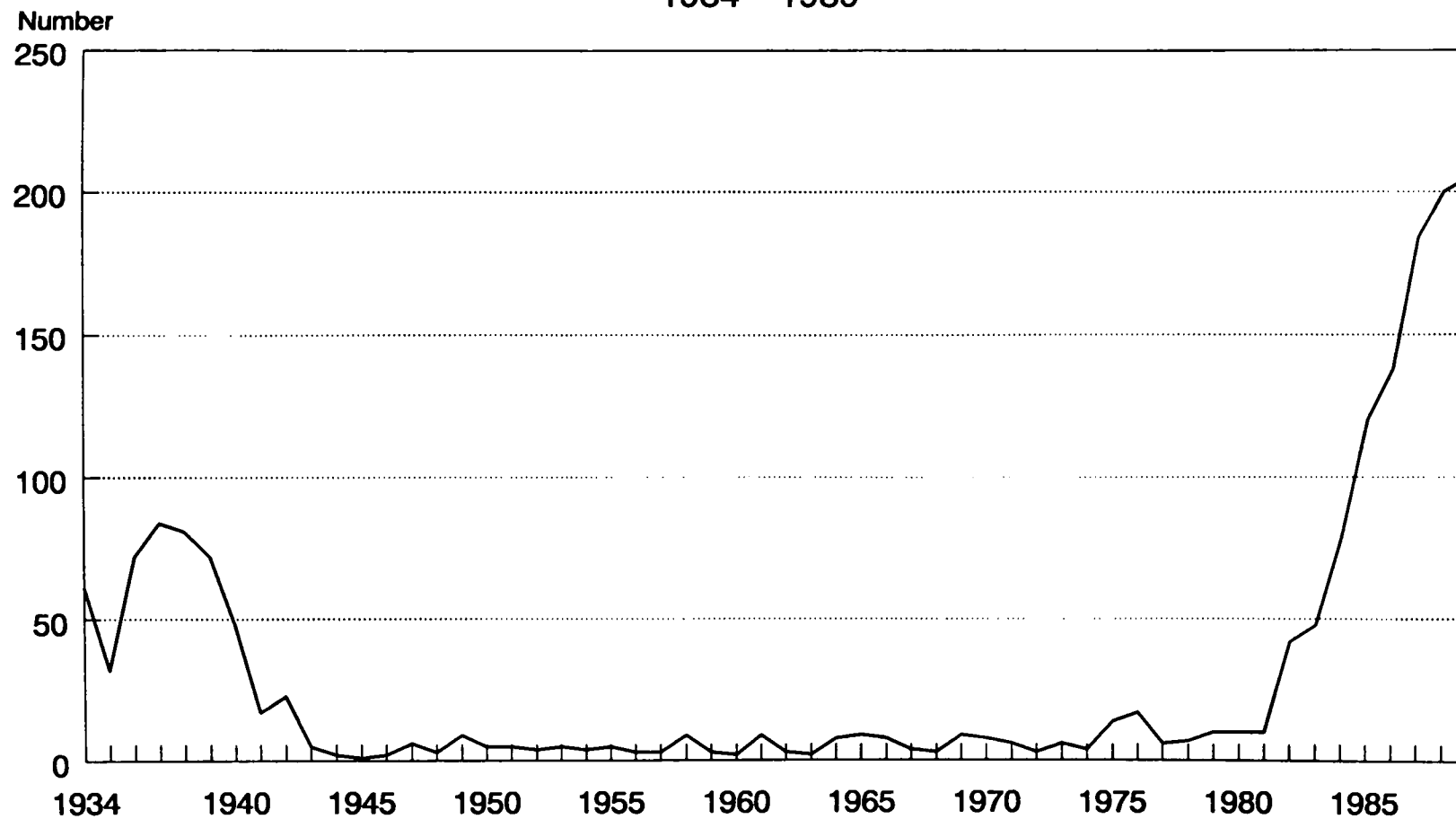
Perhaps the most persuasive piece of evidence that banking is a riskier business is the number of failed banks (Figure 5). Between 1943 and 1981, the greatest number of banks that failed in any one year was 17, in 1976. Annual failures increased dramatically in the 1980s, however, reaching a peak of 221 in 1988. Net loan chargeoffs also rose significantly in the 1980s, reaching a peak of 1.15 percent of total loans in 1989 (Figure 6). A decade by decade comparison of the banking industry's return on assets reveal a fall in that measure of profitability during the most recent decade (Table 6). The slide is more evident when a trend line is fitted to industry return on assets for the period 1960-1989 (Figure 7).

One cause of bank difficulties has been a general rise in both the level and volatility of interest rates (Figure 8). Double-digit interest rates became common in the 1980s. The marketplace has reacted to the banking industry's difficulties by being wary of bank stocks. As a percent of the Standard and Poor's 500 Stock Index, the Salomon Brothers 35 Bank Index has generally fallen since 1975 (Figure 9). The Bank Index was 55 percent of the S&P 500 in 1975, but only 38 percent in 1989.

### **Banks Are Encountering More Competition**

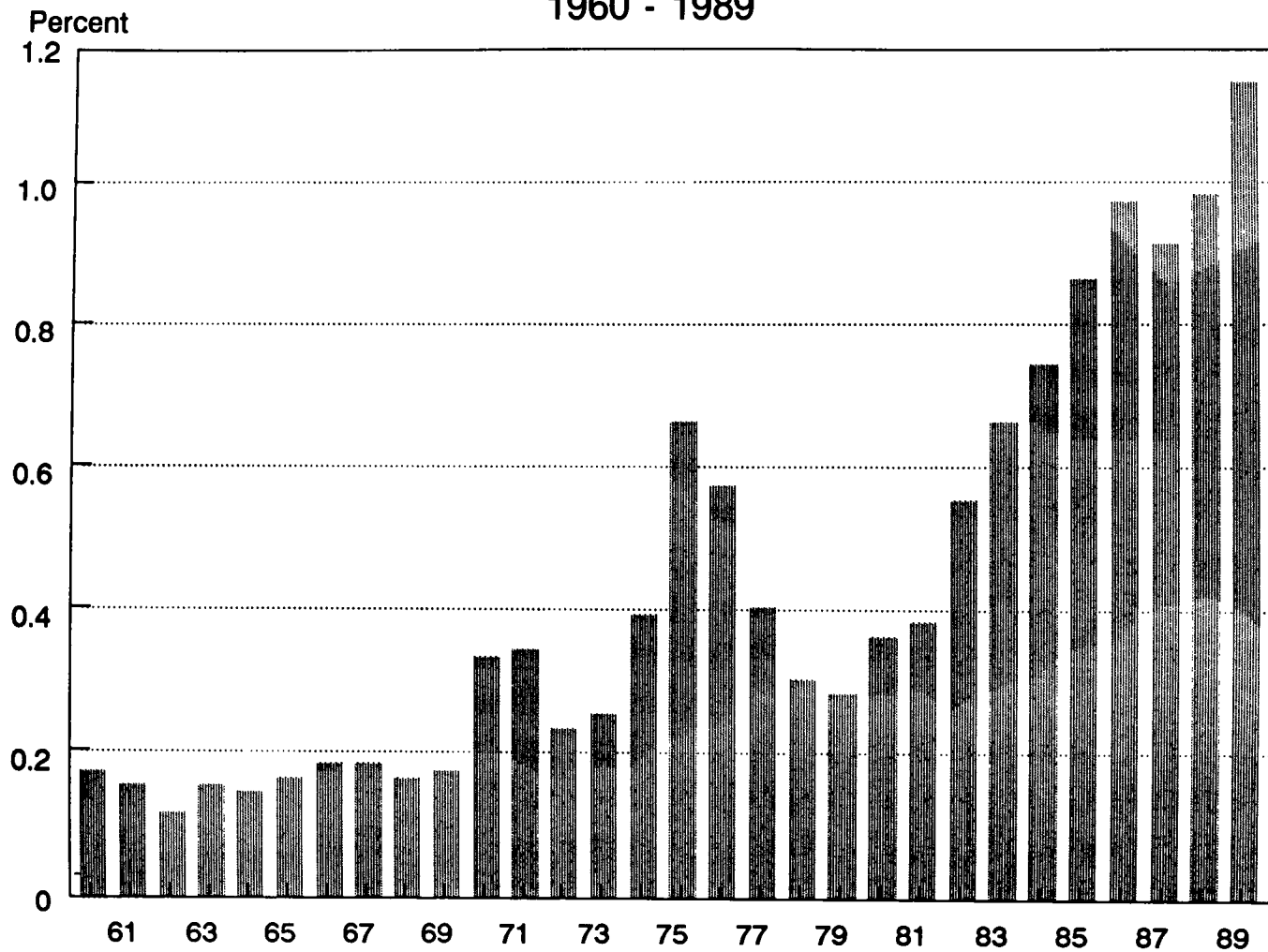
The financial marketplace has become more crowded. A greater variety of players are offering a wider variety of products and services. One result is that the banking industry's share of financial sector assets fell from 34 percent in 1960 to 27 percent in 1989 (Table 7). The decline was most pronounced in the 1980s: banks still had 33 percent of the total in 1980. The decline in the proportion of financial sector assets held by the banking industry was due to increasing proportions held by

Figure 5  
Number of Failed Banks by Year  
1934 - 1989



Source: FDIC Annual Reports and Statistics on Banking.

Figure 6  
Net Charge-Offs to Total Loans  
Insured Commercial Banks  
1960 - 1989



Source: FDIC Annual Reports and Statistics on Banking.

Table 6

## Selected Balance Sheet Ratios for Insured Commercial Banks, 1934-1989

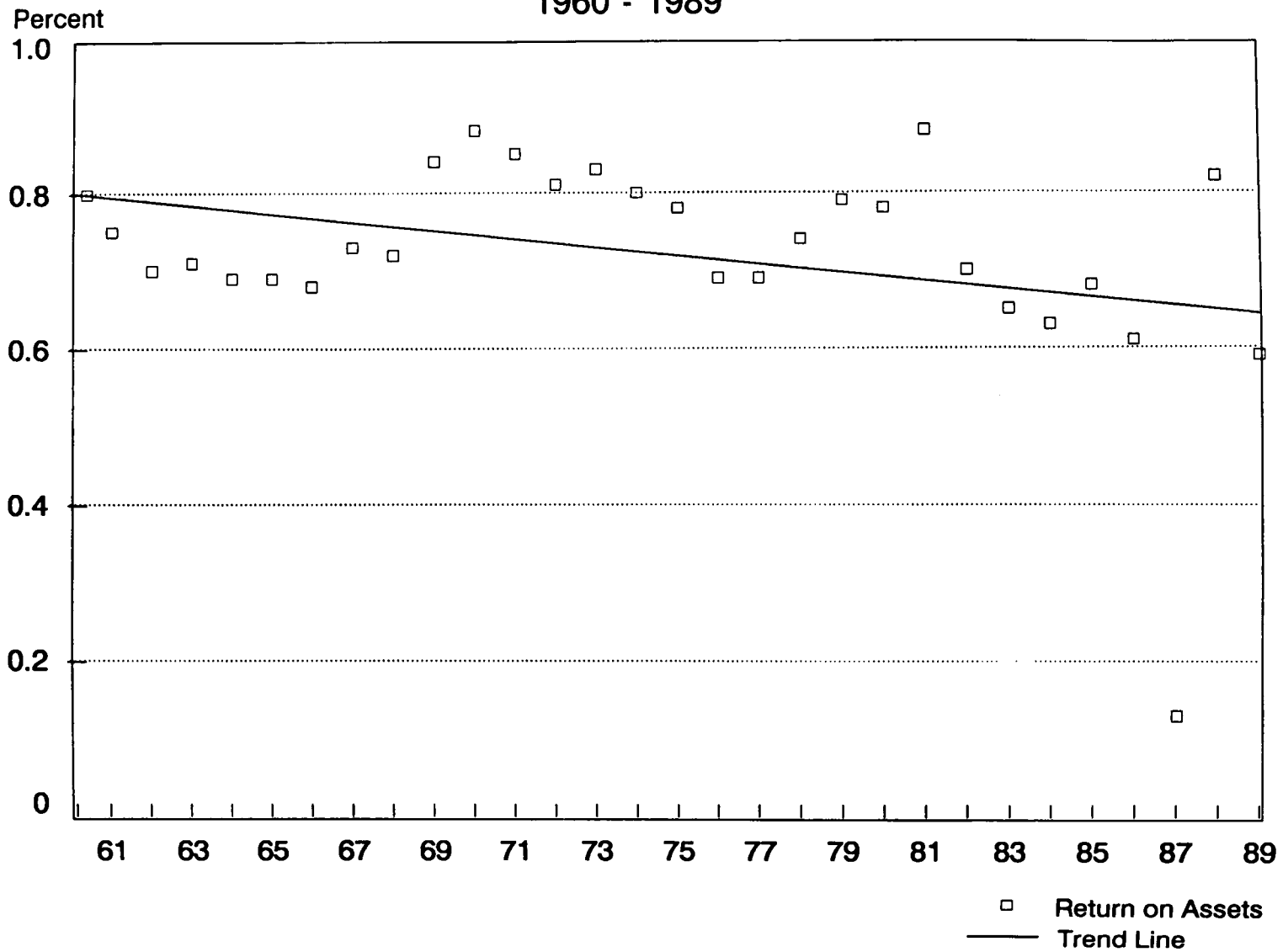
(In percent)

Item	1934-39	1940's	1950's	1960's	1970's	1980's	1980-84	1985-89
Equity/assets.....	11.88	6.89	7.38	7.62	6.39	6.11	5.96	6.22
Loans/assets.....	29.43	22.04	38.35	51.49	53.73	57.75	54.71	59.94
Loans/equity.....	2.48	3.20	5.20	6.75	8.41	9.45	9.18	9.64
Reserves/loans.....			1.65	1.98	1.33	1.78	1.14	2.20
Loans/deposits.....	33.92	23.79	42.19	58.92	65.00	74.15	69.67	77.42
Return on assets.....	0.46	0.56	0.61	0.73	0.77	0.61	0.69	0.55
Return on equity.....	3.84	8.19	8.22	9.61	12.09	9.94	11.65	8.77
Net interest margin.....	1.85	1.46	2.32	2.76	3.00	3.32	3.20	3.41
Net loan charge-offs/loans and leases.....			0.07	0.17	0.39	0.82	0.57	0.99
Net loan charge-offs/net income.....			4.39	11.88	26.86	78.39	45.04	108.96

Source: Federal Deposit Insurance Corporation.

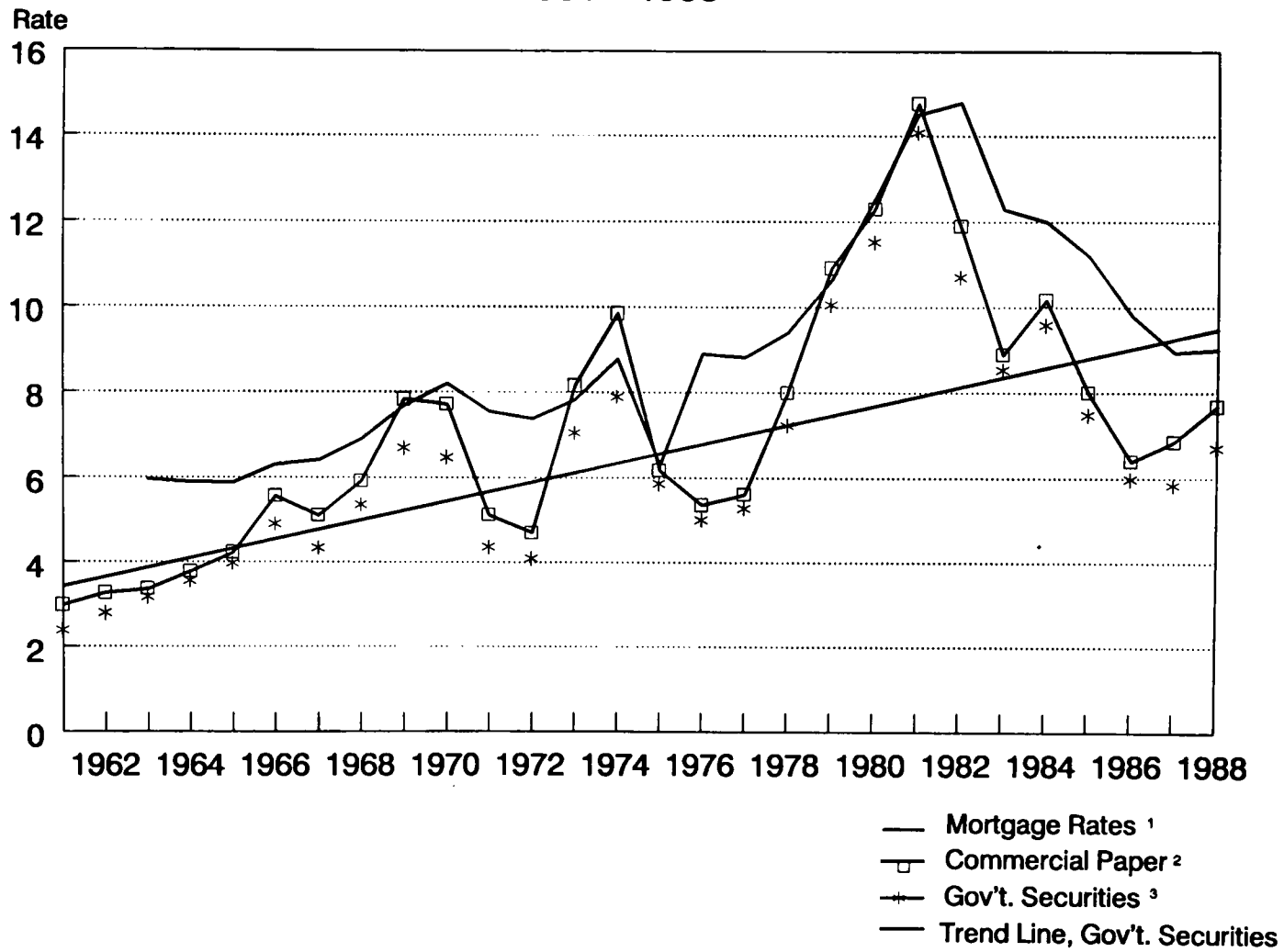


Figure 7  
Return On Assets  
Insured Commercial Banks  
1960 - 1989



Source: FDIC Annual Reports and Statistics on Banking.

Figure 8  
Average Interest Rates  
1961 - 1988



Sources: U.S. Department of Commerce, Business Statistics.

<sup>1</sup> Existing Home Purchases - U.S. Average

<sup>2</sup> Average Yield on 6-Month Maturity Paper

<sup>3</sup> Yield on new issue 90-day T-bills

Figure 9  
Bank Stocks as a Percent of S&P 500  
1975 - 1989

Bank Index as a Percent of A&P 500

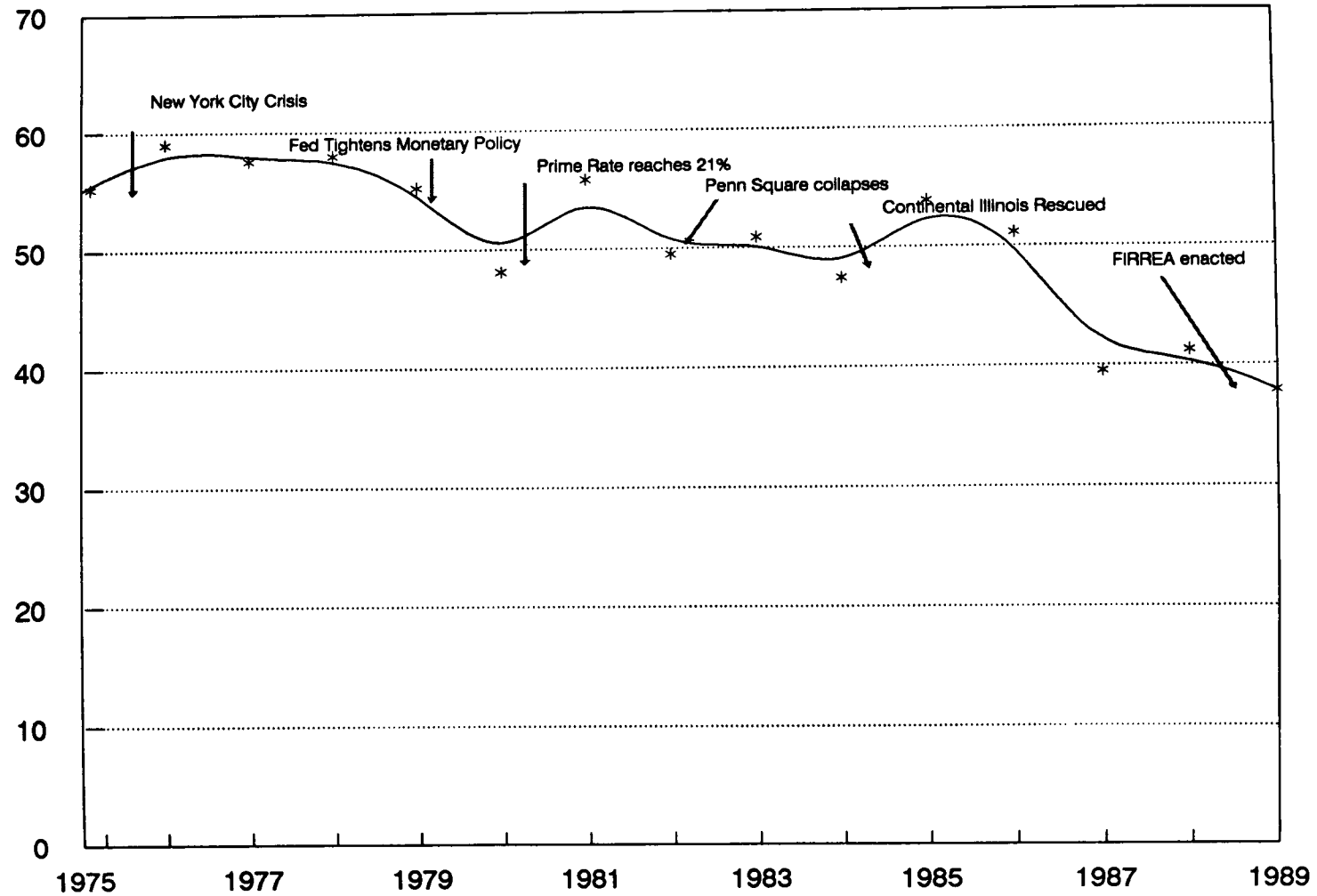


Table 7

## Financial Assets Held by Financial Sector, 1960-1989

(In percent)

Year	Commercial banks	Other depository institutions	Agencies and mortgage pools	Monetary authority	Insurance companies	Pension and retirement funds	Mutual and money market funds	Other
1989.....	26.56	14.11	10.80	2.59	14.47	15.55	8.08	7.84
1988.....	26.73	16.61	10.48	2.75	14.13	14.90	7.39	7.01
1987.....	27.24	16.98	10.40	2.84	13.78	14.85	7.64	6.27
1986.....	28.51	17.28	9.67	3.04	13.37	14.69	7.91	5.52
1985.....	29.49	18.09	8.80	3.08	13.66	15.06	6.21	5.61
1984.....	30.25	18.98	8.54	3.17	13.56	14.75	5.41	5.34
1983.....	30.32	18.37	8.21	3.33	14.03	15.70	4.79	5.26
1982.....	31.14	17.67	7.94	3.56	14.11	14.86	5.43	5.29
1981.....	32.32	18.22	7.28	3.66	13.95	14.13	4.95	5.48
1980.....	32.83	19.11	6.85	3.85	14.15	14.74	3.06	5.41
1979.....	32.80	20.71	6.68	4.29	14.81	12.57	2.50	5.65
1978.....	33.53	21.64	5.96	4.57	14.98	12.03	1.66	5.62
1977.....	33.49	21.98	5.41	4.78	15.13	11.94	1.65	5.63
1976.....	34.25	21.56	5.24	5.09	15.32	11.06	1.90	5.59
1975.....	35.30	20.99	5.14	5.27	15.10	10.65	1.98	5.57
1974.....	37.19	20.26	5.08	5.27	15.01	9.46	1.75	5.98
1973.....	36.96	19.77	3.87	5.19	15.37	10.52	2.30	6.02
1972.....	34.91	19.51	3.04	5.17	16.04	12.21	3.20	5.92
1971.....	34.89	17.90	3.02	5.68	16.44	11.85	3.39	4.41
1970.....	35.12	17.29	3.19	5.76	17.02	11.46	3.25	4.54
1969.....	34.81	17.37	2.65	5.89	17.44	11.33	3.53	4.64
1968.....	34.40	17.52	2.11	5.93	18.07	11.29	4.12	3.90
1967.....	33.94	17.96	2.03	6.17	18.72	10.97	3.83	3.81
1966.....	33.66	18.40	2.25	6.35	19.05	10.47	3.28	4.12
1965.....	33.53	11.65	1.85	6.27	19.26	10.50	3.50	4.07
1960.....	34.22	16.97	1.71	7.90	21.82	8.75	2.57	3.65

Source: Federal Reserve Board Annual Statistical Digest.

government-sponsored mortgage agencies, pension and retirement funds, and mutual and money market funds.

Figures 10 and 11 present more vivid evidence of the increased competition being encountered by U.S. banks. The commercial paper market has attracted a number of high-quality organizational customers that once relied on bank loans for short-term funds. The ratio of bank commercial and industrial loans to commercial paper outstanding has accordingly decreased (Figure 10). C&I loans fell from almost 10 times the amount of commercial paper outstanding in 1960 to only 1.2 times in 1989. In Figure 11, the growth in competition afforded by foreign banking organizations is depicted. In 1972, foreign banking organizations controlled 3.6 percent of U.S. domestic banking assets. In 1989, the proportion was 21.4 percent.

A major change in the financial industry has been the growth of what might be termed nontraditional financial instruments. One example is provided by the packaging of mortgages for resale--also known as "securitization." The proportion of mortgages in mortgage pools grew from one percent in 1970 to 23 percent in 1987 (Figure 12). By increasing the efficiency and liquidity of the mortgage market, securitization has contributed to a narrowing of spreads available to bank and thrift mortgage lenders.

As another example of the growth of nontraditional financial instruments, the volume of financial futures contracts traded each year increased from 0.6 million in 1977 to 117 million in 1988, for an annual growth rate of 61 percent (Figure 13).

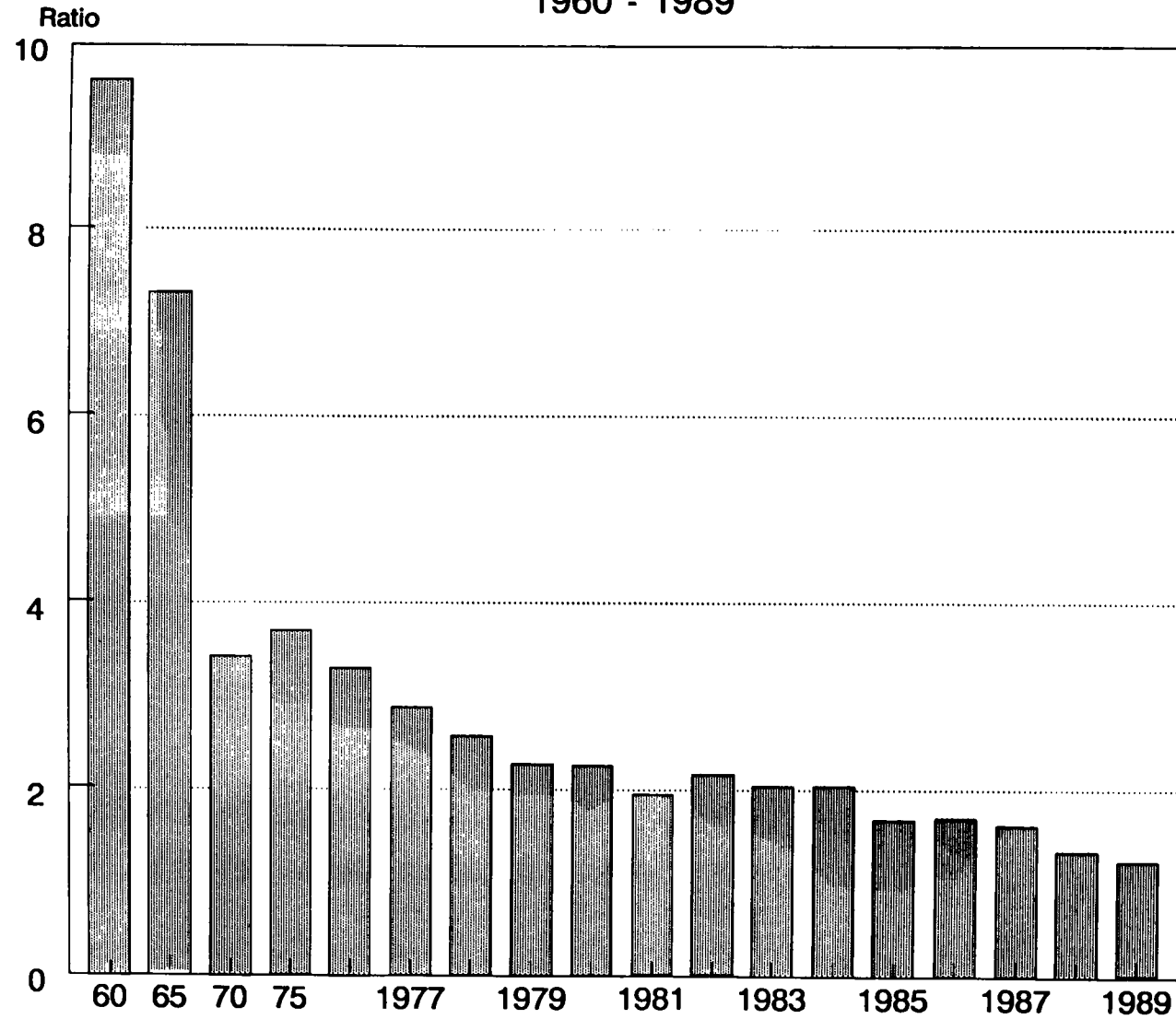
### **The Banking Business Is Changing**

One of the most important functions of banks is to provide credit. The making of loans is probably the form that most often comes to mind when the credit-providing function of banks is mentioned. Loans, however, have not constituted a stable percentage of the banking industry's assets. During the 1930s, loans were only 30 percent of industry assets. The percentage actually fell during the 1940s. The decline was due to the large quantities of government securities that banks acquired during World War II and to the constraints on non-war related economic activity during those years.

Since the 1940s, the proportion of loans in bank portfolios has steadily increased, reaching a peak of almost 60 percent for the period 1985-1989. While the loans to assets ratio of the banking industry was increasing, however, the equity to assets ratio remained static (Table 6). This has most likely resulted in a steadily increasing level of risk in the banking system because loans are for the most part more risky than the other major category of bank assets--investment securities.

Figure 10

### The Growth of the Commercial Paper Market Ratio of Bank C&I Loans to Commercial Paper Outstanding 1960 - 1989



Note: Horizontal axis is not continuous for years 1960-1957.  
Source: U.S. Department of Commerce, Business Statistics.

Figure 11  
Foreign Controlled Banking Assets  
as a Percentage of Total Domestic Banking Assets  
1972 - 1989

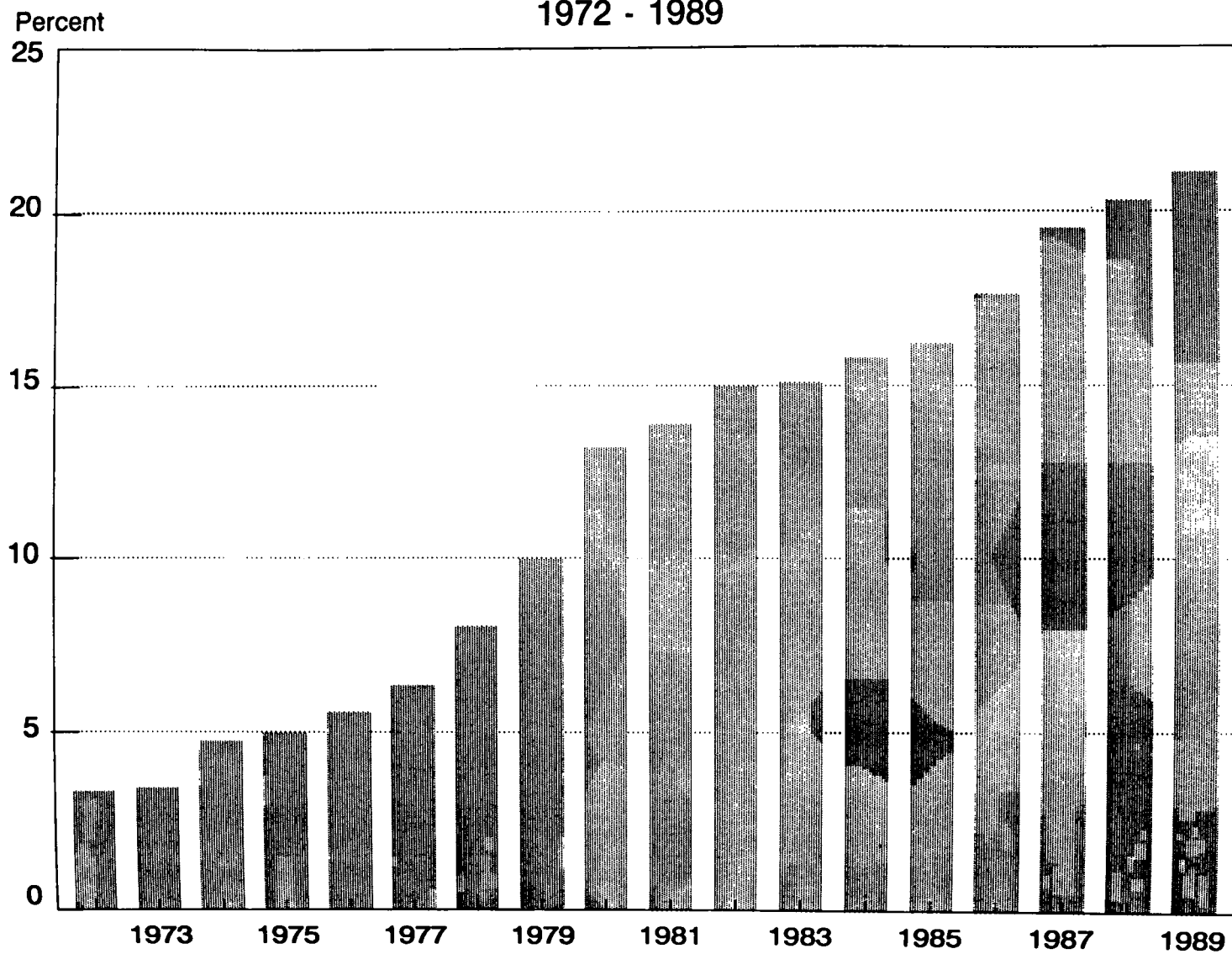
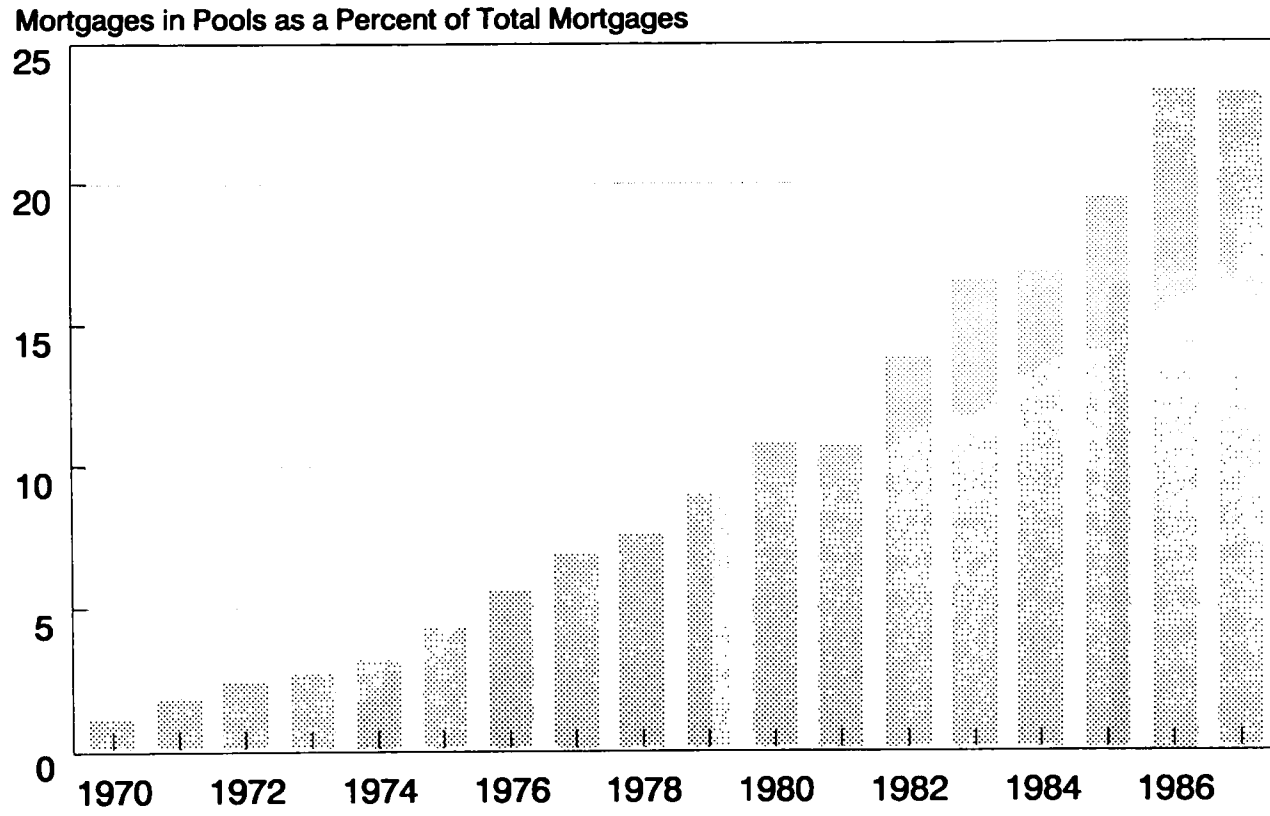


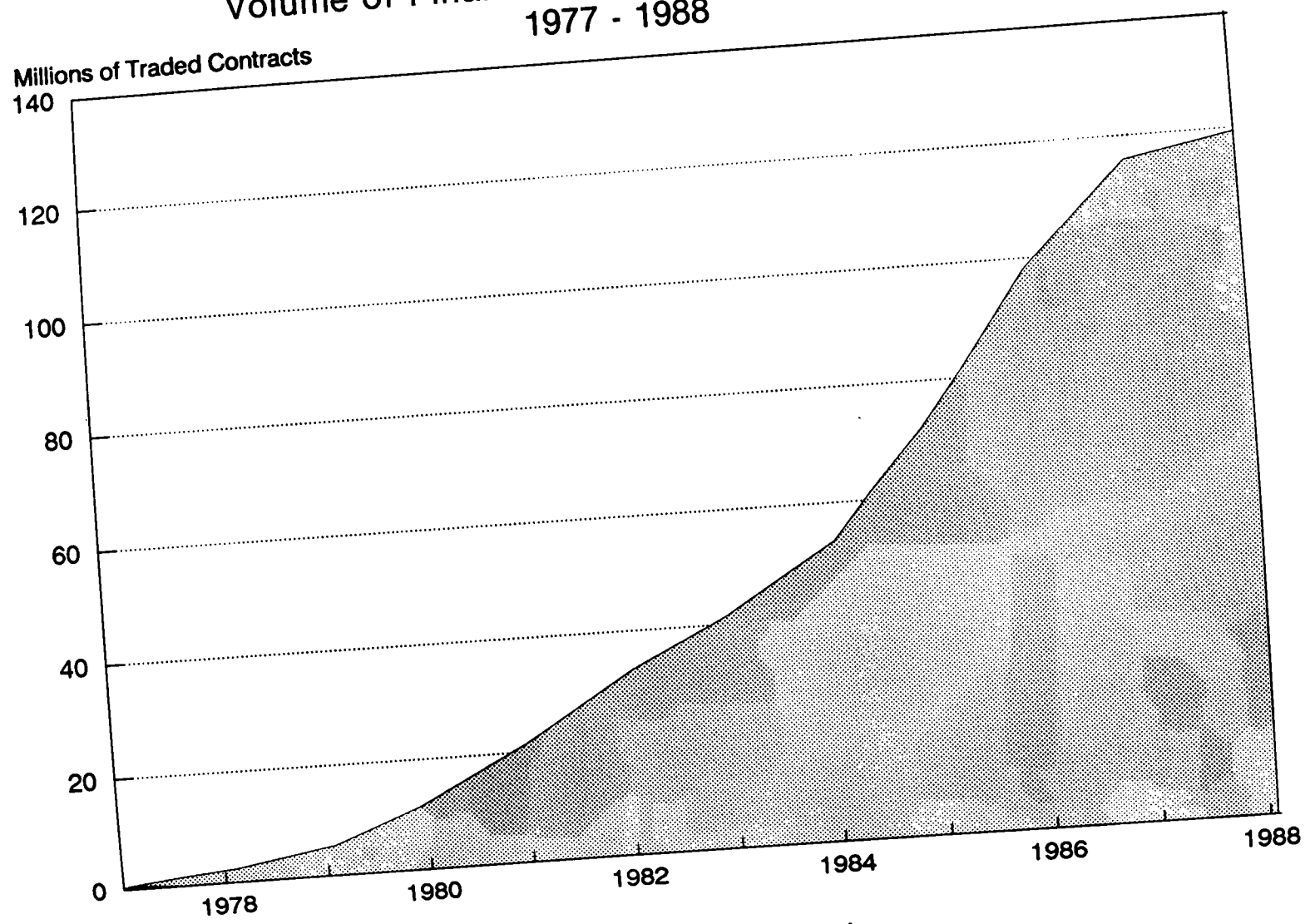
Figure 12  
The Growth of Mortgage Pools  
1970 - 1987



Source: U.S. Department of Commerce and Statistical Abstract of the United States.



Figure 13  
Growth of the Financial Futures Market  
Volume of Financial Futures Contracts Traded  
1977 - 1988



As the percentage of the banking industry's assets devoted to loans has risen, the composition of the loan portfolio has changed. Two major changes are that the proportion of real estate loans has increased and the proportion of commercial and industrial loans has decreased (Figure 14). This shift in portfolio composition has exacerbated the effects of downturns in regional real estate markets. The reduction in C&I lending, however, by banks has not been a unilateral move. The rise of the commercial paper market has forced banks to seek other lending opportunities.

In the last several years banks have developed a market in highly leveraged transactions (HLTs) to augment their corporate finance business. Some observers have expressed concern that these transactions expose banks to more risk than conventional commercial lending. Thus far, however, no bank failures have been attributed to HLTs.

Other changes in the banking business bear noting. For example, noninterest income has become more important, constituting 16 percent of total income in 1989 (Figure 15). And off-balance sheet activities have increased substantially. The major categories of such activities grew in dollar terms from 58 percent of bank assets in 1982 to 116 percent of bank assets in 1989 (Figure 16).

## 6. Summary

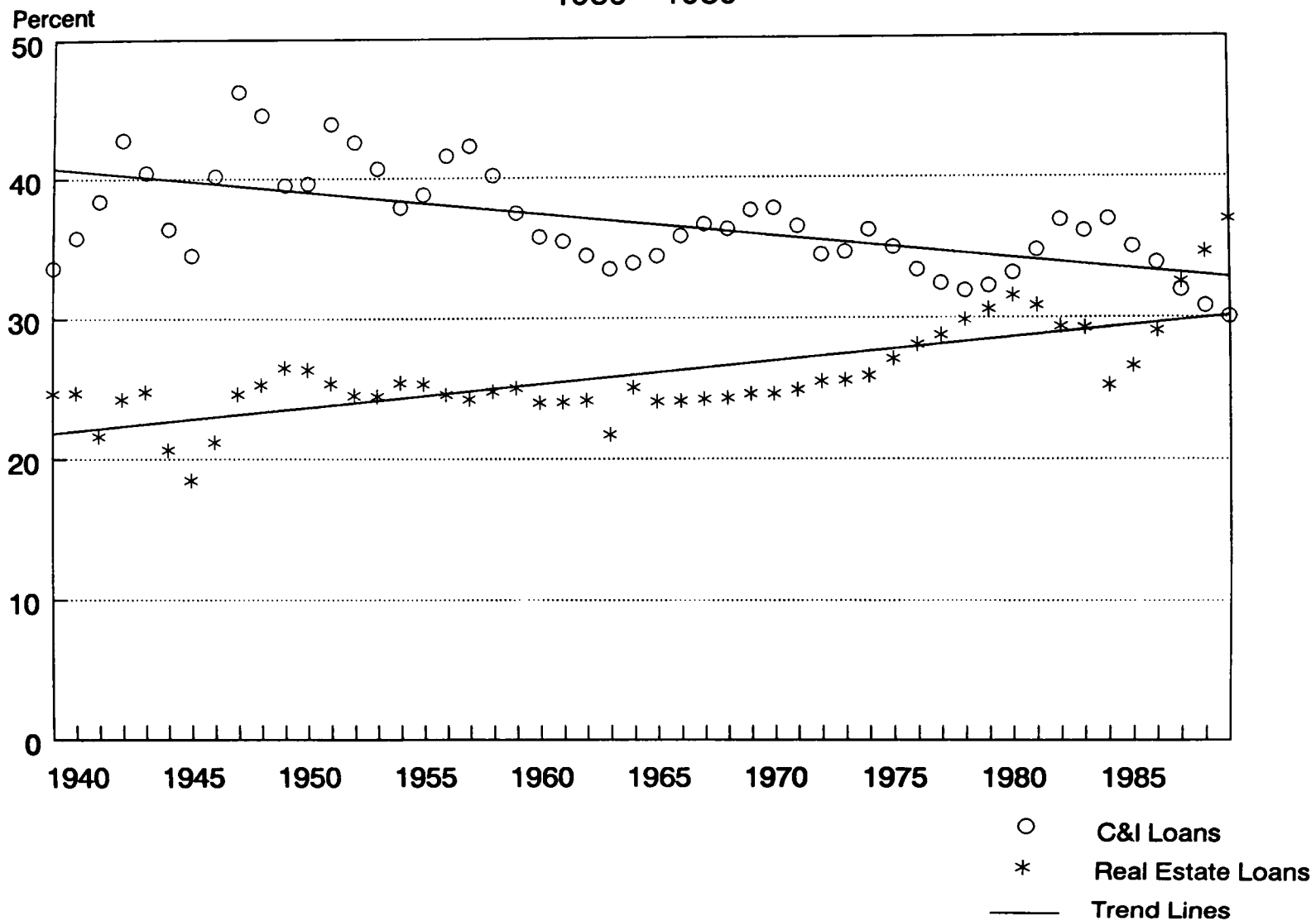
The banking industry, and the financial marketplace in general, have been undergoing significant changes. Risk has risen. Competition from both inside and outside the industry has increased. Maintaining profitability is more difficult than it once was, and in that sense the health of the banking industry has been on the decline.

### F. Deposit Insurance and Supervisory Systems -- An Overview

The supervisory system for depository institutions in the United States is exceedingly complex. Authority at the federal level is divided among five principal agencies: the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of Thrift Supervision (OTS). The discussion in this chapter will cover all of these agencies except the NCUA, which is covered in a separate chapter on credit unions.

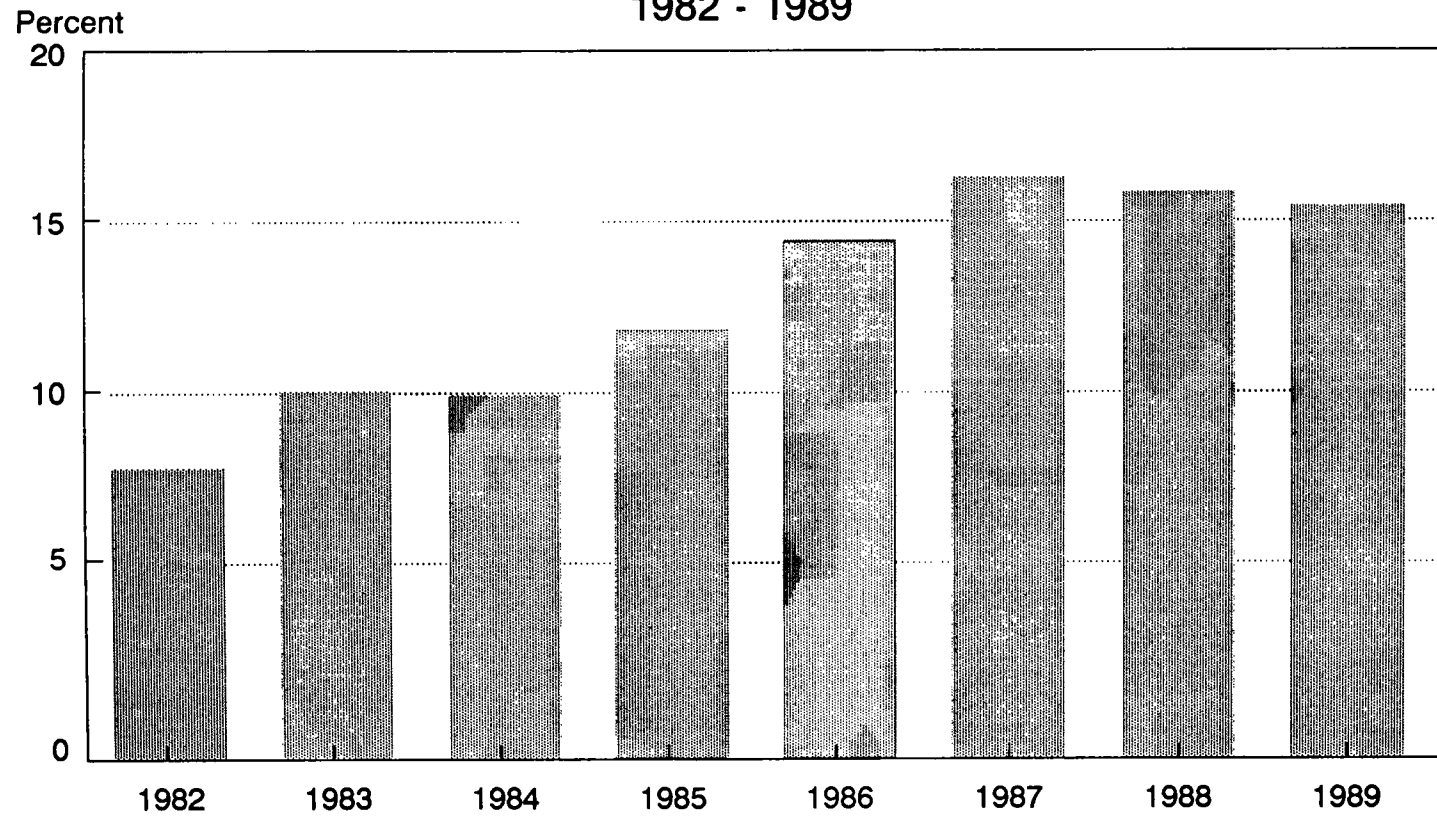
In addition to the five principal agencies, a number of other federal entities, such as the Securities and Exchange Commission and the Department of Justice, have responsibilities regarding depository institutions. Moreover, depository

Figure 14  
**Real Estate and C&I Loans as a Percent of Total Loans  
 Insured Commercial Banks  
 1939 - 1989**



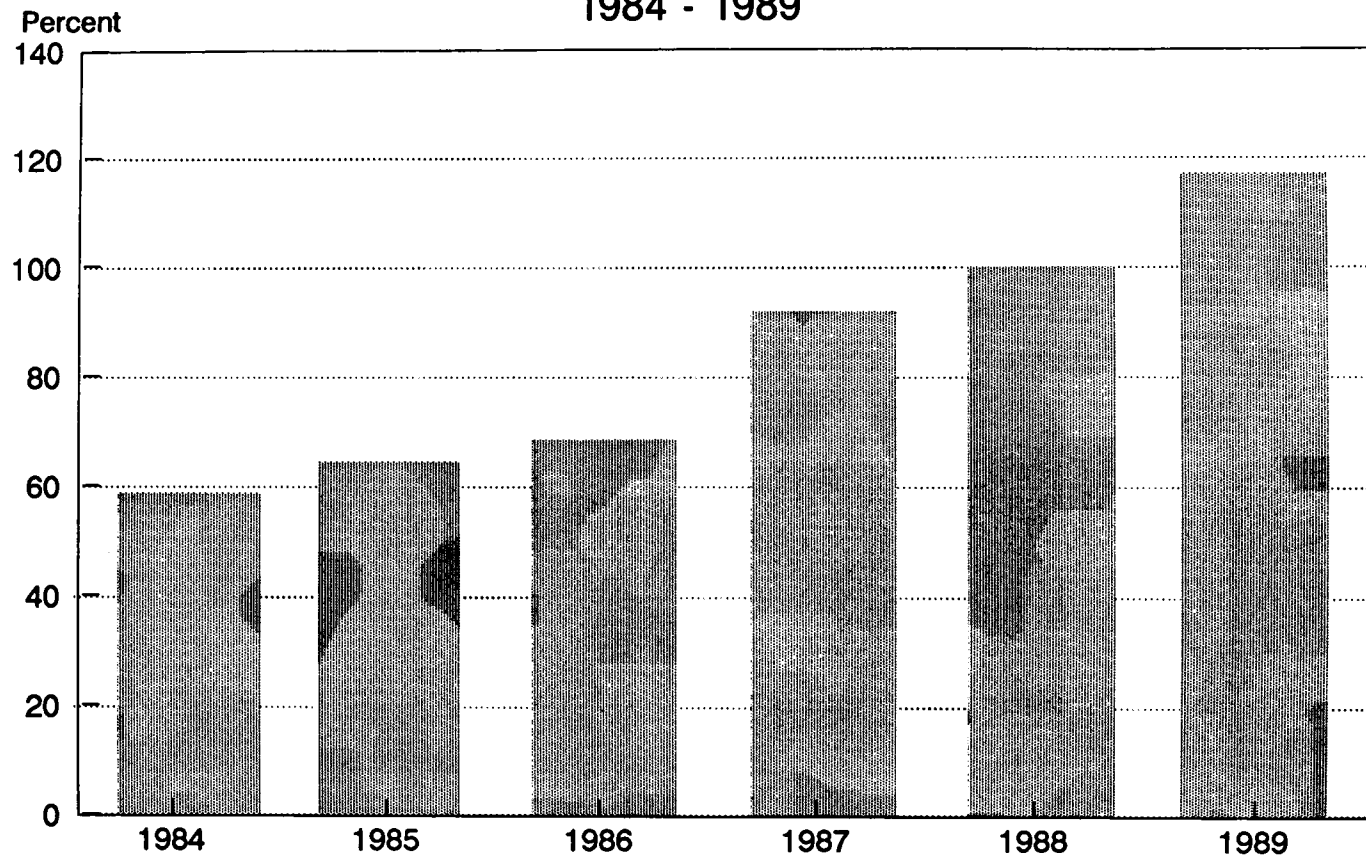
Source: FDIC Annual Reports and Statistics on Banking.

Figure 15  
Non-Interest Income as a Percent of Interest Income  
Insured Commercial Banks  
1982 - 1989



Source: FDIC Annual Reports and Statistics on Banking.

Figure 16  
Selected Bank Off-Balance Sheet Activities  
as a Percent of On-Balance Sheet Activities  
1984 - 1989



Note: Off-balance sheet activities include loan commitments, standby and commercial letters of credit, futures and forwards contracts, and commitments to purchase foreign exchange.

Source: FDIC Annual Reports and Statistics on Banking.

institutions may be chartered either by a state or the federal government. State-chartered depository institutions are, in most instances, supervised by both a state and a federal supervisor.

The depository institutions regulatory system has undergone a number of changes over the years. The most recent changes were mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). The Act abolished the independent Federal Home Loan Bank Board (FHLBB), which had been the federal supervisor of savings and loan associations and some savings banks. An office of the Department of the Treasury, the OTS, was created to assume many of the duties of the FHLBB. The deposit insurance responsibilities of the FHLBB, however, which had been carried out by a subsidiary entity, the Federal Savings and Loan Insurance Corporation (FSLIC), were transferred to the FDIC.

As of year-end 1989, the FDIC provided deposit insurance to 12,706 commercial banks, 469 state-chartered savings banks, 20 federally chartered savings banks and, as a result of FIRREA, to 2,878 federally and state-chartered savings associations that had formerly been insured by FSLIC. The FDIC is the primary federal supervisor, however, only for those state-chartered banks that are not members of the Federal Reserve System. There were 7,491 of these nonmember banks at year-end. The FDIC also supervised 469 state-chartered savings banks at year-end 1989. The FDIC has limited authority to close a bank. That authority mostly resides with the OCC for national banks, with the state banking agencies in the case of state-chartered banks, and with the Office of Thrift Supervision for savings and loans. In addition, the FDIC can terminate insurance under certain circumstances.

The OCC is the chartering authority and primary federal supervisor for national banks, which numbered 4,180 at year-end. The remaining 1,035 FDIC-insured commercial banks on December 31, 1989, were state-chartered members of the Federal Reserve System. This category of institution is supervised at the federal level by the Federal Reserve, which also is the primary federal supervisor for bank holding companies. At year-end 1989, 8,846 of the nation's banks were subsidiaries of bank holding companies, of which there were 6,444.

Chartering authority for federal savings associations now resides, as a result of FIRREA, with the OTS. That agency supervises not only the federal savings associations it charters but also those state-chartered savings associations with federal deposit insurance and savings and loan holding companies. At yearend 1989, there was a total of 2,878 federal savings associations and state-chartered savings associations with federal deposit insurance.

There is a great deal of formal and informal cooperation among the federal supervisory agencies. This includes coordination of examinations, exchange of examination reports and discussion and coordination of enforcement actions. There is also considerable cooperation between the FDIC and the various state banking commissions with regard to examinations, enforcement actions and, in most cases, the decision to close a bank.

Prior to the enactment of FIRREA, deposit insurance in banks and thrifts was the responsibility of two separate agencies. The FDIC provided deposit insurance for banks, and the FSLIC provided deposit insurance for thrifts. The FDIC now administers the deposit insurance program for both types of institutions, although through two different funds.

The Bank Insurance Fund (BIF) is the successor to the Permanent Insurance Fund that had been in existence for banks since 1935. The Savings Association Insurance Fund (SAIF) is the successor to the thrift fund that had been administered by the FSLIC.

Funds for the federal deposit insurance programs are provided by assessments on insured institutions. At the time of the passage of FIRREA in 1989, the assessment rate for banks was 1/12 of one percent (0.083 percent), and the assessment rate for FSLIC-insured institutions was 0.208 percent. FIRREA increased the BIF rates to 0.12 percent for 1990 and to 0.15 percent for 1991 and thereafter. The SAIF rates were increased to 0.23 percent for 1991 and are scheduled to fall to 0.18 percent in 1994 and to 0.15 percent in 1998. More recently, the FDIC Board voted to increase the BIF insurance premium to 0.195 percent for 1991 and thereafter.

In October 1990, Congress enacted the "FDIC Assessment Rate Act of 1990," which rendered obsolete a number of the FIRREA provisions regarding assessment rates. The Act grants broad discretion to the FDIC Board to set premiums for both BIF and SAIF members in order to maintain designated reserve ratios. Ceilings on assessment rates and assessment rate increases were eliminated. Also eliminated was the requirement that investment earnings on reserves in excess of 1.25 percent of insured deposits will be distributed to fund members, as well as the cap of 1.50 percent on the funds' reserve ratios.<sup>32</sup>

At year-end 1989, the Bank Insurance Fund contained the BIF's predecessor, the Permanent Insurance Fund, which had reached a peak level of \$18.3 billion in 1987. Losses of \$4.2 billion in 1988 and 0.8 billion in 1989 reduced the fund to \$13.2 billion by year-end 1989. Further losses of perhaps \$4 billion are expected in 1990.

The deposit insurance fund administered by the FSLIC had reserves of \$6.4 billion at the end of 1980. Due to difficulties in the thrift industry, however, the fund began incurring losses in 1984 and had a deficit of \$75 billion by the end of 1988.<sup>33</sup> The deficit was attributable to expected future losses. FIRREA in effect made the U.S. taxpayers responsible for much of these losses.

## **G. How the FDIC Has Handled Bank Failures<sup>34</sup>**

In principle, how the FDIC handles bank failures can have an important impact on bank risk-taking and the cost of the deposit insurance system. It often is argued that to the extent the FDIC handles failures in a manner which protects uninsured depositors and other general creditors, these creditors have no incentive to monitor a bank's condition, and all discipline against risk-taking is removed from the system. This section reviews the methods the FDIC has used in handling bank failures. Table 8 presents more detailed information (than is available in Table 1) for the 1980-89 period on the types of transactions the FDIC has used in handling bank failures. Information on the FDIC's loss experience by transaction type, for recent years, is presented in the "Early Closure" chapter.

### **1. Historical Background**

The Banking Act of 1933 provided the FDIC with the authority to pay off insured depositors of failed institutions through newly created Deposit Insurance National Banks (DINB). No other resolution process was authorized. The 1935 Banking Act gave the FDIC the additional authority to pay off depositors directly or through an existing bank. It also gave the FDIC authority to make loans, purchase assets and provide guarantees to facilitate a merger or acquisition.

Between 1935 and 1945 the FDIC resolved approximately 390 bank failures, using either the payoff method or a merger with a healthy bank. In payoff resolutions, the insured depositors were paid off and a receivership was created. The receivership held the assets of the failed bank against which the uninsured depositors became general creditor claimants. The FDIC also maintained a claim against the receivership as a general creditor for the amount advanced to insured depositors. Uninsured depositors frequently did not receive the full amount of their deposits, and even when they did, long delays typically created some loss through foregone interest.

At first, the majority of failures were resolved with payoffs. However, the mix shifted so that at the end of the ten year period, more failures were resolved through merger (or assumption). Eventually, payoffs were generally limited to



Table 8

Failure Resolutions by Transaction Type,<sup>1</sup> 1980-1989

Year	Purchase and assumptions (P&A's)			Insured deposit transfers	Insured deposit payoffs	Open-bank assistance	Total
	"Traditional"	"Whole bank" <sup>2</sup>	"Small loan"				
1980 .....	7	0	0	0	3	1	
	\$218,331	\$0	\$0	\$0	\$17,832	\$7,953,000	\$8,000,133
1981 .....	8	0	0	0	2	3	
	4,808,042	0	0	0	51,018	4,599,000	9,407,060
1982 .....	35	0	0	0	7	8	
	11,046,997	0	0	0	585,418	8,543,000	20,175,415
1983 .....	36	0	0	0	9	3	
	7,026,923	0	0	0	164,037	2,890,000	7,090,960
1984 .....	62	0	0	12	4	2	
	1,905,924	0	0	499,517	356,051	34,147,919	36,558,411
1985 .....	87	0	0	7	22	4	
	2,235,182	0	0	325,841	284,315	5,895,930	8,461,268
1986 .....	98	0	0	19	21	7	
	6,375,900	0	0	759,400	575,100	718,800	8,439,200
1987 .....	114	19	0	40	11	19	
	3,833,870	584,092	0	2,190,700	348,300	2,551,115	9,507,977
1988 .....	54	110	0	30	6	21	
	1,523,979	37,351,973	0	1,153,000	123,700	13,539,018	53,688,670
1989 .....	30	87	58	22	9	1	
	960,982	23,099,693	3,013,685	1,630,243	548,024	5,699	6,008,327
<b>Total.....</b>	<b>531</b>	<b>216</b>	<b>58</b>	<b>130</b>	<b>94</b>	<b>69</b>	
	<b>\$39,936,130</b>	<b>\$61,035,758</b>	<b>\$3,013,685</b>	<b>\$6,558,701</b>	<b>\$3,053,795</b>	<b>\$80,843,481</b>	<b>\$168,200,750</b>

<sup>1</sup> The second row in each year contains total assets in thousands of dollars.

<sup>2</sup> The "whole-bank" P&As include some large bank failure transactions in which the acquirer has a contractual relationship with the Federal Insurance Corporation (FDIC) to service problem assets. This involves an ongoing loss exposure for the FDIC. The term "whole-bank" P&A normally refers to a transaction in which the FDIC has no ongoing exposure.

Source: Federal Deposit Insurance Corporation.

situations in which no buyers came forward--often in states that did not permit branching thereby complicating any potential acquisition. In merger transactions, a healthy bank assumed all deposits and general creditor claims. The acquiring bank then obtained all good assets from the failed bank and an offsetting cash payment from the FDIC. The FDIC would hold and liquidate the bad assets. These transactions became favored because they were less disruptive to the local community, imposed fewer resource demands on the FDIC and avoided some liquidation costs. Unlike the more recent "purchase and assumption transactions" described later in this section, in the old assumption transactions the failing institution was not actually closed and no receivership was established.

During the period from 1945 through 1955 there were only 25 failures of FDIC insured banks. Each of these was resolved through the merger and assumption method. Thus, no depositor or other general creditor suffered a loss during the period. This resulted in extensive questioning of FDIC policies during Senate Banking Committee confirmation hearings of FDIC Directors during the Fall of 1951. Senator Fulbright argued that providing 100 percent insurance coverage de facto was an extension of coverage beyond the scope originally intended by Congress. In response, the FDIC agreed to make a cost comparison between a payoff and liquidation on the one hand, and an assumption transaction on the other, and pursue the cheaper alternative. (The informal cost test subsequently became an explicit requirement of the Garn-St Germain Depository Institutions Act of 1982).

Between 1955 and 1958 there were nine payoffs and only three assumption transactions. From 1959 through 1964 there were 18 payoffs and no assumptions. In the original assumption transactions, troubled banks were not closed. This meant that the FDIC required approval of the shareholders and creditors of the failed bank before consummating the resolution transaction. In the mid-1960's, the FDIC recognized that if the Comptroller of the Currency or the state banking authority closed a bank and created a receivership, the assumption transaction could be arranged without the consent of the former stockholders (and thus reduce its cost).

During the late 1960s, the FDIC realized that acquiring institutions might be willing to pay a premium for the assumed deposits and good assets. By 1968 an explicit bidding process had been established for handling closed bank purchase and assumption transactions. For the next fifteen years most failed banks, including virtually all large ones, were handled in this manner. In these transactions, the potential acquirers bid on the failed bank's deposits, certain other liabilities, and specific good assets (including enough cash to balance the package).

## 2. Payoffs

Over the past 20 years, only about 25 percent of bank failures have been resolved through payoffs. These have been banks in which no acquirer offered a premium sufficient to pass the cost test, or the presence of fraud or significant contingent claims made it difficult to estimate losses in order to apply the cost test. The largest payoff transaction was the Penn Square Bank in July of 1982. Penn Square had deposits of \$470 million of which \$250 million were insured. The FDIC expected a substantial number of lawsuits to be filed by banks which had purchased participations in poorly performing loans from Penn Square. Under a purchase and assumption transaction, the FDIC would have had to protect the acquiring bank against these contingent claims as they were resolved in court. On the other hand, a payout resolution exposed the FDIC to, at most, the insured deposits (less the FDIC's share of receivership collections).

One major benefit of payout resolutions is that, by exposing large depositors in failed banks to losses, they promote depositor discipline. However, the actual resolutions could be very disruptive to the local economy as uninsured funds are frozen while FDIC liquidators recover the receivership assets. In 1984, an attempt was made to develop a payout procedure which reduced the disruption. The result was termed a modified payout. It involved an initial payment of a conservative estimate of the receivership recoveries being paid immediately to uninsured depositors with additional, future payments being made if collections exceeded expectations. The insured deposits and selected assets were transferred to an acquiring bank through a bidding process similar to a purchase and assumption transaction.

The modified payout process was still being refined when Continental Bank required assistance in 1984. The banking agencies did not consider a payoff of Continental to be a feasible option, due to the risk of disrupting financial markets and the payments system. Once a decision was made to protect uninsured depositors and creditors in a large failed bank, it was thought to be unfair to apply a more stringent routine in the failure of smaller banks.

One lasting benefit of the modified payout experiment was the development of procedures for an insured deposit transfer. This transaction is now routinely used whenever a healthy bank is willing to pay a premium to acquire insured deposits and, perhaps, certain assets of a failed bank for which a payoff would otherwise be warranted.

### 3. Bridge Bank Authority

In 1984, Continental Bank experienced a run of uninsured depositors and other unprotected funding sources. The sale of liquid assets and collateralized borrowing from the Federal Reserve produced the cash to accommodate the outflow. Bank regulators recognized that the bank would require additional assistance. However, any assistance package would have required time to construct. As time passed, uninsured deposits were replaced by insured deposits and secured loans. Therefore, the cost to the FDIC of undertaking an insured deposit transfer continued to increase. Although the situation at Continental was of a greater magnitude than normal, the FDIC typically faces increasing resolution costs as uninsured depositors and general creditors become aware of a bank's deteriorating condition and protect their positions by withdrawing funds or collateralizing loans.

In 1987, the FDIC was given statutory authority to create "bridge banks." A bridge bank is a limited-life institution into which an insolvent bank is merged through a Purchase and Assumption (P & A) transaction. The bridge bank then can continue operations (e.g., processing customer payments) until a deal is negotiated with the ultimate purchaser. The FDIC has discretion as to which liabilities to merge into the bridge bank. All insured deposits will be transferred. Beyond that, it is conceivable that only a percentage of the uninsured liabilities might be transferred, thus imposing a "haircut" on other creditors (including uninsured depositors).

The use of bridge banks has several advantages. To the extent it is deemed possible or desirable to inflict losses on nondeposit creditors or uninsured depositors, this can be done at the outset without having to rush into a final transaction. By continuing its operations, the failing bank may be able to retain more of its value to acquirers, and there is likely to be less disruption to the local community. The moral hazard problems that arise as a result of prolonging the operations of a failing bank are eliminated, because the failing bank is closed, management is replaced and holding company creditors and shareholders lose their investment.

Through year-end 1989, the FDIC had used its bridge bank authority on five occasions. Most prominent among these were the bridge banks created to deal with the failures of the banks of two large Texas bank holding companies (BHCs). On July 29, 1988, 40 of the banks of First Republic Bank Corporation with \$32.9 billion in assets were closed and placed in a bridge bank, and subsequently acquired by NNCB, a North Carolina bank holding company. On March 28th and 29th, 1989, 20 of the banks of MCorp with \$15.8 billion in assets were closed and placed in a bridge bank, and subsequently acquired by BancOne, an Ohio BHC.

#### 4. Open-Bank Assistance

In 1950, the FDIC was given legislative authority to provide assistance to open banks. Section 13(c) of the Federal Deposit Act was modified to permit such assistance "when in the opinion of the Board of Directors the continued operation of such bank is essential to provide adequate banking service in the community." The Garn-St Germain Depository Institutions Act of 1982 expanded that authority. The FDIC may provide assistance to prevent the failure of any insured bank. A finding of "essentiality" is required only if the cost of assisting a bank exceeds the cost of closing and liquidating it.

The FDIC first used its authority under Section 13(c) in 1971. During the period 1971 through 1989, there have been 1,149 transactions in which the FDIC made expenditures in connection with troubled commercial banks or savings banks. Of those, 841 transactions were P&As, 244 were payoffs and 64 were open-bank assistance transactions. The 64 open-bank assistance transactions included some large banks including First Pennsylvania Bank, N.A. (1980) with assets of almost \$8 billion, Continental Illinois National Bank (1984) with assets of \$36 billion, The Bowery Savings Bank (1985) with assets of \$5 billion, BancOklahoma (1986) with assets of \$2 billion, BancTEXA Group (1987) with assets of about \$1.5 billion, and First City Bancorporation (1988) with assets of \$11 billion.

The financial importance of open-bank transactions is greater than their relatively small number would indicate. According to the FDIC's 1989 Annual Report estimated losses to the Corporation since 1933 total \$8.4 billion for deposit assumption transactions, \$2.8 billion for payoffs, and \$11.2 billion for open-bank assistance transactions. The remainder of this section provides information on some of the major open-bank assistance transactions of the 1980s.

##### FDIC-Insured Savings Banks

The unanticipated steep rise in market interest rates in the late 1970s and early 1980s caused severe stress on certain segments of the financial services industry. Institutions that financed long term investments with short term borrowings were especially hard hit. Among this category were FDIC-insured savings banks. These banks were heavily invested in residential mortgages and mortgage backed-securities. Although the credit quality of the assets had not deteriorated, the market value of assets fell below the value of liabilities at many institutions. In some cases the market value of assets fell to 75 percent or less of the outstanding liabilities. Closing and liquidating these institutions would have placed an enormous burden on the FDIC fund. Arranging P&A transactions in which the FDIC provided

the buyer with cash to compensate for the negative net worth would have been equally expensive.

The FDIC created "Income Maintenance Agreements" for assisted mergers to avoid recognizing the losses at once, with the expectation that interest rates would eventually drop towards historic levels. Under these agreements, the FDIC would pay the acquiring bank the difference between the asset yield and the average cost of funds for a number of years. Thus the FDIC retained the interest rate risk in the transaction. This type of agreement was used in nine of the twelve assisted mergers of failing savings banks that occurred between 1981 and early 1983. Because market interest rates later declined, the FDIC reaped significant savings from these arrangements.

The FDIC did not close the failing savings banks. Instead, assisted mergers were undertaken in ways that minimized the value retained by the managers and investors of the failed institutions. Senior management and trustees of the failed banks were prevented from serving with the surviving institution. Subordinated debt holders were required to accept losses in the form of lower interest payments or extended terms. Although their losses would have been greater in a liquidation, these savings were offset by avoiding lawsuits which might have delayed the transactions, the greater cooperation obtained from state supervisors and the greater flexibility for the acquirers in continuing leases and other contractual arrangements. In addition, an important consideration was that these savings banks were mutual institutions. Therefore, there were no stockholders benefiting from the transactions.

The Bowery Savings Bank, with assets of \$5 billion, was the largest savings bank to receive FDIC assistance. A large number of FDIC-insured institutions, as well as other interested parties, were invited to submit bids for The Bowery. The proposal which was accepted included a \$100 million equity contribution by the new investors and installation of a new management team.

#### **Continental Illinois National Bank**

The difficulties of Continental Illinois National Bank became public in 1982 when it experienced large losses resulting from the purchase of hundreds of millions of dollars of energy loans from the failed Penn Square Bank in Oklahoma City. By early 1984, in excess of eight percent of the bank's total loans were not performing as agreed, more than twice the average percentage of nonperforming loans at the nation's banks. In early May, Continental experienced a massive deposit run triggered by rumors of the bank's impending collapse and the withdrawal of several billion dollars of foreign deposits.

During this time, the FDIC, the OCC and the Federal Reserve began to consider possible solutions to Continental's problem.

The regulators did not consider feasible a payoff of insured depositors. More than \$30 billion in uninsured deposits and other private claims would have been tied up in receivership, with uncertain ramifications for economic stability. Effecting a modified payoff could well have required a cash advance greater than the size of the FDIC fund. Runs on other banks could have resulted, creating substantial additional costs for the FDIC as well as disruption of credit.

Continental's size and its large volume of troubled loans and outstanding lawsuits made it difficult to attract a merger partner at a reasonable cost. It became increasingly clear that open bank assistance would have to be the final solution. The final assistance package included top management changes; the sale of problem loans to the FDIC in return for the FDIC's assumption of the bank's \$3.5 billion borrowing from the Federal Reserve Bank of Chicago; and a \$1 billion capital infusion from the FDIC including a preferred issue convertible into an 80 percent ownership interest in Continental Illinois Corporation. As of this writing the FDIC retains an ownership interest in Continental.

#### **BancTEXAS Group**

In July, 1987, the FDIC made a one-time cash contribution of \$150 million to assist 11 of the subsidiary banks of BancTEXAS Group, a BHC in Dallas, Texas. These banks had about \$1.3 billion in assets. Control of the organization was assumed by a group of outside investors, who contributed \$50 million in new capital.

The transaction was determined by the FDIC to be less expensive than either a P&A or a payoff. Problem assets were retained and managed by the new owners with no ongoing financial commitments by the FDIC, which would not have been the case in a payoff. The investor group which approached the FDIC sought control of the entire franchise. There were tax and accounting reasons for this, but in addition the investors believed that the value of the entire franchise was much greater than the value of a few banks within the franchise.

The FDIC believes it was correct in evaluating the transaction as being very cheap. In light of the subsequent performance of the Texas economy, the investor group had not asked for enough assistance to make BancTEXAS a viable organization. The lead bank in Dallas failed in March, 1990, and the investor group lost its \$50 million investment.

## **First City Bancorporation**

On April 20, 1988, the FDIC consummated a plan to recapitalize the subsidiary banks of First City Bancorporation of Texas, an \$11 billion organization with 59 banking subsidiaries. Control of First City was assumed by a private investor group that raised \$500 million in new capital through a stock offering, and the FDIC provided \$970 million in assistance.

### **5. Forbearance and Government Ownership**

A discussion of the FDIC's failure-resolution methods would not be complete without some discussion of the instances in which normal supervisory procedures or failure-resolution methods have been superceded for selected troubled financial institutions. These instances fall into two categories--forbearance from enforcing capital or other supervisory standards for operating institutions which are financially troubled but are judged to be "viable," and instances in which the FDIC takes an ownership position in the institution resulting from an assistance transaction.

#### **Forbearance Programs**

Forbearance as just defined is not a failure-resolution method since the institutions receiving it are supposedly financially viable. Nevertheless, the concept of forbearance has received considerable criticism as a contributing factor in increasing the ultimate cost of depository institution failures. This is particularly true of the forbearance received by many insolvent S&Ls during the 1980s, described above in the section on the performance of S&Ls during the 1980s.

The Garn-St Germain Act included provisions whereby savings banks and other qualifying institutions could apply for net worth certificates if they met certain conditions with respect to losses and low surplus ratios. The net worth certificate program was a form of capital forbearance in which notes were exchanged between the insurer and a savings bank, resulting in the creation of "regulatory capital" which the institution could use to satisfy supervisory requirements. Altogether, 29 FDIC-insured savings banks participated in the program; 16 have retired their certificates, 10 have failed or merged, and as of year-end 1988 three still have certificates on their books. In March of 1986, under pressure from Congress, the FDIC, the OCC and the FRB released a Joint Policy Statement outlining a capital forbearance program for "well-managed" banks whose difficulties are "largely the result of external problems in the agricultural and/or oil and gas sectors of the economy."<sup>35</sup> The practical effect of a bank's admission into the program is that the banking agencies will not issue a capital directive against the bank to enforce normal capital standards. Banks in the program are required to



adhere to a recapitalization plan; those failing to do so are terminated from the program.

The Competitive Equality Banking Act of 1987 contained a loan-loss amortization program to further assist agricultural banks. This Act allows eligible banks to amortize, over seven years, losses from sales and/or reappraisals of qualified agricultural loans between 1984 and 1991 inclusive, and losses from reappraisals and/or sales of agriculturally related property between 1983 and 1991 inclusive. The full unamortized portion of loan losses can be included in primary capital for regulatory and supervisory reporting purposes. Requirements for admission to the program are similar to those outlined above for the capital forbearance program, except that only banks with assets less than \$100 million may participate, and participating banks are required to maintain specified percentages of agricultural loans to total loans.

As of year-end 1989 there were 168 banks with \$6.2 billion in assets in the capital forbearance program and 47 banks with \$1.3 billion in assets in the Agricultural Loan-Loss Deferral Program. The average asset size of these 215 institutions is about \$35 million. Of all the banks originally admitted to the programs, 21 have failed.<sup>36</sup>

#### **FDIC Capitalization of Insured Depository Institutions**

In most bank failure or assistance transactions, the FDIC contributes an amount sufficient to cover the negative net worth of the troubled institution; the acquirer or new investor is responsible for contributing sufficient capital to meet the capital requirement. In some cases, however, part of the capital requirement has been met by an FDIC injection of capital.<sup>37</sup> Under certain circumstances, FDIC investment in a bank counts as capital under Generally Accepted Accounting Principles (GAAP), and under certain circumstances is accepted by bank supervisors as capital. An FDIC investment does not, however, meet the conceptual definition of "capital" from an insurer's point of view. That is, it does not cushion the insurer against loss. FDIC investment is thus a form of capital forbearance. FDIC investment creates potential conflicts of interest between the FDIC's ownership and supervisory roles, creates potential competitive inequities, and raises the question why the FDIC should capitalize a private firm when private investors were unwilling to do so. For these reasons the FDIC has always sought to avoid contributing capital in connection with bank failure or assistance transactions.

In some instances the FDIC has judged that circumstances required it to contribute capital in connection with a bank failure or assistance transaction, despite the problems just mentioned. A major argument for an FDIC capital contribution is

that investors will generally require substantial protections against loss on problem assets. It is often argued that since the FDIC is protecting the investors on the "downside," it should assume an ownership interest in order to share in potential windfalls to the acquirers.

In short, if the alternatives of paying off the bank or of removing all problem assets from the bank appear sufficiently costly, and if the returns demanded by acquirers for capitalizing the entire institution appear sufficiently exorbitant, the FDIC has occasionally judged that an FDIC capital contribution is the least costly alternative. This occurred in the FDIC's assistance to Continental Illinois where the FDIC assumed an 80 percent equity interest and an option to purchase the remaining 20 percent; in the NCNB Corporation's acquisition of the banking assets of First RepublicBank Corporation where the FDIC assumed an 80 percent equity interest; and in the BancOne acquisition of the banking assets of MCorp, where the FDIC assumed a 75 percent equity interest. The acquirer of First RepublicBank has since bought out the FDIC's ownership positions.

## 6. Treatment of Parties in a Bank Failure

### Insured Depositors and Secured Creditors

Depositors are insured to \$100,000. Insured deposits always receive 100 percent coverage in any bank failure.

Some other claims on a failed bank may be secured by the value of specific assets of the bank. If a bank fails, these assets are used to satisfy the secured claims. Thus, at minimum, secured creditors receive full payment or the value of their collateral, whichever is less.<sup>38</sup>

### Uninsured Depositors

If insured-depositors in a failed bank are paid off, either through a payoff and liquidation or through an insured-deposit transfer, uninsured depositors receive only receivership certificates entitling them to their pro rata share of recoveries on the failed bank's assets. They are thus likely to recover only a portion of their funds, and only after several years. In a modified payoff, described earlier, uninsured depositors receive a cash advance at the time of failure equal to estimated recoveries.

Payoffs have been used by the FDIC primarily in situations where both the failed bank is small and where potential acquirers are unwilling to pay a premium sufficient to pass the FDIC's statutory cost test.<sup>39</sup> Other FDIC assistance has been handled either through P&As or through direct assistance to open banks. In all such cases, uninsured depositors have been fully

protected, with the recent exception of certain intra-BHC deposits.

There are several reasons the FDIC generally has provided full coverage to uninsured depositors in P&As in preference to transferring only the insured deposits to another institution. First, where the volume of uninsured accounts is small, it is often not worth the trouble of separating insured from uninsured accounts. Second, the premium paid by the acquirer in a P&A is likely to be somewhat higher than it would be in an insured deposit transfer, since it is likely to be easier for the acquirer to retain the core deposits of the acquired institution in a P&A.<sup>40,41</sup> Third, because the FDIC has provided full coverage to uninsured depositors in very large bank failures for the sake of financial stability it is difficult from the standpoint of fairness to inflict losses on uninsured depositors in smaller banks.

Finally, "the cost test" does not require the FDIC to choose the cheapest transaction. The FDIC's statutory cost test requires that in the absence of a finding that the bank is "essential" to its community, the FDIC may make uninsured depositors whole if doing so is less expensive than a payoff and liquidation of the bank. The FDIC may choose between a P&A in which all depositors are made whole and an insured deposit transfer, if both transactions are estimated to be cheaper than payoff and liquidation. Then the FDIC need not choose the cheaper transaction under the cost test.

FIRREA clarified existing law, limiting the FDIC's maximum liability to any category of claimants of a failed bank to the amount these parties would have received in a deposit payoff. In addition, the legislation allows the FDIC complete discretion to use its own resources to make additional payments to any claimants or categories of claimants in the interest of maintaining stability and confidence in the banking system, without obligating itself to make similar payments to all other claimants.

This "pro rata" authority has affirmed the FDIC's flexibility to settle the liabilities of failed banks. The FDIC has used this authority to make only pro rata payments to intracompany credit extensions in the failures of banks affiliated with First Republic Bank Corporation and Texas American Bancshares. If the FDIC had made the intracompany credit extensions whole, many of the banks in these BHCs may not have been declared insolvent. Also, the value of the "package" offered to acquirers would have been much less and the FDIC's costs much greater.

The FDIC used its pro rata authority because these BHCs had operated their banks essentially as branch systems, in which the

smaller affiliates channelled funds to the lead banks which made most of the large loans. Since these intracompany deposits had been instrumental in funding the bad loans of the lead banks, the FDIC believed that it was inappropriate that they be made whole with insurance fund money.

The FDIC's ability to protect itself in failures involving BHCs is further enhanced by a provision of FIRREA which permits the FDIC to impose liability on commonly controlled depository institutions to recoup any losses resulting from handling the failure of, or providing assistance to, an insured bank. The FDIC's experience in implementing the cross-guarantee provisions of FIRREA is very limited. By enforcing cross-guarantees, however, the FDIC should be able to better protect itself from losses stemming from interaffiliate transactions within a holding company.

### **Nondeposit General Creditors and Contingent Claims**

For most of its history, the FDIC provided full protection to nondeposit general creditors and contingent claimants in P&As. These creditors suffered losses only in payoffs, which were few in number and of negligible importance in terms of the volume of assets and liabilities handled. The reason for the full coverage of nondeposit creditors was simple. Given that a decision had been made to do a P&A that included full payment to uninsured depositors, the FDIC believed it was practically incapable of measuring the pro rata share of other general creditors of the bank.

In 1973, U.S. National Bank in San Diego failed and was resolved with a P&A transaction. However, the FDIC treated claims arising from standby letters of credit as inferior to those of general creditors and did not transfer them. The claimants took successful legal action against the FDIC (First Empire Bank, New York, et al. vs. FDIC). A California federal court ruled that the plaintiffs had the status of general creditor and that, under the circumstances of that case, the FDIC could not discriminate among equivalent classes of creditors.

Penn Square Bank failed in 1982. Although it had deposits of \$470 million, Penn Square had sold loan participations with nominal value in excess of \$2 billion. The maximum cost of a payout transaction was \$250 million (the total of the insured deposits) minus the FDIC's share of receivership collections. It was anticipated (correctly) that purchasers of the participations would file lawsuits against the receivership for hundreds of millions of dollars. Therefore, any acquiring bank in a P&A transaction would have also assumed massive contingent liabilities against which the FDIC would have had to provide guarantees. Under the payoff that occurred, litigants who won

their lawsuits became general creditors who shared in the proceeds of the receivership with other general creditors.

In more recent P&A transactions, the FDIC provided uninsured depositors with better treatment than other general creditors. While uninsured depositors were kept whole, other general creditors were given receivership certificates representing their pro rata share of the receivership's collections. This put them in a position equivalent to that of the FDIC. When this process was challenged in court, the Tennessee Supreme Court upheld the FDIC's right to provide, at its own expense, greater payments to uninsured depositors without obligating itself to provide other creditors with similar subsidies. This authority was affirmed in FIRREA which gives the FDIC the explicit ability to distinguish among the receivership claimants and provide specific parties with better treatment than others (provided that each party receives at least as much as would have occurred under a payout). In future failure resolutions, the presence of substantial contingent claims or nondeposit claims therefore may no longer militate in favor of a liquidation and payoff.

#### Other Parties

Other claimants of a failed bank generally lose their investment. Subordinated debtholders stand behind general creditors in the receivership and generally receive little if any recovery. Owners and stockholders of the bank--including its holding company if applicable--stand behind general creditors and subordinated debtholders in the receivership, and also generally do not recover any of their investment. Creditors and shareholders of BHCs are not protected by the FDIC if the failure of an affiliated bank causes the bankruptcy of its holding company.

There are other parties who stand to lose a great deal in a bank failure. FDIC policy is to replace management, directors and officers of a failed bank who played an important role in the development of the bank's problems. The cost to these people in terms of lost salary and reputations can be substantial. The FDIC also enters into lawsuits against entities it deems responsible for a bank failure, suits which can result in great inconvenience and cost to these entities.

Special note should be made of the role of holding companies in open bank assistance transactions. When a bank is closed, the bank's equity holders, including its holding company, get receivership certificates from the FDIC. Owners and creditors of the holding company itself, however, receive nothing else from the FDIC. In a transaction in which the bank receives assistance from the FDIC, but remains open, however, the consent of some percentage of the holding company creditors is required in order

to consummate the transaction. This is because these creditors may be asked to accept only partial payment of their claims against the holding company.

FDIC policy is that these holding company creditors should get no more in an open bank assistance transaction than they would have gotten had the bank been closed. This amount is difficult to ascertain. In practice, the creditors may have to be offered somewhat more than this in order to obtain their consent for a transaction which would reduce the FDIC's costs. The most well-known example where holding company creditors are alleged to have received more than they would have in a closure involved the FDIC's assistance to Continental Illinois National Bank, where the holding company creditors were fully protected. Observers close to the transaction argue, however, that these creditors would have recovered close to the full value of their claims even had the bank been closed, because of the large volume of non-banking assets in the holding company. Another example involves the FDIC's assistance to the banking affiliates of First City Bancorporation, where arbitrageurs purchased holding company debt at a discount and withheld their consent to the transaction, betting that the FDIC would accept a lower threshold of creditor concessions. When this proved to be the case, the holdouts received face value for their debt. In a more recent example, when faced with a similar situation involving the creditors of Texas American Bancshares and National Bancshares Corporation, the FDIC "called the bluff" of the creditors and closed the bank.

## 7. Asset Disposition in Bank Failures<sup>42</sup>

How the FDIC handles the disposition of assets from failed banks greatly influences its costs. In recent years, failure-resolution costs for commercial banks have averaged about 15 cents per dollar of assets; for smaller banks those costs typically range between 30 cents and 40 cents per dollar, but may exceed 50 cents per dollar.<sup>43</sup> These are not insignificant amounts given the volume of assets handled by the FDIC. The asset disposition problem as it relates to the handling of bank failures is this: when the FDIC takes over an insolvent institution, how should the transaction be structured to maximize the net present value of asset collections?

### What has been Done in the Past?

The economic value of a failed bank's "problem" assets is usually highly uncertain and therefore subject to risk. Someone has to absorb that risk. Traditionally, it has been the deposit insurance agency. Historically, the FDIC has handled failed banks through either a clean-bank purchase-and-assumption (P&A) transaction or a deposit payoff. In both cases the FDIC takes over and liquidates any asset with uncertain value.

In a purchase-and-assumption transaction or "P&A" a buyer purchases some of the failed bank's assets and "assumes" its liabilities. In the "clean-bank" version of this transaction the buyer only takes over the highest quality assets such as cash, government securities (which are marked to market) and in some cases, selected installment and real estate loans. The remaining difference between the value of acquired assets and assumed liabilities would be covered by a cash payment from the FDIC to the acquirer. The FDIC retains all assets with uncertain values and attempts to maximize its return on those assets in order to reimburse itself for some portion of its cash outlay.

In a deposit payoff there is no buyer and the FDIC "pays off" insured depositors. All of the bank's assets are then serviced by the FDIC in its capacity as receiver for the failed bank.

An advantage of a clean-bank P&A is that the acquirer can get off to a clean start. That is, the buyer does not face the risk of being burdened with difficult collection efforts or existing losses in the asset portfolio. Losses that exist prior to when the acquirer takes over should be absorbed by the insurer. There are, however, two notable disadvantages associated with an FDIC liquidation of problem assets. First, there is a policy issue related to a large role for a federal government agency in the disposition of assets. As the number of bank failures increased an FDIC asset liquidation workforce of 500 in 1981 had grown to over 5,000 by 1985. Second, there is a cost concern. There may be inefficiencies associated with a government liquidation relative to having the private sector dispose of problem assets. Such inefficiencies may exist if there are information costs associated with bank assets that give them a greater value in an ongoing institution relative to a liquidation, or if the government is a less efficient liquidation agent than is the private sector.

#### **What is Being Done Now?**

The disadvantages associated with the FDIC handling a large volume of troubled assets led to a reevaluation and revision of policy. Now, the FDIC's objective is to keep assets in the private sector to the extent feasible. In 1985 the FDIC began more vigorously experimenting with alternatives to the clean-bank P&A. Certain "problem" assets were transferred to the acquiring institution with a putback option. That is, within a specified period of time these assets could be returned to the FDIC for their original book value. During 1986, P&A transactions with putback provisions became fairly routine. Often, the putbacks included a "haircut" or loss of five percent to ten percent off book value that had to be absorbed by the acquirer if assets were returned to the FDIC after a specified time period. In 1987 the program was extended to incorporate all of a failed bank's

assets. Rather than allow for putbacks, however, institutions generally were encouraged to reduce their bid by an amount reflecting the estimated difference between book and market values of the dirty assets. These transactions became known as "whole-bank" transactions.

In a whole-bank transaction the FDIC sells virtually the entire institution. A check is written to the acquirer to reflect the difference between assumed liabilities and market value of assumed assets, less any premium paid for the franchise value of the failed bank. The acquirer recapitalizes the bank and the FDIC's liquidation activity is complete.

Nineteen whole-bank P&A transactions were conducted in 1987. By 1988, it was routine policy to generally first attempt a whole-bank transaction before resorting to alternatives in which fewer assets were passed on to an acquirer. In 1988, 110 of 164 P&As were whole-bank transactions;<sup>44</sup> in 1989, 87 of 175 P&As were whole-bank transactions. More recently the FDIC has begun experimenting with "small-loan" P&As in cases where an acceptable bid for a whole-bank P&A is not forthcoming. In a small-loan P&A, the acquirer assumes a package of performing and nonperforming small loans, and the FDIC is responsible for liquidating the remainder of the problem assets of the failed institution. Similar transactions had been effected as early as 1977, but in these older transactions acquirers did not assume any problem assets. 58 of 175 P&As in 1989 were small-loan P&As.

The results appear positive so far. FDIC liquidation personnel were reduced from their peak level of over 5,000 to about 3,500 as of mid-year 1989. However, one concern with whole-bank transactions is that the acquirer rather than the FDIC accepts the risk associated with uncertain asset values. This may be acceptable if the acquirer is large relative to the acquired institution--hence, the risks are not that significant. However, in other situations the acquirer may be taking on unacceptably high levels of risk, or may demand such large compensation for assuming risk that a whole-bank transaction becomes less desirable than alternative types of transactions.

## H. Summary

This chapter has attempted to familiarize the reader with the deposit insurance system as it has evolved over the past 58 years and as it stands today. The sections briefly reviewed how the deposit insurance system came into being in the 1930s; the purpose and benefits of deposit insurance as well as the concerns and criticisms of it; the financial performance of federally insured institutions and the risk exposure of the deposit insurance funds; information on the operation of the U.S. deposit



insurance system; and finally how the FDIC has handled bank failures.

With this general background the reader should be better able to understand how the following chapters in this study relate to deposit insurance reform.

## Endnotes

<sup>1</sup> William Shakespeare, Julius Caesar, Act I, Scene ii, line 134.

<sup>2</sup> U.S. Department of Commerce, Bureau of the Census, Historical, Statistics of the United States: Colonial Times to 1970, Part 2, p. 1038.

<sup>3</sup> For convenience, the word "bank" will be used to refer to both banks and thrifts, unless precision requires that a distinction be made.

<sup>4</sup> Federal Deposit Insurance Corporation, Federal Deposit Insurance Corporation: The First Fifty Years (Washington, D.C.: Federal Deposit Insurance Corporation, 1984, p. 36).

<sup>5</sup> A discussion of the Federal Reserve System's attitude appears in Milton Friedman and Anna J. Schwartz, A Monetary History of the United States, 1867-1960 (Princeton, New Jersey: National Bureau of Economic Research, 1963), pp. 357-59.

<sup>6</sup> See Carter H. Golembe, "The Deposit Insurance Legislation of 1933: An Examination of its Antecedents and Its Purposes," Political Science Quarterly, Vol. 75, No. 2, June 1960, pp. 181-200.

<sup>7</sup> For an in-depth analysis of the early state insurance programs, see Carter H. Golembe and Clark Warburton, Insurance of Bank Obligations in Six States (Washington, D.C.: Federal Deposit Insurance Corporation, 1958); and Clark Warburton, Deposit Insurance in Eight States During the Period 1908-1930 (Washington, D.C.: Federal Deposit Insurance Corporation, 1959).

<sup>8</sup> For further discussion, see Arthur J. Murton, "Bank Intermediation, Bank Runs, and Deposit Insurance," FDIC Banking Review, Spring/Summer 1989, pp. 1-10.

<sup>9</sup> See Ben S. Bernanke, "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression," American Economic Review, June 1983, pp. 257-76.

<sup>10</sup> Goodhart, C.O.E. "Why Do Banks Need a Central Bank?" Oxford Economic Papers 39 (1987), p. 86.

<sup>11</sup> The term "moral hazard" as used by economists refers to the incentive an economic agent, (call him "Mr. A") may have to act in a manner which is contrary to the interests of another party (call him "Mr. B") whose well-being depends on Mr. A's actions but who cannot perfectly control or monitor Mr. A's actions due to Mr. A's superior information. For example, Mr. A might be a corporate manager with an incentive to consume

perquisites to the detriment of Mr. B, a stockholder of the firm. In our context, Mr. A is a bank owner or manager and Mr. B is the FDIC. Mr. A may have incentive to make speculative investments which, if they succeed, will benefit the bank, but whose cost if they fail will accrue to the FDIC.

<sup>12</sup> FIRREA grants authority to the FDIC to select some classes of uninsured depositors and creditors to protect fully while providing only pro rata payments to other classes, payments based on estimates of what these groups would have been entitled to in a liquidation. The FDIC is using this authority to withhold full protection from nondeposit creditors and, in special circumstances, certain classes of uninsured depositors. The impact of this new authority on market discipline is discussed in Chapter III.

<sup>13</sup> Testimony of Alan Greenspan before The United States Senate Committee on Banking, Housing & Urban Affairs, July 12, 1990.

<sup>14</sup> A more complete discussion of market value accounting is contained in Chapter XI.

<sup>15</sup> The statutory capital requirements are minimum levels acceptable for a well-run bank. Riskier or more poorly-run banks can, in theory, be required to hold additional capital.

<sup>16</sup> Exceptions are made for affiliations that existed prior to the enactment of the Bank Holding Company Act in 1956, and for those allowed by subsequent amendments or as permitted by the Federal Reserve Board under Reg. Y (12 CFR 225.22).

<sup>17</sup> In 1992 the European Community will authorize commercial banks in all member nations to operate under a Single Banking License which will permit banks to conduct in any member nation any banking activities permitted by their home country authorities.

<sup>18</sup> Banking and economic developments during this period are summarized in Federal Deposit Insurance Corporation, Deposit Insurance in a Changing Environment (Washington, D.C.: Federal Deposit Insurance Corporation, 1983), pp. I-4 - I-6.

<sup>19</sup> Golembe, Carter H., and Holland, David S. Golembe Associates Inc., Washington, DC, 1985 Federal Regulation of Banking 1986-87.

<sup>20</sup> To save space, the term "S&L" is used in preference to "FSLIC-insured thrift."

<sup>21</sup> See R. Dan Brumbaugh, Jr. and Andrew S. Carron, "Thrift Industry Crisis: Causes and Solutions," Brookings Papers on Economic Activity, 2:1987, p. 353.

<sup>22</sup> Ibid., p. 354.

<sup>23</sup> See R. Dan Brumbaugh, Jr., Thriffs Under Seige, Bollinger Publishing Co., Cambridge, Massachusetts, 1988. Brumbaugh's Table 2.8, p. 52, indicates that FSLIC-insured institutions had assets of \$651 billion at year-end 1981. Table 2.7, p. 50, indicates these institutions had a market value net worth of -17.3 percent of assets, or -\$113 billion.

<sup>24</sup> Alan S. McCall and Ronald A. Auerbach, "Permissive Accounting Practices Inflate Savings and Loan Industry Earnings and Net Worth," Issues in Bank Regulation (Summer 1985), pp. 17-21.

<sup>25</sup> For a chronology of the S&Ls' regulatory capital requirement see James Barth and Michael Bradley, "Thrift Deregulation and Federal Deposit Insurance," Federal Home Loan Bank Board Research Paper #150, November, 1988, pp. 14-20.

<sup>26</sup> From Office of Thrift Supervision monthly data.

<sup>27</sup> Ibid. Fully-phased-in requirements are those effective December 31, 1994, after all transition periods granted by FIRREA expire.

<sup>28</sup> These figures are from various issues of the FDIC's annual publication Statistics on Banking.

<sup>29</sup> See "Farm Bank Problems and Related Policy Options," FDIC Staff Study, February 1986.

<sup>30</sup> For further detail, see Maureen Prowley, "Playing Texas Roulette: Understanding the High-Risk Characteristics of these Commercial Banks," Senior Honors Thesis, College of the Holy Cross, 1990; and John P. O'Keefe, Causes and Consequences of the Texas Banking Crisis, FDIC Banking Review, Vol. 3, No. 2.

<sup>31</sup> Office of the Comptroller of the Currency "An Evaluation of the Factors Contributing to the Failing of National Banks: Phase II," Quarterly Journal, Vol. 7, No. 3, p. 12.

<sup>32</sup> This legislation is described more fully in Chapter XVI.

<sup>33</sup> Federal Home Loan Bank Board 1988 Annual Report, Washington, D.C., 1989.

<sup>34</sup> For further discussion see John F. Bovenzi and Maureen Muldoon, "Failure Resolution Methods and Policy Considerations,"

FDIC Banking Review Vol. 3, No. 1 and Stanley C. Silverberg, "Can Losses be Imposed on Depositors in Large Bank Failures?."

<sup>35</sup> 51 Federal Register 15,306.

<sup>36</sup> For further information see Lynn Nejezchleb and R. William Morgan, "A Report Card on Capital Forbearance at Commercial Banks," Preliminary Draft Report, March 1990.

<sup>37</sup> The Federal Deposit Insurance Act prohibits the FDIC from purchasing common or voting stock of an insured depository institution. This prohibition does not apply to bridge bank stock.

<sup>38</sup> If a secured liability of the bank is a deposit, then the liability is protected to at least \$100,000 regardless of the value of the underlying collateral.

<sup>39</sup> Even in these situations the FDIC need not pay off a bank if it finds the bank is "essential" to its community.

<sup>40</sup> In a P&A deposits are assumed by the acquirer, and deposit accounts automatically pass to the acquirer. In an insured deposit transfer the acquirer is technically acting as the FDIC's paying agent. Within a specified time after the transfer, depositors must notify the acquirer that they wish to retain their accounts with the acquirer. This reduces somewhat the core deposits the acquirer is likely to be able to retain. It is difficult if not impossible to measure the effect on the premiums paid by acquirers due to this difference in difficulty of retaining core deposits. This is because difference in premiums between two failure resolution transactions reflects the differences in the franchise values of the institutions. Moreover, institutions whose failures are handled as P&As are likely to have considerably more franchise value than those handled as insured deposit transfers.

<sup>41</sup> It is important to note that a higher premium paid by the acquirer in a P&A does not necessarily mean that the P&A would be cheaper to the FDIC than an insured deposit transfer. In fact, as described in Chapter III, the additional premium would normally not be sufficient to offset the extra cost of covering uninsured deposits, so that an insured deposit transfer could often be cheaper to the FDIC than a P&A.

<sup>42</sup> For further discussion see "Asset Disposition in Bank Failures: Theory and Practice," by John Bovenzi, George French, and Arthur Murton, in Banking System Risk: Charting a New Course, Proceeding of 1989 Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago.

<sup>43</sup> See Table 5 of Chapter X. The 15 cent figure is obtained by dividing the total loss reserve for all banks in the table by the total assets. For further discussion and analysis, see Bovenzi, John F. and Murton, Arthur J. "Resolution Costs of Bank Failures" FDIC Banking Review, Fall 1988, Vol. 1, No. 1.

<sup>44</sup> This figure includes some large bank failure transactions in which the acquirer serviced assets under contract to the FDIC. The term "whole-bank" P&A usually refers to transactions in which the FDIC has no ongoing contractual relationship with the acquirer.

## **Chapter II**

### **CAPITAL ADEQUACY**

#### **A. Introduction**

Chapter II focuses on strengthening the role of capital in ensuring the stability of the banking industry. This chapter is organized in the following manner: Section B reviews the purposes and benefits of depository institution capital; Section C provides some perspectives on bank capital ratios; Section D discusses recent and continuing efforts to establish common "risk-based" capital requirements across industrialized nations; Sections E and F analyze two proposals for further changes in capital rules--increasing the minimum capital ratio and increasing reliance on subordinated debt; and Section G compares risk-based capital standards with risk-based premiums.

At the outset it should be emphasized that the issues of capital adequacy and prompt corrective action or closure of capital-impaired institutions are closely, even inextricably, related. Thus, the connections between this chapter and Chapter X are considerable.

#### **B. Purposes and Benefits of Capital**

In a private, competitive market economy, the primary purpose of capital is to cushion both equity owners and debtholders from unexpected losses. Debtholders are protected by the "equity cushion" that must be exhausted before the firm's losses eat into their principal. Equity holders are protected in the sense that, in a world where bankruptcy is costly, substantial equity reduces the probability that bankruptcy will occur.

The existence of the federal safety net for depository institutions increases the importance of capital, since the safety net adds taxpayers to private debtholders as potential losers if an institution fails. Adequate capital holdings by depository institutions therefore have the following positive benefits: (1) lowers the probability of bank failure; (2) reduces the incentive to take excessive risk; (3) acts as a buffer in front of the insurance fund and the taxpayer; (4) reduces the misallocation of credit caused by the safety net subsidy; (5) helps avoid "credit crunches;" and (6) increases long-term competitiveness.

Of course, firms can and do still fail even if they have substantial capital cushions, and thus capital is not by itself sufficient to protect taxpayers and debtholders--strong supervision and risk-related insurance premiums are also important. However, the "market discipline" exerted by owners with major portions of their own wealth at stake is significant and is, in a very real sense, the first line of defense against failure and excessive risk taking.

### **1. Adequate Capital Lowers the Probability of Bank Failure**

The primary purpose of a firm's capital is to cushion both its equity owners and its debtholders, and thus taxpayers, from unexpected losses. The more capital a depository institution has, the more it can withstand unexpected losses without becoming insolvent. Capital therefore makes banks safer and decreases the likelihood of failure, by giving a bank and its regulator time to work through problems. The benefit to existing shareholders of sufficient capital is to help ensure that they will retain control of the firm, even if unexpected shocks deplete the firm's profits.

### **2. Reduces Incentives to Take Risks**

The combination of low capital and federally insured deposits creates a "moral hazard" problem. Owners with little of their own money at stake have an incentive to take risk with a virtually unlimited supply of funds. This incentive exists because gains from excessive risk taking accrue to the depository institution owners, but losses, if they exceed capital, are shared with (or put to) the firm's debtholders, the insurance funds, and then the owners of the safety net (taxpayers).<sup>1</sup>

Other things equal, then, a larger capital cushion means that an institution's owners must lose more of their own funds before losses are imposed on debtholders or taxpayers. Therefore, owners with a significant amount of their own funds at stake have a powerful incentive to control the amount of risk their bank incurs. Some argue, however, that higher capital requirements may increase risk taking as bank owners attempt to maintain a desired rate of return on equity. (For further discussion, see Section E below.)

### **3. Acts as a Buffer Ahead of the Insurance Funds and the Taxpayer**

When banks fail, every dollar in losses absorbed by capital is one less dollar absorbed by the FDIC or the taxpayer. From the perspective of the insurer, capital serves as a "deductible" for bank owners to suffer losses first, just as a car owner suffers losses on his or her deductible before the insurance company pays.



#### **4. Reduces Misallocation of Credit Caused by the Safety Net**

Large direct losses to taxpayers are not the only potential costs imposed on the broader society by capital-impaired, and even insolvent, depositories that are allowed to remain open. A misallocation of credit and distorted competitive incentives also result from the behavior of such institutions. Allowing troubled institutions to remain open, to continue deposit-taking activities backed by federal guarantees, and even to make new loans circumvents the market mechanism whereby scarce funds are shifted out of a low profit, or even an unprofitable, sector of the economy and into more productive investments. The federal guarantee deters depositors from withdrawing their funds, and the moral hazard incentive encourages troubled depositories to make new and even riskier loans. This tilt in the allocation of society's scarce resources can be significant when the number or size of weak depositories is large.<sup>2</sup>

It is often alleged that the administrators of the safety net, depository institution regulators and elected officials, have strong incentives to forbear in imposing strong sanctions on or closing capital-deficient institutions.<sup>3</sup> To the extent that regulatory and political forbearance retard the flow of investment funds out of unprofitable sectors, then loan interest rates will tend to be lower than otherwise in those sectors, and higher than otherwise in healthy sectors. If troubled institutions begin to pay higher deposit rates in order to attract even more funds, or perhaps because of market pressures, then competitive incentives become even more distorted as healthy institutions are forced to raise their deposit rates.<sup>4</sup>

Capital can be viewed as playing a supporting role in reducing the market distortions caused by the safety net. Adequate capital lowers the moral hazard incentive and imposes greater market discipline on managers. Managers wanting to expand their institutions must convince investors that the expected returns justify the commitment of risk capital.

#### **5. Helps to Avoid "Credit Crunches"**

In an economic downturn, a poorly-capitalized institution that suffers losses is more likely to restrict credit in an effort to shrink so as to build capital ratios. A well-capitalized institution can afford more losses and yet continue to lend in the same circumstances. Thus, adequate capital should help keep credit flowing even during economic downturns.

#### **6. Increases Long Term Competitiveness**

Since capital helps ensure a bank's long run viability by lowering its likelihood of failure, it helps an institution to develop and maintain long term customer relationships. Capital

also aids in providing the time (by absorbing losses) and the financial resources to respond to positive, as well as negative, changes in the economic environment.

On balance, the overwhelming view among economists and finance experts is that substantial capital significantly reduces both the probability of failure and the moral hazard of deposit insurance, and thus provides as well the other, secondary benefits discussed.<sup>5</sup>

### **C. Bank Capital Ratios in Perspective**

#### **1. Historical Trends**

It is clear that equity capital ratios in the U.S. banking industry are, despite some success in raising them in recent years, at the low end of their broad historical range. This is seen in Figure 1, which gives the book-value asset-weighted average equity to assets ratio for the banking industry from the 1840s through the 1980s.<sup>6</sup>

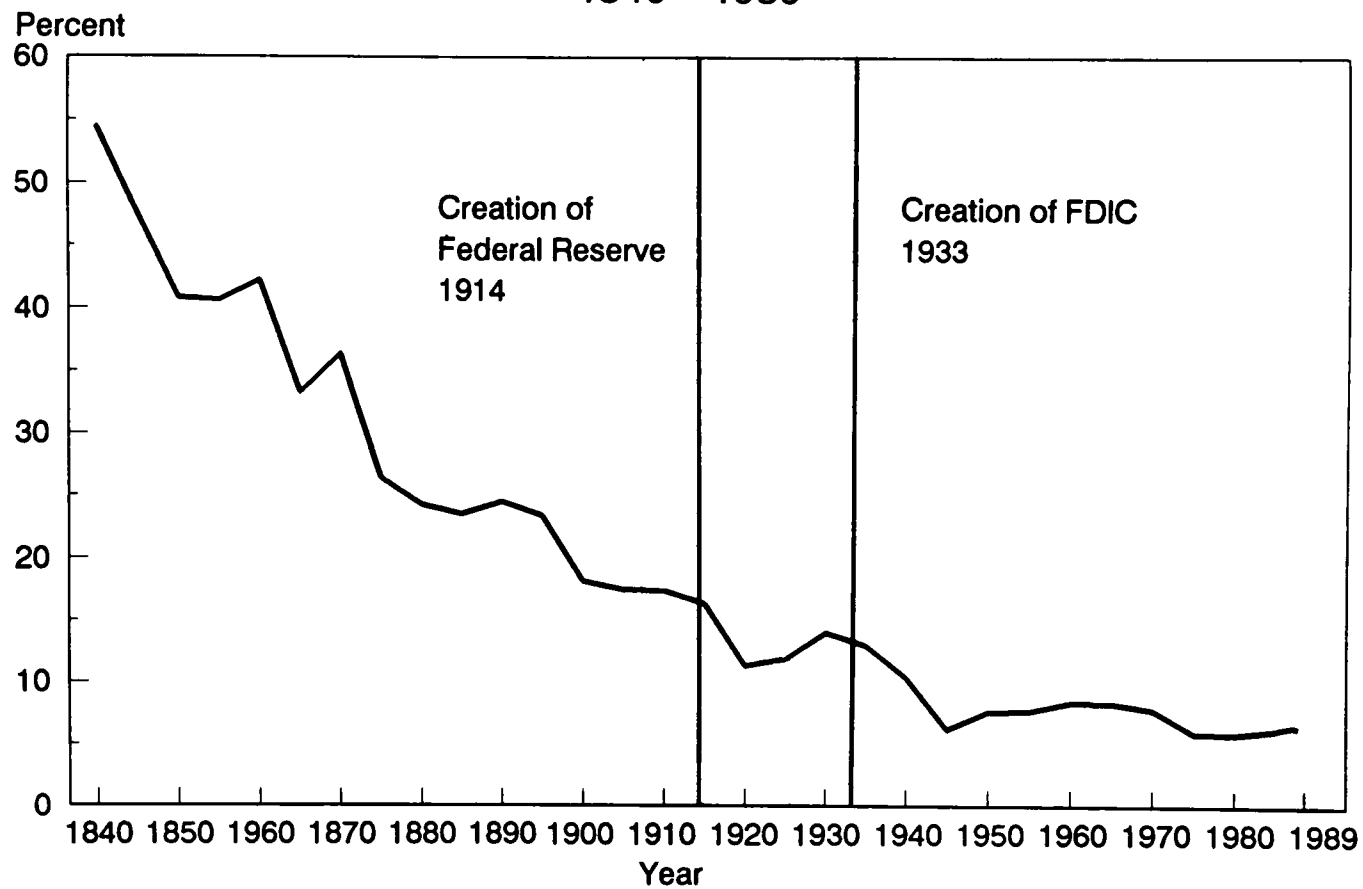
While the world has obviously changed radically over the last 150 years, and care must be exercised when using such a long time series, the chart is suggestive. Over the last 150 years the aggregate capital ratio of the banking system has generally declined from a high of over 50 percent in the 1840s to its current levels of well under 10 percent. Contemporary levels are 1/6th the levels of the mid-1800s, and are less than one-half the level some 50 years ago.

Capital ratios were declining long before creation of either the Federal Reserve System or the FDIC. Indeed, much of the decline both before and after the creation of the safety net no doubt reflects the growing efficiency of the U.S. financial system. Nevertheless, the federal safety net is most likely a key factor in explaining why bank capital ratios can remain near their current levels without weakening public confidence in the banking system. It is difficult to believe that many banks and thrifts operating over recent decades could have expanded their assets so much, with so little additional investment by their owners, were it not for the depositors' perception that, despite the relatively small capital buffer, their risks were minimal. Furthermore, the moral hazard problem has surely given many owners the incentive let their firms grow without a corresponding increase in their capital cushion.<sup>7</sup>

#### **2. Capital Holdings by Institutions Not Under the Safety Net**

Additional perspective on this point is provided by a comparison of bank and bank holding company (BHC) capital ratios with those of financial service firms not accorded safety net

Figure 1  
Equity as a Percent of Assets  
For All Insured Commercial Banks\*  
1840 - 1989



\*Ratio of aggregate dollar value of bank book equity to aggregate dollar value of bank book assets.

Source: Statistical abstract through 1970.  
Report of condition thereafter.

protection. For example, Boyd and Graham (1988) report that, from 1971 through 1984, the median capital to asset ratio for a sample of BHCs was 5.8 percent; compared to 20.1 percent for a sample of securities firms, 20.6 percent for life insurance companies, and 22.1 percent for property/casualty insurers.

More recent data, provided in Table 1, compares median capital to asset ratios over the 1980s at the 50 largest banks, and samples of publicly-traded national BHCs, securities brokers and dealers, life insurance companies, property and casualty insurance firms, short-term business credit companies, and personal credit companies.<sup>8</sup> While care must be taken in interpreting these data, it is striking that the capital ratio (based on book values) is always substantially smaller for the banks and BHCs.<sup>9</sup> Indeed, it seems reasonable to suggest that these large differences derive, in part, from differences in safety net protection.

### **3. Bank Capital by Asset Size Class**

A final perspective on bank capital is given in Table 2, which provides selected statistical data for all insured commercial banks by asset size class, as of December 31, 1989. The last row of Table 2 shows average bank equity capital ratios by size class of bank. Clearly, bank capital ratios generally fall as asset size increases. Indeed, as a percent of total assets, average equity capital at the largest 25 banks (4.8 percent) at the end of 1989 was only 57 percent of that at the average bank in the smallest size class (8.42 percent).

These differences may reflect in part the higher incidence of failure at smaller banks, despite their relatively higher capital ratios, due to risks associated with higher asset and geographic concentrations. In short, since smaller banks have not generally been viewed as "too-big-to-fail," their owners may have felt such banks needed a relatively large capital cushion to help ensure their long run existence.

### **D. Risk-Based Capital**

In July 1988, the central bank governors of the G-10 countries endorsed a system of risk-based capital guidelines for banking organizations under their jurisdiction.<sup>10</sup> This so-called Basle Accord is currently in its phase-in period and will be fully phased-in by December 31, 1992.

#### **1. Purposes of Risk-Based Capital**

The primary purposes of the Basle Accord's risk-based capital guidelines are to: (1) make regulatory capital requirements sensitive to differences in risk profiles among

**Table 1**  
**Median Equity-to-Total Assets Ratios\***

(In percent)

Year	50 largest banks	Large national bank holding companies	Securities brokers and dealers	Life insurance	Property and casualty insurance	Short-term business credit companies	Personal credit companies
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1980.....	4.63	5.60	19.51	19.71	23.12	19.53	14.85
1981.....	4.64	5.67	24.49	21.06	24.20	20.42	14.71
1982.....	4.62	5.70	17.89	20.69	24.42	22.28	15.32
1983.....	4.73	5.72	28.92	19.92	23.08	20.42	14.22
1984.....	4.96	5.83	21.63	18.26	20.48	19.66	12.66
1985.....	5.16	5.94	19.94	15.44	16.85	19.16	12.34
1986.....	5.24	6.01	18.04	14.62	22.98	20.73	12.51
1987.....	4.90	6.03	23.41	13.40	21.91	17.04	14.26
1988.....	5.43	6.21	26.41	12.67	20.51	16.07	13.49
1989.....	5.00	6.27	19.69	12.37	22.29	13.76	13.30

\*In order to make the nonbank equity definition more comparable to that of banks, the value of redeemable preferred stock has been subtracted from nonbank equity.

Sources: Data in column (1) are from bank call reports. All other data are for publicly-traded firms and are from Standard and Poor's Compustat Service, Inc.

**Table 2**  
**Selected Statistical Data on All Federally Insured Commercial Banks Classified by Asset Size**

(As of December 31, 1989)

(In millions of dollars)

	Less than \$300 million	\$300 million- \$1 billion	Greater than \$1 billion except top 25	Top 25	Total
Number of institutions.....	11,741	588	352	25	12,706
Total assets.....	\$693,994	\$297,811	\$1,278,580	\$1,028,919	\$3,299,304
Total domestic deposits.....	\$613,083	\$245,676	\$899,426	\$478,294	\$2,236,479
Nondeposit liabilities.....	\$21,991	\$28,361	\$262,907	\$189,280	\$502,539
Equity capital as a percent of total assets.....	8.42	7.10	5.98	4.80	6.22

Source: Bank call reports.

banking organizations; (2) take off-balance sheet exposures into explicit account in assessing capital adequacy; (3) minimize disincentives to hold liquid, low-risk assets; (4) foster coordination among supervisory authorities from major industrial countries; and (5) reduce international competitive inequities due to differences in capital policy.<sup>11</sup>

The risk-based capital guidelines assign on- and off-balance sheet items to one of four risk categories. Each category is given a risk weight, equal to 0, 20, 50, or 100 percent, depending upon the perceived credit risk of a given class of assets. Risk-weighted assets is defined as the sum of the dollar values of on- and off-balance sheet items in each category multiplied by a given category's risk weight. This risk-weighted assets measure is the denominator in the risk-based capital ratios established by the Basle Accord.

## **2. Components of Risk-Based Capital**

The Accord establishes two types of "qualifying" capital, and defines minimum capital to risk-weighted assets ratios. Under the implementing guidelines adopted by U.S. authorities, Tier 1, or "core," capital must represent at least 50 percent of a bank's total qualifying capital, and consists primarily of common stockholders' equity, certain types of perpetual preferred stock, and minority interest in the equity accounts of consolidated subsidiaries, less goodwill.

Tier 1 capital may be thought of as a close approximation to pure, tangible equity that is available to absorb unexpected losses. Thus, when Tier 1 capital is exhausted, a firm is, for all practical purposes, insolvent. Under the U.S. implementing guidelines, Tier 2, or "supplementary," capital consists primarily of a limited amount of loan loss reserves, certain types of perpetual preferred stock not included in Tier 1 capital, intermediate-term preferred stock, and term subordinated debt.<sup>12</sup>

Tier 2 capital, while it also stands between owners and depositors (and the FDIC), includes more debt-like characteristics than does the core capital in Tier 1. For example, various elements of Tier 2, such as subordinated debt, are subject to loss only after Tier 1 capital has been exhausted. The maximum amount of Tier 2 capital that may be included in an organization's qualifying total capital is limited to 100 percent of Tier 1 capital.

## **3. Minimum Capital Requirements**

At the end of 1992, the minimum risk-based capital standard for banks of Tier 1 capital to risk-weighted assets is 4.0 percent; and the minimum standard of total (Tier 1 plus Tier 2)

capital to risk-weighted assets is 8.0 percent. Elements of Tier 1 and Tier 2 capital are generally measured on an historical cost basis.

In December 1989 the Office of Thrift Supervision (OTS) adopted a set of risk-based capital guidelines for thrift institutions that closely parallel those for commercial banks.<sup>13</sup> This was, in part, a response to FIRREA, which mandated that thrift capital standards generally must be no less stringent than those that apply to national banks, with a few permissible statutory deviations. As with the bank standard, the risk-based capital ratios for thrifts will be fully phased-in by the end of 1992. To date, the National Credit Union Administration has not adopted a comparable risk-based capital standard for credit unions.<sup>14</sup>

In addition to minimum risk-based capital requirements, all of the federal bank regulatory agencies and the OTS have either adopted, or have announced their intention to adopt in the near future, a minimum three percent total leverage ratio of Tier 1 capital to adjusted total (not risk-weighted) assets. The agencies have required or will require any institution operating at or near the three percent minimum to have well-diversified risk, including no undue interest rate risk exposure, excellent asset quality, high liquidity, good earnings and, in general, be considered a strong organization with the highest possible supervisory rating. Indeed, banks and thrifts that have not received the highest supervisory rating are expected to maintain leverage ratios of at least 100 to 200 basis points above the three percent minimum.

#### **4. Interest Rate Risk**

The three percent minimum leverage ratio was adopted partly in recognition that the risk-based guidelines are not, as currently specified, sufficient in all cases to ensure the capital adequacy of banks and thrifts. For example, interest rate risk is not currently incorporated in the risk-based guidelines. There has been no systemwide method for bank regulators to monitor interest rate risk, and no established method for adjusting capital to reflect that risk. An interest rate risk component is clearly an area that could lead to substantial improvements in the risk-based capital standard.

Progress is being made in this area. In December 1990, the OTS issued for public comment a proposal for monitoring and measuring interest rate risk.<sup>15</sup> The OTS's proposal focuses on the estimated change in the market value of an institution's portfolio of assets, liabilities, and off-balance sheet instruments when interest rates change.<sup>16</sup> In addition, bank supervisors from a dozen countries are working under the aegis of the Bank for International Settlements (BIS) to develop a

detailed interest rate risk measurement system and capital standard for internationally-active banks. U.S. bank regulators are currently developing a less extensive measurement system that would identify banks with exceptionally large interest rate risk positions. Once identified, such banks would be required to maintain additional capital.

## **5. Potential Effectiveness of Risk-Based Capital**

As just noted, the risk-based standards promulgated by the bank and thrift regulatory agencies are limited attempts to make bank and thrift capital costs sensitive to risk. But to criticize risk-based capital as imperfect probably misses the point. The key question is whether the risk-based system can be expected to do a better job of protecting the insurance funds and controlling moral hazard than the old system of essentially fixed minimum capital ratios that included loan loss reserves in its definition of "primary" capital.

This issue is addressed in a recent study of commercial banks by Avery and Berger (1990). These authors attempt to estimate the extent of statistical correlation between measures of bank risk--bank earnings, earnings variability, nonperforming loans, loan charge-off rates, and bank failure--with variables representing the extent to which banks conform to the risk-based capital standards and the previous capital standard.

Statistical models are estimated for both relatively small (total assets less than \$250 million) and relatively large banks over the period from 1982 through 1989. The results strongly suggest that the new risk-based capital standards are better predictors of problem banks than are the old capital rules. Also, this and other research indicate that bringing off-balance sheet items into the risk-based capital computation helps to identify relatively risky banks in advance of their imposing losses on the FDIC.<sup>17</sup>

### **E. Responding to Arguments Against Increased Capital**

This section discusses increasing the level of the minimum capital ratio in order to increase market discipline on insured depositories, and increase the capital cushion of protection for the FDIC. Section F considers another possible way of achieving this objective through increasing reliance on subordinated debt.<sup>18</sup> A third way, prompt corrective action or timely closure of capital impaired depositories, is discussed in Chapter X.<sup>19</sup>

Increasing the minimum required capital ratio may be viewed as a way of increasing the "insurance deductible" in federal deposit insurance. This shifting of risk to the private sector could be expected to have a number of benefits, all of which were



Table 3

## Banks That are Estimated Not to Meet Increased Risk-Based Capital Standards

(As of June 30, 1990)

Number Not Meeting/Number of Banks

Percent of Total Assets

Total Capital Deficiency

(In millions of dollars)

Asset size class	4% Tier 1	5% Tier 1	6% Tier 1	7% Tier 1	8% Tier 1
	8% total	9% total	10% total	11% total	12% total
	(1)	(2)	(3)	(4)	(5)
\$0-\$25 .....	123/3,557	159/3,557	242/3,557	367/3,557	504/3,557
Percent.....	4	5	7	11	15
Amount.....	\$59	\$70	\$91	\$124	\$171
\$25-\$50 .....	94/3,196	143/3,196	230/3,196	387/3,196	602/3,196
Percent.....	3	4	7	12	19
Amount.....	\$96	\$117	\$159	\$235	\$359
\$50-\$100 .....	66/2,737	121/2,737	224/2,737	392/2,737	606/2,737
Percent.....	2	4	8	15	23
Amount.....	\$130	\$169	\$250	\$406	\$660
\$100-\$500 .....	93/2,378	218/2,378	398/2,378	653/2,378	922/2,378
Percent.....	4	11	19	31	43
Amount.....	\$398	\$660	\$1,219	\$2,108	\$3,383
\$500-\$1,000 .....	25/243	53/243	87/243	128/243	161/243
Percent.....	10	22	36	52	66
Amount.....	\$134	\$344	\$722	\$1,306	\$2,059
\$1,000-\$5,000 .....	30/263	70/263	138/263	172/263	205/263
Percent.....	14	31	59	71	83
Amount.....	\$723	\$1,872	\$4,053	\$7,219	\$10,882
\$5,000-\$10,000 .....	14/60	29/60	46/60	51/60	56/60
Percent.....	25	49	78	85	93
Amount.....	\$1,115	\$2,513	\$4,900	\$7,910	\$11,123
Greater than \$10,000 .....	19/45	29/45	41/45	43/45	43/45
Percent.....	52	72	95	98	98
Amount.....	\$10,108	\$18,453	\$29,082	\$40,871	\$52,769
Total .....	464/12,479	822/12,479	1,406/12,479	2,193/12,479	3,099/12,479
Percent.....	27	44	64	71	77
Amount.....	\$12,762	\$24,198	\$40,476	\$60,178	\$81,407

Note: The 1992 risk-based capital standards are applied to June 30, 1990 call report data.

Source: Federal Reserve Board.

Table 4

## Savings and Loans That are Estimated Not to Meet Increased Risk-Based Capital Standards

(As of June 30, 1990)

Number Not Meeting/Number of S&amp;Ls

Percent of Total Assets

Total Capital Deficiency

(In millions of dollars)

Asset size class	4% Tier 1 8% total	5% Tier 1 9% Total	6% Tier 1 10% total	7% Tier 1 11% total	8% Tier 1 12% total
	(1)	(2)	(3)	(4)	(5)
\$0-\$25 .....	41/238	42/238	51/238	56/238	65/238
Percent.....	18	19	22	25	28
Amount.....	\$19	\$23	\$27	\$32	\$37
\$25-\$50 .....	83/366	95/366	113/366	137/366	161/366
Percent.....	23	27	31	38	44
Amount.....	\$104	\$122	\$144	\$171	\$202
\$50-\$100.....	155/523	192/523	215/523	241/523	275/523
Percent.....	30	37	41	46	53
Amount.....	\$266	\$338	\$423	\$517	\$625
\$100-\$500.....	319/790	371/790	416/790	465/790	497/790
Percent.....	41	48	54	60	64
Amount.....	\$1,892	\$2,346	\$2,862	\$3,439	\$4,057
\$500-\$1,000.....	62/121	73/121	79/121	88/121	93/121
Percent.....	50	60	64	72	77
Amount.....	\$1,193	\$1,470	\$1,779	\$2,119	\$2,494
\$1,000-\$5,000 .....	86/123	92/123	94/123	97/123	105/123
Percent.....	71	76	77	79	86
Amount.....	\$6,054	\$6,970	\$7,961	\$9,005	\$10,095
\$5,000-\$10,000 .....	12/15	13/15	13/15	13/15	13/15
Percent.....	78	88	88	88	88
Amount.....	\$2,756	\$3,155	\$3,558	\$3,961	\$4,365
Greater than \$10,000.....	8/10	9/10	9/10	9/10	9/10
Percent.....	83	93	93	93	93
Amount.....	\$5,245	\$6,541	\$7,927	\$9,338	\$10,748
Total .....	766/2,186	887/2,186	990/2,186	1,106/2,186	1,218/2,186
Percent.....	65	72	74	77	80
Amount.....	\$17,528	\$20,965	\$24,682	\$28,581	\$32,623

Note: The 1992 risk-based capital standards are applied to June 30, 1990 data. Thrifts in or targeted for conservatorship are excluded. Investments in subsidiaries deducted from assets and capital.

Source: Office of Thrift Supervision.

discussed earlier in this chapter. It should be stressed that any increase in capital requirements would be accompanied by a substantial transition period to avoid adverse effects on the economy.

One way of increasing minimum bank capital requirements would be to raise the Basle Accord's minimum risk-based capital ratios.<sup>20</sup> Tables 3 and 4 show estimated effects of one way of raising risk-based capital requirements--increasing the Tier 1 requirement from the fully phased-in level of 4 percent to 8 percent in one percentage point intervals (the Tier 1 plus Tier 2 standard rises from 8 percent to 12 percent, and the 3 percent minimum total leverage ratio is held constant). Data are displayed by asset size class, column 1 gives estimates for the current (4/8) standard, and the remaining columns show the potential effects of progressively higher standards. Each cell of the table shows: (i) the number of banks or savings and loans (S&Ls) in the cell that would not pass the standard; (ii) the total number of institutions in the cell; (iii) the percent of total bank or S&L assets in the cell that are in institutions that would not pass the standard; and (iv) the dollar amount of capital that banks or savings and loans that would not pass the standard would have to raise to meet the standard.

For example, the >10,000 row of column 3 in Table 3 shows that if a 6 percent Tier 1 and 10 percent total capital standard were in place in June 1990, 41 of the 45 largest banks would fail the standard. These 41 banks hold 95 percent of the largest banks' assets and the aggregate capital shortfall of the largest banks is estimated to be \$29 billion.

It should be emphasized that the estimates in Tables 3 and 4 must be interpreted with some care because they allow for no portfolio adjustments by depositories in response to increased capital requirements. That is, the estimates in the tables assume a constant depository size and portfolio composition as of June 1990. In addition, many BHCs whose banks have capital ratios below the 1992 minimums have consolidated BHC capital ratios above the minimums. This suggests that a redeployment of existing BHC capital can, at least in some cases, assist subsidiary banks in meeting the risk-based minimums. For all these reasons, the results should be considered high-side estimates of the potential impact of higher standards.<sup>21</sup>

The results displayed in Table 3 suggest some interesting conclusions. First, it is estimated that 464 banks (column 1), or 3.7 percent of the total, would not pass the current 4/8 capital standard. Not surprisingly, the incidence of banks not meeting the standard is highest at the largest firms. Overall, it is estimated that banks will need to raise some \$13 billion in capital to meet the 1992 Basle standard, almost 5 percent of current Tier 1 plus qualifying Tier 2 capital (\$259.0 billion).

It should be noted however, that 93 percent of the \$13 billion deficit consists of (relatively lower cost) Tier 2 capital.

Raising the standard to 5 percent Tier 1 and 9 percent total (column 2) increases by three-quarters (from 464 to 822) the total number of banks that would not meet the standard. The percentage increases in the number of banks with capital deficiencies are smallest in the largest size class and the smallest two size classes. This is because the largest size class already has many banks that do not meet the Basle standard, and in the smallest size classes many banks now hold capital substantially in excess of minimum risk-based requirements. In the 5/9 experiment, the estimated aggregate capital deficit (last row) is some \$24 billion, or about 9 percent of current Tier 1 plus qualifying Tier 2 capital.

As capital requirements increase toward 8 percent Tier 1 and 12 percent total capital, the increase in the number of banks that would not meet the standard is fairly uniform, except for the largest size class, where nearly all banks would not pass by the 6/10 standard. Indeed, most smaller banks currently have sufficient capital to pass the 8/12 standard.

It is not until the \$500 million to \$1 billion asset size class that more than half of the banks fail this high standard. In part this is because most smaller banks have little or no off-balance sheet activities, and many have portfolios that are rich in assets that have low risk weights. Of course, they also tend to have higher ratios of equity to total assets. Overall, the \$40 billion aggregate capital deficiency for the 6/10 standard is fairly large, 16 percent of current capital. Most of this deficiency is in the largest size class, which has an estimated shortfall of \$29 billion.

Column 1 of Table 4 shows that an estimated 766 savings and loans, or 35 percent of all savings and loans that are not either currently in conservatorship or targeted by the OTS for conservatorship would, as of June 1990, not meet the current 4/8 capital standard. While the incidence of institutions not meeting the standard is, as is the case with banks, highest at the larger savings and loans, the percentage of thrifts not meeting the standard is considerably higher than that at banks for all size classes.

The estimated aggregate capital deficiency at thrifts for the current standard is \$17.5 billion, some 52 percent of their current \$33.9 billion of Tier 1 plus qualifying Tier 2 capital. From these data alone it seems clear that many thrifts will have a difficult time meeting the current standard, much less a higher one. For example, if a 6/10 standard were adopted, it is estimated (column 3) that 45 percent of thrifts would not meet the standard, and the aggregate capital deficiency would rise

about \$7 billion to \$24.7 billion. In contrast, this is 61 percent of the estimated aggregate bank capital deficiency (column 3 of Table 3) of \$40 billion for a 6/10 standard, which an estimated 11 percent of banks would not pass.

Still, there are some thrifts that would meet higher risk-based capital requirements, even a standard as high as 8/12. As is the case with banks, the incidence of such thrifts is highest in the lower size classes.

Opponents of increased capital ratios cite four principal concerns: (1) it would be very difficult and costly for many U.S. banks and thrifts to raise more capital; (2) higher capital requirements for U.S. depositories would hurt their domestic and international competitive positions; (3) at some institutions increased capital requirements may actually increase the incentive to take risks as these institutions seek to maintain a desired return on equity; (4) asset growth at insured depositories would be slowed, thus engendering macroeconomic effects comparable to the implications of contractionary monetary policy; and (5) consolidation of the U.S. banking industry would be accelerated. Each of these arguments is discussed below. In addition, the issue of the appropriate level of capital ratios is addressed.

#### **1. Raising Additional Capital Would be Difficult and Costly**

One way of meeting higher capital requirements would be to issue new equity. An examination of the history of depository institution stock offerings gives some hint of the feasibility of this approach. A recent study by Berkovec and Liang (1990) found that since the late 1970s, the dollar volume of new equity issues by banking organizations has grown at a greater rate than the total dollar volume of new domestic issues by all domestic corporate firms. Moreover, the dollar volume of new equity issues in domestic markets by BHCs, as a percentage of both total assets and total equity, has increased since the late 1970s. In addition, the data shown in Table 5 indicates that new equity issues by banking firms over the 1980s have been fairly impressive. Annual levels of \$3 billion have not been uncommon.

However, annual issuance has been well below the aggregate levels estimated to be required by the experiments summarized in Table 3. In addition, the stock price of many BHCs has fallen precipitously in 1990, greatly complicating efforts to raise new equity capital in the near term. On balance, it would appear that while BHCs have the demonstrated ability to raise substantial amounts of new equity, it is also the case that any increased capital requirements above the Basle standards now being phased-in would probably also have to be phased-in over a significant period of time. The need for a substantial phase-in period is even more compelling for savings and loans.

Table 5

New Equity Issues and Equity Capital-To-Assets Ratios for All Banks and for 19 Large Bank Holding Companies,<sup>1</sup> 1970-1989

	All banking firms			19 large banking firms		
	New equity <sup>a</sup> (in millions of dollars)	Number of new equity issues	Equity capital- to-assets (percent)	New equity <sup>a</sup> (in millions of dollars)	Number of new equity issues	Equity capital- to-assets <sup>a</sup> (percent)
1970 .....	30.3	6	6.58	0	0	5.51
1971 .....	243.3	40	6.33	0	0	5.31
1972 .....	319.8	43	5.96	0	0	4.81
1973 .....	89.2	25	5.67	0	0	4.31
1974 .....	23.0	8	5.65	0	0	4.04
1975 .....	172.9	8	5.87	75.0	1	4.31
1976 .....	370.1	12	6.11	278.6	2	4.61
1977 .....	407.4	11	5.92	277.8	3	4.41
1978 .....	483.9	23	5.80	99.8	1	4.21
1979 .....	45.5	8	5.75	0	0	4.11
1980 .....	398.6	29	5.80	186.6	2	4.11
1981 .....	211.9	18	5.82	0	0	4.20
1982 .....	1,770.6	41	5.85	1,161.4	8	4.31
1983 .....	3,239.7	75	5.99	1,780.9	10	4.71
1984 .....	1,196.8	60	6.14	452.5	4	4.97
1985 .....	2,269.1	89	6.18	986.6	13	5.12
1986 .....	4,411.1	134	6.17	962.7	5	5.34
1987 .....	3,728.5	94	6.00	1911.13	10	4.81
1988 .....	1,239.0	11	6.27	637.8	4	5.33
1989 .....	3,208.1	29	6.20	2,415.0	12	5.12

<sup>1</sup> These are the bank holding companies that, over this period, are continuously in a bank sample followed by Salomon Brothers. The sample is a mix of both money center and regional institutions.

<sup>2</sup> Includes new equity issues in domestic markets. Data for 1970-87 are from Registered Offering Statistics, Securities and Exchange Commission. Data for 1988-1989 are from Federal Reserve Board staff.

<sup>3</sup> December call report data aggregated over all banks.

Source: Federal Reserve Board.

The need for a substantial phase-in period is reinforced by the argument that new issues of common equity can be expected, at least in the short run, to decrease the per share value of a firm's common stock. This is a standard result for nonfinancial firms, and has also been found in the few studies of the effect for banking organizations.<sup>22</sup>

The reasons for this effect are the subject of active debate in the economics and finance literature. One major explanation is the differential tax treatment of debt and equity. Interest on debt is tax deductible, while dividends on equity are not. Thus the substitution of equity for debt increases, other things equal, a firm's tax liability, thereby lowering the discounted value of its future after tax earnings, that is, the price of its shares.

Berkovec and Liang (1990) present models of the change in stock price that rely exclusively on this tax effect. For a small sample of large BHCs, they estimate that the price elasticity of the change in BHC stock prices with respect to a change in the stock of equity is essentially equal to minus the corporate tax rate. That is, an increase in a BHC's equity equal to 10 percent of the value of its initial equity could depress the equity's price by about 3.4 percent (assuming a corporate tax rate of 34 percent).

While the corporate tax deductibility of interest creates a bias in favor of debt financing, personal taxes may give some advantage to equity investments. Under current law, the top marginal tax rate for ordinary income is 31 percent, compared to 28 percent for capital gains. This gives some investors a preference for capital gains over ordinary income, and a corresponding preference for equity investments that generate capital gains. Thus the bias of the overall system toward corporate debt finance is reduced, and this may lower the loss from issuing new equity that would be projected based on the corporate tax effect alone.

Another hypothesis argues that equity issues may reveal information that managers have heretofore kept confidential about firm performance and/or investment opportunities. In theory this information could be good news, if, for example, investment opportunities are better than expected, or bad news, if, for example, managers think the firm's stock price is too high. The conventional view appears to be that equity issues are considered to be bad news about the firm, and hence prices will fall for reasons unrelated to leverage changes.

However, the practical importance of this effect for regulator-mandated increases in capital may well be minor, since the information revealing content of such an increase would seem to be small. This is especially the case if the same regulatory

standard were imposed on many banks or thrifts simultaneously. Some evidence in support of the view that the negative impact on stock prices is smaller at BHCs than at unregulated firms is found by Wansley and Dhillon (1989): "Announcements of the issue of common stock are associated with a significant negative effect, and the magnitude of this effect is similar to that found previously for utilities" (another regulated industry) "and smaller than that found for industrial firms."<sup>23</sup>

Increased capital may also decrease depository stock prices by reducing the implicit government subsidy to banks through the provision of federal deposit insurance. That is, higher capital ratios lower the value of the deposit insurance put option, which is clearly an asset to the bank or thrift, the value of which accrues to the owners of the firm. Of course, reducing the value of the deposit insurance subsidy would be a primary objective of increased capital standards, or any other deposit insurance reform.

#### **Positive Effects of Higher Capital on Stock Prices and the Cost of Debt**

In the long run, the effect of increased capital standards on depository stock prices may well be positive. As discussed earlier, increased capital is likely to be viewed as strengthening the long run competitiveness and viability of depository institutions. Even today it is often true that the most nationally and internationally competitive U.S. banking organizations are also the best capitalized, compared to banks of similar size. Furthermore, there is evidence that the best capitalized banks also tend to earn the highest returns on equity.

Even in the short run, a lower probability of failure would decrease expected bankruptcy costs and likely reduce the cost of uninsured debt. This should offset somewhat the negative effects of increased capital on both stock prices and the overall cost of capital. This latter possibility is often called the Modigliani-Miller effect, and refers to the argument that because a higher capital ratio lowers the risk of debtholder loss, the cost of debt should fall as the capital ratio rises.<sup>24</sup>

In banking there is some evidence that the interest rates paid on uninsured liabilities tend to rise with bank risk, at least at those banks not considered too-big-to-fail.<sup>25</sup> It seems likely that this pattern would become more pronounced if the deposit insurance subsidy were reduced. Indeed, in other sectors of the economy an inverse relation between risk and the cost of debt is well established. As discussed later in the subsection, this pattern appears to be increasingly the case with respect to interest rates paid by banking organizations on subordinated debt. Lastly, any other costs imposed on investors by low



capital ratios, such as the need to monitor depository risk-taking too intensely, would be reduced by higher capital ratios. Other things equal, such cost reductions to investors should stimulate investor demand for bank and thrift stocks.

## **2. Higher Capital Requirements Would Hurt U.S. Banks' International Competitiveness**

The potential impact of higher capital standards on the international competitiveness of U.S. depositories is extremely difficult to assess. Although the short run net impact on an institution's funding costs is ambiguous, in the long run there is likely to be a net positive effect. Even the current positions of U.S. depositories with respect to the 1992 Basle standards relative to the positions of their major foreign rivals is unclear.

The last time an international committee of bank supervisors assessed the situation (as of the end of 1989), it seemed likely that by the end of 1990 most G-10 banks, including the largest U.S. banks, would have achieved the final 1992 standards.<sup>26</sup> Based upon these comparisons, the capital positions of the largest U.S. banking organizations were generally in line with those of the other G-10 countries.

However, even this conclusion must be qualified. This is due to a number of differences across nations including reporting procedures, sample selection procedures regarding what banks were used in the test, and methods of calculation during the transition period to the full Basle standard. Finally, it should be emphasized that the general issue of competitiveness, both domestic and international, is not just a matter of capital standards, but of the entire system of laws, regulations, economic environment, and culture under which U.S. depositories operate. When viewed in this context, it would probably be a mistake to focus attention on capital requirements alone.

## **3. Higher Capital Requirements May Increase Risk Taking**

Some observers have argued that increasing capital requirements on insured depositories may cause them to increase their portfolio risk in order to maintain a desired rate of return on equity.<sup>27</sup> An additional argument is that the stockholders of large, publicly-traded depository institutions may be only slightly risk averse, or even risk neutral, since the equity of such firms tends to be widely held by a large number of well-diversified owners.

Such firms, it is argued, are inclined to take excessive risk. Others challenge these arguments, especially in a world where failure is costly and deposit insurance has value to the bank.<sup>28</sup> For example, Furlong and Keeley (1989 and 1990)

examined (theoretically) the case of a publicly traded bank whose owners and managers seek to maximize the value of the bank's stock. In their model, an increase in capital reduces the value of the bank's option to sell (put) its insured liabilities to the FDIC, since now more of the owners' own money must be exhausted before the FDIC can be exploited; this is sufficient to assure that portfolio risk will not increase. However, Keeton (1988) used a more general approach that includes the put option value to show that it is possible that increased capital would result in increased portfolio risk.

Even if higher capital requirements resulted in an increase in the riskiness of a bank's portfolio, it does not follow that the bank is more likely to fail. The primary effect of an increase in capital is, other things equal, to lower the probability of failure. Indeed, a significant inverse relationship between a bank's probability of failure and its capital ratio is a standard result in empirical studies of bank failure.<sup>29</sup> To date, no theory or example that includes the facts that failure is costly and that deposit insurance has value has been offered which shows that higher capital requirements would increase a bank's probability of failure.<sup>30</sup>

#### **4. Higher Capital Requirements Would Slow Asset Growth**

To the extent that banks and thrifts could not meet increased capital standards, one option would be for such institutions to grow more slowly or even to shrink. Indeed, these responses appear to be how many thrifts have adapted to the capital ratios mandated by FIRREA. Such responses are not necessarily undesirable, since existing safety net subsidies have almost surely allowed some banks and thrifts to grow in excess of what they could have achieved without safety net protection. That is, part of the desirable reallocation of resources that would accompany a decline in the deposit insurance subsidy, however achieved, would be a reduction in excessive growth at some, and particularly poorly capitalized, insured depositories.

Lower asset growth and asset contraction are not the only possible responses of depositories that could not meet higher capital standards. Assuming that capital requirements would continue to rely on risk-based assets, depositories could also shift their asset composition toward less risky assets. While this would also no doubt restrict the availability of credit to high-risk borrowers, the appropriate capitalization of risky activities is one of the goals of both the risk-based capital policy and policies to reduce moral hazard in banking.<sup>31</sup> Also, a significant phase-in period would allow for such decisions to be made in a deliberate and prudent manner.

Nevertheless, it is possible that substantially higher capital requirements for banks and thrifts, or any other

significant reduction in the deposit insurance subsidy, could tighten the terms on which credit is made available at insured depositories by a sufficient amount to cause macroeconomic concern. The likelihood of such an effect would be higher to the extent that borrowers facing higher costs or reduced availability of credit did not have ready access to funding outside the insured depository system.

Such concern is virtually equivalent to that expressed recently with regard to a perceived tightening of credit supply conditions by banks.<sup>32</sup> In this scenario, depositories restrict the supply of credit either voluntarily in response to changed economic conditions, or involuntarily in response to tighter regulatory standards.

An appropriate macroeconomic policy response to an undesired tightening of credit conditions would be for the Federal Reserve to ease monetary policy enough to allow an increase in credit sufficient to support a sustainable pace of output growth consistent with progress towards price stability. Indeed, in the context of this type of problem, the Federal Reserve has indicated that it is well aware that it "must remain alert to the possibility that an adjustment to its posture in reserve markets might be needed to maintain stable overall financial conditions."<sup>33</sup>

However, it is important to realize that the execution of such a macroeconomic policy is difficult at best. In practice its success requires today, and would require in the future, careful monitoring of the state of the economy and prudent judgment by the monetary authority. But to dwell on the potential macroeconomic concerns of higher capital requirements, or other reductions in safety net subsidies, is almost surely a mistake. A poorly designed and administered deposit insurance system can clearly itself be the cause of macroeconomic difficulties. Thus, successful reform of deposit insurance would be expected to lower the probability that the central bank would have to take action to prevent a financial crisis.

## **5. Higher Capital Requirements Would Result in Consolidation**

Another possible reaction by banks and thrifts that would have trouble meeting a stricter capital standard would be to merge with healthier, better capitalized organizations. So long as there were no significant anti-competitive or risk enhancing effects, such a reaction could well strengthen the stability of the U.S. financial system.<sup>34</sup>

However, once again it is worth emphasizing the virtues of a significant phase-in period for substantially higher capital standards. It would take institutions time to determine their optimal responses to the new environment, and the inevitable

transition costs could likely be minimized by allowing such decisions to be made in a deliberate manner.

## 6. How High Should Minimum Capital Ratios Be?

The question of the appropriate level for minimum capital ratios for insured depositories is essentially the question of what is the maximum level of depository system risk that society is willing to tolerate. That is, other things equal, a given bank or thrift capital ratio implies a probability of failure for that firm, and an accompanying contribution to systemic risk by that firm.

Higher levels of capital imply a lower probability of failure, and a lower contribution to systemic risk. Setting a minimum capital ratio for a given firm, or for all firms in the industry, thus implies the choice of a point, or set of points, on this capital/risk continuum.<sup>35</sup>

One way of estimating such a continuum is to estimate a bank or thrift failure model, in which the probability of failure of a given institution is a function of a variety of factors, including its capital ratio. Then, for a given probability of failure, the appropriate capital ratio can be computed.<sup>36</sup> Note that this procedure does not imply a common capital ratio for every depository. Indeed, it implies quite the opposite, since the other factors in the failure equation, such as the ratio of loans to assets and measures of nonperforming loans, vary across depositories. Thus, this system is really a type of risk-based capital.

However, such "microeconomic" models do not account for the effects of changes in aggregate regional or national markets, nor do they incorporate the interdependencies among depositories. Thus they have virtually no ability to account for systemic risk. Nevertheless, they do have the potential of providing useful, but rough, approximations of the level of capital consistent with a given level of microeconomic risk.

Another approach is to assume that a given level of the deposit insurance premium, *e.g.*, the rate in use today, represents society's collective decision regarding the expected level of deposit insurance losses it is willing to tolerate over the term of the insurance contract.<sup>37</sup> Once this assumption is granted, then measures of a bank's riskiness can be estimated, for example the variability of portfolio returns, and a capital ratio computed which sets the value of the deposit insurance put option equal to the insurance premium.<sup>38</sup>

Again, note that this approach also does not imply a common capital ratio for every depository, but a menu of ratios based on an institution's portfolio risk. Also, macroeconomic and

systemic risks have not, at least to date, been included in practical applications of this approach. And, as was the case for the depository failure model, the "option model" approach has the potential to provide useful, if rough, approximations of the optimal capital ratio.<sup>39 40</sup>

The Basle risk-based capital standards attempt, in a less elegant but no-doubt more practical way, to establish a capital/risk continuum for banks and thrifts. Embedded in this approach, as in the failure and option models, is an implied level of acceptable risk.

Some notion of the level of this implied risk in the risk-based standards is suggested in a recent study by Avery and Berger (1990). These authors find, for example, that over their sample period of 1982-1989, banks that failed any aspect of the fully phased-in risk-based capital standards had a statistically significantly higher probability of failure than did banks which passed the standard. In addition, of banks that did not pass the risk-based standards as of December 1987, 32.3 percent were insolvent by the end of 1989; whereas only 1.1 percent of banks that passed the risk-based standard in 1987 were insolvent by the end of 1989.<sup>41</sup>

Historically, bank regulators have been unwilling to rely to any substantial degree on approaches such as the failure and option models to set minimum capital standards. In truth, the analytical and statistical complexity, uncertainty, and limitations of these methodologies are powerful arguments for the continued application of considerable judgment in the setting of capital standards. But technological and other advances in economics, finance, and statistics make the application of such techniques increasingly feasible. At a minimum, estimates derived from such models have the potential to provide useful benchmarks against which to measure the results of more judgmental analyses.

Two final points regarding the setting and administration of insured depository capital ratios. First, there is no reason to believe that ratios set for today's environment will be appropriate at all points in the future. Thus a flexible system is required that can evolve with changing circumstances. Second, both the complexity of the task and the need for flexibility over time are strong arguments for Congress to delegate, with appropriate oversight, the details of the process to one or more regulatory agencies. Given the difficulties of, and typically long time lags, in revising laws, too much statutory specificity regarding capital ratios could easily lead to a grossly inefficient system of capital standards for insured depositories.

## **F. Increased Reliance on Subordinated Debt**

Some observers have proposed requiring banks and thrifts to issue some minimum amount of subordinated notes and debentures (SND), or subordinated debt, as a way of increasing market discipline on insured depositories.<sup>42</sup> Requiring a minimum ratio of SND to total or risk-weighted assets is another way of increasing the insurance deductible in federal deposit insurance, and thereby shifting risk to the private sector. Thus arguments for and against increased use of SND parallel those regarding increased capital requirements.

### **1. Arguments in Favor of Subordinated Debt**

There are additional arguments that may be used in support of SND. First, it has been argued that the risk preferences of SND holders would be similar to the risk preferences of the deposit insurer. This is because SND holders receive at most a fixed return on their investment, but like the FDIC may suffer losses in bad times. Thus the market discipline exerted by SND holders would be consistent with the discipline that the deposit insurer would like to see exerted.

Second, SND provides an extra cushion against FDIC losses when insolvency is determined by the value of equity capital. Thus, SND would help to minimize FDIC losses, especially in a world where the measurement of an institution's true financial condition can be highly uncertain.<sup>43</sup>

Third, because SND holders stand to suffer losses when an institution is closed after its equity is exhausted, SND holders have a strong incentive to pressure regulators to intervene promptly with capital deficient depositories. Thus the tendency for regulators to forbear may be tempered by the SND holders.

Fourth, the marginal cost of SND to the depository institution is lower than that of equity, and thus the impact of increased capital requirements on insured depositories' cost of capital may be softened if SND were a larger part of the capital account.<sup>44</sup>

Lastly, yields on SND issues, especially if such issues were required on a serial basis, would provide regulators with a potentially useful signal of the market's view of a bank's or thrift's financial future.<sup>45</sup>

### **2. Required Minimum Subordinated Debt Holdings**

These advantages of subordinated debt could be achieved by requiring insured depositories to maintain a minimum ratio of SND to risk-based assets. The voluntary holding of SND is encouraged today by the risk-based capital standards, which allow term SND

to count for as much as 25 percent of total capital at banks, and up to 50 percent at thrifts.<sup>46</sup>

Some observers argue that this provides sufficient incentive for depositories to hold SND while simultaneously maintaining needed flexibility for an institution to choose its capital structure. However, others have proposed giving SND an even larger role in disciplining depository risk taking.

One example of such a proposal is Wall's "puttable subordinated debt," under which large banks would be required to issue puttable debentures, and must be declared insolvent if such debt outstanding fell below 4 or 5 percent of risk-weighted assets.<sup>47</sup> Oversimplifying a complex proposal: banks and thrifts operating under this plan would have 90 days after a put is initiated by any debtholder to (1) reduce assets so that the ratio of the remaining puttable debt to risk-weighted assets (after the redemption of the debt that is put to the bank) would still exceed 4 or 5 percent of risk-weighted assets; (2) issue new puttable debt to maintain the ratio; or (3) in exchange for an additional 90 days to issue sufficient puttable new debt, issue equity capital equal to the deficiency in puttable debt that would occur after redemption.

If at the end of 90 (or 180) days the puttable debt ratio were deficient, the depository institution would have to be declared insolvent and recapitalized, sold, or liquidated by regulators. Note that Wall's proposal truly uses market discipline. Bondholders concerned about the solvency of the depository and hence the value of their bonds act on their own initiative. If the depository's response does not satisfy the market in such a way that the institution meets the rule, the regulator must act. The market identifies weak depositories, and the regulator is forced to act if the firm cannot respond satisfactorily.

### **3. Potential Problems with Subordinated Debt**

There are at least five arguments that may be raised against requiring increased use of subordinated debt.

#### **Risk Preferences of Debtholders**

First, while the risk preferences of debtholders may be similar to those of regulators when the bank or thrift is healthy, as equity capital goes to zero, and bondholders become the residual claimants, bondholders' preferences may become more like those of the equity holders. That is, when equity approaches zero, debtholders may become willing to let the depository take big bets with federally insured funds in order to increase the chance that they will not suffer losses.<sup>48</sup>

## Possibility of Runs

Second, proposals such as Wall's put option approach are likely to substantially increase the probability of depositor runs, with possible systemic implications. Exercise of the put, or perhaps even the indication that a put is likely to be exercised, would be a clear signal that the insured depository is most probably in serious trouble. Uninsured depositors would almost surely seek to withdraw their funds from such an institution. Indeed, other uninsured creditors, such as other SND holders and sellers of federal funds, might also run on the news that the clock is running on a put.

In addition, allowing private creditors to make the closure decision for an insured depository assumes that private agents know as much or more about the "true" financial condition of the firm as do its supervisors. In a world of timely and thorough examination and other confidential and public monitoring by supervisors, it is unlikely that private markets possess better information.

More importantly, a primary reason for a federal safety net for insured depositories is to protect the process of financial intermediation against the risks of deposit runs and bank crises having systemic implications. The timing of the closure decision is a key tool of implementing this policy goal, and thus giving this policy instrument to the private market may be highly inadvisable.

Indeed, despite the massive deposit insurance losses of the last several years, it may well be true that in some future financial crises the least cost solution from society's point of view will be to allow the deposit insurance system to suffer some losses. This could easily imply allowing some depositories to remain open that would in fact be closed by the market.

On balance, it is reasonable to argue that the world is uncertain enough, and financial crises idiosyncratic enough, that complete removal of regulatory discretion regarding the closure decision is not prudent public policy.<sup>49</sup>

## Inflexibility of SND

Third, SND is an inflexible capital instrument in the sense that the interest on SND is a contractual obligation of the firm. In contrast, dividends on common stocks do not have to be paid and therefore provide the firm with greater flexibility in a time of financial stress. Moreover, the obligation to pay interest on SND could inhibit a bank or thrift from building capital via retained earnings.<sup>50</sup>



## Risk/Return Relationship

Fourth, studies of the market discipline exerted by SND holders under the safety net regime existing throughout much of the 1980s do not suggest a strong relationship between risk and the expected return demanded by investors. For example, a study of subordinated debt offerings by large BHCs in 1983 and 1984 by Avery, Belton, and Goldberg (1988) found no evidence of ex ante market discipline by SND holders. However, Gorton and Santomero (1990), using Avery, Belton, and Goldberg's data, but a quite different methodology, found weak evidence of market discipline in BHC subordinated debt.

Evidence regarding the market discipline potential of SND holders that is contingent on the existence of current or previous safety net arrangements is, however, suspect. If creditors really believe that some large banks are too-big-to-fail, it would be rather surprising to find that creditors of such large banks took the risk of failure seriously enough to demand substantial risk premiums on uninsured debt. Indeed, this is probably why the empirical evidence in favor of market discipline tends to be found at banks considered to be well outside of the realm of too-big-to-fail.<sup>51</sup>

In addition, there is considerable evidence from other debt markets that debtholders, when they are truly exposed to risk, demand substantial risk premiums. There are signs that this is becoming the case in banking. As bank regulators have made it increasingly clear in the latter part of the 1980s that subordinated debtholders are not protected, it appears that SND yields have come to better reflect the relative riskiness of banking organizations.

For example, beginning in late 1989, and continuing into 1990, the spread between average secondary market yields on BHC SND issues and yields on comparable-maturity Treasury securities widened significantly for both money center and regional BHCs. This seems to have been at least partly in response to the continued slide in credit ratings of U.S. banking organizations.

In addition, the impact of rating downgrades and concern about the safety and soundness of banks is clearly evident in the rates paid in 1990 by individual BHCs. The pronounced effect of a below investment-grade rating is most apparent in the very wide spreads for SNDs issued by firms with such ratings. Alternatively, a major BHC that is viewed as improving its financial condition, Bank of America, successfully raised \$225 million in Tier 2 capital with 10-year subordinated note offerings in June and July 1990.

## Uncertainty about the Market for SND

Finally, it is unclear whether a broad market for bank SND would develop. No broad market exists today for bank SND, and outside of a few large BHCs, markets are quite thin for BHC subordinated debt. In addition, it is not obvious that private investors would be particularly willing to be an explicit cushion for the FDIC, especially if bank and thrift regulators make the closure decision.

In other words, it is uncertain whether SND holders would think that either they could bring sufficient pressure on regulators to close an insured depository in time to minimize SND holders' losses, or that the regulators would give SND holders' interests a high priority. While it is possible that risk premiums would sufficiently compensate SND holders, and a government requirement that such debt be issued would certainly help create a market, it seems quite reasonable to argue that the uncertainty here, especially during the implementation period, is great.

### 4. Current Usage of SND

Some perspective on the current use of SND is provided in Table 6, which shows the current usage of SND by independent banks and multi-BHC parents.<sup>52</sup> Where relevant, data for institutions which do not issue SND are also provided. The data for independent banks shows that less than 3 percent currently issue subordinated debt. Such debt tends to be floated by relatively large banks, as may be seen by comparing the numbers outside and within the parentheses in column 2.

For those banks that do issue SND, it averages 1.8 percent of their total assets, with a considerably larger percent being issued by the largest banks. Finally, SND can be a fairly high percent of equity capital at those banks which issue SND--the average across all such banks is 32 percent. Again, this percentage is highest at the largest banks, averaging 79 percent.

A considerably higher percent of multi-BHC parents issue subordinated debt--164 out of 852, or about 19 percent.<sup>53</sup> Once again, relatively large firms dominate the issuance of SND. At multi-BHCs issuing SND, the mean ratio of SND to total assets is 8.7 percent, much higher than at independent banks; and this, on average, represents 14.7 percent of equity, much less than that at independent banks.

Additional perspective is provided by evidence regarding who currently owns the SND of banks and BHCs. This is difficult to determine, since no such data are collected, and the evidence used here comes primarily from discussions with bank supervisors.

Table 6

Use of Subordinated Notes and Debentures (SND)

(As of December 31, 1989)

Asset size quartile (total number of institutions)	Mean total assets (in millions of dollars)	Mean ratio of SND to total assets (percent)	Mean ratio of SND to equity capital (percent)
(1)	(2)	(3)	(4)
25	19.5	1.2	18.4
(904)	(10.8)	.....	.....
26	46.2	.9	16.6
(904)	(22.8)	.....	.....
25	88.8	1.0	15.7
(904)	(41.5)	.....	.....
25	535.4	4.2	79.3
(905)	(130.4)	.....	.....
101	171.2	1.8	32.4
Total (3,617)	(51.4)	.....	.....
Multi-Bank Holding Company Parents*			
41	7.1	9.8	20.5
(172)	(4.6)	.....	.....
41	27.3	9.7	14.1
(172)	(10.5)	.....	.....
41	221.7	7.8	10.3
(172)	(24.2)	.....	.....
41	4,130.7	7.4	13.8
(172)	(479.3)	.....	.....
164	1,096.7	8.7	14.7
Total (688)	(129.7)	.....	.....

\*Values for institutions without SND given in parentheses.

Source: Federal Reserve Board.

The issue is important, however, because these are the agents that would be expected to exert market discipline on depository risk taking if subordinated debt played a more important role in bank and thrift capital structures.

In the case of independent banks, it appears that existing SND is held primarily by insiders of the bank. Such insiders consist of existing shareholders, directors, and perhaps management and others with confidential knowledge of the bank. While such debt provides added protection for the FDIC, it is far from obvious that such agents have risk preferences and incentives either close to or always consistent with those of the FDIC.

Subordinated debt that is issued by a bank that is part of a BHC appears, in the vast majority of cases, to be held or guaranteed by the BHC itself. In such cases, while the SND again provides added protection for the FDIC, it is not clear that the owners have as strong an interest in the prompt resolution of problems at the bank as would independent third parties.

Of course, third-party holders of the BHC's debt would have an incentive to pressure the firm to resolve problems at its bank(s), since such problems could easily affect the BHC. However, the incentives here are clearly less direct than when the SND is held by independent investors at the bank level.

## **5. Feasibility of Substantial SND Issuances**

A final perspective is provided by recent conversations with selected market participants regarding the feasibility of banks issuing substantial amounts of subordinated debt over the next several years. These participants suggested that, to attract investors, such issues should be as simple as possible, without complex contingencies and ambiguous covenants.

They also argued that this may be difficult to achieve, as the market has the perception that the legal standing of banking organization debt is subject to considerable regulatory caprice.<sup>54</sup> The market participants also claimed that, prior to FIRREA, the advantage to debt issuance at the bank level seemed to be greatest for high quality banks that were part of a holding company. In such cases, it was claimed that it was possible to achieve considerable cost savings by issuing debt at the bank, not the BHC, level. However, the bank cross-guarantee provisions of FIRREA have apparently reduced this advantage since, in the event of insolvency, the FDIC can now lay claim to the assets of solvent banks in the holding company.<sup>55</sup>

## G. Comparison of Risk-Based Capital and Risk-Based Deposit Insurance

Chapter VIII of this Study ("Risk-Related Premiums") briefly discusses why both a risk-based capital and a risk-based deposit insurance system might be desirable. It is pointed out that a system of risk-based premiums: (1) might provide for easier incorporation of adjustments for non-credit types of risk, especially because the Basle Accord is an international agreement; and (2) would allow a depository institution greater flexibility in responding to a change in its risk position. This section reviews the relative merits of the two risk-based systems in more detail.<sup>56</sup>

Consider first an "ideal" world where the insurer has: (1) precisely the same information as the bank or thrift regarding the riskiness of the depository's activities; and (2) complete flexibility to react immediately to any change in depository risk. Several authors have shown that, under these stringent conditions, risk-based capital and risk-based deposit insurance can be designed to provide the same level of failure risk.<sup>57</sup> However, this does not mean that policy makers should necessarily be indifferent between the two. For example, the two policies may differ with respect to how efficiently they allocate risk-taking across firms.

Under a pure risk-based insurance scheme with no capital requirements, a depository would be free to choose its level of portfolio risk and its capital ratio; the FDIC would then charge the depository a premium based on the implied insolvency, or failure, risk. Ideally, the premium would recover the full value of deposit insurance to the depository, or the value of the depository's option to put part of its portfolio to the insurer in the event of failure, and have the insurer pay the depository's insured depositors in full.

In addition, other insurer costs, such as expected administrative costs and the social cost of expected systemic risk, should be included in the deposit insurance premium. In the resulting equilibrium, institutions with the best risky portfolio investment opportunities (i.e. those with a comparative advantage in holding high expected return/high risk portfolios), the highest cost of raising capital, and the least risk aversion would specialize in risky portfolios, raise the least capital, and have the greatest probability of failure. Such depositories would pay explicitly for this high failure risk through high deposit insurance premiums.

Conversely, institutions with comparative disadvantages in holding risky portfolios, the lowest cost of raising capital, and the greatest risk aversion would have the lowest probability of

failure and thus pay the lowest insurance premiums. Most institutions, of course, would be somewhere between these extremes.

A pure risk-based capital scheme with flat-rate deposit insurance would also allow a bank or thrift to choose the riskiness of its portfolio, but not its capital position nor its probability of failure. Instead of explicitly pricing insolvency risk, risk-based capital implicitly prices portfolio risk by setting a minimum capital requirement for each depository that equalizes the value of deposit insurance per dollar of deposits across institutions. That is, for any level of risk, a certain amount of capital must be raised to offset it.

When looked at in this way, it can be seen that under risk-based capital the correlation between which institutions have a comparative advantage in taking risk and which choose the riskiest portfolios is looser than under risk-based deposit insurance, since depositories with relatively high costs of raising capital that are not related to portfolio risk (as may be the case for closely held firms, or firms with high transactions costs of raising capital), will nevertheless face a relatively high implicit price for risk taking.

The correspondence between the amount of capital held and the price of capital faced by each depository is also loosened relative to risk-based insurance, since the capital standards are not based on this price, and the only way to change the total cost of capital is indirectly through changing portfolio risk. The correspondence between risk aversion and failure risk is also loosened relative to risk-based insurance, since all insured institutions must have the same put option value. Depositories can only change their risk levels by holding capital in excess of the minimum standards.

Another important difference between the two policies is that under risk-based capital, more, and perhaps substantially more, capital will be raised. This is because some institutions may hold more capital than required as part of their own optimizing strategy, but none will (without facing supervisory action) hold less. Under risk-based insurance, each depository has a choice regarding whether to hold higher capital or pay a higher premium.

A final potential difference of risk-based insurance and risk-based capital is that risk-based insurance allows for more value creation from the intermediation of deposits into insured depository assets. It is often maintained that the intermediation of insured deposits into such assets has extra, or social, value over and above the gains that accrue to private individuals. Indeed, the preservation of this value is one of the major reasons for deposit insurance. Risk-based capital may

result in a higher average capital-to-assets ratio than does risk-based insurance, and therefore forces a lower average ratio of insured deposits to assets. Thus, to the extent that these deposits create social value, more such value may be created under risk-based insurance.

The dominance of risk-based deposit insurance becomes less clear when the conditions of the ideal world are relaxed. Consider the more realistic situation where the insurer is at a significant disadvantage relative to the depository regarding knowledge of the depository's true portfolio risk. In this case, capital acts as a form of co-insurance and gives depository owners a strong incentive to respond to their confidential information about risk, and to act to control it. In addition, capital now helps to control moral hazard. Capital requirements may have the additional benefit of providing the insurer time to gain more information about portfolio risk, and the time to act on that information. This is because, for any given portfolio risk, a depository will take longer to fail if capital is higher.

During this time, fluctuations in capital value or the results of supervisory examinations may reveal information that allows the insurer to take timely action. In contrast, under pure risk-based insurance, a depository with very low capital may fail well before such information can be obtained and action taken.<sup>58</sup>

Additionally, it may be argued that capital standards can improve the pricing of risk-based insurance. Flannery (1989) shows that when portfolio risk is imperfectly observed, there is error in estimating the put option value to use in pricing risk-based deposit insurance, and this error increases as a depository's capital ratio falls. The intuition here is that lower capital ratios act to magnify errors in forecasting the rates of return on assets into larger errors in forecasting the rates of return on equity, which help determine the value of the put option. Since capital standards tend to increase capital ratios, they reduce insurance pricing errors and result in a better distribution of insurance premiums and incentives.

Consider now the situation when the deposit insurer is not completely flexible in its ability to respond to changes in depository risk. Clearly, this is a more realistic environment. In this scenario, either risk-based premiums or risk-based capital requirements are at best set with a lag determined by reporting or examination intervals. In addition, government authorities may have to follow bureaucratic, legal, or other rules for changing either premiums or capital requirements, and these rules may not allow for the full use of all information.

In terms of explicit flexibility, risk-based insurance premiums appear to have two possible advantages over risk-based capital. First, the implementation lag for premiums may be shorter--depositories can probably be made to pay a revised premium very quickly, except in extreme circumstances. By contrast, the implementation lag to meet increases in required capital may be considerable, owing in part to the sometimes long and sometimes difficult process of raising new capital. Second, risk-based insurance is more flexible since the premiums can reflect differences in failure risk resulting from a much wider range of capital ratios, rather than treating all firms above a minimum capital ratio equally.

However, in terms of implicit flexibility, risk-based capital has an important advantage over risk-based deposit insurance. Private sector agents are not bound by any bureaucratic or other rules that may constrain the ability of a government insurer to respond to changes in risk. An increase in failure risk that is publicly known will result in some market discipline through higher costs for raising equity capital, subordinated debt, and uninsured deposits.

Thus, capital standards (risk-based or not), by requiring greater amounts of equity capital or subordinated debt, have implicit flexibility in the sense that the cost to a depository of increasing risk is higher, the higher are these standards. Even for the supervisor capital standards may have greater implicit flexibility. Some observers argue that de facto capital standards are more easily changed, say in the course of an examination, than are highly visible insurance premiums.

In conclusion, in the "real" world there is likely a role for both risk-based deposit insurance and risk-based capital. Capital standards, whether they are risk-based or not, can make risk-based deposit insurance work better by putting owners at substantial risk, directly reducing moral hazard incentives, allowing the insurer time to gain information and take action, and improving the accuracy of risk-based insurance pricing. Finally, while risk-based premiums have greater explicit flexibility, capital standards are implicitly more flexible, inducing private agents to discipline risk-taking when the insurer cannot, and possibly providing the supervisor with greater flexibility.



## Endnotes

<sup>1</sup> As is well-known, deposit insurance may be viewed as a put option written by the FDIC, with an exercise price equal to the value of the bank's insured liabilities. The value of this option increases directly with the bank's portfolio risk and inversely with the bank's capital ratio. For more on these points, see Chapter VIII of this Study, "Risk-Related Premiums," and Kuester and O'Brien (May 1990).

<sup>2</sup> An excellent discussion of how the problems in the thrift industry developed is in White (1989). Both the Congressional Budget Office (1990) and the United States General Accounting Office (1990) have recently estimated the extent of problems in the banking industry.

<sup>3</sup> A recent statement of this view is contained in Kane (1989), "Changing Incentives. . ."

<sup>4</sup> Some evidence that thrifts and banks that are located in economically troubled regions pay higher rates on insured deposits than do depositories in healthier areas is presented in Golding, Hannan and Liang (1989). Also, extensive anecdotal evidence suggests that at least some troubled institutions have used higher deposit rates to attract funds.

<sup>5</sup> It is useful to note here a contrast between equity and debt which is subordinated to insured deposits. Subordinated debt, which will be discussed in detail later provides a cushion for the FDIC. However, its effect on the probability of failure is considerably smaller, if failure is defined in terms of the exhaustion of equity.

<sup>6</sup> A similar chart is presented in Federal Reserve Bank of Minneapolis (1988).

<sup>7</sup> In December 1981 federal bank regulators issued numerical guidelines for bank and BHC capital ratios, in part to "address the long-term decline in capital ratios, particularly those of the multinational group. . ." (FR Bulletin (1982), p.33). Wall and Peterson (1987) present evidence that these guidelines were somewhat effective in increasing equity capital ratios at the largest BHCs in the years of their study, 1982-1984.

<sup>8</sup> All BHC and nonbank data are computed from Standard and Poor's Compustat tapes.

<sup>9</sup> An example of why considerable care must be taken when interpreting these statistics is that capital ratios of the very largest securities brokers and dealers tend to be closer to those of the banks and BHCs. However, this is not particularly the case for the largest insurance companies. Also, sample sizes can

be quite small for the nonbank firms, and many of the business and personal credit finance companies are affiliated with larger organizations (e.g. Sears, American Express, General Motors, and ITT).

<sup>10</sup> The G-10 countries include Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. Strictly speaking, this agreement only applies to internationally active banks. However, U.S. banking authorities have applied the guidelines to all U.S. banks and BHCs. Non G-10 members of the European Community and several other nations' supervisors have agreed to apply the Basle capital accord to their banks as well.

<sup>11</sup> The final risk-based capital guidelines were issued in January 1989 and published in the March 1989 Federal Reserve Bulletin (12 CFR 208, Appendix A for banks; and 12 CFR 225, Appendix A for bank holding companies), the FDIC's "Risk-Based Capital Regulations" (12 CFR 325, Appendix A), and the OCC's guidelines are in (12 CFR Part 3, Appendix A).

<sup>12</sup> For more detail on the precise definitions see Federal Reserve System, "Capital; Risk-Based Capital Guidelines" (1989), and the March 1989 Federal Reserve Bulletin.

<sup>13</sup> See 12 CFR 567. FIRREA mandated that the Director of OTS establish a leverage ratio, a tangible capital requirement, and a risk-based capital requirement.

<sup>14</sup> According to the National Credit Union Administration, if credit unions used banks' risk-based guidelines, the average credit union would, as of December 1989, have a capital ratio of about 11 percent, all of which would be Tier 1. For more on these points see Chapter XIII.

<sup>15</sup> The OTS published its proposal on December 31, 1990. See Federal Register, Vol. 55, No. 251, 53529-53571.

<sup>16</sup> The proposal uses a computer simulation model to estimate interest rate risk exposure. The simulation methodology used by the OTS evaluates the options embedded in the mortgage assets held by thrifts and, therefore, provides a better estimate of the change in the value of those assets due to changing interest rates.

<sup>17</sup> See Avery and Berger, "Risk-Based Capital and Off-Balance Sheet Activities," (1988).

In a preliminary OTS working paper, Bradley, Wambeke, and Whidbee (1990) report evidence that the risk-based capital system for thrifts (1) helps to identify thrifts with higher probabilities of failure, and (2) has risk categories such that

items in the lower risk "baskets" generally lower the cost of failure resolution while the higher risk baskets increase it. However, these authors do not test explicitly for whether the risk-based system performs better than the previous capital guidelines for thrifts.

<sup>18</sup> Depositor co-insurance is obviously another way to increase market discipline on banks and thrifts. Use of the capital account to increase market discipline does not require increased depositor discipline, but increased depositor discipline clearly assumes that owners and nondeposit creditors are at risk.

<sup>19</sup> Only a minority of public commentators to this Study addressed the issue of capital adequacy in any detail. To the extent that commentators mentioned capital adequacy, they were generally supportive of the view that adequate capital reduces moral hazard and is the first line of defense for the FDIC. Some banks argued that minimum capital standards should be raised, but others claimed that current bank capital ratios are adequate.

<sup>20</sup> The Basle Accord only establishes minimum capital ratios. Each signatory is free to set higher standards.

Another way of increasing bank (or thrift) capital requirements would be to raise the minimum total leverage ratio. That is, the current minimum of Tier 1 capital to total assets of no less than 3 percent for federally regulated banks could be increased. The potential impact of such action could be substantial.

For example, Avery and Berger (1990) estimate that raising the minimum ratio from 3 to 6 percent would, as of December 1989, more than double the number of banks estimated to not meet the new capital standards. These banks held some 56 percent of total bank assets.

However, increasing the minimum leverage ratio would be inconsistent with the broader movement to make risk-based capital the primary measure of capital adequacy. Indeed, if raised too high the minimum leverage ratio could supplant the risk-based ratios as the binding minimums for the overwhelming majority of banks. For this reason the discussion in the text is solely in terms of risk-based capital.

<sup>21</sup> Avery and Berger (1990) report results which suggest that a fairly large number of banks may be able to meet risk-based capital standards in whole or in part via on-balance sheet portfolio changes. However, they find that the potential for meeting the standards by off-balance sheet adjustments is more limited, except for the largest banks.

<sup>22</sup> Nonfinancial firms are studied in Asquith and Mullins (1986), and BHCs in Wansley and Dhillon (1989), Wansley, Pettway, and Dhillon (1989), and Wall and Peterson (1988).

<sup>23</sup> Wansley and Dhillon (1989), p. 232.

<sup>24</sup> See Modigliani and Miller (1958), and Stiglitz (1974).

<sup>25</sup> See Ellis and Flannery (1990), Hannan and Hanweck (1988), and Baer and Brewer (1986).

<sup>26</sup> All such data for specific institutions are considered extremely confidential for obvious competitive reasons.

<sup>27</sup> See, for example, Kim and Santomero (1988), and Koehn and Santomero (1980).

<sup>28</sup> See Furlong and Keeley (1989 and 1990).

<sup>29</sup> See, for example, Avery, Hanweck, and Kwast (1985).

<sup>30</sup> This point is discussed in more detail in Avery and Berger (1990).

<sup>31</sup> Some care must be taken here since, as was discussed earlier, the Basle system does not fully account for all risks and its asset categories are quite broad. Thus, it is quite possible for depositories to take excessive risk and still be in compliance with the Basle Accord. This reinforces the point, also made earlier, that higher risk-based capital would not be sufficient, by itself, to solve the problems in deposit insurance. Other reforms, such as prompt corrective action and timely risk monitoring by the supervisors and private agents, would also be needed.

<sup>32</sup> See Greenspan (1990).

<sup>33</sup> Greenspan (1990), pp. 741-742.

<sup>34</sup> Risk could be increased if there were no diversification gains from the merger, and certain other technical conditions were met. For more on these points see Kwast (1989).

<sup>35</sup> Other factors, such as competitive and political concerns, may also of course be relevant. This discussion abstracts from such issues.

<sup>36</sup> This is the approach taken by Avery and Belton (1987). They assume a probability of bank failure equal to .7 percent over the next year, and estimate the distribution of bank capital ratios that would be consistent with this probability. At the time of their study, a probability of failure of .7 percent

implied about 95 expected bank failures per year.

<sup>37</sup> Competitive private insurers' prices are set so they recover expected losses and other marginal capital and operating costs over the life of the insurance contract, i.e. the interval between premium collections. The above assumption says that federal deposit insurance premiums are set the same way, at least on average, with perhaps an additional "cost" to account for systemic risk. Of course, in light of events over the past decade this seems like an unusually heroic assumption.

<sup>38</sup> This is the approach taken recently by Ronn and Verma (1989).

<sup>39</sup> Kuester and O'Brien (May 1990), in their recent study of the practicality of using the option model approach to compute risk-based deposit insurance premiums, conclude, however, that this model is not suitable, by itself, for implementing risk-based premiums. The same conclusions would no doubt apply to using the option model to compute risk-based capital. Another possibility is to use the option methodology to establish a risk-based examination schedule whereby riskier institutions would be examined on a more frequent basis. Such an examination schedule would be consistent with prompt corrective action strategies since it would relate the frequency of examination and closeness of supervision to depositories' riskiness. Kuester and O'Brien (September 1990) demonstrate how a risk-adjusted examination schedule could be derived.

<sup>40</sup> As noted already, a crucial assumption of the options model is that the chosen level of the deposit insurance premium is the "correct" one. Obviously, this is a strong assumption, and the risks in its use may be great. For example, if the existing premium is in fact too low, then capital ratios may be implied that are so high as to drive banks out of business. Conversely, if the existing premium is too high, the implied capital ratios may be so low as to be irrelevant.

<sup>41</sup> This does not imply that if all banks were at the risk-based minimums the aggregate failure rate would have been 1.1 percent. This is because forcing banks that failed the standards to the capital minimum would not necessarily imply they would be otherwise identical to banks that pass the standards. Nevertheless, these data provide a rough upper bound on the potential extent to which the fully phased-in risk-based capital standards could lower bank failure rates.

<sup>42</sup> See Wall (July/August 1989), and Keehn (Federal Reserve Bank of Chicago).

<sup>43</sup> See Chapter XI "Market Value Accounting and Disclosure."

<sup>44</sup> This includes the potentially depressing effect of SND issuance on bank share prices. Researchers have generally found that new issues of SND either have no effect on or may actually increase shareholder wealth, in contrast to the generally depressing effect of new stock issuance. See Wansley, Pettway, and Dhillon (1989), and Wall and Peterson (1988).

<sup>45</sup> In a recent working paper, Schellhorn and Spellman (1990) suggest that data on the risk-return characteristics of SND might help in implementing an options pricing approach to risk-based deposit insurance. If this result proves robust to further testing, it would provide another rationale for increasing the use of SND in bank and thrift capital accounts.

<sup>46</sup> Since Tier 2 cannot exceed Tier 1 capital at banks, and because SND eligible to be counted as Tier 2 capital cannot be more than 50 percent of Tier 1 capital, SND that is counted as risk-based capital cannot exceed 25 percent of total capital. Amounts of SND in excess of these limits may be issued and, while such amounts will not be included in the calculation of the risk-based ratio, they will be taken into account in the overall assessment of a bank's funding and financial condition. Thrift institutions, however, can count SND without limit in Tier 2 capital--effectively 50 percent of their total capital requirement.

<sup>47</sup> See Wall (July/August 1989).

<sup>48</sup> This possibility becomes more likely if subordinated debt were required to be converted into equity prior to the depository becoming equity insolvent.

<sup>49</sup> This does not imply, of course, that less regulatory discretion than has been allowed over the last several years is undesirable.

<sup>50</sup> The fact that interest on SND is a contractual obligation has led some observers to argue that if SND is to be counted as capital, then supervisors should have the right to suspend interest payments as part of a policy of prompt corrective action. For more on this point see Chapter XI.

<sup>51</sup> See, for example, Hannan and Hanweck (1988).

<sup>52</sup> Data on the 4,899 one-bank holding companies are extremely unreliable for the purposes used here, and therefore are not provided.

<sup>53</sup> Data on 90 multi-bank holding companies are not available for the purposes used here.

<sup>54</sup> Bank issues of subordinated debt must be approved by regulators, and cannot be paid off before scheduled maturity without regulatory approval. There are no such constraints on bank holding company issuance of SND.

<sup>55</sup> An institution's liability for loss incurred by the FDIC in connection with a commonly-controlled institution is subordinate in right and payment to: (1) deposit liabilities other than those to affiliates of the depository institution; (2) secured obligations other than those to affiliates of the depository institution which were secured after May 1, 1989; (3) other general or senior liabilities unless they are expressly described as subordinate to the cross guarantee liability; and (4) obligations subordinated to deposits or general creditors, except to the extent that they are subordinate to cross guarantee liability. See 12 USCA 1815(e)(2)(C)(ii).

<sup>56</sup> The discussion in this portion of the text draws heavily on Avery and Berger, "An Analysis of Risk-Based Capital. . ." (1990). The topic is also addressed in Avery and Belton (1987).

<sup>57</sup> See Flannery (1989), Ronn and Verma (1988), and Sharpe (1978).

<sup>58</sup> It should be emphasized that the discussion in this entire section abstracts from the issue of whether book (GAAP) measures of capital provide the clearest picture of the true financial condition of the bank. Whether market value accounting would provide a better snapshot is discussed in Chapter XI, "Market Value Accounting." Another option is to use information gained in bank and thrift examinations to adjust book equity. Examination procedures are discussed in Chapter IX, "Risk-Management Techniques," and Chapter XII "Role of Auditors."

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## Chapter III

### SCOPE OF DEPOSIT INSURANCE

#### A. Introduction

The scope of deposit insurance coverage has greatly expanded since the 1930s. The dollar amount covered has increased from \$2,500 per insured account to \$100,000 per insured account (a four-fold increase after accounting for inflation). Regulatory interpretations have expanded the number of insured "capacities" that each depositor may have in an insured institution. So-called "pass-through" deposit insurance has increased coverage for institutional investors. Brokered deposits have increased the ability of individuals to take advantage of insurance coverage. In addition, even uninsured depositors and creditors have often been fully protected by insurance coverage in failed bank resolutions.

This gradual and broad expansion of the scope of insurance coverage raises competing concerns. Proponents of increased coverage argue that system stability is increased and more bank loans are made. Opponents contend that taxpayer exposure is increased; that important market discipline is removed; and that resulting bank failures over time decrease stability in the system.

This chapter analyzes these concerns as well as specific proposals to reduce the scope of insurance coverage. Section B discusses the trade-off between stability and depositor discipline; Section C analyzes various proposals to reform the current scope of federal deposit insurance coverage; Section D explores the policy objectives of resolving bank failures; Section E discusses the ability of depositors to discipline depository institutions; Section F briefly presents the issues involved in choosing between regulatory rules and regulatory discretion; Section G notes the major public comments received on the issues of concern to this chapter; and Section H contains an appendix describing the legal underpinnings of the various legal rights and capacities and explains a method by which they could be eliminated.

## B. The Trade-Off Between Stability and Depositor Discipline

Reducing the scope of coverage necessarily involves increasing depositor discipline, which raises two significant and interrelated issues: first, the extent to which an increase in depositor discipline will increase bank runs; and, second, the practical ability of reforms to reduce coverage effectively if the "too big to fail" problem remains unresolved.

In general terms, the "ideal" amount of deposit insurance coverage for maintaining financial stability in any economy is that amount of coverage sufficient to prevent bank runs without sacrificing any other type of market discipline. Stated differently, an ideal amount of coverage would relieve market participants of any need to price (or otherwise cope with) the threat of bank runs. At the same time, however, it would not interfere with the market's pricing of any other banking risks (or any non-price market mechanisms for controlling these risks).<sup>1</sup>

Despite its heuristic value, this abstract description ignores the real world trade-off involved in attempting to reduce the incidence of bank runs without reducing the vitality of depositor discipline. As noted in other chapters, it is reasonable to believe that reducing the threat of bank runs by raising the level of deposit insurance coverage will cause a simultaneous weakening of incentives for depositors to evaluate banking risk. Risk becomes increasingly underpriced for bankers--and thus risk-taking tends to become increasingly excessive--as the scope of deposit insurance coverage increases, unless effective controls are substituted for the discipline that would have been exerted by depositors in the absence of coverage increases.

The potential trade-off of depositor discipline for a reduced threat of bank runs complicates the task of determining the "optimal" amount of deposit insurance coverage for any real-world economy. Many implications of choosing a point along the "trade-off curve" must be addressed, including: the likelihood of bank runs under different levels and forms of coverage; the magnitude of the threat posed by bank runs (the potential costs associated with a real threat of runs, relative to the costs that would be incurred under the alternative (higher-coverage arrangement)); and the comparative effectiveness of depositor discipline vs. its substitutes (supervision and regulation) under higher-coverage regimes.

There are two broad types of competing perspectives on these elements, and they produce different conclusions regarding the terms of the trade-off. One perspective favors lower insurance coverage (more depositor discipline) than is now available; the other suggests that, as a rule, more coverage (for depositors) is

preferred to less. This section examines the competing perspectives and their broad areas of disagreement. The next section reviews the different types of reforms suggested by them. (Reform proposals involving brokered deposits and pass-through deposit insurance are discussed in Chapters IV and V, respectively.)

## 1. Competing Perspectives on the Trade-Off

Given broad agreement that the present amount of coverage is adequate to provide a safe haven for small savers' funds, and given the likely prospect that the level of deposit insurance coverage is likely to remain adequate for this purpose regardless of the reforms selected, the issue of proper coverage turns largely on the matter of financial stability.<sup>2</sup> In determining the proper amount of coverage, policy makers face a possible trade-off between two potential sources of financial instability: (1) the increased threat of bank runs (perhaps leading to contagion) that accompanies lower levels of coverage, and (2) the increased incentive for excessive risk-taking (by bankers) that accompanies higher levels of coverage. These potential sources of instability underlie much of this section's discussion.

### Background

It is clear that runs by uninsured depositors remain a real possibility under the present level of coverage, whenever a bank is widely perceived to be imperilled. Runs have occurred at large banks despite an apparently broad perception of a de facto one-hundred percent guarantee of deposit liabilities.<sup>3</sup> This may suggest that large-depositors' potential costs in the event of a bank failure remain sufficiently high under perceived complete insurance to cause withdrawals; or it may indicate that, at the time a big bank develops problems, the market perceives the FDIC's guarantee of large deposits as "conjectural" (Flannery (1986)), rather than de facto one-hundred percent. (This concept is otherwise known as "constructive ambiguity.") Some have interpreted the finding of differential risk premiums for large CDs as supportive of the latter explanation (Macey and Garrett (1988)), though the evidence is mixed (James (1988); Hannan and Hanweck (1988)). Regardless, it is apparent that currently a real threat of runs remains.

It is also important to note that today's bank runs are generally confined to institutions that are insolvent, or virtually so. So-called "pure panic" runs by depositors, which are not based on any determination of the bank's longer-run viability, are not observed in the current setting. Recent events in Texas provide a case in point. Nine of the ten largest banks in Texas were recapitalized during the 1980s, accompanied by hundreds of small-bank failures. Despite these events and the



otherwise dismal economic circumstances in Texas during the 1980s, there were no deposit runs on healthy Texas banks.

Bank runs impose deadweight economic losses on society, whether or not the affected institutions are insolvent. Nevertheless, some significant losses are avoided by sparing healthy institutions the threat of contagion. Present arrangements clearly do not foreclose the possibility of bank runs based on false information or occurrences unrelated to a bank's true condition, but the empirical evidence suggests little to fear for institutions that avoid real financial difficulty (Kaufman (1988)).

The empirical evidence on the effectiveness of depositor discipline, as well as its consequent costs, is mixed. Studies focusing on the extent to which uninsured deposits pay interest premiums that reflect known risk characteristics of banks produce varied results. Baer and Brewer (1988) find that average CD rates are positively related to bank risk measures derived from stock price data. In surveying previous research of this type, however, Field (1985) finds little to suggest that depositors should be relied upon to price bank risk. James (1988) reports a positive relationship between the rates paid on large CDs and the leverage ratio, and between CD rates and two measures of banking risk. Other measures of banking risk show no significant relationship to CD rates. Hannan and Hanweck (1988) report similarly mixed results. Cook and Spellman (1989) look at CD rates for FSLIC-insured institutions and find that rates are higher at institutions with lower capital;<sup>4</sup> but there are only weak relationships between CD rates and other financial variables reflecting risk.

Hirschhorn (1990) improves upon earlier methodology by using a measure of expected loss on CDs rather than measures that are only indirectly related to depositor losses. He finds evidence of depositor discipline: CD rates reflect differences in expected return and risk. Ellis and Flannery (1989) use time-series evidence to conclude that risk is priced in CD rates for the largest banks. Randall (1989) does not look at CD rates directly but examines various ways in which the market prices large bank risks. Using a case-study approach for each of the forty large bank holding companies that became "problems" (as defined in the study) between 1980 and mid-1987, Randall finds that market discipline was invariably too little and too late. He notes that, in every case, the market did not reflect the problem until the bank itself revealed its difficulty through an announcement of higher loan loss provisions or nonperforming assets.

The weight of the evidence suggests that uninsured depositors probably do provide some discipline through risk premiums on CDs. But the evidence is not unequivocal and, even if this were the case, the issue of enhancing depositor

discipline would remain open to dispute (see Goodhart (1988) vs. Kaufman (1988)).

In fact, the different views of these matters do not reflect disputes over the factual consequences of bank runs and depositor discipline so much as differing views about whether the trade-off represented by the present level of coverage, which has expanded significantly since the 1930s, is optimal.<sup>5</sup> Difficulties arise in weighing the costs and benefits associated with changes in either direction. In the direction of lower coverage, for example, perceptions of the costs associated with nonsystemic bank runs differ: the costs associated with isolated runs, as well as the probability of contagion, are hard to measure objectively, despite rich historical experience.<sup>6</sup> The different perspectives through which history is filtered lead to the gleaning of different policymaking lessons from the same set of historical facts.<sup>7</sup> Some view the pre-insurance era as a healthy one for banking, on balance, and advocate more reliance on the market, that is, on the threat of runs and depositor discipline (Kaufman (1988); Schwartz (1988)). Others see the period as excessively unstable due to the frequency and high economic cost of bank runs (based on evidence such as Bernanke (1983) or Tallman (1988)). Neither ordinary historical facts, nor empirical evidence can fully resolve the crucial issues. Ultimately, the decision regarding coverage includes some judgment about the merits of exposing depositors to greater risk. Thus, a fundamental issue is how this judgment should be made.<sup>8</sup> Two perspectives merit consideration.

### **The Special Nature of Banks**

The recognition of banks as "special" intermediaries creates a predisposition to avoiding any significant threat of bank runs (Diamond and Dybvig (1983)). To oversimplify, bank intermediation is viewed as special because it provides a vehicle to transform short-term funds into longer-term illiquid investments. In this way, funding is provided for many viable, productive investment projects that otherwise could not be undertaken. Information costs and monitoring problems for potential lenders (savers) often preclude the direct funding of innovative types of long-term investment projects via money and capital markets (see Diamond (1984)). In other words, such difficulties (distortions) make savers unwilling to commit sufficient long-term funds to support such projects directly. This is true even if the projects are financially viable and productive for the economy. Such a market failure arises most noticeably when the prospective borrowers are small firms, entrepreneurs, or firms with no established reputation in the proposed line of business. By issuing liquid liabilities to be used for funding the illiquid projects, banks help to correct the market failure.

According to the "bank specialness" view, any threat of bank runs causes banks to forego the funding of some illiquid investment projects that are economically viable. Where the threat of runs exists, banks tend to hold more liquidity (and make fewer funds available for illiquid projects) than would otherwise be necessary. Thus, productive investment and the economy's output would be lower than they could be in the presence of deposit insurance coverage that effectively removes the threat of runs.<sup>9</sup> Note, however, that too much stability will effectively subsidize bank intermediation and may lead to a misallocation of resources, as more banks extend more credit than they otherwise would under an optimal system. Riskier and perhaps socially undesirable, investments may result.

In effect, if costly bank runs are a real possibility, irrespective of a depository's health, then banking's contribution to economic activity will be nullified through the defensive reactions of depositors (such as requiring bank-run risk premiums in deposit yields). It follows that any form of depositor discipline creating a susceptibility to bank runs is to be avoided, absent convincing evidence that reliance on alternative (nondeposit) risk controls is potentially more costly than bank runs. Advocates of this view contend that there is "a much stronger case" for one-hundred percent coverage than for any rollback of deposit guarantees (Diamond and Dybvig (1986)).<sup>10</sup>

#### **Deposit Insurance Distortions**

An alternative perspective on banking views the cost of bank runs as the short-run price that necessarily must be paid for long-run stability.<sup>11</sup> The crucial judgment here generally takes one of two forms. First, the containment of bank risk-taking is technically infeasible without greater reliance on depositor discipline, due to inadequacies in available analytical or supervisory tools or logistical impossibilities. Second, without substantial depositor discipline, deposit insurance necessitates reliance on forms of risk control that are self-defeating in the long run, due to incentive problems created both by insurance coverage and institutional arrangements in public bureaucracies. The issue of supervision is addressed in Chapter IX; the incentive distortions of deposit insurance are examined below.

Incentives are distorted by insurance coverage such that deposits tend to flow away from the most conservatively managed institutions toward the most risky. This occurs because insured depositors can usually obtain higher returns from the latter with little or no added risk. When coverage is extensive, the insurer's supervision becomes essential to preventing (an increasing) overexposure to risk in the industry. According to the "depositor discipline" perspective, such supervision is unlikely to be successful without the aid of depositor discipline (if not as a preventative, at least as an early-warning device).

Thus, it is argued, the economic incentives inherent in this supervisory arrangement work against the effective containment of banking risk.

Bankers have stronger economic incentives to take risks in order to avoid regulatory constraints or guidelines than the insurer has to prevent such risk-taking. Such a conclusion follows from the fact that the reward for bankers is more directly at stake in the outcome than is the reward for government employees and management. For example, the examiner's rewards (promotion, success, etc.) do not depend nearly so much upon "results"--that is, upon the actual frequency with which the examiner detects excessive risk-taking in time to avoid losses to the insurance fund--as it does upon following prescribed procedures. Bankers, or the stockholders for whom the bank is managed, stand to gain personally and directly by actually winning the hide-and-seek game played with examiners. In addition to avoiding constraints, bankers often seek out new, unregulated forms of risk-taking (i.e., forms that the examiner has not yet been expected to identify (Kane (1981))). The banker can try to remain one step ahead of the supervisor in this manner.<sup>12</sup> Combined with the fact that incentives favor the placement of insured deposits with the most daring bankers, this suggests that excessive reliance on insurance coverage poses a long-run threat to the stability (and efficiency) of the banking industry.<sup>13</sup>

Some proponents of this view would suggest that the costly debacle in the S&L industry was the inevitable result of a deposit insurance structure that shows little regard for the importance of depositor incentives to control risk. Given the unavoidably perverse incentives created by a deposit-insurance structure, these proponents conclude that strong depositor discipline is necessary if an S&L-type catastrophe in the banking industry is to be avoided.

Finally, critics of the "bank specialness" argument also content that banks are far less "special" than they once were. Financial institutions not covered by deposit insurance provide an increasingly large amount of intermediated credit--more now than banks. This decline in "specialness," they argue, severely undercuts the need for expansive insurance coverage, given its attendant risks.

## 2. Reconciling Stability with Depositor Discipline

The two paradigms discussed above are logically complete and internally consistent (see endnote 8). Consequently, the depositor discipline issue is posed as a clash between these particular views. While there are many views on both sides of the question, each appears lacking in some way. The insufficiencies of these views are discussed below.

## The Need for Deposit Insurance

Many who oppose greater reliance on depositor discipline base their opposition on the possibility of system-wide runs to currency or other money-supply consequences of bank runs. Such views are deficient because deposit insurance is not at all necessary for preventing problems like money supply contractions. A central bank with the powers of a last-resort lender is sufficient to counter most, if not all, significant money-supply effects associated with bank runs. Thus, the stated view lacks any economic justification for deposit insurance in the first place. How can such a view then be used to justify some particular amount of deposit-insurance coverage? It could never be clear from this type of argument that any conclusions regarding coverage are well grounded.<sup>14</sup>

The special intermediation view makes it clear why deposit insurance (or its equivalent) might be necessary: the unique type of intermediation conducted by banks is potentially susceptible to information-based market failures that stem from the threat of runs and sometimes take the form of actual runs. Deadweight losses associated with the threat of runs and with actual, fire-sale liquidations of information-intensive assets cannot be avoided through last-resort lending based on "good" collateral. A last-resort lender cannot correct the market failure unless it offers a credible, noncontingent guarantee to depositors (i.e., unless it effectively acts as a deposit insurer). Because of the special nature of bank intermediation, runs on insolvent as well as solvent banks may entail deadweight (social) losses, as may the mere threat of runs itself. The special intermediation paradigm clarifies this, thus supplying a plausible economic basis for a deposit insurance system (or its equivalent).

## The Need for Market Discipline from Depositors

Similarly, there are many views favoring increased reliance on market discipline from depositors; but most fail to explain why depositor discipline should necessarily be preferred to increased supervision, namely, that depositors, and not supervisors, would be at risk and, therefore, vigilant. It is necessary to demonstrate the essentiality of more depositor discipline if the "special intermediation" argument is valid, because the latter shows that depositor discipline can be socially costly, that is, "special intermediation" gives ample reason to choose supervisory forms of risk control over depositor discipline unless it can be shown that depositor discipline is essential. Most arguments favoring enhanced depositor discipline ignore this requirement imposed by the special nature of bank intermediation and, to this extent, they fail to make their case.

The particular argument referred to here as the "depositor discipline" approach is the argument that most directly meets the above-mentioned requirement. It suggests that depositor discipline may be essential because incentives are such that supervision is most unlikely to succeed in preventing the excessive risk-taking that is engendered by deposit insurance. The adverse incentives, which are described in the "public choice" literature and the economics of public bureaucracy (see endnote 12), rig the regulatory game hopelessly in favor of risky bankers. Because bankers have stronger incentives to innovate around regulatory constraints than regulators have to prevent this, there may be no way to prevent excessive risk-taking (under current structural arrangements) except by exposing depositors to greater risk. At a minimum, this approach suggests that supervision alone will not be sufficient. (Indeed, the inability of extensive financial regulation and supervision to prevent huge losses in the banking and thrift industries suggests that enhanced depositors discipline may be not only desirable, but necessary.) However, this argument does not simply ignore the possibility that bank intermediation is special; rather, unlike other approaches, it shows why it may be necessary to expose depositors to greater risk even if this entails the social costs suggested by the special intermediation argument. It also questions the very premise that bank intermediation is as "special" as some contend, given marketplace developments. Thus, this particular version of the depositor discipline argument appears the most defensible.

#### **Problems with Both Theories**

In any case, while the particular paradigms presented here may be the best of their kind, neither is completely convincing, for each considers only one side of the trade-off between bank runs and bank risk-taking. The "special intermediation" argument presents a strong theoretical case against bank runs as a form of discipline, but fails to establish convincingly that there are any feasible alternatives to bank runs that are better (less costly, on net). The "depositor discipline" argument makes a plausible case that some threat of bank runs may be a necessary evil, but it fails to establish convincingly that the absence of depositor discipline necessarily poses greater economic risks than does the threat of runs; that is, it fails to prove that other (nondepositor) forms of discipline will necessarily be inadequate.<sup>15</sup> Neither approach can "prove" its case, because the relative magnitudes of the potential costs are unknown, and the probabilities of incurring such costs are not objectively measurable.

Both approaches also ignore empirical realities that weaken the support for their implications. Most notably, the "special intermediary" argument fails to consider that present coverage has proved sufficient to eliminate runs on healthy institutions

or that the marketplace is rapidly developing alternatives to banks for intermediated credit. Given this reality, it is difficult to argue that the threat of runs currently interferes with bank intermediation to any significant degree. Thus, there is little to be gained by increasing coverage, or even by maintaining the current level if a decrease would not result in a significant increase in bank runs.

Similarly, for the depositor discipline argument, exposing the system to an increased threat of depositor runs may not be required to achieve adequate control of bank risk-taking (except again for the circumstantial evidence of huge depository institution losses under the currently extensive safety net).<sup>16</sup> Foreign countries apparently have not yet suffered serious breakdowns in the control of banking risk; yet their bank safety nets do not appear less wide than that in the U.S. (The perception is that, in some foreign countries, there is a close give-and-take relationship between the government and major banking institutions.) Regardless, the foreign-country evidence to date does not support the popular notion that depositor discipline is a sine qua non for deposit-insurance reform.

#### Recent Experience Suggests an Answer

Despite the theoretical arguments, recent experience suggests the need for greater market discipline from depositors. Since the 1930s, the scope of coverage has vastly increased, directly enhancing systemic stability and decreasing depositor discipline. Yet, at the same time, depository institution failures have risen dramatically, particularly in the last ten years. This suggests that our current trade-off errs in the direction of stability, at the expense of the health of the system itself.<sup>17</sup> The breadth of the current safety net has permitted depository institution owners and managers to engage in risky activities, unchecked by depositors, who are almost completely protected. Common sense suggests that more market discipline from depositors will curb risky institution behavior and thereby reduce the rate of failure.

Common sense also provides an answer to those who contend that the "too big to fail" problem must be solved before any "tinkering" with the scope of coverage can have an effect. Uninsured depositors who have no pass-through coverage or have a limited number of protected accounts will naturally choose their institutions more carefully (especially in making time deposits) and demand higher "risk premiums." With constructive ambiguity, many, although not all, uninsured depositors will exercise this discipline. Thus, at the margin, depository institution owners and managers will operate safer and sounder institutions to maintain such accounts, even under a regime in which uninsured deposits are sometimes protected.

### **C. Proposals for Reform**

Various proposals for altering the current scope of federal deposit insurance are considered below. These proposals have been grouped into the following categories: (1) increasing market discipline, (2) increasing stability, and (3) increasing depositor discipline. To appreciate and evaluate these proposals critically, the existence of legal ownership rights and capacities must be understood. Through such rights and capacities, depositors may expand their coverage and the taxpayers' exposure. Therefore, reforms must control these avenues of safety net expansion. A brief discussion of rights and capacities is presented immediately below; an analysis of various reform proposals follows.

#### **1. Legal Rights and Capacities**

The explicit deposit insurance coverage provided to depositors depends on the ownership of and beneficial interests in deposited funds. There are several broad categories of ownership for which funds are separately insured:

- o individual ownership, such as a simple checking account;
- o joint ownership, such as the savings account of a husband and wife;
- o revocable trusts, in which the beneficiary is a qualified relative of the settlor, and the settlor has the ability to alter or eliminate the trust;
- o irrevocable trusts, where the beneficial interest is not subject to being altered or eliminated;
- o interests in employee benefit plans where the interests are vested and thus not subject to being altered or eliminated;
- o public units, that is, accounts of federal, state, and municipal governments;
- o corporations and partnerships;
- o unincorporated businesses and associations;
- o individual retirement accounts (IRAs);
- o Keogh accounts;
- o executor or administrator accounts; and



- o accounts held by banks in an agency or fiduciary capacity.

(A discussion of the legal underpinnings of these capacities and legislative changes that would be required to remove them are provided at the end of the chapter.)

Generally, an individual will receive only \$100,000 of deposit insurance for insured deposits under one name in a particular capacity regardless of the number of accounts held within a single institution. That is, the individual is insured within a single institution for each account held in a different ownership arrangement. Using the individual, joint, IRA, Keogh, and revocable trust capacities, a family of three could place more than \$1 million under the safety net in a single institution. If the family owns a business, the coverage could be expanded further.

The amount of deposit insurance protection may be increased dramatically through the use of multiple insured accounts in different institutions and/or held in different capacities. The above-mentioned family of three could replicate their protection at separate institutions, thereby rendering virtually limitless the amount of protection they could derive from the safety net.

The ability of depositors to expand coverage in these ways must be kept in mind when considering various deposit insurance reform proposals, for the intent of many reforms may not be fully achieved if capacities and multiple insured accounts are not restricted. For example, reducing the \$100,000 ceiling would not be a sufficient solution without restricting multiple insured accounts. Similarly, restricting multiple insured accounts in different institutions may be only partially successful if depositors remain free to maintain insured accounts in different capacities. (A discussion of these issues within the context of pass-through deposit insurance is provided in Chapter V.)

However, capacities and multiple insured accounts do serve important goals. Retaining a separate business and association capacity may further important social activities. In addition, irrevocable trusts permit landlords, lawyers, mortgage service providers, and others to hold funds in escrow accounts where the deposit insurance passes through the nominal depositor to the beneficial owners of the funds (e.g., tenants with regard to their security deposits). Presumably, such funds could be placed in government securities money market accounts instead of depository institutions. The implications of forcing such a behavioral change, however, must be considered.

## 2. Increasing Market Discipline

### Deposit Maturity Approach

The terms of the trade-off between bank runs and bank risk-taking might be altered favorably by insuring deposits on the basis of maturity, rather than size (dollar amount). Conceptually, maturity-based deposit insurance has distinct advantages over the present system. Short-term deposits, particularly in transaction accounts that are made available on demand, are the primary sources of bank runs.<sup>18</sup> Restricting insurance coverage to short-term ("runnable") deposits, regardless of size, is clearly consistent with the primary subject of deposit insurance--to avoid the costs of bank runs without inducing excess risk-taking--and appears to have a clearer rationale on this basis than does coverage based on deposit size. That is, while the threat posed by instantly callable deposits is well established, there appears to be no such connection between the size of deposit accounts and the probability (or social cost) of bank runs (Furlong (1984)).

Moreover, coverage based on maturity could, in principle, eliminate bank runs without the complete sacrifice of depositor discipline entailed by one-hundred percent coverage, the latter being the only available option for eliminating runs (with certainty) when coverage is based on deposit size. Longer-term deposits would be at risk under a maturity-based system, thus preserving some incentive for monitoring by depositors.

Despite its conceptual appeal, maturity-based insurance coverage would undoubtedly entail transition costs and implementation problems. The initial problem arises in selecting the appropriate definition of a "short"-maturity deposit. It is clear that the maximum maturity deemed eligible for coverage should allow sufficient time for determining the financial condition of the bank, and thus the definition might reflect the frequency of bank examinations (Furlong (1984)). Beyond this minimal constraint, there is little to guide the decision, since the degree of "runnability" of different maturities is not obvious and probably would not be uniform across deposits of the same maturity, given the different conceivable terms for withdrawal. The final selection of a maturity limit may not be significantly less arbitrary than the current dollar limit based on deposit size.

Switching to a maturity-based insurance system would also affect the maturity structure of bank deposits, as more funds could be expected to flow to short-term accounts. This could encourage maturity mismatching to excessive degrees, thus increasing bank risk and making bank supervision more difficult. Although it is not clear that the supervisory task would be impossible under such a system, it is probable that a greater

commitment of supervisory resources would be necessary. Of perhaps greater concern are the uncertain macroeconomic consequences of providing an effective government subsidy to short-term accounts.

It is also possible, in principle, to use interest rate caps to reduce the risks inherent in the provision of full coverage for an entire class of deposits. For example, full coverage of transaction accounts (and other short-term deposits) might be combined with a floating interest rate ceiling for these accounts (e.g., interest rates on transaction accounts could not exceed the equivalent-maturity T-bill rate by more than x percent, or penalties could be charged for excessive interest earnings). This would limit banks' ability to abuse the deposit insurance system by attracting "hot money" in times of stress. (A variant of this idea is discussed below.)

### Floating Interest Rate Limit on Insured Deposits

The current \$100,000 limit on insured deposits, and the various proposals by which to tighten that limit, all constitute variations on a quantity-rationing approach to scaling back the aggregate level of deposit insurance and, at the same time, allocating available insurance among depositors. One drawback of quantity rationing is that it fails to ensure that the rationed good--in this case insurance coverage--finds its way to the consumer that values it most highly.

An alternative method of limiting the aggregate quantity of deposit insurance available and allocating it among depositors is to use the pricing mechanism. Specifically, a federal regulator could impose caps on the rate of interest payable on insured demand accounts and certificates of deposit. The regulator would set the caps at levels projected to attract a sufficient volume of bank deposits to allow for efficient bank intermediation. The appropriate interest-rate limits would presumably be no higher than the rates payable on Treasury securities of corresponding terms. Like Treasury securities, insured accounts would be risk-free, but unlike Treasury securities, the accounts would entitle the holder to banking services such as check-writing, statement preparation, and convenience of deposit and withdrawal.

This would not, of course, be the first time the Federal government imposed an interest-rate ceiling on bank deposits. It did so under Regulation Q until these limits were fully phased-out in 1986. Regulation Q, however, imposed a flat-rate limit on deposits without regard to the interest rates prevailing in the market. As a result, when market interest rates rose in the 1970s, depositors withdrew their deposits from banks and reinvested them in money market funds and other financial instruments.

In contrast, the current proposal would permit the limit to float with the market by expressing the ceiling as a function of the rate payable on a specified Treasury security. For example, the maximum rate payable on a three-year CD would be a function of the prevailing rate paid on three-year T-bills, and the maximum rate payable on a five-year CD would be a function of the five-year T-bill rate. This floating interest-rate cap would not, therefore, produce the adverse effects of Regulation Q.

In response to the interest-rate caps, depositors would review their bank accounts and re-allocate their funds among risk-free insured bank accounts, riskier uninsured bank accounts, and instruments available outside the banking system. A depositor's decisions would reflect his or her preferences for risk, return, services, and convenience. Consequently, a given aggregate level of deposit insurance coverage would presumably be allocated to maximize depositor welfare.

The aggregate level of coverage under this system would be a function of the schedule of interest-rate caps set by the regulator. All other factors being equal, higher caps would increase the volume of insured funds, and lower caps would decrease the volume of such funds. Indeed, the caps could serve to a limited extent as a policy lever by which to influence the availability of intermediated credit.

This price-rationing approach should not, however, be seen as a means of having the market determine the optimal volume of funds available for bank intermediation. In the absence of deposit insurance, information failures regarding the safety of banks, and the "prisoner's dilemma" facing depositors considering a run, combine to provide banks with a below-optimal level of deposits. The introduction of deposit insurance to combat the failures of the bank-depositor market, however, renders depositors indifferent to the risk of bank portfolios and consequently results in an above-optimal level of deposits. The interest-rate approach would not resolve this dilemma. It would simply give the regulator a price lever rather than the quantity lever with which to influence the scope of deposit insurance. In addition, the regulators would have to ensure that banks do not evade the caps by offering in-kind benefits (e.g. by providing toasters) to depositors.

Another virtue of the interest-rate cap is that it would be relatively easy to implement gradually, thereby allowing regulators to monitor its effect on the availability of credit. Interest rates could initially be set only slightly below current levels and reduced slowly thereafter. In addition, in order to ensure that the scope of deposit insurance is not inadvertently enlarged, the current rules regarding the \$100,000 limit could remain in place at least initially in order to help control the experiment.

Finally, if depositors choose whether to have their deposits insured or uninsured, uninsured depositors who sustain losses will not appear to be the victims that they often appear to be under the current system. Consequently the pressure to payoff uninsured depositors in the absence of systemic risk will be reduced.

There are, however, potential drawbacks to the interest-rate cap concept. It could result in arguably unfair competition between the insured accounts of community banks and the uninsured accounts of large banks. The large bank would have an advantage in the following two respects: first, it would have the benefit of being perceived to be "too big to fail," despite the actual effects of the constructive ambiguity doctrine; and, second, even aside from the "too-big-to-fail" perception, depositors could use size as a proxy for safety in subjectively evaluating the risk-return profile of a large bank. In addition, like any system in which a depositor can easily move funds from insured to uninsured status, this concept could cause increased volatility of deposit from insured to uninsured accounts. Furthermore, capping interest rates on insured accounts alone would not significantly reduce the use of brokered deposits or pass-through coverage, however. The availability of multiple insured accounts and different legal capacities would be relatively unaffected by interest rate caps.

### Depositor Preference

In simple terms, depositor preference means that, in the event of bank failure, depositor claims have priority over those of other creditors. Depositors, in other words, receive full payment of their claims before any liquidation proceeds are advanced to other creditors. Alternatively, in the absence of depositor preference, depositors and other general creditors share the liquidation proceeds on a pro rata basis. At present, depositor preference laws, applicable to state-chartered banks, exist in some 23 states, but no equivalent federal statute exists for national banks.

When depositor preference is applicable, the FDIC generally has tried to effect P&A transactions whereby only deposits are assumed by the acquiring bank. Nondeposit creditors are only entitled to receive liquidation proceeds after depositors are fully paid, and since the FDIC stands in the place of depositors nondeposit creditors do not receive anything until the FDIC is fully repaid for any cash advanced or payment made to effect the P&A. Their subordinate position effectively subjects nondeposit creditors to greatly reduced protection.

Depositor preference has been particularly effective in cutting off contingent claims related to lawsuits, letters of credit, and loan commitments, which in some instances could have

imposed substantial costs on the FDIC. Most of the affected failed banks have not had significant unsecured, nondeposit financial liabilities, and they have generally been too small to have substantial off-balance-sheet activities. When the FDIC sought federal depositor preference legislation in 1986, it was the larger banks that objected strenuously. They argued that in a bank failure, creditors whose claims derived from letters of credit and other guarantees might expect to recover little, if anything, from liquidation, and the same would apply to foreign-branch deposits if the preference applied to domestic deposits or deposits subject to insurance. This, they maintained, would substantially hamper their ability to compete with foreign banks and nonbank financial institutions in these markets.

In principle, this problem could be avoided if large banks moved certain of their activities to the holding company, thereby removing them from the advantages or disadvantages of deposit insurance. However, many bank holding companies have little (frequently negative) equity apart from their investment in their principal bank. Few would be able to compete without their lead bank.

The enactment of nationwide depositor preference legislation could have many positive effects. It could reduce the FDIC's failure-resolution costs because the FDIC would be reimbursed on its claims before nondeposit creditors. It might make it easier to adopt failure-resolution policies that enabled creditors to be treated more consistently. Depositors could be protected for banks of all sizes, while nondeposit creditors could be subject to losses more often. Market discipline might thus be increased without resorting to an increase in depositor discipline. There would be fewer concerns over the stability of the system if depositors were not likely to incur losses.

The magnitude of the deposit insurer's gains from depositor preference laws is uncertain because nondepositors can be expected to react to such laws. Hirschhorn and Zervos (1990) found that nondepositors move to collateralize their claims when depositor preference is introduced. In some cases, collateralization has been sufficient to fully offset the benefits of depositor preference to the insurer. Thus, the likely impact of national depositor preference is unclear. (The issue of collateralized deposits is discussed in Chapter XIV.)

Aside from this consideration, the biggest drawback of the proposal appears to be related to the substantial increase in costs for banks competing in certain markets. These additional costs may drive banks, particularly larger banks, out of certain businesses. Many off-balance-sheet activities of larger banks presently offer low profit margins. The prospect of greatly reduced returns (due to the effects of depositor preference laws) to nondeposit creditors may increase costs enough to drive U.S.

banks out of some of these markets. While it is not clear whether such a concern offsets the potential benefits associated with depositor preference, the FDIC's "pro rata" authority provides a resolution method which retains most of the available benefits from depositor preference without imposing such high costs on nondeposit creditors: transactions can be arranged in which all deposits are assumed by another bank, but general creditors receive their pro rata share of recoveries. Such transactions have been utilized successfully to deal with situations where cost otherwise would have prohibited P&A transactions.

### 3. Increasing Stability

The statutory coverage limit is indicative of the scope of the safety net only in the absence of implicit types of coverage for depositors. Recognizing this, some have concluded that the FDIC's handling of bank failures (whereby depositors typically avoid losses and, in large-bank failures, some general creditors also do) has effectively reduced depositor discipline to minuscule proportions and has weakened several nondeposit sources of market discipline in the process.<sup>19</sup> In other words, this view suggests that the current operation of the deposit insurance system reflects essentially a trade of market discipline at the bank level for virtually complete protection against runs on solvent institutions, despite appearances created by the statutory limit.<sup>20</sup>

This type of argument typically leads to a conclusion that explicit, one-hundred percent coverage is appropriate.<sup>21</sup> It suggests that there is virtually nothing to lose in the way of depositor discipline, and there are several gains to be made.<sup>22</sup> First, full coverage could result in somewhat greater stability than is now common, eliminating some uncertainty and perhaps providing an environment that would allow for a more orderly resolution of failures. Recalling that a major function of deposit insurance is to remove the economic inefficiency associated with the threat of runs, full coverage does this most certainly and completely. Second, it would produce a more equitable system in that large depositors would be treated equally regardless of the circumstances surrounding a bank failure, and small banks could compete for large deposits on more equal footing with big banks. Third, although full coverage could completely eliminate depositor discipline, it could increase market discipline overall if nondeposit creditors faced certain loss in the event of a bank failure. Finally, full coverage would not change the FDIC's failure-resolution costs appreciably under current methods of handling large-bank failures and, with minor changes in failure-resolution procedures under a full-coverage scheme, the fund's risk exposure could probably be reduced (FDIC (1989) and Silverberg (1988)). (As noted above, insurance, interest rate caps might be used under a full-coverage

scheme to limit the potential for abuse. Banks might be prohibited from (or fined for) paying more than x percent above the equivalent-maturity T-bill rate on insured deposits.)

The major difficulty with the argument for full coverage is the assumption that depositor discipline is completely ineffective in the current environment. Although the evidence is mixed, as noted earlier, there are periods during which CD markets appear to be fairly sensitive to bank-specific risk and act as a constraint on banks wishing to pursue riskier positions.<sup>23</sup> This constraint may be necessary for control of bank risk-taking in a deposit insurance environment, given the artificial incentives to take on risk.

Even in the absence of this evidence, however, it may be argued that constructive ambiguity provides some net benefits to the system. First, though after-the-fact discipline may come too late to help the affected institution, it may still act as a deterrent to other banks pursuing similarly risky positions. Second, the after-the-fact flight of funds from floundering institutions may alert supervisors to problems that deserve closer attention or to institutions that require closing. Absent such runs, troubled institutions may go unnoticed for some time, thereby increasing eventual losses to the insurance fund. Finally, such liquidity pressures may force chartering authorities to deal with problems (in the form of bank closings) they might otherwise be reluctant to address. In effect, uninsured depositors may act as a check on regulators, forcing them to deal with problems once they are identified.

These considerations suggest that, despite a standing failure-resolution policy that has generally provided full coverage for depositors whenever possible, there is still market discipline from depositors. Thus, the proposal for one-hundred percent coverage may amount to a trade-off of discipline for little additional protection against damaging runs. Moreover, it may be important to note that government protections, such as deposit insurance, are often difficult to roll back once they are extended. There is a danger that expanding explicit coverage to one-hundred percent would foreclose all future opportunities to enhance depositor discipline. This could prove costly if greater reliance on depositor discipline becomes even more feasible in the future. By the same token, the benefits of depositor discipline could prove insufficient to justify the costs resulting from incomplete coverage. This argues against any binding commitment to a particular amount of depositor discipline or any institutional structure that precludes the possibility of providing one-hundred percent coverage for deposits.



#### 4. Increasing Depositor Discipline

By far the most common type of deposit-insurance reform proposal would expose large depositors to greater risk. These "haircuts" for uninsured depositors (a certain loss of X percent on balances over \$100,000), reductions in the statutory coverage limit (below \$100,000), reductions in the number of accounts eligible for insurance per person and/or per institution, reductions in the maximum dollar amount of coverage attainable by any individual (a systemwide maximum for any given point in time or a maximum for the individual's lifetime, or both), graduated decreases in the percentage of deposit balances insured above a given size, certain (i.e., nondiscretionary) losses for specific types of deposits (e.g., large, corporate, long-term CDs), and many others.

As stated earlier, the first and most fundamental question for policymakers' consideration is not how to expose depositors to greater risk but whether to do so. Each of the proposals would reduce coverage for at least some depositors and thereby create a greater probability of bank runs as compared to present circumstances. The resulting potential costs, as described in the "special intermediation" paradigm, form the basis of the main objection to all such proposals. It has been suggested that the potential losses to depositors could be kept small enough that bank runs would not constitute a significant threat. But, as noted earlier, there is little factual evidence (and no conclusive analytical argument) supporting such an opinion.<sup>24</sup>

In short, the primary arguments for and against these proposals are similar to those concerning the fundamental trade-off (as conveyed by the competing paradigms considered above). Differences among these proposals will not help to determine whether depositor discipline is the right kind of deposit-insurance reform, but they will become paramount if exposing depositors to greater risk is found acceptable.

For example, there appears to be a logical inconsistency in proposing a single, lifetime deposit-insurance entitlement of \$100,000 per person. If an individual's deposit-insurance entitlement will be reduced in the event of his bank's failure, the individual retains a clear incentive to run on the bank whenever there are doubts about its condition. Such an entitlement appears to offer none of the benefits that deposit insurance is intended to provide. Depositors can be expected to continue to protect themselves from the threat of bank runs under such a system, incorporating a bank-run risk premium in the yields they require on bank deposits. It is difficult to see how this improves upon a banking system with no deposit insurance or, if it does, it is not clear how the benefits could be large enough to justify the administrative costs.

To further illustrate some of the practical consequences of depositor discipline, the individual features of a few popular proposals are considered in more detail below.

### **American Bankers Association Proposal**

This proposal introduces a new failure-resolution procedure referred to as "Final Settlement Payment." Failed institutions would be placed in receivership at the close of a business day and, overnight, a determination would be made as to which deposits are eligible for insurance coverage. New computer systems and data bases would be required in order to make this feasible for large banks. The following business day, a new entity--either an acquiring institution or a bridge bank--would assume all insured deposits as well as a specific percentage of uninsured deposits. This percentage would reflect the FDIC's average rate of recovery on failed-bank assets in the recent past, as updated over time.

Based on the experience of the 1980s, the "haircut" to be imposed on uninsured depositors would be about 10 percent under the American Bankers Association (ABA) proposal. Any gain or loss on the disposition of assets in the receivership would remain with the FDIC; that is, if the FDIC collected more (less) than average in a particular case, it would keep the excess (absorb the loss). Uninsured depositors would have no further claim on receivership assets after "final settlement payment."

To supplement depositor discipline, the ABA proposal also calls for strengthening the corps of examiners, closer scrutiny of charter applications and of newly chartered banks, and an international agreement to institutionalize depositor discipline for industrialized countries. But the truly novel feature is the final settlement payment, which is supposed to provide depositor discipline without risking systemic instability. If enforced, this feature would equalize the treatment of uninsured depositors at large and small institutions and, if systemic instability is avoided, it would reduce the cost of failure resolution.

The crucial assumption is that there will be greater stability under the ABA plan than under circumstances in which uninsured depositors are uncertain of their potential loss (as now). This seems intuitive, but it is not evident that the volatility of a deposit base is a function of the fractional loss that would be felt in a bank failure. Rational depositors will choose to participate in a bank run so long as the transaction costs incurred by transferring funds appear smaller than the expected loss incurred by remaining in the bank. Thus, the impact of the ABA solution may reduce aggregate losses, but it may not reduce the incidence of runs.

If depositors would be more prone to run under the ABA plan, then both healthy and problem institutions may suffer adverse consequences.<sup>25</sup> Problems at one bank may produce runs on similar or neighboring institutions, and the fact that runs may be self-fulfilling may have some negative industry-wide effects. In particular, the ABA plan may impair the ability of banks to provide services involving large flows of funds. Lock-box operations, which provide a non-credit source of revenue for banks, provide one example. (In a lock-box arrangement, a firm directs customers to send payments to a post office box which is controlled by the firm's bank. The bank continuously collects the check payments, credits the firm's account, and immediately enters the checks into the collection system.) If corporate lock-box customers are subject to loss, they may be inclined to take such business outside the banking industry. Such a loss of business would not necessarily reflect a form of discipline directed at poorly run institutions; it may follow solely from the desire to avoid losses resulting from unexpected bank failures.

Another example involves correspondent relationships. Many such relationships are based on check-clearing activities which, by their nature, involve large sums of money. If the ABA plan were in effect during a severe regional economic downturn, such as the Texas collapse of the 1980s, it is easy to imagine a community bank shifting its check-processing arrangements from one large, failing bank to another. The community bank may experience several haircuts in the process so that, despite the fact that a given haircut may be inconsequential, the combined impact of several may impair the health of the small institution.<sup>26</sup>

The ABA scheme also raises questions concerning the efficiency of the payments system. In particular, it seems reasonable to expect that, given the inevitable haircut that will be imposed in the event of a failure, banks, or their check-clearing agents, would wish to protect themselves from the risk of accepting checks on banks that are about to fail. They may refuse items drawn on such banks, given that Regulation CC prohibits the alternative of imposing long delays before making funds available, and the checks may be returned to the depositor for manual collection. In this manner, the efficiency of the payments system may begin to deteriorate.<sup>27</sup>

Finally, there is the issue of cost (specifically, the cost of developing and maintaining the systems required to implement the ABA plan) and there are potential legal issues concerning "final settlement payment." As noted elsewhere,<sup>28</sup> it may be costly to accomplish the computer programming and recording of accounts (for determining insurability) that would be necessary to ensure a final settlement payment on the day following a large-bank failure. Before implementing such a system, it should

be clear that the operational costs will not be overly burdensome since, ultimately, the health of the banking industry is likely to be an important determinant of deposit-insurance losses.

As suggested earlier, final settlement payment differs from previous failure-resolution methods in that depositors and unsecured creditors may sometimes receive less than would be the case in an insured-deposit payoff. It is not expected that the FDIC would make a profit across all resolutions (since the "average" could be adjusted as necessary to reflect current conditions), but there would doubtless be a profit for the FDIC on several individual resolutions. The constitutionality of taking property in excess of resolution costs (from depositors and unsecured creditors) needs to be established before building a new deposit insurance framework based upon this proposal.

#### **\$100,000 per Institution and \$100,000 per Individual**

It has been proposed that insured accounts at different institutions and the use of different legal capacities be restricted or eliminated, so that individuals would be limited to a total of \$100,000 in federal deposit insurance. Even under a "too big to fail" policy, constructive ambiguity will reduce exposure at the margin.

Proponents believe these proposals would not affect the "average" depositor, because the average size of a U.S. bank deposit is in the neighborhood of \$8,000. Such statements are partly true. However, to the extent that such measures might occasion more bank runs or otherwise produce more financial instability, all depositors (and everyone else) may be affected. Second, the data suggest that a sizable percentage of U.S. household deposits, if not all households, could be affected by these measures. The real impact on households of limiting insurance to \$100,000 per institution may be a mere payment to brokers, who could parcel the uninsured funds in \$100,000 bundles across different institutions. Limiting coverage to \$100,000 per individual would obviously have a greater impact.

The latter proposal also would require greater administrative expense and, depending upon how it is structured, this scheme may raise complex technical difficulties. There are two basic structural options for limiting insurance to \$100,000 per individual. Either individuals must designate in advance which specific accounts at which institutions are to be insured, or accounts at all institutions currently in receivership would be combined and analyzed for insurability (similar to the process currently used within a single institution).

If accounts are to be designated in advance, controls would be needed to prevent the intentional or inadvertent designation of funds in excess of \$100,000. This task is complicated by the

dynamic nature of bank deposits. Not only do customers change institutions, they also switch funds among accounts within the same institution. In addition, balances within accounts vary over time.

Perhaps most important would be the provisions allowing depositors to switch designations among institutions. As concern over a specific bank's viability mounts, we would expect depositors with time accounts to switch designations as necessary to cover any uninsured funds in the troubled institution. Because such designations would be changing continuously, banks probably would need to report any changes electronically in order to keep the FDIC's data base up to date. The cost of reporting requirements would be reflected in deposit yields and loan rates, and the FDIC's cost of data support and maintenance functions would be reflected in deposit insurance premiums.

Because individuals would be responsible for the accurate designation of account balances, they may need access to information kept on the FDIC's master file. This would raise potentially significant privacy and security-related concerns. The potential for fraudulent use of the released data may be considerable, and while information requests could be channelled through individual banks, depositors may not wish a bank to know about accounts being held at competing institutions.

The alternative structure, in which accounts at all institutions in receivership are combined and checked for insurability, entails similar administrative costs and raises similar privacy and security-related issues. In addition, the time required to sort out accounts could extend the time a failed institution is held in receivership (or equivalently dormant status). The franchise value of an institution tends to diminish the longer is the delay (Bovenzi and Muldoon, 1990).

Further problems may arise if depositors have accounts at multiple failed institutions, and the sum of the deposits exceeds the insurance limit. Under this scheme, a person with a \$100,000 deposit in each of three banks (\$300,000 total) would have \$200,000 uninsured in the event that one bank failed, and no deposit insurance would be available for this person until the failed bank is taken out of receivership. The timing of the closures and the length of the receiverships then become important in determining the extent of coverage for such depositors. Depositors could accuse the insurer of keeping a given bank in prolonged receivership in order to reduce potential liability in other institutions that are about to fail. Similarly, in the event of a regional banking calamity affecting all depository institutions and, hence, all three insurance funds (*i.e.*, BIF, SAIF, and NCUSIF), there would be an incentive for each insurer to wait until another began forcing the closure of institutions. Insurers of institutions closed the latest would

have the least risk of liability for accounts of common depositors.

The risk of a destabilizing deposit flight is most apparent under this scheme. When a bank is put into receivership, its depositors having more than \$100,000 in the banking system would lose part or all of their protection at other institutions until the failure is resolved. This clearly creates an incentive to remove funds from any institutions that may be subject to similar problems (and perhaps from all banking institutions). It is easy to see how regional economic instability might be intensified by the effect. (See Golter (1990) for details.)

One variant of this approach may substantially reduce administrative (enforcement) costs. A system of spot-checking, that is, selecting a manageably sized subset of the failed bank's depositors to check for violations of the systemwide limit, may be effective if combined with stiff penalties for violators. Relatively few resources would be required for enforcement, and there need be no delay or interference in the resolution of the failed bank. Auditors would determine the dollar amount of systemwide deposits for the randomly selected depositors as of the failure date, and the auditors would deal with violators individually. The failure resolution could proceed independently of this process. It may be possible to avoid costly, real-time reporting of accounting balances in a centralized computer and instead to focus on periodic reporting of the openings and closings of insured accounts. It remains to be seen whether such an arrangement might be feasible, but with or without it, this approach to enforcing a systemwide limit may be the least costly.

#### **Lower Statutory Limit and/or Graduated Coverage**

A great variety of proposals are designed to reduce the \$100,000 statutory limit or to graduate the levels of deposit insurance coverage (full coverage for the first \$100,000, 50 percent coverage for the next hundred thousand, etc.) or both (full coverage for \$10,000, 75 percent coverage for the next \$50,000, etc.). The primary arguments for and against such proposals have already been covered. Thus, this section focuses on the available data (size distribution of deposits) that may indicate some of the first-order effects of changes in the statutory limit (on households and small businesses). Brief summaries of the relevant data are accompanied by references to more complete analyses in the event that further information may be needed.

The only complete data set concerning the size distribution of household deposits is the 1983 Survey of Consumer Finances (SCF). (See Greenspan (1990), Appendix I, for more details and references.) The information from this survey is dated and, due to inflation, it is possible that the nominal value of deposits

in any given category is vastly larger now than is reflected by the 1983 data. Preliminary information from the 1989 SCF is not yet available but will be soon. Clearly, the 1989 survey should be consulted before any final decisions are made.

Table 1 shows selected characteristics of 1983 household account holders, classified by the size of the household's largest individual account at an insured institution. Table 2, on the same page, shows the estimated percentage of household deposits that would be covered under various hypothetical deposit insurance ceilings. The data are rough, even without considering their age. Note also that household deposits represented only 37.6 percent of total deposits in 1983. Nonetheless, the data may be suggestive. For example, only one percent of 1983 households had a deposit account equal to or greater than \$100,000. In addition, less than three percent had an individual account of \$50,000 or more. Furthermore, as Table 2 indicates, lowering the level of deposit insurance coverage will affect relatively few households. Lowering the deposit insurance level may have other costs, however. According to Federal Reserve Board Chairman, Alan Greenspan, the \$100,000 level has been in place long enough to be fully capitalized in the market value of depository institutions and incorporated into the financial decisions of millions of households.

The 1988 Survey of Small Business Finances gathered information from 3,404 businesses and weighted the responses to develop appropriate estimates for the population of small, nonagricultural, nonfinancial businesses (some 3.5 million firms). The results showed that large-balance accounts were relatively infrequent among these firms (246,000 firms (7.1 percent) had accounts of \$100,000 or more), but nearly 63 percent of all small business deposits were held in accounts that exceeded \$100,000. Several small businesses also have accounts at more than one institution. Tables 3 and 4 summarize the relevant information from this survey (see Greenspan (1990), Appendix II, for more details and qualifications). Note that small business deposits represented only a tiny share of total deposits (3.5 percent) in 1988.

The information on households and small businesses together accounts for less than half the total of U.S. deposits. Absent data concerning the majority of deposits, it is difficult to anticipate the broad first-order effects of changes in the statutory insurance limit and/or graduated coverage schemes. Nonetheless, it is relevant to consider that, since a majority of small business deposits already exceeds the statutory coverage limit and since many small businesses have multiple accounts, restricting the number of insured accounts or setting a systemwide coverage limit per depositor may be more effective in reducing the government's liability than reducing the dollar limit per account. The same could, perhaps, be said for

Table 1

Household Account Information: 1983 Survey of Consumer Finances

	Size of largest individual account at an insured depository institution					Total
	Under \$25,000	\$25,00 to \$49,999	\$50,000 to \$74,999	\$75,000 to \$99,999	\$100,000 and above	
Percent of all households.....	80.3	4.5	1.5	0.4	1.0	87.3
Amount of deposits (in billions of dollars) .....	379.2	197.9	109.8	40.9	221.0	948.8
Percent of all deposits held.....	15.0	7.8	4.4	1.6	8.8	37.6
Percent of all household deposits .....	40.0	20.8	11.6	4.3	23.3	100.0

Source: Greenspan (1990), Appendix I.

Table 2

Estimated Percent of Household Deposits Covered by Federal Deposit Insurance

("Individual account" definition as used for size categories in Table 1)

	Deposit insurance ceiling			
	\$25,000	\$50,000	\$75,000	\$100,000
Percent of household accounts covered .....	71.3	83.5	88.2	91.3

Source: Greenspan (1990), Appendix I.



Table 3

Deposit Account Ownership by Small Businesses: 1988 National Survey of Small Business Finances\*

	Size of largest individual account at an insured institution					Total
	Under \$25,000	\$25,000 to \$49,999	\$50,000 to \$74,999	\$75,000 to \$99,999	\$100,000 and above	
Amount of deposits (in billions of dollars) .....	19.4	10.9	10.9	7.0	82.0	131.2
Percent of small business deposits.....	14.9	8.4	8.4	5.4	63.0	100.0
Percent of all deposits .....	0.5	0.3	0.3	0.2	2.2	1.3
Number of accounts held (in thousands).....	3,255	331	191	83	297	4,157

\* Note that for any given respondent, all accounts at one institution were combined into one deposit account. This biases the estimate of uninsured deposits upward.

Source: Greenspan (1990), Appendix II.

Table 4

Estimated Percent of Small Business Deposits Covered by Deposit Insurance: 1988 National Survey of Small Business Finances\*

	Deposit insurance ceiling			
	\$25,000	\$50,000	\$75,000	\$100,000
Insured deposits (in billions of dollars) .....	41.9	58.8	69.7	77.1
Uninsured deposits (in billions of dollars).....	88.3	71.4	60.5	52.9
Percent of small business deposits covered .....	32.2	45.2	53.5	59.9

\* Note that for any given respondent, all accounts at one institution were combined into one deposit account. This biases the estimate of uninsured deposits upward.

Source: Greenspan (1990), Appendix II.

household deposits (although this is not certain from the data presented), since a substantial majority of these deposits would remain covered even as the dollar limit falls to \$50,000 or to \$25,000. The final impact on the government's liability obviously depends upon depositors' adjustments to the new rules, but restricting the allowable number of insured accounts or enforcing a systemwide coverage limit has the additional virtue that no amount of brokering can help the depositor to increase his coverage (and thereby expand the breadth of the safety net). Note also that the ability of individuals and businesses to divide their funds among depository institutions within numerous capacities without restriction will counteract the intended effects of a lowered deposit insurance level.

#### **Exclusion of Deposit Classes from Coverage**

A final feature for consideration pertains to reforms that would impose losses on select classes of depositors.<sup>29</sup> In particular, the proposal to impose larger (or more certain) losses on large (over \$100,000), long-term deposits by sophisticated investors (perhaps corporations) appears to have fewer drawbacks than the other proposals in this category. The usual objection to depositor-discipline proposals--that they heighten the threat of bank runs unacceptably--would appear to have less force in this instance, since the target class of deposits represents a decided minority of deposit liabilities for most banks.<sup>30</sup> Even if runs were prompted by the enactment of this proposal, they would be confined to a relatively small component of deposits. It does not seem likely that the viability of the average bank (regardless of size) could be seriously threatened by the actions of this class of depositors (especially given the leeway to define "large" and "long-term" appropriately). Meanwhile, regulators may get early-warning signals from the reactions of this class, including changes in the risk premiums embedded in the deposits' yields. While the ultimate result may in fact be the disappearance of the targeted class of deposits, it is not clear that this possibility represents a compelling argument against the proposal.

#### **D. Policy Objectives in Resolving Bank Failures**

There are several policy objectives that must be weighed against each other in determining the most appropriate failure-resolution method. First, the FDIC must resolve institutions in a manner that maintains public confidence and ensures the stability of the banking system. Thus, it has avoided using failure resolution methods it believes would unnecessarily risk destabilizing the banking system.

Second, there is a need to encourage market discipline against risk-taking. The methods used to resolve bank failures

have implications for the amount of discipline exerted by market participants against risk-taking by other banks. Failure resolution policies influence the probability of loss and the size of loss that claimants may incur. In turn, these factors influence the degree to which any particular group of claimants will monitor and attempt to control a bank's risk-taking.

Third, failure resolution procedures should be cost-effective. By law, unless the troubled bank's services are found to be "essential" to provide adequate depository services to the community it serves, the FDIC is required to meet a "cost test" in which it must be reasonably satisfied that the alternative pursued is not more costly than a liquidation and insured deposit payoff (although the law does not require the resolution to be less costly than an insured deposit transfer).

Fourth, failure-resolution policies should be as equitable and consistent as possible. In recent years, the most prominent equity issue has been the treatment of uninsured depositors and creditors in large versus small banks. Fifth, it is desirable to minimize the government's role in owning, financing, and managing financial institutions and financial assets. Finally, it is desirable to minimize disruption to the community where the insolvent institution is located.

The objectives outlined above are not always mutually compatible. The most basic trade-off exists between stability and market discipline. While some degree of market discipline is necessary to help control insurance costs, too much market discipline could lead to greater instability and increased insurance costs by encouraging depositor runs. A second inherent conflict exists between equity and cost-effectiveness. Consistency and equity considerations suggest that all bank failures should be handled in the same manner. However, this may reduce the insurer's flexibility in obtaining a less costly or less disruptive transaction in any given situation. These and other possible conflicts among policy objectives make the selection of appropriate failure-resolution policies a difficult process.

The choice of a failure-resolution transaction is suggested by the priority given to different policy objectives. If stability was the overriding concern, the FDIC should commit to handle all bank failures in a manner that fully protects all bank creditors; no bank runs would result. If market discipline and/or cost were the only concerns, the FDIC generally should restrict coverage to insured depositors. That is, banks would either be closed and liquidated or insured deposits would be transferred to another institution, which might pay a premium and even purchase some of the failed bank's assets. For any given amount received by the FDIC on the failed bank's assets (either through a P&A or a liquidation), transferring only the insured

deposits must virtually always be cheaper to the FDIC than making whole uninsured depositors or other uninsured creditors.<sup>31</sup>

## 1. "Too Big To Fail"

Equity considerations have played an important role in determining the resolution methods used by the FDIC. As a result of providing full protection to the depositors and creditors of Continental Illinois National Bank in 1984, it became "unfair and inappropriate" for the FDIC to continue its modified payoff experiment in which uninsured depositors and creditors received only a cash advance for their expected pro rata share of receivership collections. The unfairness, of course, was that the Continental transaction had demonstrated that uninsured depositors in the largest banks would not be subject to this "haircut."

As noted, an important obstacle facing depositor-discipline proposals is the "too big to fail" problem. If reductions in coverage are likely to be ignored by policy-makers in the event of large-bank failures, then discipline may not be as strong as it otherwise would. Nevertheless, constructive ambiguity will continue to enhance depositor discipline at the margin.

The phrase "too big to fail" refers to a situation in which the FDIC (or some other governmental unit) is unwilling to inflict losses on uninsured depositors and even creditors in a troubled bank (or bank holding company) for fear of adverse macroeconomic consequences or financial instability of the system as a whole. The most clearcut example was Continental Illinois National Bank, with liabilities at the time of the transaction of \$33 billion, of which only about \$3 billion were insured. The FDIC (and the other banking agencies) did not consider paying off Continental a feasible option. To date, the largest failed bank resolved through an insured deposit payoff is the Capitol Bank and Trust Company of Boston, which had deposits of \$438 million, \$25 million of which was uninsured.

In large bank failures, the FDIC is concerned with the potential systemic instability which might result from depositor losses, not with preventing the failure of the bank per se. A more accurate description of the issue is not whether there are some banks which are too big to fail, but whether there are some banks which are too big to risk the systemic consequences of allowing such a failure.

The FDIC's treatment of creditors of large banks is not unique when viewed in the context of the international banking system. As discussed in Chapter XXI, depositors at large failed banks in foreign countries generally have received full protection (although not necessarily through deposit insurance). There have been exceptions, and the coverage has been provided on

an informal and ad hoc basis, rather than a statutory basis, but, on balance, the large bank safety net in foreign countries is at least as broad as it is in the U.S.

What is the cost of a "too big to fail" approach? That is, what would the savings have been if large bank failures had been handled with insured-deposit transfers or payoffs? This question is difficult to answer, primarily because the behavior of depositors and other market participants would likely have changed after the FDIC first used an insured deposit payoff to resolve a large bank failure. On the one hand, by enhancing depositor discipline, the payoff policy may have prevented some of the problems that later brought down other large banks. On the other hand, the greater incentive for depositors to run under the threat of payoffs may have raised the social cost of bank failures by causing fire-sale liquidations of illiquid assets, and it may have produced more failures than have actually occurred.

Despite this overwhelming caveat, it may be useful to consider the liabilities that might have been available for loss-sharing with the FDIC in each of the six most recent large-bank resolutions. Table 5 shows uninsured deposits and unsecured liabilities as taken from the call report filed prior to a major news announcement regarding the FDIC's resolution transaction for each institution. The third column shows the total losses that would have been incurred by uninsured depositors and unsecured creditors under a payoff policy, as determined from the calculated value of receivership certificates that would have been presented to subsidiary banks in these cases had the banks been closed on the call-report dates. (Assets and liabilities were adjusted for secured claims, and assets were discounted to reflect the differences between book and market values.) The call report data do not include offsets, such as loans, that may have reduced the losses to uninsured depositors and unsecured creditors, so the potential savings obtainable from a payoff are overstated by column three.

There is an additional qualifier that is important for interpreting the figures in Table 5. The savings figure assumes that the primary regulator (OCC) would have been able to close these institutions at the chosen call-report dates. This may not have been possible, given the OCC's closure policy (primary capital insolvent)<sup>32</sup> at the time. Given the delay between the call report dates and the probable times of closure, there could have occurred further runoffs of uninsured deposits and some additional securing of unsecured liabilities. This would have reduced the potential for loss-sharing by the FDIC and, again, the Table would overstate the potential savings associated with payoffs.

**Table 5**

**Too Big to Fail <sup>1</sup>**

(In thousands of dollars)

	Total assets <sup>2</sup>	Uninsured deposits and unsecured liabilities <sup>3</sup>	Losses on (2) (potential savings for FDIC)
	(1)	(2)	(3) <sup>4</sup>
BancTexas.....	\$1,128,286	\$195,090	\$46,049
First City.....	14,849,781	3,550,953	598,409
First Republic.....	40,720,857	8,650,239	1,201,718
MCorp .....	18,776,872	4,377,387	851,838
Texas American Bancshares.....	6,062,392	1,214,509	187,900
National Bancshares Corporation.....	2,889,030	542,905	88,882
<b>Total.....</b>	<b>84,427,218</b>	<b>18,531,083</b>	<b>2,974,796</b>

<sup>1</sup> See text for important qualifications and description of methodology.

<sup>2</sup> Adjusted to reflect market value and secured liabilities.

<sup>3</sup> From call reports prior to major news announcements concerning the status of the institutions.

<sup>4</sup> Assuming an insured deposit payoff or transfer, this column reflects losses that could have been absorbed by uninsured depositors and unsecured creditors, rather than by the Federal Deposit Insurance Corporation.

Source: Federal Deposit Insurance Corporation.

Because uninsured parties would seek protection in the event that the FDIC embarked on a payoff policy, the total savings figure of \$2.97 billion probably is not meaningful. Moreover, for the reasons suggested earlier, the figures for individual institutions should be interpreted as reflecting the maximum potential savings available if the given institution were selected for a one-time only payoff of a large depository. So viewed, these figures cannot be summed meaningfully.

Finally, in order to solve the perceived "too big to fail" problem, some reform proposals would force the FDIC to handle all bank failures in a way that imposes losses on uninsured depositors and creditors. The impact of these proposals on banks is addressed below.

## **2. Insured Deposit Payoff Risks**

A payoff (or modified payoff) poses three sources of risk to large banks. These risks include (1) payments system problems, (2) possible "contagion" effects of large bank failures, and (3) systemic instability. Each of these is discussed below.

### **Payments System Problems**

The failure of a major bank participant in the U.S. payments system could raise systemic risk concerns from a number of perspectives. Major banks are typically actively involved in privately operated clearing and settlement arrangements, such as the large-dollar Clearing House Interbank Payments System (CHIPS) and local check clearing houses. In addition, they participate as principal in various markets, such as government securities, federal funds, mortgage-backed securities, commercial paper, foreign exchange, options, futures, and so forth. Payment obligations that arise in these markets are frequently discharged over private payment and clearing arrangements. Further, large banks provide vital correspondent banking, custodial, and securities services. Many large banks also extend and receive billions of dollars of intraday credit through various payment arrangements. Thus, there are many interdependencies among the participants in the payments system.

The following four possible scenarios involving a large bank's failure and the potential systemic ramifications of such a failure are reviewed below: (1) participation in CHIPS; (2) provision of wholesale banking (payment) services; (3) provision of custodial services; and (4) provision of credit to clearing organizations or their participants.

**CHIPS.** CHIPS is a multilateral payment netting and settlement system, operated by the New York Clearing House Association. The majority of transactions processed over CHIPS

are related to the settlement of foreign exchange transactions and international investment and trade activity. Currently, CHIPS processes payment messages with a daily average value of about \$1 trillion. As payment messages are processed, the sender's CHIPS balance is debited and the receiver's CHIPS balance is credited. At the end of the day, the CHIPS processing center calculates each participants's net debit or credit position. The payment messages exchanged among participants during the day are then settled through the use of FedWire.

The credit extended by CHIPS participants to each other is controlled through the use of bilateral credit limits. In addition, each participants's aggregate debit position is controlled through the use of net debit caps. In October 1990, CHIPS changed its risk management features to provide a facility to guarantee settlement in the event that a major participant on CHIPS was unable to fund its settlement obligation at the end of the day. In such a case, each remaining participant would incur an additional settlement obligation (ASO), amounting to a pro rata share of the defaulting participant's initial settlement obligation. The ASOs are collateralized by securities held for the benefit of CHIPS participants. If the ASOs are not promptly settled, the collateral posted by the defaulting participant may be sold to satisfy its obligation. (At present, a total of \$3.3 billion of book-entry U.S. government securities is held in CHIPS collateral accounts.)

In light of the settlement guarantee, it is unlikely that the failure of one large CHIPS participant would cause other participants to be unable to settle. Some participants, however, may face liquidity problems in funding their ASOs. Additionally, non-settling participants could experience some problems. Currently, fewer than ten banks settle for over 100 non-settling participants. If one of the settling banks did not settle, participants normally settling through it would have to settle through another settling participant. If the non-settling participants had pre-funded their settlement obligations at the defaulting settling bank, the non-settling participants might be unable to fund their settlement obligations. Thus, the failure of one settling bank could provoke multiple settlement failures.

Similarly, general instability in the banking system could lead to multiple settlement failures. If this situation were to occur, CHIPS would assess the remaining participants' ASOs to cover the combined deficit of the defaulting participants. Some participants might be unable or unwilling to cover their ASOs and, if the deficit exceeded the value of the collateral posted, CHIPS would unwind all of the debits and credits of the defaulting participants and recalculate new settlement positions. Such an unwind could dramatically change the net positions of the remaining participants and could possible lead to another round of settlement failures.



**Wholesale Payments Services.** Major banks provide a variety of collection and payment services to other banks. For example, major banks collect checks and other non-cash instruments, such as bond coupons and bankers' acceptances, and act as the settlement point for a variety of payment and investment transactions for respondent institutions. In connection with obtaining these services, respondent institutions typically maintain deposit accounts with the correspondent bank. Respondent institutions periodically draw down funds from these accounts to make payments or request the correspondent bank to make payments over FedWire or CHIPS on their behalf.

If a major correspondent bank were to fail, a large number of respondent institutions might lose the funds they have on deposit with failed correspondent. These losses could result in the respondent institutions' being unable to make payments to or on behalf of their customers. Thus, the failure of a large correspondent bank could seriously impair the liquidity, and potentially the financial stability, of many other banks, depending upon the size of deposits held at the failed correspondent bank.

In addition, some U.S. banks provide dollar clearing services in other countries. If a large U.S. bank providing such services were to fail, its failure might affect the CHIPS settlement on the day of the failure because some of the participants in the service settle with Chase via CHIPS. For the most part, however, such a situation should not have a direct effect on other U.S. banks because the users of off-shore clearing services are generally local institutions.

**Custodial Services.** Systemic problems can also arise from custodial relationships. If a large custodian were to fail during the day, there could be a number of securities transactions that were in the process of being settled. The parties most affected by the failure of a large custodian bank would be the sellers of securities or holders of matured securities that had delivered securities in physical form and were awaiting payment. Such parties could be exposed to the loss of the full value of the transactions. While the establishment of book-entry depositories has greatly reduced such intraday deliver-versus-payment risk, physical deliveries of securities valued in the billions of dollars still occur daily, with significant time gaps between delivery and receipt of payment.

**Credit to Clearing Organizations.** Banks issue credit lines to clearing organizations, such as the Participants Trust Company, which clears and settles transactions in Government National Mortgage Association securities, and to participants in such organizations. These credit lines are often relied upon to provide emergency funds at settlement or as an alternative to cash for margin payments or contributions to participants' funds.

An intraday failure of a bank providing such lines could both weaken a clearing organization's ability to assure settlement and reduce the liquidity available to it through its participants.

**Impact of Bank Failures on the Check Collection System.** In general, the risks to the check collection system associated with a bank failure relate primarily to the risks associated with the failure of an intermediary collecting bank. The risks associated with the failure of a depository bank or paying bank are relatively insignificant.

If an intermediary collecting bank fails before the prior collecting banks, which have deposited checks for collection with the failed bank, have been paid (other than by credit to the failed bank), the prior collection banks become general creditors of the failed bank. Smaller banks, which typically use only one intermediary bank for collecting checks, could be exposed to risk for all checks in the process of collection at the time the intermediary bank failed. For small banks (\$500 million or less in assets), the average amount of cash items in the process of collection is less than 15 percent of average equity capital. As banks get larger, the average amount of cash items in the process of collection becomes a higher percentage of equity capital, rising to more than 100 percent for the largest banks. Larger banks, however, tend to collect checks through more than one intermediary bank (or via direct presentment), reducing their risk exposure due to the failure of any one intermediary bank. Banks can manage this risk through their choice of intermediary collecting banks.

The risk to the check collection system from the failure of a depository bank is limited to returned checks. This risk would fall on the collecting bank that handled the check immediately after the depository bank in the forward collection process (or the paying bank, if no intermediary collecting banks were involved in collecting the check). That bank could still protect itself, however, by making a claim directly against the depositor of the check. This right would most likely be exercised only where the value of the returned check exceeds the expected cost to obtain payment from the depositor.

A paying bank must either settle checks on the day of presentment or return the checks by midnight of the day of presentment. If a paying bank settles with the presenting bank on the day of presentment, it has the right to return the checks by midnight of the banking day following the banking day of presentment. If a paying bank fails, the receiver of the bank may either (1) return the checks presented on the day of failure; or (2) settle for those checks and only return checks that otherwise would not be paid. Generally, the FDIC follows the second, less disruptive, approach for those checks presented on the day of the failure prior to the time of failure. Presentment

of checks on days subsequent to the failure are returned. The checks are considered security interest for the presenting bank; thus, if the paying bank does not settle for checks on the day of presentment, the presenting bank has a right to the checks that were presented so that the checks can be returned. Generally, the risks associated with a failed paying bank relate to the risks associated with the increase in returned checks that were drawn on the failed bank.

### **Possible "Contagion" Effects of Large Bank Failures**

The second source of risk concerns the possible contagion effects of a large bank failure. Depositors may treat the failure of the bank as a signal of the condition of similar banks. For example, the failure of a bank with a heavy concentration in energy loans may cast doubt on the condition of other such banks. That the failure was handled as a payoff may provoke uninsured depositors in such banks to withdraw their funds. In a regime in which the FDIC is prevented from stopping such runs by "assurances" to uninsured depositors, this could force the closure of viable banks with resulting unnecessary insurance costs.

### **Systemic Instability**

The third source of risk involves systemic instability. Apart from the effects of a particular payoff, there may be a tendency for the banking system as a whole to become more unstable to the extent uninsured depositors perceive themselves to be more at risk in the event of a bank failure. Such increased systemic instability could increase the tendency toward depositor runs and could force the closure of unrelated and solvent banks, leading to greater insurance costs.

### **E. Market Discipline from Depositors**

As noted in the section on depositor discipline, there are concerns about the ability of depositors and other market participants to identify risky situations in advance. Increased depositor discipline resulting from eliminating coverage of uninsured depositors, in this view, would simply be after-the-fact discipline, which already exists: under current bank failure procedures, banks identified as experiencing difficulties soon begin to lose access to uninsured and unsecured funding.

There is also a concern regarding the effect of eliminating coverage of uninsured depositors on the international competitiveness of U.S. banks. As noted previously, depositors in large foreign banks have been fully protected in most bank failures. The international competitiveness argument is similar to protectionist arguments in other contexts. If foreign

governments subsidize their banks by protecting depositors in large bank failures, should the U.S. do the same?

Concern over the direct ripple effects of a large bank failure may be mitigated to the extent the loss suffered by uninsured depositors is small. This would be the case, for example, under proposals in which uninsured depositors in a failed bank would be subject to a small "haircut." (Recall, however, that haircuts may prompt rational depositors to run on the bank even if their potential loss is small.) In any case, the smaller the haircut the more tenuous the benefits of increased depositor discipline, both in terms of behavioral impact on banks and direct cost savings to the insurance funds.

The great unknown in the "too big to fail" debate is the implication for systemic stability of putting uninsured depositors at risk in a large bank failure. In the Continental failure, the banking agencies were unwilling to find out. Even if those ultimately responsible for such decisions continue to be reluctant to impose such losses, constructive ambiguity will nevertheless enhance depositor discipline at the margin.

The FDIC's authority to provide pro rata payments to some general creditors in a failed bank while fully protecting other general creditors allows some flexibility in the decision of which creditors to protect fully. Depending on one's view of the relative importance of market discipline and cost effectiveness vs. stability concerns, all or some classes of uninsured depositors might receive only pro rata payments. The large bank problem is considered below in the context of the choice between policy rules and policy-maker discretion.

#### **F. Rules vs. Discretion**

In connection with proposals designed to enhance depositor discipline (or market discipline in general), it is often recommended that the deposit insurer be prohibited, by law or regulation, from making good on any losses not explicitly covered by federal deposit insurance. A policy of prompt corrective action is often discussed in this light. (Chapter X analyzes this issue.) The preference for rules of this type derives from a desire to avoid the large-bank incentives for risk-taking that are generated by a "too big to fail" policy, to ensure consistency and certainty in the treatment of failed-bank depositors and, more generally, to establish accountability and thereby prevent "regulator moral hazard." While these goals are noncontroversial, there is considerable disagreement about the costs that could arise from the inflexibility imposed by binding policy rules.

In particular, it is difficult to specify a given class of deposits for which losses would always be appropriate in the event of a bank's failure. In the case of large-bank failures where large deposits are significant, concerns over systemic stability make it questionable whether losses should be imposed on depositors regardless of the effect on the deposit insurer's direct costs of resolution. If the large deposits are interbank balances, additional concerns arise. It is perhaps conceivable even that nondeposit liabilities at large banks could be sufficient to create stability problems if there were no flexibility to deviate from the usual (pro rata) method of handling bank failures. In short, it may be difficult to specify a rule which would prove optimal for all cases. Perhaps a rule with some flexibility could be devised to cover most of the usual exceptions, but unless the exceptions were limited by a well-defined set of circumstances, it would be difficult to prevent policy-makers from justifying fully discretionary actions under the terms of the rule.

Perhaps more importantly, it seems most unlikely that constraining the deposit insurer with a policy rule will prevent the types of discretionary interventions that are at issue. If financial stability is viewed as important by legislators and other policymakers, they are likely to intervene (and override deposit-insurance limits) in place of the deposit insurer whenever stability appears to be threatened (say, in the case of a large-bank failure). There may be plausible arguments for shifting the decision to intervene away from the deposit insurer, but these are not the typical types of arguments offered to justify a conversion to a system of policy rules. Typically, the stated goal is to prevent the interventions. It is unclear whether any set of enforceable rules could serve as an effective preventative, given the numerous possible sources of intervention and the great variety of forms it may take.<sup>33</sup> It does seem clear, however, that the singular act of binding the deposit insurer to a narrow set of rules would prove inadequate for this purpose.

On the other hand, the adoption of policy rules could provide for formal channels through which exceptions to the rules must be validated. While rules may not prevent policymakers from exercising discretion, they may increase the frequency with which policymakers are forced to acknowledge, explicitly, departures from the rule.<sup>34</sup> To the extent that rules might reduce uncertainty over failure-resolution policy and might diminish opportunities for "gaming" between market participants and the deposit insurer, the social costs generated by the deposit-insurance system could also be reduced.<sup>35</sup> Again, the decision on policy rules hinges on the weighting of these advantages as compared to the potential costs described above.

## G. Public Comments

In response to the Department of the Treasury's request for public comment on this Report's topics, comments were received on many of the issues covered in this section. Most of those commenting on "too big to fail" wished to see de facto insurance eliminated. Commenters included the Federal Reserve Bank of Cleveland, Merrill Lynch, Citicorp and several small banks, the American Bankers Association, the Independent Bankers Association of America, and a few "think tanks." Several commenters favored some limit on the dollar amount of insurance for a deposit, but those who commented directly on the \$100,000 ceiling favored the status quo (one of these responses was signed by 16 small banks and a state trade association). No direct comments were received concerning rules vs. discretion.

## H. Appendix: Legal Rights and Capacities<sup>36</sup>

### 1. The Legal Underpinnings

The extent to which the FDIC insures deposits in financial institutions is governed by the Federal Deposit Insurance Act (FDI Act).<sup>37</sup> With respect to the amount of deposit insurance provided by the FDIC, the heart of the FDI Act is Section 3(m)(1).<sup>38</sup> That section defines the term "insured deposit" to mean "the net amount due to any depositor . . . for deposits in an insured depository institution . . . less any part thereof which is in excess of \$100,000."<sup>39</sup> Section 3(m)(1) further provides that "[s]uch net amount shall be determined according to such regulations as the [FDIC] Board of Directors may prescribe, and in determining the amount due to any depositor there shall be added together all deposits in the insured depository institution<sup>40</sup> maintained in the same capacity and the same right for his benefit either in his own name or in the name of others . . ."<sup>41</sup> In addition, Section 12(c) of the FDI Act<sup>42</sup> provides that the FDIC need not recognize, as the owner of a deposit, any person whose name or interest does not appear on the deposit account records of an insured institution that is in default. Finally, Section 3(m)(1) of the FDI Act authorizes the FDIC Board of Directors to clarify and define, by regulation, the extent of deposit insurance coverage resulting from Subsection 3(m)(1), 3(p), 7(i), and 11(a) of the FDI Act.<sup>43</sup>

Based on the above-noted statutory language,<sup>44</sup> the FDIC has been insuring deposits according to the "rights and capacities" in which they are owned. To the extent that deposits are owned in the same right and capacity, whether deposited directly by the owner or by someone else on the owner's behalf, they have been aggregated and insured up to \$100,000. Conversely, to the extent that funds are owned in different rights and capacities, they have been separately insured up to the \$100,000 maximum.<sup>45</sup> The

FDIC's deposit insurance regulations,<sup>46</sup> which were initially adopted in 1967 and substantially revised in 1990,<sup>47</sup> enumerate the various rights and capacities in which funds may be owned, and thus separately insured, for deposit insurance purposes. Prior to the adoption of the regulations in 1967, the various rights and capacities in which funds were insured was determined primarily by informal FDIC staff interpretations of the FDI Act.

### Revocable and Irrevocable Trusts

Pursuant to Section 3(m) of the FDI Act, the FDIC has looked to the persons with beneficial ownership interests, as opposed to the named depositors, in applying the insurance limits. Under the FDIC's existing regulations, deposit accounts maintained by fiduciaries (*i.e.*, agents, nominees, custodians, conservators, guardians, or trustees) are insured in the amount of up to \$100,000 for the interest of each principal or beneficial owner in such accounts,<sup>48</sup> provided that certain recordkeeping requirements are satisfied.<sup>49</sup> Because the insurance coverage for such accounts passes through the fiduciary and is measured by the interests of the beneficial owners of the funds, this type of insurance coverage is commonly referred to as "pass-through" insurance. For instance, if the trustee of an irrevocable express trust maintains a deposit account comprised of trust funds at an insured depository institution and the trust has three beneficiaries, the deposit insurance would pass through the trustee to each beneficiary so that each beneficiary's interest in the account is separately insured up to \$100,000.<sup>50</sup> In addition, such insurance coverage would be separate from the coverage provided for any other accounts maintained by, or for the benefit of, the settlor, trustee, or beneficiaries in different rights and capacities at the same insured depository institution. However, if a beneficiary has interests in more than one trust account established pursuant to trusts created by the same settlor, then all of those interests would be aggregated and insured on a combined basis up to \$100,000.<sup>51</sup>

Most pension plans, profit-sharing plans, and other trustee employee benefit plans are also insured by the FDIC, under the existing deposit insurance regulations, on a "pass-through" basis. This means that they are insured in the amount of up to \$100,000 for the interest of each beneficiary, provided that the FDIC's recordkeeping requirements for fiduciary accounts (see Endnote 48) are satisfied. This insurance coverage is separate from (and in addition to) the insurance coverage provided for any other deposits maintained by the plan sponsor, the trustee, or plan beneficiaries in different rights and capacities in the same insured bank.

However, pass-through insurance coverage is provided for employee benefit plan deposits only when the value of each participant's interest in the plan's assets can be determined

without evaluation of any contingencies, except for those contained in the present-worth tables and rules of calculation for their use (which concern life expectancy and interest rates) that are set forth in the Federal Estate Tax regulations.<sup>52</sup> Therefore, while the deposits of an employee pension or profit-sharing plan would, in most cases, qualify for pass-through insurance coverage, the deposits of a health and welfare plan generally would not qualify for such coverage because the present value of a participant's interest in the assets of a health and welfare plan is contingent on an event (*i.e.*, illness or accident) that is not covered by the above-noted present-worth tables. This means that the deposits of a health and welfare plan in an insured institution would generally be added together and insured up to \$100,000 in the aggregate, as opposed to being insured on a per-participant basis. The insurance of such trust funds would, however, be separate from the insurance afforded to deposits maintained individually by the settlor, trustee, or beneficiaries of the plan.

Moreover, pass-through insurance is not provided for employee benefits plans in which the employees (participants) do not have any ownership interests in the assets of the plans. One example is the "457 Plan," which is a deferred compensation plan established by a state government, local government, or non-profit organization for the benefit of its employees, that qualifies under Section 457 of the Internal Revenue Code.<sup>53</sup> The deposits of such plans are not accorded "pass-through" insurance coverage because, under Section 457 of the Internal Revenue Code, the funds of such plans are required to "remain (until made available to the participant or other beneficiary) solely the property and rights of the employer (without being restricted to the provision of benefits under the plan), subject only to the claims of the employer's general creditors."<sup>54</sup> This provision enables the employer (*i.e.*, the state government, local government, or non-profit organization) to utilize 457 Plan funds for its own purposes and makes those funds subject to the claims of the employer's creditors. The employer, rather than the employees, is thus deemed to be the sole owner of the funds until they are distributed. Consequently, deposit accounts at FDIC-insured banks that are comprised of 457 Plan funds have been added together and insured in the amount of up to \$100,000 in the aggregate together with other deposits of like kind maintained by the same official custodian of the same public unit.<sup>55</sup>

### **IRAs and Keoghs**

In addition to pass-through deposits insurance, the FDI Act mandates that certain deposits be insured separately from other deposits. For instance, Section 11(a)(3) of the FDI Act provides that time and savings deposits of IRAs and Keogh Plans must be insured separately from other accounts maintained by the beneficiaries of such retirement accounts. Moreover, Section



7(i) of the FDI Act provides that when funds are held by an insured depository institution in a fiduciary capacity, whether held in the fiduciary institution's own trust department, another department of the fiduciary institution, or in another insured institution, those funds are insured separately from any other funds of the owners or beneficiaries.

### **Public Units**

Finally, Sections 3(m)(1) and 11(a)(2) of the FDI Act require that each official custodian of government funds (including the funds of the Federal, state, and municipal governments, as well as certain territories/possessions of the United States) be insured (1) up to \$100,000 for all time and savings deposits in an insured institution in the same state where the public unit is located; (2) up to \$100,000 for all demand deposits in an insured institution in the same state where the public unit is located; and (3) up to \$100,000 for all deposits (whether time and savings or demand deposits) in an insured institution outside the state where the public unit is located. Although the official custodian is the nominal depositor, it is the funds of the public unit that are insured. Moreover, this provision provides more than \$100,000 to public units since a public unit can have more than one official custodian and can have both demand deposits and time and savings deposits at the same in-state institution, which would be separately insured, in the amount of up to \$100,000 each, for a total of up to \$200,000.

## **2. Proposal for Eliminating Different Rights and Capacities**

In order to limit the total amount of deposit insurance available to a maximum of \$100,000 per person or entity, per insured institution, a number of statutory provisions, must be added, amended or deleted. Section 3(m) of the FDI Act must be revised to eliminate the "same right and capacity" provision as well as the provisions relating to the insurance coverage provided for official custodians of public units. Sections 3(p) and 7(i) of the FDI Act, which provide separate insurance for funds held by an insured depository institution in a fiduciary capacity, would have to be deleted in their entireties. Section 11(a)(2) of the FDI Act concerning public unit funds and Section 11(a)(3) concerning IRA and Keogh deposits would also have to be deleted. Finally, Section 12(c) of the FDI Act, which concerns the provision of insurance for the interests of persons not identified on deposit account records, would have to be deleted.

In place of the amended and deleted provisions, statutory language could be drafted to provide that each individual or entity would be insured up to a maximum of \$100,000 for their interests in all accounts maintained at a single insured institution. Under this approach, each individual would be

insured up to \$100,000 for the total of all his/her individually-owned accounts. Joint accounts would no longer be separately insured from individual accounts. They would simply be split amongst the co-owners,<sup>56</sup> and each co-owner's share would be added to his/here individual accounts for insurance purposes.

In addition, the statutory amendments would have to designate who is the owner of certain types of accounts in order to clearly specify whose insurance limits those accounts should come under. In the case of revocable trust accounts, "payable on death" accounts, "Totten" trust accounts, and other similar accounts, the revocable nature of such accounts suggests that the settlor should be designated as the owner of the accounts and that they should be added to any other individually owned accounts of the settlor for the purpose of applying the \$100,000 insurance limit. If there is more than one settlor, the account should be split, and equal portions should be allocated to each settlor, to be included with that settlor's individually owned funds for the purpose of applying the \$100,000 limit.

In the case of accounts established pursuant to written irrevocable trust agreements, the trust itself is a separately recognized legal entity and thus its accounts should be added together and insured up to \$100,000, separately from the accounts of the settlor, trustee, or the beneficiaries. "Pass-through" insurance would no longer be provided for such accounts, which means that the beneficiaries interests in such accounts would not longer be recognized and separately insured. To prevent individuals from increasing deposit insurance by setting up multiple trusts for the benefit of the same beneficiary(ies), some provision limiting insurance coverage for irrevocable trust accounts established by the same settlor(s) for the benefit of the same beneficiary(ies) should probably be adopted.

A similar approach could be taken with respect to the deposits of all employee benefit plans, including pension plans, profit-sharing plans, health and welfare plans, deferred compensation plans, Keogh plans, vacation loans, and the like. The deposits of all plans established by the same employer or group of employers would be added together and insured up to \$100,000. The interests of the beneficiaries in such plans would no longer be recognized and insured separately up to \$100,000 per participant. IRA accounts should, however, be treated as the individually owned funds of the person who established the IRA since they are, in effect, individual accounts.

With respect to agency, custodial, nominee, and guardianship accounts, eliminating pass-through insurance means that the nominal owner (the agent, custodian, nominee, or guardian) should be designated as the insured party, and any funds held by that person as a fiduciary for one or more individuals would be added to the fiduciary's personal (individually owned) funds and the

total would be insured up to \$100,000. The obvious practical problem with this approach is that a person may be acting in a fiduciary capacity for the funds of numerous individuals and those funds would be counted against the \$100,000 insurance limit of the fiduciary, rather than the real owners (the principals).

Accounts maintained by a sole proprietorship should be added to any other individually owned funds of the sole proprietor (as they are under the current rules), since sole proprietorships are generally not recognized as separate legal entities and all assets of sole proprietorships are owned by the sole proprietor. Accounts of corporations, partnerships, and unincorporated associations should probably continue to be separately insured from the accounts of their shareholders, partners, and members, so long as they are engaged in an independent activity, because they are generally recognized as separate legal entities. Because unincorporated associations are, under most state laws, fairly easy to establish (*i.e.*, do not have the same filing requirements and other formalities necessary to establish a corporation) perhaps the statutory amendments should define what an "unincorporated association" is for insurance purposes.<sup>57</sup> Without such a definition, any two individuals who pool their money for a particular purpose could claim they are an unincorporated association.

The above-noted framework for limiting deposit insurance seems much easier to understand and administer than some of the other proposals to limit deposit insurance coverage. It would be relatively easy to determine insurance coverage as long as the statutory amendments attribute ownership of the various types of accounts to one or more persons or entities involved in those accounts for deposit insurance purposes. There may be fairness concerns, however, with attributing ownership of funds to nominal depositors (*i.e.*, agents or custodians) when the funds really belong to the principals. If a lawyer or real estate agent is holding funds in escrow for hundreds of clients/customers, it is the lawyer or real estate agent who would be the insured party even though he or she did not have any ownership interest in those funds but was merely acting as an intermediary. Moreover, the possibility of increasing insurance coverage by establishing numerous trusts or corporations where all of the individuals involved are the same, must be addressed if the effort to limit insurance coverage is to succeed. Finally, the possibility of "straw men" being used to increase insurance coverage would also have to be addressed.

## Endnotes

<sup>1</sup> The interest rates that banks are charged for borrowing may be thought of as including a market-determined risk premium with two components: one reflecting the threat of bank runs and another (with many elements) reflecting all other types of risk. Using this artificial partitioning of risk premia, the ideal level of deposit insurance coverage may be described as the smallest amount that is sufficient to produce a value of zero (or nearly so) for the bank-run component without altering the value of the other component (or any of its elements) in a material way.

<sup>2</sup> Other issues are relevant, such as FDIC costs in handling bank failures and equity in the treatment of large- and small-bank depositors. These issues may affect the decision to alter coverage in a particular way, but they do not refer to the original purposes of insurance coverage. The primary function of deposit insurance coverage is presumably not to minimize FDIC costs or redress inequities, but to correct a perceived market failure, that is, to provide a setting that improves upon the results of a free-market arrangement in a way that is agreeable to all parties (in economic jargon, a "Pareto-efficient" alteration of market arrangements). It follows that this primary policy goal takes priority in determining the optimal scope of coverage.

<sup>3</sup> In virtually every failing-bank case, some uninsured deposits leave the bank in the period immediately preceding failure (defined by the declaration of the chartering authority). Cases such as Continental Illinois, First Republic, and others demonstrate that such withdrawals may develop into runs that create a terminal liquidity crisis for the affected institution.

<sup>4</sup> Similar evidence is reported by Short and Guenther (1988) and Von Drunen and Wikstrom (1988).

<sup>5</sup> The "level of coverage" refers to the total amount provided in an ordinary bank failure, and not just the dollar amount of the statutory guarantee. A lower value for the statutory guarantee would not necessarily alter the level of coverage if failure-resolution policies remained unchanged. Until specific proposals are discussed, any reference to lowering the "level of coverage" means any reduction in de jure or de facto coverage, or both, which effectively lowers the amount of coverage that can rationally be expected by at least some depositors in the case of an ordinary bank failure.

<sup>6</sup> The fundamental historical facts are well known. For example, that there were seven or so discernable banking "panics" (contagions of varied origin) prior to the establishment of deposit insurance in the U.S., and that, while not the norm, runs

originally confined to one bank did sometimes precipitate runs or other institutions even in the absence of a generalized panic.

<sup>7</sup> See Kaufman (1988) and Schwartz (1988) vs. Goodhart (1987).

<sup>8</sup> The choice involves the conceptual framework, or analytical "paradigm," that should be used for understanding, evaluating, and selecting among alternative banking arrangements. A paradigm embodies two components: a theory of economic behavior (a system of reasoning by which the economic implications of proposed arrangements are inferred), and a set of prioritized policy objectives (a method of ranking the inferred outcomes of the alternative arrangements). Recognition of the paradigm behind a policy proposal is necessary in order to determine whether there is a defensible logic and a consistent ranking system (*i.e.*, the elements of a coherent policy strategy). (The usage of "paradigm" follows that of Kuhn (1970)).

<sup>9</sup> Moreover, the actual occurrence of runs produces additional social costs. Bank runs force a sale of assets (in particular, illiquid commercial loans) that are not ordinarily or voluntarily traded -- they are not traded because information costs are prohibitive for developing tradable paper claims--and thus the actual occurrence of bank runs produces deadweight losses due to the market's inefficiency in valuing information-intensive assets. See Woodward (1988).

<sup>10</sup> Implicit in this view is the suspicion that market-type pricing of bank risks is likely to be misleading, since many bank assets are information-intensive and, hence, are not well suited to valuation by market-type trading. The market's response to a recent (September 1989) issue of subordinated debt by the Bank of New England may be cited as a case in point. Subordinated debt virtually never avoids losses in the event of a bank failure. Prospective purchasers therefore have clear incentives to assess risks correctly, and perhaps moreso the longer the maturity of the debt. Bank of New England's long-term debt issue was oversubscribed in September, when its stock price was in the neighborhood of \$28 per share. Three months later, the stock was selling for about \$4, with no intervening economic shocks to explain the sudden reversal of fortunes. In fact, it was an autumn bank examination that revealed problems previously undetected by purchasers of subordinated debt.

<sup>11</sup> Stated differently, the moral hazard problem is not containable in the absence of depositor discipline.

<sup>12</sup> Diluted and conflicting incentives place the insurer's management at a similar comparative disadvantage, as described in the economic theories of regulation and public bureaucracy

(Buchanan (1975); Tullock (1965); Stigler (1971); Kane (1981); Gwartney and Stroup (1982)). Again, private wealth incentives favor a long-run outcome in which banks successfully innovate around constraints. Moreover, public sector incentives are such that regulated firms may have an advantage in the bargaining that shapes regulatory policy. The incentives in the public sector are biased in favor of policies with clearly visible, short-term benefits, but hidden or long-run costs. This ensures a record of identifiable "successes" during the watch of the reigning leadership, and such a record may be promoted to the leadership's further advantage. There is evidence to suggest that private firms are able to exploit this public-sector bias (Gwartney and Stroup (1982)). Thus, incentives are such that the "compromises" worked out between regulators and regulated firms are likely to produce policies with visible short-run benefits to the economy, but at the risk of hidden or longer-run costs that grow out of unconstrained profit opportunities successfully negotiated by the regulated firms.

<sup>13</sup> This is not to suggest that supervision cannot be effective in combination with depositor incentives to monitor risk. There is clear evidence that it can be. The argument here refers to reliance on supervision in place of depositor discipline. It is an argument against "too much" insurance coverage and not against deposit insurance per se.

<sup>14</sup> The same appears true for coverage arguments based upon payments-system concerns and small-saver protections. It is never clear why a deposit insurance system should be viewed as the proper type of institutional arrangement for addressing either of these concerns.

<sup>15</sup> Note that market discipline may emanate from many sources other than depositors. At the bank level, potential sources of discipline include shareholders, managers, subordinated note-holders, and other nondeposit creditors. All of these parties face a significant risk of loss under the failure-resolution methods employed by the FDIC. The analogous parties at the bank holding-company level also provide potentially important sources of discipline for the bank. Holding-company shareholders and creditors invariably suffer losses when a bank fails within their system and, hence, they also have incentives to constrain their banks' risk-taking. Since effective market discipline can potentially be imposed through any and all of these sources, and since bank supervisors can presumably impose some discipline as well, it is not obvious that the control of banking risk is necessarily unachievable without a substantial strengthening of depositor discipline.

<sup>16</sup> Endnote 15 shows why the necessity of depositor discipline is not obvious as a logical matter. The casual empirical evidence to follow is but one example of several types

that also could be used to question the implications of the depositor discipline paradigm.

<sup>17</sup> The inflation-unemployment trade-off provides a useful analogy. There is no particular point on the short-run Phillips curve that is unambiguously preferred to all others. The relative magnitudes of the social costs generated by inflation and unemployment are not objectively quantifiable. Thus, we could never decide conclusively which point on the curve is the optimum selection, even if we knew the shape and position of the curve at any given moment (which we do not). A reasonable policy response is to alter the terms of the trade-off so that, whatever our current position on the curve, the consequences of the associated inflation and unemployment are both less harmful than they would otherwise be. Examples might include the provision of job information services to speed the rehiring of displaced workers, tax indexation to mitigate the real effects of inflation and, more generally, the removal of distortions to facilitate speedier, and more generally, the removal of distortions to facilitate speedier and more efficient market adjustments.

<sup>18</sup> Longer-term deposits also can be the subject of "runs" in that depositors may decline to "roll over" this type of bank debt. This is different from the traditional notion of a bank run and the associated deadweight costs may be more avoidable than those which form the basis for deposit insurance protection. For an opposing view see Goodhart (1989, Ch. 8).

<sup>19</sup> The latter conclusion is often supported by noting that 70 percent of all U.S. banking assets and 66 percent of all U.S. deposits are held by 3 percent of all U.S. banks. Thus, it seems reasonably safe to infer industry-wide effects from the handling of large-bank failures.

<sup>20</sup> In the framework of Endnote 17, it is alleged that the present operation of the deposit insurance system amounts to the selection of a "corner solution" on the curve, corresponding to a maximum protection against runs and zero depositor discipline.

<sup>21</sup> See Humphrey (1976), Field (1985), Silverberg and Fleschig (1978), Leff (1976), and the references there cited for more details and alternative arguments.

<sup>22</sup> The remainder of this section borrows heavily from Nejezchleb (1988).

<sup>23</sup> See Baer and Brewer (1986), Hannan and Hanweck (1989), and Ellis and Flannery (1989).

<sup>24</sup> To state the same point differently, if potential losses are so small as to trivialize the threat of runs, then it is unclear why incentives would be sufficiently strong for

depositors to price risks accurately (i.e., to ensure a significant strengthening of depositor discipline).

<sup>25</sup> Recall that most banks, healthy or not, are probably insolvent on a liquidation basis. They have many illiquid (nonmarketable) assets and many perfectly liquid liabilities, so that fire sales (such as occur with bank runs) are not likely to produce revenues sufficient to meet all obligations. Combined with the fact that runs can be self-fulfilling and need not be based on any evaluation of an institution's viability, this suggests that healthy banks could suffer consequences if depositors are exposed to greater risk. A related point is that, once a run is underway, the troubled bank's viability depends upon the behavior of depositors. Potential lenders are unlikely to trust that the run will cease if they make funds available to the bank; thus, private sources of stability such as the Fed funds market (mentioned in the ABA proposal) may not be reliable in this type of crisis.

<sup>26</sup> This assumes that the check-clearing business is not simply passed to the local Federal Reserve Bank, a possibility which would reduce large-bank profits.

<sup>27</sup> The payments system effects and depositors' behavioral responses to the ABA plan may depend importantly upon the closure rule to be used. When in the process of a bank's borrowing (to fund its obligations) should the door be closed? An interesting question arises if, during the daylight hours preceding a closure, the Fed would refuse Fedwire transactions to a troubled institution that had exceeded its overdraft limits. What would be the standing of depositors who requested funds before the closure but did not receive them due to the Fed's decision (and what should be their legal standing)?

<sup>28</sup> Golter, op cit.

<sup>29</sup> FIRREA authorizes the FDIC to discriminate among classes of creditors of equal standing.

<sup>30</sup> Note that if this were not true for some particular institution, it could not possibly be performing (as its primary function) the type of intermediation regarded as special to banking. (Long-term deposits that are uninsured cannot be raised in sufficient quantities to fund the types of loans we have identified as characteristic for banking's special role in the economy. This is basic to the notion of why banks exist in the first place.) Thus, the primary purpose of deposit insurance would not be relevant for such an institution, and leaving the question of its viability to purely market forces would seem appropriate (at least in the extreme case where such deposits are the institution's only liabilities).



<sup>31</sup> A rare case could arise where the loss on the failed bank's assets is sufficiently small that the share of losses borne by the uninsured depositors is less than the incremental franchise value to the acquirer of retaining the uninsured deposits.

<sup>32</sup> Primary capital consists of equity plus loan-loss reserves. Thus, a bank may be solvent on a primary capital basis even if equity is zero, so long as reserves have not been depleted.

<sup>33</sup> Sources include the Treasury, Congress, the Federal Reserve System, and other government agencies, and forms include loans, direct expenditures, forbearance, tax breaks, and transfers of many types.

<sup>34</sup> Note, however, that skirting a policy rule may take extremely subtle forms. Suppose the deposit insurer is directed to impose losses on uninsured depositors with accounts outstanding at the time of a bank's failure. The insurer could potentially avoid imposing losses by simply waiting (and perhaps relying on the Fed to fund withdrawals), thus allowing time for all uninsured depositors to escape. Policy rules would require careful crafting in order to ensure that departures from the rule are acknowledged explicitly.

<sup>35</sup> An observation of private business arrangements certainly suggests that rules may offer mutual benefits over pure discretion; in private dealings, contracts between parties are the norm, and pure discretion is unusual (Barro 1986). A large economic literature describes the features of optimal contracts. It would seem that some form of contract (a binding commitment to rules) could have similar value in the area of public policy, provided that the appropriate features are know, articulable, and enforceable. Leijonhufvud (198) draws an analogy using professional basketball to counter the argument favoring pure discretion for those presumed to be "in the best position to know." He notes that if the latter argument were valid, we could do without rules for basketball (except perhaps the forbidding of "deliberate mayhem"). To the extent that this seems unreasonable, he suggests, so is the idea that pure discretion by "those in the know" should always be preferred to rules.

<sup>36</sup> This section is taken, in large part, from the FDIC's "Findings and Recommendations Concerning Pass-Through Deposit Insurance, February 1990.

<sup>37</sup> 12 U.S.C. 1811, et seq.

<sup>38</sup> 12 U.S.C. 1813(m)(1).

<sup>39</sup> Ibid.

<sup>40</sup> Prior to the enactment of FIRREA, the definition included the term "insured bank," rather than the term "insured depository institution."

<sup>41</sup> 12 U.S.C. 1813(m)(1).

<sup>42</sup> 12 U.S.C. 1822(c).

<sup>43</sup> 12U.S.C. 1813(m)(1), 1813(p), 1817(i), 1821(a).

<sup>44</sup> The statutory authority has remained basically unchanged since 1935, with only minor revisions, such as the substitution of the term "insured depository institution" for the term "insured bank" that was made by the FIRREA.

<sup>45</sup> A basic example is that funds owned by an individual and deposited in his or her individual name are insured separately from any funds that that person owns and deposits jointly with another person because funds owned by an individual are deemed to be held in a separate right and capacity from funds owned and deposited jointly with another individual.

<sup>46</sup> The recently amended deposit insurance regulations are to be codified at Part 330 of Title 12 of the Code of Federal Regulations.

<sup>47</sup> 55 Fed. Reg. 20,111 (May 15, 1990).

<sup>48</sup> 12 C.F.R. 330.1(c), 330.2(b), 330.2(c), and 330.10.

<sup>49</sup> The recordkeeping requirements for fiduciary accounts are enumerated at 12 C.F.R. 330.1(b). The basic requirements of that section are: (1) the deposit account records of the depository bank must indicate the fiduciary nature of the account (*i.e.*, that it is a pension loan account); and (2) the records of either the bank or the depositor, maintained in good faith and in the regular course of business, must indicate the name and interest of each person in the account.

<sup>50</sup> In order for each beneficiary's interest to be separately insured, the value of the interest must be determinable without evaluation of any contingencies other than those contained in the present worth tables and rules of calculation for their use (having to do with life expectancy and interest rates) that are set forth in the Federal Estate Tax regulations (26 C.F.R. 20.2031-10).

<sup>51</sup> 12 C.F.R. 330.10.

<sup>52</sup> 26 C.F.R. 20.2031-10.

<sup>53</sup> 26 U.S.C. 457.

<sup>54</sup> 26 U.S.C. 457(b)(6).

<sup>55</sup> There is a "grandfather" provision for deposits of existing plans in section 330.16 of the FDIC's recently amended deposit insurance regulations.

<sup>56</sup> On an equal basis, unless otherwise specified in the deposit account records.

<sup>57</sup> Under Section 330.9(c) of the FDIC's recently amended deposit insurance regulations, an unincorporated association is defined to be any association of two or more persons formed for a religious, educational, charitable, social, or other noncommercial purpose.

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## **Chapter IV**

### **BROKERED INSURED DEPOSITS**

#### **A. Introduction**

FIRREA requires this study to include an evaluation of possible limitations on brokered deposits. This chapter focuses on restricting the use of brokered deposits as a means of limiting the scope of the safety net. Section B contains background information, including a review of historical trends and a discussion of numerous empirical studies regarding the effect of brokered deposits. Section C discusses the major public policy issues generally associated with the use of brokered deposits. Section D examines various alternatives for limiting the use of brokered deposits.

#### **B. Background**

Brokered deposits are funds received by depository institutions through third party intermediaries, collectively referred to as deposit brokers. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) defined a deposit broker as: "(A) any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties; and (B) an agent or trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan." In addition, FIRREA broadened the definition of brokered deposits to include solicitation of high cost funds by "money desks" operated by depository institutions.<sup>1</sup>

Obtaining deposits through the services of outside brokers or money desks is an alternative to raising funds through branch operations or other more traditional methods. The use of brokered deposits is also an alternative to nondeposit sources of funds. For depositors, deposit brokerage reduces the cost of learning about deposit placement opportunities as well as the cost of actually placing the deposits, and thus greatly expands the range of institutions at which they can place accounts.

The use of brokered deposits increased significantly when deposit interest rates were deregulated following the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980. This occurred because deregulation increased the extent to which rates could vary, particularly between institutions in different regions. Increased rate variation, in turn, increased the gains from moving deposits between institutions to take advantage of higher rates.

Concern over the use of brokered deposits has been prompted by the degree to which some failed institutions have relied on these funds; such reliance may be a means of avoiding market discipline, which ultimately could increase resolution costs for the FDIC. In response, regulatory agencies have attempted either to limit access to brokered deposits or to increase supervision over institutions that make extensive use of them.<sup>2</sup> In the mid-1980s, both the Federal Deposit Insurance Corporation (FDIC) and the Federal Home Loan Bank Board (FHLBB) considered rules to limit the use of brokered deposits. FIRREA amended the Federal Deposit Insurance Act to prohibit institutions that fail to meet their minimum capital requirements from accepting brokered deposits unless explicitly approved in advance by the FDIC.<sup>3</sup>

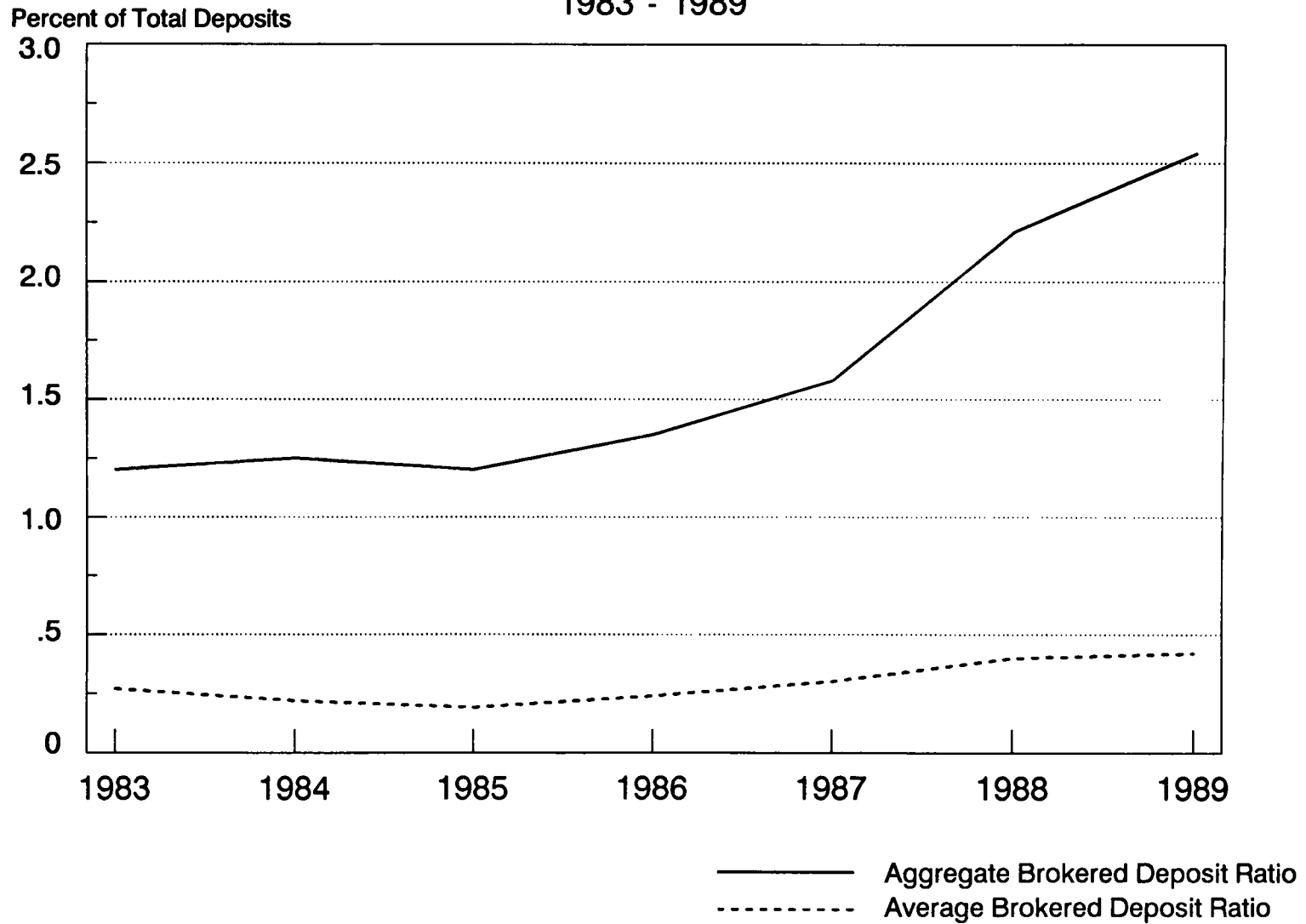
## 1. Historical Trends

Figure 1 consists of two measures of the amount of deposits placed by third party brokers at FDIC-insured commercial banks from 1983 through 1989. Figure 2 shows these same measures for federally-insured thrift institutions from 1978 through 1989. The "aggregate" ratio shows brokered deposits as a percentage of total industry deposits, whereas the "average" ratio is the average of all individual institutions' brokered deposit to total deposit ratios.<sup>4</sup> By consolidating all institutions as if they were one large institution, the aggregate ratio is dominated by the data from the large institutions, whereas the average ratio gives equal weight to each institution, regardless of size.

Figure 1 shows that, in the aggregate, bank reliance on brokered deposits increased from approximately 1.25 percent of total deposits in 1983 to 2.5 percent in 1989.<sup>5</sup> Figure 2 shows that brokered deposits accounted for well below 1 percent of total thrift deposits through 1981, which was before deposit rates were fully deregulated. At the end of 1982, only 1.5 percent of total deposits at federally-insured thrifts were placed by brokers; one year later, brokered deposits increased to 4.5 percent of the total. The ratio of brokered deposits to total deposits for thrifts reached a peak of 8.2 percent in June 1989.<sup>6</sup>

The divergence between the two measures of brokered deposit use shown on Figures 1 and 2, with the aggregate brokered deposit ratios exceeding the average ratios across institutions, indicates that larger institutions have tended to make

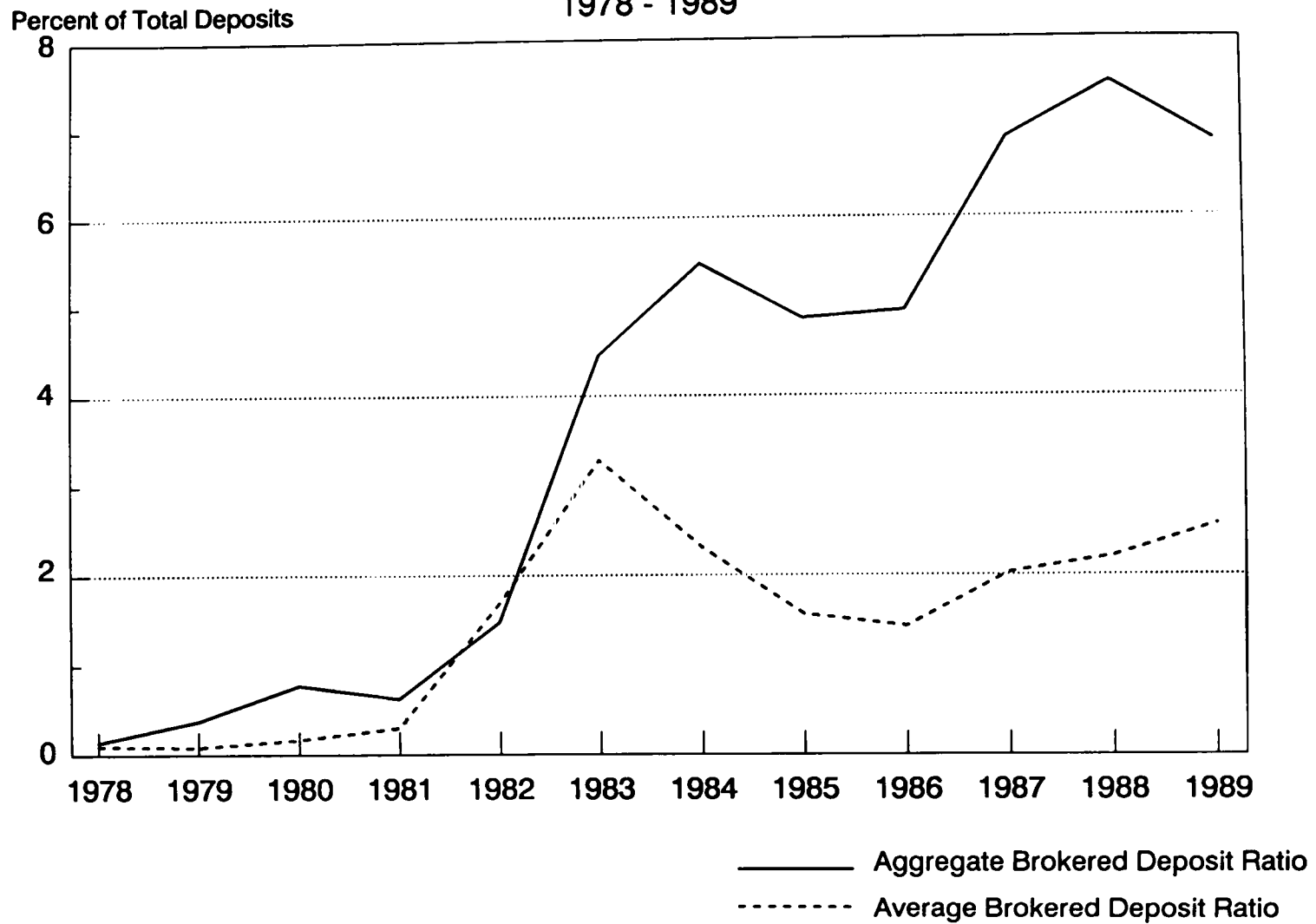
Figure 1  
Brokered Deposits  
All FDIC-Insured Commercial Banks  
1983 - 1989



Source: Federal Reserve Board.

Figure 2

Brokered Deposits  
All FSLIC/SAIF-Insured Thrifts  
1978 - 1989



Source: Office of Thrift Supervision.

considerably greater use of brokered deposits. The average ratio for commercial banks rose over the period for which data are available, but was still only 0.4 percent at the end of 1989. For thrifts, the average ratio indicates that the "typical" institution has not significantly increased its use of brokered funds since 1984.

The proportion of commercial banks with brokered deposits increased from 4.2 percent to 5.9 percent between 1983 and 1989.<sup>7</sup> Brokered deposits have been more widely used by thrifts. The proportion of insured thrifts with brokered deposits has fluctuated between 20 and 25 percent since 1983.<sup>8</sup> Although brokered deposits have been used by thrifts throughout the nation, there have been definite regional variations. A majority of thrifts in California, Nevada, and Arizona have used brokered deposits since 1983, with the proportion peaking at over 70 percent in 1983 and 1984. Elsewhere in the West and the Southwest, brokered deposits also have been extensively used. Between 1983 and 1989, the proportion of thrifts in the FHLBB's Ninth, Tenth, and Twelfth Districts reporting the use of brokered deposits ranged from 30 to 34 percent.<sup>9</sup> In contrast, the maximum number of thrifts using brokered deposits between 1983 and 1989 in Illinois and Wisconsin was less than 11 percent.

Brokered deposits have been used by both financially strong and weak institutions, though weak institutions have used them substantially more. Figure 3 compares the average ratio of brokered deposits to total deposits at FDIC-insured banks with equity capital ratios under 3 percent to banks with equity capital ratios over 3 percent. With the exception of 1984 and 1985, when both groups made similar use of brokered deposits, less well capitalized banks have relied much more heavily on this funding source. The ratio of brokered deposits to total deposits at banks with equity capital ratios under 3 percent averaged 4.1 percent from 1986 through 1989, as compared to an average ratio of 1.9 percent for banks with equity capital ratios over 3 percent.

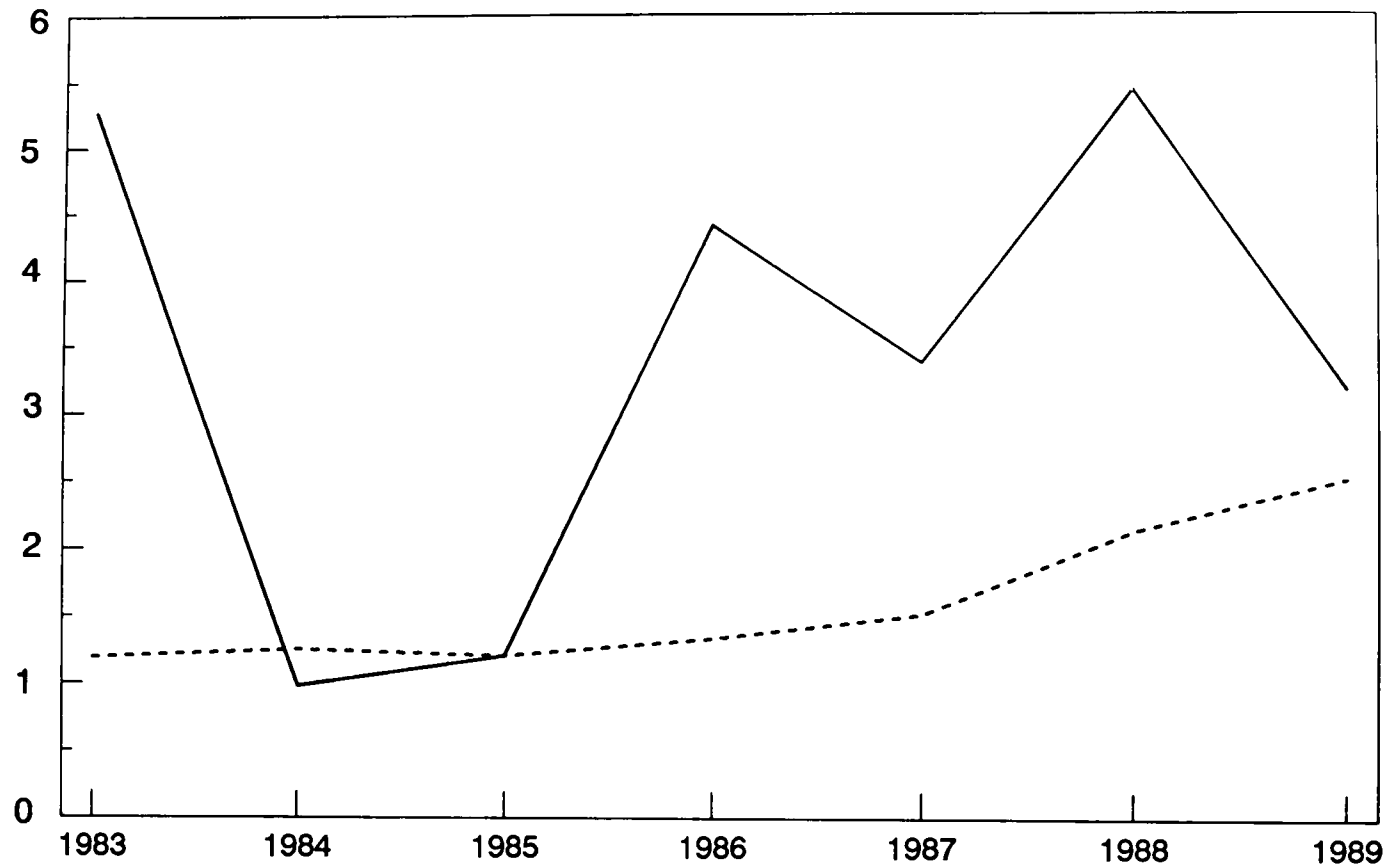
Figure 4 compares the average ratio of brokered deposits to total deposits at thrifts in three capitalization groups: thrifts with negative tangible capital, thrifts with tangible capital ratios between zero and three percent, and thrifts with tangible capital ratios over three percent. Figure 4 clearly shows that weaker thrifts have used brokered deposits as a source of funds much more than their better-capitalized competitors.

## 2. Empirical Studies

Associated with the thrift crisis of the last several years, there have been many well-publicized instances of "high-flying" depository institutions using brokered deposits to fund reckless growth. But the reckless use of brokered deposits is not just a recent phenomenon limited to the thrift industry. In 1985

Figure 3  
Use of Brokered Deposits by Capital-Asset Ratio  
All FDIC-Insured Commercial Banks  
1983 - 1989

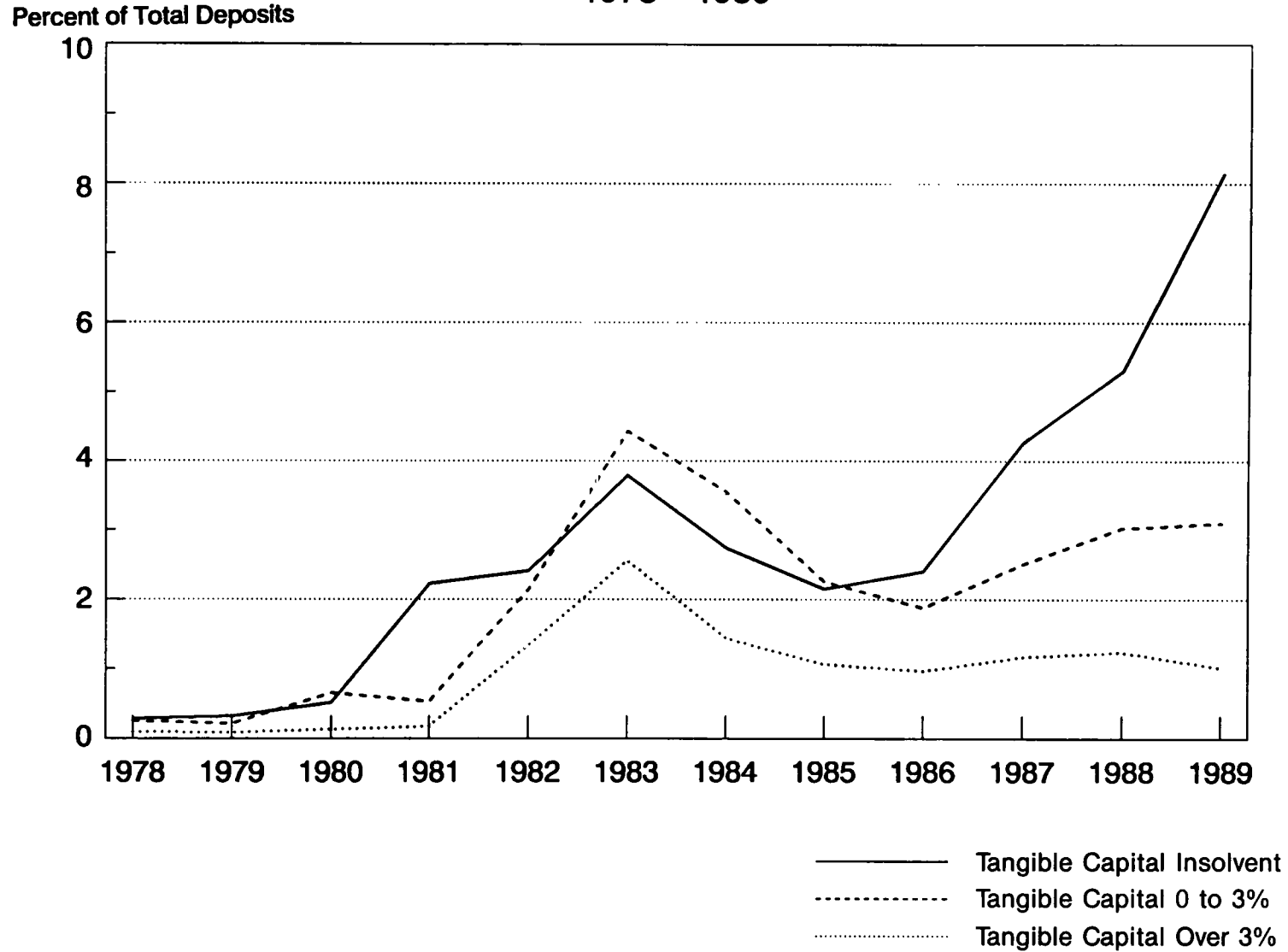
Percent of Total Deposits



— Equity Capital Ratio Under 3%  
- - - Equity Capital Ratio Over 3%

Source: Federal Reserve Board.

Figure 4  
 Use of Brokered Deposits by Capital-Asset Ratios  
 All FSLIC/SAIF-Insured Thrifts  
 1978 - 1989



Source: Office of Thrift Supervision.

testimony before Congress (referred to in endnote 2), FDIC Chairman William Isaac presented a case study of 80 institutions with significant amounts of brokered funds that failed between January 1, 1982 and July 12, 1985. Nearly half of these institutions had brokered deposits representing over 20 percent of total deposits (17 institutions with 40 percent or more).

For thrifts, the data show that brokered deposits have been used more extensively by high-growth institutions.<sup>10</sup> (The correlation between asset growth and brokered deposit growth peaked in 1988.) Among tangible-insolvent thrifts, there has been a negative correlation between net worth and brokered deposits, indicating a greater use of brokered deposits at less healthy institutions. This result is consistent with the tendency of undercapitalized institutions to use insured brokered deposits for risky activities that the market would not otherwise fund.<sup>11</sup>

Empirical studies of depository institution failures and the cost of failures to the insurance funds have also sought to evaluate the effect of brokered deposits. Avery, Hanweck, and Kwast (1985) report that commercial banks that failed in 1984 made greater use of brokered deposits than a sample of banks that did not fail.<sup>12</sup> Barth, Bartholomew, and Bradley (1990) compared the reliance of federally-insured thrift institutions on brokered deposits during three periods in the 1980s. The study finds that, in the period after interest rate deregulation, insolvent institutions held more brokered deposits than solvent thrifts.<sup>13</sup> This study did not attempt to directly measure the effect of brokered deposits on failure costs for the deposit insurer.<sup>14</sup>

Although studies of depository institution failures have not found a consistent, statistically significant relationship between brokered deposits and either the probability or cost of failure, these studies use a more restrictive definition of brokered deposits than that contained in FIRREA. The brokered deposit data used by these studies only include deposits placed by third party brokers, excluding deposits raised through money desk operations. It is possible that the findings of these studies are related to this characteristic of the data rather than the absence of a relationship between a more broadly defined measure of brokered deposits and FDIC loss exposure.<sup>15</sup>

### **C. Arguments For and Against Use of Brokered Deposits**

Typically, when risks to the deposit insurance system are discussed, the focus is on the asset side of the balance sheet or on maturity mismatches across the balance sheet. However, a discussion of the risks posed to the insurance funds by brokered deposits, as balance sheet liabilities, must involve their effect on the behavior or tendencies of insured institutions to take on credit or interest rate risk.



## **1. Increased Taxpayer Exposure Through Expansion of Scope of Deposit Insurance Coverage**

A well-functioning capital market allocates funds to their highest valued uses; the market recognizes weak institutions by requiring them to pay risk premiums for their funds. As discussed more fully in Chapter III, "Scope of Deposit Insurance," deposit insurance can distort this market by subsidizing insured institutions -- and the projects they choose -- at the expense of their uninsured competitors. The economy in general suffers if such a subsidy causes good, economically sound investment opportunities to go unfunded while loans to uneconomic projects are financed. One of the principal criticisms of brokered deposits is that they help insulate depository institutions from the risk-taking checks normally imposed by the market, make it easier to raise insured deposits -- thereby expanding the scope of deposit insurance coverage -- and thus increase taxpayer exposure to potential losses.

Brokered deposits can be used by institutions as a substitute for uninsured or nondeposit liabilities. For example, wealthy depositors can use brokered deposits to obtain multiple insurance coverage by spreading deposits among several institutions. This allows the people who need coverage the least to secure aggregate insurance coverage in excess of the \$100,000 insurance limit that applies to deposits at a single institution.

Brokered deposits thus give institutions greater access to funds that are fully covered by federal deposit insurance. Because the safety of their accounts is guaranteed, these depositors have no incentive to limit risk-taking by the depository institution, nor do they demand higher interest rates from institutions taking on more risk. To the extent that depository institutions use brokered deposits to avoid raising uninsured funds, they erode market discipline in the system.

Without sufficient market discipline, depository institutions can more easily engage in behavior that increases the risk exposure of the federal safety net. Because the market requires institutions to pay substantially higher risk premiums for uninsured funds -- if it provides funds at all -- the availability of brokered deposits in denominations qualifying for full insurance coverage reduces their relative cost and increases their attractiveness, particularly for weaker institutions investing in risky activities.<sup>16,17</sup> The fact that a large majority of brokered accounts are in denominations under the insurance ceiling supports this view.<sup>18</sup>

## **2. Increased Costs Associated with Brokered Deposits**

To the extent that brokered deposits are used as substitutes for uninsured deposits and other nondeposit liabilities, and assuming the FDIC does not protect uninsured depositors, brokered

deposits raise the FDIC's cost of resolving failed institutions by increasing the ratio of insured deposits to total liabilities. This increases the FDIC's overall liability and may reduce its options for resolving insolvent institutions.

An additional concern with respect to brokered deposits involves the effect of a decline in market discipline on the effectiveness and costs of supervision. Regulations intended to control risk-taking that were developed for an environment with a given level of market discipline might prove inadequate if innovations reduce the market's risk-limiting mechanisms. For example, if brokered deposits lead to very fast growth or the ability of an institution to change its risk profile rapidly, the capacity of supervisors to monitor risks to the insurance funds may be strained. This may in turn change the type of regulations needed to control risk and substantially raise the cost of achieving a given level of risk management.

### **3. Potential Benefits of Brokered Deposits**

Although the arguments regarding the added risks associated with the use of brokered deposits have tended to dominate the debate, there are a number of arguments that have been made in favor of brokered deposits.

For instance, geographical restrictions on the activity of depository institutions, including branching restrictions and prohibitions on interstate banking, have artificially limited the deposit bases from which individual depository institutions draw and the range of choices available to depositors. When there are local imbalances between the supply of savings and the demand for loans, it may be necessary for institutions to attract funds from outside the region. Thus, to the extent that brokered deposits reduce the cost of inter-regional flows of funds, they can reduce regional interest rate differentials and allocate funds to areas where they can be more profitably invested.

On the other hand, it may be more appropriate to overcome such local imbalances more directly. One alternative would simply be to break down interstate branching restrictions. In addition, depository institutions could use uninsured sources of funds such as the federal funds market, correspondent bank networks, the Federal Reserve's discount window, and the Federal Home Loan Bank System, rather than insured brokered deposits.

Another argument for brokered deposits is that, notwithstanding their effect on market discipline, they can provide an important source of funding at lower costs than uninsured alternatives. Cost savings may accrue not only from access to an expanded market, but from a reduced need for branch operations and other overhead costs such as record-keeping (particularly if brokered deposits are in larger denominations than retail deposits). In addition, funds raised through brokers

can be priced independently of other deposit accounts. It might be less expensive for an institution to pay higher rates on a specific set of funds raised through a brokered deposit program while maintaining stable rates on other types of deposits rather than attracting funds by increasing rates on a broad range of accounts.

Another argument for brokered deposits suggests that they might reduce failure resolution costs. If brokered deposits are used as a substitute for even more expensive, uninsured funds, they could reduce operating losses in periods prior to closure. This could, in turn, reduce the magnitude of insolvency when a failure is resolved, assuming that the timing of closure is not affected by the change in operating losses. (This is a reasonable assumption, because most failures follow from volatility in asset values rather than from prolonged expenditure of relatively small differences in interest costs. Substituting brokered deposits for other funds would therefore not alter the timing of most failures.) On the other hand, if brokered deposits reduce operating costs by replacing higher cost, uninsured funds, they may still raise failure costs to the FDIC, because the use of brokered deposits has increased the amount of insured deposits which the FDIC must honor.

Although it is generally argued that brokered deposits can reduce market discipline, there is one argument that suggests that some types of deposit brokerage may strengthen it. In response to the Department of the Treasury's request for public comments on this study's topics, Merrill Lynch suggested that if brokered funds are intermediated by sophisticated institutions with greater analytical ability than the depositors whose funds are placed, the quality of risk evaluations, at the margin, may increase rather than decrease. Deposit brokers might exercise market discipline on depository institutions if their brokerage activities include buying very large deposits and dividing them among their customers or if they maintain a secondary market in their customers' deposits. In these situations, the broker runs the risk of holding deposits in excess of the insurance limit, so it would have to evaluate risk to protect itself. Deposit brokers might also monitor risk to protect their reputations or to reduce the likelihood of encountering any difficulties that might arise from placing funds at institutions that fail. On the other hand, if brokered deposits replace uninsured deposits or nondeposit liabilities, both of which are more market-oriented sources of funds, insured deposit brokerage probably does not increase market discipline.

A final issue raised by brokered deposits is their potential effect on liquidity. It can be argued that liquidity is enhanced by access to brokered deposits as a readily available source of funds to which institutions may turn when other sources dry up. Brokered deposits might also enable an institution to obtain

longer-term funds than would be available in its local market, and thus reduce interest rate risk.

The problem with the liquidity argument is that institutions that rely on brokered deposits for liquidity may, ironically, have greater liquidity risk. Brokered deposits are placed indirectly and the depositors may live far from the institutions that receive their funds. These deposits are therefore likely to be more volatile than local deposits, and would be particularly sensitive to changes in market conditions. They also would be influenced by a broader range of market conditions, including changes in deposit rates in other regions and in relative returns of a broad array of alternative investments. By increasing the volatility of an institution's funding sources, brokered deposits could decrease liquidity. The net effect of brokered deposits on liquidity is, therefore, uncertain and variable for different types of institutions and in different regions.

#### **D. Policy Options**

##### **1. Restrict for Weak Institutions**

By statute, brokered deposits may not be accepted by institutions that do not meet minimum capital requirements, except under limited circumstances. This restriction was contained in FIRREA as an amendment to the Federal Deposit Insurance Act. The FDIC has the authority to permit, on a case-by-case basis, undercapitalized institutions to use brokered deposits if it determines "that the acceptance of such deposits does not constitute an unsafe or unsound practice with respect to such institution."<sup>19</sup> In practice, undercapitalized institutions have been permitted to accept brokered deposits when they have agreed to restrictions such as prohibitions on the payment of dividends, limits on how brokered funds will be used, or submission of plans to reduce the future use of brokered or other high cost funds.

##### **2. Limit Insurance Coverage on Brokered Deposits**

There are several proposals to limit the insurance coverage on brokered deposits in order to reduce the extent to which deposit brokerage facilitates multiple insurance coverage. One suggestion is to eliminate pass-through insurance coverage of brokered funds. The \$100,000 limit on insurance coverage at each institution would be applied to the broker placing the funds rather than to the customers whose funds are deposited. This would significantly reduce the amount of fully insured deposits that any individual broker could place at any single institution. A shortcoming of this proposal is that brokers might be able to expand their capacity to place deposits by establishing several separate entities to handle deposit brokerage.

### **3. Interest Rate Limits**

Brokered deposits might be regulated by imposing limits on the interest rates that can be offered on all insured accounts. Rate limits do not necessarily mean fixed absolute rates, as was the case before most rate limitations were phased-out between 1980 and 1986. For example, limits could be established through maximum spreads over the yields on Treasury securities of similar maturity. Limiting spreads would restrict the ability of institutions to attract funds by offering higher rates than their competitors. The rationale behind rate limitations is that, since the federal government insures deposits, it is reasonable for it to exercise control over the rates paid by the institutions that issue these accounts, and that these rates should not be significantly higher than the government pays for other borrowings.

The key shortcomings of rate limits are that they can have adverse consequences for depository institutions and for the economy when market interest rates fluctuate. Excessively restrictive limits can lead to disintermediation when market interest rates rise sharply. This can aggravate "credit crunches" and impose severe costs on interest rate sensitive sectors of the economy such as housing.

Interest rate limits would also be difficult to enforce because depository institutions might attempt to replace explicit interest with implicit interest in the form of non-interest payments, gifts, or by offering services, such as reduced fees or the convenience of extensive branching networks.<sup>20</sup> It is impossible to regulate all of the dimensions of depository services on which implicit interest can be based. Implicit interest is also a less economically efficient method of paying depositors, because payments through gifts, reduced fees, or additional branches are imperfect substitutes for explicit interest.

### **4. Growth Limitations**

One problem for any option aimed specifically at brokered deposits is that it might be difficult to define these deposits in a manner that could not be circumvented by new instruments or innovations in institutional arrangements. Adaptations in several aspects of deposit brokerage could inhibit the effectiveness of restrictions designed for the current environment. An alternative to restrictions aimed directly at brokered deposits might be to focus on the practices that raise the greatest concern about risk, specifically rapid growth by undercapitalized institutions.

Excessive growth could be directly regulated, either by limiting growth by institutions that do not meet their minimum capital requirements or by requiring prior notification of

supervisory agencies by institutions planning to embark on growth strategies. FDIC-insured banks are required to notify the FDIC at least 30 days in advance of initiating any special funding plan or arrangement to increase assets by more than 7.5 percent during any three-month period. The plans to which this regulation applies include "any effort to increase the assets of a bank through the solicitation and acceptance of fully insured deposits obtained from or through the mediation of brokers or affiliates, the solicitation of fully insured deposits outside a bank's normal trade area, or secured borrowing, including repurchase agreements."<sup>21</sup>

Thrift institutions requiring more than normal supervision (determined by examination ratings, failure to meet capital rules, or other considerations) are barred from growing in excess of net interest credited without prior approval. As of January 1, 1991, thrifts failing their capital requirements are not allowed to grow at all (except for very limited growth that may be approved on a case-by-case basis). Similar requirements might be applied to plans for significant changes in overall business strategies.<sup>22</sup>

## **5. Other Requirements**

The concern that brokered deposits could reduce market discipline might be addressed by requiring institutions using such funds to engage in other practices that would offset this effect. For example, higher capital requirements or special disclosure requirements for institutions using brokered deposits could compensate for the market discipline lost when brokered deposits replace other sources of funds.

## **6. Eliminate Brokered Deposits**

While the preceding options attempt to control the use of brokered deposits, it can be argued that they do not directly address the fundamental problem of decreased market discipline, an expanded safety net, and the resulting increase in taxpayer exposure. Another option would be to eliminate altogether the use of brokered insured deposits. The argument for this is simply that deposit insurance was never intended to protect wealthy, sophisticated investors. The use of insured brokered deposits avoids the need to raise uninsured funds and nondeposit liabilities, thus reducing market discipline in the system. Other mechanisms can be used to even out regional credit disparities without involving insured funds, including the federal funds market, correspondent bank networks, the Federal Reserve's discount window, the Federal Home Loan Bank System, or uninsured brokered deposits.

## Endnotes

<sup>1</sup> 12 U.S.C. 1831f(f).

<sup>2</sup> In testimony on July 16, 1985 before the Subcommittee on General Oversight and Investigations of the House Banking Committee, William M. Isaac, Chairman of the FDIC, said:

"It is a simple fact that troubled banks and thrifts use brokered funds more frequently and more extensively than well-rated institutions. These institutions tend to pay the highest rates, and brokered funds flow to the highest bidders. Our studies have revealed that troubled banks are twice as likely as all banks as a group to hold significant amounts of insured brokered funds."

<sup>3</sup> Such an approval must be based upon "a finding that the acceptance of such deposits does not constitute an unsafe or unsound practice with respect to such institution." (12 U.S.C. 1830, Section 29(c))

<sup>4</sup> The data on brokered deposits discussed in this section are for deposits placed by third party brokers and do not include funds raised through money desks.

<sup>5</sup> As of June 1990, this ratio increased further to 2.7%.

<sup>6</sup> This ratio decreased to 6.9% as of December 1989, and 5.4% as of June 1990. It is likely that this was at least partly due to the resolution activities of the RTC.

<sup>7</sup> Data are from the Bank Reports of Income and Condition for year-end.

<sup>8</sup> Data are from the Thrift Financial Reports for year-end.

<sup>9</sup> The Ninth District consisted of Arkansas, Louisiana, Mississippi, New Mexico, and Texas; the Tenth District consisted of Colorado, Kansas, Nebraska, and Oklahoma; and the Twelfth District consisted of Idaho, Montana, Oregon, Utah, Washington, and Wyoming.

<sup>10</sup> The correlations discussed in this section are from annual data from the Thrift Financial Reports using several measures of brokered deposits: the ratio of brokered deposits to total deposits, changes in this ratio, and the growth rate of brokered deposits. These data show consistently positive (though not consistently strong) correlations. The correlations between asset growth and these measures were generally under .10, but in some years they were considerably higher. The correlation between asset growth and brokered deposit growth was .51 in 1988.

<sup>11</sup> For thrift institutions with tangible capital-to-asset ratios over 3 percent, the correlation between brokered deposits and asset growth has been positive, indicating that well-capitalized institutions have used brokered deposits to grow. As previously discussed, this result could be consistent with a scenario in which funds moved from regions with excess supplies of funds to healthy institutions in regions with excess demands for funds. Alternatively, this result may simply reflect the fact that well-capitalized institutions use insured brokered deposits to evade market discipline and grow at the expense of uninsured institutions that may be capable of investing the funds more productively.

<sup>12</sup> However, they did not find a statistically significant relationship between the ratio of brokered deposits to total deposits and either the probability of failure or the FDIC's cost of failure resolution.

<sup>13</sup> At the aggregate level, however, there was little difference between reliance on brokered deposits by thrifts with new worth ratios between 0 and 3 percent and thrifts with net worth ratios over 3 percent. See their Tables II-IV, pp. 740-42, and their statistical tests in Table V, p. 744-45, and Table VI, p. 748-49.

<sup>14</sup> Barth, Bartholomew, and Bradley include tangible net worth in their failure cost equation. Individual balance sheet items, such as brokered deposits, influence resolution costs through their effect on tangible net worth.

<sup>15</sup> See, for example, Barth, Brumbaugh, and Sauerhaft (1986). Their results are reported in Table 6, p. 23.

<sup>16</sup> Baer and Brewer (1988), James (1988), Ellis and Flannery (1989), Hannan and Hanweck (1988), Short and Gunther (1988), Cook and Spellman (1989), Von Drunen and Wikstrom (1988), and Hirschhorn (1990) find that weak institutions pay higher interest rates on deposits. Gorton and Santomero (1990) show similar results for subordinated debt.

<sup>17</sup> The experience in Texas during the late 1980s was evidence that weak institutions can be required to pay higher rates on insured funds as well. Insured funds will, of course, still be cheaper than uninsured funds, and the incentive to use insured brokered deposits for riskier activities remains.

<sup>18</sup> Since 1985, over 70 percent of brokered deposits at FSLIC- and SAIF-insured thrift institutions were either in denominations under \$100,000 or were over \$100,000 but were sold by brokers to investors in participating shares of under \$100,000, for which pass-through insurance is provided.

<sup>19</sup> 12 U.S.C. 1831f.



<sup>20</sup> Flannery (1983) reviews the ways in which implicit interest can substitute for explicit interest.

<sup>21</sup> 12 C.F.R. 304.6.

<sup>22</sup> 12 U.S.C. 1464(t).

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## Chapter V

### PASS-THROUGH INSURANCE

#### A. Introduction

Despite the explicit \$100,000 limit on federal deposit insurance for any one deposit account, a single deposit account well in excess of \$100,000 may be fully protected with "pass-through" insurance. This type of insurance coverage usually applies to deposit accounts maintained by fiduciaries (i.e., agents, nominees, custodians, conservators, guardians, or trustees). Because fiduciary accounts are not maintained for the benefit of the fiduciary-depositor, but for others, the Federal Deposit Insurance Corporation (FDIC) has permitted deposit insurance to pass through fiduciaries to the beneficial owners of the account so that each beneficiary receives up to \$100,000 in coverage. Consequently, an account amounting to millions of dollars may be fully insured.

Pass-through treatment, therefore, expands the scope of coverage of deposit insurance, and, over the years, FDIC regulations have expanded the types of accounts that are subject to such pass-through treatment. Today, pass-through insurance applies generally to the following types of accounts: (1) employee benefit plans, the managers of which utilize both traditional deposit accounts and bank investment contracts (BICs); (2) brokered deposits; (3) escrow accounts maintained by lawyers, landlords, travel agents, mortgage servicing firms, and others; and (4) accounts maintained to facilitate the payments system, including check processing and Visa and MasterCard payments processing.

This chapter discusses whether the expansion of deposit insurance coverage for these types of accounts is justified and is organized as follows: Section B describes the FDIC's eligibility requirements for receiving pass-through deposit insurance; Section C discusses the types of accounts that receive pass-through coverage, with particular emphasis on employee benefit plans; Section D discusses the public policy issues involved in providing pass-through coverage; and Section E contains an appendix that provides more details concerning the regulatory history of pass-through insurance.

## **B. Eligibility Requirements for Pass-Through Protection**

The eligibility rules for pass-through insurance treatment have developed over time from FDIC staff interpretations and regulations promulgated under the Federal Deposit Insurance Act (FDI Act). Assuming that funds invested with an insured depository are a "deposit" for purposes of the FDI Act, two conditions must be satisfied in order for the account to receive pass-through coverage.

First, the account must be held as either an irrevocable trust or by an agent, nominee, custodian, conservator, guardian, or trustee on behalf of true, identifiable owners (the "beneficial" owners). This ensures that the nominal owner of the account is not the true beneficiary of the account.

Second, the interests of the beneficial owners must be determinable without the consideration of certain contingencies. This ensures that beneficiaries are truly likely to receive the funds placed in the account. Thus, for example, an irrevocable trust in which the beneficiary is to receive funds only upon the completion of medical school involves a contingency that may very well not occur; pass-through coverage would therefore be denied. But an irrevocable trust in which the beneficiary is to receive funds upon the death of the grantor involves a contingency that will occur; pass-through coverage would therefore apply.

The regulatory history of these rules, as well as other examples of their application, is set forth in Section E.

## **C. Accounts Receiving Pass-Through Coverage**

As mentioned above, four types of accounts generally receive pass-through coverage: (1) employee benefit plans; (2) brokered deposits; (3) certain escrow accounts held by lawyers, landlords, etc.; and (4) certain payments processing accounts. There is little controversy about pass-through coverage applying to the last two types of accounts, because such deposits are not made for investment purposes, and beneficiaries typically have no readily available alternative for the convenient safekeeping of such funds.

In contrast, there is considerable controversy about the application of pass-through coverage to facilitate the use of brokered deposits. However, issues involving brokered deposits in general are discussed in detail in Chapter IV; pass-through coverage is merely a means to make brokered deposits more available. Accordingly, the discussion in this chapter will not focus on brokered deposits, although one point is important: to the extent it is appropriate to limit the general use of brokered

insured deposits, it may also be appropriate to limit the application of pass-through insurance to such deposits.

The final type of account subject to pass-through coverage is employee benefit plan deposits. Extending pass-through coverage to these accounts raises fundamental questions about the appropriate scope of deposit insurance coverage. Accordingly, the remaining part of this section is a detailed description of various types of employee benefit plans and the application of pass-through coverage to each.

#### **1. Pension Plan Deposits in Depository Institutions**

Of all private pension plans, 126,297 of them maintain deposits of more than \$100,000 in depository institutions, according to Department of Labor data from 1988. These plans cover nearly 33 million participants and hold almost \$652 billion in total assets. Moreover, these plans have deposited 13 percent, or about \$88 billion, of their assets in depository institutions. Assuming that no participant's benefits exceed \$100,000, deposit insurance coverage will pass-through plan administrators to the participants and thereby protect all \$88 billion on deposit. Table 1 shows the relevant data regarding the total number of plans, their participants (employees), and the estimated cash holdings at the end of 1988. Table 2 shows similar data for those plans that exceeded \$100,000 for the same period.

Current estimates suggest that there are between \$100 billion and \$150 billion in employee benefit plan assets on deposit with depository institutions. The Federal Reserve Flow of Funds reports, which are based on a survey of larger plans and a sample of data from the Form 5500 annual reports submitted by all private plans, estimate deposits at about \$100 billion. A complete analysis of the Form 5500 reports by the Department of Labor indicates that the total holdings of plans in "cash or equivalents," the preponderance of which is in insured deposits, was \$136 billion at the end of 1988.

There are a number of types of employee benefit plans that hold these deposits. The largest holdings are by single employer plans, with defined benefit plans estimated to hold \$28 billion and defined contribution plans \$56 billion at the end of 1988. Multi-employer plans held about \$11 billion and state and local government plans \$25 billion for the same period. In addition to these direct holdings, plans held about \$16 billion indirectly through shares in various pooled investment arrangements.

Employee health and welfare plan deposits in banks do not receive pass-through coverage because they fail to satisfy the second condition of the FDIC's test, that is, the interest of each beneficiary depends on an unacceptably contingent event

Table 1

## Pension Plans With More Than One Participant, Year-End 1988

(Estimates derived from 1988 Form 5500 filings)

	Plans	Participants (in thousands)	Assets (in billions of dollars)	Deposits (in billions of dollars)	Percent assets
Single Employer Defined Benefit.....	130,271	30,334	710	28	
Single Employer Defined Contribution.....	576,570	34,841	566	56	
Multi-Employer Defined Benefit.....	2,013	7,900	130	8	
Multi-Employer Defined Contribution.....	1,170	1,700	16	3	
State and Local Government.....	2,400	15,600	606	25	
Subtotal.....	712,424	90,375			
Allocated Insurance Contracts.....			213		
Pooled Funds.....				16	
Total.....			2,241	136	

Source: U.S. Department of Labor.

Table 2

## Private Pension Plans With More Than \$100,000 in Deposits, Year-End 1988

(Estimates derived from 1988 Form 5500 filings)

	Plans	Participants (in thousands)	Assets (in billions of dollars)	Deposits (in billions of dollars)	Percent assets
Defined Benefit.....	32,209	17,422	360.6	34.9	
Defined Contribution.....	94,088	15,280	29.1	52.7	
Total.....	126,297	32,702	651.6	87.6	

Source: U.S. Department of Labor.

(e.g., accident or illness). By contrast, most trustee employee pension and profit sharing plans satisfy both conditions of the test, and deposits of such plans in banks therefore receive pass-through treatment.<sup>1</sup>

Pension plans hold a considerable percentage of financial assets in the United States. It is estimated<sup>2</sup> that as of year-end 1989 pension plans held about \$2.7 trillion in assets, distributed as indicated in Table 1. This included 26 percent of all equity holdings,<sup>3</sup> 15 percent of all taxable bonds,<sup>4</sup> and four percent of all cash items<sup>5</sup> in the U.S. economy.

From a regulatory standpoint, there are two broad categories of pension plans: private pension plans, which generally are covered by the Employee Retirement Income Security Act of 1974 (ERISA),<sup>6</sup> and state and local government plans, which are not. Section 403 of ERISA requires, with limited exceptions not relevant here, that all assets of an employee benefit plan shall be held in trust by one or more trustees. Trustees and other responsible fiduciaries have a duty under ERISA to manage the funds in the interest of plan participants (employees and retirees) and their beneficiaries. At year-end 1989, private trustee plans held assets of \$1.6 trillion.

It is also useful, in discussing private trustee plans, to distinguish between defined benefit plans, whose benefits generally are insured by the Pension Benefit Guaranty Corporation (PBGC),<sup>7</sup> up to certain legal limits, and defined contribution plans, which are not insured. Defined contribution plans may be further divided into those that provide for individual participant direction of investments and those that are managed by trustees or other responsible fiduciaries. Both defined contribution plans and defined benefit plans may take the form of either single employer plans or multi-employer plans. As discussed below, the PBGC maintains separate insurance programs for single employer and multi-employer defined benefit plans.

## **2. Defined Contribution Plans**

A defined contribution plan provides an individual account for each participant. A participant's beneficial interest is determined by the value of his or her account, which is based on the amount of contributions allocated to the account plus any income, expenses, and investment gains or losses charged against the account. Investment risk in a defined contribution plan remains with the participant. Money purchase plans, profit sharing plans, stock bonus plans, 401(k) plans and employee stock ownership plans are all types of defined contribution plans.

At year-end 1988, defined contribution plans held assets valued at \$582 billion, as indicated in Table 1. Of this, approximately \$59 billion was on deposit in bank and thrift



institutions. These funds generally qualify for pass-through insurance coverage. The only funds which would not be explicitly insured involve situations in which an individual has more than \$100,000 worth of pension plan benefits on deposit at a single depository institution.

Of the 126,297 private pension plans with more than \$100,000 on deposit in depository institutions, more than 94,000, or 74 percent, are defined contribution plans. Despite their dominance in numbers, defined contribution plans account for only 47 percent of the participants and for only 45 percent of the assets (\$291 billion). However, 18 percent of these assets, \$53 billion, have been deposited in banks and thrifts and receive pass-through deposit insurance coverage. Funds held in defined contribution plans are managed by a trustee who has a fiduciary duty to the participants. The trustee is responsible for selecting the investment vehicles which implement the broad choices made by the plan participants.

Defined contribution plans are often funded throughout the year with payroll deductions or employer contributions. Through the use of self-directed individual accounts, participants in defined contribution plans often have the responsibility of determining how the funds in their accounts will be invested. The number of investment options provided to each participant depends on the structure of the defined contribution plan and may range from choices of broad investment vehicles, such as equity funds, bond funds, money market funds, etc., to accounts where participants may choose individual securities or other types of specific investments. Therefore, simply because plan assets of a defined contribution plan are held in trust by a trustee or other manager does not necessarily mean that the assets of the plan are "professionally managed."

Particularly with respect to self-directed individual account plans, while in form there may be a trustee or other manager, their role would be circumscribed to the extent that the individual participant directs the amounts and types of investments. Many plans allow participants to change investment allocations at specific times of the year. In order to accommodate such cash flows, the insurance industry developed Guaranteed Investment Contracts (GICs) in the early 1980s.<sup>8</sup> These contracts are entered into by an insurance company and the sponsor of a pension plan. They provide that plan participants will direct funds from their individual accounts to be invested with the institution over a period of time and will earn a guaranteed interest rate for the term of the contract.<sup>9</sup>

GICs proved to be a very attractive product, holding an estimated \$150 billion in funds by year end 1988. Some banks began to compete for these funds by offering BICs that replicated the features of GICs. Like GICs, BICs may have relatively simple

contractual terms that resemble a traditional certificate of deposit, or more complicated terms that provide for a "window" period when deposits may be made at a contractually guaranteed interest rate or that allow plan sponsors or participants to withdraw funds at book value prior to the contract's maturity.

In order to estimate the extent of BIC activity, the Federal Reserve Board conducted a survey of 51 major banking organizations in March 1990. Twenty-six of the respondents reported that they offered BIC contracts, and an additional five indicated that they had plans to enter the market in 1990.<sup>10</sup> Respondents reported holding BIC balances of \$2.3 billion in 1988, \$7.5 billion in 1989,<sup>11</sup> and the expectation of holding balances of \$10.3 billion by the end of 1990. Ten institutions expected to have BIC balances in excess of \$250 million by year-end 1990.

There have been suggestions that deposit insurance should be denied to BICs because they are riskier to issue than standard deposit instruments. In fact, some of the pioneer GIC issuers took large losses in later years when mispricing of earlier contracts became apparent.<sup>12</sup> The FDIC has taken the position that each BIC must be examined in light of section 3(1) of the FDI Act<sup>13</sup> to determine whether it is a "deposit." If a BIC falls within the meaning of the term "deposit," and meets the FDIC's two conditions described earlier, the FDIC has stated that it would be insured on a pass-through basis like most other trustee employee benefit plan deposits. Although the FDIC has not issued any blanket opinion that would apply to all BICs, the BICs which have been examined appear to come within the meaning of the term "deposit" and thus are entitled to pass-through insurance like most other deposits of trustee employee benefit plans.<sup>14</sup>

### 3. Defined Benefit Plans

A defined benefit plan provides a definite formula under which the amount of a participant's pension is determined, such as a specific dollar amount for each year of credited service. In defined benefit plans, the amount of the employer's contribution is actuarially determined each year based upon such factors as the number and age of the participants and the investment returns of plan assets. Unlike defined contribution plans, all investment risk in defined benefit plans resides with the plan sponsor. Any earnings that exceed prior expectations will reduce future funding requirements. Any deficiency in earnings, or actual losses, will require an increased level of funding in future years. At year-end 1988, defined benefit plans held assets of \$840 billion, \$36 billion of which was held in deposits. These deposits currently are covered by pass-through insurance.<sup>15</sup>

Of the 126,297 private pension plans with more than \$100,000 on deposit in depository institutions, only 26 percent are defined benefit plans. Although fewer in number, these plans account for 55 percent of the assets (\$361 billion) and have 53 percent of the participants. In the aggregate, 10 percent of the assets of these plans, or \$35 billion, are on deposit at depository institutions. As with the \$53 billion deposited by the plan administrators of defined contribution plans, all of the deposits are protected by federal deposit insurance with pass-through coverage.

The PBGC, a wholly-owned government corporation, was created in 1974 to insure the pension benefits of participants in terminated covered defined benefit plans. PBGC insures private defined benefit plans, except for professional service employer plans with 25 or fewer participants and for certain other plans. (The insurance program for multi-employer defined benefit plans is described below.) All covered plans pay the PBGC annual premiums, although the PBGC's insurance is not dependent upon payment of the PBGC premiums. For all plans, the premium (determined by Congress) is based on a fixed rate multiplied by the number of plan participants. Single-employer plans pay an additional amount that is based on the amount of a plan's underfunding.

An underfunded single employer plan may be terminated, thus triggering the PBGC's guaranty, in one of two ways. A plan may terminate voluntarily in a "distress termination" if the plan sponsor (and any other trades or businesses under common control with the plan sponsor) can demonstrate that it satisfies any of four statutory "distress tests," each of which is intended to reflect severe financial hardship. Secondly, PBGC may terminate a plan on its own motion, either by agreement with the plan sponsor or by obtaining a court order.

Upon plan termination, PBGC becomes liable, as guarantor, for all unfunded basic pension benefits, subject to certain statutory limitations ("guaranteed benefits"). PBGC is also liable to plan participants and beneficiaries for a portion of their unfunded benefits in excess of those guaranteed by PBGC. This portion is based on the percentage of the PBGC's recovery on its "employer liability" claim. The "employer liability" claim is PBGC's claim against the plan sponsor (and all members of the plan sponsor's controlled group) for the entire plan underfunding, most of which is frequently uncollectible. Because of this, the PBGC's single-employer insurance program had a deficit of \$1 billion at the end of FY 1989. However, the PBGC has a positive cash flow and expects to be able to meet its guarantee obligations for the foreseeable future.

#### **4. Multi-Employer Plans**

Multi-employer plans are plans to which two or more unrelated employers contributed and which is maintained under one or more collective bargaining agreements. A common trust is used to hold employer contributions and distribute benefits. Approximately two-thirds of these plans are defined benefit plans. As shown in Table 1, multi-employer plans held assets of \$146 billion as of year-end 1988, of which \$4.3 billion was held in bank deposits, and most, if not all, of this would receive pass-through coverage.

Under the revised insurance program for multi-employer plans adopted by Congress in 1980, PBGC guarantees benefits payments under insolvent multi-employer plans (i.e., those currently unable to pay benefits when due). PBGC's guarantee is in the form of a loan to the insolvent plan, and the amount of benefits guaranteed is less than under the single-employer insurance program. There have been only a few claims against the multi-employer program, and it has a surplus.

#### **5. State and Local Government Plans**

Approximately three-fourths of state and local government plans are defined benefit plans, although some allow employees to make additional contributions. These plans are not covered by ERISA. In 1989, these plans held \$726.2 billion, \$26.4 billion of which was on deposit in depository institutions, and subject to pass-through protection.

One type of plan used by state and local governments, and also some non-profit organizations, is authorized under section 457 of the Internal Revenue Code. The FDIC has made a distinction in the case of "457" deferred compensation plans. Because Section 457 of the Internal Revenue Code states that the funds of such plans are required to "remain solely the property and rights of the employer," the FDIC determined that the first condition for pass-through insurance coverage mentioned above is not met, that is, the funds are technically not held on behalf of other beneficiaries. The FSLIC, on the other hand, had provided these plans with pass-through coverage. Recent regulations to provide uniformity between the insurance funds have grandfathered pass-through coverage to accounts of existing 457 Plans at savings associations until January 29, 1992, or the first maturity date of a time deposit thereafter.

#### **D. Public Policy Issues Concerning Pass-Through Insurance**

As discussed above, the application of pass-through coverage to employee benefit plans is almost by definition an expansion of the scope of deposit insurance coverage. This expansion raises

three questions relating to the goals and consequences of deposit insurance:

- 1) Is pass-through coverage consistent with the original deposit insurance goal of protecting small, unsophisticated depositors and promoting financial stability?
- 2) Does the provision of pass-through insurance affect the level of risk in the financial sector? Does it affect the amount of risk assumed by the insuring agency?
- 3) How does the policy toward pass-through insurance affect the efficient allocation of capital in the economy?

In examining each of these questions, emphasis will be placed on the elements which are unique to pass-through accounts. Consideration will be given to the profile of the typical beneficiary of these plans, the individuals making the investment decisions, the types of financial instruments that are used, and the institutions that are active in the market.

It is also important to consider the effect of failure resolution policy on depositors' investment decisions. To the extent that the FDIC provides protection to most uninsured depositors in all bank failures (or in all failures involving a certain class of banks), explicit regulations on deposit insurance limits become less meaningful. At the same time, however, the doctrine of constructive ambiguity (discussed more fully in Chapter III) suggests that failure resolution policies do not alter the fact that uninsured depositors exercise discipline on depository institutions at the margin. The fear that they, unlike insured depositors, may lose something enhances their vigilance. In addition, the fiduciaries controlling employee pension plan funds may feel obligated to act only on explicit guarantees (such as that provided by federal deposit insurance), rather than relying on the implicit protection of uninsured deposits.

It is also important to consider that any efforts to reduce potential FDIC liability on insured deposits by reducing pass-through coverage might conceivably be thwarted by unforeseen technological end-runs. It is possible that instruments could be created that actually split the accounts into small pieces, each representing the interests of a single member of the pool.

#### **1. Protecting Small Depositors and Promoting Bank Stability**

One of the original goals of the federal deposit insurance program was to provide a safe haven for the savings of small, unsophisticated depositors. These investors could not be

expected to differentiate between sound and unsound institutions. Sophisticated investors, on the other hand, are able to play a constructive role in fostering market discipline if their deposits are at risk in the event of a bank failure. For example, managers of large pension funds are typically well-paid professionals whose business is to assess the riskiness of various investments.

Applying this expertise to bank deposits would not only help provide important market discipline to the system, it would also help provide protection for beneficiaries in the absence of deposit insurance. This protection is enhanced by the large body of fiduciary laws that already require such managers to evaluate the long-term health and viability of depository institutions in making investment decisions. Moreover, a number of pension fund beneficiaries are already protected by the federal government through the PBGC, as described above--deposit insurance appears to be clearly unnecessary in such cases.

It is true, however, that despite professional management, fiduciary laws, and the protections of PBGC, some pension plan participants could suffer losses from bank failures in the absence of deposit insurance, just as they could suffer losses from other plan investments not guaranteed by the government.<sup>16</sup> Obviously, loss of a substantial portion of funds because of a depository institution failure could be greatly disruptive to participants' lives and create high social costs. Pass-through coverage of employee pension plan deposits could thus be viewed as consistent with the goal of deposit insurance to provide a safe haven for small savers, even if it is an expensive and sometimes redundant means of doing so.

Three additional points are worth noting. First, basing pass-through insurance coverage on the needs of various ultimate beneficiaries could result in an unmanageable process if it requires measuring the relative value of funds to different kinds of bank customers. Such concerns may be better addressed by other government agencies, such as the Labor Department.<sup>17</sup>

Second, the protections discussed above for some pension fund participants--professional management and PBGC protection--do not apply to many other participants. For example, beneficiaries of self-directed defined contribution plans choose their own investments, including bank investments. Their circumstances may not be appreciably different than investors outside of pension plans who choose bank deposits as savings vehicles for retirement. Arguments for denying pass-through coverage in such circumstances are less compelling.

Finally, any policy that extends the scope of deposit insurance may promote systemic stability by reducing the probability of bank runs. However, such policies might also

expose the insurance fund to greater potential for loss by removing the constraining effects of market discipline. This risk is discussed in the next section.

## 2. Risk to the Insurance Fund

Many factors affect the ability of the insurance fund to maintain an appropriate reserve over time. These include the overall health of the banking industry, the scope of insurance coverage, the size of the assessment base, and the distribution of that base across institutions of various risk profiles. Market discipline imposed on institutions by sophisticated depositors may be an effective tool to reduce bank risk. Policies increasing pass-through insurance coverage may remove market discipline from some of the depositors who are best able to assess risk.

Put another way, if policies regarding pass-through insurance increase the ability of risky institutions to raise deposits, it could have negative consequences for the insurance fund. Given the extremely large amounts of money now in pension plans, the viability of the federal deposit insurance funds could be threatened if these investors start funding high-risk banks.

In employee benefit plans, a pool of funds may be invested by a professional manager. These funds are neither small nor are the managers unsophisticated (except for participant directed plans and, perhaps, some small business pension plans). Exposing these deposits to risk in the event of a bank failure might increase the level of market discipline in the system.

However, as discussed above, even with pass-through coverage available to pension plans there are factors that might prevent a trustee from placing pension money in high-risk institutions paying the highest interest rates.<sup>18</sup> While these factors help make deposit insurance unnecessary for pension fund beneficiaries, they also reduce the degree to which the removal of deposit insurance would increase market discipline.

For example, ERISA requires that the plan trustee be guided by strict fiduciary standards.<sup>19</sup> This requires that plans must evaluate the risks before selecting any investment and ensure that they invest prudently.

Another factor concerns the problems involved in bank failures apart from permanent loss of funds. Pension plans typically involve substantial amounts of money and numbers of beneficiaries. In most depository institution failures that are resolved through a payoff or insured deposit transfer, only a few days are required to pay off retail depositors. Where a large plan is involved, however, the time required to determine appropriate payoff amounts could be longer. During this period,

the funds could not be reinvested, their deposits would not be earning interest, and beneficiaries would not have access to them. In addition, plan sponsors may find it difficult to meet benefit distributions or effect transfers from one plan option to another.<sup>20</sup>

Furthermore, an institution acquiring pension plan deposits from a failed bank in an insured deposit transfer would be able to re-set the interest rates on the funds. Many pension plan investments are long term, thus exposing the plan administrator to interest rate risk when depositing in a financially unsound institution. Even with the provision of pass-through insurance, plan sponsors and participants cannot receive the highest yields from high-risk institutions without also facing some increased risks.

Plan managers currently appear to avoid risky institutions. If some pass-through coverage were eliminated, it seems reasonable to assume that managers' scrutiny of depository institutions would increase, although perhaps not dramatically. This limited increase in market discipline would likely benefit the FDIC (i.e., "good" institutions may become "better" ones in order to obtain, or not lose, the business). At the same time, elimination of pass-through coverage for some pension plan deposits is not likely to induce managers to pull these funds out of banks altogether. Indeed, the constraints of applicable fiduciary laws suggests that deposit insurance is somewhat irrelevant to managers. It is likely that any actual loss of funds would occur only at the margin--and to the extent that occurs, it may be a healthy form of market discipline for the industry.

### **Bank Investment Contracts**

Concerns also have been expressed about the increased exposure to interest rate risk facing banks that issue BICs. Some BICs, called "bullet" contracts, have relatively simple terms that resemble a traditional certificate of deposit. Others are more complicated, providing for a "window" period when deposits may be made at a contractually guaranteed interest rate. Some BICs also allow plan sponsors or participants to withdraw funds at book value prior to the contract's maturity. In the case of the complex contract, unanticipated changes in prevailing interest rates above or below the contract interest rate may result in unanticipated deposit inflows or withdrawals, thereby exposing the bank to a form of interest rate risk.

In traditional certificates of deposit, interest rate risk is shared with the depositor. If market rates go up during the term, the customer "loses." Conversely, the bank "loses" if market rates go down during the term. However, customers are allowed to fund BICs with a pre-determined yield over a period of



time. Therefore, depending on the contractual arrangements of the BIC, the customer may be able to take advantage of any change in market interest rates to the detriment of the bank. Should market rates go down, the customer may be able to invest more funds in the BIC, at a contracted higher interest rate, than he might have originally planned. Should rates go up, the customer may deposit less. Insurance company competitors in this market have cited these increased risks as reason for denying FDIC coverage to BICs.

The extra risk can be controlled, however, among other means, by contract language that limits the length of the deposit window, imposes penalties if some minimum level of deposits is not reached or some maximum level is exceeded, and/or restricts penalty-free withdrawals to a limited set of specified events. Increasingly, these types of limitations are being utilized by participants in the BIC/GIC market. Institutions may also use financial instruments as hedges against some of this risk.<sup>21</sup> Moreover, the potential risk that BICs pose to a particular institution needs to be evaluated in the context of a bank's overall asset/liability management practices.

As described previously, FDIC insurance eligibility has been based on the ownership of deposited funds rather than on the type of deposit instrument. There is little doubt that federal deposit insurance provides a competitive benefit to banks vis-a-vis insurance companies for a virtually identical financial instrument.

Nevertheless, if FDIC criteria are changed, several policy questions would arise. How would insurability decisions be made about new, complicated deposit-like products that may be developed in the future? Some may argue that adopting a conservative approach to providing federal guarantees for such products is appropriate.

If some banks, but not all, are sophisticated enough to manage the risks in a specific deposit product, should insurability be denied to all institutions? If insurability is denied, should the instrument be assessed for insurance fees? Is the best way to prevent excessive risk to BIC issuers through a blanket FDIC policy or through case-by-case analysis by examiners and supervisors? Given the issues that would arise if BICs were singled out for special treatment among deposit instruments, some may argue that attention is more appropriately focused on insurance coverage of pension plans' deposits generally, rather than on one particular kind of deposit.

### **3. Efficient Allocation of Capital**

Financial regulations have the potential of distorting the efficient flow of capital. Decisions concerning the provision of

pass-through insurance coverage should consider its effect on the cost of funds across financial intermediaries, between domestic and foreign banks, and among domestic banks. Consideration of these effects should be based on the realization that other distortions already exist in tax codes, regulatory structures and other types of intervention. It is difficult to determine in which direction the combined effect of these distortions lead. If the provision of pass-through insurance provides depository institutions with subsidized funding, then the banking sector will be larger than it otherwise would be, thereby directing more funds than would be optimal to bank borrowers and expanding the government safety net. On the other hand, the absence of deposit insurance may permit an inherent market instability, potential depositor runs, to result in an underfunding of banking organizations. It should be remembered, however, that this would increase market discipline and thereby induce depository institutions to operate in a safer and more sound manner.

#### **Allocation of Funds Across Financial Intermediaries**

The type of financial instrument banks sell to employee benefit plans is also available from certain life insurance companies. Does pass-through insurance coverage enable excess capital to flow into the banking industry, away from the insurance industry? The economic implications of the potential misallocation are important to the extent that the types of projects financed by banks differ from those financed by insurance companies.

It is not possible to determine from purely a priori reasoning whether the provision of pass-through insurance has socially detrimental effects on the allocation of capital between banks and other intermediaries. All financial intermediaries are subject to a complex array of laws, regulations, restrictions and preferences. It is not possible to calculate accurately the cumulative effect of these distortions and determine the net effect on the allocation of capital. Although the existence of pass-through insurance may, by itself, lead to more funds flowing into the banking industry, it is not clear if this mitigates or intensifies other existing distortions.<sup>22</sup> Furthermore, it may not be possible to establish a neutral policy. Because FDIC insurance assessments are based on all domestic deposits, banks competing for employee benefit plan funds have to absorb this additional cost regardless of whether pass-through insurance coverage is provided. Therefore, if the coverage is not provided, the assessments could act as a tax, misdirecting funding out of the banking industry. On the other hand, providing pass-through protection could act as a government subsidy, misdirecting funds into the banking industry.

## **Allocation of Funds Across Banking Firms**

Pass-through coverage, as is the case with any deposit insurance coverage, may enable banks with riskier policies to attract additional funding priced according to the insurance guarantee, rather than the fundamental financial condition of the bank. However, as pointed out earlier, ERISA and other considerations may limit the extent to which pension funds may choose to invest in high-risk banks.

If pass-through coverage is not provided, and there is no resolution of the "too-big-to-fail" doctrine, some funds may be directed to large banks simply due to their size. This would hinder smaller, equally solvent banks from competing effectively with their larger counterparts.

At present, only one large U.S. banking firm has senior debt with an AAA rating from private credit rating agencies. The provision of pass-through insurance presents institutions with ratings as low as BBB access to some funds controlled by fiduciaries that would otherwise go to higher rated competitors. These competitors include insurance companies and some foreign-owned banks. Providing pass-through insurance coverage enables weaker domestic banks to compete more easily with nonbank firms and foreign-owned banks. However, as with any form of protectionism, shielding domestic firms from competition may, in the long run, result in a less efficient industry. Under protection, domestic banks could have less incentive to strengthen their balance sheets in order to improve their credit ratings and compete in these markets.

### **E. Appendix: Regulatory History<sup>23</sup>**

The extent to which the FDIC insures deposits in depository institutions is governed by the FDI Act.<sup>24</sup> With respect to the amount of deposit insurance provided by the FDIC, the crux of the FDI Act is Section 3(m)(1).<sup>25</sup> That Section defines the term "insured deposit" to mean "the net amount due to any depositor . . . for deposits in an insured depository institution . . . less any part thereof which is in excess of \$100,000."<sup>26</sup> Section 3(m)(1) further provides that "[s]uch net amount shall be determined according to such regulations as the [FDIC] Board of Directors may prescribe, and in determining the amount due to any depositor there shall be added together all deposits in the insured depository institution<sup>27</sup> maintained in the same capacity and the same right for his benefit either in his own name or in the name of others . . ."<sup>28</sup> Finally, Section 3(m)(1) authorizes the FDIC Board of Directors to clarify and define, by regulation, the extent of deposit insurance coverage resulting from Subsections 3(m)(1), 3(p), 7(i), and 11(a) of the FDI Act.<sup>29</sup>

Based on this statutory authority,<sup>30</sup> the FDIC has been determining the extent to which deposits in FDIC-insured depository institutions are entitled to deposit insurance coverage. In accordance with Section 3(m)(1) of the FDI Act, the FDIC has been insuring deposits according to the "rights and capacities" in which they are owned. To the extent that deposits are owned in the same right and capacity, they have been aggregated and insured up to \$100,000. Conversely, to the extent that funds are owned in different rights and capacities they have been separately insured up to the \$100,000 maximum. The FDIC's deposit insurance regulations,<sup>31</sup> which were first adopted in 1967, and substantially revised in 1990,<sup>32</sup> enumerate the various rights and capacities in which funds may be owned, and thus separately insured, for deposit insurance purposes. Prior to the adoption of the regulations in 1967, the various rights and capacities in which funds were insured were determined primarily by informal FDIC staff interpretations of the FDI Act.

Under the FDIC's recently revised regulations, deposit accounts maintained by fiduciaries (*i.e.*, agents, nominees, custodians, conservators, guardians, or trustees) are insured in the amount of up to \$100,000 for the interest of each principal or beneficial owner in such accounts,<sup>33</sup> provided that certain recordkeeping requirements are satisfied.<sup>34</sup> Because the insurance coverage for such accounts passes through the fiduciary and is measured by the interests of the beneficial owners of the funds, this type of insurance coverage is commonly referred to as "pass-through" insurance. For instance, if the trustee of an irrevocable trust maintains a deposit account comprised of trust funds at an insured depository institution and the trust has three beneficiaries, the deposit insurance would pass through the trustee to each beneficiary so that each beneficiary's interest in the account would be separately insured up to \$100,000.<sup>35</sup> In addition, such insurance coverage would be separate from the insurance coverage provided for any other accounts maintained by, or for the benefit of, the settlor, trustee, or beneficiaries in different rights and capacities at the same insured depository institution. However, if a beneficiary has interests in more than one trust account established pursuant to trusts created by the same settlor, then all of those interests would be aggregated and insured on a combined basis up to \$100,000.<sup>36</sup>

The deposits of most pension plans, profit-sharing plans, and other trustee employee benefit plans are entitled to pass-through insurance and are thus insured in the amount of up to \$100,000 for the interest of each beneficiary, provided that the FDIC's recordkeeping requirements for fiduciary accounts are satisfied. This insurance coverage is separate from (and in addition to) the insurance coverage provided for any other deposits maintained by the plan sponsor, the trustee, or plan beneficiaries in different rights and capacities in the same insured bank.

However, pass-through insurance coverage is provided for employee benefit plan deposits only when the value of each participant's interest in the plan's assets can be determined without evaluation of any contingencies other than those contained in the present-worth tables and rules of calculation for their use (which concern life expectancy and interest rates) as set forth in the Federal Estate Tax regulations.<sup>37</sup> Therefore, while the deposits of an employee pension or profit-sharing plan would, in most cases, qualify for pass-through insurance coverage, the deposits of a health and welfare plan generally would not qualify for such coverage because the present value of a participant's interest in the assets of a health and welfare plan is contingent on an event (*i.e.*, illness or accident) that is not covered by the above-noted present-worth tables. This means that the deposits of a health and welfare plan in an insured bank would generally be added together and insured up to \$100,000 in the aggregate, as opposed to being insured on a per-participant basis. The insurance of such trust funds would, however, be separate from the insurance afforded to deposits maintained individually by the settlor, trustee, or beneficiaries of the plan.

In the case of a pension plan which qualifies for pass-through insurance, the interests of the participants in the plan's assets are determined differently based upon whether the plan is a defined contribution plan or a defined benefit plan. In the case of a defined contribution plan, the value of an employee's interest in the plan's assets would be deemed to be the beneficiary's account balance as of the date that the insured bank fails. In the case of a defined benefit plan, the value of an employee's interest in the plan would be deemed to be the present value of the beneficiary's interest in the plan determined on an actuarial basis. It should be noted, however, that the interest of each participant in a pension plan is evaluated, for deposit insurance purposes, as if the interest of the participant had fully vested, regardless of whether vesting has actually occurred.<sup>38</sup>

Pass-through insurance coverage for the deposits of most pension plans, profit-sharing plans, and other trustee employee benefit plans has been provided by the FDIC since the FDIC's insurance regulations were first adopted in 1967.<sup>39</sup> Prior to 1978, however, there was no specific regulation which addressed the insurance coverage provided for deposits of pension and other trustee employee benefit plans. Pension and other trustee employee benefit plans usually qualified as irrevocable trusts and their deposits were insured according to each individual trust interest (on a per-beneficiary basis). However, only the vested portions of the participants' interests were considered in determining the participants' insurable interests. All nonvested interests were aggregated and insured up to \$40,000.<sup>40</sup>

In 1978, the FDIC amended its deposit insurance regulations to specifically address the insurance provided for the deposits of pension and other trustee employee benefit plans.<sup>41</sup> Section 330.1(c)(1) of the FDIC's regulations was amended to expressly provide that the interest of each participant in pension and other trustee employee benefit plans would be evaluated for insurance purposes as if the interest of the participant had fully vested as of the date that the insured bank was closed. This represented a codification of the FDIC's pre-existing position, which was that the deposits of pension and other trustee employee benefit plans were insured on a pass-through basis (according to the interest of each participant in the accounts). However, the amendment also broadened the insurance coverage provided for such deposits by treating all of the participants' interests as having vested, regardless of whether they had actually vested.

## Endnotes

<sup>1</sup> In 1978, regulations were adopted which clarified that the FDIC would treat the interests of all plan participants as if they were fully vested when determining beneficial interests.

<sup>2</sup> All estimates in this paragraph are from Employee Benefit Research Institute, Quarterly Pension Investment Report, 2nd Quarter 1990.

<sup>3</sup> Equity assets include both common and preferred stock of domestic and foreign companies.

<sup>4</sup> Bonds are credit market instruments with current date-to-maturity of one year or more, including U.S. government securities, government agency mortgage backed securities, corporate and foreign bonds, and convertibles.

<sup>5</sup> Cash items includes demand deposits, certificates of deposit, open market paper, and credit market instrument with current date-to-maturity of less than one year.

<sup>6</sup> 29 U.S.C. 1104(a).

<sup>7</sup> For more information about the Pension Benefit Guaranty Board and its ability to meet its obligations, see Estrella, Arturo, and Beverly Hirtle, "The Implicit Liabilities of the Pension Benefit Guaranty Board," Federal Reserve Bank of New York Research Paper #8905 (April 1989).

<sup>8</sup> "Rethinking GICs," Institutional Investor, January 1989.

<sup>9</sup> It is important to note that the word "guarantee" refers to the interest rate earned on the funds. It does not imply that the principal balance is protected if the issuing firm became insolvent.

<sup>10</sup> Because institutions were selected for the survey in the hope of capturing all major BIC issuers, it is unlikely that substantial additional activity also exists.

<sup>11</sup> This is less than the estimated \$27.5 billion in total deposits held by defined contribution plans. An estimated \$2.5 billion was deposited in checking accounts, while the remaining \$17 billion would represent time deposits that are not BICs.

<sup>12</sup> It is important to note that, while GIC issuers have suffered losses internally on the product, no GIC purchasers have experienced any losses to date.

<sup>13</sup> 12 U.S.C. 1813(1).

<sup>14</sup> The information in this paragraph has been taken from FDIC, "Findings and Recommendations Concerning 'Pass-Through' Deposit Insurance," February 1990.

<sup>15</sup> In the event of the failure of a bank holding funds for such plans, the FDIC would determine the level of coverage in the following manner: (1) Should the plan be overfunded, the percentage by which the plan is overfunded is applied to the account balance. This amount is separately insured for up to \$100,000. (2) The remaining funds are insured based on the interests of each plan participant. All participants are assumed to be fully vested. The percentage of total plan benefits accrued to the participant with the largest benefit is applied to the funds on deposit. If this amount is less than \$100,000, all funds are insured. If this amount is more than \$100,000, the difference is uninsured and the same calculation is performed for the participant with the next largest accrued benefit. The process is repeated until the largest fully insured participant is determined.

<sup>16</sup> In the case of a defined contribution plan, the participants directly suffer from investment losses. The investment risk in defined benefits plans resides with the plan sponsor. However, participants may suffer if losses occur in a plan which is subsequently taken over by the Pension Benefits Guaranty Corporation. In that case participants may only receive basic benefits which might be less than those envisioned by the original plan.

<sup>17</sup> It should be noted that eliminating pass-through insurance coverage of defined benefit plans would not result in a mere transfer of obligations from one government agency (FDIC) to another (PBGC). Should losses be imposed on the deposit of a defined benefit plan, the plan sponsor would first be obligated to compensate the plan, over time, for the resulting funding shortfall. Only if the plan sponsor was insolvent, or driven insolvent by the bank failure, would the PBGC's increased liability match the FDIC's savings.

<sup>18</sup> However, these factors do not necessarily dominate the decision process. Some banks with large substantial pension plan deposits are rated BBB, or perhaps lower.

<sup>19</sup> 29 U.S.C. 1104(a).

<sup>20</sup> The information in this paragraph is taken from FDIC, "Findings and Recommendations Concerning 'Pass-Through' Deposit Insurance," February 1990.

<sup>21</sup> For a description of hedging strategies, see Belton, Terry, and Burghardt, "SLICs, BICs, and GICs," Discount Corporation of New York Futures.



<sup>22</sup> For example, pension plans have grown to significant size partially due to their special tax treatment. However, the existence of such plans may have an indirect effect on banks by diverting personal savings out of traditional accounts. It may not even be possible to list all of the government policies which affect the flow of capital into the banking sector, let alone determine the net effect of these policies.

<sup>23</sup> Section E is taken in large part from FDIC, "Findings and Recommendations Concerning 'Pass-Through' Deposit Insurance," February 1990.

<sup>24</sup> 12 U.S.C. 1811, et seq.

<sup>25</sup> 12 U.S.C. 1813(m)(1).

<sup>26</sup> Id.

<sup>27</sup> Prior to the enactment of FIRREA, the definition included the term "insured bank" rather than the term "insured depository institution."

<sup>28</sup> 12 U.S.C. 1813(m)(1).

<sup>29</sup> 12 U.S.C. 1813(m)(1), 1813(p), 1817(i), and 1821(a).

<sup>30</sup> The statutory authority has remained basically unchanged since 1935, with only minor revisions, such as the substitution of the term "insured depository institutions" for the term "insured bank," which was made by the FIRREA.

<sup>31</sup> The deposit insurance regulations are codified at Part 330 of Title 12 of the Code of Federal Regulations.

<sup>32</sup> The final amendment to the regulations can be found at 55 Federal Register 20,111 (May 15, 1990).

<sup>33</sup> 12 C.F.R. 330.6, 330.10, and 330.11.

<sup>34</sup> The recordkeeping requirements for pass-through insurance of fiduciary accounts are enumerated at 12 C.F.R. 330.4(b). The basic requirements of the Section are: (1) the deposit account records of the depository bank must indicate the fiduciary nature of the account (i.e., that it is a pension plan account); and (2) the records of either the bank or the depositor, maintained in good faith and in the regular course of business, must indicate the name and interest of each person in the account.

<sup>35</sup> In order for each beneficiary's interest to be separately insured, the value of the interest must be determinable without evaluation of any contingencies other than

those contained in the present worth tables and rules of calculation for their use (having to do with life expectancy and interest rates) which are set forth in the Federal Estate Tax regulations (26 C.F.R. 20.2031-10).

<sup>36</sup> 12 C.F.R. 330.11.

<sup>37</sup> 26 C.F.R. 20.2031-10.

<sup>38</sup> 12 C.F.R. 330.12(b)(3).

<sup>39</sup> This insurance coverage was, in fact, provided pursuant to interpretations of the FDI Act prior to 1967 although the exact year is uncertain.

<sup>40</sup> The basic insurance limit in 1978 was \$40,000. The limit was increased to \$100,000 in 1980. 45 Federal Register 23,645 (April 8, 1980).

<sup>41</sup> The amendments were published at 43 Federal Register 10,683 (March 15, 1978).

## **Chapter VI**

### **INSURANCE TREATMENT OF FOREIGN DEPOSITS**

#### **A. Introduction**

This chapter discusses the appropriate assessment and insurance treatment of foreign deposits in U.S. banks. Section B provides background information, while Sections C and D provide arguments for and against assessing foreign deposits. Section E briefly describes a number of alternatives for the treatment of foreign deposits.

#### **B. Background**

For purposes of this paper, foreign deposits are defined as deposits in foreign offices of U.S. banks, which include foreign branches of U.S. banks, Edge Act and Agreement corporations, and International Banking Facilities (IBFs).<sup>1</sup> Foreign deposits are not insured by the FDIC, and they are not assessed insurance premiums.

Beginning with the Banking Act of 1933, Congress has consistently excluded foreign deposits from both insurance coverage and insurance assessments. Nevertheless, foreign deposits have on occasion been protected by the FDIC in bank resolutions. As a result, it has been argued that foreign deposits should be assessed and possibly insured.

This issue has become increasingly prominent as the dollar volume of foreign deposits has increased, particularly in the last decade. Foreign deposits were negligible in the 1930s, but totaled about \$260 billion at year-end 1989, or 10 percent of all deposits at U.S. banks.<sup>2</sup> Foreign deposits are heavily concentrated at the largest banks, with the ten largest U.S. banks holding 67 percent of all foreign deposits, and the 25 largest holding 85 percent. Among the largest banks, the ratio of foreign deposits-to-domestic deposits varies greatly, ranging from 81 percent to 26 percent of total deposits.<sup>3</sup>

#### **Legislative History**

Congress passed the Banking Act of 1933 in response to a domestic banking crisis with the goal of restoring depositor confidence in the U.S. banking system. Reflecting this focus,

the definition of an insured deposit excluded deposits payable at offices outside the United States. Indeed, the question of assessing foreign deposits was expressly addressed during hearings on the legislation, yet Congress decided to exclude them from the assessment base in part because of concern over possible effects on international competitiveness.<sup>4</sup> For similar reasons, Congress excluded deposits at foreign branches of U.S. banks from Federal Reserve requirements and federal interest-rate controls. This policy was reaffirmed in the Depository Institutions Deregulation and Monetary Control Act of 1980.

In 1981, the assessment issue emerged during hearings on legislation concerning IBFs. An FDIC witness pointed out that international activities had grown dramatically and suggested a review of the assessment base and foreign deposit exclusion.<sup>5</sup> Again, primarily for reasons of international competitiveness, Congress retained the exemption for foreign deposits in the 1981 International Banking Facility Act.

Interest in the issue intensified after the 1984 FDIC assistance of Continental Illinois National Bank and Trust Company, in which no depositor, foreign or domestic, lost money. During discussion of the Senate's Financial Services Competitive Equity Act in 1984, an amendment was proposed which would have included foreign deposits in the assessment base while reducing the assessment rate, thus having a revenue-neutral effect; this amendment did not pass.<sup>6</sup>

In 1986, during consideration of the fiscal year 1987 budget resolution, the Senate voted to assess insurance premiums on foreign deposits as a remedy for the budget short-fall. However, the proposal was dropped from the bill during the House-Senate conference on the budget resolution.

In 1988, a bill was introduced which would have included foreign deposits in the assessment base while lowering the overall assessment rate; no action was taken on the bill.<sup>7</sup> During consideration of FIRREA, an amendment was offered which would have given the FDIC authority to include foreign deposits in the insurance base, but it was not supported by the Senate Banking Committee and did not pass.<sup>8</sup> During the 101st Congress, H.R. 1531 and S. 3184 would have assessed foreign deposits, but were not passed.

## **C. Arguments in Favor of Assessing and Insuring Foreign Deposits**

### **1. Increased Revenue to Insurance Fund**

One benefit of assessing and insuring foreign deposits is the potential for increased revenue to the insurance fund. Assuming that deposit growth averages four percent per year,

assessing foreign deposits at the current rate of 19.5 basis points would add \$550 million to the fund in 1991, and about \$3 billion between 1991 and 1995. Of course, these numbers assume that the market for foreign deposits would remain unchanged by the assessment.

If foreign deposits were both assessed and insured, and assuming that the percentage of insured foreign deposits-to-total foreign deposits is 25 percent, rough estimates indicate that the fund-to-insured deposit ratio would actually decline slightly. However, if one assumes that foreign deposits are currently de facto insured (i.e., they are already included in the denominator), the fund-to-insured deposit ratio improves with the additional income.

Opponents argue that assessing premiums on foreign deposits would either: (1) force banks to absorb the additional costs, which would make them unprofitable; or (2) drive down rates offered on foreign deposits, which would make the U.S. banks uncompetitive in this market as depositors shifted funds into higher paying instruments (presumably those offered by foreign banks which do not have to pay the added cost of insurance). While estimates of the resulting decline in foreign deposits of U.S. banks vary, there seems to be general agreement that the effect would be substantial. One estimate suggests that foreign deposits would decline by over 50 percent.<sup>9</sup> If deposits declined by 50 percent in the first year (and grew at an annual rate of four percent thereafter), additional income to the fund would be only \$1.5 billion between 1991 and 1995, as opposed to the \$3 billion calculated earlier. In addition, assessing foreign deposits could lead to conversion of branch operations into locally chartered subsidiaries or even an exit from the system of some institutions. This could decrease assessable foreign deposits by a significantly further amount.

## 2. De Facto Insurance

One of the major arguments for assessing and insuring foreign deposits made by such groups as the Independent Bankers Association of America (IBAA), a number of small banks, and the Federal Reserve Banks of Richmond and Boston, involves the distinction between de jure (\$100,000 coverage for each depositor as provided by law) and de facto (all depositors made whole by means of sale or merger of an institution) coverage. The rescue of Continental Illinois and several subsequent large-bank resolutions in which no depositors lost money support the notion that some banks are "too big to fail" and thus receive de facto 100 percent insurance protection for all of their domestic and foreign deposits. Proponents of assessing foreign deposits argue that if large banks receive de facto insurance coverage of foreign deposits, they should pay for it.

However, as described in Chapter III, a certain amount of "constructive ambiguity" remains as to whether and to what extent uninsured depositors will be protected in large bank failures. Along these lines, the new receivership rules contained in FIRREA give the FDIC more latitude to encourage market discipline. When resolving a failed institution by merger, the FDIC may impose losses on uninsured depositors and unsecured creditors equal to what the losses would have been if the institution were liquidated.

That bank certificates of deposit are priced at significantly higher rates than Treasury securities provides more evidence that the market does not consider de facto insurance automatic; a demand for risk premiums indicates that investors do not consider uninsured deposits free from default risk. Moreover, recent studies have shown that yields on uninsured bank deposits vary systematically with measures of bank risk, such as the variability of asset returns, capital-to-asset ratios, and the market value-to-book value ratio of bank equity.<sup>10</sup>

Thus, despite the practice of often protecting uninsured depositors, there is evidence to suggest that neither the market nor the FDIC view large banks' uninsured deposits as effectively 100 percent insured. Even if foreign deposits are protected in some instances, the fact that they are neither assessed nor explicitly insured may help foster "constructive ambiguity." This in turn can help maintain market discipline in the system.

### 3. The Fairness Issue

Proponents of assessing and insuring foreign deposits, such as the IBAA, argue that the current assessment system is inequitable because it results in large banks' insurance coverage being subsidized by the smaller banks. Large banks, it is argued, should pay their fair share of insurance costs. If, as discussed above, uninsured liabilities at large banks are de facto covered while those at smaller banks are not, premiums should be assessed on uninsured foreign deposits simply as a matter of fairness.

For example, because of its large percentage of foreign deposits, one large bank paid an effective premium rate of one-thirty-third of one percent on its total deposit base (including foreign deposits) in 1989, while small banks with no foreign deposits paid an effective rate of one-twelfth of one percent, or nearly three times the large bank rate. There are variations in effective premium rates among the large banks as well. Those with large domestic funding bases clearly pay substantially higher effective rates than one-thirty-third of one percent.

#### 4. Improved Competitiveness for Smaller Banks

Another argument for assessing foreign deposits is that it would reduce the funding-cost handicap of regional and smaller banks that have limited access to foreign deposits, and thus render those banks more competitive in deposit markets. Equalizing the marginal cost of deposit insurance would raise the cost of funding for large banks with foreign deposits relative to smaller banks. Funding costs for U.S. banks in the international markets would increase, and the highly competitive nature and thin spreads in these markets might prevent large U.S. banks from passing the increased cost on to their customers. If new relative funding costs were then incorporated into domestic loan pricing, domestic loan costs of banks active in Euromarket funding would increase relative to the domestic loan costs at smaller banks with a domestic deposit base. In theory, such an increase in domestic loan costs or lower deposit rates could shift business away from large U.S. banks toward smaller banks.

#### 5. Other Arguments for Assessing Foreign Deposits

A number of other arguments have been raised in favor of assessing and insuring foreign deposits. For instance, it has been estimated that at one point in time as much as one-fourth of dollar-denominated foreign branch deposits were actually Eurodeposits of U.S. residents.<sup>11</sup> These deposits have been characterized as evading legitimate reserve requirements and insurance assessments.

Some argue that large banks could experience positive effects associated with explicitly insuring foreign deposits which counterbalance the increased costs of assessments. For example, the perception of increased safety for their foreign branch deposits might give U.S. banks an edge in developing their overseas retail business. This would depend on their ability to absorb the added cost of premiums, and on the attractiveness of a U.S. government guarantee compared to local government or private insurance schemes.

Others argue that in addition to the apparent de facto insurance resulting from some FDIC failure resolutions, case law suggests that foreign deposits may already be insured. These cases generally have held that the U.S. headquarters of a bank with foreign deposits in a foreign office is liable for these deposits even when the supporting assets have been expropriated or local law prevents the bank from using the foreign assets to satisfy its foreign deposit obligations.<sup>12</sup> If these cases indicate that the U.S. headquarters of a bank can be called on to repay deposits made at a closed foreign branch of a U.S. bank, it could be argued that they are insured deposits and thus should be assessed.

## **D. Arguments Against Assessing and Insuring Foreign Deposits**

### **1. Expanding the Safety Net**

Opponents of assessing and insuring foreign deposits argue that such actions would explicitly broaden the safety net and thus increase the potential liabilities of the FDIC at a time when the emphasis should be on reducing the federal government's liabilities. They argue that while foreign deposits are sometimes protected for systemic purposes, the effort should be to reduce the number of these occasions, not increase them; assessing and insuring foreign deposits would send exactly the wrong signal. Moreover, if foreign deposits were immediately included for insurance purposes, the fund-to-insured deposit ratio would drop slightly, not rise. At the same time, the insurance fund's potential liabilities could be significantly increased should a large bank with substantial foreign deposits fail.

Insuring foreign deposits could also subject the FDIC to increased levels of foreign exchange risk. While the FDIC presently insures foreign currency deposits in U.S. domestic bank offices, the level of such deposits is not significant. Insuring foreign deposits would add significantly to the amount of foreign currency-denominated liabilities that the FDIC might be obligated to cover in U.S. dollars at the prevailing exchange rate.

### **2. Competitive Effects**

Opponents of assessing foreign deposits such as the Bankers Association for Foreign Trade, the Association of Reserve City Bankers, and the New York Clearing House, argue that such assessments would place U.S. banks at a severe competitive disadvantage in international banking markets, particularly in the interbank and wholesale loan market, where it is estimated that overseas branches of U.S. banks raise between two-thirds and three-quarters of their funds. The interbank market is highly competitive, with narrow spreads of 12.5 basis points over the last two years.<sup>13</sup> U.S. banks would either have to lower their deposit rates, which would cost them business, or absorb the added cost in their bid-offer spread. To absorb a 19.5 basis point assessment in 1991 would render this business unprofitable.

Likewise, spreads on international loans have fallen steadily over the years and are now very thin. Over the past decade, spreads on syndicated loans for borrowers from the industrialized countries have fallen by one-third and are now about 42 basis points.<sup>14</sup> For investment-grade corporations the spreads are even thinner. While data on the marginal non-interest costs of lending in foreign branches is not available, an additional FDIC premium cost might reduce spreads to a point



where they would no longer cover the lending risks and marginal operating costs.

Another possible result of the added cost of insurance premiums might be a loss of competitiveness for U.S. banks in the local currency, retail deposit business. In addition, local retail deposits are in some cases assessed and insured abroad, and an additional FDIC insurance premium would result in a double assessment of such deposits. In such jurisdictions, it would raise complex questions as to which insurance scheme was liable in what proportions if the bank or branch failed. It has also been argued that a host country's supervisory activities may obviate the need for foreign deposits to be assessed or insured.

### **3. Effect on Bank Profitability**

The recent increase in insurance premiums (from 12 to 19.5 basis points) on total domestic deposits will likely have significantly different effects on the net income of individual banking organizations, attributable in part to the different amounts of foreign deposits held by these banks. According to one recent study, a premium increase on domestic deposits of three basis points would have represented three to four percent of net income (after adjusting for taxes) for the majority of large regional banks, while it would typically be below two percent for large money-center banks, using historical returns.<sup>15</sup> This study suggests, however, that insurance premiums of 12 basis points on foreign deposits would have represented 49 percent of net income for the 25 largest banks in 1989.<sup>16</sup>

### **4. The Fairness Issue**

As discussed above, proponents of assessing foreign deposits argue that small banks subsidize the insurance coverage of large banks. However, some opponents of assessing foreign deposits make the exactly opposite point, arguing that large banks already subsidize the deposit insurance costs of smaller banks. If this latter argument were true, one would expect to see large banks responsible for a smaller percentage of the fund's losses than their assessment contributions. As Table 1 shows, larger banks do appear to have subsidized the failure costs of smaller banks between 1985 and 1989, in that they pay far more to BIF than is spent on large bank failures. (The conclusion does not change even with the inclusion of the the resolution of Continental Illinois in 1984 and Bank of New England in 1990.)<sup>17</sup> Although these results could change if several large banks were to fail, the data presented in this table cast considerable doubt on the argument that small banks subsidize large banks.

Opponents of assessing foreign deposits also argue that if all depositors -- domestic and foreign -- of all banks received

Table 1

Distribution of Resolution Costs by Bank Size: Failures of FDIC-Insured Banks and Savings Banks, 1985-89

Asset size of bank	Percent of total costs	Percent of total assessments
Less than \$30 million .....	11.8	2.6
\$30-\$100 million .....	16.5	8.8
\$100-\$500 million .....	16.0	13.3
\$500 million-\$1 billion .....	3.8	4.6
Greater than \$1 billion.....	51.5	70.7

Note: There were 750 failures of banks with less than \$1 billion in total assets, and nine failures of banks with more than \$1 billion in total assets during this period. The total cost of these failures was about \$16 billion.

Source: Federal Deposit Insurance Corporation.

FDIC protection only up to the \$100,000 limit, large banks would be subsidizing the deposit insurance coverage of smaller banks, because large banks would be paying assessments on their larger volume of uninsured domestic and foreign deposits. In a sense, then, it could be argued that the too-big-to-fail approach to resolving failed banks has actually provided equity between large and small banks. In other words, the subsidy paid for by large banks is reduced to the extent that there is de facto 100 percent of uninsured domestic deposits in large banks. The subsidy is further reduced to the extent that a large bank's foreign deposits receive de facto coverage.

## **5. Effects on Foreign Countries**

Insuring foreign deposits exposes the FDIC to extraterritorial jurisdictional disputes that could arise in countries where bank assets can be seized or frozen by foreign governments. By insuring and assessing deposits in foreign offices, the FDIC would of course want to lay claim to the assets funded by these deposits in the event of a failure. However, the FDIC could run into difficulty trying to access foreign assets which a foreign government may want to use to protect other liabilities of the bank not insured by the FDIC. If the case were reversed, one could imagine U.S. authorities preventing a foreign country from using assets of a U.S. branch of one of its failed banks to repay the bank's non-U.S. claimants.

De jure or de facto insurance coverage of foreign branch deposits could also be viewed by foreign governments as unfair competition for local banks if it were considered a subsidy of U.S. banking operations abroad (particularly if the local foreign banks do not enjoy such coverage). This could cause problems between governments if there were an outflow of deposits from domestic banks of foreign countries. This would be an even greater concern if the increased competitive edge of U.S. banks impeded development of indigenous banking systems in developing countries. In addition, FDIC coverage of foreign branch deposits might result in a drain of international deposits out of U.S. domestic offices into foreign branches of U.S. banks if depositors' concern over local country risk were reduced.

## **6. Effect on International Interbank Funding Markets**

Opponents of assessing foreign deposits, including the Bankers Association for Foreign Trade, argue that two undesirable effects on the interbank funding market would occur. First, assessing foreign deposits would result in a decrease in this important source of international liquidity. It is possible that the assessment of foreign deposits could influence the size of the market (i.e., the added cost of doing business for U.S. banks may result in some contraction). It follows, then, that any contraction could influence the ability of banks to buy and sell

large blocks of funds quickly without affecting rates and, thus, decrease liquidity.<sup>18</sup>

Second, assessing foreign deposits could, perversely, result in increased systemic risk to the international banking system. To the extent that reduced liquidity in the market decreases the ability of an individual bank to adjust to a large shock, the risk to other banks dealing directly or indirectly with that bank and ultimately with other banks in the system is increased. It might be possible, however, for both of these potential problems to be mitigated through the normal liquidity adjustment mechanisms available to the central banks.

## **7. Adverse Impact on Trade**

Opponents of assessing foreign deposits also contend that the action would ultimately hurt the U.S. current trade account, as the added cost of insurance would impair the ability of U.S. banks to fund and extend competitive financing to U.S. exporters. Thin spreads coupled with the added cost imposed by insurance premiums could render international lending business unprofitable. This point is even more worrisome at a time when the U.S. current account is in significant deficit, and U.S. producers need the support of a strong banking system with ample funds to finance U.S. exports.

## **E. Other Options**

Besides either maintaining the status quo (*i.e.*, neither assessing nor insuring foreign deposits) or assessing and insuring all foreign deposits up to \$100,000, two other options might be considered. One would be to assess, but not insure, foreign deposits. This proposal would bring increased revenue to the insurance fund and satisfy small banks' concerns about inequitable treatment. It would also resolve the problem of explicitly increasing contingent risks to the insurance fund. However, even simply assessing foreign deposits would likely be taken as a signal that the FDIC was more inclined to protect them. Thus, the safety net could be seen as having been expanded, and the market discipline resulting from constructive ambiguity would be reduced. In addition, assessing but not insuring foreign deposits could have an even worse impact on the international competitiveness of U.S. banks, which would have the worst of both worlds: the added expense of assessments, but not the added safety of insurance.

Another option is to assess foreign deposits at a lower rate than domestic deposits. This has similar benefits and costs, in principle, as a full assessment, but in practice the negative effect might be somewhat mitigated. A key issue would be finding a rate that satisfies arguments about inequities, does not unduly

penalize foreign interbank deposit transactions, and results in a meaningful increase to the insurance fund.

Still another option might be to assess only retail foreign deposits, excluding wholesale deposits. The resulting assessment would probably not be sufficient to satisfy small banks' arguments about inequitable treatment. In addition it would result in limited additional revenue to the insurance fund, as the majority of foreign deposits are wholesale in nature. It could, however, minimize increased contingent risk to the insurance fund, put foreign retail deposits on an equitable basis with domestic retail deposits, and avoid anticompetitive effects on U.S. banks' involvement in interbank foreign deposit markets.

## Endnotes

<sup>1</sup> Edge Act Corporations are federally-chartered international banking corporations in which national and state member banks of the Federal Reserve System may invest. Agreement Corporations are organized under state law to conduct international or foreign banking business. Such corporations are required to enter into an agreement with the Federal Reserve Board regarding the nature of their activities. Both Edge Act and Agreement Corporations may accept deposits, subject to certain restrictions.

International Banking Facilities are under the supervision and control of the Federal Reserve Board, and were created to permit U.S. banks to compete more effectively with foreign banks and foreign branches of U.S. banks. The law permits U.S. and foreign banks to establish these facilities in the United States to take deposits from foreigners and make loans to support foreign operations free of certain legal requirements for domestic deposits. In practical terms, most IBFs amount to a separate set of books of accounts within the head office of the parent institution.

The establishment of a foreign branch generally requires the prior approval of American banking authorities. Foreign branches of U.S. banks may receive time and demand deposits from foreign residents and nonresidents in the manner specified by the host country.

The definition of foreign deposits in this chapter does not include deposits in foreign subsidiaries of U.S. banks. No proposal for assessing foreign deposits would be likely to include these deposits, because they are in institutions incorporated under the laws of the host country.

<sup>2</sup> The FDIC Quarterly Banking Profile, (Federal Deposit Insurance Corporation, Fourth Quarter 1989) Commercial Banks only. This source reports foreign deposits of \$311 billion, which, according to unpublished Federal Reserve Board data, includes about \$50 billion of deposits of U.S. banks in foreign subsidiaries. For purposes of this study, we have excluded the \$50 billion from our calculations unless otherwise noted.

<sup>3</sup> Call Reports, (Federal Deposit Insurance Corporation, September 1989). These numbers include deposits of U.S. banks in foreign subsidiaries.

<sup>4</sup> U.S. Congress, House of Representatives, Hearing on H.R. 5357, (74th Congress, 1st Session, Washington, D.C., February 26, 1935.)

<sup>5</sup> U.S. Congress, House of Representatives, "Statement by Mr. Edward T. Lutz," House Committee on Banking, Finance, and Urban Affairs, Hearings on H.R. 4879, (97th Congress, 1st Session, Washington, D.C., November 4, 1981.)

<sup>6</sup> Senator William Proxmire proposed this amendment.

<sup>7</sup> Representative Gerald Kleczka introduced this bill.

<sup>8</sup> Senator Don Nickles offered this amendment.

<sup>9</sup> "The Sensitivity of Foreign Deposits to FDIC Assessments." J.P. Morgan (April 26, 1990). This study estimated interest rate elasticities of demand using bid-offer rates for interbank deposits, as well as the effects on nonbank deposits of three changes in reserve requirements. It was estimated that a 15 basis point assessment would result in a loss of 55 percent of deposits in foreign branches.

It should also be noted that in its report, "Reducing the Deficit: Spending and Revenue Options" (February, 1990), the Congressional Budget Office estimated a 37 percent decrease in foreign deposits resulting from a 15 basis point assessment. The CBO number included deposits in foreign subsidiaries, which the Morgan study indicates have a substantially lower elasticity of demand than deposits in foreign branches.

<sup>10</sup> See Chapter III, "Scope of Deposit Insurance," for a more detailed discussion of this issue.

<sup>11</sup> Jeffrey C. Marquardt, "Deposit Insurance Assessments on Deposits at Foreign Branches of U.S. Banks," International Finance Discussion Papers, No. 299, (Federal Reserve Board, Washington, D.C., February 1987).

<sup>12</sup> Wells Fargo Asia Ltd. v. Citibank, N.A., 660 F. Supp. 946 (S.D.N.Y. 1987); Vishipco Line v. Chase Manhattan Bank, 660 F.2d 854 (2d Cir. 1981); Trinh v. Citibank, N.A., 850 F.2d 1164 (6th Cir. 1988).

<sup>13</sup> This estimate is based upon a Data Resources, Inc. survey of banks during 1988 and 1989.

<sup>14</sup> Financial Market Trends, (Organization for Economic Cooperation and Development, 1989).

<sup>15</sup> Olson Research Associates, "Painful But Not Fatal." U.S. Banker (April 1989).

<sup>16</sup> Although net income for the largest banks was particularly depressed in 1989 due to large provisions for real-estate and LDC loan losses, this is still an important point.

Moreover, the current assessment of 19.5 basis points (rather than 12) would obviously have an even larger effect.

<sup>17</sup> This table does not include Continental Illinois, which failed in 1984, and Bank of New England, which failed in 1990. However, adding in the cost of these failures (\$1.1 billion for Continental and \$2.3 billion for the Bank of New England), as well as all failures through the first half of 1990, does not substantially alter the results. Large banks still pay a larger percentage of total assessments than their share of the costs.

These new results would show the largest banks representing about 55% of all costs (while paying just over 70% of assessments); banks with total assets between \$500 million and \$1 billion representing 4.3% of costs; banks between \$100 million and \$500 million representing 15.1% of costs; banks between \$30 million and \$100 million representing 15.2% of costs; and banks with less than \$30 million in total assets representing 10.5% of costs.

<sup>18</sup> Marquardt, Op. Cit.



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## Chapter VII

### ALTERNATIVES TO FEDERAL DEPOSIT INSURANCE

#### A. Introduction

The creation of a federal deposit insurance system was opposed by some out of fear that it would encourage excessively risky bank operations. President Franklin Roosevelt at first resisted proposals for deposit insurance, saying: "The minute the government starts to do that the government runs into a probable loss . . . . We do not wish to make the United States Government liable for the mistakes and errors of individual banks, and put a premium on unsound banking in the future."<sup>1</sup>

The thrift crisis and record numbers of bank failures have helped reopen debate as to the appropriate role of federal deposit insurance. While deposit insurance protects the unsophisticated saver, it also removes the need for insured depositors to monitor the safety and soundness of depository institutions and require risk premiums commensurate with the riskiness of the institution. Thus, insured institutions are likely to assume greater risk because the price of doing so has been reduced. In addition, deposit guarantees strengthen the economic incentive for the owners and managers of institutions, especially when faced with failure, to take additional risks. This moral hazard problem is, as noted elsewhere in this study, present with any insurance.

Some observers believe that moral hazard can be adequately controlled while retaining the federal guarantee, by improving oversight and supervision, by offsetting moral hazard with stronger penalties for excessive risk-taking, by requiring banks to hold more capital, and by intervening sooner to minimize losses at failing institutions. Others, however, have asked whether the current problems reflect the inherently costly and destabilizing effect of having the government extend a broad blanket of protection over deposits -- an effect which can only be corrected by removing that blanket. Given the dramatic development of financial markets in the over 50 years since the introduction of federal deposit insurance, they argue that such extensive government guarantees are no longer necessary because the market failures to which federal deposit insurance was a response no longer exist. They propose to reduce, replace, or drastically alter the federal government's deposit insurance role.

One alternative to the present federal deposit insurance system would be to shift the insurance function to the state level. State government sponsored systems may have the same problems as the current federal system, however, without some of the advantages. These advantages derive from national uniformity of protection and associated regulation and from broader geographic diversification of risks than is possible within a single state.

Perhaps the most extreme alternative would be to eliminate the government's deposit insurance role altogether. In that case, two scenarios are envisioned. In the first, it is argued that market forces would lead to an evolution away from demand deposits toward claims on marketable securities, much like a money market mutual fund and similar to the secure depositories discussed later in this chapter. It is argued that this type of claim is immune to depositor runs. In this scenario, it is presumed that the non-marketable assets of banks would be financed by non-demand deposits, non-demand debt, or equity capital and would also be immune to depositor runs.

In the second scenario, it is argued that deposits would retain their current form and market forces would set the degree and terms of depositor protection, including price. If the demand for protection proved to be widespread, a private deposit insurance industry might develop. It is argued that such a private system is more viable today than it was 50 years ago. If the market works as it should, deposit insurance would be available at prices that properly balance risk and depositor protection. However, the burden on depositors to assess risk, their exposure to losses when depository institutions fail, and the increased potential for depositor runs are troublesome features of this scenario.

Other options all retain some government role in protecting depositors, and some actually extend coverage to all depositors:

- o One approach would be to have the federal government mandate deposit insurance but shift some or all responsibility for providing insurance and the related tasks of monitoring and supervision to private firms.
- o A more modest step with some similar features would be to have the government continue to pay the lion's share of insurance losses but to have private firms cover a specified percentage of losses and take on the responsibility for pricing and monitoring risk.
- o Other proposals would narrow the range of deposits covered by federal insurance. Coverage might be restricted, for instance, to deposits invested in a narrow range of low-risk assets such as government

securities. The probability of deposits being lost through mismanagement thus would be greatly reduced if not eliminated, and the task of monitoring risk would be greatly simplified. For such "secure depositories," in fact, deposit insurance might be redundant. Under such an arrangement, those seeking a higher return on their savings could opt for uninsured investments.

While each of the major alternatives to federal deposit insurance may have some appeal in principle, questions must be addressed regarding the desirability and practical difficulty of placing the insurance responsibility in the private sector. Section B of this chapter summarizes the major objections generally made to federal deposit insurance. The remainder of the chapter examines each of the major options: Section C discusses state deposit insurance systems; Section D considers federally mandated private insurance; Section E examines private insurance as a supplement, rather than replacement, for federal insurance; Section F discusses limiting federal insurance to institutions investing in "safe" assets ("narrow banks"); and Section G reviews non-deposit insurance approaches.

## **B. General Objections to Federal Deposit Insurance**

Some analysts believe that moral hazard cannot be adequately controlled as long as the government retains the primary responsibility to protect depositors. Two theoretical arguments support this view: (1) that the nature of the political process and its incentives undermine effective control of moral hazard by postponing and redistributing the costs of excessive risk-taking; and (2) that government micro-regulation and supervision are inherently less effective in balancing risk with depositor protection than is the market.

### **1. Bias Against Effective Policies**

The first argument is that the incentives for government policy-makers are, in the long run, inconsistent with a sound insurance operation that effectively limits moral hazard and controls costs. When the government is involved, the inherent difficulty of limiting the moral hazard created by deposit guarantees is complicated by well-organized political pressures to forbear in closing sick institutions, to extend the guarantee, and to underprice or misprice coverage. In this view, the recently exposed flaws in federal deposit insurance policies are no accident. They reflect a basic bias in the political process.

The bias of the political process against effective deposit insurance policies can be partly attributed to the timing and distribution of costs and benefits. The costs of actions that inhibit moral hazard -- for example, early closure of troubled

institutions -- are immediate and direct, whereas the benefits of those actions are diffuse and lie in the future. As a result, those in opposition to such actions tend to be better organized and more effective than those in support.

Deposit insurance policies may be temporarily tightened during periods of public dissatisfaction with the operation of the system. However, if political incentives are the long-run source of deposit insurance problems, they may eventually recreate the conditions that have led to past policy errors.

## 2. Government Inefficiency

The second argument against federal deposit insurance is that government regulation and supervision are poor substitutes, at best, for the price information and resulting financial incentives generated by efficient private capital markets. The modern financial marketplace may be capable of meeting demands for insured accounts by offering such protection at an appropriate price. Private insurers might outperform the government as monitors of risk. Because private firms make decisions on the basis of their own profitability and are not subject to the direct political pressures that shape a government insurer's policies, they should be less likely to misprice their guarantees, to overlook emerging risks, or to delay action to deal with a failing institution.

If the market were used to set prices, riskier firms would be forced to pay more for deposit guarantees -- at least to the degree that risk-taking can be detected and properly priced. Accurate risk-based pricing of the guarantee would eliminate the cross-subsidization of imprudently operated institutions by well-run institutions. Individual institutions, and the banking system as a whole, would function with greater efficiency. While risk-based pricing of insurance coverage is possible in theory under a government-operated system, a freely operating market may be more likely to set prices consistently close to the right level.

Private insurers would have a powerful incentive to move quickly against institutions whose actions threatened major losses. In addition to having the right incentives, private insurers may be in a better position than government to develop and pay for the systems and expertise necessary to monitor risk effectively.

If deposit insurance were a private commodity, guarantors would experience profits or losses commensurate with their own investments. One historical study of state-level deposit insurance systems suggests that these schemes were far more likely to succeed and survive when individual member banks shared significantly in the cost of failure by any other member, giving

them strong incentives to monitor each other (Calomiris, 1989 and 1990).

The current federal deposit insurance structure departs drastically from this formula. Individual institutions have no responsibility for monitoring risk at other institutions or means of doing so. Moreover, the method of assessment spreads the cost of failing to adequately control moral hazard across all member institutions in proportion to their deposits. In periods when insurance losses exceed premium income and other fund revenue, costs also are shared by federal taxpayers.<sup>2</sup> When premiums are raised, the incremental cost to individual institutions is relatively modest. In short, the federal government would have to play a different and more limited insurance role than at present in order to give member institutions the opportunity and incentive to control risk-taking by other members.

### **C. State Deposit Insurance Systems**

State deposit insurance systems of various design have existed in the past and have either failed or been abandoned. The fresh memory of the collapse of state-level deposit insurance systems in Ohio, Maryland and most recently in Rhode Island may be reason enough to question whether the states should have this responsibility. Moreover, in principle, state government systems would appear to be subject to the same kinds of general problems, mentioned above, as federal deposit insurance.

#### **1. Analysis**

Additional arguments can be raised against delegating deposit insurance to the individual states. Today, far more than in the past, depository institutions are linked together in one national system. Linkages include not only the economy's payments system but also direct financial relationships among individual institutions and, increasingly, the extension of individual firms across state lines. Thus, problems originating in one institution or one state quickly become national concerns. The greatest fear might be that the effects of excessively risky activities resulting from a flawed or weakly administered deposit insurance program in one state could spread, resulting in losses for insured depositors, as well as uninsured depositors, creditors, and others, in many states. Also, some state systems have been overwhelmed by regional economic downturns that led to the simultaneous failure of many institutions, including those that were well-managed. State systems are far more vulnerable to economic cycles than one national system which is, by definition, regionally diversified.

Nevertheless, at least two arguments can be made for giving states a major, if not primary, deposit insurance role:

1. The U.S. dual banking system gives the federal and state governments overlapping responsibility for chartering and regulating depository institutions. This system, which in the past has encouraged innovation and responsiveness to community needs, is to a degree undermined by federal deposit insurance and the resulting pressures for national uniformity in powers and organization. Moreover, the current division of responsibility for overseeing and insuring state-chartered institutions may give states insufficient incentive to control risk-taking, because all failure losses are paid at the federal level.
2. State systems would have fewer members than a national system. As a result, when a failure occurred, each would bear a greater share of all insured losses than under a national system in which losses are shared across a much larger number of institutions and in some cases by taxpayers. As explained below, this might give each guarantor a stronger incentive to promote and participate in effective monitoring and control of moral hazard.

Despite the recent history of failures, some past state-sponsored deposit insurance experiments may offer lessons for future deposit insurance policies. In particular, three state-level mutual guarantee insurance systems created prior to the Civil War were successful and survived until supplanted by the National Banking System in 1863. A key to the success of these systems was the alignment of the incentive to regulate with the authority to regulate. Member banks had control over the supervisory authorities. Because any losses resulting from fraudulent or risky practices were shared directly by the members, they had a collective interest in restricting excessive risk-taking and free riding (Calomiris, 1989).

The failures of other state systems in the same era and later also are instructive. State systems proved vulnerable to regional economic problems that a nationally diversified system could have survived. However, most state system failures can be attributed at least in part to flaws in their design. For instance, where members were free to join or leave the system without penalty, the riskiest institutions tended to dominate the system. In other cases, a combination of fixed premium charges and inadequate supervision failed to control moral hazard.

The historical record aside, one final argument for a state deposit insurance role is that experimentation with a variety of alternatives could lead to an improved model for government deposit insurance. Superior methods would gradually be replicated in other states or at the national level.



## **2. State Deposit Insurance Systems - Summary**

Although states may have certain hypothetical advantages over the federal government as deposit insurers, shifting the deposit insurance function from the federal to the state level does not seem promising either in light of recent experience or in theory. Moreover, this alternative addresses none of the arguments listed at the beginning of this chapter against a government-operated system, and it would hardly be reassuring to those who have lived through or observed the recent failures in Ohio and Maryland. The remainder of the chapter is devoted to options that would either reduce or eliminate the government's role.

### **D. Privately Capitalized Deposit Insurance**

Recent problems with federal deposit insurance have been widely attributed to the fact that the federal insurance agencies do not make full use of the tools that private insurers employ to protect themselves against risk. As applied to banking, these exposure-reducing tools would include: (1) more precise information on risk, including frequent marking to market of assets and liabilities to determine the market value of capital; (2) risk-based deductibles (i.e., risk-based capital requirements) and risk-based insurance premiums; and (3) prompt termination of insurance (i.e., early closure) when risk parameters are exceeded (see White, 1989).

While the potential benefits of improved monitoring, risk-based capital and insurance premiums, and prompt closure of troubled institutions are well-recognized, there is less consensus as to the best method for realizing these benefits. Some argue that such reforms can take place within the current federally administered system (again, see White, 1989). Others maintain that these benefits can be achieved only by putting the deposit insurance function in the private sector. Detailed proposals for private deposit insurance have been put forth by Ely (1990) and Ely and Wallison (1990) and less detailed suggestions by Calomiris (1990) and others. All such proposals presume that private operation of the deposit insurance system would lead to greater efficiency in monitoring risk, pricing coverage, and making closure decisions than could be achieved under any system operated by the federal government. If so, this, in turn, would lower the aggregate costs imposed on society by deposit insurance. Furthermore, any unexpectedly large losses incurred by insolvent institutions would be absorbed by the private insurers, rather than by taxpayers.

## 1. How Private Deposit Insurance Might Work

To provide a concrete basis for discussion, it is useful to examine one proposal in detail -- that presented by Ely (1990).<sup>3</sup> This would be a government-mandated but privately operated and capitalized system. All deposits would be insured, and each depository institution would have its deposits guaranteed by a syndicate of other depository institutions. At the same time, each guaranteed bank might itself participate in one or more other guarantor syndicates. Thus, depositors would be protected by a complex network of cross-guarantees.

Private deposit insurance, whether as envisioned by Ely or by others, would operate within a legal framework established by the federal government. The government's first role would be to mandate that some or all deposits be protected by a private guarantee.<sup>4</sup> The government might also be called upon to set minimum capital standards and other regulations governing banks, or others, who act as private guarantors. Ely, for instance, proposes that the FDIC regulate the issuance of cross-guarantees to ensure that all depositories are covered by insurance contracts meeting appropriate specifications. Under a privately operated system, the government also might play a residual role as a catastrophic insurer, maintaining a backup fund to cover losses should widespread economic problems or negligence by guarantors cause a partial failure of the primary, private guarantee mechanism. Finally, the government might retain the authority to close or force recapitalization of a failing bank, even if its private guarantors did not act.

Despite a continuing government role, deposit insurance would essentially be a private responsibility. Private capital would back the guarantees. Private firms (primarily banks under the Ely proposal) would price the guarantee. Market forces would determine the price and other contractual terms for guarantee issuance and termination, including the range of activities permitted to depository institutions.

Private insurance might largely remove, or at least reduce, the need for detailed government regulation of bank powers. To the extent that bank regulation reflects the need to control insurance losses, the regulatory function could be delegated to private insurers. If deposit insurance is the primary justification for limits on banks' powers, minimum capital requirements, and restrictions on relationships with other classes of firms, then these matters could be largely left to the banks in their capacity as private guarantors. However, banks would still face government regulation intended to protect the payments system, support monetary policy, and for other reasons.

## **Stop Loss Provisions**

A distinctive feature of the Ely proposal is its mechanism for spreading costs. Typically, private insurers try to manage their risk exposure by insuring a large number of risks and by diversifying their risks so that losses are spread evenly over time. They have difficulty assuming risks that are either very large or tend to generate losses simultaneously (are statistically correlated). Bank failures fall into this category.

The insuring of such risks becomes practical only if losses can be spread over a broad group of mutual guarantors and, as needed, over a secondary group of reinsurers. A concrete example of this approach, successful over many years, is the insurance market created by Lloyd's of London.

The cross-guarantees feature of the Ely proposal would work in a similar fashion. Several banks would join together to issue guarantees, for which they would charge premiums. Every dollar on deposit in every American-domiciled bank would be guaranteed with respect to both principal and immediate liquidity by such a syndicate. A syndicate might guarantee the liabilities of several depository institutions, or it might be formed to guarantee a single institution. Functionally, the guarantee would be similar to a standby letter of credit issued by a bank.

If a bank failed, its guarantors would absorb that bank's losses up to a certain point. Further losses would be spread across many other banks through the use of mandatory stop-loss provisions, i.e., reinsurance contracts. The purpose of the stop-loss provisions would be two-fold -- to ensure that no bank is driven to insolvency solely by participation in a badly managed syndicate, and to make the entire industry's earnings and capital available to deal with the most catastrophic circumstances. This is the type of stop-loss reinsurance used by Lloyd's and elsewhere in the insurance world to prevent domino effects, where one large loss triggers a number of insurer insolvencies.

The combined capitalization of solvent banks and thrifts far exceeds the FDIC's nominal reserves, and would have been capable of absorbing the largest insolvencies seen prior to the savings and loan crisis. In late 1989, solvent banks alone had a combined book value of capital in excess of \$250 billion; to date, FDIC expenses to cover failure losses have not exceeded \$10 billion in any one year. Moreover, non-depository institutions could also act as guarantors, subject to the same stop-loss provisions and other requirements as bank guarantors. This would further expand the pool of capital available to back guarantees.

To implement the stop-loss provisions, the capital of guarantor banks would be divided into two components -- a "base" capital amount, and an "excess" amount. Guarantor banks would only be permitted to commit a pre-specified fraction of their excess capital to deposit guarantees. If a guarantor's losses from this activity exceeded this threshold, the additional losses would be passed on to the guarantor's own guarantors. Conceivably, this process could go through several stages, and extremely large losses could be diffused through several tiers of guarantor syndicates.

### **Risk-Sensitive Insurance Pricing**

Guarantor syndicates would be free to set terms of the insurance contracts with the banks they guaranteed, and syndicates would compete for any given bank's business. As with other forms of insurance, premiums could be varied to reflect risk-related attributes of the insured bank, including perceived asset risk and the adequacy of its capital. Because of the stop-loss provision, reinsurers would also be concerned with monitoring risk at the insured bank and would reflect these assessments in their own pricing. Thus, in theory, they would raise the reinsurance premium charged to a bank that was being overly aggressive in its own guarantor activities.

Since the terms of insurance contracts would be set in the market, it is difficult to predict exactly what these contracts would look like. Premiums might be reset at frequent intervals, perhaps as often as every two weeks. However, banks would not necessarily go into the market to seek competing bids from syndicates that often. Rather, they would perhaps enter into longer-term contracts with a syndicate, incorporating explicit formulas for resetting premiums based on continuously updated information from the insured bank.

### **Monitoring Insured Banks**

Frequent resetting of insurance premiums would require intense monitoring by the syndicate, similar to the supervisory function now performed by the government. To the extent that guarantor banks are competitors of the bank they are insuring, there would be some potential for guarantors to acquire important confidential information about firms they are insuring. To minimize the potential for such conflicts of interest, monitoring would be carried out by an agent for the syndicate. The monitoring agent would be a private firm with its own professional staff, not drawn from the syndicate's member banks. Informational "Chinese walls" would be erected between the monitoring agent and guarantors. Premiums paid by the insured bank would include a small monitoring charge paid to the agent.

## **Dealing with Troubled Institutions**

The incentive structure of private deposit insurance would change the methods for dealing with troubled institutions. First, it is likely that the risk-based nature of insurance premiums would force many institutions facing difficulties to address them at an earlier stage, thereby averting insolvency. For example, an institution with inadequate capital might voluntarily attempt to raise new capital or restrict growth in order to lower its insurance premium. Or, if management were initially unwilling to do so, pressure from stockholders (perhaps via the takeover market) might lead to a similar outcome. Because insurance premium rates would be public information, they could act as an early signal to stockholders, creditors, and customers that an institution was perceived to be at increasing risk of failure.

If early intervention failed, private deposit insurance would provide an alternate mechanism to close the failing institution. Under the terms of the government-mandated system, banks would not be allowed to operate without a guarantee contract. As specified in its contract with a bank, a syndicate would have the right to terminate its insurance coverage on 90 days' notice. If the bank were unable to find an alternative insurance provider during this period, the syndicate would have the contractual right to dispose of the bank -- either selling, reorganizing, or liquidating as it saw fit. In a liquidation, all depositors would be paid off immediately by the syndicate. The syndicate (and its reinsurers if necessary) would bear any losses associated with closure.

## **2. Analysis**

The private deposit insurance system described above differs from the current government-operated system in four major ways:

1. The scope of explicit insurance coverage is broader;
2. Although the FDIC may continue to serve as a backup insurer, private capital is the primary line of defense against bank losses, so the regulation of capital is structured differently;
3. Insurance pricing is done in the private marketplace, so premiums are likely to vary with the risk of the insured bank; and
4. Primary responsibility for dealing with troubled institutions is delegated to private guarantors.

Each of these features is discussed below. It should be noted that the first two represent areas where alternative proposals for private deposit insurance could vary -- the scope of insurance coverage and the nature of capital regulation could be different than under the cross-guarantees proposal designed by Ely -- and these alternative possibilities are discussed as well. The last two features of the cross-guarantees proposal are likely to be common to any system of private deposit insurance.

### Depositor Protection

Private insurance would assign the tasks of monitoring and controlling risk to private guarantors. Thus, as at present, depositors would ordinarily pay little attention to the safety of their deposits and would not be a source of discipline on bank risk-taking.

Depositors might be exposed to losses under a private insurance system if private guarantors failed to perform and if subsequently the federal government did not step in immediately to provide protection. This problem could be dealt with by making federal backup explicit and, as under the cross-guarantees proposal, by requiring assessments to build a fund sufficient to cover a possible bailout.

Retaining the federal government as an explicit backup insurer is not a necessary feature of a privately operated system, but it may be highly desirable. The government would likely retain a residual, even if implicit, responsibility to maintain public confidence in the security of savings, because it alone can credibly deal with the most severe macroeconomic shocks.

Even if the government were not explicitly committed in advance to back up a private system, it would have after-the-fact responsibility to do so in the face of a major economic disaster. Making this backup role explicit may enhance public confidence while adding little to the de facto burden assumed by the government. On the other hand, an explicit federal fail-safe mechanism has the potential drawback of making such bailouts more probable. Guarantors will be aware that their liability is limited and thus may be more willing to take on risk and to default on their obligations under duress. This, in turn, may justify government imposition of capital requirements and other regulations on private guarantors.

If a private system were effective in managing risk, it might be possible to expand coverage beyond the current \$100,000 limit per account. If private guarantees worked as predicted by their advocates, total liability would be less than under the current system. In that case, it would be financially feasible,

and perhaps desirable, to insure all deposit accounts, as suggested by Ely.

A major objection to cross guarantees involves the possibility of increased systemic risk. One or several large failures could produce a destabilizing run of large depositors, and could also weaken other institutions. This possibility might be decreased if private insurance were extended to cover all deposits.<sup>5</sup> The reluctance of federal insurers to impose losses on large depositors of very large banks has been attributed to concern over the wider systemic effects that could be triggered by the sudden withdrawal of uninsured funds. The result has been inequitable treatment of large and small banks. Coverage of all deposits might reduce or eliminate the possibility of a depositor run, and allow insurers to move quickly against a very large failing institution with less fear of wider effects. In principle, under the improved discipline of a successful cross-guarantee system, extending protection to large accounts would make it possible to close even the largest banks without fear that taxpayer funds would be used to cover losses. Thus, even though full depositor protection is not an essential feature of a privately operated insurance system, it might be an attractive option.

Arguably, the government has more discretion than a private insurer would have in determining whether to cover losses on accounts that it does not explicitly guarantee. Some would interpret the present system as one that combines explicit protection of all accounts up to \$100,000 with the option to extend that protection to all deposits after the fact on a case-by-case basis. While the latter approach has drawbacks, it also may present an advantage to the extent that large depositors are left in doubt about their degree of protection.<sup>6</sup> This may retain some depositor discipline on bank risk-taking and thus help control insurer exposure. A private deposit guarantor, on the other hand, may be legally obliged to specify the extent of its coverage clearly in advance in the guarantee contract.

### Regulation of Bank Capital

A major potential advantage of the cross-guarantee approach is the increased insulation of federal taxpayers from potential losses. If this system worked as intended, the capital base of the entire industry would be mobilized to back the guarantees. As noted above, the capital in the banking system today could comfortably cover insurance losses at the level of recent historical experience, excluding the extraordinary savings and loan losses.

Although private deposit insurance would not allow the government to completely abandon its role as a monitor and regulator of capital adequacy and soundness, it would shift

concern from the capital of each insured institution to that of the private insurers, both collectively and individually. Under Ely's proposal, the government would permit a bank to write insurance once its capital ratio exceeded 2 percent. In late 1989, the combined capital of solvent banks equalled 5.8 percent of total industry assets.<sup>7</sup> Thus, according to Ely, most banks today would have enough capital to participate in issuing guarantees. But even if capital is adequate to support cross-guarantees for the industry as a whole, it is less certain that the largest banks would have enough capital in the near future to participate in cross-guarantee arrangements with each other.

Although Ely suggests that the government's minimum capital requirements could be less stringent than at present, it is likely that private insurers would be less tolerant of failure risk, and thus of low capital levels, than is the government. Moreover, through their control of pricing, they would be in a strong position to enforce higher capitalization. Thus, if a particular bank were to be operated with the same level of risk as at present, it might well face a privately imposed capital requirement at least as stringent as that set by the government today. If this were the case, it is likely that many banks would not currently be considered sufficiently capitalized to participate in the issuance of guarantees.

In addition, there may be an element of circularity to the argument that private market incentives will lead to sufficient capital on a bank-by-bank basis. The argument implicitly assumes that guarantor syndicates are (perhaps like the insurers who participate in Lloyd's of London) rational, self-interested profit maximizers. It also assumes that the syndicates, through their agents, are able to accurately measure the insured risk. Given these assumptions, the syndicates would price insurance correctly, and have an incentive to require their clients to hold adequate capital.

However, because the syndicates themselves would be composed of insured banks, a new moral hazard problem might arise. For a bank with little of its own capital at stake and looking to make a risky investment, one option would be to join with others in issuing guarantees on less-than-stringent terms in order to generate fee income. One form this might take is failure to charge adequate premiums to an undercapitalized institution. If the syndicate's reinsurers did not themselves act to restrain this behavior by raising the price of their reinsurance, then such risk-taking could be attractive in the short run to certain firms.

To summarize, it is not clear whether a private system would lower or raise capital levels on average. Nor is it likely that such a system would eliminate the need for the government to set minimum capital standards for individual banks, at least in their



role as insurers. It follows, also, that the government would be required to continue monitoring institutions to the extent necessary to set risk-adjusted requirements for each bank.

### **Risk-Based Pricing**

A private insurance system is not a prerequisite for risk-based deposit insurance premiums, just as it clearly is not a prerequisite for risk-based capital standards. However, proponents of a private system believe that it would allow for a more refined and efficient implementation of risk-based premiums.

If risk-based premiums are to work properly, they must be based on good information regarding risk. Ideally, premiums should be set tied to a wide range of indicators, some very concrete and publicly observable, some less so.<sup>8</sup>

It may be infeasible for such a system to be administered by a government agency because of political pressures -- including both charges of discrimination by those who are assessed high premiums and attempts by interested parties to influence the process. Although it is certainly possible to have premiums vary with a few broad, concrete measures of risk under government administration--as capital standards will under the Basle accord--going much further could be difficult. Complaints about premium rates set by the government will always have an element of plausibility, since there is no objective standard against which to judge the "correctness" of the premiums.

In a private system, premiums would be set in a competitive marketplace. This would not eliminate the technical or practical barriers to measuring risk.<sup>9</sup> However, over time, the pressures of the marketplace may be more likely than those of the regulatory/political process to yield technical improvements and force the development of good information at reasonable cost about the risks that are being insured. This seems to be a reasonable, if not certain, inference from the incentives that private insurers would face and the way markets ordinarily work to generate information and reward performance.

Still, a private system would face obstacles to basing premiums on all available information about risk. First, if monitoring were done by agents of the guarantor syndicate on its behalf, it would be essential to ensure that agents have the incentive and capability to accurately measure risk. An agent that failed to perform could expose guarantors to substantial losses. Although experience and competitive pressures would tend to minimize such problems with time, an early monitoring agent failure could shake public and guarantor confidence.

Second, and perhaps more significantly, if guarantee contracts were relatively long-term in nature, interim

adjustments to premiums might have to be made under a pre-determined formula relating premium levels to variables that the monitoring agent could readily quantify. This would leave a syndicate with less flexibility in using subjective information to reset premiums than it otherwise would have and possibly less flexibility than the government.

Even if one takes the view that the private market typically will use information more efficiently than the government, ways might be found to capture this advantage without placing the full insurance responsibility in private hands. The same benefit might be obtained, for instance, by requiring only a small fraction of each bank's deposits to be insured in the private market, with the government insuring the rest. This option is discussed in the following section.

### Dealing with Troubled Institutions

Many have observed that delays in closing institutions whose capital was declining or exhausted contributed to the enormous cost of the thrift crisis (cf., Kane, 1989; Barth and Bartholomew, 1990). Some have noted that the tendency of a government insurer to forbear has its roots in the political process, which creates incentives for both elected officials and deposit insurance agency leadership to postpone painful choices (White, 1989; Kane, 1985). Although some of these critics of a government-operated system believe that such problems can be dealt with while retaining that system, proponents of private deposit insurance see its mechanisms for dealing with troubled institutions as among its strongest advantages.

As noted earlier, risk-based premiums may help to trigger early intervention by outsiders to recapitalize and reorganize a troubled institution. A major determinant of premiums is likely to be the market value of a bank's capital; as it approached insolvency, its premiums would rise sharply. The bank then would have a strong incentive to improve its capital ratio before it actually failed, either by selling off assets or attempting to raise new equity.

When a troubled institution does not or cannot respond to rising premiums by recapitalizing or when failure is sudden, the issue becomes one of taking control of the institution and either merging, reorganizing, or liquidating it. When failure becomes likely, private guarantors will have a clear, strong financial incentive to exercise their contractual rights to take control quickly, thus avoiding additional costs resulting from delay. However, this logic holds only if, at the time a problem is recognized, failure costs have not already exceeded the capacity of the private guarantor to cover losses; otherwise, the insurer's incentive might be to delay action until the government was forced to intervene and share losses.

The greater discipline on risk-taking under a private system is largely dependent, therefore, on the ability to recognize losses quickly and act without delay.<sup>10</sup> If banks are closed promptly when they become insolvent, not only will insurance losses be relatively small, but the anticipatory response of other banks to the practice should substantially reduce the moral hazard of deposit insurance.

Proponents of a private system envision a simple set of mechanisms for closing institutions. If a bank violated certain covenants of the insurance contract with its current guarantor syndicate or, at contract renewal time, was unable to purchase insurance from any syndicate, then the current syndicate would assume control of the bank and dispose of it as it saw fit.

The owners of a failing bank might resist such efforts, however. The potential for legal challenges to enforcement of the guarantee contract is a major uncertainty, in addition to technical problems in measuring capital and risk, that casts doubt on the potential for early and prompt closure of a failing firm. Equity holders typically will have an incentive to avoid or delay closure, if at all possible. They may sue, claiming that guarantors are unfairly expropriating their wealth. Even a suit with no merit could force costly delay. Moreover, the legal basis for a challenge to guarantors may be stronger in such cases than it would be if the failing firm were, say, an industrial company. Whereas firms in less regulated industries take on debt and other legal obligations more or less voluntarily, banks operating under a government-mandated system are forced to purchase guarantees. Although the courts might uphold guarantor closure rights, an actual or potential legal challenge could cause at least temporary weakness in the market for guarantees. Such problems probably would diminish over time as the legal basis for private deposit guarantee system became better established.

Another concern is the possibility that private insurers, acting to minimize their exposure, would move too soon to close a viable institution. However, this presumes that banks would be forced to commit in advance to contractual terms that were unfavorable to their interests. It seems likely that insurance contracts could be constructed on terms that properly balance the interests of insurer and insured. The incentive for premature closure also would be held in check by the availability of alternate coverage.

It is also possible that a syndicate could use its guarantees in a predatory manner to eliminate or take over competitors. The latter problem could arise under a cross-guarantee system, for instance, because both parties to the guarantee contract would be members of the same industry. Whether justified by the facts or not, antitrust suits against

guarantors could be a common response to rising premiums or a threatened takeover. The potential for such conflicts would be reduced to the extent that the market for guarantees was competitive, so that banks could choose to deal with a syndicate whose membership generally did not pose a potential competitive or takeover threat. Conversely, however, the threat of antitrust actions could limit the number of banks and others interested in issuing guarantees and cause premium levels to be higher than otherwise.<sup>11</sup>

### 3. Private Deposit Insurance - Summary

Proponents of private deposit insurance argue that private insurers are the only ones who, over the long run, will consistently employ proper insurance practices. Based on their analysis of financial and political incentives, some may conclude that these tasks would be performed better if carried out by people with a clear, substantial financial interest in limiting risk, competing in the private marketplace.

If a private deposit insurance system succeeded, a major rationale for many federal banking regulations, including limits on bank powers, would be removed. This set of legal restrictions on bank operations and the associated regulatory apparatus have been created largely to contain the inducement to risk-taking generated by government deposit insurance. A privately operated system might use price mechanisms and market-driven interventions to limit this moral hazard. If such means were insufficient to deal with the informational problems faced by the private insurers, they might resort to restrictions similar to those currently mandated or greater disclosure to resolve the problems. In any case, the mix of mechanisms and restrictions would likely be efficient since it would be determined by market forces. Insurers providing the most cost-effective means of resolving the incumbent problems would have a comparative advantage over their competitors.

It is not certain, however, that a private insurance system would work as envisioned by its advocates. Uncertainty might be reduced by analysis of rather similar private mutual guarantee systems such as those of the Chicago Mercantile Exchange clearinghouse and other futures and stock markets (Rutz, 1989). Also, the private voluntary deposit insurance arrangements of some other industrial nations -- notably one adopted by Italy in 1987 -- provide models.

A basic concern is how effectively capital requirements and risk-sensitive premiums would limit both private insurer and government exposure under a private system. Given that the government would be a deposit insurer of last resort, it is probably essential that it regulate and monitor the capital levels of guarantors.

If a private system were mandated, the transition period might be especially problematic because the guarantee market would not be well established and there may currently be insufficient capital in the system. The combination of a limited market and the relatively high levels of risk-taking that prevail today under the present system could mean that many banks would find it too costly to purchase private guarantees. Thus, several years might be necessary for an orderly transition. Over time, as a result of improved incentives under a private system, levels of risk and potential insurance losses could fall sharply, allowing premium levels to drop and making the selling of guarantees a more attractive proposition.

Another uncertainty surrounds the practicality and desirability of letting private guarantors close depositories. If failing institutions were closed more promptly, a private system could both lower the moral hazard of deposit insurance and reduce losses that arise from delayed closure. However, legal and technical problems could arise. These problems could result, in some cases, in premature or predatory closure of viable firms or, in other cases, in delays resulting from legal challenges. If banks were closed more quickly in an effort to minimize guarantor losses, contagious runs might become a more frequent phenomenon.

Faced with these uncertainties, some may conclude that it is wiser to draw lessons from a private insurance model and attempt to apply these to reform of the government-run system than to move to a privately operated system. Others may conclude that the benefits associated with private market information and incentives can be obtained only in a private system.

Proposals for a mixed system of public and private guarantees might produce some benefits of a private system while retaining the basic structure of the present government-run system. This set of options is examined in the following section.

#### **E. Private Insurance as a Supplement to Federal Insurance**

It may be possible to introduce private monitoring of risk and market incentives into insurance premium pricing and bank closure decisions without moving to a fully private system. This is the key idea behind proposals for a combined system of government and partial private reinsurance. Under such an arrangement, the government would remain the primary deposit guarantor but resell, i.e. reinsure, a small portion of the coverage in the private market.

## 1. How a Public-Private Reinsurance System Might Work

Again, it is useful to start with an illustrative proposal in order to provide a concrete basis for discussion. Private reinsurance might have the following features:

1. The government would decide which classes of deposits will be insured and which will not.
2. Private insurers would bid for the right to cover a pro rata fraction (e.g., 5 or 10 percent) of depositor losses, and the public insurer would cover the remainder. The percentage of deposit insurance that would be privately insured could vary inversely with bank size. The objective in setting the proportion of private insurance would be to have the amount of deposits insured in any one bank of sufficient size to warrant careful monitoring by the insurer but not so large as to limit severely the pool of firms that could provide insurance.
3. The public insurer would set its premium rate equal to that charged by the private insurer, thereby assigning the pricing function to the private market.
4. As in all types of insurance, private deposit insurers would be required to have sufficient capital to assure their solvency. Constraints on the types of assets held by the private insurers may also be appropriate. These standards would be determined by the insurance industry in consultation with the FDIC.
5. The terms of the private insurance contract would allow for frequent readjustment of insurance premiums. When a private insurer altered its premium, the government insurer would follow.
6. Private insurers could not shed their liability unless a new insurer was found. If a new insurer could not be found, the current private insurer could deem the bank insolvent and have it closed.
7. After a bank was closed in this fashion, it would be sold off in open auction to the highest bidder.

Many variants of this proposal can be constructed (cf. Baer, 1985; Calomiris, 1990). For instance, Calomiris suggests that "co-insurance among banks . . . be relied upon entirely for reimbursing depositors of the first banks that failed; the government would share increasingly in subsequent losses. . . ."

## 2. Analysis

Partial private reinsurance of deposits might be one way to capture many of the benefits claimed for private insurance while avoiding some potential problems and uncertainties. As under a purely private system, an independent source of private capital would be at risk, and thus market forces would be involved in both monitoring and premium setting. Private insurers would also have incentives to develop accounting and control systems that would minimize the cost of deposit insurance. Also, market signals of growing problems at an institution could be used to trigger interventions up to and including closure. In contrast to a fully private system, however, the federal government would continue to provide the vast majority of the insurance and thus assure confidence in the overall system.

The interaction between the private and public sector insurers might promote a healthy evolution of depository regulation. Initially, the principal benefit would be through the risk-limiting incentives produced by risk-based premiums. However, as private insurers gained experience in assessing and monitoring the risks faced by depository institutions they, in conjunction with the government insurer, might propose innovative insurance products. These products might trade off premium rates with restrictions on banking activities, closure policies, or asset portfolio choices. Depending on how well private reinsurance and the resulting innovations managed the moral hazard inherent in deposit insurance, the proportion of insurance provided by the private sector might be increased over time. Thus, private reinsurance might permit a gradual reduction of the government's role in depository regulation.

The following discussion addresses four aspects of the reinsurance model: (1) depositor protection; (2) regulation of capital; (3) premium pricing; and (4) the closure decision.

### Depositor Protection

Because the tasks of risk monitoring and control would be delegated primarily to the private insurer, just as under a fully private system, it may be easier to accept the additional liability generated by explicit 100 percent coverage of all deposits. However, something less than 100 percent coverage would be an option, provided concerns regarding depositor runs at very large institutions were adequately addressed.

The risk that depositors would be exposed to losses by failure of private guarantors to pay off may be less under a reinsurance system than under a private system. Capital requirements for private deposit insurers would be set to minimize the possibility of non-performance by such insurers. Presumably, risk-based premiums introduced by the private

insurers would discourage risk-taking by depository institutions and thus greatly reduce the number of depository failures. However, even in the event of a long downturn during which one or more private deposit insurers failed, the risk to depositors would be minimal. Not only would most of the loss already be covered explicitly by the federal government; but because the federal insurer would be sharing the loss, it could readily expand its coverage to fill the gap left if a private guarantor failed to perform. On the other hand, the government might be reluctant to take this step because doing so would violate the principle that the private and public insurers face parallel loss exposure.

### Regulation of Capital

One way the partial private reinsurance model differs strongly from the purely private model is in its more direct concern with the adequacy of private insurer capital. In a fully private model, banks would have the incentive to demand that private insurers have adequate capital since depositor confidence would be directly related to confidence in the private insurer. With reinsurance, banks would be less concerned about the capital of the insurer since the vast majority of their coverage still would be provided by the government. In fact, since the premium rate for all coverage would be set by the private insurer, banks might be happy to contract with an undercapitalized private insurer that set low insurance premiums. Clearly, then, any reinsurance model would require regulation of private insurer capital. Unlike a fully private cross-guarantee system, a reinsurance system would have no mechanism other than direct regulation to ensure that private insurers hold enough capital.

A difficult question which arises with private reinsurance is whether the government also should impose capital requirements on insured banks. It can be argued that direct regulation of capital would be unnecessary because private insurers' premium levels would be linked to bank capital adequacy. Thus, banks should have an incentive to hold just enough capital to balance the cost of capital against current premium charges. As under a purely private system, if the marketplace works as expected, private insurers might price their guarantees so as to raise average bank capital levels. They might also insist on a minimum level of capital as a means of controlling the "moral hazard" problem implicit in any type of insurance.

Under a reinsurance system, the circular moral hazard problem that might arise under a system of interlocking cross-guarantees could not occur. If private insurers were sufficiently capitalized, they would bear all costs of their own mistakes. Thus, they would have no incentive to be too aggressive in pricing or too lax in penalizing banks for inadequate capital.



In contrast to a purely private system, however, a partial reinsurance arrangement would at least initially continue the government's large, immediate exposure to failed bank losses. If, for unforeseen reasons, the premium pricing mechanism did not work as described above to encourage sufficient bank capital, taxpayers could suffer large losses. Consequently, prudence still might dictate at least secondary federal oversight of individual bank capital ratios.

### **Risk-Based Pricing**

Because insurance premiums would be set in essentially the same way as under a fully private system, most of the analysis of premium pricing under a private system applies to partial reinsurance schemes as well. Assuming the private insurer were liable for a fixed percentage of the total loss, the public and private insurers' losses would be exactly symmetrical. In that case, the simplest approach to pricing would be to set the premium rate for the government's share of the insurance equal to that charged by the private insurer.

### **Dealing with Troubled Institutions**

If the closure decision were left in the hands of a private reinsurer, the potential costs and benefits of early closure would be similar to those for a fully private system. However, reinsurance raises new questions about the disposition of an institution once a private insurer determines it has failed.

Under a fully private system, the guarantor syndicate could take control of a failed institution and dispose of it by whatever method it found most cost-effective. Depending on the circumstances, this could be either a full or partial liquidation, or an assisted sale. A partial reinsurance scheme would be likely to result in conflicts of interest between the public and private insurer at the time of closure. For example, if a large bank were unable to obtain a new private insurance contract, its current private insurer might then decide that it is in its interest to pay off insured depositors and liquidate the bank. However, if deposit coverage were less than 100 percent, the public insurer might be concerned about the potential for destabilization resulting from the threat of losses by uninsured depositors and thus favor an assisted sale.

Without pre-set rules, the outcome would depend on who was vested with the control rights. If the public insurer had control, it might prefer liquidation to deal with some small bank failures but be very reluctant to impose losses on any large bank depositors. However, it might be difficult to attract private capital to underwrite private insurance unless the private insurer can control the method of disposition.

Even if private investors were willing to insure under these conditions, bifurcation of closure and disposition rights could lead to problems. For example, private insurers might move to terminate insurance very early, before an institution was in serious difficulty, to protect themselves against the uncertain costs associated with a disposition that is beyond their control.

This problem might be dealt with either by giving disposition rights to the private insurer (as in a fully private system) or committing to a certain rule for disposition. If the former course were chosen, the government would be forced to accept the possibility that a private insurer could move to liquidate a bank considered "too big to fail" by the government. This possibility might in turn lead to a conclusion that explicit 100 percent coverage is needed to prevent such liquidations from causing financial disruption.

### **3. Private Supplement to Federal Insurance - Summary**

A public-private reinsurance arrangement may offer benefits similar to those of a fully private system in the area of risk-based premium pricing and market-driven monitoring and closure decision-making, while minimizing the possibility of disruption or loss from private insurer insolvency. However, many of the uncertainties that surround private implementation of the closure decision would still be present. Furthermore, new problems might be created by the potentially conflicting interests of private and public insurers at the point of closure. For these reasons, it might be appropriate to create a demonstration project to determine the feasibility of this approach.

## **F. Non-Deposit Insurance Approaches**

The final set of proposals discussed here are those which either drastically reduce or eliminate deposit insurance. The first set of such proposals is designed to minimize reliance on deposit insurance by restructuring depository institutions in a way that isolates deposit-taking from the risks inherent in extending credit. The other set of proposals would have the federal government step back from its deposit insurance role on the grounds that depositors would actually be better protected and the financial system more stable if most savings were not protected by government guarantees.

### **1. Narrow Banks**

In the 1930s, financial institutions played a central role in the economy as intermediaries between those who needed a safe place to put their financial assets while retaining the option to retrieve them quickly and those who needed relatively long-term credit to finance investments. As a consequence of the role

played by depository institutions (as well as other financial institutions) in this liquidity and maturity transformation, and specifically of the relatively illiquid, long-term nature of the assets they held, they were subject to panics.

Over the past 50 years, financial markets have developed and now provide a variety of means for liquidity and maturity transformation, including some that bypass depository institutions. For example, whenever the government issues short-term debt (Treasury bills) or a corporation issues high-grade commercial paper, such a transformation is made. If financial markets can provide sufficient liquidity and maturity transformation, then a very direct way to protect depositors and reduce deposit insurance losses is to limit the range of investments that depository institutions can make with insured deposits. If a bank could only invest insured deposits in very safe and very liquid assets, such as short-term U.S. Government securities or high-quality commercial paper, then the risk of failures resulting from poor decision-making or intentional high-risk business strategies would be greatly reduced if not eliminated. Moreover, because all such assets would be of a type routinely traded, both depositors and any deposit-insuring agency (whether government or private) could monitor risk and assess the current capital strength of the institution on a market-value basis far more precisely, frequently (perhaps at the end of each day), and cheaply than at present. As a result of depositors' ability to assess the financial condition of such institutions, they would be relatively immune to runs.

Depending on the restrictiveness of the limits placed on asset powers of such secure depository institutions, there might be no need or demand to insure their deposit accounts. At the least, the reduced probability of a costly failure and the reduced need for depositor monitoring of risk might make it possible to offer deposit insurance coverage as an option for which depositors would be charged little or nothing.

### **An Illustrative Proposal**

Variations of a secure depository proposal have been outlined by Robert Litan, Lowell Bryan, and others.<sup>12</sup> Often referred to as "narrow banks", secure depositories are not far removed from proposals for 100 percent reserve banking. A Brookings Institution task force report puts forward a version of the concept that serves to illustrate how deposit insurance might operate for narrow banks (Brookings, 1989).

The federal government would insure deposits of a new class of institutions whose asset powers would be limited to assets that could be traded on well-organized secondary markets. Assets might also be limited to those of short maturity. This would presumably include not only government and agency securities, but

also highly rated commercial paper. Such institutions would be close substitutes for money market funds, which are uninsured.

Because the federal government would continue to provide insurance, it would continue to supervise and monitor secure depositories. The need for government-imposed minimum capital standards, premiums tied to risk, and other regulatory restrictions is unclear. The Brookings report suggests that capital requirements for each depository institution would depend on the risk of its portfolio. Assets and liabilities could be marked to market as often as the end of each business day to determine the institution's capital position. An institution that fell below its required capital level would produce additional capital within a day or be subject to forced reorganization. Given the types of assets held, the tasks of determining the risk and capital position of the institution would be relatively trivial.

The narrow bank could be part of a holding company whose other subsidiaries might include a loan-making finance or mortgage company. It is envisioned that this would facilitate the division of existing banks and thrifts into insured and uninsured components. The uninsured components, which would be in the business of making long-term commercial loans and mortgages, would be operated as non-insured banks (or as non-banking institutions). These non-insured components likely would fund new loan-making activity by securitizing the loans and mortgages they held in transactions that would resemble the asset-backed financings that have burgeoned in the last five years. Distinct, prominent labelling would have to ensure that savers could distinguish between insured and uninsured instruments. For instance, debt issued by an uninsured affiliate would be clearly identified as "not insured by an agency of the federal government." After division, the holding company could continue the important economic function of coordinating the activities now conducted in a single depository institution. Despite this continuing operational connection, however, daily revaluation of risk and capital compliance in the insured subsidiary should ensure that transactions between the narrow bank and its parent or affiliate could not jeopardize its solvency. Thus, no limits on the activities of the holding company would be needed.<sup>13</sup>

### **Analysis**

A successful system of narrow banks appears to offer two major advantages over the present system. First, by narrowing the scope of federal insurance, it could free a large part of the financial system from government oversight and restrictions on banking powers that are mainly justified by the need to control deposit insurance losses. Second, from depositors' standpoint, it could render deposit insurance a secondary, largely redundant

level of protection. The moral hazard problem would be solved in a very straightforward manner, by requiring that insured deposits be used only for virtually riskless investments. The complex problems of monitoring and pricing risk that arise under the present system and would arise as well under private insurance or partial reinsurance systems would be bypassed. Although some insured losses could result under this arrangement from residual interest-rate risk and fraud, the main questions raised by proposals for narrow banks have to do with practicality and efficiency.

One practical problem that could arise is an insufficient supply of "safe" assets (such as government securities and commercial paper) to match the demand for insured deposits. However, this problem may be diminishing. Since 1980, the volume of Treasury bills and commercial paper has exceeded the level of checkable bank deposits and is currently almost twice as large (Gorton and Pennacchi, 1990). In fact, narrow banks could become a secure source of government funding.

In any case, a current shortfall would not necessarily indicate a problem, since there would be adjustments on both the demand and supply sides of the equation as the new class of institutions was created. If the demand for insured deposits were great enough, the marketplace would surely respond as well by creating additional marketable assets. For example, more companies might issue commercial paper. Additional loans and other assets might be securitized. The resulting tradeable securities could be provided with credit enhancements to minimize or eliminate risk to investors, thus qualifying them as "safe" assets.

Furthermore, some flexibility could be exercised in defining which assets the narrow banks would be permitted to hold. However, to protect the integrity of the narrow bank and ensure accurate risk evaluation, it is essential that their investments be limited to those with a deep, liquid market.

Another criticism of narrow banking is that it would introduce inefficiencies by splitting the two core functions of deposit-taking and loan-making. In the traditional view, depository institutions perform an essential service for the economy by converting liquid funds into productive, but relatively illiquid, uses. Bundling the deposit-taking and loan-making functions in one institution is said to provide synergy by allowing lenders to monitor the receipts and payments of borrowers (Black, 1972). This synergy need not be lost provided the loan-making arm of a financial holding company were granted access to information generated by its narrow bank arm.

Some recent analysis suggests, however, that this dual role of depository institutions may be declining in economic

importance (cf., Gorton and Pennacchi, 1990). According to this view, changes in technology and markets are breaking apart the traditional banking functions of providing liquidity and evaluating credit. The rise of alternate sources of liquidity such as money market funds and the separation of credit evaluation and funding made possible by the growth of loan sales and asset securitization create new structural possibilities. The share of commercial credit provided by firms that are not banks continues to grow. Well-capitalized finance companies that do not rely on insured deposits now make more business and more consumer loans than do commercial banks. Also, the volume of commercial paper, some of it backed by bank credit lines and letters of credit, now exceeds 70 percent of commercial and industrial bank loans (Gorton and Pennacchi). The gradual emergence of these alternatives, despite the continued subsidization of the traditional depository institution through insurance on deposits, may suggest that the newer mechanisms can be more efficient than traditional banking. In that case, it could be argued that the insurance of deposits used to fund relatively risky assets is retarding the evolution of a more efficient set of institutions.

While this line of argument may suggest that limiting deposit insurance to narrow banks is consistent with the recent evolution of private markets, it would nevertheless lock in a particular institutional arrangement. Like the present set of government regulatory and statutory restrictions on bank powers, it would impose a particular institutional structure rather than let the free play of markets determine what mix of functions is to be provided by various institutional classes. That arrangement could be less efficient than the present one if traditional arguments regarding the importance of bank-like intermediation between savers and borrowers are correct and if this imposed structure leads to a net reduction in that intermediation process.

On the other hand, in a world of narrow banking, any financial firm that did not rely on insured deposits would be relatively unrestricted. Overall, the level of subsidy conveyed by deposit insurance, and any distorting effects on patterns of investment that result from that subsidy, would be far less than at present.

Looked at from the perspective of the banks, many of today's depository institutions might find the inefficiencies resulting from splitting their business in this fashion too great and thus would not undertake such a split voluntarily. It is unclear whether, absent at least some synergistic relationship with other holding company affiliates, the narrow bank would generate the returns needed to cover the costs of running a substantial portion of the payments system.<sup>14</sup> This might be a special

problem for smaller community banks for whom a holding company arrangement would be impractical.<sup>15</sup>

It is therefore possible that the mandatory creation of narrow banks could be accompanied by a decline in credit access for some communities, especially those served by smaller institutions with a local focus. Local savings often are recycled as loans to community businesses because the bank that accepts savings has both sound business reasons and the localized expertise needed to invest a large portion of these funds locally. However, a system in which small savers' funds are invested only in marketable securities would break this cycle. It is possible that no institution would fill the gap, thereby limiting credit to some communities.

A possible solution would be to exempt the smallest banks altogether, allowing them to continue offering federally insured deposits while providing the present range of services. In terms of aggregate deposit insurance losses, exempting a large number of very small institutions would make only a modest difference.

A final possible criticism focuses on the effect that such a major restructuring of institutions would have on the stability of the financial system. While it is clear that the potential for runs by insured depositors would be minimal under this arrangement, some argue that this may not represent a net gain in system stability. Potential instabilities may be merely transferred to institutions that fund themselves from uninsured sources. Lacking insurance protection, the creditors of these firms would be inclined to move their funds at the first sign of problems. In fact, depositors might maintain sets of linked low-yielding insured and higher-yielding uninsured accounts. Under ordinary conditions, most funds might be kept in uninsured accounts. However, an external shock, such as the 1987 stock market crash, might trigger a massive shift of funds from uninsured to insured accounts, causing widespread financial firm failures.

A weakness of this line of argument is that it presumes that uninsured demand debt would be used by financial institutions to finance risky assets. Currently, nothing precludes this type of activity, but little or none of it exists. Rather, finance companies tend to be financed with non-demand debt and equity and thus are not subject to financial panics. Why such an inherently unstable institutional structure would evolve is unclear. Nonetheless, if it were to evolve, potential instabilities would arise.

#### **Narrow Banks - Summary**

The creation of a class of institutions for which deposit insurance would be largely redundant seems, at first glance, to

be a clean, almost costless solution to the problem of moral hazard. A number of new questions are raised. It is hard to predict the new equilibrium that would result from imposing narrow banking on all banks, and this uncertainty may be a deterrent to doing so.

It may be possible to obtain some of the benefits associated with narrow banking in a fashion that reduces these uncertainties. One way to do so would be to give banks the option to switch to narrow banking, perhaps in exchange for broader powers in a holding company structure (cf., Bryan, 1990). This would allow banks to adopt a structural form that simultaneously removes deposit insurance backing for high-risk activities and encourages diversification and evolution that does not depend on deposit insurance support. It is possible that many banks would find this tradeoff attractive and take the option.

## 2. No Deposit Insurance

If deposit insurance were eliminated, two scenarios are envisioned. Some argue that market forces would lead to demand deposits evolving into claims on safe, marketable securities, much like a money market mutual fund (Fama, 1980).<sup>16</sup> If this were the case, then we would end up with a system much like the narrow banks discussed above, but without deposit insurance. This should make very little difference, because for narrow banks deposit insurance might well be redundant.

Others envision the deposit claim retaining its current form. They argue that any level of deposit insurance creates moral hazard. Depositors' resulting indifference to the fate of the institution where they place their savings removes a source of potential discipline on the owners and managers of the firm. Conversely, if no deposits were insured, many depositors would closely monitor their banks' condition and would withdraw their money as soon as they detected problems threatening a loss. If the institution were indeed insolvent, those who failed to move their funds in time would bear a disproportionate share of losses that had occurred by the time the institution was sold or placed in bankruptcy. If the institution was otherwise solvent and could meet its liquidity needs through emergency borrowing, then no depositor loss would result. In any case, at least the threat of bank runs would be a common feature of such a system and would be a principal mechanism for regulating risk-taking to limit depositor losses.

If such a system worked as described above, depository institutions would be much more conservatively managed than today. The threat of depositor runs would deter banks from taking excessive risks. Depository institutions would compete for depositors and other customers on the basis of their safety,



financial strength, and stability. Moreover, the full burden of monitoring would not fall on depositors unaided by others. Bond rating agencies and other firms would respond to depositors' and other creditors' needs for information by producing independent risk assessments. The need for costly, and often ineffective, efforts by Government to monitor and price risk, to set capital requirements and other regulations, and to discipline institutions could be greatly reduced if not eliminated.

It is also possible that the marketplace would generate private deposit insurance products in much the same fashion as under a mandated system of private deposit insurance. However, voluntary private deposit insurance systems would face the potential for adverse selection of risks that often caused the collapse of voluntary deposit insurance systems in the past (Calomiris, 1990). Such adverse selection is inherent in the structure of any voluntary system, because insurance coverage is disproportionately sought where the risk of loss is higher than average while those facing low risk opt out of coverage to avoid premiums. As a consequence, it is somewhat doubtful whether a private insurance market could fill the gap.

Although uninsured, most depositors could avoid losses -- provided they paid attention to and could interpret readily available information regarding the level of risk. Even so, the prospect of any loss of savings, especially by small depositors of limited means, is disturbing to many people -- so much so that the political reaction to such losses would probably force the government to cover them after the fact, even without an explicit prior guarantee. Therefore, many who advocate greater depositor discipline for the reasons just given would retain federal deposit insurance protection for small accounts (cf., England, 1990). Others would require only that depositors share losses (in effect, acting as co-insurers with the government) above a certain level (cf., Boyd and Rolnick, 1988; Secura Group, 1989).<sup>17</sup> Although these proposals would yield the advantages of greater discipline by larger depositors, who would be exposed to loss, they would not go so far as to eliminate the government's supervisory and regulatory responsibilities.

### **Analysis**

To the extent that government deposit insurance has served to protect depositors and to reinforce system stability, eliminating deposit insurance would be expected to reduce those protections. The extent of this potential reduction depends on the type of financial system that would evolve if government deposit insurance were eliminated. If it were one based on narrow banks, then the reduction might be small. If it were characterized by voluntary private insurance or no insurance, then presumably the reduction in protection would be greater.

A common criticism of proposed reforms that would expose depositors to losses is that most savers have neither the time nor the expertise to adequately monitor and evaluate bank risk. It is pointed out that even regulators and private stock analysts often are misled about the true condition of an institution until it has become insolvent on a market-value basis.

Counterarguments to this view emphasize the changes in levels of information and sophistication that would accompany the elimination or reduction of deposit insurance. Today, it is not rational for even large depositors to gather and analyze detailed information regarding the relative financial strength of competing banks. If depositors were interested and had a need for such information, however, it is likely that this service would be provided to them. As noted above, in this environment, depository institutions would compete with one another on the basis of financial strength and thus would have an interest in making available to customers detailed information on their condition and operations.

Nevertheless, without deposit insurance either operated or mandated by the government, less sophisticated savers would bear losses resulting from bank failures. This cost of reducing depositor protection must be weighed against the costs that depositors and other taxpayers have experienced as a result of the failure of federal deposit insurance to control insurance losses in recent years. It may be noted that the government does not fully protect people against other devastating losses, such as the sudden death of a family breadwinner. However, eliminating deposit insurance altogether becomes an appealing option only if one concludes that other reforms cannot offset the moral hazard generated by deposit insurance. Otherwise, there is no advantage to placing unsophisticated savers at greater risk.

The effect that eliminating deposit insurance would have on system stability is harder to evaluate. The Federal Reserve System and the Federal Home Loan Bank System are likely to be active in maintaining liquidity of solvent institutions that are affected by depositor runs. However, as principal safeguards of systemic stability, a greater burden would be placed on the lenders of last resort to plan for and deal swiftly with the consequences of a large bank failure or a spreading run.

Finally, it is possible that, without deposit insurance, banks would be unable or unwilling to rely on liquid savings deposits as a source of funding because of their increased instability. This could weaken their important economic function as intermediaries, thereby reducing economic efficiency. In this environment, banks would charge depositors the full cost of maintaining liquid accounts. As a result, a smaller share of savings would be held in such accounts. However, it has been

suggested that other mechanisms would develop to help depositors and bankers balance their conflicting needs for liquidity and stable funding, such as secondary markets for smaller certificates of deposit. On the asset side of banks' balance sheets, increased securitization of loans could increase liquidity. Thus, banks might conceivably adapt in ways that maintain their intermediary function.

#### **No Deposit Insurance - Summary**

Removing the "safety net" of federal deposit insurance would be a drastic and difficult step to take. Although relatively stable systems can be envisioned, there is no guarantee that such will develop without the financial system first experiencing a period of substantial turmoil.

A system with no deposit insurance has clear benefits in the form of increased depositor discipline and the resulting improvement in the average quality of bank management. If other ways of controlling the moral hazard of deposit insurance were found to have serious flaws, then eliminating, or at least greatly reducing, depositor protection would become a more appealing option.

## Endnotes

- <sup>1</sup> Press conference, March 8, 1933.
- <sup>2</sup> Intervention by the Federal Reserve System may involve costs that are paid for out of seignorage, thus adding to the Federal deficit even when premium income covers insurance losses.
- <sup>3</sup> The proposal of Wallison (1990) is similar in major respects.
- <sup>4</sup> Under the Ely and Wallison version of the cross-guarantee proposal, depositories with less than \$1 billion in assets could choose either to be privately insured or to continue under the current system.
- <sup>5</sup> Ely (1990) estimates that a policy of 100 percent coverage would extend coverage to \$1 trillion of deposits that are currently not explicitly protected.
- <sup>6</sup> This issue is addressed in FDIC (1989), chapter 8.
- <sup>7</sup> This is equity capital as calculated according to Generally Accepted Accounting Principles, i.e., using historic book rather than current market valuation of assets and liabilities, ignoring off-balance sheet items, and without risk weighting.
- <sup>8</sup> Given the importance of information in order to monitor risk, premium charges might also vary according to the quality and reliability of information provided to guarantors.
- <sup>9</sup> Boyd and Rolnick (1988) note that "regular monitoring of banks' behavior toward risk is labor-intensive and expensive" and argue that "even if the risk could be measured accurately, pricing this risk without market data on the value of bank loans would be difficult and arbitrary (p. 10)." The difficulty that outsiders face in measuring loan quality implies that risk-based insurance premiums may be linked primarily to risk-adjusted measures of capital adequacy rather than separate assessments of asset quality or other sources of risk. White (1989), who analyzes risk-based premiums in a Government-run system, and Ely (1990), who describes how they might work in a private system, both emphasize that capital would be a primary determinant of premiums.
- <sup>10</sup> A major attraction of market-value accounting, under a public or private system, is its use to trigger closure decisions at an early stage and thus reduce insurance losses (see White 1989). These issues are discussed in Chapter XI.

<sup>11</sup> The threat of antitrust actions could be reduced or eliminated by exempting guarantor syndicates from private antitrust liability. To prevent anticompetitive behavior, the federal government would have to retain the authority to enforce antitrust laws against these syndicates.

<sup>12</sup> Bryan (1990) has subsequently modified his thinking, endorsing a model in which deposit insurance is restricted to a "core bank" with powers broader than those usually proposed for narrow banks but narrower than those granted today's depository institutions.

<sup>13</sup> A variation on the narrow bank, also offered in the Brookings (1989) report, would allow depository institutions to continue any activities they wish but obligate them to collateralize insured deposits with marketable assets (defined in the same way as for the narrow bank) in legal custody of a third party. In this case, the government's supervision and monitoring would focus on the safety of the deposits rather than the safety or solvency of the larger corporate entity. It is asserted that this variation would require no constraints on the activities of the depository institution or firewalls between it and its holding company affiliates.

<sup>14</sup> For larger banks, the probable efficiency loss from splitting the bank could be minimized by allowing limited transactions and sharing of facilities and services between the narrow bank and other holding company affiliates. However, this could in turn increase the risk that problems originating in the uninsured affiliates would, in a crisis, spill over into the narrow bank, leading to deposit insurance losses.

<sup>15</sup> The Brookings (1989) proposal recognizes this--at least to the extent of providing institutions the option of collateralizing insured deposits with marketable assets within a unified firm. However, even this requirement might force firms to allocate their investments in ways that would be less than optimal either from their viewpoint or that of the economy.

<sup>16</sup> Money market funds, i.e., those mutual funds that invest most of their assets in short-term debt securities, now account for 48% of total mutual fund assets. The assets of these funds have grown substantially in the last 5 years, and already compete with insured checking and savings accounts.

<sup>17</sup> As noted by Boyd and Rolnick (1988), the original FDIC plan that was to go into effect in July of 1934 would have fully insured deposits up to \$10,000, covered 75 percent of losses on deposits between \$10,000 and \$50,000; and covered 50 percent of losses on deposits over \$50,000. This plan was superseded by the Banking Act of 1935, which provided full coverage up to \$5,000.

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## Chapter VIII

### RISK-RELATED PREMIUMS

#### A. Introduction

Regardless of their financial condition, all FDIC-insured banks (thrifts)<sup>1</sup> pay the same statutory rate for deposit insurance and share proportionately in any premium rebates.<sup>2</sup> As a result, deposit insurance rates do not vary with the level of risk that a bank poses to its insurance fund. This system of flat-rate premiums has been criticized on the grounds that it encourages excessive risk-taking and that it inequitably distributes the burden of insurance losses among banks.<sup>3</sup>

There are good reasons to review the FDIC's pricing policies. First, there have been substantial changes in the banking industry during the last decade. Changes in the regulatory, economic, and technological environment have created new incentives and opportunities for risk-taking. Thus, although the Bank Insurance Fund (BIF) has been adequate to handle insurance losses thus far, the past may not be a good indicator of the appropriateness of our current pricing system. Recent FDIC estimates suggest that the BIF will decline to \$9 billion at the end of 1990, and will suffer further losses in 1991. Moreover, insurer solvency only means that, on average, insurance premiums have been sufficient to cover losses. Allocative inefficiencies still could exist. In effect, more conservatively run banks may be paying for the excesses of others, and banks that elect to take advantage of risk subsidies will grow relative to those that do not.

This chapter, primarily drafted by the FDIC and nearly identical to parts of the FDIC's risk-based study recently prepared for Congress, will discuss the implications of mispriced deposit insurance premiums in Section B. Section C will point out a number of existing factors which may at least partly compensate for the effect of mispriced premiums. Section D will then discuss the obstacles to implementing a system which accurately prices risk. Sections E and F discuss the major proposals for risk-related premiums, and the arguments for and against the proposals. Finally, Section G briefly summarizes public comments received regarding risk-related premiums generally.



## **B. Implications of Mispriced Deposit Insurance**

### **1. Premiums as a Subsidy or Tax**

At the industry level, the deposit insurance premium can act as a subsidy or tax, depending on whether the premium is below or above the premium that would be set in a competitive market. The provision of a credible guarantee to pay off insured depositors in the event of a bank's insolvency allows insured institutions to attract deposits at a risk-free rate (or at some rate less than the proper risk-adjusted rate) and, thus, gives them a competitive advantage over uninsured institutions. If this advantage is not offset by charging insurance premiums (either explicitly or implicitly through supervision and regulation) sufficient to cover potential insurance losses, depository institutions will have competitive advantages over other providers of financial services. Thus, the subsidy would allow the industry to grow beyond the size that would result from a purely competitive process, growth that would come at the expense of uninsured providers of financial services. Conversely, setting insurance prices too high would act as a tax on the industry. Banks would be at a competitive disadvantage relative to uninsured institutions, and banks would either drop their insurance or resources would be diverted from banking to other financial service providers.

### **2. Moral Hazard**

Mispriced deposit insurance is most often discussed in terms of its implications for the risk-taking behavior of depository institutions. The current flat-rate system has been criticized because it creates incentives for banks to increase their portfolio risk. Market participants are normally confronted with a risk-return trade-off: higher yields can only be obtained at the expense of greater risks. In the absence of deposit insurance, the gains that stockholders may realize from moving to riskier positions would be limited by depositors, who would demand additional compensation for increased risk-taking by the bank.

However, with the introduction of deposit insurance, insured depositors no longer require risk premiums commensurate with the level of risk since their investment is safe and, under a flat-rate premium structure, banks' insurance costs will be the same regardless of their risk position. As a result, banks may take on additional risk without having to pay higher interest rates on deposits or higher insurance premiums. The risk-return trade-off has been altered such that the price of assuming greater risk has been reduced and, consequently, the bank is likely to move to a riskier position.<sup>4,5</sup> This problem is referred to as the "moral hazard" problem throughout this study.

Thus, there are two aspects to the mispricing of deposit insurance, both of which result in a misallocation of credit resources. First, if the overall level of insurance pricing is not equal to the price that would be set in a competitive market, deposit insurance will act as an industry subsidy or tax, and insured institutions will be at a competitive advantage or disadvantage relative to uninsured institutions. Second, the flat-rate pricing system provides incentives toward greater risk-taking, with the result that some risky investment projects will be undertaken that would not otherwise have been undertaken. As a consequence, bank failures are likely to be more numerous and more costly than if insurance prices varied with the level of risk.

### **C. Counterbalances to Increased Risk-Taking Under Current System**

#### **1. Market Discipline**

It should be noted that under a flat-rate system there still may be important counterbalances to increased risk-taking. To the extent that uninsured liabilities are at risk, these debt-holders will exert some discipline on bank risk-taking. In addition, stockholders (or owners) have an important stake in the survival of an institution. Provided that they have sufficient capital to lose (adequate capital levels are maintained) and are sufficiently averse to risk, stockholders will place limits on management's risk-taking activities. Thus, while a flat-rate system generally will lead to greater risk (an exception is noted in footnote 4), it does not necessarily imply that institutions will seek the riskiest portfolios.

#### **2. Regulatory Discipline**

In practice, risk-taking also is limited by the fact that, in addition to the statutory premiums, banks incur other costs under the current system. The provision of deposit insurance requires that insured institutions submit to federal supervision and regulation. Regulations limit insured institutions from engaging in certain financial activities and set minimum capital requirements. Regulators periodically examine banks to determine if they are engaged in safe and sound banking, and undesirable behavior may be penalized through issuance of cease-and-desist orders, removal of bank officers or directors for certain violations, and/or the levying of fines. In addition, the FDIC, as insurer, has the exclusive authority to suspend temporarily or to terminate permanently an insured institution's deposit insurance if the FDIC determines that the institution is engaged in an unsafe and unsound banking practice. These regulations and supervisory sanctions limit the ability of some banks to engage in overly risky activities and they represent an implicit cost of obtaining federal guarantees. To the extent that these implicit

costs vary with the riskiness of the bank, they act as a system of risk-related premiums and constrain risk-taking.<sup>6</sup>

#### D. General Problems in Pricing Bank Risk

##### 1. Ex Ante vs. Ex Post Risk

Nearly all insurance settings are characterized by asymmetric information concerning the insured's risk type. That is, the insured possesses better information about his or her risk type than does the insurer. For example, automobile drivers know their own driving patterns and behavior better than the insurer and, if they were honest with themselves, could better assess their own risk than could the insurer. However, high-risk drivers have incentives to hide their true risk characteristics and to pose as low-risk types. In order to overcome this problem, insurers will attempt to bridge the information gap by using actuarial information to make ex ante judgments about a driver's risk type based on such characteristics as age and sex. The insured's driving record (e.g., traffic tickets and accidents) can be used to obtain ex post information about the driver's risk type. Of course, even with this information the insurer will not know the driver's true risk type with certainty.

Although automobile insurance differs from deposit insurance in many respects, the example helps to illustrate the general problems associated with asymmetric information. Just as in the case of drivers, banks possess more information about their risk type than does the FDIC. Moreover, determining a bank's risk type ex ante is arguably more difficult than in most insurance settings. A major function of banks (as well as other intermediaries) is to assess the risks of lending to idiosyncratic borrowers (borrowers who are obtaining credit for information-intensive projects). For many of these borrowers, public information on their economic condition and prospects is so limited and expensive that the alternative of issuing marketable securities is not economically viable (Goodhart (1987), p. 86). Thus, banks specialize in obtaining information about the very events (credit risks) that are most likely to result in a loss to the insurer.<sup>7</sup> Because of this specialized knowledge, the ex ante information gap between the insurer and the insured is perhaps larger than in most other insurance settings.<sup>8</sup>

##### 2. Adverse Selection

Asymmetrical information regarding the insured's risk type results in two problems common to insurance settings: the difficulty of correctly classifying a client's risk type resulting in an overabundance of risky clients in the insurance pool (sometimes referred to as the adverse selection problem) and

the problem of controlling the insured's risk-taking once insurance is granted (moral hazard).

The insurer can reduce the adverse selection problem by obtaining more information about the client. Of course, the benefits of greater information (more appropriately priced insurance and lower insurance losses) would have to be weighed against the costs of obtaining that information (costs of additional resources needed to obtain information).

Another solution to the adverse selection problem is to offer incentive-compatible contracts.<sup>9</sup> For example, automobile insurers offer varying amounts of deductible insurance in combination with different premium rates. If a driver feels that he or she is a particularly safe driver, he or she probably will opt for a relatively high-deductible, low-premium contract, and vice versa for a high-risk driver. By allowing insurance contracts to vary by more than one characteristic, for example, price and coverage, the incentive-compatible contract is designed to induce insurers to signal their true risk type.

An incentive-compatible deposit insurance contract could involve offering banks the choice of various price/capital combinations. Banks that choose higher capital levels (these could be adjusted for loan quality) would pay lower insurance premiums, and vice versa. The idea is that obtaining additional capital would be less expensive for low-risk banks than for high-risk banks. Thus, low-risk banks would prefer to select a high-capital/low-premium combination, while the opposite would be true for high-risk banks. The goal would be to adjust the price/capital combinations so that the long-run revenues of each risk category would be sufficient to cover long-run costs. In doing so, each risk category would be paying an actuarially fair premium and cross-subsidization between risk classes would be eliminated.

In banking, the difficulty is determining when the revenues of any particular category are sufficient to cover expected costs. In casualty insurance, this is relatively easy since the events being insured against are normally occurring events that are fairly evenly distributed over time. As a result, an automobile insurer will learn in rather short order whether the premium revenues are sufficient to cover the long-run costs of any risk category. However, bank failures are not evenly distributed over time. Instead, they tend to be associated with the business cycle or economic shocks. In this environment, adjusting the price/capital combinations so that the long-run revenues are sufficient to cover the long-run costs of each risk category would be a lengthy learning process.<sup>10,11</sup>

### **3. Monitoring the Insured**

After granting insurance, the insurer must guard against the client taking actions that increase the insurer's potential loss. The moral hazard problem will vary depending on the extent to which the insured has incentives (normally financial incentives) to take actions that increase his or her risk and the extent to which these actions are unobservable by the insurer.

In many insurance settings, moral hazard often is controlled by making the insurance payout contingent on the insured party acting in a specified manner. For example, an insurance company will not pay off on fire damage if the insured party commits arson. However, payouts to depositors contingent on bank behavior would not be feasible, since it would reintroduce the problem of bank runs. Alternatively, the moral hazard problem may be dealt with by monitoring bank behavior (examinations) and imposing penalties on managers and owners when undesirable behavior is observed.

#### **E. Proposals for Risk-Related Premiums**

There is widespread acceptance that a flat-rate premium structure, by itself, creates perverse incentives toward greater risk-taking and penalizes more conservatively run institutions. There is less agreement whether a more explicit risk-related pricing system could be developed that would be a significant improvement over the current system. A number of proposals for establishing risk-related premiums have been made; each has some advantages and disadvantages when compared to the current system. These proposals generally can be categorized into those that try to incorporate the market's assessment of bank risk and those that rely on the public insurer's assessment of risk.

##### **1. Using Market Information to Assess Risk**

Several methods that rely on the use of market information to price deposit insurance are found in the literature. For example, the use of interest rates on uninsured deposits, private reinsurance of deposits, and option pricing theory have been advanced as means of correcting for governmental mispricing of deposit insurance.

##### **Interest Rates on Uninsured Deposits**

Deposit insurance provides explicit coverage for deposits of \$100,000 or less, leaving uninsured those deposits greater than \$100,000. It has been proposed that insurance premiums could be based on the market rates paid on these uninsured deposits (Peltzman (1972), Thompson (1987)). This approach is based on

the idea that depositors will demand a risk premium if they perceive that their uninsured deposits are at risk. Since depositors could place their uninsured funds in an alternative investment with the same level of risk (e.g., a money market or bond fund), there should exist a similar risk premium with either investment option.

There are, however, several limitations to this approach that stem from market imperfections. First, investors may perceive that large banks will not be allowed to fail. This expectation of de facto coverage for uninsured depositors may obviate the need for uninsured depositors to demand an appropriate risk premium, especially in the case of large banks. Second, in addition to differences in risk, rate differentials between insured and uninsured deposits may also reflect market imperfections, such as transaction costs or less than perfectly competitive markets. Many large corporations, for example, maintain large bank account balances that are technically uninsured. This observed behavior is likely due to the impracticality of parceling these deposits into insured accounts as well as the perception that some banks are "too big to fail." In addition, some sophisticated (and uninsured) depositors may feel that they always will have sufficient warning to withdraw their funds prior to failure.

Thus, the rate paid on uninsured deposits may not accurately reflect the risk premium that should be charged. If so, risk premiums on these deposits may not be appropriate for setting insurance premiums.

### **Private Reinsurance**

Some combination of public and private insurance has been suggested as a way to overcome the shortcomings associated with purely public or private deposit insurance systems. Under one such proposal (Baer (1985)), production and pricing would be separated: government would provide most of the insurance, while private insurance companies would determine market-based prices for both public and private insurance.<sup>12</sup> For example, the FDIC could insure 95 percent of the \$100,000 limit, but utilize the prices established by private insurers who would be insuring the remaining 5 percent. In the event of a bank failure, private insurers would be responsible for paying off their portion of the bank's insured deposits, and would share losses on a pro rata basis with the federal insurer.

In order for such a system to be successful, however, the private insurer must be able to survive systemic risk. This suggests that the private insurer would need to hold a high percentage of reserves against insured deposits and would need to be prohibited from canceling insurance when bank failure appears imminent. In addition, there may be instances where the

objectives of the public insurer may conflict with those of the private insurer, particularly in the areas of closure and failure resolution policies. The extent to which private insurers would be willing to provide such insurance under terms consistent with public policy objectives is unclear. This topic is discussed more fully in Chapter VII, "Alternatives to Federal Deposit Insurance."

### Option Pricing

Option pricing theory has been suggested as a method of determining the value of deposit insurance to a bank. In this literature, deposit insurance is shown to be analogous to a put option. Options, as financial contracts, have been popular because they confer on the holder the right, but not the obligation, to buy or sell specified property at a fixed price and on some fixed future date. There are two basic types of option contracts. The call option gives the holder the right to buy an asset at a specified price, called the exercise or strike price, on some future date. The put option, in contrast, gives the holder the right to sell an asset at the exercise price on some future date.

The value of the put option at maturity depends on the current value of the underlying asset relative to the contract's exercise price. If, at the option's expiration or maturity date, the asset price is greater than the exercise price, the option is not worth exercising and therefore the value of the option is zero. In this case, the put is termed "out-of-the-money." However, if the asset price is less than the exercise price, the option is termed "in-the-money." It will be exercised, since the asset can be sold at a price that is greater than the asset's current market value. The option holder will realize a profit equal to the difference between the exercise price and the asset price. Therefore, the value of the put option at maturity is equal to the maximum of the difference between the exercise price and the asset price, or zero. Similarly, the value of an option prior to its maturity or expiration date will depend on the probability of the option being in-the-money.

Essentially, in purchasing deposit insurance, the bank has purchased a put option, and has the right to sell (put) its assets at a price equal to its insured liabilities. If the value of the bank's assets falls below the bank's obligations to insured depositors, the insurer will appropriate the bank's assets and, in turn, pay off insured depositors. This option to sell its assets to the insurer at a price equal to the value of the bank's insured liabilities has value to the bank because it makes insured deposits perfectly safe and allows the bank to attract deposits at a risk-free rate.<sup>13</sup>

Merton (1977) was the first to suggest that option pricing theory could be used to determine the value of deposit insurance to a bank. Using the option pricing framework developed by Black and Scholes (1973), Merton derives an option pricing formula for valuing deposit insurance. When the option pricing framework is applied to the problem of pricing deposit insurance, the relationship between the value of the put (and in turn the "fair price" of deposit insurance to the bank) and the probability of insolvency is underscored. Notably, changes in the capital position of the bank lead to changes in the value of the deposit insurance contract. For example, if the value of the bank's assets were to decrease relative to the value of its liabilities, the value of the put (or deposit insurance) to the bank's owners would increase. Similarly, an increase in the variability or volatility of the bank's return on assets would increase the probability of insolvency which would be reflected in an increase in the value of the put and deposit insurance to the bank's owners. (The put option analogy also reveals other factors that influence the value of deposit insurance. Among these are the lifetime of the put option, as measured by the time between bank examinations, and the total amount of insured deposits, referred to as the strike or exercise price of the put option. Additionally, the closure rule followed by the regulators will affect the total amount of liabilities covered by insurance and therefore the exercise price.)

The feasibility of using option pricing theory to price deposit insurance depends on the ability of the insurer to adequately measure the return volatility of bank assets in a timely manner. This requires considerably more information than is available for most banks and, therefore, would be difficult to implement for most institutions. However, even though an option pricing scheme for deposit insurance may be difficult to implement, it is a valuation approach which deserves, and is currently receiving, more study.<sup>14</sup>

## **2. Using Nonmarket Information to Assess Risk**

When it is not possible or when it is undesirable to utilize the market's assessment of bank risk, the federal insurer would be left with the task of developing its own methods for assessing risk. Various proposals that have been made would permit the FDIC to administratively determine variable-rate premiums, including the FDIC's own proposals (FDIC (1983); Hirschhorn (1986)). Some of these proposals attempt to measure risk ex ante; that is, they attempt to measure the inherent risk of banking activities regardless of the bank's current performance. Most proposals, however, have relied primarily on ex post measures of risk, those that measure risk after it has materially affected the performance of the bank.



Charging banks risk premiums by measuring ex ante risks has the advantage of discouraging risky behavior before it adversely affects the performance of the bank. Not surprisingly, devising such a system is difficult. Ex ante approaches to risk measurement have generally sought to measure various components of risk that are thought to be inherent in the business of banking. These components might include interest rate risk, credit risk, operating risk, liquidity risk, diversification risk, and the risk of fraud or insider abuse.<sup>15</sup> While there may be acceptable ways to measure some of these individual risk components (most notably interest rate risk, although banks do not now report the kind of information that would be required), attempts to measure and aggregate all of the various components have been largely unsuccessful.<sup>16</sup>

### Asset Risk Baskets

The risk-based capital guidelines utilized by the bank regulatory agencies are an attempt to apply ex ante measures of perceived credit risk. The plan classifies assets into broad categories according to their perceived risk of default and attaches risk weights to these categories. A risk-based pricing scheme should not be inconsistent with these risk-based capital guidelines.

It would be possible to devise a risk-based premium system using the same approach. The measurement of portfolio risk under this system may be questioned on the grounds that it simply attaches risk weights to individual asset types, while ignoring the composition of assets within the entire portfolio. Furthermore, institutions would be able to increase the risk in their portfolios, without a corresponding increase in their risk measure, by moving to the risky end within each asset category and by having concentrations of assets in particular areas (either sectoral or geographic). Such problems underscore the difficulty in finding acceptable ex ante measures of risk.

Given the existence of the risk-based capital guidelines, a question arises as to the need for a system of risk-based premiums. There are a couple of reasons why it may be desirable to have both systems in place. First, the risk-based capital guidelines focus on credit risk, which is only one form of potential risk. A system of risk-based premiums could further incorporate other forms of risk-taking into the pricing scheme. In addition, because the risk-based capital guidelines are based on an international agreement, changing the guidelines to accommodate other forms of risk-taking or to accommodate changes in the level of risk that these different forms pose to the insurance fund would be more difficult. Second, the explicit pricing of risk utilized under a system of risk-based premiums has some advantages over a regulatory standard or minimum that is established under the risk-based capital guidelines. In the case

of a regulatory standard or minimum, an institution either passes or fails the standard: there are no gradations of risk as there might be under a system of risk-based premiums. Moreover, when facing a price, as opposed to a capital standard, an institution has greater flexibility in responding to a bad situation. For example, for an institution that temporarily falls below its desired capital position and faces abnormally high costs in attracting additional capital (capital markets may not always be efficient), the most efficient way to deal with the problem may be to pay higher insurance premiums and temporarily live with the lower capital level, rather than immediately raise capital.

### **Ratings Based on Examination Information**

It has been suggested that information derived from the regulatory agencies' onsite examinations could be used as a basis for risk-related premiums. As a result of the examination process, each bank is assigned an overall rating from 1 to 5 (5 being the worst) based on the bank's financial condition. This rating is commonly referred to as the CAMEL rating and is derived from the examiner's evaluation of a bank's capital adequacy, asset quality, management, earnings and liquidity.<sup>17</sup> Perceptions of ex ante risk play some role in the determination of CAMEL ratings, since examiners evaluate management's policies and practices that influence the bank's future performance. In the areas of capital adequacy, asset quality, and earnings, however, perceptions of risk are largely based on the bank's current performance. Nevertheless, a major argument in favor of using information derived from examinations is that it may contain inside information on a bank's operations that is not obtainable through other means (i.e., offsite monitoring).

A major objection to using examination ratings as the sole basis for assigning risk premiums is that it could have a negative impact on the examination process. One of the advantages of onsite examinations is that they allow examiners to use their experience and judgment to tailor their assessments and solutions to unique situations. However, because of the financial stakes involved with basing premiums on examinations and the likelihood that such ratings would become public information, extreme care would need to be taken to ensure the application of uniform standards and procedures for rating banks. With greater reliance on rules and procedures for assigning premiums, an important attribute of onsite examinations -- examiner discretion -- may be lost. Further, basing premiums on examinations introduces an adversarial relationship into the examination process, and the flow of information that normally occurs during an examination probably would be reduced. While the examination process can have an adversarial aspect, the purpose also is to provide useful information to bank management and regulators about the soundness of its operation and about how it may be improved. Increasing the financial stakes of the

examination outcome could lessen the extent to which an examination could serve this purpose.<sup>18</sup>

### **Failure-Prediction Models**

Some proposals for risk-related pricing schemes have been based on information provided by bank failure-prediction models.<sup>19</sup> Failure-prediction models utilize historical information to determine the importance of various financial variables (usually taken from the reports which are submitted to the federal bank regulators) in predicting the success or failure of an institution. Those financial variables (e.g., measures of nonperforming loans, earnings, capital levels, etc.) that have been consistent predictors of past failures can then be used as a basis for a risk-related pricing system. That is, pertinent financial data can be used to estimate the likelihood of failure for currently operating institutions, and insurance premiums can be assigned on the basis of each bank's probability of failure. More recently, these types of models have been modified to estimate each bank's expected insurance cost (roughly equal to the probability of failure, multiplied by the FDIC's average cost when a bank fails). The expected cost then can be used as an estimate of the risk-related portion of the insurance premium (Avery, Hanweck, and Kwast (1985)).

Not surprisingly, the financial variables that turn out to be most successful in predicting failures are primarily ex post measures of risk and, as a consequence, the predictive power of these models declines rather rapidly when predicting failures much beyond a year. For example, in one recent FDIC proposal (Hirschhorn (1986)), the financial variables that did the best job of replicating the problem bank list included variables describing a bank's capital level, its earnings performance, and the quality of its loans. Using a model based on December 1983 data and limiting the designation of high-risk banks to roughly 20 percent of all banks,<sup>20</sup> the model classified about 90 percent of all failures in 1984 as high-risk banks. However, using the same model (i.e., based on 1983 data) only about 60 percent of the failures in 1985 were classified as high risk. This profile is common in failure-prediction models, and illustrates the difficulty in detecting and pricing risk in a timely manner.<sup>21</sup>

### **Adjusted Capital Approach**

This approach would use a depository institution's capital-asset ratio, adjusted for some measure of asset quality and/or other performance measure(s), as the basis for the institution's deposit insurance assessment rate. One such proposal can be found in FDIC (1983), Chapter II. Capital is important to the federal insurer because it provides a protective cushion against adverse changes in an institution's asset quality and earnings. It is this direct relationship between more capital and a lower

probability of failure which serves as the foundation for the adjusted capital approach.

Three issues must be addressed in formulating the adjusted capital measure: (1) the definition of capital; (2) the adjustment(s) to capital; and (3) the definition of total assets. The first issue would involve questions regarding what should be included in the capital measure (e.g., common equity, allowances for loan losses, and subordinated debt). With regard to the second issue, an institution's assets, and therefore capital, might be reduced by an amount equal to the losses expected on its nonperforming assets (i.e., assets categorized as past due or nonaccrual). Expected losses on such assets might be based on the industry's historical relationship between nonperforming assets and charge-offs. The third issue would involve whether to include some or all of the "off-balance-sheet" assets in the definition of total assets.

In sum, this approach has advantages in its simplicity, its use only of information currently reported to the federal banking agencies, and its reliance upon the most proximate measure of risk to the insurance fund--capital. On the other hand, it could be argued that this approach needlessly creates a third definition of capital (in addition to risk-based capital and the leverage ratio), and only attempts to accomplish what loan loss reserves should do in the first place: recognize potential losses already existing on an institution's balance sheet.

#### Ex Post Settling Up

A more recent proposal for risk-related premiums involves an ex post settlement for failed banks (Benston, et al (1986); Merrick and Saunders (1985)). As a condition for receiving federal insurance, banks could be required to establish an escrow account with the FDIC, or bank shareholders could be legally subject to extended liability. In the event of a failure, ex post penalties could be assessed depending on the insurer's actual loss experience. Extended liability would expose the bank to an extended set of negative outcomes resulting from its investment behavior (and thereby lower its expected return), rather than limiting the set of negative outcomes to its initial equity investment. Such a system of ex post settling-up may provide the bank with incentives approaching those that would exist with ex ante measures of risk.

A general problem with this type of ex post settlement proposals is that they may result in increased costs for all commercial banks regardless of their current risk position. Extended liability for stockholders will increase the costs of retaining and attracting capital, since stockholders will demand additional compensation for the increase in their potential losses should the bank fail. Requiring banks to maintain escrow

accounts is equivalent to increasing capital requirements, while restricting the earnings potential of the added capital. (It seems likely that the bank earnings on the escrow account would be limited to Treasury bill rates.) While these proposals have the potential to reduce the incentives toward risk-taking, they also have the potential to significantly increase banks' cost of capital, regardless of the actual risk position of individual banks, and could overly restrict the growth of the banking industry relative to other financial service providers.

### **Multi-Test Risk-Based Pricing Schemes**

More recent suggestions for structuring a risk-related system include the use of combinations of the above approaches. For example, statistical models utilizing bank Call Report data could be used to estimate the risk of failure or the expected cost to the FDIC. Premiums based on these estimates could be double-checked by noting the rates paid on uninsured deposits or other uninsured debt, by comparing them to the most recent CAMEL rating, or by using option pricing techniques. Further, depending on the size of an institution, different risk classification techniques might be used in order to improve risk measurements. Although potentially more complicated, a multi-test risk-based pricing scheme might instill greater confidence in the regulator's risk assessments, and so, avert any serious mismeasurement of an institution's risk.

## **F. Arguments For and Against Risk-Related Premiums**

### **1. The Use of Market Information**

Conceptually, the advantage of utilizing market information is that it represents the assessment of numerous individuals who have a financial stake in correctly assessing bank risk. Moreover, on a theoretical level, basing insurance premiums on those that would be set in competitive, unregulated markets would result in the optimum risk-return trade-off for the economy (assuming no third-party effects).

Despite these conceptual advantages, basing insurance premiums on some form of market information raises questions regarding the quality of market information that could be obtained and whether a market-based scheme would, in reality, lead to more accurate pricing. With respect to the quality of market information, most market-based approaches face some sort of information problem. For example, basing premiums on the rates paid for uninsured deposits would require well-developed markets for both large and small banks. Even if the FDIC were to abandon its policy of providing 100 percent de facto insurance (for "uninsured" depositors) in purchase-and-assumption transactions, regional interest-rate differentials and imperfect

markets for small banks' uninsured deposits would make such an approach difficult to implement.

The informational requirements of option pricing techniques also present problems. In order to provide estimates of the value of deposit insurance for all banks, some estimate of asset returns (market returns) and their volatility over time must be made. Studies which have used option pricing to estimate the value of deposit insurance have typically relied on changes in an institution's stock prices over some historical period to estimate returns and their volatility. But these estimates are based on historical returns and do not necessarily represent the returns that an institution expects to receive based on its current investment decisions. To the extent that expected returns deviate from historical returns, the option price will be incorrect. Moreover, as Pyle (1983) has pointed out, small errors in the estimation of the value of assets or their volatility can have major effects on the value of the option contract (i.e., the insurance premium). A further informational difficulty is knowing the appropriate closure rule. If assumptions concerning closure rules are wrong, the value of the put may be in substantial error. Brickley and James (1986) provide some empirical evidence on this point. They show that for the S&L industry during the early 1980s, the assumption that closure would occur at the point of insolvency resulted in an understatement of the option value of deposit insurance (i.e., insurance would have been underpriced with this assumption).

Another practical problem with using the option pricing model is that stock market information is available only for the largest banking organizations. While a proxy for stock prices can be estimated, it is not clear how well this kind of estimation technique would work. Moreover, where stock price information is available, it only is available for the holding company and not for individual banks.

A more fundamental question is whether the market's assessment of individual banking risks is measurably better than information derived from other sources that are potentially available to regulators. A major reason why borrowers obtain loans from intermediaries rather than issue marketable securities is that public information on their economic condition and prospect is extremely limited and expensive. Thus, with respect to the quality of a bank's loans, the bank possesses information that is generally not publicly available.<sup>22</sup> To some extent, the very existence of banks (and other intermediaries) is explained by the inability of markets to act as efficient devices for valuing these loans. If this is the case, we should not expect markets to be particularly efficient at evaluating credit risks in banking.<sup>23</sup>

Whether a system based on an option pricing model would do worse job than the current system or some other (nonmarket) risk-related system is not clear, and more investigation is needed.<sup>24</sup> However, while the option pricing model appears to do relatively well at ranking the current financial condition of publicly traded bank holding companies at a point in time, from the studies reviewed it's not clear how well the model assesses risks in an ex ante sense or how well it establishes the appropriate premium level for a particular institution. For example, in looking at changes in bank risk-taking for 98 of the largest bank holding companies from 1981-86, Furlong (1988) estimated that the value of deposit insurance increased from an average of 2.4 one-hundredths of a basis point per dollar of deposits in 1981 to 2.6 tenths of a basis point in 1986. Even the higher 1986 estimate represents only about 3 percent of the 8 basis points that banks were charged at the time. On the other hand, assuming a less stringent closure rule, a study by Ronn and Verma (1986) estimated the average value of the insurance guarantee in 1983 (again for large bank holding companies) to be roughly equal to the 8 basis points. The magnitude of these differences underscores the difficulties in implementing the option pricing model.

## 2. The Use of Nonmarket Information

If market information is not used in setting insurance premiums, then it should be recognized that an alternative risk-related scheme amounts to a set of administratively determined prices (either explicit or implicit). The question then turns on how accurately we believe regulators can price risk and whether a system of explicit risk-based premiums has advantages over implicit pricing.

Obtaining accurate ex ante measures of bank risk is perhaps more difficult than in many other areas of insurance. In an ex ante sense, the insured nearly always has better information about the potential risk he or she faces than does the insurer. In the case of banks, assessing the financial risks of making information intensive loans is a central function of the enterprise. As a result of this specialized knowledge, the ex ante information gap between the insured and insurer is perhaps larger than in most other insurance settings.

This large informational asymmetry between the insured and insurer is perhaps one of the reasons for the inability of researchers to find good ex ante measures of risk. Although there are steps that the insurer could take to increase the amount of information concerning the inherent risks of specific institutions (such as becoming intimately familiar with an institution's credits), the costs of acquiring this information may well be prohibitive. On the other hand, using ex ante measures that are not based on highly specific information

(specific with respect to an institution's credit risks or other portfolio risks) would likely be ineffective and, more importantly, runs the risk of influencing risk-taking behavior and credit allocation in undesirable ways. Thus, most analyses have concluded that any workable system of risk-related premiums would be restricted to one based largely on ex post measures of risk (e.g., see Avery, Hanweck, and Kwast (1985); Merrick and Saunders (1985), p. 707).

There have been two major criticisms of basing risk-related premiums on ex post measures of risk. First, it is argued that if risk is recognized by a premium system only after an institution's asset quality has deteriorated, then the premium structure has not served its purpose of inhibiting risk-taking (Horvitz (1983), p.259). This argument, however, fails to recognize that after-the-fact penalties may still provide some deterrent effect. While the best approach may be to levy a higher premium for a higher level of risk regardless of the assets' current performance status, it is the case that if a lender knows that a premium penalty will be charged for poorer asset quality the lender will be forced to internalize this cost into the lending decisions, thereby acting as a deterrent to excessive risk-taking.

The second criticism of ex post measures of risk is that they will penalize banks when they can least afford it, i.e., when they have encountered difficulty. A deterioration in asset quality diminishes a bank's earnings and puts pressure on its capital buffer. A premium penalty which is based on some measure of asset quality will put an additional strain on both earnings and capital. While this premium cost is internalized by the lender, the premium charge must not be so large as to threaten the viability of an otherwise sound institution. In addition, credit quality typically declines during a downturn in economic activity. Increasing premiums during an economic downturn could further aggravate banking problems (Goodman & Shaffer (1984), p. 154), even though loan-quality problems would not necessarily be the result of poor management decisions.<sup>25</sup>

Any ex post system (for example, using nonperforming assets as a measure of risk) must balance the need to impose penalties sufficiently large to deter excessive risk-taking, against the possibility that excessive penalties may aggravate banking conditions when banks are already in a weakened condition. Realistically, the use of ex post risk measures places substantial constraints on the size of the penalty that could be levied against a high risk bank. If risk could be detected before a bank's performance has deteriorated, a relatively heavy penalty could be levied that may alter its behavior without jeopardizing its existence. However, levying a large penalty against a bank that is already performing poorly would probably ensure its eventual failure. Such a punitive policy would be



analogous to an early closure rule, and so, should not be the basis of a premium policy.

Avery, Hanweck, and Kwast (1985) suggest that one way of dealing with this problem might be to refrain from collecting the full premium penalty from a high risk institution at the time of its difficulties, but retain a contingent claim on the bank's future income if it returns to a healthier condition. During the period when the institution is classified as high risk (but still deemed to be solvent), modest financial penalties could be imposed and supervisory actions taken to reduce the bank's risk profile. However, as the authors note, temporary forgiveness of high premiums reduces the incentives for healthier banks to reduce the chance that they will eventually appear in the high premium category. Regardless, limitations in the ability to detect risk in a timely manner, together with the fact that the FDIC is a public monopolist (for all intents and purposes, banks cannot choose another insurer), argue in favor of assessing a relatively modest risk penalty while a bank is experiencing difficulties.

It was indicated earlier that, to some extent, the current system of supervision may act as a system of implicit risk-related premiums. Conceptually, implicit pricing can accomplish the same ends as explicit pricing. Banks can be dissuaded from having excessive loan concentrations either by charging them higher insurance premiums or by issuing cease-and-desist orders (with appropriate sanctions if the order is not followed). Given this, a question arises as to what a system of explicit prices would add to (or subtract from) the current system or some envisioned system of implicit pricing. (The terms "add to" or "subtract from" are used because some amount of on-site examinations and current supervisory sanctions would be needed even with explicit risk-based premiums.)

While in theory the same ends can be accomplished with either explicit or implicit pricing schemes, there are operational differences in the two approaches. From the regulator's perspective, implicit pricing generally offers some advantages in the form of greater flexibility and discretion. For many of the current forms of implicit pricing, such as letters of agreement and enforcement actions resulting from the examination process, regulators have considerable discretion in tailoring sanctions and solutions to individual cases. Even with a strictly formulated scheme of risk-based capital, regulators would probably be given considerable discretion in setting up compliance timetables for banks that fall below the standard.

Of course, the opposite side of this coin is that implicit pricing would tend to be subjective and sometimes arbitrary. Rules or formulas are often advocated as a way of overcoming these shortcomings and as a way of ensuring that public entities

act in an appropriate manner. Thus, explicit pricing formulas would have the advantage of ensuring uniformity and constraining regulators' behavior.

From a bank's perspective, explicit pricing may allow for a more flexible response. There always will be situations where some banks will find it more costly than other banks to meet a given standard. For example, banks that temporarily fall below a capital standard and face relatively high costs in attracting additional capital may find it more cost-effective to pay higher insurance premiums and live with a somewhat lower capital level. With implicit pricing, no such choice exists (except at the regulator's discretion). Thus, an explicit pricing scheme may have the advantage of allowing banks to choose a more efficient means of dealing with a bad situation.

Another operational difference is that a system of risk-related premiums is apt to receive greater scrutiny by regulators, banks, and the public. A system of risk-related premiums would be much more visible than most forms of implicit pricing. Banks would be able to observe directly the price of moving to riskier positions (as defined by the regulator). Because of the directly observable costs, banks may be more likely to scrutinize the formulas used to calculate premiums than they scrutinize the current set of implicit premiums. Moreover, a system of risk-related premiums would provide banks, analysts, and the public with information more suitable for making interbank comparisons of risk. Depending on the method used and its availability to the public, it may be relatively easy for analysts or the media to construct a list of the FDIC's riskiest banks.

There are positive and negative aspects to the increased private and public scrutiny that may accompany explicit pricing. In the short run, the adverse publicity associated with being designated a high risk bank may create liquidity problems and, therefore, may hinder the recovery of potentially viable banks. However, in the long run, the potential for this adverse publicity may increase the deterrent effect of risk-related premiums. This may be particularly important if the financial penalties associated with risk-related premiums are relatively small (initially, this is apt to be the case).

The increased visibility of risk-related premiums also may have a positive effect on the insurer's incentives to correctly assess risks in banking. With an explicit pricing formula, banks and the public would periodically question its appropriateness. While the insurer may be uncomfortable with this increased scrutiny, it would force regulators to continually rethink and revise their risk-monitoring system.

## G. Public Comments on Risk-Related Premiums

Of the comments received concerning the Treasury's Deposit Insurance Report, approximately 25 addressed the subject of risk-related deposit insurance premiums. The concept of an ideal system of risk-related premiums was viewed favorably in the majority of the comments received. That is, the accurate underwriting or pricing of the actual risks undertaken by banks was viewed as desirable, and if feasible, would be advocated as means of deposit insurance reform.

Of those who commented in detail, reservations concerning the feasibility of a risk-related premium system were expressed. Many of these comments indicated that, while conceptually attractive, the implementation of a risk-related premium system was perceived to be impractical, if not impossible. This perception led a few commentators to reject the concept in its entirety. Others saw the problem of implementing a system of risk-based premiums as currently impractical, and they advised proceeding with caution. An overview of the comments concerning the positive attributes and the shortcomings of a risk-based premium system follow.

Generally, risk-related premiums were thought to enhance the equity and efficiency of the banking system. As well, a system of risk-related premiums was seen as complementary to the risk-based capital or net worth standards. Some commentators preferred a system of risk-related premiums to the current flat-rate system, even when the problems of practical implementation were taken into consideration. For example, some believed that a risk-related system would diminish the perceived inequities of the current system.

Several practical problems concerning the implementation of a risk-related premium system were noted. First, risk-related premiums were seen as being too complex and too costly for practical implementation. In addition, the ability of a risk-related system to effectively alter risk-taking in a timely manner was questioned, as was the regulators' ability to accurately determine levels of risk and their appropriate prices. The comments underscored the concern that a system capable of being implemented would penalize behavior post, rather than modify behavior ex ante.

In some comments, the success of a risk-related system was linked to private sector involvement in the pricing of risk. Suggestions varied from modifying the current system by including a degree of co-insurance (private-sector market discipline) to the establishment of a totally private system of cross-guarantees among banks. Other suggested alternatives to risk-related premiums included increased capital and increased capital combined with co-insurance of deposits.

## Endnotes

<sup>1</sup> Unless otherwise noted, the term "bank" will refer to any depository institution insured by the Federal Deposit Insurance Corporation (FDIC).

<sup>2</sup> As mandated in FIRREA, institutions insured by the Savings Association Insurance Fund (SAIF) were assessed .208 percent of total domestic deposits until December 31, 1990. This assessment will increase to .23 percent from January 1, 1991, through December 31, 1993, and decrease to .18 percent from January 1, 1994, through December 31, 1997. The assessment rate will be set at .15 percent from January 1, 1998, onward. BIF institutions were assessed at .12 percent until December 31, 1990. As of January 1, 1991, the FDIC raised premiums for BIF-insured institutions to .195.

<sup>3</sup> The deposit insurance systems of other industrialized countries have premium structures that fall into two categories, neither being a risk-based approach in the sense that an individual institution is assessed a premium on the basis of its risk to the insurance fund. One approach, similar to the current U.S. premium structure, assesses an insured institution at a flat rate of its deposit base. Foreign countries using this approach include West Germany and Japan, whose annual premiums are 0.03 percent of deposits and 0.012 percent of savings deposits, respectively. The other approach involves the assessment of participating institutions based on losses to the insurance fund during the year, with some ceiling on an institution's contribution. France and Italy are countries where this approach is used. There are countries whose approach to funding their deposit insurance systems integrate elements from each of these two approaches. For example, Britain's premium structure requires some initial contribution from its insured institutions, with further assessments being called when necessary.

<sup>4</sup> Technically, whether or not bankers will move to a riskier position depends on their attitudes toward risk-taking. The introduction of flat-rate pricing reduces the cost of assuming more risk. This price change has the effect of inducing banks to assume more risk. This is referred to as the "substitution effect." However, the price change also creates a wealth effect: banks can earn higher returns at any given level of risk. This increased wealth or income may make some bank managers less willing to accept more risk, even though the price of accepting more risk has been reduced. If this "income effect" dominates, bank managers actually may choose a less risky position. However, most economists believe that the "substitution effect" will dominate over the "income effect."

<sup>5</sup> The perverse incentives toward risk-taking associated with a flat-rate system will exist regardless of the level of the premium.

<sup>6</sup> Whether or not the current system of implicit premiums appropriately prices risk, or assesses risk in an ex ante sense, is an open question. The point is that regulation and supervision represent a cost to the depository institution and have the potential to constrain risk-taking.

<sup>7</sup> In addition to credit risk, banking risks also include interest-rate risk, malfeasance, liquidity risk, and operating risks.

<sup>8</sup> It should be noted that the difficulties that these information problems present for designing an efficient risk-related pricing system apply equally to a system of explicit or implicit premiums, including the current system of implicit premiums.

<sup>9</sup> The term incentive-compatible simply means that there are incentives for the insured to choose the premium/attribute combination that is appropriate for their risk class.

<sup>10</sup> The problem here is similar to knowing whether the long-run revenues under the current pricing scheme are adequate to handle the long-run costs. Because of the systemic nature of bank failures, even 57 years of experience cannot tell us with much certainty whether the rate at which the fund is being accumulated is sufficient to meet long-run costs.

<sup>11</sup> Some sort of ex post settling-up or extended liability schemes could be termed incentive-compatible as well. These schemes would expose stockholders and management to more of the downside risk associated with alternative investment strategies and their implementation would not depend on accurate actuarial information.

<sup>12</sup> A similar scheme relying on private markets has received some consideration by Congressional staff. In discussing the types of proposals reviewed here, the terms coinsurance and reinsurance sometimes are used interchangeably. While these proposals have some coinsurance attributes, we will refer to them as reinsurance.

<sup>13</sup> The concept of deposit insurance as a put option could be broadened to include the "right" of the owner to transfer all deposits (insured and uninsured) to the insurer in the event of an insolvency or a failure. This interpretation may be more reflective of current failure policies of the insurer.

<sup>14</sup> For the most recent study on the feasibility of using option pricing to set premiums see Kuester and O'Brien (1990).

<sup>15</sup> These risks are defined as follows:

**Credit Risk:** The risk that a borrower will be unable to completely fulfill the terms of a debt contract to the lender;

**Diversification Risk:** The risk to a lender's asset portfolio when assets are concentrated in sectors which are likely to have simultaneous credit risk problems;

**Liquidity Risk:** The risk that an institution will be unable to retain or attract deposits which are needed to fund outstanding assets;

**Interest Rate Risk:** The risk to an institution's net interest income and net worth due to adverse movements in interest rates in conjunction with a repricing mismatch between assets and liabilities; and

**Operating Risk:** The risk to an institution's profitability due to operational inefficiencies.

<sup>16</sup> On December 31, 1990, the OTS published a proposed interest rate risk component for its capital standards for savings associations.

<sup>17</sup> The Office of Thrift Supervision has a comparable rating system, referred to as the MACRO rating, for the thrifts it regulates.

<sup>18</sup> If premiums were based on examination ratings, it would be desirable to examine banks at least once a year. The FDIC now is moving in that direction.

<sup>19</sup> Failure-prediction models can be used for several purposes. Many failure-prediction or problem-bank identification models have been designed primarily as early-warning systems. Early-warning systems assist regulators in identifying potential problems and in better allocating supervisory resources to deal with these problems. Some failure-prediction models also have been designed for the purpose of identifying the causes of past failures, rather than for predicting future behavior (Pantalone and Platt (1987)). Relatively few of these models have been used in a specific risk-related premium proposal. While all of these models may provide useful information for the design of a risk-related pricing scheme, a particular model's applicability will be limited by its intended purpose. Generally speaking, in designing a model for the purpose of setting insurance premiums (versus an early-warning system) one must take greater care to

ensure that there is a stable underlying relationship between a particular financial variable and bank risk.

<sup>20</sup> Once the parameters of the failure-prediction model have been estimated using historical data, the number of institutions that will be designated as high risk can be varied by simply changing the probability of failure threshold. The threshold level is the dividing line between what would be considered a high-risk bank (or alternatively a potential failure or a problem bank) and a low-risk bank. By lowering the threshold level one can increase the number of actual failures that are designated as high risk, but only at the cost of designating more nonfailures as high risk. In the extreme, one could correctly predict all failures by simply classifying all banks as high risk, but this would defeat the purpose of the model. In the case of the model used in the FDIC's proposal, the ability to correctly classify actual failures was achieved at a cost of rating 20 percent of all banks as high risk.

<sup>21</sup> Another factor limiting the accuracy of these estimates is the fact that not all banks report accurate data. Examinations often reveal that banks have underestimated the true extent of their problems. Perhaps assessing banks penalties when examinations reveal that they have underreported problems would partially solve this problem.

<sup>22</sup> Of course, this will vary from bank to bank. Some banks, particularly large banks, may make a considerable amount of loans to corporate borrowers for which markets generally possess a considerable amount of information, or some banks may have portfolios that are weighted more heavily with marketable securities or loans that are more easily evaluated by markets, such as mortgages.

<sup>23</sup> Of course, if there are externalities or third-party effects that result from bank failures, then the market would underprice risk. But this is another kind of inefficiency than the one being discussed here. With the existence of credible insurance, third party effects are apt to be small.

<sup>24</sup> A recent study (not yet published) by Kuester and O'Brien (1990) examines this very question. They conclude that adding market information to accounting data increases the ability to predict future bank performance, and vice versa. However, they also conclude that the option pricing methodology should not be used as the sole basis for setting deposit insurance premiums.

<sup>25</sup> Under the current rebate system it is likely that effective premiums also will rise during recessionary periods. However, with the current system the burden of higher premiums is shared evenly by all banks.

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## **Chapter IX**

### **RISK-MANAGEMENT TECHNIQUES**

#### **A. Introduction**

Banking has long been regarded as a special business. Banks, by taking deposits and making loans, provide the crucial function of financial intermediation among savers and borrowers. In large part, the earnings of banks, savings associations, and credit unions accrue from their ability to assume and manage risks inherent in lending.

The remainder of this chapter is organized into four sections: Section B briefly describes the nature of risk-taking by insured depository institutions; Section C summarizes the risk-management techniques most commonly used by insured institutions; Section D describes the role of supervision and the techniques supervisors use to monitor risk; and Section E outlines possible shortcomings in the supervisory process and suggests potential improvements.

#### **B. The Nature of Risk-Taking by Insured Depository Institutions**

In part, to ensure that liquid deposits are available for intermediation into specialized, illiquid loans, the deposit insurance system was created to maintain confidence and stability in the banking system. As this Report emphasizes, however, the protection provided by the safety net introduced new problems. Deposit insurance diminishes depositors' incentives to monitor the financial condition of institutions. This encourages greater risk taking by insured institutions that, if unchecked, can cause large losses to the deposit insurance fund and, in the extreme, to taxpayers. Active government supervision and strong capital standards are therefore necessary to counteract this incentive to take excessive risk and to ensure that the safety net can be efficiently maintained at an acceptable cost.

Most risk-taking by insured depository institutions can be divided into five major categories. Three of those categories--credit risk, interest rate risk, and operations risk--are present in virtually all deposit-taking institutions. Some insured institutions also take on fiduciary risk or foreign exchange rate risk when they engage in certain lines of business.

## **1. Credit Risk**

Credit risk, or counterparty risk, is the risk that a borrower may fail to make timely interest or principal payments. Every financial institution that lends money takes on credit risk. The returns an institution earns on its portfolio depend on its ability to assess accurately and charge appropriately for the level of credit risk implicit in a particular loan or investment.

Credit risk in depository institutions may increase when loans are concentrated in claims against borrowers whose ability to repay is correlated because of common ownership or control, financial interdependence, common business, geographic location, or sovereign control. Institutions with large credit concentrations are often more vulnerable to deteriorating conditions in particular sectors of the economy than lenders whose loan portfolios are well-diversified.

## **2. Interest Rate Risk**

Interest rate risk is the sensitivity of an institution's earnings and market value to future movements in interest rates. In financial institutions, interest rate risk arises when assets and liabilities reprice at different times. Every deposit-taking institution that engages in maturity intermediation assumes interest rate risk as part of its normal operations. Interest rate risk is one of the most significant risks that savings associations must control. Because savings associations have long operated as specialized financial intermediaries, making long-term mortgages and gathering relatively short-term deposits, the thrift industry is vulnerable to rising interest rates.

In general, interest rate risk is calculated in one of two ways: (1) by estimating possible changes in the market value of owners' equity when interest rates change; or (2) by calculating the effect of a movement in interest rates on the institution's net income stream or earnings. Although the two approaches are theoretically reconcilable--the current market value of a firm is the discounted value of its expected future net income stream--the second (earnings) method is necessarily sensitive to accounting conventions, which influence the time at which changes in value are recognized.

## **3. Operational Risk**

Operational risk is the risk that a depository institution will incur a loss as a result of its failure to properly process a transaction or to physically protect its assets. This risk is inherent in every service provided by depository institutions, including taking deposits, cashing checks, disbursing credits,

processing loan payments, operating automatic teller machines, or providing wire transfer services.

An operational failure may result from employee error or malfeasance, a breakdown in the bank's computer system, or a catastrophic event, such as a fire or flood. The level of operational risk in depository institutions depends on many factors, including the range of services provided, the number and complexity of transactions processed, the average and peak dollar value of those transactions, and the level of deductibles provided for in the institution's insurance coverage.

#### **4. Fiduciary Risk**

A financial institution assumes fiduciary risk when it exercises discretion when acting on behalf of clients and trust beneficiaries. Fiduciary risk includes the risk of loss resulting from investment decisions made on behalf of clients and the operational risk associated with the implementation of those decisions.

Factors that affect an institution's level of fiduciary risk include the amount of assets in accounts that require individual attention and the exercise of discretion, the diversity of assets held and uniqueness of client objectives, the volatility in securities markets, and the special attention and expertise a bank staff needs in order to offer new fiduciary services.

#### **5. Foreign Exchange Risk**

Financial intermediaries that hold or trade positions in foreign currencies assume foreign exchange rate risk--the risk of loss due to changes in currency prices. Institutions may hold foreign exchange positions as a result of lending and customer service activities, market-making activities, strategic positioning, or investment account exposures.

### **C. Risk-Management in Insured Depository Institutions**

The success of an insured depository institution depends on how well it identifies and manages its risks. Some risks can be quantified for analysis, measurement, and management. Other risks must be managed more qualitatively.

#### **1. Credit Risk**

Managing credit risk involves both qualitative and quantitative methods. Financial institutions should develop and maintain written standards (e.g., underwriting standards) for their loan portfolios to control credit risk. They should continuously monitor those standards, their implementation,

portfolio performance, economic conditions, and asset concentrations to maintain acceptable risk-return tradeoffs. For example, many institutions have internal loan review procedures to identify problem loans, and require regular loan portfolio reviews by staff who do not participate in originating or managing the assets. Appropriate reserves for loan and lease losses are another critical element in managing credit risk. These reserves help ensure that funds are available to absorb anticipated losses.

Many institutions also seek to limit their credit risk through securitization--a process whereby loans or other receivables of similar or identical characteristics are underwritten, packaged, and sold as interest-bearing securities. In theory, securitization enables depository institutions to limit their role to facilitating the flow of funds between depositors and borrowers, while transferring all other risks to investors. The financial institution originating the credits must recognize, however, that it may retain significant risk exposure through legal or moral obligations to provide the investor with recourse for losses.

In addition, institutions can control credit concentration risk through diversification. A particular asset or class of assets contributes to portfolio diversification if its returns are not strongly correlated with returns of other assets in the portfolio. Most correlations result from borrower-specific, industry, geographic, and general macroeconomic factors.

## **2. Interest Rate Risk**

### **Interest Rate Risk Measurement**

Management of interest rate risk is based on quantitative methods. The three principal ways of measuring interest rate risk are maturity-gap, duration-gap, and simulation models of varying complexity that directly calculate changes in market value or earnings. The tools institutions use to measure and monitor their levels of interest rate risk are derived from these methods.

The maturity-gap approach measures the difference between the dollar volume of assets and the dollar volume of liabilities that are subject to changes in contractual yields during selected measurement periods. Maturity-gap measures require less data than some other methods, but are limited in that they make numerous implicit assumptions. In addition, they are unable to capture changes in behavior triggered by changes in interest rates, including variations in prepayment rates. Gap models also cannot capture the potential effects of options (such as annual or lifetime caps on adjustable-rate instruments) on earnings or capital levels.

Duration-gap models summarize, in a single index number, the potential change in an institution's equity account resulting from a given change in interest rates. However, the duration measure approximates changes in market value only for small changes in interest rates and only for parallel shifts in the yield curve.

Unlike maturity-gap and duration-gap models, simulation models incorporate assumptions about contractual and behavioral responses to interest rate changes. The models use dynamic, interactive techniques to produce forward-looking estimates of changes in income or equity value based on different interest rate scenarios. Therefore, they offer the most potential for detailed and accurate estimates of changes in earnings or equity.

At the same time, simulation models require detailed assumptions about management and customer behavior. Their usefulness depends on the availability and quality of data, the reasonableness of the assumptions, and the technical sophistication of the model. If any one of those factors is weak, the quality of the resulting estimates can decrease significantly and reduce the possible benefits of the technique's increased complexity and detail.

### **Managing Interest Rate Risk**

Once a financial institution has chosen a technique for measuring interest rate risk, it must choose a way to control risk exposures. Every institution uses some form of asset-liability management to maximize the level of earnings while minimizing earnings variability under different interest rate scenarios.

An institution may match maturities or durations for either individual instruments or its entire portfolio. However, matching maturities only immunizes a portfolio of assets or liabilities from interest rate risk when cash flows are equally matched; matching durations only works for small, parallel changes in yields for all relevant maturities.

Some depository institutions may also use hedging strategies by offering variable-rate assets or adjusting the maturities of their investment portfolios to balance maturities elsewhere in the balance sheet. Institutions can also purchase interest rate options, futures, caps, collars, or floors<sup>1</sup>, or by engaging in interest rate swaps. Those strategies are most effective when they are continuously monitored to maintain intended coverage.

### **3. Operational and Fiduciary Risk**

Institutions manage operational risk qualitatively by identifying areas of vulnerability, using reliable processing

services, and instituting precautionary measures and back-up procedures. In addition, some institutions purchase private insurance coverage to limit their exposure to losses.

Similarly, managing fiduciary risk requires institutions to qualitatively assess the ways risks arise and to develop policies for limiting those risks. An institution may, for example, limit risks by directing efforts at accounts or assets that require substantial technical sophistication to manage, high-growth products or asset categories, or accounts and asset-types that raise novel legal questions. As with operational risk, institutions can purchase private insurance to reduce risk exposure.

#### 4. Foreign Exchange Risk

Managing foreign exchange risk also relies primarily on quantitative analysis. Institutions select systems to measure and monitor their exposure to foreign exchange rate risk based on specific characteristics of their portfolios. In the past, many depository institutions relied on three simple position measures to calculate their risk exposure. The first measure is a sum of the institution's long (owned) and short (borrowed) positions; the second measure is a net of all long and short positions; and the third measure is the sum of all short positions in currencies, including the home currency as a currency.

As foreign currency positions have increased, some institutions have begun to calculate risk exposure with complex, analytical models. These models explicitly measure, in a forward-looking context, the effects of currency price fluctuations on earnings and capital. To do so, these models require historical data on currency price patterns, correlations among and fluctuations in those patterns, and holding periods.

Both the simple and more complex methods have limitations. Simple position measures are based on simplified assumptions. Because summing long and short positions assumes no correlation between long and short positions, it tends to overstate risk exposure. Because netting long and short positions assumes those positions are perfectly and inversely correlated, it understates risk.

Nonetheless, institutions with relatively small exposures can use such measures to set risk limits (e.g., establish aggregate overnight position limits or individual currency overnight limits) that reasonably control exposure to losses due to foreign exchange rate risk. The more complex methods that attempt to directly measure the potential losses to earnings and capital often better capture larger exposures to foreign exchange rate risk. However, the resulting forecasts are correct only if the assumed historical patterns continue.



Depository institutions with significant foreign exchange positions often attempt to limit risk by hedging. An institution can enter into futures or forward contracts or purchase currency options to hedge its positions. As with interest rate risk, however, the effectiveness of hedging strategies depends upon continuous monitoring and adjustment. In addition, hedging strategies are productive only if they are tailored to an institution's specific needs and the potential benefit of risk reduction balances the implementation costs.

#### **D. The Supervisor's Role in Risk-Management at Insured Depository Institutions**

Because of the critical role insured depository institutions play in the operation of the economy, there is a public interest in maintaining systemic stability. Before there was federal deposit insurance, businesses and depositors relied on supervision and regulation of financial institutions to protect the stability of financial markets. Deposit insurance created a moral hazard problem, which diminished depositors' incentives to monitor the risk-taking of insured institutions, and encouraged managers of institutions to take greater risks.

Supervisors of insured depositories seek to maintain public confidence and systemic stability by providing a substitute for the discipline that otherwise would be imposed by holders of insured deposits. Supervisors' efforts are augmented by strong capital requirements, risk-based premiums, and market discipline exerted by uninsured creditors and equity holders.

The efficacy of supervisors' efforts depends critically on the availability of accurate information on the condition of financial institutions. Ways to improve the quality of that information are discussed in Chapter XI of this study.

##### **1. The Supervisory Process**

The supervisory process attempts to ensure that: (1) management properly identifies and controls risk-taking in depository institutions; and (2) such risk-taking does not threaten the stability of the system. Hence, supervisors must monitor risk, impose enforcement actions, and set capital standards that put private capital--rather than public funds--at risk.

To evaluate whether supervisors can control risk-taking, it is necessary to understand how such institutions are supervised. Supervisors take several steps to monitor risk. First, they seek to ensure that institutions adhere to sound business practices. Second, they attempt to ensure that institutions' financial statements correctly report assets and liabilities. Third,

supervisors evaluate the effectiveness, adequacy, and suitability of institutions' management systems to control risk. Fourth, as discussed more fully in Chapter X, supervisors initiate corrective actions when the condition of an institution deteriorates, well before it is a candidate for failure.

Corrective actions include requiring undercapitalized institutions to submit plans for restoring capital ratios, denying applications for expansion, restricting growth, requiring an agreed-upon schedule for raising capital, or restricting or eliminating dividend payments. If management fails to address an institution's problems and its condition continues to decline, the supervisor can appoint a conservator.

## **2. Tools for Controlling Risk**

Financial institution supervision relies on four primary elements to control risk--capital standards, closure rules, examinations, and corrective and punitive enforcement actions. Capital standards, discussed in greater detail in Chapter II of the Report ensure that owners of insured institutions have enough of their own money at stake to resist gambling with insured funds.

### **Closure Rules**

Closure rules vary among supervisors, but under current policy for national banks, insured depository institutions are generally closed when the book value of equity is exhausted. Book values, which are based on historical cost, can differ from market values. Discrepancies between book value and market value are likely to increase as institutions approach insolvency, especially if a bank sells off higher quality assets in an attempt to increase its capital to asset ratio. Thus, institutions may remain open after their economic net worth is depleted.

During this time, managers' incentives to follow risky investment strategies increase because owners' equity is no longer at risk. In general, closing insured institutions promptly and closer to the point at which their market value as a going concern disappears completely can minimize the cost to the deposit insurance fund of resolving failures. Closure policies are discussed more fully in Chapter X.

### **Examinations**

The third element, examination, includes a wide range of activities. Supervisors rely on timely, on-site examinations to monitor and measure risk in insured institutions. During those visits, examiners collect and analyze data on loans and other assets, meet with bank managers who are responsible for making

decisions, evaluate the ways that managers make and carry out policies, and review the institution's compliance with existing laws and regulations. Their objective is to identify current and potential problems and verify the financial statistics that the institutions report on their periodic call reports.

Examiners use various tools to determine the overall condition of the institution and to communicate the results of their analyses to the management of the institution. Analyses performed at the bank, or at other locations, by an examiner or team of examiners enable supervisors to evaluate continuously an institution's risk profile. Examiners rely on information from regularly filed financial reports, bank management information systems, visits to the bank, and special requests for information made of the bank.

Supervisors also may hold discussions with management and outside parties, evaluate data from special requests--such as reports by an institution on hedging positions--or update information on the creditworthiness of borrowers.

In general, supervisors focus their examination efforts on depository institutions that experience has shown pose the greatest risk to the banking system and the insurance fund. These include large institutions, problem institutions regardless of size, and institutions with significant exposures to troubled industries or economic sectors.

Large banks pose the greatest risk to the banking system because they hold most of its assets. For example, the 45 largest commercial banks in the U.S.--those with greater than \$10 billion in assets--represent 0.3 percent of the total number of institutions, but account for 38.4 percent of total banking system assets. By contrast, the combined assets of the 12,163 institutions with assets of less than \$1 billion are only 30.2 percent of total banking system assets.

Supervisors often assign examiners full-time to large institutions. The OCC, for example, in March, 1984 began a program to establish resident examiner teams in each national bank that is the lead bank of a multinational banking company. More recently, the OCC has expanded its program to assign to each regional bank an examiner whose primary responsibility is to supervise that bank. Additional examiners are assigned to multinational and regional banks as needed to conduct specialized examinations and asset quality reviews.

The FDIC assigns an examiner to each bank and a team of examiners visits each bank on a periodic basis, depending on the size and condition of the institution. The FDIC is considering assigning a full-time resident examiner to banks with assets greater than \$1 billion.

Large state member banks receive on an annual basis an on-site, full-scope examination conducted by the Federal Reserve. This is consistent with the Federal Reserve's policy of subjecting all state member banks to on-site, full-scope examinations at least once a year. The Federal Reserve is considering the merits of increasing its supervisory presence at large institutions, including the assignment of a full-time examiner to institutions with assets in excess of a threshold level.

To adapt to rapidly changing economic conditions, the OTS has adopted a strategy that provides for examination teams to visit all savings associations annually. In addition to this requirement, OTS will be conducting, by June 30, 1991, targeted examinations focusing on asset quality, and other high risk areas, in all savings associations with assets greater than one billion dollars.

Supervisors also devote special attention to problem institutions. Broadly speaking, there are three major categories of problems that may cause an insured institution to fail: (1) declining asset quality; (2) funding mismatches combined with unanticipated movements in interest rates; and (3) fraud and abuse.

Losses from declining asset quality (*i.e.*, losses due to credit risk) are the principal cause of failures of insured depository institutions. In general, examiners devote a great deal of effort to reviewing asset quality. For example, prices in some real estate markets across the country softened substantially in 1989 and 1990. As a result, bank supervisors made real estate loans a primary focus of their examinations.

On-site examinations provide data on asset quality that are valuable in identifying current and potential future problem institutions. This is supported by the experience of the Federal regulatory agencies, and by past and continuing statistical research which indicates that data regarding troubled loans are among the most useful indicators of a bank's future performance.<sup>2</sup> When examiner classifications and other troubled loan data result in appropriate loan charge-offs and in adequate levels for the allowance for loan losses, capital levels are more accurately measured and institutions needing regulatory resolution are more easily identified. As recent events in the Southwest and Northeast attest, examination information, especially relating to asset quality, can become stale rather quickly. Some empirical evidence suggests that, on average, the usefulness of classified loan data for predicting future failures drops off appreciably beyond a year of the examination date.<sup>3</sup>

However, when the policies and systems that an institution uses in the lending area are strong, supervisors can be more

confident that the institution's condition will not deteriorate quickly. Hence it is critically necessary for supervisors, in examining the condition of an institution, to determine the institution's ability to manage and control risk-taking.

To assess interest rate risk, the supervisor may evaluate the institution's measures of risk and independently calculate the level of risk. The supervisor also reviews the effectiveness and suitability of the institution's hedging strategies. Because interest rates can be highly volatile, data quickly become obsolete; supervisors may require institutions to submit regular information.

The objective in examining credit quality and interest rate risk is not only to identify and correct current problems, but also to address potential weaknesses. Weaknesses may arise because of poor underwriting standards, inadequate internal controls, or weak collection efforts. Therefore, examiners focus on identifying current problems and scrutinizing the policies and systems the bank uses to make and collect loans. The supervisor's skill in assessing risks is particularly important because conditions in the financial marketplace are increasingly volatile. If the supervisor finds that an institution is taking on unreasonable amounts of risk or is ill-prepared to adjust to changing conditions, it will require management to take steps to correct weaknesses (e.g., improve its management and procedures, increase its capital ratios, or create reserves against losses).

Fraud and abuse is also a source of concern. Fraud and abuse, often sophisticated and cleverly concealed, are difficult for examiners to detect. Supervisors must pay particular attention to transactions with insiders, and be alert to unusual or unexplainable patterns in the financial statements and records submitted to them. In addition, supervisors must be alert to certain red flags--for example, an institution that issues its financial statements without an auditor's unqualified opinion, or with an auditor's opinion that highlights certain problems, or an institution that changes its auditors frequently or abruptly.

To reliably appraise risk in insured depository institutions, supervisors must look beyond findings from individual institutions. Because most bank assets are long-term, supervisors must evaluate borrowers' prospects and emerging conditions. They also study risks attributable to credit concentrations by monitoring economic conditions and trends in industries to which the borrower has credit exposures. Those evaluations help supervisors direct attention to specific lending activities or institutions they identify as vulnerable to changing economic conditions.

In addition to efforts by individual regulatory agencies, the OCC, the Federal Reserve, and the FDIC conduct annual, joint

examinations of major loans through the Shared National Credits (SNC) program and the interagency review of the international credit exposures of U.S. banks. The OTS also conducts a similar program for savings associations.

The Shared National Credits program reviews loans in excess of \$20 million that are shared by two or more depository institutions. The total dollar volume of credits reviewed in the SNC program has increased from approximately \$390 billion in 1986 to approximately \$768 billion in 1990. Those credits account for more than 35 percent of commercial loans and loan commitments in all U.S. banks. They include real estate construction loans, financing for highly leveraged transactions, and other commercial and industrial loans. The OTS program reviews loans in excess of \$10 million that are shared by two or more OTS-regulated institutions. In 1990, credits reviewed totaled \$3.2 billion.

Supervisors communicate the results of these examinations to banks that hold participations in the credits so that they can take appropriate action. Supervisors also use the information gathered in the program to identify weaknesses in specific industries, areas of the country, or individual institutions and, thus, to help target their examination efforts.

The OCC, the Federal Reserve and the FDIC participate in the Interagency Country Exposure Review Committee (ICERC), which meets three times a year to review U.S. bank credit exposures to sovereign nations. ICERC uses information from a wide variety of international and U.S. sources, such as examinations of the major banks that hold this debt, to evaluate each nation's transfer risk exposure, i.e., the risk that the borrower will not have sufficient foreign currency to repay the debt. ICERC may require banks to set aside a special Allocated Transfer Risk Reserve (ATRR) to cover some portion of cross-border exposure to a particular country. Regulators notify affected banks of ICERC ratings and ATRR requirements so that they may take appropriate action. As of June, 1990, the foreign debt exposure, including commitments, of U.S. banks to all countries (including industrialized countries) totaled \$309 billion. That exposure was concentrated in the largest banks; nine money center banks held 64 percent of those loans and commitments.

Because financial services markets are continuously changing, it is important for supervisors to develop new techniques. As described in an August 9, 1990, Federal Financial Institutions Examination Council report to Congress, supervisors have developed training programs that provide examiners with knowledge of the tools and techniques for measuring and monitoring risk in insured depository institutions. That training is designed to enable staff to adapt skills to new situations, increase experience, and develop expertise in specialized areas. In addition, supervisory agencies are making

particular efforts to improve staff retention rates by maintaining competitive rates of pay.

### **Enforcement Actions**

The final tool supervisors may use to address actual or potential problems in an institution is a variety of formal or informal administrative enforcement actions. These actions are based on a careful, case-by-case analysis of the institution's condition. The severity of the action taken depends on the commitment, ability, and willingness of the board of directors and management of an institution to deal with its problems, as well as on the extent of the problem. Many enforcement actions lay out specific guidelines that are directed towards bringing institutions back to a safe and sound condition.

Supervisors may take informal action when they believe that management recognizes and intends to correct the problem at hand. For example, examiners may meet with an institution's management or board of directors to discuss areas of risk. They may also ask for commitment letters or memorandums of understanding (MOUs). The OTS does not rely on MOUs or letters of understanding. Rather, it typically requires institutions' boards of directors to provide a written response setting forth the corrective actions that will be taken to address the deficiencies described in reports of examination. Meetings with management and boards of directors are also an integral part of the supervisory process.

In the first six months of 1990, the OCC received 45 commitment letters and 10 MOUs, and the FDIC received 209 MOUs. During the same period, the NCUA received 154 letters of understanding.<sup>4</sup> The FRB received 150 MOUs during the first six months of 1990.

When supervisors believe managers are unable or unwilling to deal with problems, or when the condition of the institution warrants, they may take more formal action. Formal enforcement actions may be either remedial or punitive in nature; most are remedial. They include Formal Agreements (FAs), or in the case of the OTS, Supervisory Agreements (SAs), Orders to Cease-and-Desist (C&Ds), Formal Capital Directives (FCDs), civil money penalties (CMPs), termination of deposit insurance, and removals and/or prohibition actions.

In the first six months of 1990, the OCC issued 60 Fas and 20 C&Ds, while the OTS issued 66 SAs, 15 C&Ds, and 6 FCDs. The Federal Reserve Board completed 37 formal enforcement actions. The FDIC issued a total of 95 formal enforcement actions in the same time period, including 24 initiatives to terminate deposit insurance, 41 stipulated C&Ds and 24 initiated C&Ds. The NCUA

issued 17 formal enforcement actions during the first six months of 1990.

In general, supervisors take formal, punitive enforcement actions such as the assessment of CMPs and the suspension and removal of officers and directors only when: (1) there is serious insider abuse; (2) there are significant compliance problems or serious violations of law; or (3) when the institutions or individuals involved have disregarded or refused to respond to supervisory efforts to correct serious problems.

In the first six months of 1990, the OCC reached settlement for 94 CMPs.<sup>5</sup> In the same time period, the OTS took 43 Removal and Prohibition Actions and assessed 8 CMPs, and the Federal Reserve Board completed 20 actions, including 10 removals and 10 CMPs. In the first six months of 1990, the FDIC assessed 9 CMP, 10 orders removing and/or prohibiting individuals from participating in affairs of individual institutions, and 3 additional removal and/or prohibition actions. The NCUA did not issue any civil money penalties during this period.

#### **E. Shortcomings of Supervision and Areas for Improvement**

The supervisor cannot prevent all failures of insured institutions. Attempting to stop all failures would likely result in an uncompetitive and inefficient system. Indeed, the many changes that have characterized the financial services environment have accounted for some proportion of failures. For example, over the last decade, financial intermediaries have faced increased competition, as illustrated by the growth of the commercial paper market. In addition, scale economies in certain lines of business (e.g., credit cards) have increased.

##### **1. Potential Shortcomings in the Supervisory Process**

The failures of insured institutions in recent years, occurring at great cost to the deposit insurer and the taxpayer, suggest that supervisors have not been able to adequately control risk-taking by some insured institutions. Many industry observers partially attribute the recent problems in the thrift industry--large numbers of failed institutions, excessive cost to taxpayers, and numerous reported incidents of fraud and insider abuse--to failures in supervision.

In addition, increases in real estate lending over the latter half of the 1980s and the resulting concentration of real estate loans in the portfolios of banks have led to concerns that problems in the banking industry may deplete the resources of the bank insurance fund, exposing taxpayers to further losses and threatening systemic stability. Critics assert that although regulators warned banks about the risks of real estate lending,



supervisors could not prevent banks from continuing to make real estate loans until losses were indisputable.

Criticisms regarding the ability of the supervisory agencies to help maintain the stability of the system and protect the deposit insurance fund fall into two general categories: (1) doubts about the ability of supervisors to recognize problems before it is too late to avoid losses to the deposit insurance fund; and (2) a belief that supervisors fail to make correct judgments and/or timely judgements, even when they have adequate information.

### **Inadequate Information**

Some critics believe that supervisors have been unable to determine the true condition of depository institutions, particularly troubled ones, in a timely way. This has resulted in large losses in economic value before an institution is closed. One reason cited for this problem is that bank financial statements reflect book values rather than market values of assets. Although greater reliance on market value accounting could improve the quality of information available to bank supervisors, many bank assets are not traded actively. An accurate assessment of their value therefore requires detailed knowledge of their payment record. This suggests that the frequency and intensity of examination should be increased. There is a developing consensus that annual on-site exams are necessary for troubled and larger institutions and possibly all institutions.

### **Timely Action**

Good information is not the entire solution. The success of the supervisory agencies in maintaining the stability of the system and protecting the deposit insurance fund depends on how well the agencies apply the information gained through their evaluations of depository institutions. Many critics contend that even with correct information, supervisors do not apply the judgment necessary to protect the deposit insurance fund.

Staged intervention, or prompt corrective action, could address this concern. This recommendation, discussed in detail in Chapter X, involves a series of formalized actions (e.g., restrictions in dividend payments or asset growth), which would limit the pressure on the supervisor to forbear against troubled institutions. The critical balance is between predictable rules and the case by case judgements that are sometimes required.

The final stage of prompt corrective action is early closure, also discussed in Chapter X. The difficulty for the supervisor is that the costs and benefits associated with a particular action sometimes can only be estimated. While the

cost of delaying closure of a weakened institution can be substantial, many troubled institutions recover. If the supervisor acts too quickly, unnecessary costs, such as the dissipation of franchise value and the disruption of the markets served by the institution, may be incurred. This is why it may be important to maintain some level of discretion in the early closure decision.

## **2. Options for Supervisory Improvements**

The problems described above suggest that supervisors' control of risk-taking by insured institutions can be improved. Four options are discussed below: (1) tightened underwriting standards; (2) limits on credit concentrations; (3) increased monitoring of interest rate risk; and (4) increased supervisory resources devoted to more frequent examinations.

In addition to the options discussed in this section, other possible measures, such as strengthening capital standards, innovations in accounting standards that would improve the quality of financial information reported by insured institutions, and policies governing supervisory action when an institution's condition begins to deteriorate, are examined elsewhere in this Report.

### **Underwriting Standards**

One way supervisors can better control risk-taking in insured institutions is by more stringently monitoring and regulating credit underwriting standards. As traditional sources of earnings have come under increased pressure, some institutions have attempted to boost their earnings by lending more aggressively. This has included increasing the amount lent relative to the value of collateral, lending to cover interest payments, and extending loans to developers who have not obtained permanent financing. These developments were facilitated by statutory changes that relaxed maximum loan-to-value ratio requirements in the early 1980s.

Of course, supervisors would need to develop underwriting standards with the appropriate level of stringency. If underwriting standards are too strict, credit provision may be restricted below socially desirable levels and there is a risk that economically viable projects may be lost. Moreover, restrictions on certain types of lending, may create incentives for institutions to focus in other riskier areas. Any review of these standards should be conducted by the regulatory agencies, perhaps through the FFIEC or the Credit Standards Advisory Board, chartered by FIRREA.

## Restricting Credit Concentrations

Some observers have suggested that supervisors could better control risk-taking in insured institutions by: (1) developing guidelines for, or limits on, concentrations; or (2) requiring higher capital levels based on concentrations in particular loan categories. In general, credit concentrations greatly increase the exposure of insured institutions, and the deposit insurance fund, to loss. Institutions with large credit concentrations are more vulnerable to downturns in certain sectors of the economy than institutions whose portfolios are diversified.

Regulatory controls could limit risk in portfolios of insured institution by decreasing their vulnerability to regional or sectoral downturns. Formal controls would prevent managers from ignoring warnings that regulators issue. Enforceable guidelines could permit supervisors to require management to address problems related to concentrations before losses are incurred. Hence, the safety and soundness of insured institutions could be enhanced, and the deposit insurance fund further protected.

Some observers point out, however, that in practice, devising limits on concentrations is difficult. For example, an institution conducting business primarily in one community, reflecting its current inability to diversify geographically, might not seem to have excessive loan concentrations, but it in fact may have loan exposures to borrowers whose fortunes are closely related. Moreover, definitions of what constitutes concentrations can be difficult to develop. It may be particularly difficult to categorize for concentration purposes a loan to a firm that is itself well-diversified--for example, one that produces a wide variety of products and is also engaged in financial services through a finance subsidiary. It is unclear whether such a firm is a manufacturing company or a financial company; and if a firm is a manufacturing company, it is unclear to which industry it should be assigned. Finally, institutions can, through the use of appropriate risk-management techniques, greatly mitigate the risks associated with apparent concentrations.

In addition, poorly designed standards could be costly to institutions and to society as a whole. For example, concentration limits that are generally appropriate for most institutions may be unrealistic for certain institutions, such as small community banks or agricultural banks, that serve local markets. In addition, improperly set limits might prevent institutions from reaching efficient size.

## Interest Rate Risk

Some observers have suggested that supervisors should improve their tools for monitoring interest rate risk in insured institutions and establish capital charges or other regulatory constraints for interest rate risk. As described previously, all financial intermediaries that engage in maturity intermediation take on interest rate risk as a part of their normal operations, and many choose business strategies that expose their portfolios to significant interest rate risk.

To better monitor interest rate risk in insured institutions, the supervisory agencies could adopt measures to increase the quantity and quality of data collected on interest rate risk, or increase the volume of resources devoted to analyzing those data. As previously described, however, interest rate risk is difficult to measure precisely and any new procedures to collect additional data from institutions would require that supervisors design a standardized process for gathering and analyzing data. Therefore, any particular interest rate risk measure or reporting format that supervisors could impose on institutions will have some limitations.

The difficulties in assessing interest rate risk do not imply, however, that it would be best to maintain the status quo. Significant efforts are underway to address some of the problems noted above. For example, the OTS has recently published for public comment a proposed model for monitoring and measuring interest rate risk. The OTS's proposal focuses on the estimated change in the market value of an institution's portfolio of assets, liabilities and off-balance sheet instruments when interest rates change. The proposal uses a computer simulation model to estimate interest rate risk exposure. This approach to interest rate risk provides significantly more information than other approaches, such as the more traditional maturity gap or simple duration models. In particular, the simulation methodology used by the OTS evaluates the options embedded in the mortgage assets held by thrifts and, therefore, provides a better estimate of the change in the value of those assets due to changing interest rates.<sup>6</sup>

In addition, work is under way to develop a system for measuring interest rate risk in banks at both a domestic and international level. Although no consensus has yet been reached, there are several approaches being actively considered. One method is to require institutions to provide detailed information on the maturity and repricing of their assets, liabilities, and off-balance sheet exposures. This approach might provide a relatively accurate measure, but could also be burdensome to banks--especially to banks that are operating well within

prudent levels. This approach also requires key assumptions about the interest rate sensitivity of demand- and other "core-" deposits. These assumptions can significantly affect an evaluation of a bank's interest rate risk.

An alternative method is to employ a two-phased approach. First, institutions could be screened by the use of a rather rough measure of interest rate risk, derived from enhanced, but not extensive, information reporting. Then, only those institutions that appear to have large levels of interest rate risk relative to that of other banks could be required to submit further information for deriving a more precise measure of risk. This procedure could also lead to a specific capital charge for banks that are facing unusually large levels of interest rate risk.

Currently, bank supervisors from a dozen countries are working under the aegis of the Bank for International Settlements (BIS) to develop a detailed measurement system and capital standard for internationally active banks. Recognizing both the supervisory and competitive issues involved, their efforts address a variety of factors in order to converge the capital standards of banking and securities regulatory authorities worldwide. The results are likely to be complex, involving for example, the consideration of a bank's exposures in each of the world's principal currencies.

With regard to domestic efforts, work is proceeding on the development of a measurement system that would identify banks with large interest rate positions. The objective of this approach is to identify U.S. banks taking exceptionally large levels of interest rate risk and to determine the additional levels of capital they should maintain. This issue may be too important to wait for a new international agreement on monitoring and measuring interest rate risk. One recommendation is for the banking regulators to move as soon as possible to develop a standardized reporting system for interest rate risk that can eventually be included in the risk-based capital standard.

### **Supervisory Resources and Examination Frequency**

Supervisors should continue to consider options to identify those institutions posing the greatest risk to the system and the insurance fund and to devote proportionately more resources to them. Accurate information on the condition of an institution is an important pre-requisite for many of the measures discussed elsewhere in this study, such as implementation of an early intervention program and the adoption of prompt closure rules.

The quality of information could be enhanced by increasing the frequency, intensity, and scope of examinations. Supervisors could also assign teams of examiners to continuously examine on-

site a larger number of institutions, for example, large or troubled institutions. Other institutions that are in stronger condition might be examined less frequently.

Implementing these options could require that the supervisory agencies augment their field examination staff. In fact, the supervisory agencies have recently announced staff increases that will enable them to address new problems as they arise. For example, as prices in certain real estate markets have softened, supervisors have increased the staff assigned to those areas to increase the frequency and intensity of examinations.

Any absolute increases in supervisory effort, of course, require additional resources and impose certain costs on the banking system. Estimates of the added resources needed and the costs of doing such examinations vary. The OCC's 1991 examination operating plan, for example, calls for annual examinations covering at least 30 percent of the loan portfolios and review and testing of lending policies, systems, and controls in the 216 national banks with more than \$1 billion in assets. Those examinations would be performed in addition to the credit assessments performed under the Shared National Credits program and the ICERC process.

The OCC estimates that conducting those examinations, in addition to supervising troubled banks and community banks, will require hiring 200 additional examiners. The new hires should cost approximately \$13.3 million annually, in addition to transferring examiners who are currently in office positions to the field. At present, the OCC employs 2,344 bank examiners.

The FDIC estimates that conducting annual, on-site examinations of the 115 banks with assets in excess of \$1 billion that it supervises would require a total of 105 examiners. The FDIC is increasing its 1990 supervisory staff by about 300 to a total of 2,975 by year-end 1991.

It is the policy of the Federal Reserve that each state member bank receive an on-site, full-scope examination at least annually. Problem institutions are examined twice a year, and more frequent on-site reviews are also conducted in the case of large, nonproblem institutions, when necessary on a case-by-case basis. The annual on-site examination for state member banks with assets in excess of \$1 billion is generally conducted by the Federal Reserve, either alone or in conjunction with state banking authorities. The responsibility for the annual examination requirement for small institutions is met by the Federal Reserve or is shared with state banking departments through alternate-year or joint examination programs. If the Federal Reserve System were to assume a greater portion of this examination responsibility or if future conditions in the banking

system warrant, it may also require additional examination resources to carry out its mandate. Since 1985, the Federal Reserve's field examination staff has increased 17 percent to a current level of 990 field examiners.

The OTS currently has 1,074 field examiners, managers, and supervisors; it expects to have in excess of 1,300 examiners in place in 1991. It estimates that about 35 additional examiners are necessary to conduct annual on-site exams of savings associations with assets over \$1 billion.

The costs of adding more examiners must be carefully balanced against expected benefits since there are limits to what supervisors can achieve simply by hiring more people. Most importantly, examiners must be well-trained and have the specific skills needed to deal with conditions in the industry.<sup>7</sup> In addition, training new examiners draws on the time of experienced examiners, time that could be focused on the banks the examiners supervise.

#### F. Summary

Since its inception in the 1930s, the Federal system of deposit insurance has successfully provided a safe haven for the funds of individual depositors while contributing to the stability of the banking system. At the same time, deposit insurance reduces checks on excessive risk-taking, which must be moderated in part by appropriate supervision.

One lesson that may be drawn from the experience of insured depository institutions in the last decade is that the "safety net" depends in part on the ability of supervisory systems and policies to replace the discipline that would otherwise be provided by private debtholders. Regular and accurate assessment of the financial condition of insured institutions, strong capital standards, and early intervention when institutions get into trouble are necessary to discourage excessive risk-taking that can lead to catastrophic loss. Supervisors can and should work to improve their ability to protect systemic stability and the deposit insurance fund.

## Endnotes

<sup>1</sup> These are instruments designed to hedge cash flows over time rather than on a single date.

<sup>2</sup> See Terence Belton, "Risk-Based Capital Standards for Commercial Banks," Federal Reserve Board Working Paper, July 1987. See also, J.F. Bovenzi, J.A. Marine, and F.E. McFadden, "Commercial Bank Failure Prediction Models," Economic Review, Federal Reserve Bank of Atlanta, November 1983.

<sup>3</sup> Bovenzi et al., op. cit.

<sup>4</sup> The NCUA had 413 outstanding letters of understanding in June 1990.

<sup>5</sup> The OCC issues CMPs by serving notices of assessment to individuals. The individual then chooses to make a settlement offer or to litigate through the administrative process. In the case of a settlement offer, the individual signs a consent order sent by the agency. Agreement on litigated cases is reached through the Comptroller.

<sup>6</sup> In simplified terms, the OTS model evaluates an institution's exposure to interest rate risk through a two step process. It first determines the estimated market value of all on- and off-balance sheet instruments in an institution's portfolio under current interest rates using discounted cash flow analysis. Then, it calculates the change in market value of the aggregate portfolio that would result from a given hypothetical increase or decrease in market interest rates. Under the OTS's proposed rule, the interest rate risk component of the risk-based capital rules would be based on the decline in market value resulting from a specified change in market interest rates.

<sup>7</sup> On average, it takes five to six years for a new examiner to gain the necessary skills and experience to become commissioned. Hiring experienced people from the private sector is an option, but they too must undergo some training.



## **Chapter X**

### **PROMPT CORRECTIVE ACTION**

#### **A. Introduction**

The manner in which financially troubled institutions are handled as they approach and then reach the point of insolvency has important implications for the long-term health and viability of the deposit insurer and for the stability of the banking system itself. For example, if all failed depository institutions were closed exactly when their net worth was zero, the issues surrounding forbearance, "too big to fail," and the regulator's ability to restrict the behavior of solvent, but troubled, institutions would be all but resolved. A policy of prompt corrective action would also put both regulators and institutions on notice regarding the consequences of maintaining inadequate capital.

Under a prompt corrective action policy, more institutions would face regulatory intervention earlier. However, fewer would eventually fail. In addition, the earliest stages of regulatory action need not require changes in management or legal action. Rather, the regulators and the management of the institution would work together to return the institution to health. This serves the interests of management, owners, depositors, regulators, and, ultimately, the taxpayers.

This chapter is organized as follows: Section B discusses the necessary requirements for implementing prompt corrective action and the degree to which they are satisfied; Section C discusses proposals that encourage a policy of prompt corrective action; Section D analyzes the policy of early closure; and Section E summarizes the major public comments received on early closure.

#### **B. Prerequisites for Prompt Corrective Action**

Supervision is an important tool in controlling the perverse incentives facing an undercapitalized, federally insured bank (for convenience, the word "bank" will be used to refer to both banks and thrifts, except where precision requires that a distinction be made). As banks approach the point of economic insolvency, they have less and less to lose from pursuing aggressive, high-risk investment strategies in an attempt to return to profitability. The supervisory free rein given

undercapitalized thrifts during the 1980s is widely recognized as a leading factor contributing to the cost of resolving insolvent thrifts. Some argue that commercial bank supervision has been far from perfect, too. In this view, banks are allowed to carry assets on their books at unrealistically optimistic values and are not appropriately restrained from high-risk behavior and irresponsible dividend policy.

Broadly speaking, the ability of supervisors to take effective and early corrective action depends on three factors. First, supervisors must be able to identify potential banking problems before they impose losses on the insurance funds. Second, in cases where supervisors have identified a problem, they must have adequate powers to force correction or to prevent further deterioration. Finally, where a problem has been identified and adequate enforcement authority exists, supervisor must not forbear from using their authority in a manner that imposes costs on the insurance funds. This section will evaluate the degree to which these conditions are satisfied.

### **1. Identification of Undercapitalized Banks**

The first area concerns identifying those banks that are undercapitalized. Reform proposals to strengthen supervision of undercapitalized institutions are often expressed in terms of a continuum of capital levels: that is, if capital is above some threshold level, the bank is relatively free from supervisory sanctions, but as capital falls below successively lower "trigger points," increasingly severe restrictions are imposed. This presupposes that reported capital levels are a meaningful reflection of the economic condition of the bank. In turn, the accuracy of reported capital depends in part on the ability of examiners to detect problems and force appropriate writedowns.

Publicly reported financial data on banks that failed in 1989 are presented in Table 1. The data indicate that in the years prior to failure, the failed banks' reported equity capital ratios began to decline. The mean equity capital-to-assets ratio for the failed banks in the sample declined steadily from 10.1 percent in the second half of 1984 to -1.1 percent in the second half of 1988, just prior to failure. Similarly, the percentage of the failed banks not meeting a 5.5 percent equity ratio<sup>1</sup> increased from eight percent in the first half of 1985 to 94 percent in the second half of 1988. In general, then, most of the failed banks in the sample were identifiable as undercapitalized prior to their failures.

Some of the failed banks, however, continued to report financial data which indicated that they were well capitalized until shortly before they failed. Thus, for example, 32 percent of the banks that failed in 1989 reported equity ratios exceeding 5.5 percent as recently as the second half of 1987; six percent

of the failed banks reported equity exceeding 5.5 percent as recently as the second half of 1988. It is very likely that many of these banks had incurred economic losses which were not reflected in their financial statements.

Supervisory ratings are another source of information about banks. It is useful to analyze how early the supervisory process identified banks that eventually failed as posing a threat to the FDIC fund. CAMEL ratings<sup>2</sup> on the 347 commercial banks and BIF-insured savings banks that failed between January 1, 1989, and September 30, 1990, are presented in Table 2. The data tabulate the time prior to failure that banks were first identified as "problem banks." A "problem bank" is a bank which is assigned a CAMEL rating of "4" or "5" on a scale from one to five, with five being the worst. A CAMEL rating of five is intended to indicate a bank which has a high probability of failure within the next 12 months, and a CAMEL rating of four is intended to indicate a bank which has sufficiently severe problems that, if not corrected, would threaten its viability.

The "problem bank list" is not a list of nonviable banks, but a list of banks which are judged to pose a threat to the insurance fund if their problems are not corrected. Thus, many of the banks which are on the problem list subsequently return to health. At midyear 1990, the problem bank list comprised 1,014 banks, as compared to 208 failure or assistance transactions in 1989.<sup>3</sup>

Of 347 banks that failed between January 1, 1989, and September 30, 1990, 121 (35 percent) were identified as problem banks more than three years before failure. (See Table 2). In addition, 221 banks (64 percent) were identified as problem banks more than two years prior to failure. Furthermore, only three banks were never identified as problem banks before failure. Although not necessarily identified as problems, 201 banks (58 percent) raised supervisory concerns more than three years prior to failure.

Most of the failed banks that were not identified as problem banks (CAMEL "4" or "5") were rated "3." Three-rated banks (as well as 4- or 5-rated banks) receive increased supervisory attention and frequently are subject to enforcement actions. Thus, problems at the failed banks generally did not go undetected even at those banks which were not officially designated as "problem banks." In this regard, specific deficiencies might have been detected by supervisors and reflected in the ratings assigned to specific components of the CAMEL acronym. In addition, one must consider the possibility that the "3" rating was correct but that the bank deteriorated sharply after the exam. In general, however, the assignment of a "3" rating shortly before failure, as opposed to a "4" or "5,"

Table 1

**Reported Equity Capital for Banks That Failed in  
1989, 1982-1988**

Year	Number reporting	Percent of banks with equity below 5.5 percent	Mean equity capital/assets
1982 <sup>1</sup> .....	149	7	0.094
1983 <sup>2</sup> .....	158	8	0.102
1983 <sup>1</sup> .....	167	8	0.097
1984 <sup>2</sup> .....	176	6	0.099
1984 <sup>1</sup> .....	189	10	0.101
1985 <sup>2</sup> .....	195	8	0.096
1985 <sup>1</sup> .....	199	13	0.089
1986 <sup>2</sup> .....	202	17	0.080
1986 <sup>1</sup> .....	205	37	0.065
1987 <sup>2</sup> .....	206	43	0.060
1987 <sup>1</sup> .....	206	68	0.045
1988 <sup>2</sup> .....	206	85	0.029
1988 <sup>1</sup> .....	194	94	-0.011

<sup>1</sup> Call report data from December 31 of the year.

<sup>2</sup> Call report data from June 30 of the year.

Source: Federal Reserve Board.

Table 2

**Examination Data for 347 Failing Banks: Jan. 1, 1989, through Sept. 9, 1990\***

CAMEL rating	Never	Months prior to failure that bank first achieved CAMEL rating						
		Less than 6	6 to 12	12 to 18	18 to 24	24 to 30	30 to 36	Greater than 36
5.....	11	87	79	82	37	18	14	19
4 or 5.....	3	12	26	40	45	58	42	121
3, 4 or 5.....	0	2	5	15	32	46	46	201

\*Includes all commercial and BIF-insured savings banks failing during the same period. Banks receiving assistance are not included. The figures in this table include both CAMEL ratings assigned through the examination process and through other means.

Source: Federal Deposit Insurance Corporation.

indicates that the supervisory process had not detected the severity of the problems.

By and large, supervision and the reported financial data appear capable of identifying banks that could result in losses to the insurance funds. Moreover, the data may identify problem institutions before it is too late for corrective action. At the same time, however, it is also apparent that there are some cases in which problems go undetected, either in terms of reported capital levels, supervisory ratings, or both. Banks may fail to reserve adequately for loan losses because of misguided optimism or deliberate misrepresentation, and this under-reserving will result in overstated reported capital levels. The examination process may fail to detect this misstatement of capital for three reasons. First, some problems may appear suddenly. Second, some banks might not have been examined frequently. That is, the reason a bank is first identified as a "problem bank" less than six months prior to its failure might be that it had not been examined for some period of time. Third, some examinations may fail to detect problems.

Table 3 presents the results of examinations which were performed at various times prior to failure for the 347 banks which failed in 1989 and 1990. For every time period considered, the majority of banks examined were identified as problems. In some cases, however, the examinations appear to have failed to identify problems. Thus, for the 347 banks which eventually failed, there were 165 examinations conducted between 18 and 24 months prior to failure. Thirty-four of these examinations resulted in a CAMEL rating of "3" and six examinations in a rating of "2." Similarly, of the 197 examinations conducted between 12 and 18 months before failure, 19 resulted in ratings of "2" or "3."

Thus, while problem banks generally are identified by supervisors well in advance of failure, there are a fair number of banks whose reported capital appeared adequate and were not identified by supervisors as "problem banks" that suddenly turned out to be unsalvageable. The less problems are recognized, the less possible it is to take early corrective action. Adequate supervisory resources, both in quantity and quality, are important in ensuring prompt corrective action. (Chapter IX analyzes the supervisory process generally.)

It is not possible to demonstrate empirically that the frequency or quality of bank examinations affects deposit insurance costs. Evidence from the 1980s experience for both commercial banks and S&Ls is at least suggestive, however. Until the late 1980s, the examination program for S&Ls emphasized compliance with rules and regulations. By and large, examiners were not trained to evaluate credit quality, and credit quality did not play a major role in examinations. This was a legacy

Table 3

Examination Data for 347 Failing Banks: Jan. 1, 1989, through Sept. 30, 1990 <sup>1</sup>

Time prior to failure	Number of examinations					
	None <sup>2</sup>	One	Two	Three	Four	Five
Less than 6 months.....	23	0	0	1	0	55
6 to 12 months.....	3	0	1	0	20	103
12 to 18 months.....	0	0	2	17	68	110
18 to 24 months.....	0	0	6	34	85	40
24 to 30 months.....	0	0	10	47	81	27
30 to 36 months.....	0	0	23	43	55	12

<sup>1</sup> Includes all commercial and BIF-insured savings banks failing during the same period. Banks receiving assistance are not included. Does not include visits and other supervisory information.

<sup>2</sup> Indicates that the exam was never completed.

Source: Federal Deposit Insurance Corporation.

Table 4

Examination Staff of the Federal Banking Agencies,  
1975-1989\*

Year	Number of staff			
	FRB	FDIC	OCC	FHLBS/OTS
1989.....	974	2,326	2,325	1,159
1988.....	974	1,983	2,363	1,163
1987.....	954	1,909	2,016	3,258
1986.....	914	1,726	1,812	2,981
1985.....	835	1,547	1,787	1,990
1984.....	820	1,389	1,706	1,337
1983.....	809	1,481	1,818	1,368
1982.....	804	1,551	1,642	1,379
1981.....	800	1,655	1,810	1,385
1980.....	836	1,698	2,037	1,308
1979.....	805	1,713	2,151	1,282
1978.....	744	1,760	2,060	N/A
1977.....	653	1,556	2,157	.....
1976.....	724	1,644	2,166	.....
1975.....	644	1,455	2,113	.....

\*For the FDIC, OCC, and Federal Reserve Banks, number of staff are the approximate number of field examiners. For the FHLBS/OTS, the figures for yearend 1988 and 1989 are the number of examiners. For 1987 and prior years, the figures represent estimates of examination and supervision staff—as well as related staff supporting these functions—for the FHLBS/OTS. The examination and supervision staff levels of the FHLBB were, until 1985-1986, subject to administrative spending limitations proposed in the President's Budget and enacted by Congress.

Sources: The internal records of the Federal Reserve Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision.

from the days when S&L assets were primarily one- to four-family mortgages and credit quality was not a major concern. Even when the examiners did detect problems, the supervisory response was often inadequate.

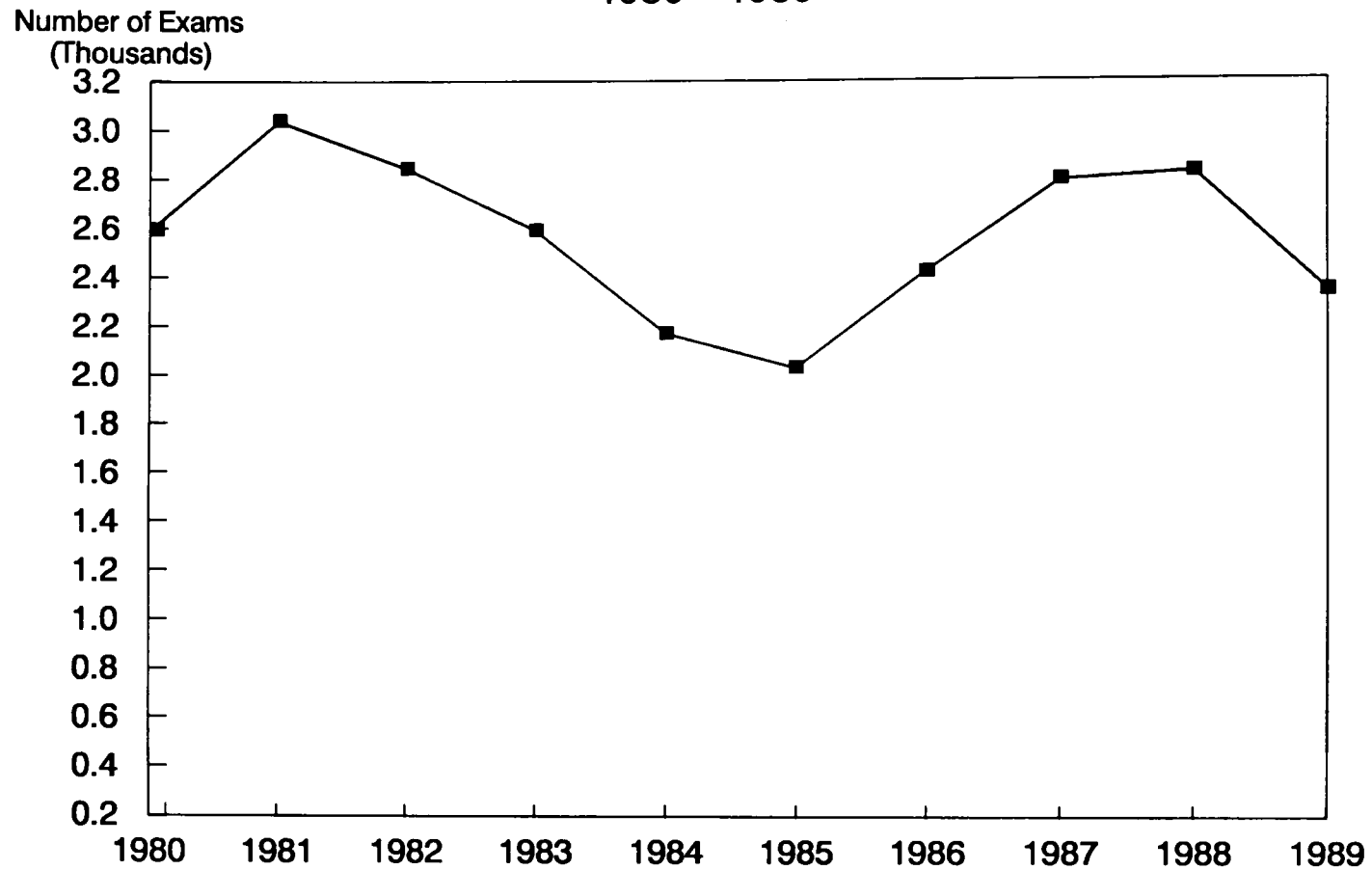
As S&Ls began to expand their activities during the 1980s, in many cases into highly risky ventures, poor credit quality became the main problem facing the industry. The examination program necessary to detect these problems lagged far behind, however. This was due in part to declines in the number of examiners available to the Federal Home Loan Bank Board (FHLBB). (See Table 4 for data on FHLBB examiner resources.) At least some part of the cost of the S&L problem can probably be attributed to deficiencies in the amount and quality of examiner resources and supervisory follow-up which were brought to bear on the S&L industry.

Two of the three commercial bank regulatory agencies also experienced a reduction in examiner resources beginning in the late 1970s and continuing through 1984. As indicated in Table 4, the FDIC's examination staff declined from 1,760 in 1978 to 1,389 in 1984. The OCC's examination staff declined from 2,151 in 1979 to 1,706 in 1984. This reduction in staff may have been caused in part by the pay differential between these agencies and private industry, and certainly by the hiring freeze under which these agencies operated.

The reductions in staff may have been responsible for a nationwide decline in the number of bank examinations from 1981 through 1985 (see Figure 1). This trend was particularly pronounced in the Southwest and especially in Texas (see Figures 2 and 3).<sup>4,5</sup> No one can ever know how much of the FDIC's enormous insurance losses in Texas can be attributed to the decline in examiner resources available to the banking agencies in the early 1980s, or to the substantial decline in examination frequency which occurred there during the mid-1980s. It is at least plausible that if the reduction in examiner resources and examinations had not occurred, problems would have been detected earlier and costs reduced as a result.

Examinations can never be expected to prevent all bank failures or even to detect all high-risk situations in advance. They can, however, go a long way towards preserving the integrity of bank financial statements and helping the supervisors and the insurer identify many potential problem areas. Armed with such information and the necessary commitment and independence to enforce prudent standards, bank supervisors can play a crucial role in controlling the cost of the deposit insurance system.

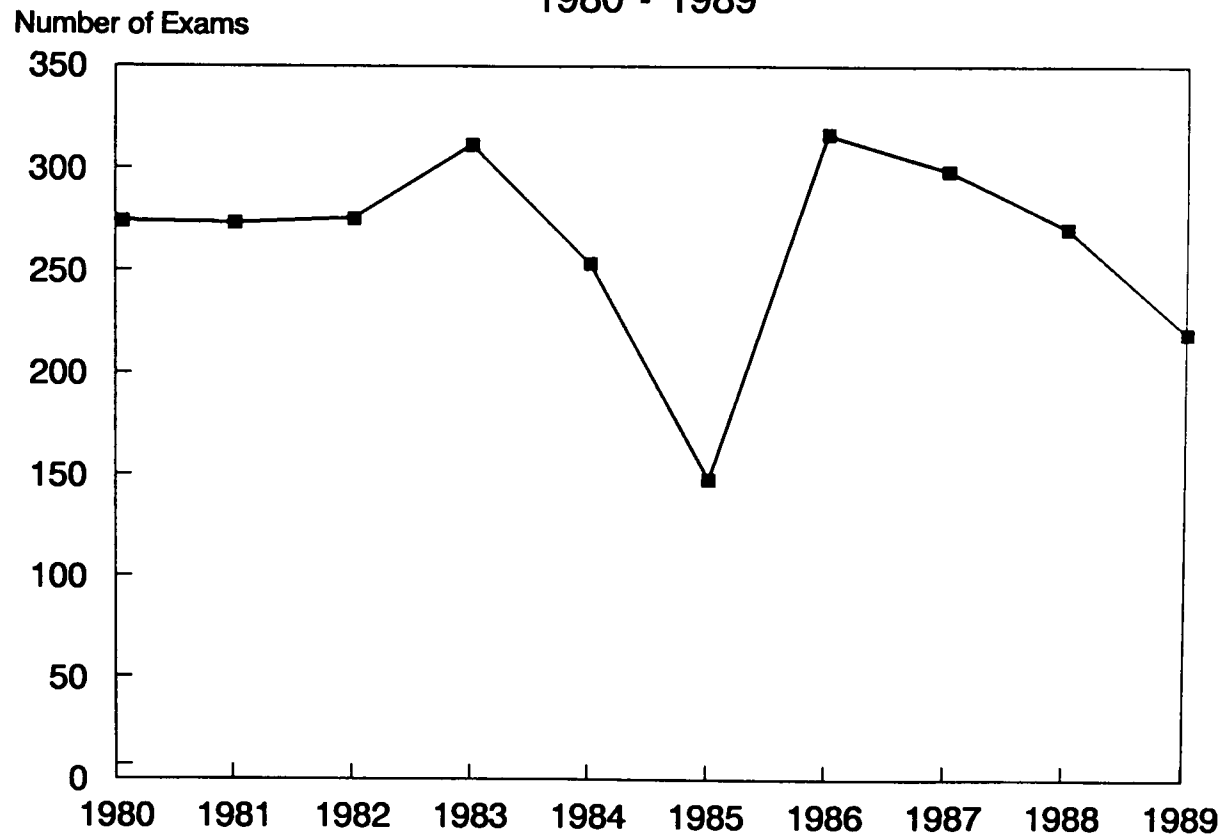
Figure 1  
U.S. Commercial Banks  
Average Number of Examinations per Quarter  
1980 - 1989



Source: Federal Deposit Insurance Corporation.

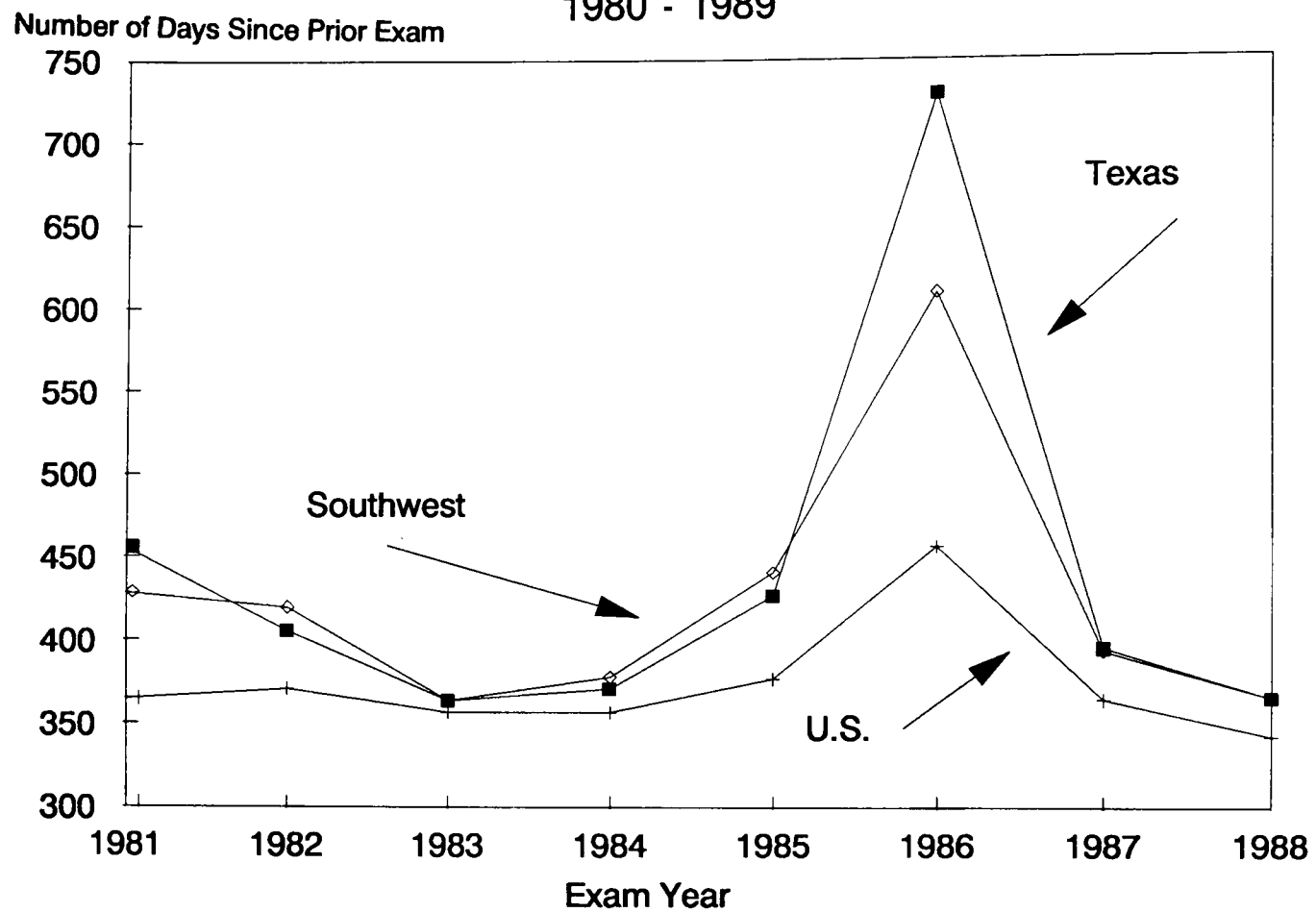


Figure 2  
Texas Commercial Banks  
Average Number of Examinations per Quarter  
1980 - 1989



Source: Federal Deposit Insurance Corporation.

Figure 3  
Median Examination Period (days)  
Failed and Assisted Banks  
1980 - 1989



Source: Federal Deposit Insurance Corporation.

## **2. Supervisory Authority**

The second prerequisite for prompt corrective action is supervisory authority to correct problems once they have been identified. Currently, when a bank's condition begins to deteriorate, the banking agencies have a number of options available to obtain correction. For example, following each examination, and at other times, examiners meet with bank management, including the board of directors, to discuss the bank's performance. These informal discussions often are successful in obtaining corrections of less severe problems.

If a bank is assigned a "3" rating, the agencies generally require some form of written commitment from bank management to take specific corrective actions. These agreements take different forms but frequently are in the form of memoranda of understanding (MOU) or board resolutions, both of which are considered informal administrative vehicles. Use of a board resolution or an MOU, as opposed to a more formal action, is appropriate when the agency believes that the problems are recognized by management and there is confidence in management's intention to make a good-faith effort to eliminate them. Failure to comply with commitments or continued deterioration in the bank's condition may be the basis for a more formal action.

Formal actions available to the banking agencies include cease-and-desist orders, suspension or removal of bank officers or directors, and prohibition of participation by institution-affiliated parties in a bank's affairs when certain conditions are met. The agencies may also impose fines on insured depository institutions and institution-affiliated parties for failure to comply with certain final and temporary cease-and-desist orders, any law or regulation, any condition imposed in writing by the appropriate federal bank regulatory agency relating to an application or request by the depository institution, or any written agreement between the institution and the agency. Insured institutions may also be assessed civil money penalties for filing false or misleading reports.

Since December 7, 1989, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) has prohibited insured institutions that do not meet the minimum capital standards from accepting, renewing, or rolling over brokered deposits, unless, on application to the FDIC on a case-by-case basis, the FDIC determines that acceptance of such deposits does not constitute an unsafe or unsound practice. FIRREA also requires depository institutions not in compliance with minimum capital requirements, as determined by the most recent uniform performance or examination report, to provide the appropriate regulator with 30 days prior notice of a proposed addition to its board of directors or the proposed employment of a senior executive officer.

Undercapitalized institutions supervised by the OTS are subject to growth restrictions. On a case-by-case basis, a thrift not meeting its capital requirements may be permitted to grow in an amount not exceeding the amount of net interest credited to its deposit liabilities if certain conditions are met.

Both the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) have authority to appoint a conservator on the basis of "insufficient capital," although this term is undefined. However, only the OTS may appoint a receiver solely on the basis of "insufficient capital"; the OCC may only appoint a receiver when a commercial bank becomes insolvent. A potentially equally powerful tool for controlling insurance risk is the FDIC's authority under certain circumstances to terminate or suspend a bank's deposit insurance.

### 3. Willingness to Use Supervisory Authority

The third prerequisite for prompt corrective action is the willingness of supervisors to use their authority. It is frequently alleged that supervisors have adequate tools to control bank risk, but lack the incentive to use those tools appropriately. The reasons that have been advanced as to why this might be true are outlined in this section. It is difficult, if not impossible, to evaluate whether supervisors forbear inappropriately from using their full authorities, and no attempt will be made to do so here.

It is often argued by students of political science that regulators tend to be "captured" by the industry they regulate. That is, the regulators are alleged to serve and promote the industry they are charged with regulating. Because of the technical knowledge necessary to regulate some industries, the regulatory bodies may come to be dominated by representatives of the regulated industry. Their common training and exposure may lead the two to think alike on some issues. The prospect of future employment with the regulated industry is alleged to influence the regulators to maintain good relations with the firms under their jurisdiction. The regulators may see their job security and status as tied up with the continued existence and profitability of the regulated industry, and thus may come to see the regulated firms as their constituents. A continual round of meetings and conferences at exotic locations between the regulators and the regulated firms may encourage a notion of a "constituency."

The "capture" of its regulators by a regulated industry is more likely to be achieved by the larger and more "well-connected" members of the industry. Thus, it is argued that the largest banks or trade associations are more likely to receive favorable supervisory treatment. The exercise of supervisory

discretion is particularly pernicious in this view because it is likely to systematically favor one group of banks over another.

Elected officials also influence the behavior of the federal regulatory agencies. To a greater or lesser degree, all federal regulatory agencies serve at the pleasure of Congress and the Administration. The influence of elected government on the regulatory agencies is transmitted through political appointees who serve as top management of the agencies,<sup>6</sup> through the oversight of the Office of Management and Budget for many but not all agencies, and through Congressional hearings and other informal contacts with Congress and the Administration.

It is proper and necessary that federal regulatory agencies be politically accountable for their actions. In the case of the bank regulatory agencies, however, many observers have expressed concern that too much or the wrong kind of political influence has led to inappropriate supervisory forbearance. The most well known expressions of these concerns have arisen in connection with the Federal Home Loan Bank Board.

Kane<sup>7</sup> argues that supervisors have incentives to forbear from prompt closure of insured banks because bank failures and insurance losses make it appear that the supervisors--and elected officials--are not doing a good job. He argues that this was one of the prime motives for the forbearance granted to insolvent S&Ls in the early to mid-1980s. According to this view, supervisors and elected officials did not want to admit that the problem was as large as it was, and so the problems essentially were concealed.

Another view of supervisory forbearance is that it is a natural result of an examination process in which supervisors are confronted with sophisticated new financial products which they may lack the training to understand, and with bank assets that are intrinsically difficult to value. Given the litigious nature of U.S. businesses, bankers may be aggressive in their defense when challenged by supervisors. Given this environment, a rational approach to allocating scarce supervisory resources may be to act so as to avoid court battles. There is also a presumption in our free-enterprise system that the burden of proof is on the government to justify interference with private behavior. The standard of proof may be difficult for regulators to satisfy.

#### **4. Evaluation and Conclusions**

An undercapitalized bank cannot be targeted for early corrective action until it has been so recognized. Thus, the foundation of supervision is the availability of reliable information about banks' economic conditions. Sources of this information are reported financial data and examination results.

In most cases, both sources of information seem to provide ample "early warning" prior to a bank's failure. That is, it is possible to identify that the bank's condition is deteriorating. At this point, even if the bank has already made enough bad loans that economic insolvency cannot be avoided, there is time for "damage control" that will limit the cost of the failure. This includes recapitalization, merger, prevention of inappropriate fund transfers out of the bank, and preventing the bank from taking undue risk in an attempt to return to profitability. In many cases it may not be too late for the bank to return to health, as indicated by the fact that many "problem banks" subsequently recover from their difficulties.

The identification of banking problems by supervisors is far from perfect, however. Both reported financial data and examination ratings sometimes give a misleadingly optimistic picture of a bank's condition until relatively shortly before it fails. And certainly bank supervisors have shown themselves to be no better than other market participants in taking precautionary supervisory measures against large scale economic disturbances, such as the Texas or New England real estate downturns. Thus, without adequate detection of problems, the degree to which early corrective action towards undercapitalized banks can make a difference to the FDIC's costs may be limited.

The ability of supervisors to identify banking problems is of limited usefulness without adequate authority to force corrective action. The various agencies have different powers, which collectively include the power to direct the bank to increase capital, issue cease-and-desist orders, levy fines, remove management, restrict dividend payments, restrict growth and brokered deposits, and appoint a conservator or receiver and, in the case of the FDIC, to terminate or suspend insurance. Federal bank regulatory agencies can issue temporary cease and desist orders to institutions and to institution-affiliated parties, which are effective upon service. Although implementation of these may be delayed by an adversarial debate before a judge while the bank continues to operate in an unsafe condition, most are, in fact, settled without protracted hearings. The Crime Control Act of 1990 requires the federal banking agencies to open formal administrative enforcement hearings to the public, unless the public interest dictates that a hearing should remain private.

There is disagreement whether bank supervisors have adequate powers. Some supervisors contend that the litigious nature of U.S. business coupled with the standards of evidence required in administrative law proceedings make it almost impossible for supervisors to require a bank whose activities are both legal and profitable to hold more capital or employ more prudent operating policies. Thus, the mere potential to suffer losses through concentrations in real estate, for example, might not be

sufficient to sustain an order to increase capital if the loans are current. Other supervisors contend that their powers are adequate, but that the will to use them is lacking. There are many theories about the factors that influence bank supervisors. It is beyond the scope of this paper to evaluate the extent to which these influences exist or have been important. However, it is clear that if early action towards problem institutions is to play an important role in limiting insurance costs, a degree of supervisor independence is desirable.

### **C. Proposals that Encourage Prompt Corrective Action**

An important set of reform proposals would attempt to reduce costs to the FDIC and, potentially, to the taxpayer by improving the supervision of insolvent or nearly insolvent institutions. This includes supervision to control the "moral hazard" problems that arise when an institution's capital is depleted and, when necessary, to require the early reorganization or closure of the institution. Typically, such proposals would subject banks to increasingly severe supervisory sanctions as their capital falls below certain prespecified "trigger points."

#### **1. Supervision to Control Moral Hazard**

##### **General Considerations**

As has been emphasized throughout this Report, as an insured depository's capital is depleted, it has less and less to lose from pursuing high-risk strategies in an attempt to return to profitability. The owners or managers may be tempted to engage in speculative lending or assume greater than normal interest-rate risk. They may be tempted to "milk" the institution through inappropriate dividend payments or other funds transfers. Such behavior has contributed importantly to the cost of resolving failed institutions. These considerations suggest that where a bank has an inadequate capital cushion from an insurance standpoint, increased supervisory oversight or control of the bank's activities may be warranted. Statutorily providing supervisors the authority to impose immediate conditions<sup>8</sup> on banking operations as soon as capital falls below acceptable levels could mimic to some extent the market discipline that would have existed to a greater degree without deposit insurance, and could increase incentives for banks to maintain adequate capital.

Such conditions imposed on bank operations could include any or all of the following: suspension of dividends or other inappropriate fund transfers, restrictions on growth, prohibitions on acquisitions and the exercise of nontraditional powers, and forced divestiture of affiliates or removal of management. Authority for immediate imposition of such

restrictions would end when capital is restored to acceptable levels. The remainder of this section presents general arguments pertaining to proposals to reduce costs to the FDIC by improving the supervision of insolvent or troubled institutions.

One of the central arguments against supervisory imposition of an extensive list of restrictions on bank operations is that this could reduce the bank's franchise value and make failure, should it occur, more expensive for the FDIC. This view is based on the belief that the business judgment of the banker generally will produce better results than would a set of government-imposed rules. Forced removal of management or divestiture of affiliates, or arbitrary restrictions on growth or certain types of lending have the potential to reduce the bank's capacity to generate business and may cause its best customers and personnel to leave.

The counterargument is that in the case of an undercapitalized institution, the business judgment of the bank may be deficient or influenced by improper incentives to grow and take risk. This certainly appears to have been the case for many insolvent and undercapitalized S&Ls throughout the 1980s and in principle this argument applies to both banks and thrifts. Another argument for even the threat of supervisory sanctions is the incentive it provides for banks to maintain adequate capital.

An important question in the implementation of an early corrective action proposal is whether the "trigger points" should be based on GAAP capital ratios or some more conservative measure of capital which incorporates the market value of certain assets (e.g., securities; loans, of course, are more difficult to value). It is frequently argued that it is unfair to penalize banks for fluctuations in the value of high-quality securities due solely to change in interest rates, when these securities are held to maturity. The counterargument is that banks' economic incentives to take risk, and the FDIC's loss exposure, are influenced primarily by market rather than book values.<sup>9</sup>

There also is a question whether imposition of restrictions on bank operations should be mandatory or should be imposed only at the discretion of supervisors. Because of the potential for impairing some banks' franchise values, there is much to be said for avoiding blanket rules which attempt to cover all cases. On the other hand, some would argue that if given the discretion, supervisors will tend to forbear inappropriately from exercising their authority.

Perhaps the best resolution of this dilemma would be a regime in which, in the normal course of events, undercapitalized banks could expect some well-defined and pre-specified supervisory treatment. Deviations from this treatment would be possible at the discretion of supervisors, in the direction of



either greater or less severity, but in either case the burden would be on the supervisors to justify their actions. Such a system might promote supervisory accountability and reduce costs to the insurance fund resulting from inappropriate supervisory forbearance. All in all, the success of such a system is likely to depend upon whether problems can be identified early and timely action taken.

### **Dividend Restrictions**

A separate set of arguments applies to a proposal to strengthen supervision of undercapitalized banks by restricting the payment of dividends, or other inappropriate funds transfers by banks that do not meet their capital requirements. As stated above, most proposals to restrict or control the operations of undercapitalized banks have at least the potential drawback that they might reduce the franchise value of the bank and make a failure more expensive if it occurs. There may be few circumstances, however, in which restricting dividend payments would reduce the franchise value of a bank.

A strong argument can be made that banks not meeting capital requirements should not be allowed to pay dividends or make other distributions of capital. If owners have not put enough capital into the bank to meet supervisory requirements, the argument goes, they should not be able to take capital out of the bank. Funds paid out in dividends by an undercapitalized bank increase the FDIC's cost dollar-for-dollar in the event of a failure or assistance transaction, and correspondingly reduce the share of loss borne by bank owners. In the last analysis, then, the question of whether dividends by undercapitalized banks should be prevented is essentially the question of who should bear the cost of bank failures.

Opponents of eliminating dividend payments by undercapitalized banks argue that banks will be unable to attract capital if investors know that dividend payments will be cut off if the bank falls below its required capital level. The argument is one of degree. For example, suppose banks were never allowed to pay dividends under any circumstances, on the grounds that there is always some small probability that a bank will fail and that the dividend would have increased the FDIC's cost if the failure occurred. Under this rule, no one would invest in bank stock. On the other hand, if a bank's failure is a certainty, it is clearly appropriate to prevent dividend payments. Between these two extremes, there is some threshold of safety and soundness below which banks should be prevented from paying dividends. The supervisory capital requirement is an arbitrary, but logical, point at which to draw this line.

Preventing dividend payments by banks not meeting their capital requirements will not prevent most banks from attracting

capital. Some banks not meeting their capital requirements will be forced to recapitalize through earnings retention. For banks that investors judge to have more than a minimal probability of failing their capital requirements, capital may become more costly. It can be strongly argued, however, that this would be an entirely appropriate result of shifting more of the burden of handling bank failures to bank owners and away from the FDIC.

As with the other proposals to strengthen supervision of undercapitalized banks, one of the most important benefits of preventing dividend payments by banks not meeting their capital requirements would be to give bankers the incentive to maintain adequate capital. Presumably, management would come under substantial pressure from bank owners to avoid a situation where dividends were suspended.

Data on dividend payments by U.S. commercial banks from 1980 through 1989 are provided in Table 5. In 1989, 9,119 banks (72 percent of the industry) with \$2.8 trillion in assets paid dividends, while 3,586 banks with \$476 billion in assets did not. The number of banks paying dividends has increased only slightly during the noted time-period. In the aggregate, dividend payments have remained fairly constant, while bank income has fluctuated. For example, in 1986 net income was more than double aggregate dividend payments, while in 1987 dividends were more than double net income.

There have been a number of cases in which undercapitalized, unprofitable banks have paid dividends. In 1989, for example, 18 banks with equity ratios between zero and three percent, with an aggregate return on assets of -2.64 percent, paid dividends amounting to 35 basis points of assets. Such examples are not confined to 1989, as is evident from Table 5.

It is noteworthy that of the 181 banks with equity ratios between zero and three percent at yearend 1989, the 161 banks that did not pay dividends had an average size of \$102 million, while the 18 banks that did pay dividends had an average size of \$4.7 billion. Similar size differences appear in other years. One explanation of this difference may be that owners of small banks take funds out of their banks in other ways (e.g., salaries and fees). Also, most large bank stocks are viewed as income, rather than growth, securities. In addition, these large institutions must access the public market for funds. Therefore, they will suffer harsher consequences from ending dividend payments than from the reduction in capital resulting from dividend payments.

## **2. Early Reorganization**

A substantial body of opinion in both academic and regulatory circles suggests that the supervisory process tends to

Table 5

## Dividend Payments by U.S. Commercial Banks

(In millions of dollars)

Year	Not paying dividends			Paying dividends						All banks		
	Capital ratio range	Number	Assets	Average size	Number	Assets	Average size	Equity to assets (percent)	Average size (percent)	Dividends-to-assets (percent)	Number	Assets
1989												
Less than or equal to 0 percent.....	79	23,249	294	3	188	63	-6.38	-12.23	0.18	82	23,437	
0 to 3.0 percent .....	163	16,604	102	18	84,727	4,707	2.52	-2.64	0.35	181	101,331	
3.0 to 4.5 percent ..	212	98,814	446	50	259,320	5,186	4.21	-0.38	0.28	262	358,134	
4.5 to 6.0 percent ..	526	103,759	197	502	1,108,559	2,208	5.10	0.38	0.42	1,028	1,212,318	
Greater than 6.0 percent.....	2,606	233,255	90	8,546	1,370,465	160	7.68	1.07	0.60	11,152	1,603,720	
Total.....	3,586	475,661	133	9,119	2,823,259	310	6.19	0.55	0.49	12,705	3,298,920	
1988												
Less than or equal to 0 percent.....	98	19,274	197	6	1,910	318	-3.77	-9.90	0.26	104	21,184	
0 to 3.0 percent .....	234	24,767	106	19	23,620	1,243	2.70	-0.06	0.08	253	48,387	
3.0 to 4.5 percent ..	216	204,027	945	63	75,239	1,194	4.15	0.59	0.46	279	279,266	
4.5 to 6.0 percent ..	581	197,645	340	542	1,202,787	2,219	5.37	0.99	0.49	1,123	1,400,432	
Greater than 6.0 percent.....	2,839	205,130	72	8,522	1,176,484	138	7.75	1.06	0.58	11,361	1,381,614	
Total.....	3,968	650,843	164	9,152	2,480,041	271	6.43	0.99	0.53	13,120	3,130,884	
1987												
Less than or equal to 0 percent.....	72	9,136	127	5	794	159	-4.03	-11.71	0.10	77	9,930	
0 to 3.0 percent .....	242	13,903	57	30	102,810	3,427	2.45	-2.34	0.24	272	116,713	
3.0 to 4.5 percent ..	277	136,229	492	87	356,322	4,096	3.74	-1.06	0.29	364	492,551	
4.5 to 6.0 percent ..	642	108,166	168	597	982,631	1,646	5.20	0.10	0.38	1,239	1,090,797	
Greater than 6.0 percent.....	3,178	251,343	79	8,564	1,033,060	121	0.78	0.96	0.53	11,742	1,284,403	
Total.....	4,411	518,776	118	9,283	2,475,618	267	5.97	0.19	0.43	13,694	2,994,394	
1986												
Less than or equal to 0 percent.....	68	3,408	50	4	188	47	-1.06	-7.45	0.41	72	3,596	
0 to 3.0 percent .....	182	17,107	94	30	2,553	85	1.84	-4.11	0.27	212	19,660	
3.0 to 4.5 percent ..	256	121,757	476	83	142,545	1,717	4.27	0.24	0.21	339	264,302	
4.5 to 6.0 percent ..	797	154,944	194	894	1,357,403	1,518	5.27	0.67	0.29	1,691	1,512,347	
Greater than 6.0 percent.....	3,164	190,419	60	8,710	950,350	109	7.76	0.96	0.51	11,874	1,140,769	
Total.....	4,467	487,637	109	9,721	2,453,038	252	6.17	0.75	0.37	14,188	2,940,675	

Source: Federal Deposit Insurance Corporation.

close or reorganize undercapitalized banks much too late. In this context, "too late" means that insurance costs are needlessly compounded by the continued operation of undercapitalized banks that the supervisors allegedly should have resolved earlier. A reform prescription that arises from this concern is for supervisors to reorganize banks while they still have some book capital. An alternative, but related, reform would be to change the accounting rules to force an earlier (and presumably more realistic) recognition of insolvency. The latter type of reform is discussed in Chapter XI; the former, the "early closure" proposals, are discussed below.

### **General Considerations**

It is important at the outset to distinguish between two very different views as to why early reorganization might be appropriate. One view is that banks should be closed when they are economically insolvent or "nonviable." The argument contends that under any accounting system, troubled banks' financial reports are likely to be overly optimistic. Consequently, it is necessary to build a "fudge factor" into the closure rule and close banks when their reported capital falls below some positive number. The alternative view is that supervisors should be able to reorganize or close banks based solely on the basis of their operating in an unsafe and unsound condition, regardless of any judgement of "viability." In this view, insurance would be provided under the mutual understanding of all parties that if capital drops below some predetermined level, the bank is by definition unsafe and unsound and must be recapitalized.

These two views have different implications for the operation of an early closure policy. Proponents of the first view would probably argue for considerable supervisory discretion in determining which undercapitalized banks are viable and which are not. Those favoring the second view would not be troubled by mandating supervisors to close or reorganize any bank determined to be operating in an unsafe and unsound manner (even if arguably viable in the long-term).

Under any early reorganization policy that is not based on impersonal, market-determined events, there will be an element of subjectivity and, hence, confrontation, in determining whether a bank falls below the capital cutoff. This is because many loans are not readily marketable. For many borrowers, reliable information about their financial condition and repayment prospects is not publicly available. Banks find profitable investment opportunities by evaluating the credit quality of these borrowers. The limited information available to potential purchasers prevents the development of a well-functioning secondary market for such loans, so that there is no readily ascertainable "market price" for most bank assets. Given this uncertainty about the value of many bank assets, due process

would probably require the existence of some sort of appeal process.

### Arguments For and Against Early Reorganization

The most convincing evidence that delay in closure exists is the continued operation of hundreds of insolvent S&Ls throughout much of the 1980s. One can also argue that the supervisory process for commercial banks has tended to close banks "too late." In this regard, the FDIC's recent bank failure cost experience is presented in Table 6. Depending on the type of transaction and the size of the bank, the FDIC's average costs have ranged from 10 percent to 51 percent of failed bank assets. Clearly, despite the existence of some deadweight costs of reorganizing or liquidating banks, most banks are substantially economically insolvent at the point they are formally recognized as being book insolvent.

Although these numbers suggest that banks are not being closed soon enough, other factors must also be considered. First, bank capital may move very discontinuously over time. For example, a bank with 10 percent capital might make some bad lending decisions and suddenly have an economic net worth of minus thirty percent. In cases like this, there will be no gradual deterioration of economic net worth which supervisors could have identified, and "early reorganization" will be irrelevant.

Second, one must note that losses in failed commercial banks, as a percentage of bank assets, appear to be lower in recent years than they were in the 1921-1933 period, prior to the introduction of deposit insurance. Thus, as indicated in Table 7, depositor losses in the 1921-1933 period amounted to 22 percent of deposits in suspended<sup>10</sup> commercial banks. In contrast, the FDIC's total estimated loss was only 15 percent of the total assets in failed and assisted banks reported in Table 6. Since the 1921-1933 period was a time when depositors and other market forces decided when to close banks, one should not be too hasty to lay the blame for commercial bank failure costs in the 1980s to supervisory forbearance.

Third, there are considerable deadweight costs associated with reorganizing or liquidating a bank. Any policy that results in closing banks that would not otherwise have been closed, will be beneficial only if the savings associated with closing nonviable banks earlier exceeds the extra deadweight costs of closing viable banks unnecessarily. These costs include the administrative cost to the FDIC of structuring transactions; costs to the acquirer of merging the troubled bank into its organization; and especially, costs that acquirers must incur for asset reviews and the discounts they will demand to buy assets of uncertain quality. It is sometimes argued that this last

**Table 6**  
**Bank Failure Costs to the FDIC**  
(In millions of dollars)

Year and transaction type <sup>1</sup>	Number	Total assets	Assets retained by FDIC	Assets acquired <sup>2</sup>	FDIC loss reserve <sup>3</sup>	Reserve assets (percent)
1987						
Payoff and Liquidation.....	11	\$350	\$348	\$2	\$122	3
Insured Deposit Transfer .....	40	2,223	1,251	972	660	2
P&A—"Clean Bank".....	114	3,764	1,630	2,135	1,124	2
P&A—"Whole Bank".....	19	584	70	514	84	1
1988						
Payoff and Liquidation.....	6	136	135	0	50	3
Insured Deposit Transfer .....	30	1,271	589	682	429	3
P&A—"Clean Bank".....	54	1,490	655	835	472	3
P&A—"Whole Bank".....	70	3,665	167	3,497	545	1
1989 <sup>4</sup>						
Payoff and Liquidation.....	7	483	483	0	244	5
Insured Deposit Transfer .....	22	1,627	1,007	620	582	3
P&A—"Clean Bank".....	58	3,025	1,158	1,867	869	2
P&A—"Whole Bank".....	31	1,072	123	949	215	{
Large Banking Organizations <sup>5</sup> .....	9	75,874	N/A	N/A	8,435	11

<sup>1</sup> The mechanics of the various transaction types are described elsewhere in the Report.

<sup>2</sup> This column gives the amount of the failed bank's assets purchased by the acquiring entity.

<sup>3</sup> As of September 30, 1989.

<sup>4</sup> Includes only failures occurring prior to September 30, 1989.

<sup>5</sup> The Bowery Savings Bank, First National Bank & Trust Co. (OK), BancTexas, Syracuse Savings Bank, First City Bancorporation, First Republic Bank Corp., Texas American Bancshares, and National Bancshares Corporation (TX).

<sup>6</sup> In some of these transactions, assets can be put to the FDIC at the discretion of the acquirer, so the distinction between retained and acquired assets becomes less meaningful.

Source: Federal Deposit Insurance Corporation.

**Table 7**  
**Depositor Losses in Commercial Bank Suspensions,\***  
**1921-1933**  
(In millions of dollars)

Year	Deposits in U.S. commercial banks	Deposits in suspended banks	Depositor losses	Losses-to-deposits (percent)
1921 .....	33,432	173	60	34.7
1922 .....	35,532	91	38	41.8
1923 .....	38,175	150	62	41.3
1924 .....	41,343	210	79	37.6
1925 .....	45,230	167	61	36.5
1926 .....	46,952	260	83	31.9
1927 .....	48,704	199	61	30.7
1928 .....	49,582	142	44	31.0
1929 .....	49,385	231	77	33.3
1930 .....	51,267	837	237	28.3
1931 .....	47,277	1,690	390	23.1
1932 .....	35,658	706	168	23.8
1933 .....	32,078	3,597	540	15.0
Total.....	N/A	8,453	1,900	22.5

\* "Suspensions" refers to suspensions of depositors' ability to convert deposits into currency.

Source: Milton Friedman and Anna Schwartz, "A Monetary History of the United States," p. 438, and U.S. Department of Commerce, "Historical Statistics of the United States, Colonial Times to 1970, Part II"

category of cost can be reduced sharply by providing the acquirer with ongoing protection against losses on acquired assets. Such arrangements have their own costs, however. There are costs associated with monitoring these agreements, and the loss protection given acquirers may sharply limit their incentives to do a good job managing the acquired problem assets. Finally, FDIC removal and liquidation of the problem assets would result in administrative costs and liquidation losses.

The simplest argument against the proposal is that without the consent of owners and creditors, early closure might involve confiscating private property. Because of the reorganization costs just enumerated, bank owners may see their investment reduced in value or wiped out by a government-imposed reorganization. The inevitable uncertainty involved in assigning a value to illiquid bank assets could make this process somewhat arbitrary and subject to legal challenge. The arbitrariness of the process would not be the most substantive counterargument, however, since the current system also relies on subjective examiner judgments about asset values. The more pointed question is whether the government should take, or cause to be reduced in value, owners' positive equity in their bank.

A related issue is whether a statutory scheme requiring, under certain circumstances, the sale, merger, or liquidation of a technically solvent bank could result in an unconstitutional taking of property from the investors in the bank or thrift or its parent holding company. The Fifth Amendment to the Constitution states, 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." Case law has established that contract rights are property protected by the Fifth Amendment.

However, all contractual arrangements are subject to regulation by the government. Accordingly, the establishment of a statutory framework for prompt corrective action and early closure that would place investors on notice that their property rights in the organization might be affected by future regulatory actions, would appear to resolve the constitutional taking issue with respect to those shareholders and bondholders who acquired their interest in the organization after passage of the legislation.

The constitutional issue is more difficult with respect to those whose investments predate the passage of prompt corrective action legislation. The courts have held that retroactivity is not necessarily fatal to an administrative agency's order; however, they have also held that the government's power to modify existing contracts is not without limits. Nevertheless, there are several arguments that would support a finding that regulatory action under a prompt corrective action statute would

not constitute an unconstitutional taking, even with respect to those investors whose ownership interest predated the legislation.

First, one protection could be preventing regulatory action that could even be considered a "taking" until the investors had been given several opportunities to submit and implement a capital plan and had failed to do so. Placing the bank in conservatorship or receivership would be the last in a series of well-defined actions to be taken by the regulators.

Second, the fact that the bank is technically solvent under accepted accounting standards does not by itself imply that there is a taking of property with economic value. The loss experience of the insurers in closing banks and thrifts should make it clear that the economic value of the institution generally disappears while the institution still has positive regulatory capital. As long as the level of positive capital at which the appropriate regulatory authority must place an institution in receivership or conservatorship is not unreasonably high, requiring such actions should not be considered a taking. In this regard, FIRREA specifically authorizes the OCC to appoint a conservator for a national bank, and the OTS to appoint a conservator or receiver for a state or federal savings association, when the institution has "substantially insufficient capital."

Finally, there is a body of law that would support the proposition that an investor in an institution that benefits from government subsidies, such as federal deposit insurance and access to the Federal Reserve discount window, accepts the regulatory conditions associated with those benefits. Accordingly, the investor in such an institution, having taken advantage of the provisions of the statute that enhance the institution's value, could be estopped from contesting the reasonable burdens and conditions imposed by that statute.

Apart from the argument that most banks tend to be substantially insolvent when they are closed, there are other arguments in favor of early reorganization of troubled, but solvent, banks. Owners or other insiders of a poorly capitalized bank may have incentives to make speculative investments in an attempt to recover from their difficulties, or to "milk" the bank to the greatest extent possible prior to what they regard as its eventual failure. Troubled institutions may suffer substantial deterioration in franchise value the longer they remain open, as the best personnel and customers leave in search of more permanent business relationships with healthier institutions. Losses may be exacerbated by excessive operating expenses or mismanagement. Early reorganization can mitigate these problems of moral hazard and deterioration in value.



Another argument in favor of early reorganization may be gleaned from Table 6. Notice that over time, the largest banking organizations tend to have had the lowest resolution costs. One explanation for this is probably that these institutions are watched closely by supervisors and have tended to be resolved earlier (as measured by the time the institutions have been deteriorating) than smaller banks. If this is an explanation for the lower resolution costs of large banks, as is likely, it adds credence to the view that early reorganization can make a difference to the FDIC's costs.

Another argument in favor of early reorganization relates to the division of a bank's liabilities between insured and uninsured. As a bank's problems become more and more apparent, uninsured deposits and other general-creditor liabilities tend to leave the bank and to be replaced by insured deposits or secured liabilities. This increases the cost to the FDIC of handling the bank if it eventually fails.

It could be argued that since the FDIC handles most bank failures by P&A and generally elects to protect fully all depositors, the bank's mix of insured and uninsured deposits should make no difference to the FDIC's cost. This is incorrect for two reasons. First, as between a P&A and a payoff of insured deposits and liquidation, the FDIC generally is required to pursue the cheaper alternative.<sup>11</sup> For a given deposit base, a high percentage of uninsured deposits can make a payoff cheaper than a P&A and thereby reduce the FDIC's costs. Conversely, allowing uninsured deposits time to leave the bank can make a payoff more expensive, forcing the FDIC to do a P&A and increasing the FDIC's costs.

Second, the FDIC currently handles most bank failures in such a way that most unsecured nondeposit liabilities are not made whole, but receive only the pro rata payment they would have been entitled to in a liquidation. Thus, if these nondeposit unsecured liabilities leave the bank over time and are replaced by insured or secured liabilities, the FDIC's cost must increase. On balance, there appear to be considerable benefits associated with early reorganization of solvent but financially troubled institutions, but these must be weighed carefully against the possibility of incurring needless insurance outlays.

### **Reducing Supervisory Discretion in the Closure Decision**

The early closure proposal discussed above would allow supervisors to reorganize a solvent, but troubled, bank when its capital fell below a certain level. Other reform proposals would require such supervisory action. There are several observations that should be made about mandatory vs. discretionary early reorganization. (A more general discussion of the rules vs. discretion issue is provided in Chapter III.)

Mandatory early intervention proposals are based on the view that the influences and incentives facing bank supervisors tend to give them the incentive to forbear inappropriately from taking action against troubled institutions. These alleged incentives to forbear, in conjunction with the potentially considerable costs of delaying closure, provide the argument for removing supervisory discretion in the closure process.

The argument in favor of retaining some degree of supervisory discretion is based on the costs associated with reorganizing a troubled bank. In light of these costs, it is argued that less draconian approaches to enforcing capital compliance may be more cost-effective. In short, supervisory forbearance in the closure process may sometimes be the result not of cowering to the banking industry, but of a rational calculus of cost minimization.

Additionally, implementing a "mandatory early reorganization policy" might simply cause the exercise of supervisory discretion to be pushed one step farther back, to the examination process. Thus, if requiring a writedown or reserve for certain bank assets will push its book capital below the critical level that would force its reorganization, supervisors are likely to weigh carefully the advantages and disadvantages of requiring such writedowns. Alternatively, supervisors simply might elect to postpone examining a particular bank. The result may be to reduce the integrity of banks' financial statements. In addition, bankers would be likely to challenge a supervisor's decision that the criteria for mandatory intervention are satisfied.

There are several proposals under which supervisors would automatically be forced to close a bank when some market-determined event occurred. For example, in a regime in which the FDIC was statutorily prevented from paying more than its insurance obligations, runs by uninsured depositors could force a bank's closure. Similarly, supervisors could be required to close a bank if it is unable to attract and rollover subordinated debt in some minimum percentage of assets. Alternatively, supervisors could be required to close a bank if it is unable to obtain private insurance for a portion of its liabilities.

An example of an automatic early reorganization mechanism is Wall's "puttable subordinated debt" plan,<sup>12</sup> also discussed in Chapter II. Under Wall's plan, large banks would be required to issue and maintain on their balance sheets "puttable" subordinated debt in some specified percentage of risk-weighted assets, say four or five percent. "Puttable subordinated debt" is subordinated debt which is subject to immediate repayment on demand by lenders. Supervisors would be required to declare insolvent any bank failing to maintain the minimum percentage of subordinated debt.

The puttable subordinated debt proposal, and other proposals that might be devised, are similar in that closure would be based on a market judgment of viability, rather than on a supervisory or examiner judgment. This would have the advantage of imposing more market discipline on banking and eliminating supervisory forbearance. A disadvantage of these proposals is that, as pre-deposit insurance experience indicates, the "market" can suddenly and disruptively close even solvent banks. This is because the illiquid nature of bank assets gives uninsured creditors the incentive to be at the head of the withdrawal line if they believe there is even a possibility of the bank's failure. Early closure of solvent banks is likely to result in unnecessary insurance costs in addition to any disruption of economic activity that might occur. (Chapter III discusses the trade-off between systemic stability and market and depositor discipline.)

There would be another disadvantage of the proposal if any of the puttable subordinated debt were allowed to be held by the bank's holding company or, more generally, by its owners. The owners could cash in the subordinated debt and allow the bank to fail, resulting in increased deposit insurance costs. This would be a legal way for insiders to "milk" the bank by passing on the costs of bank failures to the insurance funds or the taxpayers. This problem relates to the general question of whether subordinated debt owned by bank owners should count as bank capital. A strong argument against this is that subordinated debt can be used to circumvent dividend restrictions, because regulators cannot cut off scheduled payments of principal and interest on subordinated debt by a bank that is technically solvent.

#### **Other Proposals for Early Reorganization**

Early closure proposals have been put forth by the Brookings Institution,<sup>13</sup> the Shadow Financial Regulatory Committee,<sup>14</sup> and at least one member of Congress (*i.e.*, S. 3103, which was introduced by Senator Riegle).<sup>15</sup> These three proposals are very similar. The Brookings proposal and the Shadow Committee proposal each divide banks into four groups, or "capital tranches," with progressively more stringent supervisory actions applied to banks in the weaker tranches; S. 3103 envisions three tranches.

An "adequately capitalized" group of banks would be largely free of supervisory interference apart from the broad framework of safety and soundness regulation. In the Shadow proposal, the cutoff capital ratio for this group is 10 percent; in the Brookings proposal, it is eight percent; and in S. 3103, it is an undetermined minimum capital ratio to be set by the supervisors.

In the Brookings and Shadow proposals, there is a "weakly capitalized," or "first level of concern," group which would consist of banks with capital ratios of six to eight percent or

six to 10 percent, respectively. Under these proposals, supervisors would have the discretion to require a bank in the weakly capitalized group to submit a business plan to increase capital, to cease paying dividends, to limit growth, or to reduce excessive concentrations of risk.

The Brookings and Shadow proposals identify a group of banks with capital ratios between three percent and six percent as "inadequately capitalized," or "second level of concern." Under both proposals, banks in this group would be prohibited from paying dividends or interest on subordinated debt, and from making unapproved outflows of funds to affiliates. They would also be prohibited from growing and would generally come under heavy supervisory scrutiny. S. 3103 would require similar treatment for banks with capital below an undefined minimum capital ratio and above an undefined "critical capital ratio."

Under the Brookings and Shadow proposals, a "solvency endangered," or "mandatory recapitalization," group is identified as those banks with capital ratios less than three percent. Supervisors would be required to close, reorganize, place into conservatorship, or otherwise resolve banks in this group if they fail to recapitalize themselves promptly. In S. 3103, the same treatment is mandated for banks whose capital ratio falls below a "critical level" determined by supervisors.

The Brookings proposal would include both on and off-balance sheet items in determining the capital ratio and would use market values, rather than book values, where possible (further details are not specified). The Shadow Committee advocates the use of market values in determining the capital tranches. S. 3103 advocates defining the tranches in terms of market values to the extent feasible.

#### **D. Prompt Corrective Action and Costless Bank Failures**

Prompt corrective action may result in costless bank failures if early closure is always possible. However, early closure is not always possible because bank assets are difficult to value, and even if market values are available, economic shocks may cause rapid changes in those values. Thus, the FDIC may incur losses even when operating under a policy of prompt corrective action and early closure.

A recent legislative proposal would require that capital requirements be set high enough and intervention early enough that the FDIC would incur no costs (S. 3103, the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1990, introduced by Senator Riegle on September 25, 1990.) To protect the FDIC against losses in all cases, however, the capital buffer

at insured institutions may need to be excessively high--higher than what is socially optimal.

Some perspective on this issue can be gained by inspecting the FDIC's bank failure costs over the past several years as presented in Table 6. Costs typically have ranged between 30 and 50 percent of banks' total assets at the time of failure in payoffs and insured deposit transfers. These resolution methods generally have been used in disposing of the least desirable and most severely troubled franchises, and so, not surprisingly, have the highest cost. Among the small bank failures, the cheapest transactions have been for banks which were sufficiently attractive that investors were willing to acquire most of the assets--"whole bank" P&As. These transactions have cost between 10 and 15 percent of assets.<sup>16</sup> Finally, transactions involving the very largest banking organizations have typically been cheapest as a percentage of bank assets, with costs over a five year period averaging 11 percent of assets.

Earlier closure would have lowered FDIC costs in these cases. However, assuming that early closure would not have been possible in all cases, because, for example, problems developed too quickly, then the capital buffer that would have been required to avoid imposing any costs on the FDIC may have been substantial. Excessively high capital requirements would reduce the lending function of banks. It is therefore possible that the level of financial intermediation in the economy would fall significantly.

In short, if the goal is to eliminate the FDIC's loss exposure entirely, a more direct approach is to mandate an extreme version of narrow banking in which banks hold only investment grade securities. Prompt corrective action may have substantial benefits in reducing the FDIC's loss exposure, but to eliminate that exposure entirely would require drastic changes in the nature of the banking business.

#### E. Public Comments

Most comments concerning the issue of early closure favored the idea. Specifically, the Federal Reserve Banks of Richmond and Cleveland, several banks and savings and loan associations, the Shadow Financial Regulatory Committee, the CATO Institute, the New York Clearing House, and some private consultants supported such a policy.

## Endnotes

<sup>1</sup> The regulatory capital requirement for banks throughout much of the 1980s was 5.5 percent primary capital and 6.0 percent total capital. These capital measures include loan loss reserves, however, which are not included in equity capital.

<sup>2</sup> CAMEL is an acronym for capital, asset quality, management, earnings, and liquidity. Each of these five components is rated by supervisors and a composite rating, the CAMEL rating, is assigned. CAMEL ratings can change not only as a result of an on-site full-scope examinations, but also through the ongoing process of supervisory monitoring. A similar supervisory rating for thrifts is referred to as a MACRO rating.

<sup>3</sup> The percentage of banks on the problem list that eventually fail cannot be obtained by dividing annual failures by the number of banks on the list. This is for two reasons: (1) economic conditions could change; and (2) even with unchanging economic conditions, the result of the calculation would be biased unless banks happened to stay on the list for precisely one year. For example, if 10 banks per year entered the list, stayed on the list for 5 years, and then failed, in the "steady state" one would observe 50 banks on the list and 10 failures per year, for an estimated failure rate of 20 percent. The true failure rate, however, would be 100 percent.

<sup>4</sup> These figures are from John O'Keefe, "Causes and Consequences of the Texas Banking Crisis, 1980-1989," internal FDIC study, July 1990.

<sup>5</sup> The dip in the number of commercial bank examinations in 1989 pictured in Figure 1 was probably caused by the FDIC's examination of many formerly FSLIC-insured thrifts.

<sup>6</sup> In some agencies political appointees serve well down into the ranks of management, while others have only a few appointees.

<sup>7</sup> See, for example, Edward Kane, The S&L Insurance Mess, Chapter 4.

<sup>8</sup> Note that due process requirements may be a complicating factor.

<sup>9</sup> For a complete discussion of market-value accounting, see Chapter XI.

<sup>10</sup> "Suspended" refers to the suspension of convertibility of deposits into currency.

<sup>11</sup> A full discussion of how the FDIC handles bank failures can be found in Chapter I. Note that the FDIC is not required to choose the insured deposit transfer method of resolution, even if it is cheaper than either the P&A or the insured deposit payoff.

<sup>12</sup> See Larry Wall, "A Plan for Reducing Future Deposit Insurance Losses: Puttable Subordinated Debt," Federal Reserve Bank of Atlanta, Economic Review, July/August 1989, pp. 2-17.

<sup>13</sup> "Blueprint for Restructuring America's Financial Institutions--Report of a Task Force," The Brookings Institution, 1989.

<sup>14</sup> "An Outline of a Program for Deposit Insurance and Regulatory Reform," Shadow Financial Regulatory Committee Statement No. 41, February 13, 1989.

<sup>15</sup> S. 3103, the "Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1990," introduced on September 25, 1990.

<sup>16</sup> It cannot be overemphasized that one cannot use the difference in cost between a payoff (30-50 percent of assets) and a whole-bank P&A (10-15 percent of assets) as a measure of the difference in costs between government vs. private sector liquidation of assets. This is because whole-bank transactions are done only if they are estimated to be less expensive than a payoff and liquidation. Thus, to some extent, costs in whole-bank P&As are not lower because of the transaction type; rather, the whole-bank transaction was used because the failed bank was in relatively good condition compared to other failed banks. Most observers believe there is a cost advantage associated with leaving failed bank assets in the bank as opposed to placing them in government liquidation. However, because of the self-selection problem, it is very difficult to measure this cost difference.

## **Chapter XI**

### **MARKET VALUE ACCOUNTING**

#### **A. Introduction**

Title X of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) directed that this Report investigate, review and evaluate the feasibility of market value accounting (MVA) for depository institutions. MVA has been proposed as a means of improving the quality of financial accounting information about depository institutions, which would be required to provide in their financial reports estimates of fair market values for assets, liabilities, and off-balance sheet items.

This chapter examines issues raised by MVA. The discussion begins with a review, in Section B, of current accounting standards for depository institutions and recent developments that have increased the need for timely and accurate financial information about these institutions. Section C presents the case for MVA as a framework for the recognition and measurement of resources and obligations of depository institutions in financial reports. Sections D through G evaluate four broad categories of objections to market value accounting dealing with its relevance, reliability, cost, and potential economic consequences. Since the options for improving the quality of financial information about depository institutions are not limited to comprehensive MVA and the current accounting framework, Section H discusses several additional alternatives. These include the adoption of market value accounting only for marketable assets; the provision of greater market value information through supplemental disclosures such as footnotes; and the disclosure of additional raw data that could be employed by users of financial statements to construct their own market value estimates or for other purposes.

#### **B. Current Accounting Standards**

##### **1. Background**

The preceding chapters noted that the present deposit insurance system creates moral hazard incentives for depository institutions to assume excessive risk. Approaches to mitigate this problem include regulatory policies to reduce the likelihood and costs of depository institution failures, and proposals that would shift failure costs to the private sector, thereby



encouraging greater private market discipline of depository institutions.

Implicit in both approaches is the assumption that regulators or private markets have sufficient information to monitor the true economic conditions of depository institutions in a timely manner. In general, the better the quality of this information, the more effective would be public and private sector discipline.

Accounting standards shape the nature of much of the financial information about individual firms that is available to guide economic and regulatory decisions. Such standards provide guidance on the timely presentation of information in financial statements and related disclosures.<sup>1</sup> In the United States, financial statements audited by Certified Public Accountants (CPAs), including those of banking and thrift organizations, must conform with generally accepted accounting principles (GAAP).<sup>2</sup>

The hierarchy of accounting rules that constitute GAAP include, at the most authoritative level, standards and interpretations promulgated by the Financial Accounting Standards Board (FASB). Auxiliary sources of GAAP include other FASB pronouncements, formal interpretations by the SEC, statements of position and other guidance of the American Institute of Certified Public Accountants (AICPA), and prevalent practice.

The SEC has authority to prescribe accounting measurement and disclosure standards for companies whose securities are publicly traded in the United States. However, historically the SEC has looked to the private sector to establish and improve accounting standards, subject to Commission oversight, and has required that companies under its jurisdiction adhere to GAAP.

The federal bank regulatory agencies have broad authority to establish their own rules for regulatory reporting. Under the Federal Financial Institutions Examination Council (FFIEC), the FDIC, FRB, and OCC have developed uniform reporting standards for the Reports of Condition and Income (the "Call Report"), filed quarterly by commercial banks and FDIC-supervised savings banks. Data provided in the Call Report are used by the banking agencies for determining capital adequacy, and for other regulatory, supervisory, surveillance, analytical, and general statistical purposes.

As a matter of policy, the reporting standards set for the Call Report are based almost entirely on GAAP for banks. The two differ only in circumstances where the banking agencies have an overriding supervisory concern, in which case Call Report requirements are intended to be more conservative than GAAP, or where such differences are mandated by the Congress.<sup>3</sup> The OTS maintains its own reporting standards for the Thrift Financial

Report, filed monthly by thrifts under its jurisdiction. Since January 1990, these standards have been identical with GAAP for thrifts, which differs somewhat from GAAP for banks.<sup>4</sup>

## 2. The Historical Cost Principle under GAAP

The primary goal of accounting standards is to ensure that financial reports provide information that is useful for evaluating the economic condition, performance, and underlying riskiness of an enterprise. For information to be useful, it should be: (a) relevant, timely, and understandable to users of financial statements; (b) reliable, in the sense of being accurate, objective, and verifiable by outside parties; and (c) reported in a consistent manner to facilitate comparisons over time and across firms. Since information is costly to provide, accounting standards also should satisfy a cost-benefit test. Within GAAP, this latter notion is formalized in the Full Disclosure Principle, which states that financial statements should provide information that is sufficiently important to justify its cost.

In practice, of course, there are tradeoffs among these objectives. When issuing accounting standards, the FASB and the AICPA attempt to resolve such tradeoffs through due process procedures designed to encourage extensive participation by issuers, auditors, and users of financial statements, including investors, analysts, and regulators.

The core of GAAP embodies standards for determining when specific items should be recognized in financial statements and how they should be measured. As a rule, items are recognized on balance sheets only when they give rise to future benefits or obligations that are likely to occur and can be measured reliably and at reasonable cost. Thus, some items are not reported as assets or liabilities due to the uncertainties or costs associated with their measurement.

Certain intangible resources of institutions, such as customer relationships and management quality, generally are excluded from the balance sheet because their valuations are difficult to establish. Also excluded are contingent contracts, such as commercial and standby letters of credit and loan commitments, although selected information about these items is disclosed in annual reports and regulatory reports.

Under current GAAP, the measurement of most balance sheet items is governed by the Historical Cost Principle, which mandates that assets and liabilities ordinarily be carried on an (amortized) cost basis.<sup>5</sup> When an asset or liability is first recognized, the reported carrying amount ('book value') is the fair value of the resources expended or received at acquisition. Subsequent market revaluations, however, usually are not

recognized (or disclosed) unless the item is sold or settled, at which time any accumulated gain or loss is reflected in income and net worth.

The ability to use historical cost accounting as the basis for financial reporting is predicated on management's intent with regard to such assets.<sup>6</sup> Exceptions to the Historical Cost Principle generally involve assets that management expects to turn over relatively quickly or that are intended for sale. For example, depository institutions are required to carry trading account assets at current market value, while assets held for sale--such as loans originated by mortgage banking operations--are carried at the lower of historical cost or market value (LOCOM). Interest rate and foreign exchange contracts that are not used for hedging purchases are usually marked to market in financial statements. In addition, depository institutions are required to provide estimates of the market value of their investment securities, as well as selected data on interest rate risk and credit risk, through supplemental disclosures in audited financial statements and regulatory reports.<sup>7</sup>

Although the current accounting framework incorporates some information on market values, the above discussion highlights three important limitations of traditional accounting data. First, accounting and economic measures of value may diverge owing to off-balance sheet activities and nonrecognition by GAAP of unrealized gains and losses. Second, current disclosure requirements for depository institutions do not readily permit users to adjust all reported historical cost data to a market value basis. Third, the carrying values of essentially identical assets may vary within or across firms depending on how items are classified and when they were originally acquired. For example, while a bond that management designates as a trading account asset would be carried at current market value, the carrying value of the same bond, should management designate it as an investment security, would depend primarily on its original acquisition price.

### **3. Increased Need for Accurate Financial Information**

To a considerable extent, current GAAP reflects the traditional role of accounting as a system of control over assets. As noted by Benston (1982, 1989), early accounting practices and the double-entry system of bookkeeping were developed not to estimate economic values, but to monitor the real property and financial resources that entered and exited firms, in order to prevent misuse or theft. For such purposes, the accuracy, objectivity, and verifiability of underlying data were paramount concerns, and actual prices associated with arms-length, market transactions provided reliable and cost-effective means of valuing resources at acquisition.

Prior to the 1970s, the GAAP framework for recognition and measurement used by banks and thrifts was not widely viewed as a significant public policy issue. That period was characterized by relatively stable interest rates and a variety of statutory, regulatory, and institutional limitations on the competition faced by depository institutions in funding and lending. Economic values of depository institutions typically exceeded their book values by considerable amounts, owing to a significant unrecorded intangible resource--franchise or charter value--representing the present value of future earnings opportunities in excess of competitive rates of return. With regulatory definitions of capital and solvency based on book rather than (generally higher) economic net worth, substantial unrecorded franchise values increased shareholders' equity at risk, thereby lessening both moral hazard incentives and failure resolution costs incurred by the insurance funds.<sup>8</sup>

Deregulation, together with financial and technological innovations, have progressively dismantled many past barriers to competition in the banking and thrift industries and reduced rates of return due to intermediation. Regulation Q interest rate ceilings on deposits have been largely removed, as have many restrictions on intrastate and interstate expansion. Money market mutual funds, brokered deposits, securitization, foreign competition, expanded asset and liability powers for thrifts, the loss of prime corporate borrowers to securities and commercial paper markets, and other technological and financial innovations also have worked to reduce the profitability of intermediation. In this new environment, franchise values of depository institutions have eroded, raising moral hazard incentives and failure resolution costs borne by the insurance funds.

At the same time that the need for accurate monitoring of depository institutions has probably increased, the relationship between traditional accounting and economic measures of financial condition may have weakened, owing to heightened volatility in financial markets and a surge in off-balance sheet activities of depository institutions.

The savings and loan crisis demonstrates the potential adverse consequences of divergences between accounting and economic measures of value. While deregulation, regulatory forbearance, and fraud were predominant factors contributing to the problems of the savings and loan industry, accounting treatment also played a significant role. During the sharp increase in market interest rates in the early 1980s, GAAP failed to acknowledge massive unrealized losses in many savings and loan mortgage portfolios until after institutions were deeply insolvent on an economic basis. The problem was compounded by reduced capital requirements and lax regulatory accounting principles (RAP) adopted by the Federal Home Loan Bank Board

(FHLBB) and the Federal Savings and Loan Insurance Corporation (FSLIC).<sup>9</sup>

Although declines in the economic values of institutions were reflected in lower earnings and eventual insolvencies, many economically bankrupt savings and loans continued to operate for extended periods, assuming increasing levels of risk (and losses) at the expense of the deposit insurance system and, ultimately, taxpayers. Many students of the thrift crisis have observed that GAAP and RAP accounting distortions, by masking savings and loan losses, contributed to unsound practices, to initial delays in closing weak savings and loans and to large underestimates of the depth of the problem by regulators, Congress, and the public.

### **C. Market Value Accounting**

Market value accounting has as its purpose improving the quality of financial information about depository institutions. It is premised on the view that valuations based on current market prices provide more relevant information about current conditions of depository institutions than valuations based on historical acquisition costs. Under MVA, estimated market values, rather than historical costs, would form the basis for GAAP and regulatory reporting.<sup>10</sup> Assets and liabilities would be reported at their fair market values and many items now treated off the balance sheet would be recognized directly on the balance sheet. Fair market value is typically defined as the current price at which an item could be sold or settled in a timely fashion with both the buyer and seller acting prudently, knowledgeably, and in their own self-interest.

#### **1. The Case for Market Value Accounting<sup>11</sup>**

Advocates claim that a principal benefit of MVA would be better estimation of each depository institution's capital, which is a key indicator of an institution's ability to bear business and financial risks. Capital reduces moral hazard incentives by placing shareholders' own money at risk, and provides a protective cushion against losses for depositors, creditors, and the insurance funds. Measures of capital ratios based on accounting data are the cornerstone of safety and soundness regulation of banks and thrifts, as experience and empirical research have consistently shown such measures to be among the most useful indicators of current and future problem institutions.<sup>12</sup> From an economic perspective there is no fundamental distinction between value attributable to realized or unrealized gains and losses, or to on- or off-balance sheet activities. Thus, many believe that, relative to current GAAP, MVA would produce economically more meaningful measures of capital.

Under MVA, public sector discipline would benefit to the extent that regulators were better able to identify depository institutions that were capital impaired on an economic basis, for which moral hazard incentives are greatest. Closer monitoring and prompt corrective action directed at such institutions could then begin sooner, potentially reducing insurance fund losses. Because book values typically mask substantial unrealized losses at weak depository institutions, solvency determinations based on timely and accurate MVA data could help ensure that undercapitalized depository institutions were closed in a timely manner. Indeed, when a depository institution becomes insolvent, the actual exposure of the insurance fund is based on the realizable value of the institution's assets--historical costs are irrelevant in this case.<sup>13</sup>

By making the actual performance of firms more transparent, it has been suggested that MVA would also enhance the accountability of managers, encouraging better hedging of the true economic risks of depository institutions and better investment and business decisions. With improved financial reporting, risk premiums on uninsured obligations of depository institutions might more closely reflect each institution's true economic condition.

In addition, proponents claim that MVA would discourage transactions motivated by accounting rather than economic profitability. Accounting policies and business decisions frequently appear to be influenced by their consequences for reported earnings per se, independent of underlying economic earnings.<sup>14</sup> Possible explanations for this behavior include institutional and regulatory practices tied to financial accounting data, such as executive compensation schemes, covenants in borrowing agreements, and regulatory definitions of capital and solvency.<sup>15</sup> In addition, while a large body of research indicates that stock markets are not 'fooled' by reported earnings when underlying economic performance is readily observable, investors may have difficulty assessing true economic performance when financial reports do not provide relevant information.

Two examples of accounting-driven behavior that might be reduced by MVA are the smoothing of accounting earnings, rather than economic earnings, and "gains trading." For whatever reasons, firms in many industries attempt to stabilize their reported earnings over time.<sup>16</sup> Evidence suggests that depository institutions have used the allowance for loan losses to offset weakness in other components of income, and may tend to hedge accounting rather than true economic risks.<sup>17</sup>

An abusive practice known as "gains trading" is a tendency to sell assets having unrealized gains and to retain assets having unrealized losses in order to boost reported earnings and

net worth.<sup>18</sup> These practices tend to raise failure resolution costs of the FDIC in two ways. First, greater economic risk taking by depository institutions raises the likelihood of failure. In addition, by the time depository institutions are declared insolvent on the basis of regulatory net worth, their remaining assets invariably are well "under water" on a market value basis.

In summary, proponents of MVA argue that financial reports should record on- and off-balance sheet instruments using estimates of market values, rather than historical costs. Market value accounting, it is argued, would provide more relevant financial information about depository institutions, thereby improving the effectiveness of public and private sector discipline over risk taking by banks and thrifts.

## **2. The FASB Financial Instruments Project**

Because of concerns about the quality of accounting data, the FASB currently is assessing whether to expand the use of market value data in financial statements and related disclosures. Traditionally, when accounting rules for a particular type of transaction have been judged to produce reported information that is misleading or incomplete, reporting guidelines for that transaction have been modified. Generally, in these situations the new reporting guidelines have been intended to better reflect the actual economic substance of the underlying transactions.

With respect to financial instruments, this case-by-case approach to resolving accounting problems has been criticized for addressing the symptoms of a common ailment rather than the cause--namely, differences between book and market measures of value--and for resulting in a patchwork of accounting standards, many of which are inconsistent.<sup>19</sup>

In May 1986, the FASB added to its agenda a project reexamining the conceptual framework of GAAP for recognition and measurement of financial instruments.<sup>20</sup> Part of this project involves the consideration of whether to adopt some form of MVA as the basis of GAAP reporting for financial instruments by all firms, including depository institutions.

As an intermediate step in this process, in 1987 the FASB issued an Exposure Draft of a proposed statement, Disclosures about Financial Instruments, that would have required supplemental disclosures of the market values of financial instruments to the extent that information was determinable, and additional disclosures about credit risk, interest rate risk, foreign exchange risk, and cash flows of financial instruments. In response to largely unfavorable comments by preparers of

financial statements, the FASB decided to address disclosures in phases.

The first phase focused on financial instruments with off-balance sheet risk of accounting loss and resulted in the issuance of Statement of Financial Accounting Standards No. 105, Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk in March 1990. This Statement requires certain disclosures of information about the "extent, nature, and terms of financial instruments with off-balance sheet credit or market risk and about concentrations of credit risk for all financial instruments." The Statement does not require disclosures of the fair market values of financial instruments.

In March 1990, the FASB initiated the second phase of the disclosure project, focusing primarily on disclosures about market values. On December 31, 1990, FASB issued an Exposure Draft, Disclosures about Market Value of Financial Instruments. The proposal would require all entities to disclose the market value -- if practicable to estimate -- of most financial instruments, both on- and off-balance sheet. Financial instruments specifically exempted are deferred compensation plans, substantively extinguished debts, most insurance contracts, lease contracts and warranty obligations.

The FASB is likely to receive many of the same objections to MVA in response to its current exposure draft as were raised in the 1987 exposure draft and in public comments to the present Treasury Study. Broadly, these criticisms address the relevance, reliability, cost, and possible economic consequences of MVA.<sup>21</sup> These issues are discussed in the sections below.

#### **D. Relevance of Market Value Information**

A frequent objection to MVA is that market valuations of assets, liabilities, and off-balance sheet instruments are irrelevant to managers and to users of financial statements. Two separate arguments are often made. First, it is claimed that market values convey no useful information if the institution has both the intent and ability to hold an item to maturity. The second argument rests upon the observation that many items, such as business loans, trade only in illiquid markets. It is argued that liquidation prices in these markets (*i.e.*, the current price at which an item actually could be sold or settled), even if ascertainable, might not accurately reflect "going concern" values to current owners.

Proponents of MVA, however, consider market-based reporting to be keenly relevant to users of financial information, especially in light of the business strategies employed by



depository institutions and the uncertainties and volatility of today's economic environment.

### **1. Intent and Ability to Hold to Maturity**

Opponents of MVA contend that even if items are actively traded, market values are relevant only if management were to consider selling or settling an asset or liability before maturity. Otherwise, it is claimed, intervening market values are of no consequence, since they have no effect on the firm's cash flows.

The argument that unrealized gains or losses are irrelevant when a depository institution has the intent and ability to hold an item to maturity is inconsistent with basic economic and business principles. This argument, for example, would deny that accurate information about the extent of unrealized losses of savings and loans resulting from the steep increase in interest rates during the early 1980s would, at that time, have been useful to investors, regulators, and the public. In fact, the availability of such information would have indicated that many of these savings and loans were economically insolvent and, therefore, did not have the ability to hold assets to maturity. Such information also would have permitted more exact assessments of the true exposure of the FSLIC.

An institution's current intent to hold, say, a marketable debt instrument to maturity should have no bearing on subsequent business decisions, since it is management's responsibility to continually reassess the most productive uses for a firm's resources. Indeed, large depository institutions typically evaluate and compensate the managers of their investment securities portfolios on the basis of earnings calculated using MVA concepts, rather than on the basis of GAAP accounting profitability. The market price of a security represents an institution's actual opportunity to convert that instrument into cash, which can then be distributed to owners and creditors or redeployed within the organization. Banking and thrift regulatory agencies recognize that prudential asset/liability management techniques may require the selling of investment securities prior to maturity as part of an overall business plan or to effectively manage liquidity and interest rate risk. Under these circumstances, the meaning of "intent and ability to hold to maturity" is ambiguous, and the prospect that financial instruments are frequently sold prior to maturity substantially limits the usefulness of this concept.

The market value of an asset also may be a relevant measure of the opportunities for redeploying resources even without selling the item. It is often possible to obtain the economic benefit, or overall portfolio effect, of selling an asset without actually undertaking that transaction. Instead of selling a loan

or investment security, an institution could purchase or issue financial instruments that offset characteristics of a long position. For example, a long position in an asset could be offset by issuing liabilities having offsetting cash flows. Similarly, the interest rate risk of a fixed-rate loan could be neutralized by hedging with appropriate interest rate swap, forward, futures, or option contracts. Over the past decade, expanded competition in the financial services sector, coupled with technological and financial innovations, have sharply reduced the costs of hedging.

## 2. Transaction Prices vs. Going Concern Values

Advocates of MVA believe that, whenever appropriate, actual transaction prices in secondary markets should be used to value similar items held by depository institutions. Opponents of the comprehensive application of MVA respond that depository institutions tend to specialize in financial instruments that are not traded in active markets. These critics maintain that it would be inappropriate to use transaction prices in illiquid markets to estimate fair market values. In such markets, it may be difficult to determine the price an item would bring without actually attempting to sell it. If an item is traded infrequently, data on past transactions may not reflect current conditions, and the expected price may depend on the length of time the seller has to dispose of the asset. Furthermore, while a current dealer bid may be useful in establishing a value for a small individual transaction, it might not accurately represent the realizable value of an entire portfolio.

Even when current transactions for similar items are observable, it is frequently maintained that prices in illiquid markets may systematically understate going concern values. Economic theory suggests that market illiquidity often reflects transactions costs and nontransferable value added that may limit opportunities for mutually advantageous trading, except in forced sales. If transactions costs--such as taxes, commissions, and other selling expenses--can be deferred or avoided by retaining an asset, the going concern value to its current owner may exceed the net amount that would be realized in a current sale.

Transaction prices also may fall short of going concern values owing to value added by knowledge, skills, and other intangible resources of current owners that might not be conveyed freely to acquirers.<sup>22</sup> An expanding literature suggests that depository institutions earn profits through intermediation by specializing in relatively illiquid loans for which they have comparative advantages over other investors in gathering and analyzing information about borrowers and in servicing loans after they are made. Indeed, one objective of deposit insurance has been to prevent 'runs' on depository institutions that could force sales of illiquid loans at fire-sale prices. In the

presence of informational differences between potential buyers and sellers, and the substantial due diligence expenses often necessary to bridge these differences, the value of a loan to its originator may substantially exceed what it would command if sold in the marketplace.<sup>23</sup>

Proponents of MVA generally agree that, where transaction data is not an appropriate measure of value, other market-based alternatives to historical cost accounting can and should be used. For example, to the extent that they utilize private information, fair market valuations based on discounted cash flow methods are not subject to the criticism that they fail to account for going concern values. Users may incorporate any private information they possess in estimating expected net cash flows from an asset, or in determining appropriate discount factors. The subjectivity inherent in such valuations, though, is cited as a concern by critics of MVA. This issue is discussed further in the next section.

Proponents also note that, over time, financial innovations are improving the liquidity of secondary markets, and enabling asset sales to be structured in ways that more fully preserve going concern values. Voluntary mergers and acquisitions and failure resolution methods such as whole bank purchase and assumptions (P&As) are well-known examples of such transactions.

Significant recent innovations that have enhanced secondary markets for previously illiquid assets include the use of third party ratings or guarantees; recourse agreements with sellers; structured financings or securitizations; and participation and assignment techniques in sales of business loans (in which originators retain the servicing rights and a significant interest in the loans sold). Also, to reduce uncertainties faced by bidders in failed depository institution auctions, the FDIC and RTC have appended options to liquidated assets, affording purchasers a window to put items back to the agency at the original purchase price. While such innovations seem likely to continue, as noted below, at present the markets for most assets held by depository institutions are fairly illiquid, and will likely remain so over the near term.

#### **E. Reliability of Market Value Accounting**

Because depository institutions tend to specialize in assets, liabilities, and off-balance sheet commitments that do not trade in active markets, under MVA fair market values for such items would have to be estimated. Although official standards for estimating fair market values have not yet been developed, discussions tend to focus on two separate aspects. The first is whether standards for MVA could be developed and implemented to produce reliable--that is, reasonably accurate,

objective, and verifiable--estimates of fair market values. The second, addressed in Section F, is whether standards could be developed and implemented at reasonable cost.

Virtually any resource can have its value estimated. From time to time entire financial institutions or minute subsets of their operations are bought and sold. As part of normal business practice, parties to such transactions typically develop internal estimates of the values of the resources transferred. Such valuations, though, generally involve approximations and judgment. Inherent subjectivity in estimating fair market values for nontraded assets and liabilities could reduce the comparability of estimates of fair market values provided by different institutions and render it difficult to verify valuations through audits and examinations.

The extent to which reliability would be a serious problem under MVA is difficult to gauge. Depository institutions historically have not produced market value estimates for most nontraded items on a regular basis, making it impossible to determine with certainty how reliable such valuations would be. Critics and proponents of MVA attach different significance to this observation, reflecting in part the different roles each sees for accounting information. Critics appear to place overriding weight on the precise verifiability of reported information, so that users can be confident in its factual accuracy as they form their own judgments about the performance and condition of firms. Proponents of MVA, on the other hand, contend that owing to informational advantages, depository institutions themselves are in the best positions to evaluate their own resources. It is argued that certain institutions already value their financial assets at market under current GAAP. Furthermore, imprecise estimates of true economic values, it is suggested, still may be more useful than precise data about historical costs.

The following discussion dealing with the potential reliability of MVA information begins with a summary of the principal measurement issues associated with calculating fair market values for tangible and intangible assets, liabilities, and contingencies of depository institutions. The importance of accounting standards and their role in the verification process are then reviewed. The discussion also surveys the experience of financial industries that are now required to use MVA under current GAAP.

## **1. Measurement Issues Involving Tangible Assets**

Table 1 summarizes the composition of balance sheets for insured banks and thrifts as of June 1990. Under current GAAP, fair market values are required to be reported or disclosed in notes to financial statements for roughly one-third and one-

**Table 1**  
**Assets and Liabilities of Insured Commercial Banks**  
**and Thrifts**

(As of June 30, 1990)

(In percent)

	Banks	Thrifts <sup>1</sup>
<b>Assets:</b>		
Cash and Deposits .....	9	
Investment Securities .....	18	
Trading Accounts .....	1	
Federal Funds and Repurchase Agreements.....	4	
Loans and Leases .....	62	65
Consumer .....	11	5
Credit Cards .....	4	(3)
Other .....	8	5
Real Estate .....	24	60
Revolving Home Equity.....	2	1
Other 1-4 Family .....	11	44
Other .....	11	14
C&I .....	19	2
Other .....	9	(3)
Less Reserves.....	1	1
Premises .....	1	1
Other Real Estate Owned.....	(3)	2
Intangible Assets.....	(3)	1
Other.....	4	4
<b>Total Assets.....</b>	<b>100</b>	<b>100</b>
<b>Liabilities:</b>		
Total Deposits .....	77	75
Transaction .....	19	5
Savings and MMDAs <sup>2</sup> .....	17	12
Time Deposits.....	32	57
At Foreign Offices .....	10	(3)
Other Borrowings .....	12	19
Other Liabilities.....	4	2
Equity Capital.....	6	4
<b>Total Liabilities .....</b>	<b>100</b>	<b>100</b>

<sup>1</sup> Excludes thrifts in conservatorship.

<sup>2</sup> MMDAs refer to money market deposit accounts.

<sup>3</sup> Less than 0.5 percent.

Source: Federal Reserve Board.

fourth of the total assets of banks and thrifts, respectively. Depository institutions are required to provide market value estimates for all investment and trading securities, while book values of cash, federal funds, repurchase agreements (RPs), and deposits with other depository institutions probably are very good estimates of fair market values, owing to the typically short-term nature of these items. For these assets, therefore, reliability would be no more problematic under MVA than under current GAAP.

The estimation of fair market values for foreclosed real estate (*i.e.*, other real estate owned or 'OREO') also would pose little additional problems or burden relative to GAAP. Under current accounting practices, banks carry OREO at the lower of cost or market (LOCOM), which implicitly incorporates an estimate of fair market value.<sup>24</sup> Such estimates are based upon regular appraisal reports prepared by independent appraisers. While highly judgmental and imprecise, such appraisals would likely be no more inexact under MVA than under current GAAP.<sup>25</sup> Moreover, the same standards used for estimating fair market values of OREO presumably could be used to value premises.

On the asset side of the balance sheet, proponents of MVA concur that an area of substantive concern would be the valuation of whole loans, which account for the bulk of the remaining assets of depository institutions.<sup>26</sup> Most types of loans are not actively traded as whole loans, and so under MVA could not be valued directly from observed secondary market prices for identical or similar whole loans.<sup>27</sup> Although techniques for valuing non-traded assets exist and are used routinely by many financial institutions, such applications do involve approximations and judgment. Proponents of MVA observe that approximations and judgement are currently required in determining the allowance for loan loss. Furthermore, in practice the usefulness of empirically-based valuation techniques is often limited by the lack of publicly-available pricing data for originations and sales of loans other than home mortgages.

The major exception to the above characterization is one-to-four family residential mortgages ('home mortgages'), which are actively bought and sold by financial institutions.<sup>28</sup> On a daily basis, the FHLMC and FNMA post minimum yields at which they stand ready to purchase for cash (at par) home mortgages meeting their underwriting standards ('conforming mortgages'). While these posted yields could be used to value conforming mortgages, many mortgage products, such as jumbo loans, do not qualify for these programs. Sales of nonconforming mortgages typically are negotiated between private parties, and detailed pricing information generally is not made public.

Moreover, the cash yields posted by the FHLMC and FNMA may not represent effective market yields even for conforming

mortgages, since the implicit prices obtainable through the agencies' swap programs usually are higher.<sup>29</sup> For this reason, many financial institutions prefer to value home mortgages based on yields on publicly-traded mortgage-backed securities (MBS), using the techniques described below.

In the absence of comparable secondary market prices for assets, under MVA some form of discounted cash flow analysis would have to be employed to estimate fair market values. This technique involves estimating the value of, say, a loan as the present value of its contractual or expected net cash flows, with discount rates chosen appropriately to reflect current market rates commensurate with the risks involved.<sup>30</sup> Existing accounting literature acknowledges that discounted cash flow analysis is appropriate where no comparable secondary market data is available.

Nevertheless, even for relatively simple fixed-rate term loans, valuations under this method depend on assumptions about appropriate discount factors and possibly on projections about future cash flows. Many financial instruments also contain embedded options--such as prepayment options, caps, floors, and collars--which must be valued through complex statistical models.<sup>31</sup> While complexity per se is not a serious problem, these calculations tend to be sensitive to highly technical assumptions, which may be difficult for auditors, examiners, and less financially sophisticated preparers of financial reports to evaluate.

A strength of the discounted cash flow method is that it allows practitioners to incorporate informational or other advantages they may have over the market as a whole. For example, because of a depository institution's knowledge of and familiarity with a borrower, or its relatively low operating costs, the discount rate that it might consider appropriate may be different from rates required on the same loan by other investors. However, this flexibility is also a potential drawback, since these underlying assumptions could be manipulated. Verification of fair market values would be more difficult the greater is the degree of subjectivity inherent in the valuation process. Diversity in the estimation methods and assumptions used by practitioners also would tend to limit the comparability of valuations provided by different firms.

In practice, a technique known as matrix pricing is commonly used to reduce the degree of subjectivity involved in determining the risk premia or discount factors employed in discounted cash flow analysis. This method attempts to infer hypothetical market risk premia for nontraded assets from observed market yields on similar or related instruments. Formally, the technique involves constructing an empirical model relating risk premia to asset characteristics believed to be important to investors, such as

remaining maturity and the borrower's credit quality. Model parameters are statistically or judgmentally calibrated using pricing data collected for a benchmark sample of comparable instruments, such as publicly-traded or privately-placed bonds, new originations and syndications, loan sales, or related asset-backed securities (ABSs). Once the parameters have been determined, the model is used to simulate hypothetical market risk premia for the specific loans held in a portfolio.

While a disadvantage of matrix pricing is that estimates of fair market values may not incorporate private information, an advantage is that it lessens the ability of firms to manipulate reported values. Still, the approach does not eliminate all approximations and subjectivity from the valuation process. Some factors that influence required market yields undoubtedly will be excluded, and, at best, an estimated model represents an average relationship among market yields and characteristics of the benchmark sample. In addition, judgment is required in the specification of the model, the selection of the sample, the determination of parameters, and the simulation of hypothetical risk premia. The quantification of characteristics such as credit quality also involves judgment.

Matrix pricing is widely used by financial institutions to value home mortgages. These applications are facilitated by the availability of large amounts of pricing data for MBSs, which trade in a highly liquid market.<sup>32</sup> In contrast, the applicability of matrix pricing for business and other types of loans is severely limited by a lack of transaction data on loan pricing terms. For competitive reasons, detailed pricing data for most private placements, loan sales, and new loan originations generally are not made available to the public.<sup>33</sup> Data on publicly-traded corporate bonds are readily available, but such securities may tend to differ systematically from loans in terms of liquidity, borrower characteristics, and other features.<sup>34</sup>

## **2. Measurement Issues Involving Intangible Assets**

The most comprehensive application of MVA would capitalize all resources of an institution, tangible and intangible. Under current GAAP, intangibles are not explicitly recognized in financial statements, unless they are acquired as part of arms-length transactions, in which case they are carried at amortized historical cost. The most important examples of intangible assets are loan servicing rights, core deposit intangibles, and goodwill.

### **Loan Servicing Rights**

Measurement and verification issues associated with valuing loan servicing rights are similar to those for valuing loans.



These rights entitle the owner to collect certain fees for servicing a loan until the loan prepays, matures, or defaults. Conceptually, the value of the servicing rights to a loan equals the value of the claims to the stream of servicing fees and to the earnings on float (*i.e.*, cash collected and then invested by the servicer until being disbursed to investors), less the present value of costs associated with providing the servicing. Uncertainty arises in estimating float, future prepayments, and foreclosures. For loans serviced and held by the same institution, the estimated value of the loan implicitly would incorporate the value of the servicing rights.<sup>35</sup>

### **Core Deposit Intangibles**

In the aggregate, core deposits--comprising transaction deposits, savings deposits, money market deposit accounts, and small denomination time deposits--account for more than half the total book liabilities of commercial banks and thrifts. Core deposits pay rates of interest below those on alternative market sources of funds, even after allowing for their relatively high servicing costs, and tend to have effective maturities much longer than their stated maturities. Thus, from an economic perspective core deposits provide potentially valuable benefits, representing the opportunity to retain funds at favorable rates of interest.

In theory, the value of the benefits associated with core deposits, often referred to as 'core deposit intangibles,' equals the present value of the stream of expected future cost savings (net of servicing costs). Such valuations are complex and judgmental, because evaluations of the effective maturities and future yields of core deposits will differ across depository institutions, depending on the path of future market interest rates, the strength of customer relationships, competitive factors, and other variables.

Nevertheless, valuations of core deposit intangibles are possible and are routinely undertaken by depository institutions when performing due diligence for prospective mergers and acquisitions (including bids to assume deposits of failed depository institutions at FDIC and RTC auctions). Financial consulting firms market discounted cash flow models of varying complexities for valuing core deposit intangibles.<sup>36</sup>

### **Goodwill**

This item is broadly defined as those "intangible resources and conditions attributable to an enterprise's above-average strength in areas such as technical skill and knowledge, management, and marketing research and promotion that cannot be separately identified and valued [and that] represent expected earnings in excess of anticipated normal earnings."<sup>37</sup> Under

GAAP, goodwill arises in connection with merger and acquisition transactions accounted for by the purchase method when the purchase price exceeds the fair value of the identifiable net assets that are acquired.

Clearly, the true economic value of a depository institution should capitalize all future fee- and revenue-generating capacities of the enterprise such as cash management, trust and investment services, transaction-related, and credit activities. Realistically, of course, this is not achievable by any accounting system. While financial markets implicitly incorporate such assessments into securities prices, it is doubtful that formal accounting rules could ever adequately resolve the inherent uncertainties and judgment in such valuations. Indeed, given the speed of financial, technological, and institutional changes taking place in the financial services industry, as well as normal market forces that tend to reduce excess profits over time, current competitive advantages may be fleeting.

Critics of MVA frequently suggest that an inability to reliably value all potential sources of income to a firm would lead to divergences between accounting and economic measures of net worth, the precise situation MVA seeks to avoid. MVA advocates readily acknowledge that "[g]oodwill, while important, rarely can be determined in a manner that is not subject to abuse."<sup>38</sup> However, the relevant issue is whether MVA would be any less accurate than current accounting practices. Because of the subjective nature of the determination, goodwill under MVA might be handled in much the same way as under current GAAP; that is, goodwill would be recognized only if acquired through arms-length transactions, and its historical cost would be amortized over some appropriate period of time.

### **3. Measurement Issues Involving Liabilities**

Various observers presume that, under comprehensive MVA, the principles governing valuations of liabilities would be the same as those applicable to assets. Actively-traded liabilities, such as some CDs and bonds, would be valued at prices in secondary markets. Otherwise, the present values of liabilities would be estimated by discounting contractual obligations at the same rates of interest that financial markets would demand for cash flows having similar risks. Under this view, MVA would pose the same reliability issues in the context of calculating present values for liabilities as for assets.

A problem with this approach, however, is that there may be valid differences in an institution's net worth when viewed from the separate perspectives of shareholders, liability-holders, and regulators. In principle, net worth from the viewpoint of shareholders should incorporate the value of their limited

liability, that is, the value of the bank's option to default on its contractual obligations. The value of this option equals the magnitude of the difference between the market value of the liability and that of default-free debt having identical contractual obligations. Reflecting this option, the true net worth of the institution to its shareholders is never negative, or stated differently, an institution would never become insolvent on a MVA basis. However, from the perspective of the deposit insurance fund and uninsured creditors, the value of this option should be excluded in calculating the economic net worth of the depository institution, since ultimately they bear the costs of default.

The above argument suggests that even if a liability were actively traded and its price could be observed, this price may not be the appropriate measure of value in computing net worth under MVA. From a regulatory perspective, one might want to measure net worth as the cushion available to protect liability-holders against default; that is, the maximum amount by which the market value of total assets could decline and still leave the institution with sufficient resources to fully meet its contractual obligations. This might be estimated under MVA by measuring liabilities as the present value of the contractual cash flows discounted at the default-free (i.e., Treasury) rate of interest. In any event, clear standards would be necessary to ensure accuracy and consistency in the treatment of implicit default options so that MVA would not mask the insolvency of problem institutions.

#### **4. Measurement Issues Involving Contingencies**

Off-balance sheet financial instruments of depository institutions include contingencies such as interest rate and foreign currency contracts, loan commitments, commercial letters of credit, and guarantees. Commercial banks already must estimate market values for interest rate and foreign exchange rate contracts in order to disclose on Call Reports the aggregate replacement cost of contracts having positive mark-to-market values. Complex discounted cash flow models, similar to those used to value loans having embedded options, often are used to make such valuations. These estimates, though, are generally based upon specific parameter assumptions that may be difficult for auditors and examiners to evaluate.

In principle, discounted cash flow models also could be used to value other contingencies, such as loan commitments, letters of credit, and guarantees. However, since these instruments have some probability of becoming loans, the likelihood of this contingency must be considered in the valuation process. Such applications, though, appear to be rare.

Benston (1989) proposes that, under MVA, commitments be brought onto the balance sheet by recording the amount of the guarantee or commitment both as an asset and a liability. In the event the depository institution is required to perform under the contract, the asset would then be revalued appropriately; for example, as a loan.<sup>39</sup> The net effect of this proposal would be to mark to market the commitment only if and when it becomes a loan.

## 5. Verification and Accounting Standards

Under any accounting system, objective principles and guidelines are essential for ensuring the reliability of information. Absent official standards, the credibility and acceptance of market value estimates would be diminished as manipulative practices would be difficult to detect. Clear standards also facilitate the development and implementation of accounting systems by preparers and help avoid confusion on the part of users of financial reports, thereby reducing the costs of producing, disseminating, and analyzing financial information.

The above discussion indicates that MVA would inherently involve some subjectivity. To many observers, this suggests that fair market value estimates would be noncomparable across institutions, potentially subject to manipulation, and difficult to verify through audits and examinations.<sup>40</sup> Thus, the American Bankers Association (1990) argues that "[i]t is highly doubtful that adequate [accounting] standards can be developed and implemented to cover the valuation concepts and methodologies to be used by most banks."

Proponents of MVA contend that such concerns are vastly overstated, and that in practice such estimates would be sufficiently reliable for most purposes. They note that the appropriate benchmark for assessing reliability is current GAAP, which itself is only an approximation to economic reality. According to this view, it may be better to have an imprecise estimate of an economically meaningful concept than a precise estimate of largely irrelevant historical costs.

In some respects the subjectivity in valuing assets under MVA probably would be no greater than under current accounting standards. All audited firms, including depository institutions, are required to estimate fair values for assets and liabilities acquired through a merger or acquisition when employing the purchase method of accounting. Depository institutions report loans held for resale at LOCOM, which implicitly incorporates estimates of the fair market values of these assets. In addition, the allowance for loan losses (which some view as a partial mark-to-market adjustment for credit risk under GAAP) involves high degrees of approximation and judgment, and is not strictly comparable across depository institutions since some

institutions tend to estimate potential credit losses more conservatively than others. Even so, the adequacy of reserves for loan losses is routinely attested to by accountants and reviewed by examiners, which have access to internal information systems at depository institutions, including credit files.

Current GAAP also requires the use of MVA for investments of registered securities brokers and dealers, registered investment companies (including junk-bond and bank loan mutual funds), and private pension plans. The portfolios of these institutions include many of the same types of illiquid, nonmarketable assets held by banks and thrifts: (private placement) business loans, commercial mortgages, real estate, and purchased bank loans (including troubled debt).<sup>41</sup> Moreover, the financial reports prepared by these industries, which are subject to audit, apparently have not evidenced significant reliability problems.

For the most part, GAAP does not mandate specific rules or formulas to be used in valuing items that must be marked to market. Rather, companies generally are required only to use their 'good-faith' judgment. This approach is based on the presumption that management typically is in the best position to acquire and apply any specialized knowledge that is needed to carry out such appraisals. Furthermore, as financial markets and technologies change over time, the most appropriate methodology for valuing a particular asset is likely to evolve as well. For example, current approaches for valuing fixed-rate mortgages are the combined result of the improved liquidity in secondary markets for MBSs, theoretical innovations in options pricing theory, and advances in computer technologies that have enabled firms to apply complex pricing techniques to practical situations.

Given the rapidity of change within the financial industry, it seems likely that for assets without active secondary markets, highly specific rules or formulas for calculating fair market values would run some eventual risk of becoming obsolete. Indeed, institutions that actively trade financial instruments spend millions of dollars annually attempting to improve their internal methodologies for pricing these instruments in order to gain competitive advantages in the marketplace. It may be unrealistic to expect that accounting standards-setters could produce detailed valuation techniques matching the sophistication and accuracy of proprietary systems generated by the private sector. Therefore, under MVA, valuation standards could also take the form of general principles or guidelines enunciating factors that should be considered in arriving at fair market valuations.

Ultimately, reasonably specific principles governing reporting standards and auditing practices would need to delineate those classes of valuation methodologies that could be

used by preparers of financial statements to estimate fair market values. In some important areas, standards could draw on existing practical experience. For example, at present, mark-to-market software for loans and core deposit intangibles is produced and marketed by numerous private consulting firms employing a wide range of analytic methods. Accounting standards-setters might certify allowable approaches and provide rules for determining the inputs to models. To facilitate consistency in the estimation of matrix models, the agencies could furnish representative pricing data obtained through surveys of depository institutions and set uniform guidelines to be used in specifying and estimating such models.<sup>42</sup>

A drawback with these approaches is that they may fail to account for important idiosyncratic factors at some institutions. In addition, to the extent that particular guidelines fail to keep pace with changes in financial markets, they would risk creating accounting and behavioral distortions similar in spirit to those for which current GAAP has been criticized. Where preparers are given discretion in selecting valuation techniques, standards would need to be developed for the documentation of assumptions used in estimating market values in order to facilitate the verification of estimates during audits and examinations.

#### **F. Costs of Market Value Accounting**

A key issue in the MVA debate is whether the potential usefulness of market value information justifies its cost of production, dissemination, and verification. Many depository institutions contend that the overall cost and reporting burden to them under comprehensive MVA would be considerable, since much of the required information that would be needed to periodically revalue resources and obligations are not now assembled on management information systems. The costs would include incremental development and ongoing expenses associated with gathering and analyzing cash flow data, estimating appropriate discount rates for financial instruments, and training employees. Further costs would be incurred by the banking and thrift industries and by the supervisory agencies in verifying market value estimates through audits and examinations. The burden of converting to MVA, of course, would depend on the extent of the application, the complexities of the calculation methods, and the scope and frequency of revaluations and audits and examinations. Proponents respond that many larger institutions have already made a significant investment in gathering some of information that would be needed in calculating fair market values.

Hard estimates of the incremental costs of implementing MVA have not been produced by either side in the MVA debate. Thus,

formal cost-benefit analyses cannot be completed until more precise estimates of costs are available.

## 1. Direct Implementation Costs

The banking and thrift industries maintain that implementation costs would be prohibitive if MVA were adopted as the basis for recognition and measurement under GAAP and regulatory reporting. Depository institutions generally presume that under such a framework they would be obligated to mark to market each individual asset and liability, an enormous task even for highly automated operations. Because such comprehensive systems are not now in place at any depository institution, specific cost estimates are difficult to obtain, and would be subject to considerable uncertainty.

Many depository institutions claim that comprehensive MVA would involve significant additional developmental and operating expenses to obtain necessary data, modify existing information systems, perform required calculations, and train personnel. Such costs would fall disproportionately on small depository institutions, which would have to spread the fixed costs of developing and operating these systems over fewer total assets. The initial conversion cost for continually producing lifetime cash flow projections in order to mark to market existing items is frequently cited as especially burdensome, although once a system was in place new items presumably could be added more readily at inception.<sup>43</sup> The costs of performing audits and examinations also likely would increase under MVA, since subjectivity in the valuation process would make verification of estimated fair market values more difficult.

Many proponents of MVA note that marking to market each individual balance sheet item is not necessary to obtain the bulk of the benefits from MVA. Instead, financial instruments could be aggregated into pools of similar assets having comparable coupon rates, durations, credit ratings, and so forth. The fair market value for each of these aggregate portfolios would then be estimated as if it were a single asset, with characteristics determined as a weighted average of those of the assets in the pool. Relative to item-by-item valuations, the deterioration in precision associated with the aggregative approach (when applied to portfolios consisting of many loans) is likely to be slight, and the implementation costs much lower.

If MVA were mandated for depository institutions, implementation and operating costs would probably decline over time. New and existing firms likely would come forth to meet the increased demands for related information and software. The costs of developing and maintaining standardized information databases and computation programs could then be spread across many users. At present, MVA applications and databases tend to

be more or less customized to each user, driving up implementation and ongoing costs. Formal adoption of MVA also would likely spur the development of new or less costly techniques for estimating fair market values of hard-to-value items.

## 2. Factors Offsetting Direct Implementation Costs of MVA

The net costs to society of greater market value disclosures by depository institutions would likely be less than the direct implementation costs, owing to the benefits associated with improved investor, managerial and regulatory decisionmaking. Any enhanced regulatory and market discipline arising from MVA would tend to improve overall economic efficiency and reduce FDIC losses over time, and should be netted against the direct implementation costs.

In addition, the information produced by MVA systems would be available to help establish, carry out, and evaluate internal risk-management policies of depository institutions. It is interesting to note that some depository institutions evidently believe that their private gains justify the expense of setting up MVA systems for internal risk management purposes. Currently a number of thrift institutions carry out MVA internally, as do the FHLMC and FNMA, in order to better quantify and manage their exposures to interest rate risk. And, at least one major money-center bank estimates the net present value of its portfolio on a regular basis. Market value information also is a critical component of internal risk-management systems used by securities brokers and dealers, investment companies, and some life insurance companies.

Not all observers, however, believe that the pure private benefits would outweigh the costs of comprehensive MVA. Critics of MVA note that if this were the case, comprehensive MVA would be actively sought by outsiders, such as investors, financial analysts, and regulatory agencies. While institutional investors and financial analysts have expressed great concern about the adequacy of current reporting and disclosures by depository institutions, they generally have not viewed comprehensive MVA as the only vehicle for addressing this problem.<sup>44 45</sup> User surveys typically reveal a preference for additional data in the form of supplemental disclosures, so as to permit users to make their own adjustments to historical cost data embodying their own forecasts and assumptions.<sup>46</sup> In addition, for reasons noted above and in Section G below, the federal banking agencies generally have not been supportive of comprehensive MVA for depository institutions.

Proponents of MVA contend that widespread demands for substantial additional supplemental disclosure implies a need for changes in the basic measurement criteria of GAAP. Indeed, proponents note that the unreliability of depository



institutions' financial statements is reflected in the low price-to-earnings ratios of many depository institutions. In addition, proponents note that by providing effective 100 percent protection (de jure or de facto) for most claims, the present deposit insurance system reduces the incentives for depositors and creditors to demand greater information from depository institutions. Given the relatively highly leveraged nature of the banking and thrift industries, it has been suggested that investor demands for market value information might increase if substantial portion of the risk presently borne by the insurance funds were shifted to the private sector.

Furthermore, while stockholders should be interested in better measures of firm performance, both they and managers of depository institutions may have an overriding moral hazard incentive to limit the amount of information revealed to regulators and the public regarding the condition of their institutions. White (1990), for example, argues that the ability to determine, within limits, when losses and gains are recognized under GAAP is perceived as an important prerogative by managers of depository institutions.

Under the current institutional framework, advocates of MVA note that perhaps the greatest beneficiaries of greater market value information about depository institutions would be the federal regulatory agencies and taxpayers. Difficulties encountered by regulators and the public in gauging the true magnitude of the savings and loan problem attest, in part, to the limitations of current financial reporting standards. Some MVA proponents suggest that opposition to MVA from regulators may stem less from valid concerns over the potential usefulness of market value information than from desires to avoid public accountability, given an inherent preference to forbear and to defer painful or politically sensitive decisions. Making the true economic conditions of depository institutions more visible to the public, it is suggested, would afford better decisionmaking by public officials.

#### **G. Possible Economic Effects of Market Value Accounting**

Because accounting standards may influence business, investment, and regulatory decisions, a decision to retain or change those standards could have important economic effects. There are differing views regarding the extent to which accounting standards should attempt to balance, on the one hand, the legitimate information needs of public investors and, on the other hand, possible adverse implications for financial markets and the economy.

Critics of MVA, while agreeing with a need for adequate information disclosures, argue that MVA could have adverse

consequences both for depository institutions, whose viability is heavily dependent on public confidence, and for the economy. These effects, they contend, should be considered when evaluating alternative accounting rules. Under this view, the subjectivity and verification problems inherent in market value estimates could lead to financial statements more prone to manipulation, thus increasing rather than diminishing uncertainty about the true conditions of depositories. Another concern stems from the observation that asset prices seem to exhibit considerable short-term volatility that is unrelated to underlying economic fundamentals. Accounting rules that did not take a longer-term perspective, therefore, might encourage depository institutions to undertake lending and other activities on the basis of short-term, rather than long-term, considerations.

Proponents of comprehensive MVA counter that the efficiency of the U.S. financial system is itself critically dependent on public investors' trust and confidence in financial reporting standards. Widespread concerns about the accuracy and fairness of information disclosures could disrupt the smooth channeling of savings into the investments necessary for sustaining the growth of individual industries, including depository institutions, and the aggregate economy. It is suggested that the recent depressed price-to-earnings ratios of many banking organizations testify to investors' skepticism about the relevance of traditional accounting information and uncertainties about the true condition of these institutions.

In deciding the accounting framework that is most appropriate, many observers maintain that the sole focus should be the relevance and materiality of the information conveyed, excluding related consequences of such disclosures. That is, accounting standards should be evaluated only on how well the resultant financial statements would reflect the true condition of firms and provide a basis for well-informed decision making. Proponents of MVA often cite the thrift crisis to illustrate the problems that may result when accounting standards do not fairly represent economic reality, but instead are allowed to be weakened by other policy considerations.

#### **1. Safety and Soundness**

Many observers believe that securities prices are subject to substantial volatility, often reflecting speculative and not true appraisals of 'intrinsic' worth. Under MVA, it is argued, such price volatility could discourage some banks and thrifts from investing in long-term bonds in order to minimize instability in reported capital and earnings. Other institutions might be induced to focus on short-term trading gains, causing them to buy and sell more frequently than necessary for prudent investment purposes.

The validity of these arguments depends largely on one's views regarding the efficiency of present-day financial markets. A fundamental assumption underlying free-market economies is that competitively determined market prices provide an appropriate yardstick by which to value resources. Within finance theory, this concept--known as the Efficient Markets Hypothesis (EMH)--provides a basis for supposing that market prices represent the best available measures of economic value.

An extensively tested implication of the EMH is that trading rules based on publicly-available information will not yield (risk-adjusted) profits, on average, that exceed the risk-free rate of return. Although theoretical conditions that ensure the validity of the EMH are quite stringent, early empirical tests lent substantial credence to this characterization of financial markets, particularly with respect to stock prices. Subsequent research, however, suggests that profitable trading strategies can sometimes be constructed based on publicly-available information.<sup>47</sup>

A related challenge to the EMH is a growing body of research suggesting that stock and bond prices exhibit considerable randomness or noise that is unrelated to identifiable economic fundamentals.<sup>48</sup> Various economic theories have been constructed to explain such results, based on time-varying risk and liquidity premia, limited rationality, investor fads, or speculative bubbles. Market professionals have long maintained that such factors at times are important, and perhaps even the predominant short-run determinants of prices in particular markets. The validity and implications of these empirical and theoretical results continue to be debated by researchers. However, the findings to date raise the possibility that reported net worth and earnings could be more volatile under MVA, independent of an institution's long-term economic situation.

By itself, evidence of noise or arbitrage opportunities in asset prices does not necessarily argue in favor of historical cost accounting. Market value accounting still might provide better information with which to assess the actual historical performance of a firm and the efficacy of management policies to control economic risks, whatever their source. Proponents of MVA contend that current GAAP masks the true volatility of economic earnings and net worth, permitting some institutions to defer losses on speculative activities. The problem of gains trading illustrates that incentives to speculate do not disappear under historical cost accounting. Instead, their consequences may become more severe because losses may be more difficult to detect in the short-run.

An important objective of MVA is to make the true performance and condition of depository institutions more transparent to investors, regulators, and the public, thus

encouraging managers to better hedge against true economic risks. With the enhanced accountability afforded by MVA, it is argued, excessive risk taking by depository institutions would be less, not more, compared with current GAAP. In this context, a shift to less risky portfolio strategies by depository institutions -- such as a reduced willingness to fund fixed-rate, long-term assets with short-term deposits -- should be interpreted as an intended and beneficial effect of MVA.

Such reduced risk taking by depository institutions would have economic consequences for other sectors of the economy. Prospective borrowers would likely face less favorable tradeoffs between financing costs and the risks that depository institutions would be willing to assume; relative interest rates on long-term, fixed-rate loans could rise, and borrowers would likely end up shouldering some of the risks previously borne by depository institutions. Of course, any reform that reduces the subsidy and moral hazard incentives of the federal safety net necessarily will raise yields on assets now favored by depository institutions and shift risk taking away from depository institutions and, indirectly, the deposit insurance funds.

## **2. Credit Availability**

A second potential economic consequence of MVA raised by opponents relates to its possible adverse implications for credit availability. It is suggested that MVA would tend to restrict credit availability during periods of declining asset prices, as the capital positions of depository institutions eroded. Thus, underlying volatility in asset prices could engender instability in the supply of bank and thrift credit available to meet the needs of borrowers.

The practical relevance of the credit availability argument probably has diminished significantly over time, with the development of broader and less segmented capital markets and with the advent of a more activist role for monetary policy in stabilizing the economy. The argument also ignores the likelihood, discussed above, that under MVA depository institutions would attempt to more fully hedge their capital exposure to market value risk.

Still, under MVA depository institutions' willingness to lend could be more sensitive to short-term changes in asset values as price movements would be passed directly through to current earnings and capital positions of banks and thrifts. A reduced willingness by depository institutions to lend under these circumstances could affect many borrowers, such as consumers and small businesses, who do not have ready access to capital markets and other alternative sources of financing.

Also, the ability of monetary policy to fully offset unanticipated changes in the supply of credit is highly imperfect, especially in the short-run. Lags exist both in the decisionmaking process and in the transmission of changes in policy instruments to the economy. In addition, a given easing in policy is likely to have a less stimulative and more uncertain effect on the lending behavior of depository institutions that are capital constrained. Moreover, the instruments of monetary policy are not well-suited to redressing economic problems that might be confined to particular types of borrowers and lenders or to a specific region of the country.

### 3. Financial Stability

In addition to the above concerns, some have suggested that the public might misinterpret or overreact to greater volatility in reported or perceived earnings and capital under MVA, possibly increasing the likelihood of destabilizing depositor runs. Depository institutions play a vital economic role in implementing the payments system and in originating and supplying credit to many sectors of the economy. An individual depository institution's capacity to carry out these functions is dependent on maintenance of public confidence in its soundness and its ability to attract and retain investible funds. Owing to the short-term nature of most deposits at depository institutions, some have suggested the emergence of any significant public concern about the safety of these funds due to misinterpretations of MVA disclosures could precipitate substantial withdrawals and possibly threaten an institution's viability.

In response, proponents of MVA note that an important role of deposit insurance and the federal safety net is to prevent systemic and institution-specific runs on fundamentally solvent institutions. If such runs do occur, the Federal Reserve's discount window is available to provide the time needed to resolve temporary liquidity problems in an orderly manner. Usually this process involves convincing private financial markets that the depository institution remains economically viable. The more complete the information available to investors, presumably the more accurate such assessments are likely to be. Moreover, since depositors are likely to have little incentive to 'run' on depository institutions known to be sound, more complete information about the true condition of depository institutions might be expected to reduce the probability of runs on economically solvent institutions.

Lastly, runs by uninsured depositors and creditors on unsound depository institutions are a form of market discipline. On the one hand, runs may shorten the time available to regulators attempting to seek the least costly methods of resolving weak depository institutions, possibly forcing unpreferred actions. On the other hand, critics of regulatory

forbearance suggest that the possibility of a run may help prod regulators into taking more prompt corrective actions to resolve a problem institution.

#### 4. Competitiveness

Some observers have argued that heightened volatility of reported or perceived earnings and capital under MVA could adversely affect the competitiveness of U.S. depository institutions. Such volatility might lead investors to judge U.S. depository institutions to be more risky, thus raising their cost of capital. It is claimed that this development could place U.S. depository institutions at a disadvantage relative to other industries and foreign competitors that are permitted to report on an historical cost basis. Indeed, an important objective of the Basle risk-based capital accord, which was negotiated on the implicit assumption of a continuation of the historical cost accounting framework within countries, is to achieve greater uniformity in capital requirements of international banking organizations. The unilateral adoption of MVA for U.S. depository institutions could undercut this objective by, in effect, subjecting U.S. banking organizations to different capital measures than other international institutions.

Proponents of MVA question whether it is in the public interest to, in their view, tailor financial accounting standards to lower the funding costs of a particular industry. The cost of capital for U.S. depository institutions would rise under MVA only if investors believed they are currently undercompensated for the true risks that they assume. However, such a response would represent market discipline at work; higher capital costs for riskier firms would be expected to reduce moral hazard incentives and improve the allocation of economic resources. Moreover, it is not obvious that failure to provide investors with relevant, but potentially unfavorable, information would systematically lower the cost of capital for depository institutions over time. To the extent that lack of information raises the level of uncertainty surrounding the true conditions of all depository institutions, additional information might be expected to reduce capital costs, on average, especially for stronger institutions.

For equity reasons, if MVA were required of depository institutions, it perhaps also should be made applicable to other financial institutions, including finance company subsidiaries and other financial operations of commercial enterprises. Most of the arguments for and against MVA discussed above apply equally to all financial institutions. MVA probably is less appropriate for nonfinancial firms, since the bulk of their going concern value likely reflects goodwill--that is, future profitable earnings opportunities which would be difficult to mark to market--rather than existing financial assets.

## **H. Alternatives to Comprehensive Market Value Accounting**

The complexities of comprehensive MVA have led some to propose alternative approaches for improving the quality of accounting information about depository institutions. These alternatives are more evolutionary than revolutionary, and build on, rather than scrap, the existing accounting framework. They include: (1) requiring mark-to-market accounting only for items that have active secondary markets; (2) requiring supplementary disclosures, but not formal reporting, of market value information; and (3) requiring disclosures of additional raw data about depository institutions, but relying on users of financial reports to make their own estimates of the fair market value of firms.

### **1. Market Value Accounting for Marketable Assets**

This approach, sometimes referred to as the 'partial' approach, would require the use of MVA only for assets having active secondary markets, such as marketable securities and conforming home mortgages. Valuation procedures for such assets based on secondary market prices are widely used by many financial institutions, including depository institutions. In addition, banking and thrift organizations are already required to disclose the market values of their investment securities in financial statements. Thus, implementation costs would be smaller relative to the comprehensive MVA proposal. The verification of estimated market values for actively traded assets also would be less problematic than for nontraded assets and liabilities.

Proponents of partial MVA argue that, while its application will not result in perfect measurements, it is superior to the present method of reporting. Although some banks may hedge their interest rate risk with off-setting cash positions, application of current accounting principles does not distinguish among individual institutions, but rather reports that all institutions have perfectly hedged their interest rate risk. This rewards the risk takers and penalizes those who have effectively managed their interest rate risk. It is argued that since the majority of a depository institution's liabilities have short-term contractual maturities, its liabilities are presently reported at amounts closer to their fair values than its assets. Therefore, proponents believe that measuring readily marketable assets at their fair values would likely improve this imbalance and reduce measurement error. To the extent that an institution uses options, forward contracts, or similar instruments to hedge market-valued assets, these hedges could also be marked to market under present accounting rules, resulting in more timely reporting of this portion of the institution's hedging strategies.

Critics respond that the partial MVA approach would create significant measurement and behavioral distortions by exempting from MVA major categories of assets and liabilities. For instance, to lessen interest rate and other risks for the institution viewed as a whole, depository institutions often take positions in marketable securities that act to hedge positions elsewhere on the balance sheet, and vice versa. A depository institution may adjust its investment portfolio to reduce the mismatch between the repricing frequencies of its loan portfolio and the effective (as opposed to the contractual) maturities of its core deposits; or, an institution may lengthen the duration of its managed liabilities to offset holdings of long-term, fixed-rate bonds or home mortgages. In response to an unforeseen change in the general level of interest rates, some components of the portfolio would be expected to experience gains, and others offsetting losses, leaving the overall economic net worth of the enterprise more or less unchanged.

Under these circumstances, the partial MVA approach would measure some assets on the basis of current market values and other assets and liabilities at historical costs. Some economic losses or gains would be recognized without acknowledging possibly offsetting changes in the economic values of other parts of the balance sheet. Thus, critics argue that measures of earnings and net worth under the partial MVA approach could be more inaccurate and more volatile than under either current accounting standards or comprehensive MVA and that distortions of such accounting treatments could discourage hedging transactions that are in the best economic interest of an institution.

Furthermore, it is suggested, depository institutions might be inclined to reduce their holdings of marketable securities that would have to be marked to market, thereby working against an important objective of prudential bank and thrift management.

However, proponents of partial MVA argue that bank regulators may be expected to continue to require appropriate levels of portfolio liquidity to satisfy prudential concerns. Institutions that put themselves into an imprudently illiquid condition will also be subject to market discipline when the fact is publicly disclosed.

## **2. Supplemental Disclosures of Market Value Information**

As another alternative to comprehensive MVA, depository institutions could be required to provide estimates of the fair market value of their resources and obligations through supplemental disclosures in financial reports, such as footnotes and memoranda items. If the arguments supporting MVA are valid, the benefits claimed for MVA attributable to improved market and regulatory discipline may not depend importantly on the manner in which information is presented. Many believe that relevant



information would be used efficiently regardless of whether it appears in the main bodies of financial reports or in supplemental disclosures.

Relative to comprehensive MVA, the disclosure approach has number of important advantages. First, the disclosure approach may be substantially less costly to implement. Some observers have expressed concern that, under comprehensive MVA, depository institutions would be obliged to estimate separate fair market values for every asset, liability, and off-balance sheet item. Under supplemental disclosure, on the other hand, estimates of fair market value might not be required for all individual items but could instead be calculated for pools of similar items using less costly, albeit somewhat less precise, aggregative approaches.<sup>49</sup>

The disclosure approach also would provide useful flexibility and time for accounting bodies, preparers, and users of financial reports, including regulators, to assess the quality of market value information, its usefulness, and its possible impact on business decisions and economic activity. The disclosure approach could be supported as an interim or transitional program by those favoring eventual adoption of comprehensive MVA. Any accuracy or verification problems that became evident under the disclosure approach could be rectified, prior to full implementation of comprehensive MVA, at less cost to preparers of financial reports. Such problems might also cause fewer difficulties for users as well, since information now provided in financial reports would not be disrupted. In addition, as is now the case with regulatory reporting, more detailed disclosures might initially be required only of large depository institutions, who could be given latitude to develop their own cost-effective methodologies for estimating fair market value. Such methodologies, if found to be useful, might later form the basis for standards applicable to all depository institutions.

The disclosure format also might permit accounting bodies to implement market value disclosure requirements on a phased basis as estimation guidelines for particular balance sheet categories were developed, without waiting for comprehensive MVA to be implemented in its entirety. Unlike the partial MVA approach discussed above, under the disclosure approach, information that is currently provided in financial reports would not be eliminated. Thus, users would have the option of utilizing supplemental market value information as they saw fit.

Proponents of comprehensive MVA, rather than the partial MVA approach, contend that the need for market value data is so critical that capital markets are not well served by providing such information through supplemental disclosures. They argue that only sophisticated users of financial statements would be

able to accurately use supplemental data to adjust the information reported in the main bodies of financial statements; less sophisticated users would tend to rely on the unadjusted data presented in the primary financial statements. Thus, it is argued, footnote and other supplemental disclosure is not an appropriate substitute for fair measurement in financial statements.

### 3. Greater Disclosures of Raw Data

Some have suggested a third approach for improving the quality of financial accounting information that would require depository institutions to disclose additional information that could be employed by users to construct their own market value estimates and for other purposes. In particular, advocates of this approach suggest expanded disclosures regarding asset quality and credit risk, interest rate risk, and future cash flows.

Many of the recent difficulties experienced by banks and thrifts stem from credit risk. Since the purpose of loan loss reserves under current GAAP is to adjust carrying values for changes in credit risk, it has been suggested that improving the accounting standards for loss reserves would go a long way toward narrowing differences between economic and accounting measures of value.<sup>50</sup> In addition to more frequent comprehensive asset quality examinations, depository institutions might be required to provide more detailed information about performing and nonperforming loan portfolios, to allow users to make independent assessments of the adequacy of loss reserves. For example, depository institutions might be required to provide aggregate breakdowns of internal credit ratings assigned to loans by borrower type and the location of collateral (for commercial and residential mortgages). Consideration also could be given to requiring disclosures of assets that have been classified by examiners or making examination reports available to the public.

Interest rate risk is still a significant issue for many thrifts. To counter this risk, the OTS has recently proposed for public comment an interest rate risk reporting system.<sup>51</sup> At present, commercial banks and thrifts generally disclose publicly the dollar amounts of deposits, borrowings, loans, and securities portfolios falling within various maturity or repricing intervals. Such data are useful for undertaking gap or duration analyses of an institution's exposure to interest rate risk. However, to the extent that important categories of on-and off-balance sheet items are excluded, disclosed information may provide only a limited perspective on the overall interest rate risk borne by an institution. Moreover, contractual maturities may substantially understate and overstate, respectively, the effective maturities of core deposits and loans having prepayment options.

More detailed and comprehensive interest sensitivity data collected from savings and loans on a confidential basis, through Schedule MR of the Thrift Financial Report. Such data could be made available to the public and required also of commercial banks. In addition, additional information about future projected cash receipts and payments by institutions would be useful not only for assessing interest rate risk, but also for evaluating the condition of depository institutions facing potential liquidity problems.

Bank supervisors from a dozen countries are currently working under the aegis of the Bank for International Settlements (BIS) to develop a detailed measurement system and capital standard for internationally-active banks. With regard to domestic efforts for monitoring and measuring interest rate risk, work is proceeding on the development of a measurement system that would identify banks with large interest rate positions.

Clearly, an approach oriented to providing additional raw data on market values in financial reports would be less costly to preparers than any of the other approaches considered above, since such raw data presumably is more readily available from internal management systems. Moreover, problems of subjectivity and verification would be reduced, though not eliminated, as users rather than preparers of financial reports would be responsible for interpreting and analyzing the data.

However, shifting the burden of distilling and analyzing raw data to users of financial reports has significant disadvantages. First, the aggregate costs of analyzing the data would be greater to the extent that each user independently would need to develop procedures for utilizing the information. Publicly-disseminated reports prepared by financial analysts, however, would tend to lessen any tendency for excessive duplication of analytical effort. A second disadvantage is that users would be responsible for analyzing raw data even though, owing to informational advantages, the preparer generally would be better able to interpret this information more accurately. Of course, a major concern, particularly in light of the savings and loan debacle, is that some preparers of financial reports may have difficulty presenting unfavorable information fairly and objectively.

## Endnotes

<sup>1</sup> The four principal financial statements are the statement of financial condition (i.e., balance sheet), the income statement, the statement of cash flows, and the statement of changes in shareholders' equity, including related supplemental disclosures in footnotes. The main bodies of financial statements present standardized information that is considered most relevant to users. Footnotes and other supplemental disclosures amplify or explain information presented in the main body that might otherwise project an incomplete or misleading picture of the firm. Supplementary disclosures often contain information that is relevant but somewhat imprecise, or information that is helpful but not considered essential to users. See Kieso and Weygandt (1989), chapter 2.

<sup>2</sup> Rule 203 of the American Institute of Certified Public Accountants (AICPA) prohibits a member from attesting that financial statements are prepared in accordance with GAAP when there are material departures from those principles, unless [s]he states that the financial statements would otherwise be misleading. Failure to comply with this rule can lead to the expulsion of a member from the AICPA or from state professional societies of CPAs. State Boards of Accountancy, which license certified public accountants, also may impose sanctions, including revoking an accountant's license to practice. See the discussions in Kieso and Weygandt (1989), chapter 1, and Miller and Redding (1988), chapter 1.

<sup>3</sup> Bank regulatory reporting requirements differ from GAAP mainly in the treatments of asset sales with recourse; hedging transactions involving futures, forwards, and options; excess servicing fees; and in-substance defeasance of debt. In addition, banks accepted into the agricultural loan loss amortization program pursuant to Title VIII of the Competitive Equality Banking Act of 1987 have been permitted to defer and amortize losses incurred on agricultural loans between January 1, 1984 and December 31, 1991. This program also applies to losses incurred as a result of reappraisals and sales of agricultural Other Real Estate Owned and agricultural personal property. Differences between GAAP and regulatory reporting requirements for banks are discussed in Angell (1990), Seidman (1990), and Board of Governors (September 1990).

<sup>4</sup> The principal differences between GAAP for banks and thrifts involve the allowance for loan losses and the valuation of foreclosed real estate. Section 402 of the Competitive Equality Banking Act of 1987 (CEBA) required the establishment of regulatory accounting standards for all FSLIC-insured thrifts consistent with GAAP to the same extent as the standards adopted by the federal banking agencies. This requirement was fully

implemented by the OTS effective January 1990. Section 1215 of FIRREA seeks, but does not require, uniform reporting standards for all federally-insured depository institutions.

<sup>5</sup> Assets (liabilities) purchased (issued) at a premium or discount are carried at amortized costs; fixed assets are carried at historical cost less estimated depreciation.

<sup>6</sup> Because intent is difficult to verify, the federal banking agencies, through the FFIEC, have established guidelines for evaluating whether the reporting of securities holdings is consistent with management's intent. A recent FFIEC proposal would expand the list of factors to be considered in determining when continued use of the Historical Cost Principle is appropriate. See FFIEC (1991).

<sup>7</sup> The SEC requires publicly-traded bank and thrift holding companies to provide supplemental disclosures and follow additional accounting practices that are not presently required by GAAP. These reporting standards are set forth primarily in SEC Regulation S-X, Industry Guide 3, Financial Reporting Releases, and Staff Accounting Bulletins. Relative to GAAP, the SEC requires greater disclosures about past due and nonaccrued loans and troubled debt, loan losses, and interest rate sensitivity. Much of this additional information is disclosed in the Management Discussion and Analysis (MD&A) section of annual reports, which is not audited by CPAs.

<sup>8</sup> See the discussions in Benston (1989); Benveniste, Boyd, and Greenbaum (1988); and Keeley (1990).

<sup>9</sup> For a discussion of thrift accounting standards in the context of the savings and loan crisis, see Breeden (1990) and White (1989).

<sup>10</sup> The generic label 'market value accounting' has been applied to a variety of accounting approaches. The discussion in Sections C through G focuses on the most comprehensive MVA proposal, under which market value estimates would form the basis for recognition and measurement under GAAP and regulatory reporting. Section H discusses alternative approaches that would apply market value accounting concepts only to selected on- and off-balance sheet items, such as certain financial instruments, or would provide market value information through supplemental disclosures, such as footnotes.

<sup>11</sup> A classic exposition of the case for MVA appears in Benston et al. (1983), chapter 8.

<sup>12</sup> See, for example, empirical studies by Martin (1977); Bovenzi, Marino, and McFadden (1983), Avery, Hanweck, and Kwast

(1985); Lane, Looney, and Wansley (1986); and Pantalone and Platt (1987).

<sup>13</sup> As discussed below, the pre-insolvency market value of a depository institution's net assets may differ from the realizable value after insolvency.

<sup>14</sup> See Greer and Morrissey (1978), Lev and Ohlson (1982), and Wyatt (1983).

<sup>15</sup> See Leftwich (1981); Kelly (1983); Healy, Kang, and Pelepu (1987); and Greenawalt and Sinkey (1988).

<sup>16</sup> See, for example, J. Burns (1976), Belkaoui and Picur (1984), and Brayshaw and Eldin (1989).

<sup>17</sup> See Worthy (1984), Greenawalt and Sinkey (1988), Ma (1988), and Rawls (1989).

<sup>18</sup> See Johnson and Peterson (1984) and White (1988). Gains trading involving investment securities is regarded as a trading activity and should be accounted for as such for regulatory purposes. The approach adopted by the regulatory agencies addresses the problem through the normal supervisory process.

<sup>19</sup> For discussions of such inconsistencies see Feters and Livingstone (1989), Kripke (1989), and Stewart (1989).

<sup>20</sup> FASB (1990) defines a financial instrument as cash, evidence of an ownership interest in an entity, or a contract that both:

- a. Imposes on one entity a contractual obligation to (1) deliver cash or another financial instrument to a second party or (2) to exchange financial instruments on potentially unfavorable terms with the second entity.
- b. Conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

<sup>21</sup> Excellent summaries of arguments frequently raised against MVA are presented in A. Burns (1976), American Bankers Association (1990), Garvelink (1990), and Greenspan (1990).

<sup>22</sup> Liquidation prices also may depend on the identity of the seller. A loan originator with an established reputation for sound underwriting and documentation standards might attract greater interest from potential buyers than other originators. Similarly, a loan purchased from an originator with a 'triple-A' credit rating might be valued more highly than an identical loan

from a lesser-rated firm owing to expectations that the stronger firm would be better able to service the loan and honor any implicit or explicit guarantees made to purchasers. If the seller is the FDIC or RTC, assets may be perceived as being tainted in some way, and liquidation prices could be lower than if the assets were still in the private sector.

<sup>23</sup> This point is made forcefully in Berger, Kuester, and O'Brien (1990).

<sup>24</sup> Both banks and thrifts initially record OREO at fair market value. Thereafter, thrifts normally carry OREO at the lower of cost (the initial fair market value estimate) or net realizable value (NRV), which equals the present value of the property's net cash flows discounted at the thrift's cost of capital. In general, NRV will exceed fair market value.

<sup>25</sup> Appraisals (other than those for 1-4 family homes) ordinarily involve the judgmental pooling of results from three separate valuation exercises: (1) estimation of the current replacement cost of the property less allowances for deterioration and functional and economic obsolescence; (2) discounted cash flow analysis based on assumed income streams and reversion; and (3) review of recent selling prices for comparable properties in the same market. Appraisals of 1-4 family homes usually are based only on a review of selling prices for comparable residential properties.

<sup>26</sup> Mengle (April 1990 and July 1990) presents a very detailed discussion of the issues associated with valuing loans under MVA.

<sup>27</sup> The amounts outstanding of commercial and industrial loans that have been sold by banks exceed \$200 billion. Current transactions, however, overwhelmingly reflect new loans, so that little information is revealed by transaction prices beyond that currently reflected in historical cost data. Consumer loan sale (excluding home mortgages) typically involve relatively few, very large transactions associated with credit card and automobile loan securitization programs. For a discussion of the loan sale market see Gorton and Haubrich (1988).

While some have suggested using transaction or quoted price for estimating market values of loans to troubled LDCs, there is considerable controversy regarding the actual depth of the market for LDC loans and the economic relevance of prices in that market. (See, for example, Board of Governors (March 1990) and James (1990).) Although dealer quotations are readily available and transactions volume aggregates to more than \$60 billion annually, the market is considered illiquid by many observers because most trading occurs in large blocks at irregular intervals. It is frequently argued that prices in this market

reflect "... a 'distress' price for creditors simply looking to rid themselves of their burdens, based less on economic fundamentals than the perceived political climate." ["'Black Market' Gives Big Banks an Edge in Debt Sales," American Banker, March 8, 1989, as quoted in Mengle (1990)]. However, some view these claims skeptically, in effect arguing that prices associated with voluntary exchanges among large institutional investors, involving loans to a few well-known borrowers, are unlikely to deviate consistently from fundamental values.

<sup>28</sup> See Bergman (1986).

<sup>29</sup> Under the swap programs, mortgage originators form pools of loans that they exchange (swap) with the agencies for highly-liquid mortgage-backed securities representing undivided interests in those pools. In 1989, the volume of securities issued under the combined swap programs of the two agencies was nearly \$130 billion, compared to volume under the cash programs of around \$15 billion.

<sup>30</sup> As noted in Berger, Kuester, and O'Brien (1990), the rates used to discount contractual payments correspond conceptually to quoted market interest rates. By convention, quoted interest rates in financial markets generally are the discount rates that equate a security's market price with the present value of its contractual payments.

The appropriate factors for discounting expected cash flows are required rates of return, rather than quoted market rates of interest. In this approach, economic models, such as Option-Adjusted Spread (OAS) models described below, typically must be used to determine the required rate of return.

<sup>31</sup> A form of discounted cash flow analysis, called the Option-Adjusted Spread (OAS) model, is used by major institutional investors to value option-related instruments. Conceptually, OAS models compute average present values over a large number of simulated economic scenarios. The technique involves four basic components: (1) stochastically simulating many future interest rate paths for given assumptions regarding volatilities of, and correlations among, interest rates; (2) forecasting the stream of net cash flows along each simulated path; (3) computing the present value of these payments for each path, taking as discount factors the simulated short-term interest rates plus a constant risk premium; and (4) averaging the present values across all interest rate paths. In addition to being technically more complicated than simple cash flow models, OAS valuations tend to be highly sensitive to the volatility and correlation assumptions in (1). Moreover, the parameters of the models tend to be very difficult to estimate, partly because their true values appear to change over time. For a discussion of this technique see Belton (1988).



<sup>32</sup> Conceptually, pools of home mortgages are valued by breaking the underlying cash flows into four components: (1) the stream of returns that would have to be paid to private investors in mortgage-backed securities (MBS) collateralized by the pool; (2) the stream of fees that (hypothetically) would have to be paid to a third party, such as a mortgage insurer, to provide credit enhancements for a MBS; (3) the residual cash flows that would remain with the depository institution if the pool were securitized ('servicing fees'); and (4) the cost of servicing the mortgage pool. The fair market value of the pool equals the sum of the present values assigned to (1) and (3) less those assigned to (2) and (4). For a discussion of this methodology, see Peterson and Kenny (1990).

<sup>33</sup> One exception, noted in Mengle (1990), involves loans made in connection with public offerings of securities, for which certain pricing data must be reported in SEC registration documents. Such loans, though, generally involve larger credits and may not be representative of loans made to smaller borrowers.

<sup>34</sup> As noted in Berger, Kuester, and O'Brien (1990), the use of market yields on (non-mortgage) ABSs to value whole loans, as suggested by some MVA proponents, also is problematic. Not only are ABSs fairly illiquid compared to MBSs, but the loans underlying these securities often contain credit enhancements or conform to strict underwriting and documentation standards that may differ from loans originated and held by a particular depository institution. The adjustments necessary to compensate for such differences can be complex, judgmental, and inexact. Indeed, documentation deficiencies and other technical exceptions in loans may go undetected unless an attempt is made to sell these assets. For a thorough discussion of the securitization process see Pavel (1986).

<sup>35</sup> Mortgage servicing rights are actively bought and sold by depository institutions and other financial institutions; however, these instruments are not highly liquid because of the amount of due diligence required by prospective purchasers. As with whole mortgages, since each loan pool is somewhat unique, transactions tend to be privately negotiated, and detailed data on pool characteristics and servicing fees usually are not publicly disclosed. Nevertheless, representative benchmark prices for valuing mortgage servicing rights may be obtainable from brokers and mortgage bankers. Alternatively, potential buyers and sellers routinely estimate fair values for mortgage servicing rights using discounted cash flow models and matrix models similar to those used to value whole mortgages.

<sup>36</sup> See, for example, Ayaydin, Richard, and Rigsbee (1989, 1990).

<sup>37</sup> Quoted from Kieso and Weygandt (1989), chapter 12.

<sup>38</sup> Quoted from Benston (1989).

<sup>39</sup> As noted by Mingle (1989), prior to performance by the depository institution, this procedure would not accurately reflect uncertainties concerning whether the institution actually would be required to advance funds, and whether, in this event, the depository institution would be able to collect fully from the counterparty.

<sup>40</sup> This point is emphasized in Berger, Kuester, and O'Brien (1990) and Beaver, Datar, and Wolfson (1990).

<sup>41</sup> Relative to the portfolio of a comparably-sized depository institution, however, the number of loans held by a mutual fund or private pension plan is small, and the average loan balance quite high.

<sup>42</sup> To promote consistency among the internal credit rating systems of depository institutions, the Shared National Credit (SNC) Program--administered jointly by the OCC, FRB, and FDIC--could be used to ensure comparable ratings for loans shared by several banks. Each spring, all (domestically-booked) loans exceeding \$20 million and shared by two or more banks are examined and assigned ratings by teams of examiners. Over the next year, these ratings are used by all examiners in the course of their asset quality examinations of banking organizations that participated in these loans. Each bank and bank holding company is provided a listing showing the ratings of all SNC loans in which it participates. In 1989, the book value of SNC loans exceeded \$260 billion, and accounted for more than one-quarter of aggregate business loans at domestic offices of U.S. commercial banks. Consideration could be given to expanding the program to include smaller shared credits, shared loans booked at offshore offices of U.S. banking organizations, and loans shared by or with thrifts.

<sup>43</sup> Apparently few, if any, depository institutions now produce such detailed cash flow forecasts routinely, owing to perceptions that the incremental benefits of the additional information for management decision making would not exceed the expected costs. One large banking organization recently developed a discounted cash flow system for use in managing for the FDIC a pool of about 10,000 troubled loans. Just the third party costs of creating this system (involving outside consultants and purchased software) exceeded \$2 million. Only part of this system, however, is devoted to the requirements of calculating present values of individual loans; the bulk of its capabilities is associated with automating activities and information processing that would be performed (in a less structured manner) by workout groups in any event.

<sup>44</sup> See Arthur D. Little, Inc. (1978) and Benston (1980, 1982, 1989).

<sup>45</sup> Other, sometimes more timely, sources of information about depository institutions include corporate releases, financial press accounts, trade publications, and government releases. In addition, reports prepared by financial analysts distill most publicly-available data and are widely disseminated. Credit rating agencies and direct lenders (through private placements and loans) may be given access to inside information under SEC regulations, while regulatory agencies receive comprehensive first-hand information from periodic on-site examinations and other supervisory oversight mechanisms.

<sup>46</sup> See Arthur D. Little, Inc. (1978).

<sup>47</sup> Examples include evidence of seasonality in stock prices, mean-reversion (negative correlations) in individual and aggregate stock prices, and systematic underpricing of shares in smaller companies and in firms with low P/E ratios. See LeRoy (1989) and the references cited therein.

<sup>48</sup> See Black (1985); Summers (1986); Lo and MacKinley (1988); Cutler, Poterba, and Summers (1989, 1990); Lehmann (1990); and LeRoy (1989).

<sup>49</sup> This assumes that if market value information were disclosed then it would be used by regulators only for internal analytical purposes and not for the determinations of solvency or regulatory capital.

<sup>50</sup> A variation on this approach is put forth by Berger, Kuester, and O'Brien (1990). Their proposal calls for more accurate treatment of loss reserves--which would continue to be used to adjust the net worth of depository institutions for changes in credit quality--and for reporting historical cost values of assets, liabilities, and off-balance sheet items after adjustments for changes in the general level of interest rates and foreign exchange rates.

<sup>51</sup> The OTS published its proposal on December 31, 1990. See Federal Register, Vol. 55, No. 251, 53529-53571.

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## **Chapter XII**

### **ROLE OF AUDITORS**

#### **A. Introduction**

Section 1001 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires this Report to address: (1) the extent of communication between independent accountants (also referred to as external auditors) and the regulatory agencies; and (2) the feasibility of implementing in this country aspects of the Bank of England system of using auditors as part of the supervisory framework for financial institutions. Taken together, these topics require consideration of the benefits of enhancing the role of the external auditor in the supervision of depository institutions.

This chapter is organized as follows: Section B reviews audit and regulatory functions and audit coverage of depository institutions; Section C analyzes the benefits of increasing communication between regulators and external auditors; Section D discusses the advantages of adopting aspects of the Bank of England system, given the structure of the U.S. regulatory system; and Section E considers four options for strengthening the relationship between regulators and external auditors.

#### **B. Audit and Regulatory Examination Functions**

##### **1. Audit Functions**

For purposes of this discussion, an external audit is an examination made by independent certified public accountants (CPAs) for the purpose of expressing an independent opinion on the fairness of an institution's financial statements taken as a whole, prepared in accordance with generally accepted accounting principles. Audits are generally conducted on an annual basis and, in some instances, may occur at the same time as regulatory examinations.<sup>1</sup>

Professional auditing standards of the American Institute of CPAs (AICPA) require that audits be planned and performed to obtain reasonable assurance that financial statements are free of material misstatement. These standards require auditors to gain an understanding of an institution's internal control structure. Auditors also examine, on a test basis, underlying transactions and records supporting financial statement balances and disclosures. An auditor assesses the accounting principles used

and significant estimates made by management and evaluates the overall financial statement presentation.

An auditor's opinion on the financial statements is usually a one-page document that is published with the financial statements in the institution's annual report to shareholders. CPAs also are required to report material weaknesses to management orally or in confidential management letters.

Auditors are required to evaluate the aggregate information coming to the auditors' attention for indications of substantial doubt about an entity's ability to continue as a going concern. When substantial doubt exists in this area, an auditor's opinion must clearly express this in an explanatory paragraph.

While audits are not intended to detect all fraud, errors, irregularities, or illegal acts, audit standards require that audits be designed to provide reasonable assurance of detecting material misstatements of financial statements due to such events. The auditors have a search responsibility for illegal acts that have both a direct and a material effect on the financial statements. Furthermore, the auditor has an investigation and reporting responsibility for all illegal acts that come to the auditor's attention, unless they are clearly inconsequential. Auditing standards require the auditor to express a qualified or adverse report if the act has not been properly accounted for or disclosed in the financial statements. Accordingly, there is some reporting mechanism required. Auditing standards also require the auditor to consider withdrawing from an engagement if the client does not take the appropriate remedial action. An auditor withdrawal would trigger the SEC Form 8-K reporting requirement. AICPA audit standards do not require auditors to report such events to regulators directly.

In addition to financial statement audits, independent CPAs and other professionals may perform other audit-related services, such as audits of certain departments, internal control reviews, and other risk evaluation work.

FIRREA expanded the reach of the federal banking agencies' enforcement authority to include institution-affiliated parties, such as accountants.<sup>2</sup> Thus any accountant who knowingly or recklessly participates in any violation of law or regulation, any breach of fiduciary duty, or any unsafe or unsound practice which caused or is likely to cause more than a minimal financial loss to, or significant adverse effect on, an insured depository institution may be subject to an enforcement action.

## **2. Regulatory Functions**

While there are some similarities between audits and

regulatory examinations of depository institutions, regulatory examinations generally differ from the objectives and focus of financial statement audits.

The examination process serves as a major fact-finding arm of regulatory agencies in discharging their responsibilities. The essential objectives of an examination are: (1) to provide an objective evaluation of a depository institution's soundness and compliance with banking laws and regulations; (2) to permit the agencies to appraise the quality of management and the board of directors; and (3) to identify those areas where corrective action is required to strengthen the financial institution, to improve the quality of its performance, and to enable the institution to comply with applicable laws, rulings, and regulations.

The evaluation of the prudence of practices, adherence to laws and regulations, adequacy of liquidity and capital, quality of assets and earnings, nature of operations, and adequacy of financial reports, internal controls and audit programs are among the procedures utilized to accomplish these objectives.<sup>3</sup>

### 3. Audit Coverage of Depository Institutions

Federally insured depository institutions are not subject to a uniform external audit requirement. However, in practice, virtually all larger institutions receive external audits. All federally-insured savings and loan associations are required to have annual audits.<sup>4</sup> These audits must generally be performed by external auditors, although internal auditors may conduct this work with the permission of the Office of Thrift Supervision (OTS). In practice, however, virtually all savings and loans (i.e., all but three institutions) receive an annual external audit.

Section 919 of FIRREA requires insured credit unions to have annual audits by CPAs when supervisory committee audits (i.e., internal audits) are not conducted or are not satisfactory, or when the institution has serious recordkeeping deficiencies.<sup>5</sup> Approximately 25 percent of all credit unions receive an annual external audit. Virtually all larger credit unions (those with over \$50 million in total assets) receive an annual external audit.<sup>6</sup>

The banking agencies require some, but not all, banks to receive audits. The Office of the Comptroller of the Currency (OCC) presently requires audits of newly-chartered national banks. The Federal Deposit Insurance Corporation (FDIC) requires audits of institutions for the first three years after they receive federal deposit insurance.<sup>7</sup>

In addition, the Federal Reserve and the FDIC require audits of state-chartered banks under their supervision that are subject to the reporting requirements of the Securities Exchange Act of 1934. The Federal Reserve also requires audits of bank holding companies with \$150 million or more in total consolidated assets. The three banking agencies may use cease and desist orders to require banks to obtain external audits when these institutions experience internal control or reporting problems.<sup>8</sup>

Finally, the Securities and Exchange Commission (SEC) requires external audits of all public companies--generally, those with over 500 shareholders and \$5 million in total assets, with securities traded on a national exchange, or which have had a public sale of securities under the Securities Act of 1933. Thus, the SEC requires audits of those bank holding companies and thrift holding companies that are public companies.

Based on Reports of Condition and Income filed with the banking agencies, as of March 31, 1990, approximately two-thirds of all federally-insured banks, with about 95 percent of the banking industry's assets, received external audits from CPAs directly or as part of audits of their consolidated bank holding companies. The external audit coverage of banks with over \$1 billion in consolidated assets is virtually 100 percent (i.e., all but two banks).

The banking agencies encourage institutions to have regular external audits as an integral part of safe and sound bank management. However, the banking agencies have not required audits of all institutions because of concerns that the costs of external audits may exceed the benefits for smaller institutions and recognition that other arrangements, such as audits of bank holding companies on a consolidated basis or comprehensive internal audits coupled with regulatory examinations, may provide essentially the same benefits.

Moreover, the agencies have been concerned about the quality of some audits, particularly in those cases when unqualified audit reports were given to institutions with serious problems that ultimately failed. Although audit failures are not in and of themselves a cause of the savings and loan crisis, concern has also been expressed about the existence of serious problems in the savings and loan industry, in spite of the long standing industry practice of virtual 100 percent external audit coverage.

With respect to the topic of audit coverage, a number of commentors on the Report's topics, including two trade associations for banks, opposed a mandatory audit requirement for depository institutions. However, comments were also received supporting mandatory external audits and mandatory management

reports on internal controls and compliance with laws and regulations.

### **C. Analysis of Communication Between Auditors and Regulators**

This section addresses: (1) whether the regulator should share examination information with the auditor; (2) whether the auditor should directly send audit reports to the regulator; and (3) whether auditors should participate in meetings between regulators and depository institutions. Most of these policies are, in fact, already required by statute or are otherwise reflected in existing practices of the federal regulatory agencies.

#### **1. Auditor Access to Regulatory Reports**

Section 931 of FIRREA requires insured depository institutions to provide copies of the following supervisory reports and documents to their external auditors: (1) the most recent Report of Condition made by the institution; (2) the most recent examination report received by the institution; and (3) any written agreements, other supervisory actions or reports thereon received from regulators and in effect during the period covered by the audit, and any civil money penalties assessed by the federal or state banking agencies on the institution or on any institution-affiliated party.

Before FIRREA, auditors had access to reports of condition and to publicly-available financial ratio analyses of these institutions, prepared by the regulatory agencies on the basis of these reports. In addition, prior to FIRREA, the federal regulatory agencies permitted depository institutions to provide their auditors with access to examination reports and other confidential supervisory documents in order to aid the auditor in assessing the risk profile of an institution when conducting an external audit.

A number of commentors noted that this information was available to auditors and indicated that this information was sufficient for audit purposes. However, other respondents commented that these current arrangements were not sufficient because they rely on institutions to provide examination reports and related information to auditors. These commentors believe that these arrangements could be strengthened by requiring regulators to provide auditors directly with examination reports and related information.

#### **2. Submission of Audit Reports to Regulators**

With respect to the submission of audit reports to the federal regulatory agencies, examiners at each agency are

expected to review audit reports and management letters prior to or during examinations and to encourage each institution to follow up on the recommendations of the auditor in a timely manner.

However, the regulatory agencies differ somewhat in their policies regarding the direct submission of audit reports to the agency. The OTS requires each auditor of a savings and loan association to provide the agency with copies of the audit reports directly once the audit has been completed and the auditor has provided its report to the client institution. Auditors must notify the district director of examinations of apparent defalcations that the auditor has discovered and reported to client management but that have not been reported by the institution to the OTS. Also, auditors must report to the OTS any material weaknesses in a savings and loan association's system of internal control and the auditors' recommendations for correcting these weaknesses.

OTS district directors of examination can request external auditors to provide the agency with the auditors' completed work programs and workpapers and with a letter discussing audit procedures and findings. Moreover, OTS district directors of examinations can require auditors to perform special audit procedures for the agency.

The FDIC requests each state non-member bank that is audited to send a copy of auditor reports directly to its regional offices. The Federal Reserve requires that audit reports accompany the audited financial statements that are transmitted to it annually by bank holding companies with consolidated assets over \$150 million and by those state member banks subject to SEC reporting requirements. The OCC and FDIC have similar requirements for banks under their supervision that are subject to SEC reporting requirements.

The Federal Reserve and the OCC do not have a requirement that audit reports for other banks under their supervision be sent to them directly. However, the reports of condition identify those banks that are receiving audits and, thereby, notify the agencies that the reports are available. Bank examiners are expected by each agency prior to or during examinations to review audit reports and other reports, including management letters, submitted by auditors to their client banks.

Through cease and desist orders, the banking agencies may require banks to have external auditors perform special audit procedures and report the results thereof to the agencies. However, the banking agencies generally do not require external auditors to report defalcations and material internal control weaknesses to the agencies. Also the banking agencies do not

require external auditors to make their audit work programs and workpapers available for review by the agencies.

The agencies have traditionally viewed such direct reporting by auditors as being outside the scope generally associated with client-auditor relationships in the banking industry. Therefore, the agencies have generally gathered information on internal control weaknesses and defalcations through direct reporting by the institution and through the examination process, including the review of management letters and other reports that banks receive from auditors.

The agencies currently require banks and savings and loan associations that are subject to the reporting requirements of the Securities and Exchange Act of 1934 to report changes in auditors directly to the institution's regulatory agency. In addition, the agencies expect examiners to determine whether institutions have changed auditors during the last year and to determine the reasons for the change.<sup>9</sup>

A number of commentors, including bank trade associations and an accounting firm, indicated that expansion of auditor responsibilities to include direct reporting to the regulator would violate the traditional auditor-client relationship and would make auditors more like regulators.<sup>10</sup> This could diminish the auditor's role in providing accounting and systems advice and other services to the client institution and could make institutions less willing to provide information on activities to their auditors.

Concern was also expressed that more direct auditor responsibility to regulators might increase the risk that confidential client information might somehow come into the public domain. Commentors recommended that regulatory examinations and financial statement audits should remain independent of each other.

On the other hand, a few comments indicated that additional auditor reporting responsibilities would greatly aid the regulatory agencies in determining some of the problems that exist at institutions in the intervals between on-site examinations. Furthermore, several respondents recommended that management should be required to annually report on the adequacy of its internal control system and compliance with applicable laws and regulations, and that auditors should be required to audit assertions in these management reports.

### **3. Auditor Participation in Conferences and Meetings**

The federal regulatory agencies currently permit external auditors to participate in a number of conferences between agency representatives and the depository institution, with the



institution's permission and appropriate notification to the regulatory agency. For example, an external auditor may participate in the "exit conference" that takes place when examination field work is substantially completed and the examiner discusses the results of this work with the institution's management. Participation in these conferences provides the auditor with information about an examiner's tentative conclusions before the final examination report is received by the institution.

Other forms of communication between auditors and the regulatory agencies are also permitted under current policies of the agencies. With permission of their client institutions, external auditors are permitted to contact senior representatives of the regulatory agencies to discuss supervisory matters regarding their clients. These types of discussions would generally occur when audits take place in the intervals between supervisory examinations.

The AICPA issued guidance in 1990 that informed external auditors of financial institutions of the policies of the regulatory agencies in these areas and the requirements of Section 931 of FIRREA. This guidance also required auditors to review examination reports and other supervisory documents and communicate with the agencies as part of their audits of financial institutions.

Most commentators generally viewed the current policies of the federal regulatory agencies regarding auditor participation in meetings as appropriate. A number of respondents expressed concern that auditors should generally receive permission from management before attending meetings with regulators and that auditor participation in all meetings with regulators would not be necessary. Commentors also recommended that auditors participating in these meetings should be protected from liability for any potential breach of confidentiality associated with the disclosure of client problems to regulators. In addition, some comments indicated that auditors should not hold discussions with regulators unless management is present to address auditor comments.

#### **D. Consideration of the Bank of England System for Using Auditors for Supervisory Purposes**

In order to assess the feasibility of adopting regulations similar to the provisions of England's Banking Act, 1987 (1987 Act), it is important to understand the system that the Bank of England has established based on these statutory provisions. Thus, this section presents an overview of the Bank of England system of using auditors and then addresses the specific provisions of the 1987 Act.

## 1. Overview of Bank of England System

The provisions of the 1987 Act that enable the Bank of England to require information to be reported by accountants are substantially the same as the powers that it had under the Banking Act 1979.<sup>11</sup> However, after the 1987 Act, the Bank of England formalized its requirements by issuing guidance to banks' and their accountants that established a system of reports by accountants regarding a bank's accounting systems, internal controls, and regulatory financial reports.

It is important to emphasize that the supervisory systems in the United States and the United Kingdom are very different. For example, whereas the United States has long utilized on-site examinations of institutions by agency examiners as part of its supervisory efforts, the United Kingdom has not. In the United Kingdom, since on-site examinations are not conducted, auditors fulfil many of the on-site review tasks that examiners fulfil in the United States.

It is also important to note that with approximately 560 banks, the United Kingdom has a much smaller number of depository institutions to supervise than do the federal regulatory agencies in the United States. Furthermore, most of the larger banks have headquarters very near to the Bank of England's main offices in London, thus making supervisory monitoring and consultations with bank management somewhat easier than in this country.

The provisions of the 1987 Act that are considered in this study enabled the Bank of England to issue guidance which requires "reporting accountants" (frequently, a bank's external auditors) to report annually on the adequacy of a bank's (a) accounting and internal control systems and (b) regulatory reports, called "returns," filed with the Bank of England. Returns are similar to the reports of condition used by the United States regulatory agencies to periodically gather information on the financial condition, performance, risk profile, and capital adequacy of banking organizations. The Bank of England does not require all regulatory reports to be examined by reporting accountants, but instead selects a sample of returns for these reviews.

In the attestation reports dealing with a bank's accounting and internal control systems, the reporting accountant must opine whether these systems were established and maintained in accordance with the requirements set forth in guidance issued by the Bank of England. The attestation report that addresses the returns must state whether, in the accountant's opinion, in all material respects, the information contained in the regulatory reports: (a) has been completely and accurately extracted from the accounting and other records; (b) has been prepared and presented in accordance with the current reporting instructions

of the Bank of England; and (c) has used the same accounting policies as those applied in the most recent financial statements. When exceptions are determined with respect to either type of attestation report, the reporting accountants must attach an appendix discussing the issues in question. Both reports are for the use of the Bank of England and are not released to the public.

The Bank of England has also used its powers under the 1987 Act to issue guidance that establishes a framework for: (a) meetings between the Bank of England, the management of a bank, and the bank's external auditors and reporting accountants; and (b) for auditors and reporting accountants to inform the Bank of England (confidentially or otherwise) of information regarding problems at the bank under review.

## **2. Analysis of Specific Provisions of the 1987 Act**

The provisions of England's 1987 Banking Act that FIRREA requires that this study consider are contained in chapter 22 of the Act and include sections 8, 39, 41, 45, 46, 47, 82, 83, 85, and 94. These specific sections are summarized and discussed below.

Section 8 gives the Bank of England (Bank) the power to require a report by an accountant (or any other expert) on any information provided to the Bank in connection with a new application for "authorization." Authorization is essentially approval to conduct business as a bank and is similar to obtaining a bank charter. Once the application is approved, a bank is referred to as an "authorized institution." The Bank of England has not extensively used this section to require such reports.

Section 39 empowers the Bank of England to require an authorized institution to provide the Bank with a report by an accountant on information it may require for the performance of its functions under the Act. The Bank of England must approve of the accountant that is selected by the bank to provide this report.

Under section 41, the Bank of England is given the power to appoint investigators of institutions and related parties. The section also addresses the duty of the auditors to provide information, etc. to these investigators. These investigators would report directly to the Bank of England.

Section 45 requires institutions to keep the most recent audited financial statements at United Kingdom offices where deposits are accepted.

Institutions are required by section 46 to notify the Bank of England of proposed or actual changes in auditors. Auditors

are required to notify the Bank when they: (a) resign; (b) decide not to seek reappointment; or (c) decide to qualify the auditors' report.

Under section 47, auditors are empowered to communicate in good faith to the Bank of England (whether or not in response to a request from the Bank) certain information or opinions regarding client institutions without violating duties to those clients. (Generally, auditors would only report problems to the Bank of England if management has not previously done so.) Thus, auditors would be protected from lawsuits from a client bank, if in good faith, the auditor provided necessary information regarding the client to the Bank of England.

Sections 82, 83, and 85 restrict the Bank of England from disclosing confidential information about institutions obtained as a result of its supervisory activities. The Bank of England is permitted to disclose information to reporting accountants that is necessary to the conduct of their examinations.

Under section 94, it is a criminal offense for anyone, including an auditor: (a) to provide, knowingly or recklessly, the Bank of England with materially false or misleading information; or (b) fail to disclose to the Bank of England or an investigator that it has appointed, information relevant to its supervisory functions.

These sections of the 1987 Act provide the Bank of England with the power to establish a framework for using auditors to conduct on-site examinations of institutions. In a regulatory environment that does not use on-site regulatory examinations, such a system provides information to the regulatory authority about bank activities, internal systems, and the quality of regulatory reports that it would not otherwise be able to obtain.

In contrast, in the United States, regulatory examinations already provide this information to regulatory authorities. Therefore, many of these provisions would be redundant in this country. Although generally not addressing specific sections of the 1987 Act, virtually all comments indicated opposition to the implementation of the Bank of England supervision system because of this redundancy and the dramatic change that would result in the auditor-client relationship.

Section 8 of the 1987 Act duplicates existing United States regulatory policies. The federal regulatory agencies already perform on-site examinations before as well as after institutions come under their supervision, for example, as a result of new charters, applications for federal deposit insurance or for membership in the Federal Reserve System.

In addition to on-site examinations, scrutiny of such organizations is achieved by audits. As previously discussed, the OCC presently requires audits of newly chartered national banks, and all federally-insured savings associations are required to have annual audits by external or internal auditors. While state-chartered banks are generally not subject to audits as part of the chartering process, the FDIC requires audits of institutions for the first three years after they receive federal deposit insurance. Also, the Federal Reserve requires audits of bank holding companies with over \$150 million in total consolidated assets and of state member banks subject to the reporting requirements of the Securities Exchange Act of 1934.

With respect to sections 39 and 41, the federal regulatory agencies use on-site examinations to perform the activities that the Bank of England might request of reporting accountants. Furthermore, the agencies already have the authority to require institutions to have external auditors perform specialized review tasks for the agencies and report their findings to the agencies.

Similarly, the provisions of section 45 would also be redundant in this country. The federal regulatory agencies already have regulations that require institutions to make available to depositors, shareholders, and others a copy of their reports of condition and published annual reports.

With regard to sections 82, 83, and 85, these sections have a specific relevance in the Bank of England system because of the Bank's particular use of auditors to perform the work of examiners. However, since examiners are employed by the federal regulatory agencies in the United States, the restrictions that these sections place on the Bank of England regarding the provision of confidential information to auditors would be inappropriate for regulators in this country. Furthermore, examination report information is already subject to very strict confidentiality rules in the United States.

In some respects, sections 47 and 94 duplicate existing requirements in the United States. Since examiners are employees of the regulatory agencies, they are empowered by the agencies to report to the agencies on the banks under examination. Also, since they are employees of the regulatory agencies, they are not under pressure to withhold relevant information from, or provide misleading information to, the agencies.

Instead, these provisions could be applied to external auditors, providing the regulators with additional information on client problems uncovered during an audit. There is precedent for this in the thrift industry. As noted earlier, the OTS already requires auditors to notify the district director of examinations of apparent defalcations that the auditor has discovered and reported to client management but that the

institution has not reported to the OTS. Auditors must also report to the OTS any material weakness in a savings association's system of internal controls.

Auditors might be more willing to share information with regulators if they received protection from client confidentiality suits (section 47) and were held criminally liable for refusing to provide relevant information, or for providing misleading information, to regulators (section 94). Of course, reasonably specific standards would have to be developed as a basis for auditor reporting to regulators.

However, the adoption of provisions such as sections 47 and 94 would result in a significant change in the auditor-client relationship. Professional auditing standards in the United States do not require auditors to design audits to detect all errors, irregularities or illegal acts, but rather, to detect those that could result in material misstatements of financial statements. Auditors are generally required to report these types of problems only to an institution's management, audit committee, and Board of Directors. Therefore, in response to provisions such as sections 47 and 94 auditors might expand the scope of their work to include more testing for, documentation and reporting of, errors, irregularities and illegal acts. This additional work could significantly increase audit costs.

Furthermore, auditors would be forced to report to regulators confidential information regarding their clients, which is viewed by some as a violation of the existing auditor-client relationship. The regulatory agencies would have to devote more attention to reviewing reports from auditors, a process which would result in additional personnel and training costs.

The authority provided by section 46 could enhance the ability of the agencies to identify potential problems at institutions between examination dates and improve the quantity and quality of information that examiners receive from auditors. Prompt notification of changes in auditors and qualifications of audit reports (section 46) would help regulators to identify potential problems at institutions between examinations and reduce the opportunity for institutions to change auditors due to disagreements over accounting principles. These requirements are similar to the Form 8-K reporting requirements of the Securities and Exchange Commission.

#### **E. Options for Strengthening the Ties Between Regulators and External Auditors**

The practical options for addressing the topics involving the communication between auditors and regulators and use of

audit information in the regulatory process are listed below.

### **1. Require Audit Reports to be Sent Promptly to Regulators**

This option would seek to enhance regulatory supervision by requiring depository institutions or their auditors to provide a copy of audit reports, management letters, and other reports or correspondence directly to regulators in a timely manner. When audits take place between regulatory examinations and examinations are less frequent, this approach may provide the bank regulatory agencies with information from audits on client problems in a timely manner. In addition, this requirement would not increase the costs of examinations or audits.

This option, however, could be viewed as a violation of, or a change in, auditor-client relationships, when confidential management letters or other auditor correspondence contain information on client problems.

### **2. Require Prompt Notification of Changes in Auditors**

This option would, in effect, require the enactment of statutory authority similar to section 46 of the United Kingdom's 1987 Banking Act. This could improve the quality of audit information available for use in the supervision of institutions by requiring prompt notification of changes in auditors and qualifications of audit reports.

This would not increase the costs of examinations or audits and would improve the quality of information available to regulators, since changes in auditors and qualifications in audit reports can indicate problems at institutions. This requirement could also reduce the occurrence of "opinion shopping" at institutions (*i.e.*, the practice of institutions searching for firms that give them the types of audit opinions and accounting guidance that they want).

On the other hand, this requirement would place an additional burden on institutions and their auditors to make notification.

### **3. Require Auditors to be More Accountable to Regulators**

This option would, in effect, require enactment of the statutory authority similar to sections 47 and 94 of the United Kingdom's 1987 Banking Act and require auditors to report defalcations (that have not been reported by management) and material internal control weaknesses or other problems determined during audits. Under the Bank of England system, auditors receive protection from client confidentiality suits (section 47) and are held criminally liable for refusing to provide relevant

information, or for providing misleading information, to regulators (section 94).

This requirement could provide regulators with more information on client problems uncovered during audits. In addition, there are precedents in thrift regulatory practice for the direct reporting to regulators of defalcations, material control weaknesses, and other problems discovered by auditors.

There are several disadvantages with this requirement. For the banking industry, this approach would be a violation of the existing auditor-client relationship and it might reduce the willingness of depository institutions to share information with auditors. Furthermore, since audits are not required of all institutions, some institutions may decide not to have audits in order to prevent the dissemination of confidential information to regulators.

#### **4. Adopt an Enhanced Mandatory Audit Requirement**

This option would require enactment of statutory authority for the regulatory agencies to require audits when certain criteria are met. The burden associated with this option could be limited by adopting a mandatory audit requirement (a) only for depository institutions with assets greater than \$150 million which are not audited directly or as part of a bank holding company audit; and (b) for institutions with inadequate internal audit programs or serious recordkeeping problems (*i.e.*, similar to the FIRREA section 919 requirement for credit unions). For institutions audited as part of bank holding company, the regulators, through the FFIEC, could develop minimum audit guidelines to ensure that these banks receive adequate audit coverage.

This approach would provide an independent review of financial reports, separate from the regulatory examination process. It would also improve the regulatory benefits of the previous options, since institutions could not forego audits in order to avoid the implementation of those options.

On the other hand, the audit requirement would entail additional costs for institutions. Furthermore, a mandatory audit requirement may be unnecessary. Only 66 commercial banks with assets over \$150 million, representing about one percent (\$31 billion) of the banking industry's total assets, are currently unaudited. Furthermore, the savings and loan industry has experienced massive problems in spite of a mandatory audit requirement.



## Endnotes

<sup>1</sup> These audits must be conducted in accordance with the professional auditing standards of the American Institute of Certified Public Accountants.

<sup>2</sup> See 12 USC 1813(u).

<sup>3</sup> Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation, Commercial Bank Examination Manual (Washington, D.C.: FRB, 1984), Section 1.1, p.1.

<sup>4</sup> See 12 CFR 563.170.

<sup>5</sup> See 12 CFR 701.13 and 741.2.

<sup>6</sup> Source: National Credit Union Administration

<sup>7</sup> Some state statutes or state banking authorities require certain auditing procedures to be performed each year with a copy submitted to the state authority.

<sup>8</sup> Federal banking agencies may issue temporary cease and desist orders if an institution's books and records are so incomplete and inaccurate that the appropriate agency is unable to determine the institution's condition through the normal supervisory process or the agency is unable to determine the details or purpose of any transaction that may have a material effect on the financial condition of the institution. See 12 USC 1818(b) and 1818(c)(3)(A). In addition, Federal banking regulators may require institutions and institution-affiliated parties to take affirmative action to correct conditions resulting from violations or practices by issuing cease and desist orders.

<sup>9</sup> The FDIC has also requested that state non-member banks notify the FDIC regional offices directly of any changes in auditors.

<sup>10</sup> The use of the term "auditor-client relationship" in this Chapter is not intended to imply that an auditor-client privilege is recognized by Federal law.

<sup>11</sup> Financial statement audits are generally not the subject of the 1987 Act provisions that FIRREA requests this study to consider. All banks in the United Kingdom are subject to financial statement audits, but these are required by the Companies Act of 1985.

## **Chapter XIII**

### **CREDIT UNIONS**

#### **A. Introduction**

This chapter focuses on credit unions and their federal insurance fund, the National Credit Union Share Insurance Fund (NCUSIF). FIRREA requires this study to include an evaluation of "[t]he adequacy of capital of insured credit unions and the National Credit Union Share Insurance Fund, including whether the supervision of such fund should be separated from the other functions of the National Credit Union Administration."<sup>1</sup> Sections B and C of this chapter provide background information on credit unions and the NCUSIF. Section D examines capital in the credit union industry, and attempts to compare it to the banking industry. Section E discusses the accounting treatment of the one percent deposit credit unions contribute to their insurance fund, and Section F considers the adequacy of the fund. Finally, Section G addresses the issue of separating the credit union regulator from the NCUSIF.

#### **B. Structure of the Credit Union System**

A federal credit union is "a cooperative association organized...for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes."<sup>2</sup> Each credit union member, regardless of his or her number of shares, has one vote; voting by proxy is prohibited. A credit union's board of directors is elected from its membership, which is required to be "limited to groups having a common bond of occupation or association, or to groups within a well-defined neighborhood, community or rural district."<sup>3</sup>

The National Credit Union Administration (NCUA) and the NCUSIF supervise and insure approximately 8,600 federal credit unions and 4,400 state-chartered credit unions. Most credit unions are themselves members of -- with deposits in -- what are known as corporate credit unions, which provide investment and liquidity services to their members. The corporate credit unions are, in turn, members of the U.S. Central Credit Union, an uninsured credit union affiliated with the Credit Union National Association (which is the principal national trade association for credit unions). U.S. Central, with assets of over \$25 billion, provides investment opportunities, as well as other

wholesale financial and payment services, to corporate credit unions and their members.

The Central Liquidity Facility (CLF) is a mixed-ownership government corporation managed by the NCUA. The NCUA may, under certain conditions, authorize the CLF to advance funds to the NCUSIF.<sup>4</sup> Also under certain conditions, the Secretary of the Treasury is authorized to lend up to \$500 million to the CLF.<sup>5</sup> U.S. Central, acting as agent for its corporate credit union members, owns a large percentage of the stock of the CLF. Thus, most credit unions, either directly or through their ties with corporate credit unions, are members of the CLF. (See Figures 1 and 2)

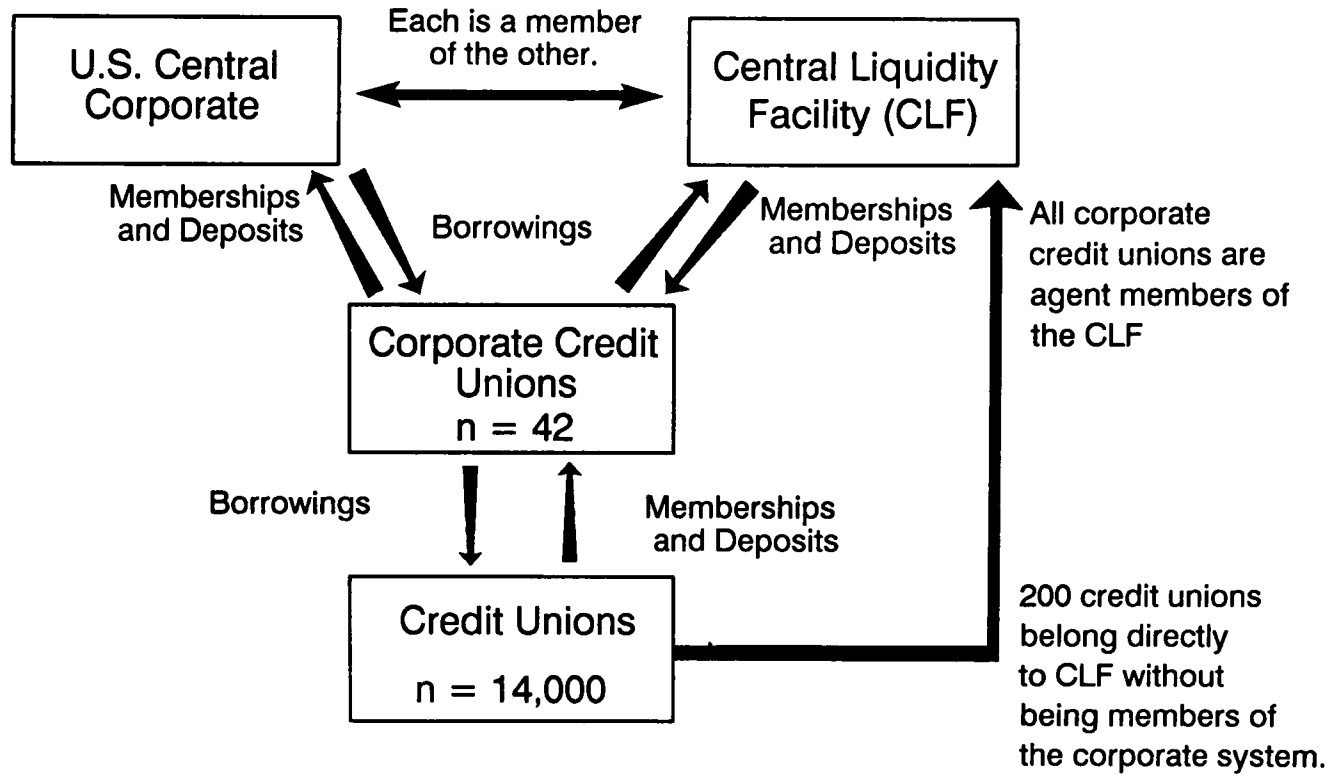
Year-end 1989 assets of federally insured credit unions totalled \$184 billion, accounting for 3.7 percent of the assets held by the nation's depository institutions. (See Table 1) This represents substantial growth since 1970, when credit unions held \$10.6 billion in assets (1.3 percent of total assets in depository institutions), and 1980, when assets totalled \$60.9 billion (2.3 percent of total assets in depositories). Table 2 shows the asset mix of credit unions compared to banks as of December 1989. Since 1980 the major change for credit unions has been the rapid growth in loans secured by one-to-four family dwellings, which have risen from less than five percent of assets in 1980 to 21.7 percent in 1989. This rate of growth has recently begun to slow.

### C. History of the NCUSIF

The NCUSIF is administered by the NCUA's Office of Examination and Insurance. When the NCUSIF was created in 1970, its primary source of income, like the other federal insurers of depository institutions, was the assessment of insurance premiums. Low insurance losses and minimal operating expenses initially allowed the NCUSIF to put most of its revenues directly into reserves. In the late 1970s and early 1980s, credit unions grew rapidly and offered new services to their members. Between 1977 and 1984, deposits ("shares") grew from \$37.4 billion to \$84.2 billion and assets grew from \$43.5 billion to \$92.9 billion.

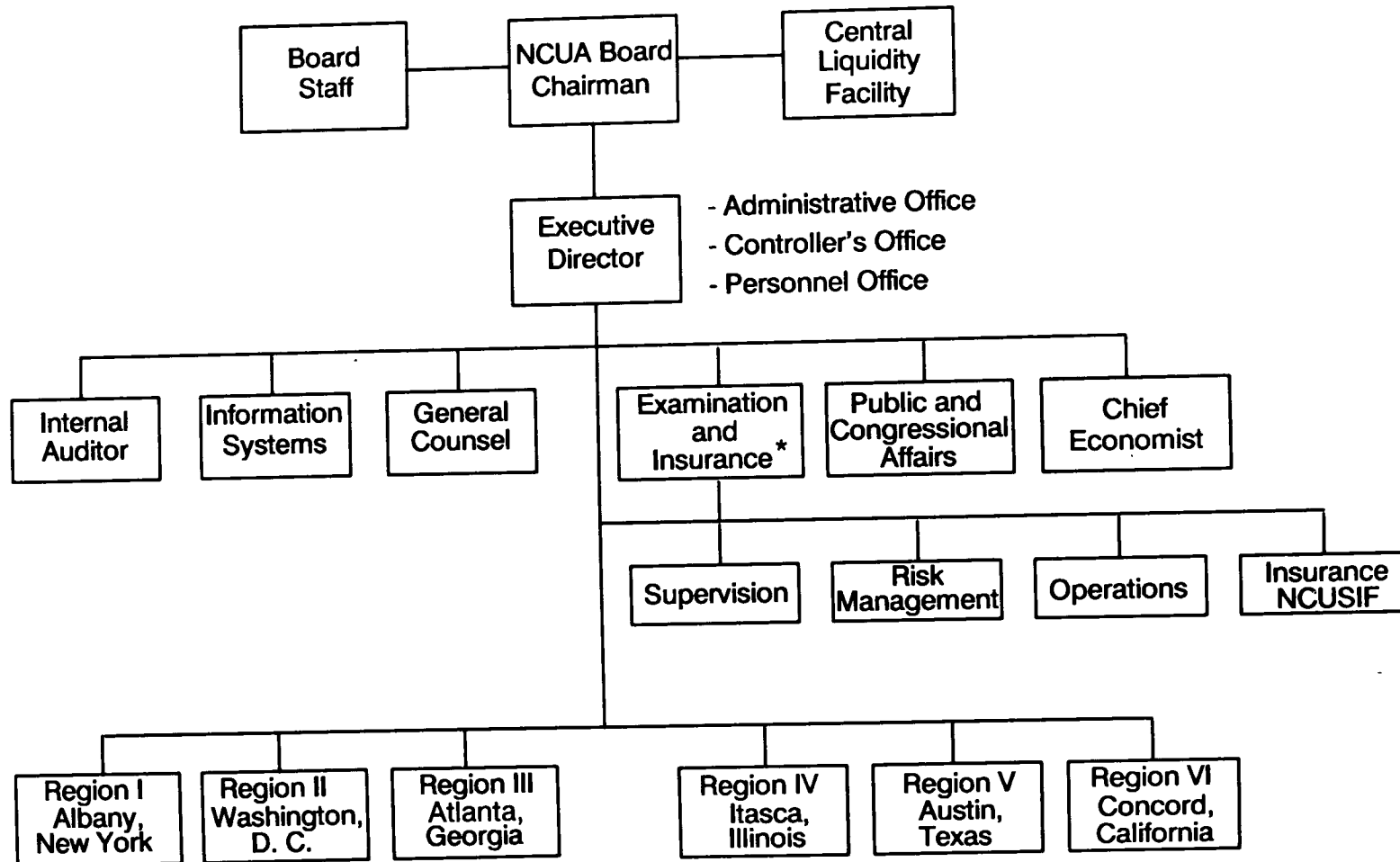
During the early 1980s, credit unions experienced liquidity and earnings problems, to a large extent caused by high interest rates. Between 1934 and 1979, the statutory interest rate cap on loans for credit unions was 12 percent, even when the prime rate surpassed 20 percent.<sup>6</sup> In addition, with many credit unions sponsored by one employer, plant closings forced an unusually large number of institutions to liquidate. As a result, over 1,200 credit unions failed between 1980 and 1984. By 1982 the NCUSIF had only \$.26 for each hundred dollars of insured

Figure 1  
The Credit Union System



Source: National Credit Union Administration.

Figure 2  
 NCUA Organizational Chart



\* All supervision, examination, and insurance issues are coordinated and directed by four departments within the Office of Examination and Insurance .

Source: National Credit Union Administration.

Table 1

## Summary Statistics for Credit Unions and Commercial Banks

(As of December 31, 1989)

	Credit unions	Commercial banks
Number (Federally Insured) .....	13,371	12,714
Assets (in millions of dollars).....	\$183,688	\$3,299,627
Equity Capital (in millions of dollars)....	\$13,535	\$205,494
Average Size (in millions of dollars) ....	\$13.7	\$259.5
Equity Capital Ratio (percent).....	7.4	6.2

Table 2

## Asset Distribution of Credit Unions and Commercial Banks

(As of December 31, 1989)

	Credit unions		Commercial banks	
	In billions of dollars	Percent	In billions of dollars	Percent
Total Assets .....	\$183.7	100	\$3,300.0	100
Total Loans .....	122.6	66.8	2,057.7	62.3
Consumer .....	80.8	44.0	400.6	12.1
Commercial/Industrial <sup>1</sup> .....	1.5	.8	618.8	18.8
1-to-4 Family R/E .....	39.8	21.7	350.9	10.6
Commercial and Other Real Estate <sup>2</sup> .....	N/A	N/A	410.8	12.4
Other Loans .....	.5	.3	276.6	8.4
Total Investments .....	52.2	28.4	883.9	26.8
Cash .....	4.3	2.3	214.8	6.5
Other Assets <sup>3</sup> .....	4.6	2.5	143.6	4.4

<sup>1</sup> For credit unions: agriculture loans and commercial loans, including some commercial real estate.<sup>2</sup> For banks: loans on apartments, non-residential-non-farm properties, farms (including residence), land development and construction, and foreign real estate.<sup>3</sup> Premises, other real estate owned, all other assets, minus allowances for loan and investment losses.

Source: National Credit Union Administration.

Table 3

## Distribution of Number, Capital, and Assets of Credit Unions by Capital Ratios

Capital ratios	Number	Percent of total	Total capital (in millions of dollars)	Percent of total	Total assets (in millions of dollars)	Percent of total
Less than 3% .....	498	3.7	\$40.9	3.0	\$8,109	4.4
3% to 3.99% .....	451	3.4	297.6	2.2	8,464	4.6
4% to 4.99% .....	778	5.8	905.0	6.7	19,956	10.9
5% to 5.99% .....	1,147	8.6	1,412.6	10.4	25,727	14.0
6% or more .....	10,498	78.5	10,878.9	80.4	121,432	66.1
Total .....	13,371	100.0	13,535.0	100.0	183,688	100.0

Source: National Credit Union Administration.

deposits, a level well below what was considered safe. In 1982 and 1983, the NCUSIF doubled its premium assessment to 17 basis points, which proved sufficient to pay for losses but had little effect on the fund's level as losses continued to rise.

In 1984, Congress approved legislation to recapitalize the NCUSIF. This legislation required federally insured credit unions to deposit and maintain an amount equal to one percent of insured shares in the fund.<sup>7</sup> Credit unions are not required to expense this deposit, but instead carry it on their books as an asset. Credit unions forego the income earned by the one percent deposit, which accrues to the insurance fund.<sup>8</sup> The NCUSIF may assess a premium of 12 basis points if this income is insufficient to pay for losses. On the other hand, if the fund exceeds 1.3 percent of insured shares, the balance above that level must be distributed on a pro rata basis to the credit unions.<sup>9</sup> No premium has been assessed since capitalization, while distributions were made only in 1985.

The NCUSIF currently has just over \$2 billion in assets. Its equity ratio (computed by dividing insurance fund reserves by total insured shares) was 1.23 percent in 1985 following the capitalization, and has risen to 1.28 percent as of June 30, 1990. Since capitalization, earnings on the fund have covered administrative and insurance costs, while the equity ratio has stayed between 1.25 percent and 1.30 percent. During this same period, credit union capital ratios increased from 6.5 percent in 1985 to 7.4 percent as of December 31, 1989.

#### D. Credit Union Capital

Credit unions are chartered without capital, which they accumulate by retaining earnings. No stock or debt instrument is permitted. By statute, credit union reserve (capital) requirements are based upon the amount of risk assets that a credit union has on its balance sheet.<sup>10</sup> Risk assets, which are given a 100 percent weight, are defined as all assets except cash and government-guaranteed loans or investments. Investments and loans over three years in maturity are also considered risk assets, even if they are government guaranteed.

Credit unions are required to transfer a certain percentage of gross income to a regular reserve at the end of each accounting period. The amount of the transfer and the amount of reserves required depend on the age and size of the credit union and the amount of risk assets. A credit union in operation more than four years and having assets of \$500,000 or more sets aside 10 percent of gross income until the regular reserve equals 4.0 percent of outstanding loans and risk assets, and then 5.0 percent of gross income until the regular reserve equals six percent of loans and risk assets. Credit unions in operation

less than four years or under \$500,000 in assets have the same transfer rates but have higher reserve level requirements, 7.5 percent and 10 percent respectively.

Table 3 shows the distribution of credit unions by capital ratio. Almost 80 percent of the total number of credit unions and about two-thirds of total assets are in institutions with reserve ratios in excess of six percent. About 3.7 percent of the number of credit unions and 4.4 percent of assets are in institutions with capital ratios less than three percent.

Table 4 provides a comparison of bank and credit union capital ratios. Although the non-risk weighted capital ratios for banks are higher than those for credit unions at all size classifications below \$100 million in total assets, credit unions appear to have less risky portfolios, on average, than other financial intermediaries.<sup>11</sup> For example, the banking industry's risk-based guidelines require capital equal to eight percent of risk-weighted assets, half of which must be core capital. If credit unions were to use these guidelines, they would have a capital ratio of over 11 percent, all of which would be core capital. (See Table 5.)

## **E. Accounting Treatment of One Percent Insurance Deposit**

### **1. Arguments Supporting Current Treatment**

An issue which has received considerable attention in the past is the accounting treatment of credit unions' one percent deposit in the NCUSIF. As noted above, credit unions do not expense this contribution, but carry it as an asset on their books. The following arguments are made in support of this treatment:

- 1) This accounting method is consistent with generally accepted accounting principles (GAAP), and is supported by the Financial Standards Accounting Board (FASB) and the American Institute of Certified Public Accountants (AICPA).
- 2) This accounting method parallels the accounting treatment used by banks for investments in Federal Reserve Banks.
- 3) The one percent deposit is an investment which will not pay dividends to credit unions unless the fund's equity ratio exceeds 1.3 percent. Thus, NCUSIF-insured credit unions have a direct financial stake in the operation and annual performance of the fund, which gives them an interest in controlling their own riskiness as well as the riskiness of other credit unions.



**Table 4**  
**Capital Ratios of Credit Unions and Banks by Size**

**Commercial Banks**

(As of December 31, 1989)

Asset size (in millions of dollars)	Number of banks	Percent of total	Assets (in millions of dollars)	Capital <sup>1</sup> (in millions of dollars)	Capital (perce
0 to 2.....	26	0.2	34	18	
2 to 10.....	747	5.9	5,337	743	
10 to 50 .....	6,204	48.8	168,861	15,488	
50 to 100 .....	2,744	21.6	192,282	16,417	
Over 100.....	2,985	23.5	2,933,455	172,226	
<b>Total.....</b>	<b>12,706</b>	<b>100</b>	<b>3,298,968</b>	<b>204,893</b>	

Source: Federal Deposit Insurance Corporation.

**Credit Unions**

Asset size (in millions of dollars)	Number of credit unions	Percent of total	Assets (in millions of dollars)	Capital <sup>1</sup> (in millions of dollars)	Capital r (perce
0 to 2.....	6,107	45.7	4,575	501	
2 to 10.....	4,233	31.7	20,098	1,774	
10 to 50 .....	2,295	17.2	50,894	3,860	
50 to 100 .....	389	2.9	27,320	1,860	
Over 100.....	347	2.6	80,802	5,540	
<b>Total.....</b>	<b>13,371</b>	<b>100</b>	<b>183,688</b>	<b>13,535</b>	

<sup>1</sup> Equity capital. Excludes loan loss reserves.

Source: National Credit Union Administration.

**Table 5**  
**Risk-Based Capital Estimate for Credit Unions**  
(As of December 31, 1989)

	Assets (in millions of dollars)	Risk weight (percent)	Risk assets (in millions of dollars)
Loans except:	\$93,401	100	\$93,401
First Mortgage Real Estate .....	23,207	50	11,604
Unused Home Equity Credit Commitments .....	2,500	50	1,250
Government-Guaranteed Loans .....	6,000	20	1,200
Cash .....	4,295	0	0
U.S. Government Securities .....	6,688	0	0
Federal Agency Securities .....	9,415	20	1,883
Federal Agency Securities Pools .....	1,144	20	229
Investments in other Depositories .....	33,584	20	6,717
Other Investments .....	1,321	100	1,321
Other Assets .....	4,633	100	4,633
<b>Total .....</b>	<b>186,188</b>		<b>*122,238</b>
Balance Sheet .....	183,688		
Off Balance Sheet .....	2,500		

\* Equity capital of \$13,535 million divided by risk-weighted assets of \$122,238 million, equals an 11.1 percent capital-to-risk asset ratio.  
Source: National Credit Union Administration.

## 2. Arguments Against Current Treatment

A number of concerns are often expressed regarding the current accounting treatment of the insurance fund. First, it is argued that the amount of protection between the taxpayer and credit union losses is overstated because assets in the insurance fund and on credit union balance sheets are double-counted by the current accounting treatment of the fund. Most of the assets of the credit union insurance fund also count as industry capital, unlike the relationship between banks and their insurance fund. Thus, there is only one effective layer of protection for the taxpayer from credit union losses, while there are two layers between the taxpayer and bank losses.

A second concern involves the possible consequences of industry losses sufficient to require the NCUSIF to draw upon the one percent reserve. If the reserve were written down by the NCUSIF, its value would also have to be written down by each credit union. This would cause a reduction in credit union capital at the very time it might be most needed, which could cause even more failures and additional write-downs.

This is in contrast to the structure of the bank insurance fund. Banks are not required to replenish the insurance fund immediately from bank capital, but may instead rebuild the fund over time through premiums. As with other more traditional insurance policies, substantial losses might result in gradual, higher premiums which would allow banks to incorporate the added expense into their earnings plans. In most circumstances bank capital would not be subjected to unexpected, extraordinary losses in a "pay-as-you-go" structure.

With regard to the argument that the credit union system encourages more industry self-discipline, it is not clear that this is significantly different from the banking system. The flat premium paid by banks requires healthy banks to pay for the losses of weak banks, although not as quickly as would be required for credit unions. In traditional insurance settings, this sort of structure is blamed for the problem of adverse selection.<sup>12</sup> Even if the self-discipline argument were sound in principle, however, there is no clear mechanism for healthy credit unions to use to stop excessive risk-taking on the part of other credit unions.

### F. Adequacy of the NCUSIF

NCUSIF has retained earnings of \$452 million, specific reserves for potential losses of \$71 million, annual interest income of approximately \$160 million, and the ability to assess a premium of \$137 million for a total of \$820 million available in one year to absorb losses prior to using any of the one percent

deposit. Since 1980, the fund's worst year (1982) resulted in total expenses of \$1.52 for every \$1000 of insured deposits.<sup>13</sup> This rate would result in \$246 million of expenses to the fund if applied to total insured deposits at the end of 1989. Thus, it can be argued that the NCUSIF would have to experience expenses over three times its highest annual expense rate before any portion of the one percent deposit would have to be written off as an expense by credit unions.

According to this argument, the NCUSIF would have to experience an annual rate more than eight times the 1982 rate before the entire \$2.1 billion fund would be wiped out (including the one percent deposit). To achieve such a loss, for example, would require the failure in one year of the largest insured credit union (with assets of \$4.2 billion) at a loss of 50 percent of assets. The NCUSIF's recent loss experience for liquidating insured credit unions has been approximately 10 percent of assets.<sup>14</sup>

If the entire NCUSIF fund were wiped out, credit unions are required by statute to expense the one percent on their books and make an additional deposit of one percent (\$1.6 billion as of year-end 1989) in the NCUSIF. This expense would lower credit union capital-to-asset ratios by nearly one percentage point to 6.5 percent.

With current credit union capital levels, an additional one percent assessment would cause the technical insolvency of about 50 to 60 credit unions with aggregate assets of \$1 billion. If these credit unions were merged or liquidated at the NCUSIF's average loss rate of 10 percent of assets the fund would lose an additional \$100 million. Even after this catastrophic scenario, however, the credit unions would have \$12 billion of capital reserves. It could thus be argued that the fund would have to experience expenses at about 50 times the 1982 rate to deplete the industry's capital.

This scenario seems remote. On the other hand, until the late 1970s, the thrift industry looked very stable, with low historical loss rates. But when trouble did occur, a large proportion of the thrift industry was affected at once. Moreover, it was severe losses in a number of years, not just one year, which eroded the insurance fund. Thus, when discussing depository institutions, it is not appropriate to rely too heavily on low historical loss rates.

#### **G. Separating NCUA from NCUSIF**

The fact that the NCUSIF is part of the NCUA is another issue which has received a great deal of attention. In the case of the thrift industry, there is general agreement that the

Federal Savings and Loan Insurance Corporation was rendered less effective as an insurer by the fact that it was controlled by the Federal Home Loan Bank Board, which chartered and regulated thrifts. As a result, FIRREA created the Office of Thrift Supervision, and moved the insurance function to the FDIC. There are some who suggest that the thrift industry experience argues for a similar separation of the NCUSIF from the NCUA.

One argument for the separation of the insurer from the regulator is that a regulator may err on the side of promoting the industry by, for example, focusing on new areas of investment to enhance profitability. An independent insurer, on the other hand, is concerned first and foremost with safety and soundness and the integrity of the fund. New investment opportunities would first have to pass the insurer's safety and soundness test. Moreover, it is unlikely that both an insurer and regulator, each with independent examination forces and enforcement powers, would pursue lax supervision at the same time. Constructive friction between regulator and insurer could prevent abuses by either.

Another benefit of emulating the thrift industry solution and giving the insurance function to the FDIC would be the possibility of increased efficiency and experience in the handling of failing and failed depository institutions generally. For example, with one insurer for all depository institutions, it would be easier to coordinate the sale of failed institutions and their assets, thus maximizing the insurer's return. Some of these benefits might also be achieved if the NCUA Board of Directors were simply reorganized so that one position was filled by a bank regulator.

Finally, the FDIC as insurer of all depository institutions could provide a more consistent view on capital and accounting standards, examination procedures, and enforcement powers for all depository institutions. Such consistency could increase safety and soundness generally, which translates to more protection for the taxpayer. Indeed, whether it is the FDIC or another federal regulator, the government has a duty to the taxpayer to provide uniform and effective oversight of all depository institutions which benefit from a federal guarantee.

A number of arguments are made against the separation of the insurer from the regulator. For instance, there could be confusion over the roles and responsibilities of the insurer and of the regulator. In addition, costs might increase for a given level of supervision because of redundancy and the need for increased coordination. A separated structure might also allow the regulated institution to play the insurer against the regulator. Finally, in a unified structure, the regulator might be less likely to ignore risks to the insurance fund because it is the insurer as well. A separation of the regulator and

insurer could put the insurer in the situation of insuring a fund without having total control of its risk level.

## Endnotes

<sup>1</sup> 12 U.S.C.A. 1811 note.

<sup>2</sup> 12 U.S.C. 1752(1).

<sup>3</sup> 12 U.S.C. 1759.

<sup>4</sup> 12 U.S.C. 1795f(a)(18). In addition, if the NCUA determines that it is necessary, the Secretary of the Treasury must lend up to \$100 million to the NCUSIF. This loan would be made on such terms as agreed to by Treasury and the NCUA Board. 12 U.S.C. 1783(d).

<sup>5</sup> 12 U.S.C. 1795e(b).

<sup>6</sup> The Depository Institutions Deregulation and Monetary Control Act of 1980 raised the loan ceiling to 15 percent and permitted the NCUA to raise the ceiling further when economic conditions warranted. (Pub. L. No. 96-221)

<sup>7</sup> 12 U.S.C. 1782.

<sup>8</sup> 12 U.S.C. 1783(c). Funding for salaries and expenses of the NCUA Board and its employees is obtained from fees and assessments, including income earned from the investment of the one percent deposit. 12 U.S.C. 1766(j).

<sup>9</sup> 12 U.S.C. 1782(c). The form of the distribution is prescribed by the Board and may include a waiver of insurance premiums, rebates and/or distributions from NCUSIF equity. 12 CFR 741.9(e).

<sup>10</sup> 12 U.S.C. 1762.

<sup>11</sup> In addition, it is difficult to compare banks and credit unions, particularly at the smallest asset sizes, because banks are required to capitalize at their initial incorporation. Thus, for a new bank, the bulk of initial funds may be in capital.

<sup>12</sup> Adverse selection occurs when an insurer either cannot, or will not, price insurance according to the client's risk type. This can result in an overabundance of risky clients in the insurance pool. This issue is discussed at greater length in Chapter VIII, "Risk-Related Premiums."

<sup>13</sup> NCUSIF annual reports, 1984-89.

<sup>14</sup> Between 1980 and 1989, although it has been somewhat higher the last two years.

## Chapter XIV

### COLLATERALIZED BORROWING

#### A. Introduction

This chapter reviews the feasibility of adding collateralized borrowing to the deposit insurance base. Collateralized borrowing can be costly to the insurance funds in two ways. First, to the extent that it replaces uninsured deposits that would have suffered losses, the resolution cost of a failed institution is increased. Second, when a depository institution shifts its funding from deposits to collateralized borrowing, its insurance fund loses a source of premiums.

On the other hand, there are several significant disadvantages to assessing premiums on collateralized borrowing: (1) it would raise funding costs for banks and thrifts; (2) it could discourage the use of longer-term Federal Home Loan Bank advances, which are a useful tool for asset-liability management; and (3) it would put banks that are government securities dealers at a competitive disadvantage with non-bank government securities dealers.

Chapter XIV is organized as follows: Section B reviews the use of collateralized borrowing by depository institutions; Section C discusses the incentives to use collateralized borrowing; Section D analyzes the cost to the FDIC of collateralized borrowing; Section E focuses on the problems with assessing premiums on borrowing; and Section F discusses the policy option of assessing collateralized borrowing.

#### B. Use of Collateralized Borrowing by Depository Institutions

Collateralized borrowing, a source of funds for depository institutions, includes repurchase agreements and other secured borrowing arrangements, as well as loans from the Federal Reserve discount window and Federal Home Loan Bank (FHLBank) advances.<sup>1</sup> Other obligations can also be secured (e.g., trade credit).

Collateralized borrowing usually involves pledging assets with significantly larger value than the funds borrowed. This practice, called "overcollateralization," is intended to protect the creditors against a decline in the market value of pledged assets. Collateralized borrowing arrangements that extend over medium- to long-term periods frequently include marking pledged



assets to market at regular intervals and adjusting the amount of assets pledged in order to maintain the agreed-upon rate of overcollateralization.

If the issuing institution fails, over-secured creditors are generally paid off and the FDIC then liquidates the collateral. The FDIC keeps the excess if the collateral is sold for an amount greater than the secured liabilities. If the claim is under-secured, the collateral is liquidated (often by the FDIC), and the secured creditors receive payment only up to the value of the collateral. They become general creditors for the difference between the value of the collateral and their claims. The FDIC generally does not have the right to avoid any legally enforceable security interest, e.g., a collateralized borrowing agreement, except under certain circumstances.<sup>2</sup>

In fact, the standard practice of overcollateralization provides full recovery for most secured creditors with over-collateralized claims. With deposits, the funds suppliers either are directly insured or have general claims against the unpledged assets of the institution.

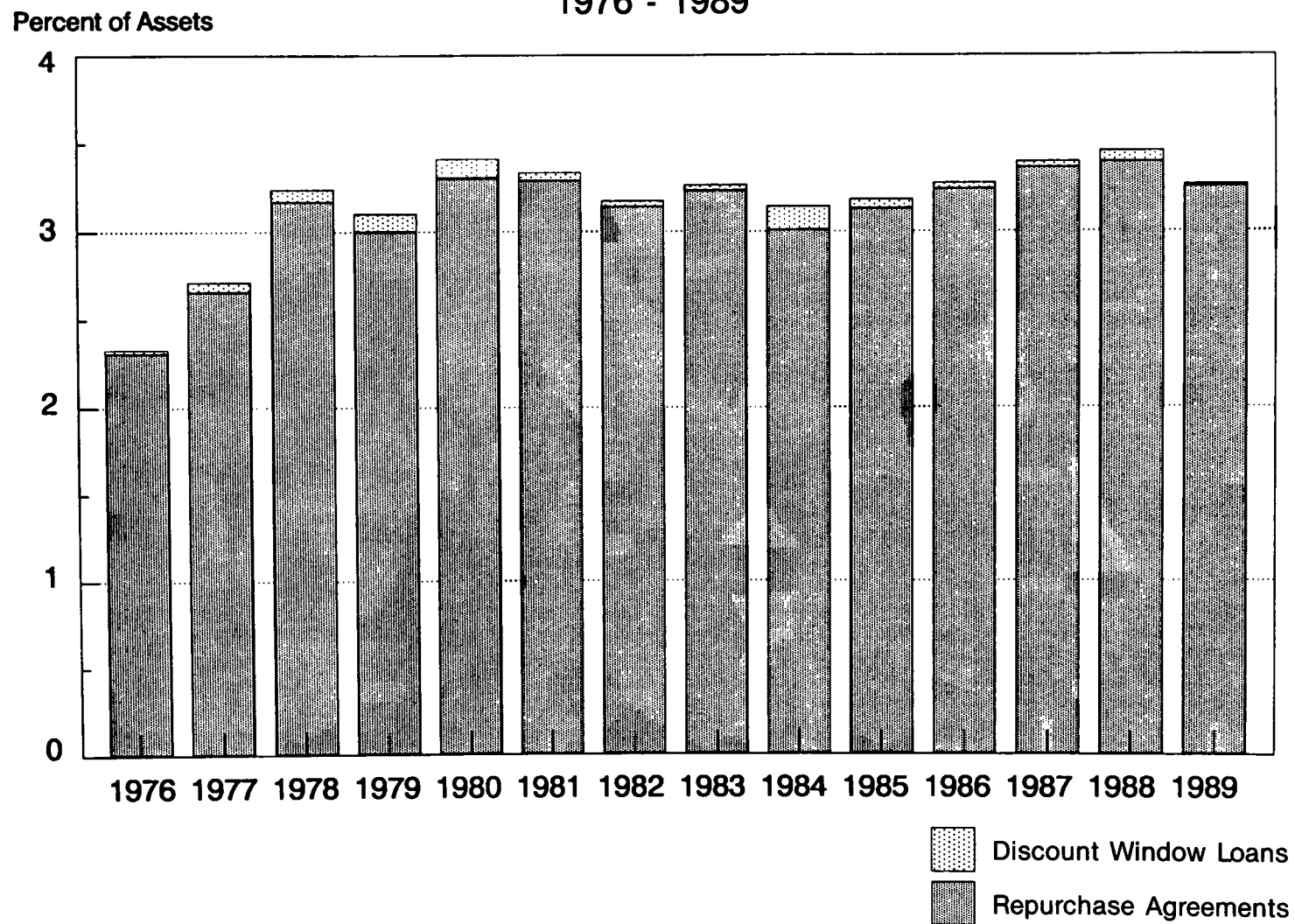
Certain depository institutions have increased their reliance on collateralized borrowing in recent years. Figure 1 shows the extent to which FDIC-insured commercial banks have relied on two categories of collateralized borrowing from 1976 through 1989.<sup>3</sup> Commercial banks have funded a relatively stable fraction of assets with collateralized borrowing, averaging between 3 and 3.5 percent over this period.

The large majority of bank collateralized borrowing is in the form of repurchase agreements, which may be term or overnight. Overnight repurchase agreements are a close substitute for federal funds.<sup>4</sup> Of the \$107 billion in bank repurchase agreements as of December 31, 1989, \$61 billion were overnight and \$46 billion had a maturity greater than one day.<sup>5</sup>

Thrift institutions have made greater use of collateralized borrowing, largely due to the fact that FHLBank advances, which until the passage of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) were only available to thrifts, are collateralized. Of the \$53.4 billion in thrift repurchase agreements as of December 31, 1989, \$2.4 billion were overnight and \$51 billion had a maturity greater than one day.<sup>6</sup>

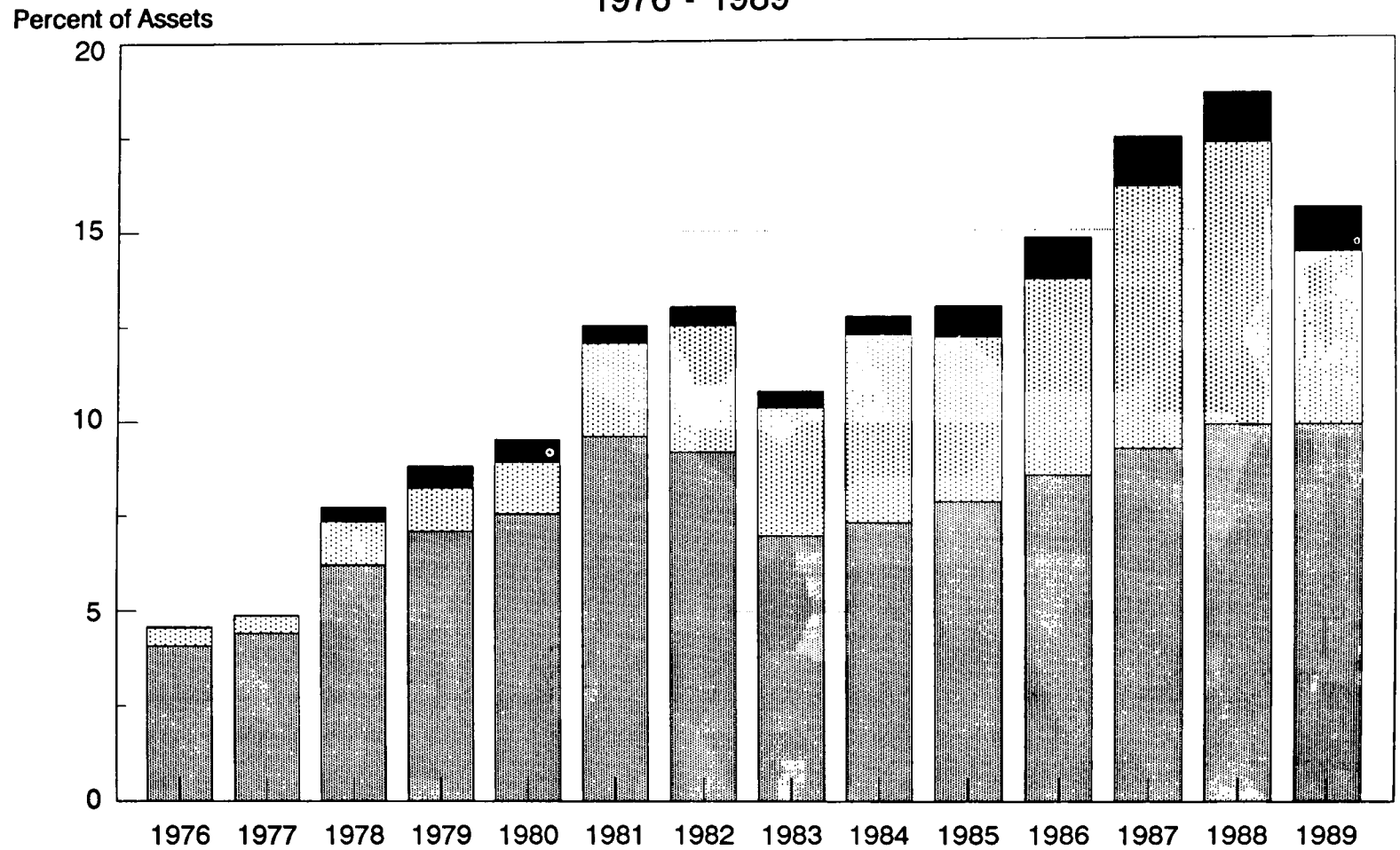
Figure 2 shows the reliance of FSLIC- and SAIF-insured thrift institutions on several types of collateralized borrowing since 1976.<sup>7</sup> In 1976, these liability categories funded less than 5 percent of assets.<sup>8</sup> They have risen over time, reaching almost 19 percent of assets in 1988 before dropping off somewhat in 1989.

Figure 1  
Collateralized Borrowing  
All FDIC-Insured Commercial Banks  
1976 - 1989



Source: Federal Reserve Board.

Figure 2  
 Collateralized Borrowing  
 All FSLIC/SAIF-Insured Thrifts  
 1976 - 1989



- Mortgage-Backed Bonds Issued
- Repurchase Agreements
- FHLB Advances

Source: Office of Thrift Supervision.

Collateralized borrowing is used by a broad spectrum of depository institutions, but thrifts in weaker financial condition have tended to use it more than healthier institutions. Figure 3 shows the average ratio of collateralized borrowing to total assets at FSLIC- and SAIF-insured thrift institutions in three capitalization groups since 1978. Thrifts with weak or negative tangible capital have funded a substantially larger share of assets with secured claims than thrifts with tangible capital ratios over three percent.

This trend is less clear for banks. Table 1 suggests that, as banks' capital levels decline, they are more likely to collateralize their liabilities, but that healthy institutions also use collateralized borrowing as a funding source.<sup>9</sup> As of December 31, 1989, undercapitalized banks generally pledged a greater percentage of their investment securities for secured borrowings than well-capitalized institutions.

On the other hand, while banks with zero tangible capital or less have the highest ratio of repurchase agreements to total assets, institutions with three to six percent tangible capital held more repurchase agreements than banks with zero to three percent tangible capital. Furthermore, the repurchase agreements held by insolvent banks tended to be highly concentrated in a few institutions.

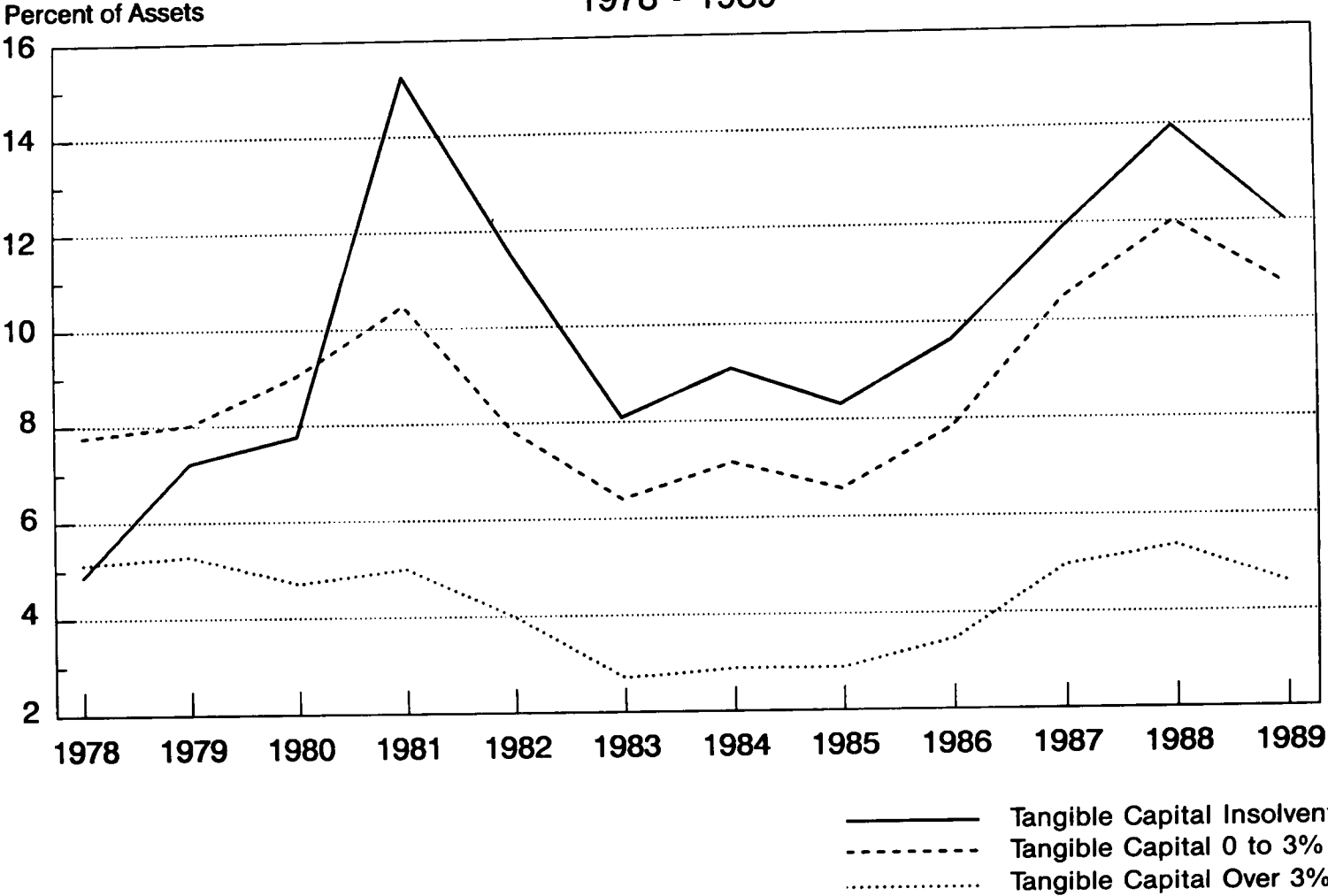
### **C. Incentives to Use Collateralized Borrowing**

#### **1. Potential Cost Savings**

As long as lenders are willing to provide funds on a collateralized basis at a rate that is less expensive than the "all-in cost" of insured deposits, depository institutions will have incentives to use such funds. The all-in cost of deposits is the sum of operating expenses, including insurance premiums, reserve requirements, the cost of servicing deposits, and the explicit interest paid to depositors.<sup>10</sup> An additional cost advantage of collateralized borrowing is that collateral can be used to safeguard claims in excess of the \$100,000 limit on deposit insurance, as well as nondeposit claims, reducing the risk to the lender.

A recent study found that the all-in cost of both a three month Federal National Mortgage Association repurchase agreement and a three month FHLBank of San Francisco advance was 39 basis points cheaper than a brokered certificate of deposit of comparable maturity and 29 basis points cheaper than commercial paper.<sup>11</sup> Certain depository institutions may therefore use collateralized borrowing as part of a business strategy to lower their funding costs. As noted above, the data suggests that thrifts have taken relatively greater advantage of these

Figure 3  
**Collateralized Borrowing by Capital-Asset Ratios**  
**All FSLIC/SAIF-Insured Thrifts**  
**1978 - 1989**



Source: Office of Thrift Supervision.

Table 1

BIF-Insured Institutions

(As of December 31, 1989)

(In millions of dollars)

Tangible capital as a percent of assets	Number of banks	Total assets	Securities sold under repurchase agreement	As a percent of assets
Less than zero .....	87	25,991	1,197	4.61
0 to 1.5% .....	76	55,388	1,466	2.65
1.5 to 3.0% .....	114	76,663	943	1.23
3.0 to 6.0% .....	1,360	1,680,806	48,588	2.89
Greater than 6% ..	11,536	1,700,479	44,265	2.60
Total .....	13,173	3,539,327	96,459	2.73

Tangible capital as a percent of assets	Investment securities pledged *	Total investment securities	Pledged securities as a percent of total securities
Less than zero .....	4,089	5,201	78.62
0 to 1.5% .....	6,141	10,656	57.63
1.5 to 3.0% .....	3,625	7,398	49.00
3.0 to 6.0% .....	110,924	218,896	50.67
Greater than 6% .....	138,127	365,891	37.75
Total .....	262,906	608,042	43.24

\* Includes securities pledged against deposits.

Source: Federal Deposit Insurance Corporation.

potential savings--collateralized borrowing represents about 18 percent of the thrift industry's assets, but only about three percent of the banking industry's assets.

One savings association, responding to Treasury's request for comment on issues addressed in this Report and arguing against assessing premiums on collateralized borrowing, commented that institutions do not view collateralized borrowing as a way to avoid paying insurance premiums. Rather, collateralized borrowing is generally used by institutions to implement balance sheet management strategies, provide immediate liquidity, improve cost-effectiveness, and diversify funding sources. On the other hand, a trade association for community banks favors assessing collateralized borrowing because it believes that all non-deposit liabilities are insured.

## **2. Liquidity and Asset-Liability Management**

The ability to raise funds by pledging assets is also a source of liquidity and an asset-liability management tool. Funds raised by pledging assets may be less expensive than generating new deposits or liquidating assets, particularly at times when an institution's liquidity is under stress and there is a need to generate liquidity quickly.

As an asset-liability management tool, collateralized borrowing, including FHLBank advances, may be a relatively inexpensive technique for matching the maturities or repricing intervals of assets. One commenter wrote that longer-term FHLBank advances have assisted thrifts in managing their interest rate risk and that any disincentive to use these longer term liabilities would substantially increase the interest rate risk of the depository institution.

## **3. Trading in the Government Securities Market**

Banks also engage in repurchase and reverse repurchase agreements through trading in the government securities market. There are currently more than 250 banks that are government security dealers, including two primary dealers.<sup>12</sup> Dealers often run matched books, whereby they obtain securities through a reverse repurchase agreement<sup>13</sup> and then use the securities as collateral to obtain funds through a repurchase agreement. The dealer makes money because the interest cost associated with the repurchase agreement is less than the interest earned on the reverse repurchase agreement.

From the federal government's perspective the government securities market is vital to two central government functions--debt management and monetary policy. The Treasury relies on this market to raise new funds and refund maturing debt. The Federal Reserve System is an active participant in the secondary market

through its open market operations, which are a crucial tool of monetary policy.

#### **4. Treatment of Creditors**

Finally, creditors may have an incentive to require collateral against loans to depository institutions because of recent changes in the treatment of creditors of failed institutions. In FIRREA, the FDIC was granted power to discriminate between classes of a depository institution's creditors and can now require unsecured creditors to sustain normal bankruptcy losses, even if all uninsured depositors are fully protected. Creditors can avoid this problem by lending only on a fully collateralized basis.<sup>14</sup>

#### **D. Cost of Collateralized Borrowing to the FDIC**

##### **1. Resolution Costs**

The effect of collateralized borrowing on resolution costs is best measured by how it changes the distribution of losses borne by the funds in the event of failure. In essence, the collateralized creditors' claims (liabilities) and the collateral pledged to them (assets) up to the value of the claims are withdrawn from the failed institution's balance sheet. Assuming full collateralization, this has the same effect on the balance sheet as if the claims were insured deposits, and the FDIC paid off these insured deposits and liquidated the institution's assets. Therefore, the resolution cost is not any different due to the substitution of collateralized borrowing for insured deposits.

An increased resolution cost to the FDIC occurs when the collateralized borrowing replaces uninsured deposits that would have suffered losses in the case of failure. When creditors shift from unsecured to secured lending, they are effectively shifting these losses to the FDIC because they have reduced the pool of uninsured creditors with whom the insurance funds might share losses. Assessing collateralized borrowing would not prevent this from occurring, but would make such borrowing more expensive for banks and help compensate for losses to the FDIC.

To the extent that collateralized borrowing is cheaper than deposits, however, and reduces a troubled institution's funding costs, it could reduce the FDIC's resolution costs.<sup>15</sup>

##### **2. Reduction in Premium Income**

The major cost to the FDIC of not assessing collateralized borrowing is its loss of premium income when institutions shift from deposits to collateralized borrowings. Estimating revenue



that would be generated by including collateralized borrowing in the deposit insurance assessment base is difficult because the level of such activities would diminish if they become subject to these charges. The maximum amount that might be raised can be calculated by applying the insurance premiums to the amount of collateralized borrowing in insured institutions. It should be recognized that this approach could overstate actual revenues that would be generated.

At year-end 1989, there were \$107 billion in repurchase agreements and discount window loans at BIF-insured commercial banks, \$6 billion in repurchase agreements at BIF-insured savings banks, and \$195 billion in repurchase agreements, FHLBank advances, and mortgage-backed bonds issued at SAIF-insured thrift institutions. Applying the 1991 insurance premiums of 19.5 basis points for BIF and 23 basis points for SAIF to these figures gives total potential income of \$221 million for BIF and \$449 million for SAIF.<sup>16</sup> This compares to \$7.5 billion in annual premium income to SAIF and BIF from deposits.

As Figure 3 indicates, troubled savings associations have consistently funded a greater proportion of their assets with collateralized borrowing, perhaps because of its relatively lower cost. This use of collateralized borrowing may have reduced these institutions' operating expenses, perhaps lowering the likelihood or cost of failure. On the other hand, the depository institutions posing the greatest threat to the SAIF have made lower premium payments due to this use of unassessed liabilities.

#### **E. Problems With Assessing Insurance Premiums on Collateralized Borrowing**

There are considerable costs associated with assessing premiums on secured borrowing that must be balanced against the expected additional premium income.

##### **1. Increased Funding Costs**

Assessing collateralized borrowing would increase certain institutions' all-in cost of borrowing, since they would be required to pay premiums to the FDIC on these liabilities. Some types of collateralized borrowing, such as repurchase agreements, are very similar to financial products offered by nondepository institutions not subject to deposit insurance premiums. Assessing premiums against collateralized borrowing would restrict the ability of depository institutions to compete for these funds and could reduce profitability.

In addition, assessing collateralized borrowing will significantly affect the relative price of FHLBank advances. For example, a 23 basis point increase in the price of FHLBank

advances would almost double the current markup the FHLBanks charge over their cost of funds. Higher advance rates would reduce the use of advances, lowering FHLBank profitability and dividends, and therefore reducing member income.

## **2. Impact on Government Securities Market**

Assessing FDIC insurance fees on banks for their collateralized borrowing would put banks that are government securities dealers at a competitive disadvantage vis-a-vis non-bank government securities dealers.

The Securities Investor Protection Corporation (SIPC) assesses fees on the net income derived from activities in the repurchase market of dealers it insures. SIPC fees are 18.75 basis points on income derived from securities activities. For a dealer that runs a matched book, net income is the difference between the income derived from obtaining the security pursuant to a reverse repurchase agreement and the expenses associated with putting a security out on a repurchase agreement.<sup>17</sup>

An FDIC fee of 19.5 basis points assessed on the amount of the liability represented by repurchase agreements would mean that banks would not be able to run a matched book of repurchase agreements and reverse repurchase agreements, because in most cases, taking into account all-in costs, the spread from a matched book in this situation would be negative. (Because the SIPC fee is on the spread income, it cannot make a positive spread negative.)

If the FDIC fee were only imposed on the net position in repurchase agreements (*i.e.*, the repurchase position minus the reverse repurchase position), then banks could run a matched book. However, they still would be severely disadvantaged with respect to non-bank dealers to the extent that they rely on the repurchase market to finance their securities inventory. Their cost of financing these positions would be a not inconsequential 19.5 basis points higher than for non-bank security firms.

The likely result of assessing FDIC fees on repurchase agreements would be to encourage some banks to get out of this line of business and for others to set up subsidiaries not subject to the FDIC fees. This potentially could affect the liquidity of the government securities market and increase Treasury's borrowing costs.

## **3. Impact on Depository Institutions' Asset-Liability Management**

Until the risk-based capital requirements fully reflect interest rate risk, anything that discourages term financing could lead to increased interest rate risk exposure. Collateralized borrowing in general and FHLBank advances in

particular often are the only source of term financing available to many depository institutions. The availability of term financing is very important if depository institutions are to avoid the interest rate mismatch often associated with mortgage finance.

#### **F. Policy Options**

In addition to the option of maintaining the status quo, there is the option of assessing collateralized borrowing. The major benefit of assessing collateralized borrowing is the loss of premium income to the FDIC when institutions shift from deposits to collateralized borrowing. Furthermore, assessing these liabilities would compensate the insurer for any increased resolution costs due to the substitution of collateralized borrowing for uninsured deposits.

However, there are several compelling arguments for not assessing collateralized borrowing. As discussed above, there could be significant costs to depository institutions, the government securities market, and the Federal Home Loan Bank System. Assessing FHLBank advances could also have a negative effect on savings associations' asset-liability management to the extent that it reduces their use of long-term FHLBank advances and increases their interest rate risk.

## Endnotes

<sup>1</sup> Mengle (1986) discusses Federal Reserve discount window borrowing and Lumpkin (1986) discusses repurchase agreements. Federal Home Loan Bank advances are discussed in Chapter XV.

<sup>2</sup> The FDIC may not void any legally enforceable security interest where the security interest was taken in contemplation of the institution's insolvency or with intent to hinder, delay, or defraud the institution or the creditors of such institution. See 12 USCA 1821(e)(11). In general, the FDIC may disaffirm any contract to which the depository institution was a party if the FDIC determines: (1) the performance of a contract to be burdensome; and (2) the disaffirmation and repudiation of the contract will promote the orderly administration of the institution's affairs.

<sup>3</sup> Repurchase agreements for commercial banks include only wholesale repurchase agreements (those greater than \$100,000) against U.S. government securities.

<sup>4</sup> Repurchase agreements have in the past traded at 10 to 25 basis points below Federal funds, although they have recently traded at the Federal funds level. Source: Office of Thrift Supervision.

<sup>5</sup> Source: Federal Reserve Board.

<sup>6</sup> Source: Federal Reserve Board.

<sup>7</sup> Repurchase agreements for FSLIC- and SAIF-insured thrifts include all funds received under repurchase agreements that are accounted for as financings in accordance with GAAP in all denominations. The only exception is that repurchase agreements with the FHLBanks are included as FHLBank advances. This definition is somewhat broader than that used for commercial banks.

<sup>8</sup> The only category of collateralized borrowing for which data are available prior to 1976 is FHLB advances. FHLB advances varied over a small range between 1950 and 1975, averaging 4.3 percent of assets, which is similar to their level in 1976.

<sup>9</sup> Source: Federal Deposit Insurance Corporation.

<sup>10</sup> Insurance premiums have risen in recent years, increasing the advantages of funds that avoid such premiums, because of higher direct charges and lower rebates. Prior to 1984, the FDIC rebated part of the premiums paid by institutions it insured, but higher insurance losses ended these rebates.

FIRREA increased premiums for both BIF- and SAIF-insured institutions and gave the FDIC authority to raise premiums to maintain the level of the insurance funds.

<sup>11</sup> The FNMA repurchase agreement had an all-in cost of 8.74 percent versus 9.13 percent for a brokered CD and 9.03 percent for commercial paper. See Hartzog et al, "Thrift Financing Strategies: An Analysis of the All-In Cost of Retail and Wholesale Funding for Thrift Institutions," Federal Home Loan Bank of San Francisco, 1990, p. 65.

<sup>12</sup> Primary dealers are those dealers with whom the Federal Reserve Bank of New York will conduct transactions in government securities as part of its open market operations.

<sup>13</sup> A reverse repurchase agreement can be characterized as lending funds on a collateralized basis.

<sup>14</sup> A frequently suggested reform to transfer losses from depositors to nondepositors is depositor preference, which subordinates the claims of nondepositors to those of depositors in receiverships.

<sup>15</sup> Lower operating costs could also reduce the number of institutions that fail.

<sup>16</sup> Sources of information: Federal Reserve Board for BIF-insured commercial and savings banks and the Office of Thrift Supervision for SAIF-insured thrifts.

<sup>17</sup> A repurchase agreement by itself results in no fee, since it is a means of financing inventory and does not in itself result in income to the dealer. Reverse repurchase agreements do bring in income and thus result in SIPC fees.

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## **Chapter XV**

### **FEDERAL HOME LOAN BANK SYSTEM SUBSIDIES**

#### **A. Introduction**

Section X of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) included in this Report an evaluation of the efficiency of providing housing subsidies through the Federal Home Loan Bank System (FHLBank System), although this topic does not relate to the issue of deposit insurance.

The FHLBanks principally promote housing finance by passing through to member institutions the benefit of the FHLBanks' ability to raise relatively low-cost funds. They are also a source of liquidity for housing lenders. The size of the subsidy provided by the FHLBanks ultimately depends on the perception by the capital markets of the government's risk of loss from the operations of the FHLBanks and the potential need for a federal rescue.

This chapter is organized as follows: Section B provides an overview of the structure of the FHLBank System; Section C discusses the FHLBank advance program; Section D discusses the subsidy associated with FHLBank advances; Section E reviews the affordable housing and community investment programs sponsored by the FHLBanks; and Section F raises a variety of issues regarding the beneficiaries and efficiency of subsidies provided by the FHLBanks.

#### **B. The Structure of the Federal Home Loan Bank System**

The FHLBank System was established by the Federal Home Loan Bank Act of 1932 to operate as a central credit facility for institutions involved in home mortgage lending. The FHLBanks make short-term and long-term advances (collateralized loans) to their members. The primary source of funding for the FHLBanks is the sale of consolidated obligations in the capital markets.

The FHLBank System consists of twelve regional banks that serve member institutions in their respective districts. The FHLBanks are stockholder-owned with all of their stock held by member institutions. They are regulated and supervised by the Federal Housing Finance Board (FHFB).<sup>1</sup>

As of March 31, 1990, there were 3,164 members of the FHLBank System. (See Table 1) All federal- and state-chartered thrift institutions that are insured by the Savings Association Insurance Fund (SAIF) are currently required to belong to the FHLBank System. The FHLBank System also includes state-chartered thrifts insured by the Bank Insurance Fund (BIF) that belong on a voluntary basis, as well as a small number of uninsured thrift institutions and insurance companies.

FIRREA expanded the range of institutions that may join the FHLBank System to include any insured depository institution with residential-mortgage loans equal to at least ten percent of assets. As of year-end 1990, 75 financial institutions, including 66 commercial banks, had joined the FHLBank System since the passage of FIRREA.

Total assets of the FHLBank System as of September 30, 1990 were \$159.7 billion with the FHLBanks ranging in size from \$5.1 billion in Cincinnati to \$42.6 billion in San Francisco (See Table 2). As third quarter, the FHLBank System had \$11.8 billion in capital for an average capital-to-asset ratio of 7.41 percent. Individual FHLBank capital ratios ranged from 6.05 percent in Dallas to 10.18 percent in Cincinnati.

### **C. FHLBank System Advances Program**

The FHLBanks primarily provide funds to their member institutions by extending FHLBank advances. Advances, like deposits, are interest-bearing liabilities for recipient institutions. However, depository institutions are not assessed insurance premiums on advances nor are advances federally insured.

#### **1. Source of Funds for FHLBank Advances**

The funds lent by FHLBanks to member institutions are obtained from four sources: (1) sale of FHLBank System consolidated debt obligations; (2) funds deposited by member institutions at FHLBanks; (3) the issuance of FHLBank capital stock; and (4) retained earnings.

#### **Consolidated Obligations**

The FHLBank System's primary source of funds is consolidated debt--bonds and notes--issued by the FHLBank System Office of Finance through securities dealers. These consolidated debt obligations include both fixed coupon rate bonds offered in maturities ranging from one to twenty years and short-term, discount notes with maturities under one year.<sup>2</sup> FHLBank System three year consolidated bonds currently carry a yield about 20 basis points over comparable Treasury securities.<sup>3</sup>



**Table 1**  
**Federal Home Loan Bank System Membership**  
 (Number of Institutions)  
 (As of March 31, 1990)

Type of member	Boston	New York	Pittsburgh	Atlanta	Cincinnati	Indianapolis	Chicago	Des Moines	Dallas	Topeka	San Francisco	Seattle	Total
Federally chartered SAIF-Insured .....	62	110	88	435	199	132	174	108	221	103	80	69	1,781
State-chartered SAIF-Insured .....	27	118	93	148	136	16	135	66	158	48	116	24	1,085
State-chartered BIF-Insured .....	225	37	7	1	0	1	0	0	0	0	0	0	14
Non-Federally Insured.....	0	3	8	0	2	0	0	1	0	0	0	0	5
Insurance Companies .....	0	0	0	0	0	5	0	0	0	0	0	0	
<b>Total.....</b>	<b>314</b>	<b>268</b>	<b>196</b>	<b>584</b>	<b>337</b>	<b>154</b>	<b>309</b>	<b>175</b>	<b>379</b>	<b>151</b>	<b>196</b>	<b>101</b>	<b>3,164</b>

Source: Federal Housing Finance Board.

**Table 2**  
**Federal Home Loan Bank System Balance Sheets \***  
(As of September 30, 1990)  
(In thousands of dollars)

	Total	Boston	New York	Pittsburgh	Atlanta	Cincinnati	Indianapolis	Chicago	Des Moines	Dallas	Topeka	San Francisco	Seattle
<b>Assets</b>													
Cash.....	1,112,458	2,463	141,715	52,752	163,998	26,305	66,664	88,263	60,118	164,682	57,834	271,705	15,959
Investments.....	37,666,544	1,365,109	3,054,190	2,759,182	6,317,291	2,290,036	991,182	4,402,537	2,522,538	4,094,754	2,260,903	5,384,128	2,224,694
Advances to members.....	117,886,846	9,038,541	14,078,139	3,422,636	13,405,738	2,574,525	6,135,850	2,460,682	2,799,254	15,575,094	5,928,659	36,441,547	6,026,181
Other Assets.....	2,995,254	118,565	840,210	114,063	243,755	255,022	68,087	100,161	78,461	442,048	95,202	556,364	83,316
<b>Total Assets.....</b>	<b>159,661,102</b>	<b>10,524,678</b>	<b>18,114,254</b>	<b>6,348,633</b>	<b>20,130,782</b>	<b>5,145,888</b>	<b>7,261,783</b>	<b>7,051,643</b>	<b>5,460,371</b>	<b>20,276,578</b>	<b>8,342,598</b>	<b>42,653,744</b>	<b>8,350,150</b>
<b>Liabilities</b>													
Member Deposits.....	26,665,292	1,893,190	2,027,871	1,626,134	3,777,294	1,381,979	768,186	3,980,149	1,075,343	3,658,076	1,481,940	4,138,113	857,017
Consolidated Obligations.....	116,336,248	7,597,469	14,404,771	4,239,544	14,193,545	3,038,330	5,735,397	2,353,623	3,474,318	14,849,921	5,806,096	33,916,666	6,726,568
Other Liabilities.....	4,824,050	159,678	356,597	83,717	645,626	201,768	265,192	139,535	508,493	542,126	459,405	1,308,830	153,083
<b>Total Liabilities.....</b>	<b>147,825,590</b>	<b>9,650,337</b>	<b>16,789,239</b>	<b>5,949,395</b>	<b>18,616,465</b>	<b>4,622,077</b>	<b>6,768,775</b>	<b>6,473,307</b>	<b>5,058,154</b>	<b>19,050,123</b>	<b>7,747,441</b>	<b>39,363,609</b>	<b>7,736,668</b>
<b>Capital</b>													
Capital Stock Outstanding.....	11,366,161	857,228	1,289,214	383,058	1,471,932	507,183	447,259	562,743	363,405	1,164,328	567,853	3,197,505	554,453
Retained Earnings.....	469,351	17,113	35,801	16,180	42,385	16,628	45,749	15,593	38,812	62,127	27,304	92,630	59,029
<b>Total Capital.....</b>	<b>11,835,512</b>	<b>874,341</b>	<b>1,325,015</b>	<b>399,238</b>	<b>1,514,317</b>	<b>523,811</b>	<b>493,008</b>	<b>578,336</b>	<b>402,217</b>	<b>1,226,455</b>	<b>595,157</b>	<b>3,290,135</b>	<b>613,482</b>
<b>Capital-Asset Ratio.....</b>	<b>7.41%</b>	<b>8.31%</b>	<b>7.31%</b>	<b>6.29%</b>	<b>7.52%</b>	<b>10.18%</b>	<b>6.79%</b>	<b>8.20%</b>	<b>7.37%</b>	<b>6.05%</b>	<b>7.13%</b>	<b>7.71%</b>	<b>7.35%</b>

\*Unaudited Data.

Source: Federal Housing Finance Board.

FHLBank consolidated bonds and notes are the "joint and several" obligation of the FHLBank System as a whole rather than the obligation of any single FHLBank.<sup>4</sup> Outstanding consolidated bonds and notes trade in the secondary markets.

As of third quarter 1990, the total amount of consolidated debt outstanding was \$116 billion. The volume of consolidated obligations grew substantially over the past decade, before declining in 1989 and 1990. From September 1989 to September 1990, outstanding consolidated obligations fell by 19 percent. Over the years, net sales of debt (issuance of new debt minus retirement of maturing debt) have fluctuated with changes in the demand for advances. Net sales were negative in 1983 and were only 0.2 percent in 1989, reflecting declines in total advances in those years.

### **Deposits**

The second source of funds for the FHLBanks is deposits from member institutions. FHLBank deposits are an investment vehicle for liquid assets and a method of satisfying thrift institutions' liquidity requirements. The FHLBanks offer several types of deposit accounts, including demand deposits, overnight deposits, and term accounts. Total deposits at the FHLBanks were \$26.7 billion at third quarter 1990.

### **FHLBank Stock**

FHLBank stock is the third source of FHLBank funds. The amount of FHLBank stock that a member institutions is required to hold is directly related to its home mortgage assets and its FHLBank advances. Each member must hold FHLBank stock equal to the greater of one percent of its home mortgage-related assets, .3 percent of total assets, or a percentage of its advances outstanding.

The minimum stock purchase requirement as a percentage of advances depends on whether the borrower passes the Qualified Thrift Lender (QTL) Test.<sup>5</sup> The minimum percentage of advances for institutions that pass the QTL test is five percent; borrowers that do not pass the QTL test have to hold stock equal to at least five percent divided by their actual thrift investment percentage.<sup>6</sup> FHLBank stock is purchased and is redeemable at the discretion of the FHLBank at its par value of \$100 per share.<sup>7</sup> It is not traded on secondary markets. As of September 30, 1990, the FHLBank System had \$11.4 billion in capital stock outstanding.

### **Retained Earnings**

The last source of funds for FHLBank advances is the retained earnings of the FHLBanks. While these totaled over

\$2.34 billion at year-end 1988, by September 30, 1990 they had dropped to \$469 million. As discussed later in this chapter, this decline in retained earnings was primarily due to the FHLBanks' statutory contributions to help fund the clean-up of the savings and loan industry. Given that the FHLBanks tend to pay out a significant portion of their net income in the form of dividends, it is unlikely that retained earnings will be an important source of funds for advances in the future.

## **2. Use of FHLBank Advances**

The volume of advances has grown substantially over time. At year-end 1935, advances outstanding were \$103 million.<sup>8</sup> Total advances peaked in April 1989 at about \$165 billion. However, they have since declined, falling to \$118 billion as of September 1990.

Growth in the level of advances was accompanied by an increase in the degree to which institutions used advances to fund their assets. For the years 1940 through 1949, the average ratio of advances to total assets for all FSLIC-insured thrifts was 3.9 percent; from 1980 through 1989, it rose to 8.6 percent of total assets.

Another measure of the degree to which thrifts use advances is the percentage of institutions that choose this funding source. In contrast to the rapid growth of the total amount of advances from the late 1970s to the late 1980s, the percentage of FSLIC- and SAIF-insured thrifts that held advances declined during this period. At year-end 1978, over 74 percent of FSLIC-insured thrifts had advances among their sources of funds. The proportion declined fairly steadily through the first half of the 1980s, falling to just over 51 percent. Between 1987 and 1989, the proportion of thrifts with advances first increased, rising to over 62 percent in the first half of 1989, before falling to 56 percent at the end of 1989.

During the late 1980s many FHLBanks served as the only source of liquidity for many troubled institutions. As difficulties in the savings and loan industry are resolved, the relative use of advances by members should again reflect the availability and price of alternative funds.

## **3. Terms of Lending for FHLBank Advances**

FHLBank advances are available only to members of the FHLBank System. Advances are available for a wide range of maturities, ranging from very short-term advances, primarily for liquidity, up to longer-term advances, a source of funds for longer-term mortgages. Some advances have fixed maturities and carry a fee to repay these advances before maturity. There are also advances that carry no prepayment fee.

To obtain advances, a borrowing institution must pledge assets as collateral for the loan. Assets eligible to be pledged are: fully disbursed, whole first mortgages on improved residential property, or securities representing a whole interest in such mortgages; securities issued, insured, or guaranteed by the U.S. Government or any U.S. Government agency (including, without limit, mortgage-backed securities issued or guaranteed by the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA), or the Government National Mortgage Association); deposits of a FHLBank; or within statutory limitations other real estate-related collateral acceptable to the FHLBank.<sup>9</sup>

Institutions that receive FHLBank advances are required to pledge collateral of somewhat greater value than the amount of advances received, depending on the type of collateral pledged. Excess collateral protects the FHLBank from decreases in the value of pledged assets.

#### **4. Cost of FHLBank Advances**

The benefit of the FHLBank's ability to raise relatively low cost funds in capital markets can be passed on to member institutions in two ways: (1) through lower interest rates on advances; or (2) through higher dividends on their FHLBank stock.

Given that advances are linked to mortgage lending through collateral requirements, at the margin, the more of the cost advantage passed through in the form of lower interest rates, the greater the likelihood that the benefit will accrue to home buyers. This is the case because members would continue funding home mortgages to collateralize their advances. The issue of who benefits from housing subsidies is discussed in Section F.

#### **Interest Cost of Advances**

The cost of advances to recipient institutions reflects two separate components of the transaction under which advances are obtained. The first and most obvious cost factor is the contract interest rate, which averages 30 to 50 basis points above the cost of FHLBank consolidated obligations of similar maturity. Each FHLBank sets its own rate and there is usually some variation among the banks.

Advances can be a relatively low cost, stable source of funding for mortgage lending. An analysis of the "all-in cost" <sup>10</sup> of three month FHLBank-San Francisco fixed rate advances found that the all-in cost of the FHLBank advances were comparable with FNMA repurchase agreements, 39 basis points cheaper than brokered certificates of deposit, and 29 basis points cheaper than commercial paper.<sup>11</sup>

## **Stock Purchase Requirements**

The second part of the cost of advances results from the FHLBanks' stock purchase requirements. As noted earlier, institutions must hold stock equal to the greater of one percent of home mortgage-related assets, .3 percent of total assets, or .3 percent of outstanding advances. For institutions whose stock purchase requirement is linked to its level of outstanding advances, the total cost of advances includes the difference between the return on FHLBank stock and the return on similar assets. The difficulty in this type of analysis is finding a "similar" asset.

Together, the rate on advances and the amount of additional FHLBank stock required to be purchased, along with its dividend yield, determine the net cost of advances for a borrower. If FHLBank stock yields a return in excess of the market rate of return, the net cost of advances is the contract interest rate minus the excess return earned on FHLBank stock per dollar of advances.

For example, a \$100 million institution that passes its QTL test and holds a portfolio that is 75 percent mortgage-related assets and currently has \$15 million in advances that wishes to obtain \$20 million more in advances would be required to purchase \$1 million in additional FHLBank stock.<sup>12</sup> If the interest rate on advances is 10 percent and the yield on its FHLBank stock exceeds the return on similar assets by 4 percentage points, the net cost of advances would be 9.8 percent.<sup>13</sup>

The dividend yield on FHLBank stock varies across the FHLBanks, reflecting differences in profitability of their operations. Prior to FIRREA, the average dividend yield on FHLBank stock was approximately 11 percent. However, the capacity of the FHLBanks to pay dividends has been diminished, in part, by several federally imposed obligations. In 1990, the dividend yield on FHLBank stock ranged from 9 to 10 percent.

### **5. FHLBank Advances and Interest-rate Risk**

Because they are available for a broad spectrum of maturities, advances can reduce interest-rate risk at institutions that otherwise might have to rely on relatively short-term deposits to fund long-term mortgages. Funding with a mix of long-term advances and short-term deposits would provide mortgage borrowers with the long-term certainty they want and savers with the liquidity they desire without incurring excessive interest-rate risk. Reducing interest-rate risk for mortgage lenders would stabilize the lending institutions and would benefit the housing market and the economy in general.

Table 3 shows the maturity distribution of FHLBank advances outstanding on July 31, 1990 at each of the 12 FHLBanks and for the FHLBank System as a whole. The data clearly reflect the two purposes for which advances are used--liquidity and longer-term funding. For the FHLBank System and for most of the individual FHLBanks, there is a relatively heavy volume of advances with very short and with relatively long maturities. There are much smaller amounts of advances with medium-term maturities.

The weighted average maturity of all FHLBank advances outstanding on July 31, 1990 was 24.46 months, or approximately two years. The weighted average maturity varied considerably among the individual FHLBanks, ranging from 10.46 months at the Boston FHLBank to 33.35 months at the Indianapolis FHLBank. The short average maturity of advances at the Dallas FHLBank is not really representative of advances, however, because a significant proportion of the Dallas FHLBank's advances are backed by FSLIC notes that were involved in insolvency resolutions.

Removing the Dallas FHLBank from the calculation raises the overall average maturity raises it to 26.64 months. Advances from the Boston and Atlanta FHLBanks, where regional economic difficulties may be straining liquidity, were also at the short end of the range of average maturities. Overall, the use of FHLBank advances for liquidity complicates the task of drawing inferences on the capacity of advances to reduce interest rate risk by lengthening the maturity of member liabilities, but the data indicate that a sizable fraction of advances have relatively lengthy maturities. Over one-third of advances have maturities greater than two years.

## **6. Effect of FHLBank Advances on FDIC Risk Exposure**

The fundamental feature of FHLBank advances when analyzing their potential effect on the risk exposure of the FDIC is that they are a form of collateralized borrowing. Chapter XIV discusses the effects of collateralized borrowing on the FDIC. This section briefly reviews the analysis presented there.

The major cost of collateralized borrowing is the reduction in the FDIC's premium income when institutions shift from deposits to collateralized borrowing. To the extent that collateralized borrowing replaces insured deposits, the FDIC's resolution costs are unchanged. When secured creditors use collateral to protect claims that would otherwise be uninsured failure, resolution costs increase. However, to the extent that collateralized borrowing is a relatively inexpensive or stable source of funds, it can help reduce an institution's operating costs. Advances, in particular, may help institutions manage their interest rate risk, reducing their probability of failure.

Table 3

## Maturity Distribution of Federal Home Loan Bank Advances

(As of July 31, 1990)

(In millions of dollars)

Months to Maturity	Boston	New York	Pittsburgh	Atlanta	Cincinnati	Indianapolis	Chicago	Des Moines	Dallas	Topeka	San Francisco	Seattle	Totals
1.....	1,116	749	245	1,749	116	105	280	189	3,339	316	2,427	779	12,130
2.....	824	441	258	1,368	51	376	93	69	2,462	211	1,076	600	10,420
3.....	645	274	298	1,096	101	135	47	43	2,326	108	1,082	500	9,365
4.....	566	202	87	379	63	15	18	146	1,546	164	646	344	7,283
5.....	658	263	27	632	74	97	55	316	1,237	209	470	219	7,128
6.....	547	327	63	389	88	148	52	95	1,722	208	134	159	6,684
7-12.....	1,554	2,362	949	2,675	394	275	582	563	1,424	1,086	6,418	878	20,111
13-24.....	1,099	3,233	608	2,508	433	1,807	332	419	573	1,284	7,814	1,468	23,547
25-60.....	1,853	5,899	705	2,415	1,307	2,783	857	1,051	1,149	2,122	10,422	1,985	38,884
Over 60.....	561	1,167	124	1,008	182	680	205	216	736	527	5,377	220	13,529
<b>Total Advances ....</b>	<b>9,423</b>	<b>14,917</b>	<b>3,364</b>	<b>14,219</b>	<b>2,809</b>	<b>6,421</b>	<b>2,521</b>	<b>3,107</b>	<b>16,514</b>	<b>6,235</b>	<b>35,866</b>	<b>7,152</b>	<b>127,868</b>
<b>Weighted Average Maturity .....</b>	<b>18.52</b>	<b>29.33</b>	<b>18.77</b>	<b>19.26</b>	<b>30.00</b>	<b>33.35</b>	<b>26.41</b>	<b>25.46</b>	<b>10.46</b>	<b>27.67</b>	<b>31.05</b>	<b>20.31</b>	<b>27.80</b>

Note: Weighted average maturities calculated using mid-points of ranges and assuming an 84-month maturity for the over 60-month range.

Source: Federal Housing Finance Board.



## **D. Subsidy Associated with the FHLBank System's Operations**

The cost of the subsidy provided by the FHLBanks can be measured by the perceived risk of loss from their operations and the potential need for a federal government rescue. The presumption of a government response to the need for help can be interpreted as a "put option." The cost of the FHLBanks' subsidy is similar to the cost of the subsidy associated with any other government-sponsored enterprise (GSE), including the FNMA or the FHLMC.

### **1. Market Perception of Implicit Government Backing**

The perception of an implicit backing of the federal government has led FHLBank bondholders to expect that if the value of the FHLBanks' assets drops below the value of their outstanding borrowings, Congress will act to make good on any shortfall in value. The potential for Congressional action has led market participants to view FHLBank equity holders as having an implied "put" to the federal government. This belief allows investors to reduce their required yield on FHLBank bonds, thereby allowing lower cost funds to be raised for mortgage lending.

The potential financial risk to the taxpayer from any GSE, including the FHLBanks, depends on the GSE's financial condition, operating practices, regulatory oversight, and the likelihood that Congress would act to provide financial assistance. To the extent that these factors reduce or increase the taxpayer's potential financial exposure, the subsidy provided by the implicit guarantee on the FHLBanks' bonds is correspondingly reduced or increased.

It is beyond the scope of this study to conduct a complete evaluation of the government's potential financial risk from the FHLBanks, although such an analysis is required to properly evaluate the amount of subsidy associated with FHLBank advances. An earlier Treasury study on the FHLBanks did find the FHLBanks to be financially strong, well-managed institutions.<sup>14</sup> Such a finding should significantly reduce the value of the put option associated with the implicit guarantee on the FHLBanks' debt and correspondingly the subsidy.

### **2. Federally Imposed Obligations**

Apart from the perceived put option value, there remains one aspect of the FHLBanks' operations that could give rise to a subsidy. Specifically, the profits of the FHLBanks are exempt from federal corporate income taxes. The FHLBanks are, however, subject to several federally imposed obligations that effectively offset the benefit of their income tax exemption.<sup>15</sup>

The Competitive Equality Banking Act of 1987 and FIRREA required the FHLBank System to contribute retained earnings to help fund the cost of resolving failed thrifts. FIRREA also requires the FHLBanks to contribute \$300 million annually toward interest payments on Resolution Funding Corporation bonds. As of December 31, 1990, the FHLBanks had contributed \$3.118 billion in earnings.<sup>16</sup> In addition, FIRREA established the Affordable Housing Program as a responsibility of the FHLBanks. (See below.)

## **E. FHLBank System's Community Investment and Affordable Housing Programs**

### **1. Community Investment Program**

The Community Investment Program (CIP) is a FHLBank System program that provides advances at favorable rates to member institutions for community-oriented mortgage lending. The CIP provides advances at the cost of consolidated obligations plus administrative costs, which makes them less expensive than standard advances. Projects that would qualify for the CIP include mortgages to finance home purchases by families whose incomes do not exceed 115 percent of the median income for their area, loans to finance the purchase or rehabilitation of housing for occupancy by families whose incomes do not exceed 115 percent of the local median income, or loans to finance commercial and economic development activities that benefit low- and moderate-income families or activities that are located in low- and moderate-income neighborhoods.

The CIP has been in operation since 1984. Table 4 shows the volume of advances made under the CIP annually in 1984 through 1989 and through the first seven months of 1990. A predecessor program to the CIP, the Community Investment Fund, operated from 1978 through 1983. The Community Investment Fund made advances at a 50 basis point discount from usual advance rates to provide low- to moderate-cost housing and projects in low- to moderate-income neighborhoods.

Prior to the passage of the FIRREA, participation in the CIP by each FHLBank was voluntary, and most of the activity from 1984 to 1987 was in the Boston, Dallas, and San Francisco FHLBanks. Participation broadened in 1988, with ten of the twelve FHLBanks extending CIP advances. The FIRREA required that each FHLBank appoint a community investment officer to implement community investment and affordable housing advance programs.

### **2. Affordable Housing Program**

The Affordable Housing Program (AHP) was established by FIRREA to provide subsidized advances and direct subsidies to member institutions engaged in lending for long-term, low- and

**Table 4**

**Community Investment Program Advances Annually,  
1984 through 1989, and period ending July 31, 1990**

(In millions of dollars)

Time period	Advances made
January 1, 1984–December 31, 1984 .....	93.2
January 1, 1985–December 31, 1985 .....	62.2
January 1, 1986–December 31, 1986 .....	152.7
January 1, 1987–December 31, 1987 .....	61.8
January 1, 1988–December 31, 1988 .....	335.7
January 1, 1989–December 31, 1989 .....	437.8
January 1, 1990–July 31, 1990.....	234.0

Source: Federal Housing Finance Board.

moderate-income, owner-occupied or affordable rental housing at subsidized interest rates. AHP-qualifying loans include mortgages to families whose incomes do not exceed 80 percent of the median income for their local area and mortgages to finance the purchase, construction, or rehabilitation of rental housing, where at least 20 percent of the units will be occupied by and affordable for households whose incomes do not exceed 50 percent of the median income for their local area.

The AHP is operated by each of the twelve FHLBanks for member institutions in their region. From 1990 through 1993, the statutory contribution of the FHLBanks to the AHP is the greater of \$50 million or 5 percent of the preceding year's net income. In 1994, the FHLBanks will provide the greater of \$75 million or 6 percent of the preceding year's net income. Beginning in 1995, annual FHLBank funding for the AHP will be the greater of \$100 million or 10 percent of the preceding year's net income.

The actual 1990 allocation for the AHP is \$78.8 million. The distribution of these funds among the twelve FHLBanks is shown on Table 5. The first year of the AHP created affordable housing valued at \$1.2 billion, leveraged by the \$78.8 million from the FHLBanks.

The AHP subsidizes projects proposed to the FHLBanks by member institutions. In 1990, approximately 24,000 single and multi-family units will be created in 382 projects. Proposals are evaluated based on their consistency with the program's goals and priorities and approved proposals are funded to the extent that the budget allows. AHP regulations limit the subsidy on advances to no more than the amount necessary to reduce the monthly housing cost for targeted households to 28 percent of their gross monthly income. Institutions receiving AHP subsidies are required to extend credit to qualified borrowers at effective rates of interest discounted by at least the amount of the subsidy granted to the institution under the AHP.

## **F. Housing Subsidies**

### **1. Beneficiaries of Housing Subsidies**

The programs discussed in this chapter are intended to provide benefits that assist families who buy or rent housing. Savings on lower funding costs for recipient institutions might be passed on to home buyers and renters; however, there are many factors that determine who actually receives the benefits of programs like these. Programs designed to benefit a particular type of individual or a particular activity may give rise to indirect effects that change the actual recipient of the benefit.

Table 5

Affordable Housing Program 1990 Funding Levels by  
FHLBank District

(In millions of dollars)

FHLBank	States	1990 total AHP funds
Boston .....	ME, NH, VT, MA, CT, RI	5.98
New York.....	NY, NJ, PR, VI	7.44
Pittsburgh .....	PA, DE, WV	3.69
Atlanta .....	MD, DC, VA, NC, SC, GA, FL, AL	8.64
Cincinnati.....	OH, KY, TN	2.35
Indianapolis .....	MI, IN	3.58
Chicago .....	WI, IL	2.44
Des Moines.....	MN, ND, SD, IA, MO	2.73
Dallas.....	AR, MS, LA, TX, MO	12.78
Topeka.....	CO, KS, NE, OK	4.91
San Francisco.....	CA, NV, AZ	20.17
Seattle .....	AK, WA, OR, GU, HI, MT, ID, UT, WY	4.07
<b>National Total.....</b>		<b>78.78</b>

Source: Federal Housing Finance Board.

The FHLBank System generally furnishes low-cost funds to depository institutions that make mortgage loans. Mortgage borrowers, however, might not receive the benefits of their low cost. Factors including the availability of other funds for mortgage lenders, the degree of competition in the mortgage market, restrictions on entry into the thrift and banking industries or other mortgage-related activities, or competition in other lending or funding activities of mortgage lenders, can influence who is the ultimate recipient of program benefits. It is possible, for example, that the benefits might not accrue to mortgage borrowers, but rather to other customers or to the owners or managers of the institutions that initially receive the subsidized funds.

Even if these programs succeed in delivering low-cost mortgages, home buyers or renters might not benefit by the exact amount that their borrowing costs are reduced. For example, widely available benefits to housing or mortgage borrowing are likely to increase demand for housing, raising home prices and rents.

If a reduction in interest rates to mortgage borrowers becomes capitalized into home prices, the benefits of the subsidy to new borrowers will be offset by a higher price. Therefore, some of the benefit would accrue to current owners, whose homes increase in value, rather than to the new mortgage borrowers.

## **2. Efficiency of the Housing Subsidies**

The primary policy issue regarding the efficiency of assisting housing through the FHLBanks is whether the FHLBanks are the appropriate vehicle to generate efficiency gains in the mortgage markets. An alternative to the direct lending approach embodied in FHLBank advances would be a securitization vehicle, such as FHLMC or FNMA, which would enhance mortgage efficiency through product standardization and the provision of guarantees.

Some analysts might argue that the existence of FNMA and FHLMC have eliminated the need for the FHLBanks, at least in the conforming loan market. This argument rests, in part, on the findings that these GSEs have reduced mortgage rates in the conforming loan market by as much as 30 basis points.<sup>17</sup>

Two factors need to be considered, however, before drawing any conclusion regarding the 30 basis point yield reduction. First, how much of the 30 basis points is an efficiency gain and how much is reflective of the market's perception of FNMA and FHLMC's put option on the government? Both agencies are significantly more levered than the FHLBanks.

Second, how much of the 30 basis point reduction is attributable to the existence of the FHLBanks? By offering an

alternative to the secondary markets, the FHLBanks help ensure that the efficiency gains are passed through to the mortgage markets and not captured by FNMA's and FHLMC's shareholders. Both of these questions require additional empirical analysis.

Furthermore, securitization requires standardization. A direct lending approach allows additional flexibility for dealing with non-standard mortgage products e.g., those where the borrowers mortgage-expense-to-income ratio does not meet secondary market standards, the size of the mortgage exceeds FNMA or FHLMC's limit, or where mortgage seasoning prevents inclusion of the mortgage in mortgage pools. It is in these markets where there is likely to be the greatest potential for efficiency gains due to the uniqueness of the mortgages. Thus, it may be that both securitization and direct lending vehicles are important to generate the maximum efficiency gains.

## Endnotes

<sup>1</sup> Prior to the passage of FIRREA, the FHLBanks were regulated by the Federal Home Loan Bank Board.

<sup>2</sup> There are no statutory limits on the maturities of consolidated obligations, but the longest maturity usually sold is ten years.

<sup>3</sup> About 18 months to two years ago, when the FHLBank System's consolidated debt issuance peaked, spreads were about 30 basis points. Source: Office of Finance, FHLBank System.

<sup>4</sup> Federal Home Loan Bank Act, section 1431(11)(b).

<sup>5</sup> The statutory Qualified Thrift Lender test requires savings associations to hold 60 percent of their portfolio in mortgage-related assets and other qualifying assets. After July 1, 1991, the percentage requirement increases to 70 percent. Various restrictions apply to savings associations that are not qualified thrift lenders, including ineligibility to obtain new advances from any FHLBank.

<sup>6</sup> "Actual thrift percentage" is the ratio used to determine compliance with the Qualified Thrift Lender Test. Effective July 1, 1991, the term "actual thrift percentage" means the percentage determined by dividing: (1) the amount of the qualified thrift investments of a savings association; by (2) the total amount of the portfolio assets of such savings association. Prior to July 1, 1991, an actual thrift percentage is obtained by (1) dividing the amount of an institution's qualified thrift investments; by (2) its total tangible assets.

<sup>7</sup> FHLBank stock is redeemable at par, unless the FHFB determines that a FHLBank's paid-in capital is, or might be, impaired. In this case, the FHFB may order the FHLBank to withhold from any payment in retirement of stock the pro rata share of such impairment. See 12 U.S.C. 1426(e).

<sup>8</sup> In 1989 dollars, the total amount of advances at year-end 1935 was \$928 million.

<sup>9</sup> Federal Home Loan Bank Act, section 1430(10).

<sup>10</sup> The "all-in cost" includes broker fees, issuance expenses, commitment fees, deposit insurance fees, collateral costs, and reserve requirements. Additionally, interest calculation methods, such as actual/360-day count and discount rate quotations, affect the all-in cost.



<sup>11</sup> See Hartzog, et al, "Thrift Financing Strategies, an Analysis of the All-in Cost of Retail and Wholesale Funding for Thrift Institutions," Federal Home Loan Bank of San Francisco, October 1990.

<sup>12</sup> For this institution, one percent of mortgage-related assets is \$0.75 million and five percent of advances is \$1 million. Since the stock purchase requirement is the larger of these two quantities, the institution would have to purchase \$1 million of FHLBank stock.

<sup>13</sup> The net cost is the rate on advances (10 percent) minus the product of the excess return on FHLBank stock (4 percent) and the ratio of stock held to advances (.05).

<sup>14</sup> See "Report of the Secretary of the Treasury on Government Sponsored Enterprises," May 1990.

<sup>15</sup> Their exact effects may exceed the benefits of the tax exemption, depending on the profitability of the FHLBanks.

<sup>16</sup> Of this amount, \$680 million was used to purchase FICO stock and \$2.438 billion went to REFCORP and the RTC.

<sup>17</sup> Hendershott (1989) presents the argument for how the mortgage agencies have reduced mortgage yields. Hendershott and Shilling (1989) quantify the effect of the mortgage agencies and the mortgage yields.

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## **Chapter XVI**

### **OPTIMAL SIZE OF INSURANCE FUND**

#### **A. Introduction**

This chapter is organized as follows: Section B describes the current financial status of the Bank Insurance Fund (BIF); and reviews the effects on BIF under both the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and more recent legislation; Section C analyzes the policy issues underlying adequate BIF reserves; and Section D describes the current financial status of the Savings Association Insurance Fund (SAIF).

Under the provisions of FIRREA, the Federal Deposit Insurance Corporation's (FDIC's) deposit insurance fund was renamed BIF. The FDIC was also given responsibility for operating two other Funds: SAIF and the FSLIC Resolution Fund. The FSLIC Resolution Fund was established to take over the assets and liabilities of the insolvent FSLIC fund. It will terminate when its debts are paid and its assets are sold. (Note that the data in this chapter have been provided by the FDIC.)

#### **B. The Bank Insurance Fund**

##### **1. Current Status**

As of December 31, 1989, the assets and liabilities in BIF amounted to \$19.6 billion and \$6.4 billion, respectively, giving it a net worth of \$13.2 billion. The Fund decreased by \$851 million during 1989. The ratio of the Fund-to-insured deposits declined to an estimated 0.70 percent, then an all-time low, at year-end 1989. As of June 30, 1990, the Fund had declined to \$11.4 billion, resulting in a ratio of Fund-to-insured deposits of 0.57 percent.

The ratio of the Fund-to-insured deposits has exhibited noticeable stability over long stretches of time, although the long-term trend generally has been downward. The ratio was at its highest levels during the first ten years of the Fund's existence, reaching an all-time high of 1.96 percent in 1941. From the mid-1940s to the late 1960s, the Fund ratio fluctuated between 1.3 and 1.5 percent and hovered around 1.2 percent during the 1970s and early 1980s. It was not until the large insurance

losses of the last couple of years that the Fund-to-insured deposits ratio declined precipitously to its current level. As late as 1987, the ratio stood well above the one percent mark. (See Table 1).

Insured deposits grew at about the same rate as total deposits in insured banks in the five years ending in 1989. At the end of 1989, an estimated 75 percent of total domestic deposits in insured banks in the U.S. were insured. This percentage constitutes an almost record-level of insured deposits. Traditionally, there has been a close relationship between the percentage of insured deposits and the position of the statutory ceiling on insured amounts (*i.e.*, as the ceiling moved up, so has the percentage of insured deposits).

For a more complete picture of the Fund's condition, it is useful to consider its relationship to total deposits, rather than just insured deposits. At the end of 1989, the ratio of the Fund-to-total deposits stood at 0.52 percent. At mid-year 1990, this ratio had dropped to 0.46 percent, an all-time low. Because the balances of uninsured depositors and, until recently, general creditors have often been protected along with those of insured depositors when banks have failed, this relationship becomes more significant when considering the risks to the Fund posed by large institutions, which account for most of the uninsured deposits.

## **2. Income and Expenses**

### **Assessments**

The BIF's assessment income in 1989 was slightly under \$1.9 billion, representing 53.9 percent of the Fund's total income (see Table 2). The increase in 1989 from 1988 was 6.3 percent, compared to annual increases in the past five years averaging 7.4 percent. For the six months ending June 30, 1990, assessment revenue amounted to \$1.4 billion.

In terms of insurance loss coverage, assessment income has weakened. Assessments relative to insurance losses declined from 144 percent in 1981 to less than 50 percent in the last two years.

### **Interest on U.S. Securities**

Section 13 of the Federal Deposit Insurance (FDI) Act provides that money of the Corporation not otherwise employed shall be invested in obligations of the United States or in obligations guaranteed as to principal and interest by the United States. As the Fund has built up over the years, interest income from Treasury securities has been a major source of BIF income.

Table 1  
Insured Deposits and the Deposit Insurance Fund, 1934-1989

(In millions of dollars)

Year	Insurance coverage	Deposits in insured banks <sup>1</sup>		Percentage of insured deposits	Deposit insurance fund	Ratio of deposit insurance fund to—	
		Total	Insured			Total deposits	Insured deposits
1989.....	100,000	2,465,922	1,873,837	76.0	13,209.5	.54	.70
1988.....	100,000	2,330,768	1,750,259	75.1	14,061.1	.60	.80
1987.....	100,000	2,201,549	1,658,802	76.9	18,301.8	.83	1.10
1986.....	100,000	2,167,596	1,634,302	75.4	18,253.3	.84	1.12
1985.....	100,000	1,974,512	1,503,393	76.1	17,956.9	.91	1.19
1984.....	100,000	1,806,520	1,389,874	76.9	16,529.4	.92	1.19
1983.....	100,000	1,690,576	1,268,332	75.0	15,429.1	.91	1.22
1982.....	100,000	1,544,697	1,134,221	73.4	13,770.9	.89	1.21
1981.....	100,000	1,409,322	988,898	70.2	12,246.1	.87	1.24
1980.....	100,000	1,324,463	946,717	71.6	11,019.5	.83	1.16
1979.....	40,000	1,226,943	808,555	65.9	9,792.7	.80	1.21
1978.....	40,000 <sup>6</sup>	1,145,835	760,706	66.4	8,796.0	.77	1.16
1977.....	40,000 <sup>5</sup>	1,050,435	692,533	65.9	7,992.8	.76	1.15
1976.....	40,000	941,923	628,263	66.7	7,268.8	.77	1.16
1975.....	40,000	875,985	569,101	65.0	6,716.0	.77	1.18
1974.....	40,000	833,277	520,309	62.5	6,124.2	.73	1.18
1973.....	20,000	766,509	465,600	60.7	5,615.3	.73	1.21
1972.....	20,000	697,480	419,756	60.2	5,158.7	.74	1.23
1971.....	20,000	610,685	374,568	61.3	4,739.9	.78	1.27
1970.....	20,000	545,198	349,581	64.1	4,379.6	.80	1.25
1969.....	20,000	495,858	313,085	63.1	4,051.1	.82	1.29
1968.....	15,000	491,513	296,701	60.2	3,749.2	.76	1.26
1967.....	15,000	448,709	261,149	58.2	3,485.5	.78	1.33
1966.....	15,000	401,096	234,150	58.4	3,252.0	.81	1.39
1965.....	10,000	377,400	209,690	55.6	3,036.3	.80	1.45
1964.....	10,000	348,981	191,787	55.0	2,844.7	.82	1.48 <sup>1</sup>
1963.....	10,000	313,304 <sup>2</sup>	177,381	56.6	2,667.9	.85	1.50
1962.....	10,000	297,548 <sup>3</sup>	170,210	57.2	2,502.0	.84	1.47
1961.....	10,000	281,304	160,309	57.0	2,353.8	.84	1.47
1960.....	10,000	260,495	149,684	57.5	2,222.2	.85	1.48
1959.....	10,000	247,589	142,131	57.4	2,089.8	.84	1.47
1958.....	10,000	242,445	137,698	56.8	1,965.4	.81	1.43
1957.....	10,000	225,507	127,055	56.3	1,850.5	.82	1.46
1956.....	10,000	219,393	121,008	55.2	1,742.1	.79	1.44
1955.....	10,000	212,226	116,380	54.8	1,639.6	.77	1.41
1954.....	10,000	203,195	110,973	54.6	1,542.7	.76	1.39
1953.....	10,000	193,466	105,610	54.6	1,450.7	.75	1.37
1952.....	10,000	188,142	101,841	54.1	1,363.5	.72	1.34
1951.....	10,000	178,540	96,713	54.2	1,282.2	.72	1.33
1950.....	10,000	167,818	91,359	54.4	1,243.9	.74	1.36
1949.....	5,000	156,786	76,589	48.8	1,203.9	.77	1.57
1948.....	5,000	153,454	75,320	49.1	1,065.9	.69	1.42
1947.....	5,000	154,096	76,254	49.5	1,006.1	.65	1.32
1946.....	5,000	148,458	73,759	49.7	1,058.5	.71	1.44
1945.....	5,000	157,174	67,021	42.4	929.2	.59	1.39
1944.....	5,000	134,662	56,398	41.9	804.3	.60	1.43
1943.....	5,000	111,650	48,440	43.4	703.1	.63	1.45
1942.....	5,000	89,869	32,837	36.5	616.9	.69	1.88
1941.....	5,000	71,209	28,249	39.7	553.5	.78	1.96
1940.....	5,000	65,288	26,638	40.8	496.0	.76	1.86
1939.....	5,000	57,485	24,650	42.9	452.7	.79	1.84
1938.....	5,000	50,791	23,121	45.5	420.5	.83	1.82
1937.....	5,000	48,228	22,557	46.8	383.1	.79	1.70
1936.....	5,000	50,281	22,330	44.4	343.4	.68	1.54
1935.....	5,000	45,125	20,158	44.7	306.0	.68	1.52
1934.....	5,000 <sup>4</sup>	40,060	18,075	45.1	291.7	.73	1.61

<sup>1</sup> Deposits in foreign branches are omitted from totals because they are not insured. Insured deposits are estimated by applying to deposits at the regular Call dates the percentages as determined from the June Call Report submitted by insured banks.

<sup>2</sup> December 20, 1963.

<sup>3</sup> December 28, 1962.

<sup>4</sup> Initial coverage was \$2,500 from January 1 to June 30, 1934.

<sup>5</sup> \$100,000 for time and savings deposits of in-state governmental units provided in 1974.

<sup>6</sup> \$100,000 for individual retirement accounts and Keogh accounts provided in 1978.

Source: FDIC Annual Reports.

Table 2

Results From FDIC Insurance and Investment Operations, 1980-1989

(In millions of dollars)

	Gross assessment	Insurance losses	Other income	Assessment as percent of losses	Interest on treasury obligations	Rebat
1980.....	\$951.9	\$(34.6)	\$16.5	\$N/A*	\$863.1	\$
1981.....	1,039.0	720.9	37.2	144	1,115.5	
1982.....	1,108.9	869.9	141.8	127	1,369.9	
1983.....	1,214.9	834.2	172.7	146	1,404.3	
1984.....	1,321.5	1,848.0	282.5	72	1,495.4	
1985.....	1,433.4	1,778.7	352.2	81	1,599.7	
1986.....	1,516.9	2,783.4	108.8	54	1,634.4	
1987.....	1,696.0	3,066.0	88.5	55	1,534.9	
1988.....	1,773.0	7,364.5	178.2	24	1,396.4	
1989.....	1,885.0	4,132.0	238.0	46	1,372.0	
Mid-1990.....	1,414.0	3,540.0	50.0	40	514.0	

\* Recoveries exceeded losses in 1980.

Source: FDIC Annual Reports.

In 1989, the Corporation received about \$1.4 billion in interest income on its portfolio of Treasury securities, with a yield ("yield to maturity at market"-monthly average) of 8.84 percent. The dollar amount represented just over 39 percent of the FDIC's total revenue in the year. For the first half of 1990, interest income amounted to \$514 million, about one-quarter of total revenue.

For many years prior to 1987, there were annual increases in investment income. However, in 1987 the securities portfolio was drawn down by more than \$500 million, and after a small increase in 1988, it fell by another \$2.5 billion in 1989. As a result, investment income in 1989 was down by 16 percent from the peak level in 1986, despite the fact that the average yield on the portfolio was rising during this period.

#### Other Income

In addition to assessment and investment income, the BIF receives income from loans and other sources connected with bank failure resolutions and assistance transactions. Such "other" income amounted to \$238 million in 1989, compared to \$178 million in 1988 and \$89 million in 1987. Other income for the first six months of 1990 amounted to \$50 million.

#### Losses and Expenses

Insurance losses and expenses, amounting to less than \$1 billion per year in 1981-1983, more than doubled in 1984. With this increase, losses and expenses surpassed assessment income and, thus, partial rebates of bank assessments were eliminated. In 1988, the provision for insurance losses rose to \$6.3 billion--more than double the 1987 level and four times the amount of 1985. Merger assistance losses and other insurance expenses accounted for another \$1.1 billion, bringing the total insurance loss expense for the year to \$7.4 billion. For the first time in its history, the FDIC experienced a net operating loss for 1988. The Fund decreased from \$18.3 billion to \$14.1 billion--a 23 percent reduction in a single year. However, selling securities from the Fund's portfolio to finance the deficit was not necessary, as the entire \$4.2 billion net worth reduction was met through additions to the Fund's liabilities, which for the year grew from \$4.2 billion to \$8.7 billion. In 1989, there was another net loss and decline in the Fund, though the amount of the deficit was reduced to \$851 million. During the first half of 1990, the provision for insurance loss was estimated at \$3.5 billion, while the deficit for the same period was projected at \$1.8 billion.

It should be noted that the FDIC records as receivable the funds advanced for assisting and closing banks and establishes an estimated allowance for loss. The allowance for loss represents

the difference between the funds advanced and the expected repayment, based on the estimated cash recoveries from the asset of the assisted or failed bank, net of all liquidation costs. This provision encompasses all banks that have been closed, or that have entered into financial assistance agreements, or that the FDIC has identified as probable failures or in need of assistance as of the date of the FDIC's financial statements.

### 3. Liquidity

#### Effect of Failure Resolutions

Accounts and transactions relating to failed bank resolutions have become dominant factors in the BIF's cash flow. Cash inflow from recoveries in bank assistance and failure cases in 1989 of \$4.3 billion was more than 1.3 times the cash resources provided by assessments and investments combined. Another \$4.3 billion was provided by the sales (net of purchases of U.S. Treasury obligations). Disbursements for bank assistance and failures and payments of liabilities incurred in these activities accounted for \$10.1 billion in cash outflow.

Liquidity is important because it is primarily through the liquid assets in the Fund and the FDIC's borrowing authority--from the U.S. Treasury, the Federal Financing Bank, and through FDIC notes--that assistance to failing institutions or payment of insured deposits can be carried out. For present purposes, liquid assets include cash and investments in U.S. Treasury securities. In contrast to liquid assets, the FDIC has other assets that cannot be readily transformed into cash. Such assets mainly include those acquired from bank assistance transactions and bank failures.

At year-end 1989, 70 percent of the Fund's total assets were invested in U.S. obligations, including small amounts of cash. Almost all of the other 30 percent of assets consisted of "net receivables" from bank assistance and failure resolutions, including accrued interest. (FDIC property and buildings accounted for 0.5 percent of assets.) Net receivables are claims for FDIC loans and advances to assist banks in trouble and to facilitate deposit assumptions and merger agreements, claims for capitalization of bridge banks, and claims against on-going receiverships for FDIC outlays to pay off insured depositors. They are "net" in the sense that an allowance for anticipated loss has been deducted from the principal value of the claim. (As of June 30, 1990, cash and U.S. securities, amounting to \$10.1 billion, constituted 56 percent of total assets in the BIF.)

Liquid assets were 214 percent of total liabilities in 1989. Liquidity has declined, however, in terms of the total amount of liquid assets. While liquid assets (cash and U.S. Treasury



securities) totalled \$13.7 billion at the end of 1989, there was a decrease of \$2.8 billion during the year. At mid-year 1990, liquid assets constituted 160 percent of BIF liabilities.

Liquidity has also decreased when measured against total deposits in insured banks. As of year-end 1989, the Fund's cash and U.S. securities constituted 0.54 percent of total bank deposits, down from 0.69 percent a year earlier, as shown in Table 3. As of mid-year 1990, the ratio of liquid assets to total deposits stood at 0.41 percent.

While the number of failures and assistance cases has been at record levels, the FDIC has been able to avoid excessive increases in the volume of assets in process of liquidation. This has been facilitated by aggressive marketing strategies and new approaches in selling assets. For example, the "whole bank" method of bank failure resolution, developed in 1987, has been a significant factor in maintaining the Fund's liquidity. In the whole-bank transaction, the purchaser agrees to assume most of the assets of the failed bank, including the nonperforming loans. Sixty-nine of the 164 purchase and assumption (P&A) transactions in 1988, and 87 of 175 assumptions in 1989 were "whole-bank" deals.

The FDIC has frequently arranged transactions in a manner that has tended to minimize cash outlays. On numerous occasions, the FDIC has issued notes in lieu of cash. As of year-end 1989, the outstanding balance of such notes was \$799 million, or about one-third of all liabilities incurred from bank assistance and failure resolutions.

Perhaps the most important component of FDIC borrowings has been the assumption of a bank's Federal Reserve Bank indebtedness that has been arranged as part of failed- or failing-bank assistance transactions. Beginning with the Franklin National Bank P&A in 1974, in virtually every instance where the FDIC has had to grant assistance to a large bank, the assumption of Federal Reserve Bank indebtedness has been involved. At the end of 1989, the Corporation's indebtedness to the Federal Reserve amounted to \$1,450 million.

### **Borrowing Authority**

Since its inception, the FDIC has had the authority to borrow to meet liquidity needs. The Banking Act of 1933 explicitly authorized the FDIC to issue "notes, debentures, bonds, or similar obligations . . ." necessary to conduct insurance operations. The Banking Act of 1935 directed the Secretary of the Treasury to purchase up to \$975 million of these obligations; in 1947, the specific authority to issue obligations to the Treasury was deleted from the FDI Act, but specific

Table 3

**BIF Assets Available to Finance Assistance to, or  
Failure of, Insured Institutions, 1980-1990**

Year-end	Fund assets (in billions of dollars)		Cash and U.S. securities as percent of total bank deposits
	Cash and U.S. Treasury securities*	Other FDIC assets	
1980 .....	\$10.7	\$0.9	0.81
1981 .....	12.2	1.0	0.86
1982 .....	13.5	1.7	0.87
1983 .....	14.0	2.9	0.83
1984 .....	14.4	7.6	0.80
1985 .....	15.8	6.3	0.80
1986 .....	16.6	5.8	0.77
1987 .....	16.1	6.3	0.73
1988 .....	16.2	6.4	0.69
1989 .....	13.7	5.8	0.54
Mid-1990.....	10.1	7.6	0.41

\*U.S. Treasury securities are shown at amortized cost, which is the purchase price of securities less the amortized premium or plus the accreted discount.

Source: FDIC Annual Reports.

authority to borrow up to \$3 billion directly from the Treasury was granted. The FDIC has never exercised this authority.

FIRREA increased the maximum amount the FDIC may borrow from the U.S. Treasury. With the approval of the Secretary of the Treasury, the FDIC can borrow from the Treasury on behalf of either BIF or SAIF. However, combined Treasury borrowing by the two funds is limited to \$5 billion. The FDIC may issue other obligations as needed. Under FIRREA, all such obligations must be attributed to the BIF or the SAIF, and total borrowing is restricted. An amendment to the FDI Act made by FIRREA provides that, in borrowing for either fund, the FDIC:

may not issue any note or similar obligation, and may not incur any liability under a guarantee or similar obligation, with respect to either the Bank Insurance Fund or the Savings Association Insurance Fund if, after reduction for the estimated cost of the obligation or guarantee, the net worth of the affected insurance fund would be less than 10 percent of assets.

In calculating the Fund's net worth for purposes of that restriction, obligations owed to the Treasury (up to \$5 billion) are disregarded, according to FIRREA.

#### **4. The Effects of FIRREA and More Recent Legislation**

##### **FIRREA**

Prior to the changes in the assessment rate provided under FIRREA, insured banks paid assessments at a basic annual rate of 1/12 of one percent of assessable deposits which are, roughly speaking, total deposits in domestic offices. Legislation in 1950 provided for a rebate to banks of a portion of their assessments in the form of a credit against their assessment payable in the following year. As amended by legislation in 1980, insured banks were rebated, on a pro-rata basis, 60 percent of the amount of the FDIC's gross assessment income in excess of its administrative and operating expenses and provision for insurance losses.

Under FIRREA, there are several important changes in the system of assessments. Beginning in 1990, the basic assessment rate was increased to 0.12 percent (from 0.0833, or 1/12 of one percent), and effective January 1, 1991, the rate rose to 0.15 percent. Provided that the Fund reserve ratio was increasing each year, the 15 basis-point assessment rate was to be in effect until January 1, 1995. At that time, if the reserve ratio had not reached the designated 1.25 percent target, the FDIC could increase the assessment rate by a maximum of 7.5 points per calendar year. The scheduled increase to 0.15 percent at the start of 1991, however, was pre-empted through regulation. In

September 1990, the FDIC, having concluded that another decline in the Fund reserve ratio during 1990 was inevitable, increased the assessment rate to 19.5 basis points beginning in 1991.

FIRREA also gave additional flexibility to the FDIC in adjusting assessment rates and pursuing reserve targets. In 1980, the Depository Institutions Deregulation and Monetary Control Act authorized the FDIC to make adjustments to the assessment credit. The FDIC was to maintain the Fund within a range of 1.25 percent to 1.40 percent of estimated insured deposits and mandated adjustments to keep the Fund no lower than 1.10 percent and no higher than 1.40 percent of insured deposits. FIRREA provided that before 1995, the FDIC may increase the assessment rate to prevent a decrease in the Fund (BIF)-to-insured deposits ratio. However, a bank's total assessment could never be above 0.325 percent of its deposit base. Once the fund reached the reserve ratio of 1.25 percent, interest earned on additional fund reserves was to be paid out as dividends to insured banks or thrifts. However, the FDIC could set the "designated reserve ratio" as high as 1.50 percent, if necessary to meet a risk of substantial future losses to the BIF.

To preserve the BIF-insured deposits ratio, FIRREA provided for entrance fees on institutions entering or converting to the BIF. In March 1990, the FDIC approved an interim rule under which the entrance fees for savings institutions converting to the BIF will be based on the ratio of the net worth of BIF-to-total deposits held in all BIF members (0.60 percent when the rule was adopted).

### Recent Legislation

In October 1990, Congress enacted the FDIC Assessment Rate Act of 1990. As a result, a number of the FIRREA provisions outlined above have been rendered obsolete, most notably the annual caps on assessment rate increases, the maximum assessment rate, the upper ceiling on the designated reserve ratio, and the timing of rate increases. The Act also affects the FDIC's ability to borrow from the U.S. Treasury. In summary, the FDIC Assessment Rate Act of 1990:

- o amends the FDI Act to permit the Board of Directors of the FDIC to set premiums for BIF members at a rate above 0.15 percent if the Board in its discretion determines it to be appropriate to maintain the actual reserve ratio of the BIF at the designated reserve ratio, or if the reserve ratio is less than the designated reserve ratio, to increase the reserve ratio to the designated reserve ratio within a reasonable period of time. Factors to be considered by the Board in setting the

rate include the BIF's expected operating expenses, case resolution expenditures and income, and the effect of the assessment rates on insured banks' earnings and capital.

- o amends the FDI Act to allow the FDIC to make mid-year adjustments in assessments rates. Rate changes must be announced not later than November 1 for the following January 1 to June 30 semiannual period and not later than May 1 for the following July 1 to December 31 semiannual period.
- o eliminates the 1.50 percent designated reserve ratio ceiling and the requirement that investment earnings on reserves in excess of 1.25 percent of insured deposits be distributed to fund members.
- o permits the FDIC, on behalf of BIF or SAIF, to borrow from the Federal Financing Bank on terms and conditions determined by the Federal Financing Bank. Such borrowing is subject to the overall FDIC obligation limitation under the FDI Act.

### **C. Policy Issues**

#### **1. Adequacy of BIF**

##### **Determining the Optimal Size**

There is no scientific way to determine the optimal size of BIF, either in terms of an absolute amount or in relation to some measure of exposure. The Fund has to be sufficient to cover losses and meet cash needs. Beyond that, however, this basically becomes an issue that depends upon what contingencies the Fund should be expected to handle, and the perceptions of the public with respect to the ability of the FDIC to protect deposits and perhaps other bank liabilities under alternative economic scenarios.

Determining the appropriate Fund amount to cover future losses and other outlays, however, is difficult. Neither failures nor insurance losses are spread evenly over time. Rather, in banking, both tend to be cyclical in nature. Under these conditions, a premium structure with the flexibility to deal with the varying loss situations over time becomes a necessity. Such a system requires insurance assessments on banks in whatever amounts are necessary to keep the Fund ratio at the desired level. The higher assessment premiums, however, are

likely to be charged at a time when many banks are least able to afford them. When failures and losses are high, there are likely to be earnings problems across much of the banking industry.

In recognition of the close relationship between assessment income, on one hand, and insurance losses and economic conditions on the other, Congress, through FIRREA, and the more recent FDIC Assessment Rate Act of 1990, has made it possible for the FDIC to vary insurance premiums from one period to the next more or less at will. How much variation in future assessments will be needed to achieve the stated objectives is a crucial question.

## 2. Recapitalizing BIF

In addition to increases in assessments, it may also be worth considering some type of recapitalization of BIF through banking industry deposits or capital contributions. In this regard, the experience of the National Credit Union Administration (NCUA) may be instructive.

The NCUA adopted in 1985 a permanent recapitalization plan for its reserve Fund. Under this plan, insured credit unions are required to place and maintain with the Fund an amount equal to one percent of their insured shares (deposits). This deposit is treated as an asset by the credit unions and earns a dividend as determined by the NCUA. Since the establishment of this fund, the interest alone has been enough to pay for administrative and insurance costs, so that the NCUA has not had to collect annual assessments from its credit union members.

A similar recapitalization approach could be taken with respect to the BIF. Indeed, a specific method to do that was presented in the last session of Congress (H.R. 5590). Under this plan, banks would provide capital to the FDIC in the form of deposits amounting to one percent of total bank deposits.

In a general sense, the argument can be made that a recapitalization reduces the probability that taxpayers will have to underwrite the cost of bank failures. Without a recapitalization, it may be difficult for the FDIC to raise sufficient assessments to pay for unforeseen losses of truly catastrophic proportions. There may be "market discipline" effects as well, as will be discussed later. On the negative side, a recapitalization would involve significant costs to the banking industry. Such costs could not only materially affect bank profitability, but could also dissuade investors from committing risk capital to the industry.

## The Basic Accounting Issue

A major issue in a recapitalization would be the accounting treatment afforded the deposits or capital contributions from member banks. It should be noted at this point that, although bank regulators may have a definite preference as to how the deposit with the FDIC should be treated, it is the accounting profession through generally accepted accounting principles (GAAP) rulings that will probably have the final say on the issue. One possibility, however, is to permit banks to carry these deposits or capital contributions as assets on their books. Such contributions would in some ways be similar to an equity investment by a bank in the FDIC. Should the BIF incur liabilities that erode the value of these funds, bank equity would be reduced accordingly.

The advantage of this method of accounting is that it would result in a more accurate and immediate reflection of deposit insurance losses on the books of the banking industry. In addition, shifting fund losses directly to banks might create incentives for self-policing by the industry. Such incentives could well discourage activities by individual banks that tend to jeopardize the industry's investment in BIF.

This accounting approach is not altogether free of potential shortcomings. It is tempting to think of the accounting issue as a non-issue; that is, banks' economic net worth should not depend on the rules used to prepare their financial statements. In this case, however, allowing banks to carry their deposits with the BIF as an asset could affect the distribution of bank failure costs between banks and, potentially, the taxpayers. Thus, it is possible that the FDIC could face a situation, as did the Federal Savings and Loan Insurance Corporation (FSLIC) in 1987, when Congress directed the recapitalized FSLIC to rebate the funds deposited in FSLIC's secondary reserves to the thrift member institutions, thereby shifting liability from the thrift industry to taxpayers. In other words, there may be more uncertainty as to the level of BIF resources if the assessments were considered to be assets of the banking institutions. In addition, having the same balance appear twice, as an asset on the books of banks and again as a component of BIF itself, may create the impression that the backing behind bank deposits is greater than it really is.

An alternative is for the funds on deposit with the FDIC to be treated not as assets by banks, but, rather, as an expense, similar to the way deposit insurance premiums are treated currently. Under this method, the increase in the BIF balance would result in an equivalent reduction in bank capital. The main drawback of an accounting rule of this sort is its possible effect on bank income and capital adequacy. If a one percent deposit requirement were expensed all at once, banks would become

subject to a large one-time loss, which may push capital ratios at some banks to dangerously low levels. If the deposit contribution, in contrast, were treated as an asset, banks could meet the requirement more easily.

### **The Effect of Accounting Options on Banks**

Clearly, the practical effects of a one percent assessment on industry capital is an issue that deserves careful consideration. A cursory look at the problem indicates that a one percent assessment based on total (domestic and foreign) deposits would cost banks about \$25 billion. Such a cost would exceed total bank profits for 1989 (\$15.7 billion) and would represent over 12 percent of the equity capital of commercial banks for the same year. Of course, all of that cost would not have to be absorbed by profits, as part of it would be deducted from taxes and probably another portion passed on to the users of bank services. Even so, the remaining effects of the assessment are still likely to be quite significant relative to the well-being of the banking industry.

If banks treated the deposit or capital contributions as an expense, it would be difficult to distinguish the recapitalization from the financing that would result from higher insurance premiums under the existing system. The impact on bank balance sheets would be the same: banks would have to raise additional capital in order to offset the expense. The main difference between the two programs is that one requires a fixed one-time deposit up front, whereas the other provides for a more gradual adjustment of the Fund towards the desired level. The advantage of allocating these costs over a longer time is that banks could meet the necessary expenses through retained earnings, rather than through a decrease in capital.

In contrast, if the contribution to BIF was treated as an asset of the contributor, a bank would have the choice of raising the funds for the deposit either by liquidating existing assets or through new borrowing. Either way, there would be little impact immediately on the bank's costs or capital ratio. Such an impact would materialize only if later the FDIC charged insurance losses and expenses against the bank's reserve balance with the Fund.

Another important consideration is whether the FDIC should recapitalize BIF on a one-time basis, as NCUA did, or do so over a period of time. A one-time recapitalization could create some difficulties for the industry, even if contributions are treated as an asset by member institutions. This would be particularly true, if the introduction occurred during a period of weak bank earnings and depressed overall economic activity.



In setting up a recapitalization plan, one has to decide on the variable against which the one percent deposit or similar contribution will be measured. While a number of aggregates for measuring the contribution are possible (e.g., as a percentage of insured deposits, a percentage of domestic deposits, or as a percentage of total liabilities) it seems that the assessment base as defined for FDIC premium purposes offers certain advantages. The assessment base can be measured accurately and the necessary data have been reported to the FDIC on a timely basis for a long time. Moreover, using the assessment base avoids the issue of changes in assessment burdens among institutions relative to present assessment policy. If, for example, the base for measuring the contribution included foreign deposits, costs to large banks would tend to increase.

### 3. Assessment Base

By law, only deposits in domestic offices are subject to assessment. Foreign deposits do not fall within the purview of the FDI Act.

Not all domestic deposits are assessable, however. The total of such deposits is adjusted downward for items in the process of collection to arrive at the assessment base for each bank. For such items in process that have not been collected (referred to as "float"), deductions of 16 2/3 percent of demand deposits and one percent of savings and time deposits are permitted. After these adjustments, the assessment base included 92 percent of domestic deposits as of year-end 1989. This percentage was up from 86 percent in 1980. The difference in the percentage is largely attributed to the fact that the relative share of demand deposits (which carry a greater deduction for float than time deposits) declined from 30 percent of domestic deposits in 1980 to 18 percent in 1989. The base, however, has grown more inclusive over the years, even when contrasted to broader measures. Against total deposits (domestic and foreign), the base rose from 71 percent in 1980 to 81 percent in 1989, while against total liabilities it grew from 61 percent to 68 percent during the same period. A major reason for this has been the relative decline of foreign borrowings by U.S. banks. Indeed, foreign deposits grew by only 10 percent between 1980 and 1989, whereas domestic deposits increased by 86 percent during the same interval.

The base for assessing premiums, however, is important not only because it affects Fund income, but also because it determines the distribution of assessment costs among banks. Potential methods of reforming the assessment base are discussed below.

## Float Deduction

Because the definition of what constitutes assessable liabilities determines the incidence of deposit insurance assessments, this topic is of intense interest to the industry. Currently, the assessment base consists of domestic deposits (i.e., deposit liabilities payable in the U.S.), reduced for float. The reduction has been in the law since 1935. Beginning in 1961, uniform percentage deductions for float became available to banks in lieu of tracking actual balances.

The deduction for float makes little sense from an economic perspective. First, the availability of a uniform percentage deduction ensures that a maximum deduction will be available; banks with low float will use the formula, whereas banks with an above-normal level will use the actual figures. Of more significance, what is referred to as float has a counterpart on the liability side of the balance sheet that, for deposit insurance purposes, is treated as any other deposit. Thus, the float deduction represents a reduction in the assessment base, without a reduction in the FDIC's liability on an individual bank basis.

## Method of Averaging

A technical issue concerns the method of averaging used for calculating the assessment base. The base currently used for the computation of banks' semiannual assessment payments is the average of deposits on the last day of each of the two immediately preceding quarters. It has been argued that certain banks tend to remove (retire) from their end-of-quarter statements certain borrowings, such as brokered funds. Use of a daily average would more accurately measure the deposit base. Over the past several years, the cost of maintaining the necessary records for daily averaging has been significantly reduced for virtually all banks. Some of the items needed to calculate the assessment (e.g., time deposits) are already reported in the call reports on a daily-average basis.

There seems to be no apparent reason why banks may want to "window-dress" demand deposits, except perhaps an incentive on the part of some banks to maintain large deposit balances at the end of the quarter in order to attain a certain size ranking in their community or the industry. In that event, banks may be able to call in balances from their correspondents to show larger statements at the end of the period. Averaging these balances on a daily basis, however, would tend to lower FDIC income from assessments.

## **Expanding the Definition of Deposit**

Currently, the FDIC has drafted a proposed rule expanding the definition of the term "deposit." The rule is intended to widen the definition of deposit in the FDI Act by prescribing that other obligations of banks are deposits by virtue of general use. There have been instruments issued by banks (sometimes called "bank notes") that have not been considered by the issuer to be deposits, even though from a functional standpoint they are the same as deposits. The exact volume of these instruments is unknown. The concern is, however, that, in the absence of the proposed rule, the FDIC may be required to treat these instruments as insured deposits in the event of bank failure and, at the same time, receive no assessment income from them.

## **Foreign Deposits**

As indicated in Chapter VI, subjecting foreign deposits to FDIC assessment is a long-standing and widely-debated issue. From the present perspective, however, an important question would be the extent to which banks would be able to evade FDIC assessments by converting foreign branch deposits into other funding arrangements, such as subordinated notes and repurchase agreements, thereby limiting potential increases in Fund revenues.

## **Secured Bank Borrowings (Collateralized Borrowings)**

Another substantive recommendation pertains to extending the assessment base to include secured borrowings (*i.e.*, borrowed money raised in the normal course of business that has a claim on assets ahead of insured deposits). The most significant amounts of funding that would be covered under this recommendation are repurchase agreements (RPs), borrowings from the Federal Home Loan Banks (FHLBanks), and borrowings from the Federal Reserve Banks. Secured borrowings are effectuated by essentially two means: pledging and RPs. A prime example of pledging is public funds. Many states have statutes requiring that state and municipal deposits with banks be collateralized, in part or in total, by U.S. government securities.

From the standpoint of FDIC insurance liability, pledging requirements and RPs have similar effects. Secured borrowings, whether public deposits or RPs, have preference over FDIC claims, as well as the claims of uninsured depositors. State and municipal deposits, including those with pledging requirements, are presently subject to FDIC assessment; RPs and similar secured borrowings are not. The pros and cons of assessing the latter are discussed in Chapter XIV.

#### 4. Liquidity and Borrowing Authority

The limit on FDIC borrowing from Treasury set in 1947, even with its subsequent increase to \$5 billion, has obviously been greatly reduced in relation to the FDIC's current and potential need for cash resources. The FDIC is increasingly facing liquidity constraints in failed bank transactions. Acquiring banks sometimes choose not to take the illiquid assets of a failed bank, and the FDIC must then purchase these assets and resell them to the private sector. That resale process can be lengthy and can tie up cash resources in illiquid assets for extended periods of time. Since the FDIC needs cash to resolve other failed banks, it must either liquidate some of its securities or resort to borrowing against its illiquid assets to obtain that cash. FIRREA provides that the FDIC may borrow against illiquid assets, but only so long as it maintains a Fund balance or net worth of at least 10 percent of total assets. This net worth cushion is designed to absorb losses if acquired assets are sold for less than originally estimated.

The FDIC borrows from banks, generally, by issuing notes directly to the acquiring institution. The interest cost to the FDIC is normally equal to 50 basis points above the FDIC's opportunity cost of money (*i.e.*, the average yield of its U.S. securities portfolio). Maturities have typically been one year or less, except in a few very large failure or assistance transactions where notes longer than one year had to be issued.

The problem with this type of borrowing is that the acquiring banks do not always wish to accept FDIC notes instead of cash because the notes are neither marketable nor can be used as collateral against borrowing from Federal Reserve Banks. This is particularly the case when the assuming bank has inherited high-cost deposit funds from the failed bank. In such a case, the acquiring bank is likely to want only cash from the FDIC in order to rid itself of the expensive funds.

The newly acquired authority of the FDIC to borrow from the Federal Financing Bank could be used as an alternative to FDIC notes. The U.S. budget treatment of FDIC borrowing from the Federal Financing Bank will be identical to the current budget treatment of FDIC notes--both transactions will be counted as outlays. To the extent, however, that borrowing from the Federal Financing Bank lowers FDIC costs, both the FDIC funds and the U.S. budget stand to gain.

Beyond borrowing from the Treasury and the Federal Financing Bank, other forms of FDIC indebtedness may be worth exploring. FDIC borrowings from the Federal Reserve could be expanded to include occasions other than failed- or failing-bank situations. Notes issued by the FDIC could become eligible for re-discount at the Federal Reserve. As for the FDIC issuing its own debt

instruments in the securities markets, as some other government agencies do currently, the prospect that borrowing under such conditions will be more costly than if the FDIC borrowed from the Treasury would, no doubt, emerge as a major consideration.

#### **D. The Savings Association Insurance Fund**

The SAIF, created by FIRREA, insures formerly FSLIC-insured thrifts which fail or require assistance after August 9, 1992, the date the Resolution Trust Corporation's (RTC's) thrift takeover activities are scheduled to terminate. This section describes the funding mechanism for the SAIF, and addresses the adequacy of SAIF's funding as insurer of the deposits of its member institutions.

FIRREA provided for the funding of SAIF by assessments from its members and also authorizes the Treasury to make payments to SAIF in 1992 through 1999 to assure that specified levels of reserves will be attained during that period.

##### **1. Sources of Funding**

###### **Assessments**

Prior to FIRREA, FSLIC-insured savings institutions paid assessments at the basic annual rate of 1/12 of one percent of their assessable deposits, the same basic rate paid by commercial banks. Beginning in 1985, the thrifts were charged, in addition, a special quarterly assessment of 1/32 of one percent, for a total assessment rate in 1989 of 0.208 percent, or 20.8 cents per \$100 of deposits. Under both the FDIC Assessment Rate Act of 1990 and FIRREA, this rate continued in 1990. Starting on January 1, 1991, and continuing through December 31, 1993, the rate is scheduled to be 0.23 percent. Beginning January 1, 1994, the rate is scheduled to decline to 0.18 percent and continue at this level through December 31, 1997, and then fall to 0.15 percent thereafter.

On January 1 of a calendar year in which the SAIF reserve ratio (SAIF net worth divided by the estimated insured deposits of SAIF members) is expected to be less than the "designated reserve ratio," as determined by the FDIC's Board of Directors, the FDIC is authorized to set an annual rate of assessments appropriate to restore the reserve ratio to the designated ratio within a reasonable time. In setting this rate, the FDIC must take into consideration the SAIF's expected expenses and income, and the effects of the assessment rate on insured savings associations' earnings and capitalization. Under FIRREA, the increase was limited to 0.075 percent in any one year, and the rate could go no higher than 0.325 percent.

Initially, under FIRREA, the designated reserve ratio was set at 1.25 percent, the same level that applies to the BIF. Under FIRREA, the FDIC could increase the ratio (for both commercial banks and thrifts) to 1.50 percent, upon a determination by the Board of Directors on a year-by-year basis that "significant risk" of substantial future losses to the Fund justified a higher level.

FIRREA provides that if the FDIC increases the designated reserve ratio above 1.25 percent, investment income on the assessments attributable to the increase will be redistributed to Fund member institutions. If the FDIC subsequently determines that the BIF or SAIF exceeds the appropriate designated reserve ratio, the excess funds are to be distributed to member institutions.

Under FIRREA, SAIF members would be granted an assessment credit whenever the FDIC determined that the SAIF reserve ratio was expected to exceed the designated reserve ratio in the succeeding year, after expenses and income were taken into account. This credit would be the lesser of (1) the amount necessary to reduce the SAIF reserve ratio to the designated reserve ratio, or (2) 100 percent of the net assessment income to be received from SAIF members in the succeeding year.

Subsequent to the enactment of FIRREA in August 1989, the FDIC, as a result of its evaluation of the banking and thrift industries and the existing provisions for funding the insurance funds, sought additional funding powers for BIF and SAIF. Responding to this situation, Congress passed the FDIC Assessment Rate Act of 1990 as a part of the Omnibus Budget Reconciliation Bill.

The 1990 Act provides for a minimum assessment rate of 0.15 percent and authorizes the FDIC to establish a higher rate at its discretion in order to maintain the SAIF reserve ratio at the designated reserve ratio or to increase the SAIF reserve ratio to the level of the designated reserve ratio within a reasonable period of time. When considering an increase in assessments, the Board of Directors of the FDIC must take into account SAIF's expected operating expenses, case resolution expenditures and income, the effect of the assessment rate on members' earning an asset, and other factors as it may deem appropriate. The new legislation also provides authority for the FDIC to set rates at such times that the FDIC, in its sole discretion, determines to be appropriate. The 1990 Act sets certain deadlines for announcing such changes for the semiannual periods.

Another major change from FIRREA in the 1990 Act is the elimination of the 1.50 percent ceiling on the designated reserve ratio. The Board of Directors of the FDIC may set a designated reserve ratio (for each Fund) as justified by circumstances that

raise a significant risk of substantial losses to the insurance fund.

#### **Non-SAIF Claims on Assessments**

SAIF is currently receiving no income from assessments because of the FIRREA-required assessments required to be paid by SAIF members to the claimants discussed below. These prior claims on SAIF member assessments are as follows.

**Nonadministrative Expenses.** SAIF assessments must pay the "nonadministrative expenses" of the Financing Corporation (FICO), principally the interest expense on the bonds issued by FICO. FICO was created by the Competitive Equality Banking Act of 1987 to issue bonds to recapitalize FSLIC. Under FIRREA, FICO was put under the authority of the Federal Housing Finance Board (FHFB). FICO is authorized to issue up to \$10.825 billion in bonds, of which \$8.17 billion in obligations have been issued.

**Resolution Funding Corporation.** SAIF assessments must also be paid to the Resolution Funding Corporation (REFCORP). This Corporation, regulated by the RTC Oversight Board, was created by FIRREA and is authorized to sell up to \$30 billion in long-term bonds for financing the RTC. A repayment fund for these bonds consists of Treasury securities purchased from capital contributions and annual payments in 1989, 1990, 1991, and 1992 from the FHLBanks. If these payments are not sufficient to finance the repayment fund, REFCORP is authorized to assess SAIF members to obtain funds. If these amounts are not sufficient, REFCORP is to obtain liquidating dividends from the FSLIC Resolution Fund (described below) to meet the shortfall.

**FSLIC Resolution Fund.** SAIF assessments must also be paid to the FSLIC Resolution Fund (FRF). As provided by FIRREA, all the assets and liabilities of FSLIC were transferred to the FRF upon the termination of FSLIC on August 9, 1989. The FRF is responsible for the obligations incurred by FSLIC prior to FIRREA. Assessments paid by SAIF members that are not required by FICO or REFCORP between August 9, 1989, and December 31, 1991, will be paid to the FRF, which will terminate when its obligations are paid and its funds liquidated. At dissolution, its remaining funds will be transferred to the U.S. Treasury.

#### **Entrance/Exit Fees**

FIRREA requires that insured depository institutions be charged entrance and exit fees in certain transactions that involve additions to, or subtractions from, the aggregate deposit base of SAIF (and BIF) members. These transactions include a change in membership status to the SAIF (and BIF), mergers and consolidations, and assumptions and transfers of deposit liabilities. The entrance fees must be established in the

"approximate amount . . . to prevent dilution" of the fund being entered. In the case of conversions from SAIF to BIF, an exit fee is charged, which is intended to represent the approximate present value of each SAIF member's pro rata share of interest expense on the obligations of FICO projected over the next 30 years.

### Treasury Payments to SAIF

In order to provide sufficient funding for SAIF, FIRREA authorizes the Treasury to make payments into the Fund in the fiscal years beginning October 1, 1992, and continuing through fiscal year 1999. These payments are of two types: (1) revenue supplements, and (2) net worth supplements. It should be noted that both are subject to the appropriations process.

In each year, the Treasury's revenue payment will be the difference between the deposit insurance assessments paid by SAIF members, less amounts paid to the non-SAIF claimants on assessments, and \$2 billion. Thus, given this limit on payments only if the net amount of premiums paid into SAIF during this period were zero would the Treasury pay the maximum of \$16 billion (i.e., \$2 billion in each of eight fiscal years). The Treasury is also authorized to pay into SAIF in each of the year the amount that is necessary, as determined by the FDIC and Treasury, to ensure that the SAIF has a minimum a net worth as follows:

<u>FY Beginning October 1</u>	<u>SAIF Minimum Net Worth</u> (in billions of dollars)
1992	1.0
1993	2.1
1994	3.2
1995	4.3
1996	5.4
1997	6.5
1998	7.6
1999	8.8

There is a ceiling on the net worth supplements of \$16 billion. Thus, the total of the Treasury's payments cannot exceed \$32 billion. In addition, no Treasury payments are authorized, either revenue or net worth, after the SAIF reserve ratio has reached 1.25 percent.

### Borrowing Authority

Since its inception, the FDIC has had the authority to borrow to meet its liquidity needs. In 1947, specific authority to borrow up to \$3 billion directly from the Treasury was granted. FIRREA increased the maximum amount the FDIC may borrow



from the U.S. Treasury. With the approval of the Secretary of the Treasury, the FDIC can borrow from the Treasury, on behalf of either the BIF or SAIF, up to \$5 billion. All borrowings must be attributed to the BIF or SAIF and become a liability of the respective Fund. Total borrowing by the FDIC on behalf of either Fund is limited by a statutory requirement that no obligation can be issued if its issuance would leave the net worth of that Fund equal to less than 10 percent of assets.

FIRREA authorizes the FDIC to borrow from the FHLBanks, with the concurrence of the FHFB, such funds as the FDIC determines to be necessary for the use of SAIF. Among the conditions for such borrowing, the interest rate may not be less than the FHLBank's current marginal cost of funds taking into account the maturities involved; the loans must be adequately secured, as determined by the FHLBank; and they must be a direct liability of the Fund and subject to the FDIC's obligation limitation.

The 1990 Act explicitly authorizes the FDIC to issue and sell its obligations, on behalf of the BIF or SAIF, to the Federal Financing Bank. The Federal Financing Bank is authorized to purchase and sell the FDIC's obligations on terms and conditions as it determines.

## 2. Current Status of SAIF

There were 2,699 SAIF-insured thrifts as of June 30, 1990, following a decrease of 521--more than 16 percent--from the end of 1986. Reflecting both deteriorating conditions in the industry and higher required capital standards, deposits fell by almost nine percent in 1989 and the first half of 1990 to \$885.1 billion. (See Table 4.)

Prior to FIRREA, each insured thrift paid its assessment in one annual payment on the institution's charter anniversary date. Beginning in 1990, the institutions pay their assessment semiannually, in February and July. In September 1989, the FDIC authorized a transition assessment in order to establish SAIF members on the same semiannual assessment system used for BIF members' payments.

Preliminary financial statements for 1989 indicate that SAIF members paid a total of \$394 million in the transition assessment, none of which went into the Fund. FICO claimed \$295 million for the payment of interest on its obligations. At year-end 1989, the remaining \$99 million plus \$2 million of recorded interest had not been distributed between REFCORP and FRF. SAIF's administrative and operating expenses of \$6 million for the period August 9 through December 31, 1989, were paid by FRF. As of December 31, 1989, SAIF's assets were \$103 million, of which \$101 million was being held in escrow, as indicated above.

Table 4

**Federally-Insured Thrift Institutions, Number and  
Deposits, 1980-1990**

Year-end	Number <sup>1</sup>	Deposits (in billions of dollars)
1980 .....	4,005	503.2
1981 .....	3,785	519.9
1982 .....	3,349	560.5
1983 .....	3,183	671.1
1984 .....	3,136	784.5
1985 .....	3,246	843.9
1986 .....	3,220	890.7
1987 .....	3,147	932.6
1988 .....	2,949	971.5
1989 .....	2,878 <sup>2</sup>	945.7
1990 <sup>3</sup> .....	2,699 <sup>2</sup>	885.1

<sup>1</sup> Institutions insured by FSLIC in 1980-1988 and by SAIF in 1989-1990.

<sup>2</sup> Includes institutions in RTC conservatorship. On June 30, 1990, 247 institutions were in conservatorship, with deposits of \$99.7 billion.

<sup>3</sup> Data are as of June 30, 1990.

Source: Federal Deposit Insurance Corporation.

The January 1990 assessment collected a total of \$930.9 million, net of the \$50.2 million credit for the FSLIC secondary reserve write-off. Of the total collections, \$389.4 million was distributed to FICO, and \$540.9 million went to REFCORP.

## **Chapter XVII**

### **INTERSTATE BANKING AND BRANCHING<sup>1</sup>**

#### **A. Introduction**

This chapter shows that interstate branching is a logical and feasible step in the evolution of the geographical structure of American banking.<sup>2</sup> This chapter is organized as follows: Section B delineates the current regulatory environment; Section C describes the origins of the existing interstate branching laws; Section D discusses the advantages of interstate branch banking; Section E analyzes models of interstate branching such as national bank branching, host-state regulation and home-state regulation; Section F discusses the effects of interstate branching on the structure of the banking industry; and Section G provides a conclusion.

#### **B. The Current Regulatory Environment**

Unique among American businesses, banks in the United States are regulated by an interrelated set of state and federal laws as to where they can conduct business. But whether a bank chooses a federal or a state charter, its geographical expansion is effectively regulated by the states.

##### **1. The Regulation of Geographic Expansion**

At the state level, banks are generally chartered to operate within the state. In addition, most states specifically forbid entry through branching, although some states have the option to approve an out-of-state bank's establishing a branch within their borders under specified conditions. Specifically, Montana, Nevada, New York, Oregon, Rhode Island, Utah, and Virginia may permit entry through branching (unpublished survey, Conference of State Bank Supervisors, 1990).<sup>3</sup>

##### **2. The McFadden Act**

At the federal level, the McFadden Act of 1927 (as amended in 1933) states that national banks

may, with the approval of the Comptroller of the Currency, establish and operate new branches...at any point within the State in which said association is situated, if such

establishment and operation are at the time authorized to State banks by the statute law of the State in question by language specifically granting such authority affirmatively and not merely by implication or recognition, and subject the restrictions as to location imposed by the law of the State on State banks. (12 U.S.C. 36(c)).

In general, McFadden gives national banks the right to branch to the same extent that state banks are permitted to branch. But even if a state were to allow interstate branching for state chartered banks, it is not clear whether national banks could be given interstate branching authority under current law because the law contains the phrase "within the State," which would appear to limit national bank branches to state boundaries. Thus McFadden is usually interpreted as prohibiting interstate branching by national banks.<sup>4</sup> Nevertheless, with the approval of the Comptroller of the Currency, a national bank that results from the conversion of a state-chartered bank may retain and operate any branches operated by the bank before its conversion (12 U.S.C. 36(b)).

### 3. The Douglas Amendment

Whatever the specifics of how banks are restricted from branching across state lines, virtually all interstate bank expansion to date has taken place through bank holding companies. The Douglas Amendment to the Bank Holding Company Act of 1956 forbids interstate acquisitions by bank holding companies unless the acquired bank's home state allows the acquisition, subject to certain exceptions.<sup>5</sup> Under current state interstate banking law and the Douglas Amendment, a bank holding company now expands interstate by acquiring a bank and then operating it as a subsidiary rather than a branch. For example, a bank holding company headquartered in Virginia and engaging in full-service banking in Maryland and the District of Columbia must operate through three separate banks, one for each jurisdiction.

One prominent wrinkle present in most but not all interstate banking laws is a ban on expansion by creating a de novo subsidiary. That is, most interstate banking statutes allow entry only by acquiring a bank that has been in existence a specified number of years. It is reasonable to assume such restrictions were necessary to secure the passage of interstate banking laws by making the laws more palatable to potential acquirers. Foreclosing the option of de novo entry removed an alternative to entry by acquisition and thereby raised premiums paid by entrants for banks. While it is likely that most banks look first at acquiring an existing depository institution, blocking de novo entry means that entrants are deprived of an option they might exercise if merger premiums seem excessive or if no existing bank in an otherwise attractive market is a suitable candidate for takeover.

Historically, the Federal Home Loan Bank Board, now the Office of Thrift Supervision (OTS), had been given exclusive authority to determine the limits of geographic operations of federally chartered savings and loan associations under the Home Owners' Loan Act of 1933, as amended (12 U.S.C. 1461 and 1464 (a)). In Independent Bankers Association of America v. Federal Home Loan Bank Board (557 F. Supp. 23 (1982)), the District Court ruled that branching by federally chartered thrifts comes under the authority of the Federal Home Loan Bank Board (now the Office of Thrift Supervision), whether intrastate or interstate. The Independent Bankers challenged the Federal Home Loan Bank Board when it adopted a policy of allowing interstate branching to acquire troubled thrifts and then allowing branching within the acquired thrift's state. The court made clear that restrictions on interstate thrift branching are administrative rules and not codified in the law as is the case with banks.

The Home Owners' Loan Act, as subsequently amended, prohibits a federally chartered savings association from branching outside the state in which its home office is located unless it qualifies as a building and loan association under the Internal Revenue Code (IRC), subject to certain exceptions. The OTS's interstate branching policy permits federally chartered associations that satisfy IRC requirements to branch across state lines if the laws of the state in which the association's home office is located permit state chartered associations to branch across state lines. Any company acquiring a thrift is subject to the Home Owners' Loan Act which permits interstate transactions that would result in formation of a multiple thrift holding company only under limited circumstances.

There are a few interstate bank branches operating today that had been established before either state or federal laws forbade them. For example, since 1905 the Bank of California has operated branches in Portland, Oregon, and Seattle and Tacoma, Washington. All three were acquired from the British bank that had originally established them. In addition, Midlantic National Bank in New Jersey operates a branch across the Delaware River in Philadelphia. Since both Bank of California and Midlantic are federally chartered, there is no problem with state regulatory authority over the branches. More recently, after the Bank of America acquired a failed Arizona thrift that had operated a branch in Utah, the Utah banking regulators allowed Bank of America to continue to operate the office as a branch.

There have been other examples of interstate branch banking (Federal Reserve Board 1933a, pp. 207-9). The First and Second Banks of the United States both had branches during their existence. For a time Wells Fargo and Company operated branches outside California. The branches were closed apparently as the result of business decisions and not because of legal or regulatory actions. Finally, in 1874 the Freedman's Savings and

Trust Company, chartered by Congress, had branches in all the Southern states and one in New York (Chapman and Westerfield 1942). Still, given the number of banks in the United States, is striking to see how little interstate branching had occurred even before it was explicitly banned.

### C. The Origins of Current Law

The history of banking in the United States is characterized not simply by the lack of interstate branching, but by the longtime lack of interest in branching within a state as well. That is, while branching has occurred throughout American banking history, it only caught on as a widespread phenomenon in the twentieth century, and then only in fits and starts. In contrast, the history of Canadian banking has included branch banking from the start and there have apparently been no serious efforts to emulate the American system. And while in Canada a small number of commercial banks with extensive branch networks have been able to serve the market, in the United States small independent banks abound even in states with no restrictions on branching.

#### 1. Early Bank Branching

Before the Civil War, there was branching at both the federal and state levels (Federal Reserve Board 1933a). At the federal level, the First Bank of the United States, which lasted from 1792 to 1811, was headquartered in Philadelphia and maintained offices in eight other cities. The Second Bank of the United States, which lasted from 1816 to 1836 and also operated out of Philadelphia, had as many as twenty-five other offices during its life.

In addition, there were state branch banking systems, although most of the branches that survived into the National Bank era after the Civil War ended up incorporating as independent national banks. Finally, "free banking" arose in the North at the same time as branch banking in other states. Free banking meant that specific legislative chartering of a bank was not required; instead, anyone meeting specified requirements (such as initial capitalization and depositing bonds with the chartering state) would be issued a charter. Free banks were unit banks, that is, they had no branches, although branch banking was not specifically forbidden.

The last category, free banking, proved significant for the future of branch banking law because the New York free banking law contained provisions specifying that "the usual business of banking...shall be transacted at the place where such banking association...shall be located..." (Federal Reserve Board 1933a) The language was apparently not aimed at branch banking per se,

but at the then notorious practice of issuing currency at the bank's main location, usually in a remote area ("wildcat banking"), but only redeeming at a discount in a city location. The provisions were significant because they were later to be incorporated into the National Banking Act and still later to be interpreted as forbidding branching by national banks, even though there is no evidence that doing so was the original intent of the legislation (Fischer and Golembe 1976).

When the National Bank System was established during the Civil War, the new system was comprised entirely of unit banks, even though state-chartered branch banks were specifically allowed to keep their branches if they converted to national charters. As it turned out, the grandfathering authority for branches was not used until the first decade of the twentieth century. The important point is that branching was simply not an important issue, not because of specific opposition to it but because of lack of interest. Apparently unit banks had a comparative advantage over branch banks.

The first stirring of renewed interest in branch banking came during the late 1890s in the form of proposals to encourage branching by national banks as a means of making banking services available to rural areas that could not support a separately incorporated bank (Comptroller of the Currency 1895). While such proposals did not elicit much interest from the public, bankers were largely opposed so none were enacted. Instead, in the Currency Act of 1900 the required capital for establishing a national bank was reduced from \$50,000 to \$25,000 (or, in 1990 dollars, from \$663,500 to \$331,750) for towns with population of less than 3,000.<sup>6</sup>

The result was, predictably, an increase in the number of banks in the United States from approximately 13,000 in 1900 to about 25,000 in 1910 (Board of Governors 1959). And of the new banks, about two-thirds were small unit banks with an average capital base of just over \$25,000 (Chapman and Westerfield 1942). The resultant growth in the number of independent unit banks made for an anti-branching force that slowed the growth of branch banking for decades.

While the number of unit banks increased, branch banking became more common at the state level. In California, branch banking started as a largely rural phenomenon, especially after branching was officially approved for state banks in 1909 (Federal Reserve Board 1933b). But in the rest of the country, branching became commonplace not in rural areas but within cities, in particular, in New York, Detroit, Philadelphia, Boston, and Cleveland.

As both branching by state banks and the number of unit banks grew, it is not surprising that unit bankers attempted to



contain the spread of branch banking. The result was, first, a flurry of laws in the 1920s to ban branch banking, mostly in states where it did not yet exist. In fact, more states banned branching in 1929 than had done so in 1910. Second, there were moves to keep national banks from branching at all, with the avowed purpose of stemming the spread of branch banking in any form.

National banks in branching states wanted the same branching privileges as their state chartered brethren. But unit banks were adamant in opposing any extension of branch banking. Further, the money center banks of the day were largely opposed to branch banking, since they stood to profit from correspondent business and were not much interested in retail customers. And apparently absent from the debate was any consideration of interstate branching.

## 2. Regulatory Policy

Regulatory policy toward branch banking varied over time. In 1911, the Comptroller requested that the Attorney General provide an opinion regarding branching by national banks. Based on the language originally adopted from the free banking statutes, the Attorney General opined that national banks were not allowed to branch. But by the early 1920s, the Comptroller allowed branching in order to meet competition by state chartered banks in branching states. Indeed, one Comptroller believed he could allow branching regardless of state laws, but simply followed state laws as a matter of policy, just as did the Federal Home Loan Bank Board in the 1980s. Finally, in 1924 in First National Bank in St. Louis v. State of Missouri (263 U.S. 640), the Supreme Court held that a state had the right to enforce its branching restrictions for national banks unless Congress specifically provided otherwise. The court also held that national banks did not have the right to branch.

The matter was put to rest by the McFadden Act of 1927, passed after three years of intense debate. The Act allowed a national bank to branch within its city boundaries if state banks were allowed the same or more liberal privileges. Since most branching at the time was within cities, the Act probably was sufficient for most banks. But in California, the restrictions were binding on national banks so they led to forms of corporate organization and affiliation that served to evade the Act's restrictions (Federal Reserve Board 1933b).

Following the McFadden Act, anti-branching sentiment waned, largely because the extensive bank failures of the late 1920s and early 1930s showed the weakness of unit banking and made branching attractive as a means of making failures less likely. The consequence was that between 1929 and 1939 the number of

states prohibiting branches fell sharply while the number permitting statewide branching doubled.

While the ultimate result of the rash of bank failures was deposit insurance rather than significantly enhanced branching powers (Fischer and Golembe 1976), there arose during this time the first explicit support for interstate branching. Senator Carter Glass of Virginia, an architect of the Federal Reserve Act, proposed in 1932 a bill that would liberalize national bank branching powers. In particular, the bill proposed not simply statewide branching for national banks but "trade area" branching as well. That is, a bank located near a state line with frequent business in the other state would be allowed to branch up to fifty miles into the state. An obvious example of such a trade area is the Washington, D.C. metropolitan area.

The Glass Bill was not enacted. Instead, the Banking Act of 1933 liberalized the 1927 McFadden provisions to permit national banks to branch to the same extent as was permitted to state banks. Thus national and state banks had approximately the same branching powers, and the law remains in force today.

As mentioned above in connection with California, one of the earliest means of circumventing state geographic restrictions on branching was through organizational structures such as group banking. Initially chain banks, and later the formation of multiple bank holding companies developed as a means to achieve geographic expansion. By the 1950s the bank holding company movement, and interstate multiple bank holding companies in particular, had become a significant concern to Congress. This led to additional restrictions on geographic expansion in the Bank Holding Company Act of 1956. Section 3(d) of the Act, known as the Douglas Amendment, prohibited bank holding companies from chartering or acquiring a bank in another state unless expressly permitted to do so by state law (although the existing interstate activities of seven domestic and five foreign bank holding companies were "grandfathered"). As in the case of the McFadden Act for bank branching, the Douglas Amendment placed control of interstate bank expansion via holding company acquisitions in the hands of the states.

### **3. The Current Status of Geographic Expansion**

Since 1933, virtually all the action on branch banking has occurred at the state level, although most changes since the Depression era occurred during the 1980s. For example, in 1939, 18 states allowed statewide branching while nine allowed only unit banks; forty years later, in 1979, the number of states allowing statewide branching and the number allowing only unit banking had both grown by three. But as shown in Table 1, by September 1990, 39 states (plus the District of Columbia) allowed statewide branching by law while only 2 states prohibited

Table 1

Summary of State Bank Expansion Laws

Statewide (40)	Limited (9)	Unit (2)
Alabama <sup>2</sup>	Arkansas <sup>4</sup>	Colorado
Alaska	Illinois	Wyoming
Arizona	Iowa	
California	Kentucky	
Connecticut	Louisiana <sup>3</sup>	
Delaware	Minnesota	
District of Columbia	Missouri <sup>3</sup>	
Florida <sup>2 3</sup>	New Mexico	
Georgia <sup>2</sup>	Tennessee <sup>3</sup>	
Hawaii <sup>1</sup>		
Idaho		
Indiana <sup>2</sup>		
Kansas <sup>1 2</sup>		
Maine		
Maryland		
Massachusetts		
Michigan		
Mississippi		
Montana <sup>1 2</sup>		
Nebraska <sup>2</sup>		
Nevada		
New Hampshire		
New Jersey		
New York		
North Carolina		
North Dakota <sup>1 2</sup>		
Ohio		
Oklahoma <sup>2</sup>		
Oregon		
Pennsylvania		
Rhode Island		
South Carolina		
South Dakota		
Texas		
Utah		
Vermont		
Virginia		
Washington		
West Virginia		
Wisconsin <sup>3 5</sup>		

<sup>1</sup> State has not enacted a law providing for entry from other states.

<sup>2</sup> Statewide branching by merger.

<sup>3</sup> Statewide branching permitted for national banks according to ruling of Comptroller of the Currency.

<sup>4</sup> Contiguous county branching Jan. 1, 1994, statewide Jan. 1, 1999.

<sup>5</sup> Statewide branching effective Aug. 1, 1989 for 1 year.

Revised: September 10, 1990.

Source: Federal Reserve Board.

branching altogether. Furthermore, of the nine states permitting limited branching, the Office of the Comptroller of the Currency has ruled that national banks can branch statewide in three (Louisiana, Missouri, and Tennessee).

In addition to this much liberalized environment for statewide branching, all but four states (Hawaii, Kansas, Montana, and North Dakota) now provide for some degree of interstate banking via the acquisition of banks by bank holding companies headquartered in other states (Table 1). In fact, 33 states have passed laws to permit bank holding company entry from all other states: 12 of these states permit nationwide banking without reciprocity; the other 21 states have reciprocity requirements. The remaining 13 states and the District of Columbia provide for interstate banking based on regional reciprocity with other states.

The extent to which the states have provided for interstate banking is impressive given the amount of controversy that surrounded the first such reciprocal arrangements. Maine enacted the first interstate banking law in 1975, reportedly to attract capital from out-of-state. New York was the first major state to enact a nationwide reciprocal bill in 1982 at the urging of the money-center banks. And while Florida entertained the first regional reciprocal bill in 1979, it was in New England that the first regional reciprocal zone was established in 1982. When the New England laws were unsuccessfully challenged in the courts by the Federal Reserve, and declared legal by the Supreme Court in June 1985, the interstate banking movement accelerated in earnest (Frieder 1986). Thus the question is no longer whether banks should be allowed to expand interstate, but whether they should be allowed to do so by branching.

#### **D. Advantages of Interstate Branch Banking**

##### **1. Safety and Soundness**

From the point of view of the banking system, interstate branching would be beneficial in that it would enhance safety. In general, the historical record supports the assertion that branch banks have a better safety record than unit banks. In particular, during the 1920s and early 1930s the failure rate was inversely related to bank size (Cartinhour 1931; Chapman and Westerfield 1942). Further, during the period 1921-31, the failure rate as a percentage of banks operating at the end of 1931 was 46.5 percent for all banks but only 26.4 percent for banks with branches (Federal Reserve Board 1933a, 1933c). But the comparison understates the difference since the majority of branch banks that failed had only one branch. For banks with over ten branches, the failure rate was only 12.5 percent (Federal Reserve Board 1933a).

There are several related reasons for the better safety record of branch banks, reasons that apply a fortiori to interstate branching. First, by its very nature, a system of small unit banks is more prone to insolvencies if funds move out of a troubled unit bank serving an area than is a system of branch banks in which funds simply flow out of a troubled branch serving the same area (Greenspan 1990). That is, events that for a unit bank would lead to insolvency might simply lead to a loss for a branch serving the same area. Second, runs are more likely in a system of small banks, since small, localized shocks are more likely to be perceived as threatening entire institutions (Calomiris 1990).

The first two reasons for branch banking's greater safety imply the third: geographical diversification. By making it less costly for banks to expand across state lines, interstate branching would make it possible for them to diversify their loan portfolios to a greater extent than is now possible. Banks would consequently be less subject to swings in regional economies such as agricultural failures or declines in regional industries, so what could mean insolvency for a geographically restricted set of banks might mean only losses for one part of a geographically diversified bank.

A fourth reason for greater safety is that a branch bank in essence serves as a mutual loss sharing arrangement under which losses to one part of a bank's operation are diffused across the entire organization. Geographically limited losses that for a geographically limited bank might mean insolvency could be more easily absorbed by a larger, geographically dispersed organization. For example, the majority of bank failures in recent years occurred in the restricted branching states of the Southwest, notably Oklahoma and Texas. Both of these states entered the 1980s with unit banking. By 1990, Oklahoma changed to statewide branching by law; Texas changed to statewide branching by regulation. And both of these states now permit nationwide interstate banking.

Finally, interstate branching would make it less costly to gather core deposits, which by definition are a more stable funding source than purchased funds. Despite their stated maturity of zero, core deposits can have effective maturities of several years (Flannery and James 1984). So by making core deposits cheaper relative to purchased funds, interstate branching could help increase the duration of a bank's liability side so the bank would be less vulnerable to interest rate swings than if it relied heavily on purchased funds.

## 2. Consumer Benefits

From the point of view of the consumer, a major advantage of interstate branching over the current system would be

convenience. For example, suppose a bank holding company has subsidiary banks in Virginia and Washington, D.C. A customer with an account at the Virginia bank might be allowed to cash a check at an office of the Washington bank, but not to make a deposit. That is, full service banking across state lines simply does not yet exist. In contrast, if the subsidiaries were branches a customer could do at an out-of-state branch everything he or she could do at a branch in his or her own state.

In addition, an interstate branch network would be beneficial to travelers needing cash and banking services. While such innovations as travelers' checks, credit cards and automated teller machines have developed to lessen the inefficiency associated with the current banking system, the availability of banking services over a wider area would add to the traveler's options. Finally, by adding to the number of banks able to branch into a market, interstate branching might increase the accessibility of banking services. Just as statewide branching has made banking services more available to consumers than under unit banking, so should interstate branching compared with the current balkanized system (Evanoff 1988).

### 3. Efficiency

From the point of view of a bank interested in operating interstate, a major argument for allowing interstate branching is efficiency. Under the current system of allowing interstate expansion only through bank holding company subsidiaries, a bank must incur parallel costs in each state in which it chooses to operate. First, each subsidiary must have a separate board of directors as well as committees associated with each board. Second, each subsidiary must submit separate regulatory reports (for example, call reports) and undergo separate examinations. Third, each subsidiary must submit its own audited financial statement. Fourth, each subsidiary requires its own support and control functions, for example, personnel, budget, audit, and accounting, that for a branch network could be consolidated. Finally, each subsidiary will maintain its own computer systems and applications for such tasks as demand deposit accounting, loans, and reserves. Even if the bank holding company is managed as if it were one bank, the requirement that each subsidiary report separately prevents the systems from being integrated completely.

Duplication is not the only source of costs in a network of subsidiaries. Each subsidiary will have to satisfy capital requirements, so there are costs associated with the complex treasury exercise of balancing capital among the subsidiaries. Further, costs incurred by the parent company must be allocated among the subsidiaries, even though there may be no economically meaningful way of allocating such costs. Finally, since each subsidiary is a separately chartered bank, moving assets between

entities must take place on an "arm's length" basis, meaning that internal transfers must be treated as if the subs were not united by common ownership. As a result, internal transactions might have tax considerations and other costs that would not arise if the subsidiaries were consolidated.

Despite the costs of maintaining separate subsidiaries, a bank holding company choosing to consolidate will lose at least four benefits of separation. First, boards of directors can be a source of referrals for loans and other business for a bank in a local area, a source that would be lost if subsidiaries were converted to branches. Second, if a bank holding company purchases a bank that had served an area competently and profitably for years, the company might prefer to preserve the "brand name capital" of the acquired bank by letting it operate as a subsidiary under its old identity instead of under the name of the acquirer. Third, unlike their Canadian counterparts, United States bankers do not have experience in managing far-flung branch networks, so decentralized management might compensate for this lack. The problem should lessen over time, however, as bank holding companies develop experience in interstate operations and develop the ability to centrally manage more geographically dispersed branch networks.

Finally, a bank holding company might stay decentralized to preserve the benefit of tiered reserve requirements. When calculating the reserves a bank is required to maintain on its transactions accounts, the required ratio of reserve balances to deposits increases as follows: the first \$3.4 million of its transaction accounts is exempt from any requirements; the required ratio is 3 percent for \$3.5 million to \$40.4 million of transactions accounts; and the ratio is 12 percent for all remaining transactions accounts over \$40.5 million (Federal Reserve Bulletin, August 1990). Since the cost of reserves is the foregone interest on the funds, a bank holding company could hold down its required reserves by expanding by means of small subsidiaries rather than branches.

Thus there is a tradeoff between costs and benefits of maintaining separate subsidiaries. As a decentralized bank holding company grows and expands the number of subsidiaries, one would expect the costs of decentralization enumerated above to rise. At the same time, at least one benefit, the lower amount of interest foregone on reserves, becomes less significant to a banking organization as it grows larger. For example, the deposits subject to the lower requirements would be 4 percent of assets for a bank with assets of \$1 billion, but only 0.4 percent of assets for a bank with assets of \$10 billion. Thus, other things equal, one would expect consolidation to become more likely as an organization increases in size.

#### **4. Payment Processing**

One of the most obvious places for improvements in efficiency lie in the payment system area. For example, consolidating a set of holding companies into a branch network would increase the number of "on-us" checks, that is, checks for which the payer and payee both hold accounts in the same bank. If so, then more clearing could take place internally (Berger and Humphrey 1988). In addition, converting interstate subsidiaries will enable a bank to consolidate the reserve accounts of its subsidiaries into one account. Since banks use reserve accounts to clear payments, there would be lower administrative costs associated with payment processing. Indeed, even under the current system some bank holding companies have chosen to process all their Fedwire payments through one account regardless of which state subsidiary they involve. Such a practice would likely become automatic under interstate branching.

#### **5. Competition and Credit Availability**

From the point of view of both banks and consumers, a major result of interstate branching would be increased competition, especially if banks could branch de novo. Since allowing interstate branching would make it less costly to enter a state, banks would be more likely to enter to take advantage of profitable lending opportunities. This would have at least two effects. First, it would increase the number of competitors (or potential competitors) in a market. Second, it could make more and cheaper banking services available to a market.

With regard to availability of credit, opponents of interstate branching (and for that matter of branching in any form) repeatedly point to the possibility that branch managers are less concerned with the local economy than are owners and managers of the bank, so a branch would simply siphon funds out of an area to be lent elsewhere. But such possibilities already exist for banks as well as branches. For example, a bank not wishing to lend in an area could sell federal funds upstream to a correspondent bank, or could put its funds into investment securities rather than loans. Further, a branch that ignores profitable lending opportunities will be vulnerable to competition from local institutions. Finally, the argument that branches suck credit out of a region is a two-edged sword: The ability to draw credit out of an area implies the ability to inject credit into an area, so branches may be as likely to bring funds into an area as to take it out.

The empirical evidence tends to support the argument that branching advances competition without diverting credit from local economies. Banks in statewide branching states have a lower return on assets and offer a broader array of consumer and business services than banks in restricted branching states



(Evanoff and Fortier 1986). And loan-to-asset ratios for most size classes of banks tend to be higher with statewide branching than with restricted branching (Scheld and Baer 1986).

### **E. Models of Interstate Banking**

The United States has a "dual banking system," which means that banks may be chartered either federally or by the states. When developing a plan for interstate branching, one must be cognizant of the interaction of state and federal laws regarding banking structure. The following paragraphs describe three possible means of implementing interstate branching.

#### **1. National Bank Branching**

Interstate branching could be instituted by simply allowing federally-chartered banks to establish branches without regard to the laws of the states in which the branches would be located. That is, the national bank system would become a national banking system in the sense of a nationwide system and not simply a federally-chartered one. Such a system could be put into place by repealing the McFadden Act and changing the language of current law to grant a national bank the authority to establish branching freely without regard to state laws. The main requirement would be specific Congressional authorization.

The advantage of using the national bank system to bring about interstate branching is that it would be relatively simple. That is, it could be accomplished through federal legislation and would not require consent at the individual state level. Further, the approach would not involve overlapping or conflicting regulatory agencies, since all national banks are supervised by the Office of the Comptroller of the Currency. Such a system is already in place in Canada, where bank chartering and regulation have been federal functions since the British North America Act of 1967.

One result of the national bank approach to interstate branching might be to put state-chartered banks at a disadvantage to national banks with respect to those states that do not grant interstate branching privileges to state-chartered banks. Within the Federal Reserve System, there would be an additional problem: All national banks are members of the Federal Reserve System, but state-chartered banks may elect to join or not to join the System. In a system of unlimited interstate branching by national banks, there would be a disparity between the powers of national banks and state member banks. Of course, there would be a simple solution: states could grant interstate branching powers to the banks they charter.

## 2. Host-State Regulation

The first alternative concerns itself only with national banks, and in effect overrides any state powers over national bank expansion. An alternative that preserves the authority of the states would be to permit state-chartered banks to branch interstate provided they abide by the regulations of the state into which the bank wishes to expand. Such an alternative would most likely retain state authority over bank structure by allowing national banks to enter a state only if the state consents.

Utah has in effect agreed to a scheme of host-state regulation when, as previously mentioned, it permitted a state-chartered bank in Arizona to maintain a Utah office as a branch. The Arizona bank had previously been a thrift, which was taken over by the Resolution Trust Corporation, then purchased by BankAmerica Corp., and then converted to a state-chartered commercial bank (American Banker, July 12, 1990). Consistent with thrifts' more liberal interstate branching powers, the thrift had operated a branch in Utah. When BankAmerica converted the thrift to a bank, however, it had to seek permission from Utah to continue to operate the office as a branch instead of convert it to a subsidiary. Utah assented, and under the agreement Utah will be responsible for examining the branch (American Banker, September 4, 1990).

Leggett (1989) has put forward a more comprehensive proposal involving host-state regulation of interstate branching. The proposal would allow bank holding companies with interstate subsidiaries to consolidate their banks as branches. It belongs in the host-state taxonomy because a branch of a state-chartered bank could not exercise any powers in the host state that were not granted to banks chartered in that state, although the proposal also provides that the out-of-state branch could not exercise any powers not granted by its home state. While the state bank's own regulators would examine the entire bank, they would be required to apply the host state's laws and standards for out-of-state branching applications. In order to ensure that such laws and standards are followed, the host-state regulator would have the authority to approve or disapprove applications for entry.

There has been legislation recently introduced in Congress that follows the host-state regulation principle (H.R. 5384 and S. 2922). The bills would (1) repeal the Douglas Amendment to the Bank Holding Company Act; (2) amend the Federal Deposit Insurance Act to specifically authorize out-of-state branches unless a state specifically forbids it; and (3) amend McFadden to allow establishment by national banks of out-of-state branches unless a state specifically forbids it. The activities allowed the branch would be governed by host state law.

Since states would have the opportunity to pass laws that block interstate branching, it is not clear how far such a bill would go toward facilitating nationwide branch systems. Still, two points are significant. First, by repealing the Douglas Amendment the bill would permit nationwide interstate banking by the holding company acquisition route, as well as eliminate all geographic restrictions on interstate entry. That alone is the most extensive nationwide banking initiative to arise at the federal level to date. Second, states would only be able to opt out of permitting interstate branching. And since states would be required to specifically pass laws that forbid interstate branching rather than laws that permit it, branching would be allowed if a state simply did nothing.

### 3. Home-State Regulation

A third alternative for interstate branch banking is based on an analogy with the European Community's Second Banking Directive, to take effect at the end of 1992 (Golembe 1989, 1990). The effect of the Directive will be to create a "single banking license" for a depository institution in any European Community nation to provide banking services. The license is based on two concepts. The first is mutual recognition by each member country that every other country's laws and regulations are equal to its own and that no country will use its laws and regulations to restrict access to its market. The second is home country control, so even if laws and regulations differ between countries, those of the home country will govern the operations of a branch in another country (Key 1989). In certain areas such as consumer protection, however, host state regulators retain authority.

As applied to the United States, the European Community approach would involve authorizing a bank chartered in one state to branch into any other state. Whatever the host state's laws, the branch would be governed by the laws of the state in which the parent bank is located. Thus, within such a framework, a bank located in a state with statewide branching would be able to expand into a limited branching state but still branch throughout the state regardless of what the local banks can do. And to take the analogy further, if a bank located in a state that permits banks to sell life insurance branches into a state that does not, the branch would be able to exercise the more liberal insurance powers even within the restrictive state's boundaries.

There are advantages to both the host-state and home-state regulation alternatives. Given the dual banking tradition of the United States, host-state regulation is likely to be more consistent with current practice. That is, by deferring to host states it is less likely that states would oppose entry from another state than if control over the branch were to lie entirely in the home state. Further, even if host-state

regulation were the norm, there is no reason why host states could not agree to defer in specific cases to home state regulators. In such an environment, host states would have the option rather than the obligation to accept another state's laws and regulations.

Home-state regulation would probably lead the laws and regulations of the various states to become more similar and consistent. Since banks in a restrictive state would be at a disadvantage relative to branches of banks from liberal states, there would arise pressure in the more restrictive states to loosen the rules. In the European Community, such a tendency toward "regulatory convergence" is fully expected to occur and is consistent with the goal of "harmonization" of rules, regulations, and standards between member countries (Key 1989).

## **F. Effects on Bank Structure**

As of June 1990, there were 12,500 insured banks operating in the United States. Because of mergers, consolidations, and failures, this number is widely expected to fall even if the current laws on branching remain in effect. Interstate branching may cause the number to fall still more. What is not clear is how much interstate branching would contribute to the fall in the number of banks.

### **1. Bank Holding Companies**

The obvious candidates for consolidation are, of course, the bank subsidiaries of interstate bank holding companies. At the time of this writing there are 160 interstate bank holding companies operating at least 465 bank subsidiaries in different states. If the law is changed to allow interstate subsidiaries to be consolidated into branches, and assuming all interstate bank holding companies decide to consolidate, then the number of separately chartered banks in the United States could fall by at least 305. And assuming that regional restrictions on interstate banking are removed, the number could fall even more by means of end-to-end mergers between banks that had been restricted to separate regional compacts such as the Southeast and New England.

### **2. Small Banks**

At the other end of the spectrum, in June 1990 there were 11,724 small banks, that is, banks with \$500 million of assets or less. The effect of interstate branching on small banks would largely depend on the laws of the various states. In states with restrictive branching laws, it is reasonable to assume that some banks have remained in business because of the laws and would be absorbed by another organization if the laws were liberalized. So if interstate branching were enacted in such a way as to

either override state branching laws or to induce states to liberalize their branching restrictions, then the number of small banks would probably fall.

But in states with liberal branching laws, there might be little if any effect on the number of small banks. For example, both North and South Carolina have statewide branching laws of long standing. In North Carolina 68 out of a total of 78 banks have assets of less than \$500 million; in South Carolina 78 out of a total of 84 banks have assets of less than \$500 million. The survival of small banks under statewide branching suggests that the vast majority would remain in business even if interstate branching were permitted. To the extent that reductions in the number of small banks occur in states already permitting statewide branching, they are likely to be the result of acquisitions of banks in markets previously divided by state lines.

### 3. Analogies with Canada and California

Another way to consider the probable effect of interstate branching is to take the number of banks per capita for countries with no limitations on branching and project the same ratio on the United States. Canada, for example, has eight major banks, of which six operate nationwide, serving its population of 26.3 million. If the United States had the same ratio of banks to population, it would have about 75 banks, of which about 56 would operate nationwide.

At first blush, 75 banks (much less 56) seems small compared with the current 12,500. But 56 banks competing with each other in markets across the United States does not seem small, especially when one realizes that the vast majority of U.S. banks currently operate only in relatively small geographic areas. Only if the 56 banks operated in separate, balkanized markets, each having a very small number of banks, would there be cause for concern. More important, even if most of the current banks were to cease to exist as separate firms, they would not simply vanish into thin air. Most would likely be converted into branches of one of the nationwide banks. Consequently, while there would be fewer banks in each market there would not necessarily be fewer banking facilities.

But Canada might not provide a relevant comparison. First, Canadian banking policy differs from the United States in that it has been and remains a strictly federal function despite the provinces' high degree of autonomy in other areas (such as securities regulation). Unlike the United States, there was no conflict between the provinces and the federal government over banking structure. Second, while banking policy in the United States has at times encouraged the spread of small, local banks, Canadian policy seems to have favored larger banks.

Specifically, while in the United States in 1900 a national bank could be chartered with as little as \$25,000 in capital, in Canada the Bank Act of 1871 required a minimum of \$500,000 in capital (Breckenridge 1910).

Finally, a structural outcome similar to the Canadian system is unlikely because small banks in the United States may have advantages over entrants into their markets simply by virtue of being there first. If a larger bank wishes to enter, it has to incur costs to buy its way in either de novo or by acquiring the incumbent. If the incumbent is earning above-normal returns, the costs of entry might be worth incurring. But if the incumbent is simply earning a normal return, the entrant would have to have an advantage over the incumbent in order to make the costs of entry worth incurring. The advantage could occur on the supply side in the form of more efficient operations, or on the demand side in the form of enhanced services and credit availability that would make consumers willing to pay more. The point is that the eventual structure of U.S. banking will depend to a large extent on the structure that is in place now and will not inevitably converge to that of Canada.

A more realistic comparison might be with California, which has explicitly allowed branching since 1909. California has 431 banks serving its 29.1 million population. The California banks per capita ratio applied to the entire United States implies about 3,700 banks. Still, such projections are precarious because they do not take into account many factors, including differences in state composition and demographics, as well as advantages of incumbent banks in markets. Thus, it is not possible to form any firm conclusions.

If interstate branching were permitted, and if such branching were to occur to a significant extent via acquisition, what would be the implication for consumer welfare? The banking industry would continue to be subject to oversight by both the regulatory agencies and the U.S. Department of Justice, and both could be expected to apply existing competitive standards, including the federal antitrust laws, to ensure that anticompetitive mergers that threaten to harm consumers would not be permitted to occur.

### G. Concluding Comments

The liberalization of geographical restraints on banking and other depository institutions has been a prominent feature of banking in the United States since the failures of the late 1920s and early 1930s. The liberalization has picked up momentum during the 1980s, during which barriers fell to both statewide branching and interstate bank holding company expansion. Given

all that has happened, it would seem logical for the next step to be to relax restrictions on branching across state lines.

Despite the arguments in favor of interstate branching, it is not likely that permitting it would immediately revolutionize the banking structure of the United States. Assuming all interstate bank holding companies were to consolidate, the number of large banks, most of which do not compete directly with each other, would fall. But while interstate branching could lead to some interstate expansion that had not occurred before, it would not likely have much effect on the number of small banks, at least those that have survived the competition in states with liberal branching laws. And given that some bank holding companies have chosen to retain a decentralized structure within their states, it is possible that some interstate organizations could remain decentralized as well.

Still, a long-term benefit of permitting interstate branching is that it could pave the way for the development of a truly nationwide banking system with geographically diversified lending and funding sources. Since interstate branching would enable interstate organizations to operate at lower cost than under the current system, it could facilitate the development of expertise in interstate operations. While nationwide organizations might not develop immediately because of capital constraints and limited knowledge of markets outside of banks' local areas, the ability to expand in a sound manner will increase as bankers become accustomed to operating branch networks over wider areas. In the end, the result could be a mixture of large banks with nationwide branch networks and markets and smaller banks specializing in local markets. In addition, interstate branching should promote competition generally, and the regulatory and antitrust authorities can protect against any mergers that could have anticompetitive effects in particular markets.

## Endnotes

<sup>1</sup> This chapter draws heavily on David L. Mengle, "The Case for Interstate Branch Banking," Economic Review, Federal Reserve Bank of Richmond, November/December, 1990. The views in that article are solely those of the author and do not necessarily reflect the views of the Federal Reserve Bank of Richmond or the Board of Governors of the Federal Reserve System.

<sup>2</sup> The Federal Reserve has recently gone on record as supporting changing current law to allow interstate branching (Greenspan 1990).

<sup>3</sup> Massachusetts allowed entry through branching in its 1982 regional interstate banking law. In September 1990, the regional law was superseded by a nationwide interstate banking law. The new law does not permit entry through branching.

<sup>4</sup> One could also argue that McFadden was intended to give national banks branching parity with state banks. If so, federal regulators might have the discretion to allow national banks to branch across state lines along with their state-chartered brethren (Eckland, Olsen, and Kurucz 1990).

<sup>5</sup> The Douglas Amendment does not apply to emergency interstate acquisitions of a bank or holding company by an out-of-state bank holding company. 12 U.S.C. 1823(f)(4)(A). In addition, the acquisition and operation by a bank holding company of a healthy or failing thrift subsidiary is a permissible nonbanking activity after passage of FIRREA. Also, the Federal Reserve Board adopted a final rule on October 10, 1989, which provides that the Bank Holding Company Act does not prevent bank holding companies from acquiring thrifts on an interstate basis, notwithstanding whether the bank holding company can operate a bank in that state.

<sup>6</sup> In comparison, in 1990 the minimum initial capital for national banks was \$50,000 in a town of less than 6,000 inhabitants, \$100,000 for a town of up to 50,000, and \$200,000 for a city of over 50,000 (12 U.S.C. Section 51). In practice all regulatory agencies have administratively adopted higher minimums.



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## **Chapter XVIII**

### **FINANCIAL SERVICES MODERNIZATION**

#### **A. Introduction**

This chapter examines the development of the financial services industry in the United States, focusing on its most heavily regulated component, commercial banking. It is organized as follows: Section B discusses the traditional banking franchise; Section C discusses the erosion of this franchise resulting from ongoing changes in the marketplace; Section D discusses how banks and other financial intermediaries have responded to the changing market environment by capturing the cost and marketing efficiencies, or "synergies," of expanding into a broader range of related financial activities; Section E examines developments in the international financial markets, showing the relative decline in position of U.S. institutions internationally; and finally, Section F concludes with some observations on the need for financial restructuring in the United States and some guidelines as to how to accomplish that restructuring.

#### **B. The Traditional Banking Franchise**

To a large extent the development of financial services in the United States revolves around the evolution and regulation of the commercial banking system. Therefore, this section reviews the original structure of the banking system, the major statutory and regulatory boundaries established for the system, and how the passage of time and competitive developments have changed the realities of today's banking system.

##### **1. Banking Prior to the Civil War**

At the time of the Revolutionary War certain rudimentary commercial banking services were provided by merchants and others, although no well-organized commercial banking system existed. It was not until the chartering of the Bank of North America in 1782 in Philadelphia that the first "modern" American commercial bank was founded. And it was not until after 1800 that the states began to charter large numbers of banks, and a true commercial banking system developed.

In the earliest days of the republic, the states typically chartered commercial banks. In lieu of paper currency provided by the federal government, state banks had developed a vigorous business in making loans in the form of promissory notes to be paid to the holder in specie on demand. These bank notes constituted the domestically-issued paper money supply.<sup>1</sup>

In 1791, the First Bank of the United States, the first federally chartered bank operating on a national scale, was established. This bank was partially owned by the federal government, and it performed some of the functions of a central bank, such as handling federal government deposits and enforcing the convertibility of state bank notes. In addition, the First Bank competed directly with state banks for business, and it operated branch facilities throughout the country. The charter of the First Bank of the United States was not renewed in 1811, and it was not until 1816 that its successor, the Second Bank of the United States, was chartered for a twenty-year period. This charter also was allowed to expire in 1836 due to opposition by state banks and other political difficulties.<sup>2</sup>

## **2. Early Federal Intervention**

For nearly three decades the commercial banking system was system made up exclusively of state chartered banks--the so-called "era of state banking." A major by-product of this period was the widespread adoption of "free banking," where banking charters were issued to applicants who met certain minimum standards, rather than through specific legislative action which was frequently open to favoritism and abuse. Nevertheless, it has been said that:

Despite these advances, the banking system, plagued with mismanagement, corruption, and just plain bad banking, sank to new depths. Banks with insufficient capital, overly speculative loans, and inadequate management were commonplace. Bank notes, promising to pay specie on demand, were often all but impossible to redeem as unscrupulous operators located "redemption centers" deep in the wilderness.<sup>3</sup>

### **The National Bank Act**

The cumulative deterioration of commercial banking under the states, a generally chaotic paper currency supply, lack of federal controls, and the growing needs of financing Civil War debt ultimately led to the passage of the National Bank Act of 1863 (modified in 1864) and the establishment of a system of federally-chartered private banks. The Office of the Comptroller of the Currency was created and placed in the Treasury Department to charter and supervise the new national banking system. The mix of state and national banks that resulted following this

legislation constitutes what has come to be known as the "dual banking system," and this system remains intact today.<sup>4</sup>

The national banking system had the advantage of being more strictly regulated than were state banks in terms of capital requirements, restrictions on the riskiness of loans, and reserves on deposits, among other things. In addition, while the issuance of state bank notes was effectively eliminated through the imposition of a ten percent tax (after which state banks successfully turned to demand deposit based banking), national banks were given authority to issue their own "national bank notes" which had to be backed by eligible government securities of at least equal value. This latter provision, however, created serious strains in the monetary system since the volume of national bank notes outstanding was effectively limited by the volume of government securities outstanding, and the latter was not sensitive to the "needs of trade."

The inability of the commercial banking system to adjust the nation's money supply to meet the demands of the economy became most apparent in the late 1800s and early 1900s. The chronic shortfall of money growth relative to growth in output in these years led to periodic cycles of deflation, accompanied by the banking panics of 1873, 1884, 1890, and 1893. But the worst of these banking panics occurred in 1907, in the face of inflationary, rather than deflationary fears. In the last two panics, especially, the typical response of commercial banks to the rush of account holders wishing to convert their deposits into cash was simply to suspend convertibility.<sup>5</sup>

### **The Federal Reserve Act**

The problem of the post-Civil War commercial banking system was more one of illiquidity than one of insolvency. At any given time there was only a fixed amount of reserves in the banking system. If a single bank encountered difficulties it was possible to borrow reserves from other banks to meet demands for deposit withdrawals. But if there was a system-wide run on deposits, no amount of shifting of reserves between banks could compensate for insufficient aggregate reserves. In response, Congress passed the Federal Reserve Act of 1913 which established the Federal Reserve System. The Federal Reserve was created primarily to stop banking panics attributable to the inability of banks to convert demand deposits into cash. For example, the Act specifically directs the Federal Reserve to provide "an elastic currency" and to be a "lender of last resort," as well as to facilitate the exchange at par of bank obligations.<sup>6</sup> The current monetary policy responsibilities of the Federal Reserve were not envisaged in 1913, as the only monetary policy tool provided at that time was the "liquidity tool" of discount loans to member banks.<sup>7</sup> It was not until the Banking Acts of 1933 and 1935 that the Federal Reserve received authority to engage in

open market operations and change reserve requirements for monetary policy purposes.<sup>8</sup>

National banks were required to be members of the Federal Reserve System. State banks could choose to be members of the Federal Reserve System, in which case the Federal Reserve became their primary federal regulator.

### **Expanding Federal Regulation**

**The McFadden Act.** One of the earliest controversies involving the banking system concerned the geographic reach of banking operations. Many states, especially those in agricultural areas, were fearful of "monopoly banks" and because of this enacted strict limits on bank branching within their borders. Other states granted their state banks liberal branching authority, a privilege not granted equally to national banks due to restrictive interpretation of the National Banking Act. In response, Congress adopted the McFadden Act in 1927 (12 U.S.C. 36) which, after amendment in 1933, effectively placed control of branching in the hands of the states. The Act authorized a national bank to branch only within its home state and then only as permitted for state banks by state law. The branching authority of state member banks was tied to national banks (under 12 U.S.C. 321), and so was similarly restricted. State non-member banks are not restricted from interstate branching by McFadden. However, while a given state may authorize its banks to branch on an interstate basis, that authorization is of little practical significance unless other states specifically open their borders to the branches of out-of-state banks. The net effect of these provisions was to place the states in control of geographic diversification through branching.<sup>9</sup>

**The Federal Deposit Insurance Corporation.** In response to widespread bank failures in the Depression years following the 1929 stock market crash, Congress also established a federal deposit insurance program in the Banking Act of 1933, and the Federal Deposit Insurance Corporation (FDIC) became the primary federal regulator of state-chartered non-member insured banks. (The purpose and structure of federal deposit insurance was examined in detail in earlier chapters of this study.)

**Interest Rate Controls.** Commercial banks did not typically pay interest on deposits until the 1920s. But there was sufficient concern over the developing trend towards interest payments to lead the Comptroller of the Currency, in 1915, to suggest a limit of four percent interest on deposits for national banks, to be imposed for safety and soundness reasons.<sup>10</sup> The Comptroller's suggestion was not implemented, but a number of states proceeded on their own to impose rate ceilings on deposits in the 1920s because of continuing concerns that "excessive"

payments were undermining bank soundness. Ultimately, it was the large number of bank failures in the 1920s and 1930s that led to federal imposition of deposit interest rate controls. The Banking Act of 1933 prohibited the payment of interest on demand deposits and gave the Federal Reserve Board the power to impose ceiling rates on time and savings deposits of member banks. In 1935, similar power was given to the FDIC with respect to state non-member banks.<sup>11</sup>

**Housing Finance.** Throughout the late 1920s and early 1930s, the housing finance sector also suffered severely from widespread mortgage defaults. By the mid-1930s, Congress had responded by establishing (1) a federal home mortgage guarantee program, (2) a system of federally sponsored banks to advance credit to thrift institutions, (3) a federal thrift chartering agency, and (4) a federal deposit insurance fund for thrifts.<sup>12</sup> Furthermore, restrictions on thrift asset powers and federal tax incentives for housing finance effectively limited thrift institutions to the provision of mortgage credit. As a result of these legislative provisions the markets of commercial banks and thrift institutions were segmented and remained so for an extended period of time. (Some years later, an analogous infrastructure for a system of specialized personal finance institutions, known as credit unions, would also be established, complete with a federal regulatory agency, a federal insurance program, and tax preferences.)

### 3. The Glass-Steagall Act

Commercial banks emerged in the late 1800s and early 1900s as significant participants in the underwriting and distribution of securities, led by such institutions as the First National City Bank of New York and the First National Bank of Chicago, among others.<sup>13</sup> According to one report, by the early 1920s "there were 10 securities affiliates of national banks, while 62 other national banks were distributing securities through bond departments. At the same time, eight state banks had affiliates, and 197 other state banks were involved in the securities business through bond departments."<sup>14</sup>

The securities activities of banks were truncated by the financial stresses of the late 1920s and the ensuing legislation. Because the stock market crash appeared to precipitate the Great Depression, because banks at that time had a large role in the stock markets, and because of widespread bank failures, Congress began a series of investigations into market abuses and ways to reform the banking system, including the famous Pecora hearings.<sup>15</sup>

As a consequence, with respect to the securities markets, Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934, both of which were specifically designed to

end the issuing and trading abuses and manipulation that had made the market unfair. This response has proved to be especially beneficial.

The other response was to legislate the separation of the commercial banking and investment banking industries. This was a response to several specific concerns. First, Congress felt that commercial banks involved in securities activities tended to channel bank funds into "speculative" investments to the detriment of overall economic growth and stability. Second, Congress concluded that the separation of commercial and investment banking was necessary to restore public confidence in the banking system, where failures had become increasingly widespread. Finally, numerous concerns were raised in the course of Congressional investigations regarding questionable activities engaged in by banks and their securities affiliates, including:

- . failure to adequately disclose information regarding investments made by banks' securities affiliates;
- . loans extended by banks to third parties to finance the purchase of securities from banks' securities affiliates;
- . direct loans by banks to their securities affiliates;
- . securities affiliates' purchases of stock in companies that were the beneficiaries of loans from the parent banks;
- . banks' purchases of stock from their securities affiliates for their own accounts or for their fiduciary accounts; and
- . the use by securities affiliates of the names and personnel of their parent banks.<sup>16</sup>

Rather than attempt to restrict or even prohibit these specific practices, however, Congress took the extreme step of separating commercial banking from investment banking altogether in the Banking Act of 1933 (the Glass-Steagall Act). Four sections of the Banking Act of 1933 specifically addressed the divorce of banking and securities activities and constitute what is known today as the Glass-Steagall Act.<sup>17</sup>

Section 16 of the Glass-Steagall Act prohibits national banks from directly dealing in, underwriting or purchasing securities (except for certain government obligations). Section 5(c) of the Glass-Steagall Act makes the limitations and prohibitions of Section 16 applicable to state-chartered banks that are Federal Reserve System members. Section 21 is a similar provision that applies to all banks and depository institutions as well as securities firms--it prohibits any individual or entity engaged in the business of issuing, underwriting, selling or distributing securities from engaging in the business of



receiving deposits. Taken together, these two provisions prevent any depository from directly engaging in most securities activities.

Sections 20 and 32 address indirect securities activities through bank subsidiaries or affiliates. Section 20 prohibits member banks from affiliating with any organization "engaged principally" in the issue, flotation, underwriting, public sale, or distribution of securities. Section 32 prohibits director, officer and employee interlocks between member banks and firms "primarily engaged" in securities activities. However, these restrictions on indirect securities activities do not apply to affiliates of state-chartered non-member banks.<sup>18</sup> Sections 20 and 32 also restrict the activities of securities firms that are affiliated with banks in a bank holding company structure. These restrictions are discussed below.

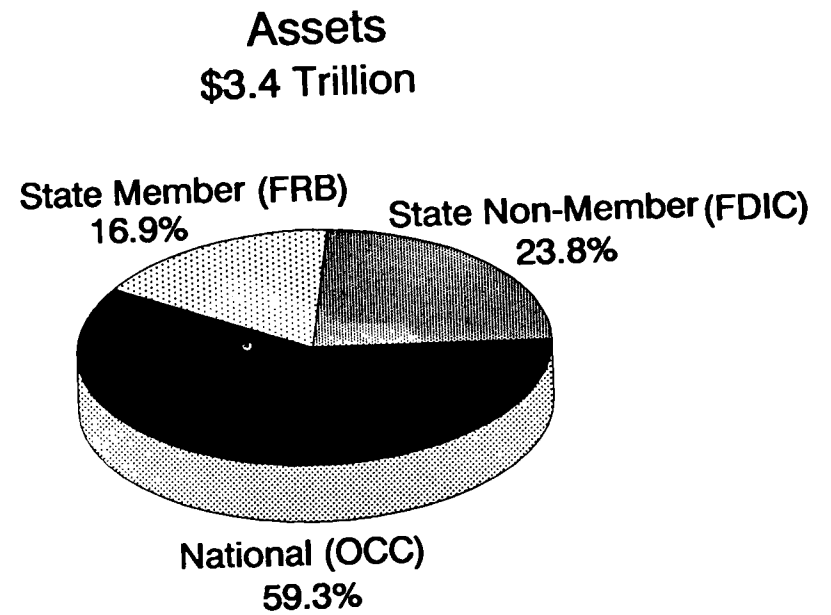
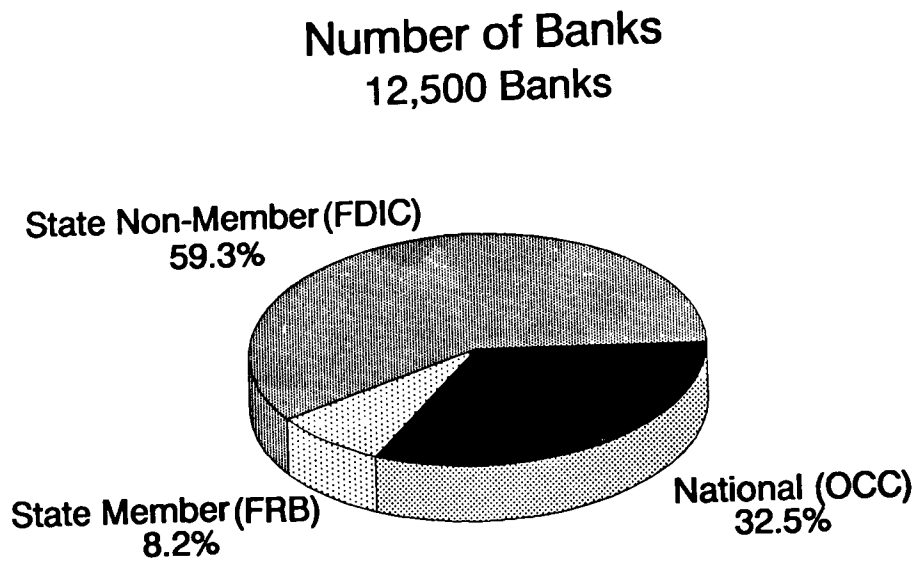
To a large extent the Glass-Steagall Act reflected the traditional doctrine of what was the appropriate role for commercial banking. This doctrine held that the quality and quantity of bank credit could be controlled if banks restricted their activities largely to short-term loans for business purposes, such as financing inventories (thus assuring that bank credit would only expand and contract in accordance with the needs of trade).<sup>19</sup> As a practical matter, this meant that commercial banks in the United States were largely restricted to accepting the deposits of the public to be used to fund short-term self-liquidating commercial loans. Over time, the "traditional" services of commercial banks evolved to include time and savings deposits, transaction accounts, commercial loans, consumer loans, mortgage loans, and trust administration.

The Banking Act of 1933 together with other legislation of the Depression years effectively set the basic framework under which commercial banks operated for nearly a half-century. Geographic restrictions on branching were established; commercial banking and investment banking were separated; deposit interest rate ceilings were implemented; the federal deposit insurance system was created; a comprehensive program to support thrift institutions was put in place; and an elaborate structure of federal agencies was given responsibility for supervising insured institutions. As of mid-year 1990, the insured commercial banks totaled 12,500 in number and held \$3.4 trillion in assets (Figure 1).

#### 4. The Bank Holding Company Act

Two major issues that were not clearly addressed in the 1930s legislation concerned the relationship of banks with commercial entities and the ability of banks to operate on an interstate basis through holding company arrangements. The particular charters of state and national banks did not permit

Figure 1  
Insured Commercial Banks by Charter Type  
1990\*



\*As of June 30, 1990.

Source: Federal Deposit Insurance Corporation.

them to engage in commercial activities. And while the Glass-Steagall Act proscribed the securities activities of banks and bank affiliates, it did not address the general ability of banks to affiliate with non-securities companies under state law. Finally, the McFadden Act only addressed the question of branching by national banks. It did not apply to interstate banking via bank holding companies.

Although bank holding companies (BHCs) were not at the center of attention in the late 1920s and early 1930s, there was growing concern over the failure of some holding company groups and the risks associated with activities of holding companies generally.<sup>20</sup> The Banking Act of 1933 included provisions requiring holding companies with member bank subsidiaries to register with the Federal Reserve. Registered holding companies were required to satisfy certain requirements regarding examination of affiliates, disclosure of financial information, and treatment of reserves and dividends.<sup>21</sup>

Issues concerning bank holding companies continued to arise during the next two decades, when a number of commercial firms acquired banks through the holding company structure. The most famous example was the TransAmerica Corporation, which combined manufacturing, ocean shipping, fishing companies, and taxi companies with the largest insurance company on the West Coast and the largest banks in each of several western states.

Such combinations created three distinct concerns: First, critics argued that credit allocation would become biased, with banks favoring their commercial affiliates and discriminating against competitors of these affiliates. Second, concerns were raised about the potential concentration of financial power. Finally, the more recent criticism is that commercial firms would unfairly "tie" the sale of their products to the use of their "captive banks" for all seller financing needs. All of these concerns raised the pressure for legislation with as many as fifteen bank holding company bills introduced between 1949 and 1955.<sup>22</sup>

Congress responded with the Bank Holding Company Act of 1956 (BHCA) and its subsequent amendments over the years. The Act prohibited bank holding companies from engaging in unrelated "nonbanking" activities by prohibiting them from owning shares in most nonbank corporations and by requiring the divestiture of any such shares already held. Bank holding companies were permitted to engage in financial activities "closely related to banking," but this was interpreted narrowly for many years. The Douglas amendment to the Act prohibited bank holding companies from acquiring a bank in another state unless expressly permitted to do so by the laws of that state.<sup>23</sup>

The addition of the BHCA to the legislation of the 1930s created a financial system consisting of segmented markets, occupied by specialized financial intermediaries. Commercial banks accepted deposits and extended loans to businesses and consumers; (2) thrift institutions were repositories for household savings and providers of long-term mortgage finance for residential housing; (3) credit unions received the funds of "affinity" groups and extended consumer loans to "affinity" groups; (4) securities firms accessed the "at risk" funds of long-term investors to meet the capital needs of commercial and industrial firms; and (5) the insurance industry collected premiums to underwrite business and individual risks, allocating the funds received to the capital markets.

### C. The Erosion of the Traditional Franchise

Within the traditional framework, commercial banks and other depository institutions generally prospered well into the 1970s. Their markets, although restricted, were reasonably well defined and protected from both product and geographic competition; their funding costs were controlled and profitability enhanced because of deposit interest rate ceilings and ready access to the funds of savers; and the federal safety net provided by deposit insurance and other mechanisms added greatly to the value of the banking franchise.

But the environment for commercial banks has changed noticeably in the last two decades in the face of high inflation, volatile interest rates, technological innovations, the advent of vigorous new competition from insured and noninsured financial intermediaries, and the ad hoc reform initiatives of the states and regulatory agencies.

#### 1. Balance Sheet Considerations

##### Liabilities

The traditional banking franchise eroded on both sides of the balance sheet. On the liability side, commercial banks (and other depositories) suffered increasingly severe bouts of disintermediation in the late 1960s and 1970s as customers transferred their savings from the rate-controlled deposits in these institutions to alternative market-sensitive instruments. Money market mutual funds (MMFs) became the most notable substitute for insured deposits. The first MMF, the Reserve Fund, was organized in 1972. MMFs were highly attractive to individual and institutional investors because of their safety, market rates of return, and low minimum denominations. MMFs grew slowly and steadily in number and assets held until the late 1970s, going from 15 funds with \$1.7 billion in assets in 1974 to 50 funds and \$7.4 billion in assets by 1977. Over the course of

the late 1970s and early 1980s, however, the growth of MMFs exploded. The most important factor in MMF growth was the surge in market rates of interest at a time when rates at insured depository institutions remained controlled. Other factors included the introduction of transaction features and other conveniences, and generally more sophisticated consumers. Between 1977 and 1990, the number of MMFs increased more than ten times, from 50 to 509; assets increased more than 55 times, from \$7.4 billion to \$414 billion.<sup>24</sup>

Also, in an effort to compete more forcefully for deposit funds, savings banks were successful in the 1970s in gaining authority to offer third-party-payment services through interest-bearing negotiable order of withdrawal accounts (NOWs), a privilege which rapidly spread throughout the thrift and credit union industries. This particular trend started in 1972 in Massachusetts where some mutual savings banks exploited a legal loophole to market NOW accounts. Until 1972, it was considered illegal for thrift institutions to offer checking account services to the public, but once breached, this barrier quickly collapsed. Credit unions started to offer share drafts in 1974. Congress enacted legislation authorizing all depository institutions in the New England states to offer NOW accounts in 1976. The Federal Reserve authorized an automatic transfer from savings (ATS) account for member banks in 1978. And in the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), Congress permitted all thrift institutions and banks nationwide to offer interest-bearing transaction accounts to their non-corporate customers.<sup>25</sup> In brief, the transaction account services that had entered the 1970s as a monopoly product of commercial banks entered the 1980s as a commonplace offering of the banks' major competitors.

Securities firms, too, began to compete much more effectively for the funds of savers by combining the sale of bank certificates of deposit with a wide range of other asset allocation services--typically in "cash management accounts" (CMAs)--that were offered to customers via large networks of brokerage offices. Brokered certificates of deposit at FDIC-insured banks are estimated by Merrill Lynch to total \$78.4 billion as of June 1990, of which \$38.8 billion are fully insured (Table 1).

The dismantling of deposit interest rate controls in the 1980s, again provided for in DIDMCA, largely completed the basic restructuring of bank liability portfolios. The removal of interest rate controls on time and savings accounts, and the introduction of interest-bearing transaction accounts, eliminated one part of the long-standing cost of funds subsidy enjoyed by traditional banks.

Table 1

## Brokered Deposits in Financial Institutions

(In millions of dollars)

	Pre-FIRREA: June 1989	Post-FIRREA: June 1990	Change	Percent cha
<b>Thrifts (FSLIC/SAIF-Insured):</b>				
Total Number of Institutions.....	2,954	2,717	(237)	(8.0)
Total Assets.....	\$1,385,348	\$1,203,166	(\$182,182)	(13.2)
Total Deposits.....	\$992,946	\$910,387	(\$82,559)	(8.3)
Total Brokered Deposits.....	\$81,096	\$46,296	(\$34,800)	(42.8)
Total Fully Insured Brokered Deposits.....	\$70,447	\$42,083	(\$28,364)	(40.2)
Total Deposits as a Percent of Total Assets.....	71.67	75.67	4.00	5.6
Fully Insured Brokered as a Percent of Total Assets.....	5.09	3.50	(1.59)	(31.2)
Fully Insured Brokered as a Percent of Total Deposits.....	7.09	4.62	(2.47)	(34.8)
<b>Banks (FDIC/BIF-Insured):</b>				
Total Number of Institutions.....	13,416	12,964	(452)	(3.4)
Total Assets.....	\$3,445,871	\$3,593,409	\$147,538	4.3
Total Deposits.....	\$2,631,054	\$2,777,707	\$146,653	5.6
Total Brokered Deposits.....	\$70,235	\$78,380	\$8,145	11.6
Total Fully Insured Brokered Deposits.....	\$31,957	\$38,804	\$6,847	21.4
Total Deposits as a Percent of Total Assets.....	76.35	77.30	0.95	1.2
Fully Insured Brokered as a Percent of Total Assets.....	0.93	1.08	0.15	16.1
Fully Insured Brokered as a Percent of Total Deposits.....	1.21	1.40	0.19	15.7
<b>Total:</b>				
Total Number of Institutions.....	16,370	15,681	(689)	(4.2)
Total Assets.....	\$4,831,219	\$4,796,575	(\$34,644)	(0.7)
Total Deposits.....	\$3,624,000	\$3,688,094	\$64,094	1.8
Total Brokered Deposits.....	\$151,331	\$124,676	(\$26,655)	(17.6)
Total Fully Insured Brokered Deposits.....	\$102,404	\$80,887	(\$21,517)	(21.0)
Total Deposits as a Percent of Total Assets.....	75.01	76.89	1.88	2.5
Fully Insured Brokered as a Percent of Total Assets.....	2.12	1.69	(0.43)	(20.3)
Fully Insured Brokered as a Percent of Total Deposits.....	2.83	2.19	(0.64)	(22.6)

Source: Merrill Lynch Capital Markets. Based on call reports, as obtained through a database furnished by Newport Associates, Inc.

The result of these trends on bank funding was clear: First, banks were faced with significant new competition in accessing the funds of savers. Second, a major component of the traditional funding subsidy provided by government regulation was clearly removed. And finally, commercial banks had lost their decades-old monopoly over the provision of payments services.

### **Assets**

A similar picture emerged on the asset side of bank balance sheets. Most notable has been the drastic change in the role of commercial banks as providers of commercial and industrial (C&I) loans--the core of the traditional franchise. Many of the banks' most credit-worthy loan customers, including blue chip corporations, now borrow directly from investors in the commercial paper market at lower rates. The trend in this case is dramatic as evidenced by the declining ratio of C&I loans to commercial paper outstanding, down from a value of nearly 10 in 1960 to 1.2 in 1989 (Figure 10 in Chapter I).

At the time that Congress was moving to deregulate liabilities at insured institutions, thrifts were sliding into deeper financial difficulties. To compensate for the imbalances caused by deregulated liabilities and highly restricted assets (largely mortgages), Congress significantly expanded the ability of thrifts to compete more directly with banks in the early 1980s. For example, in DIDMCA thrifts were granted authority to invest in unsecured consumer loans up to 20 percent of assets, invest in corporate debt securities and commercial paper up to 20 percent of assets, issue credit cards, and offer trust services, among others. In the Garn-St Germain Act of 1982 thrifts gained additional authority to invest in commercial, corporate, business or agricultural loans up to 10 percent of assets, and to increase unsecured consumer loans from 20 to 30 percent of assets.<sup>26</sup> The net effect of this was to substantially increase competition for banks in once-protected markets.

Banks sought to compensate for these trends by reconfiguring their traditional lending activities in favor of real estate, highly leveraged transactions (HLTs), and loans to less developed countries (LDCs), all of which promised higher yield but carried higher risk (Figures 2 and 3).

## **2. Other Evidence of Franchise Erosion**

Banks also have responded to the growing pressures on their traditional lending by seeking profitability through off-balance sheet activities. Off-balance sheet activities are attractive to banks as a source of fee income and traditionally have included standby letters of credit (SLCs), commercial letters of credit (CLCs), and loan commitments. In recent years investment-related

Figure 2  
Largest Loan Concentration in Real Estate  
1979 - 1990 \*

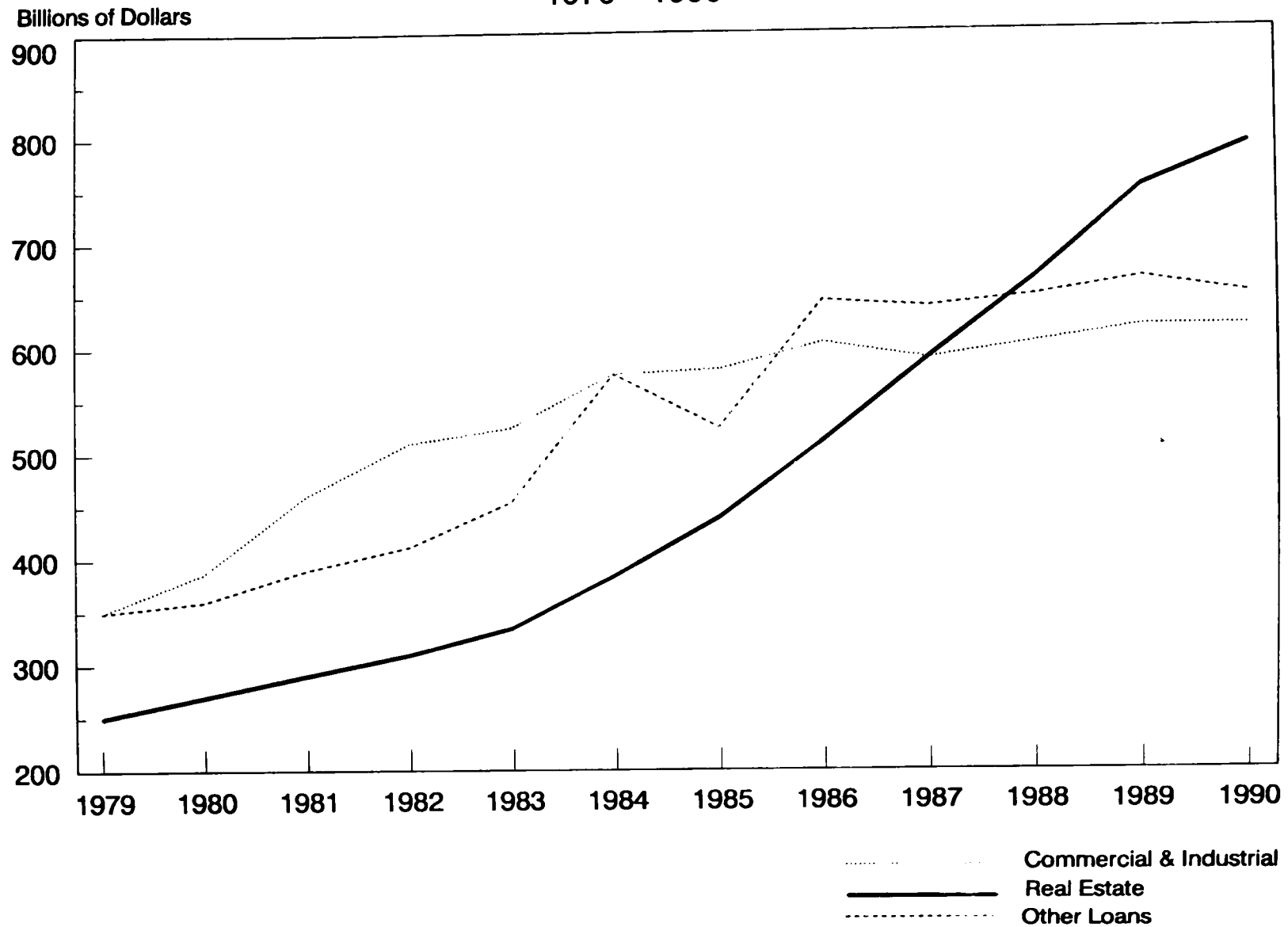
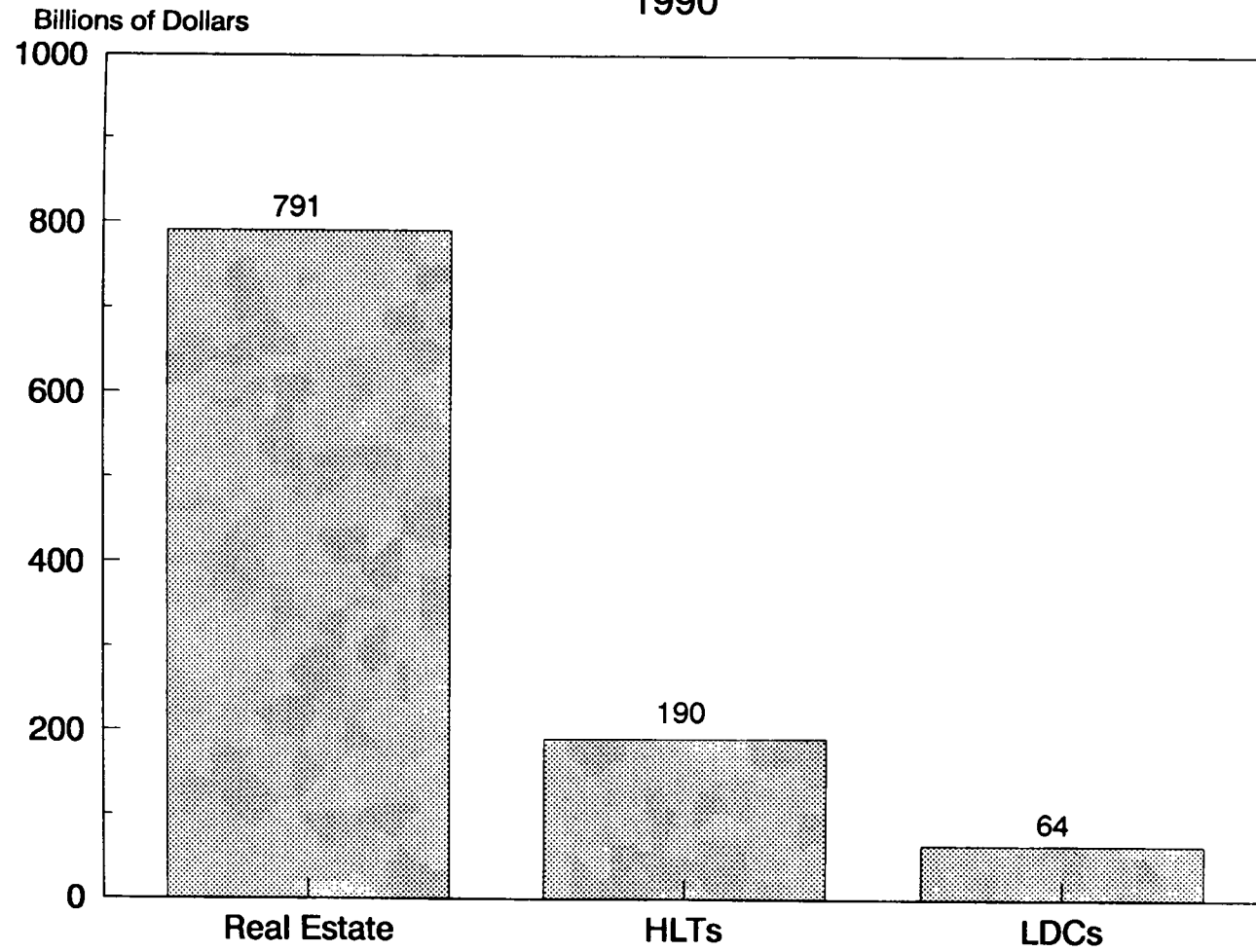




Figure 3  
Significant Risk Exposure of Commercial Banks  
1990 \*



\* As of November 13, 1990.

Source: Office of the Comptroller of the Currency.

off-balance sheet activities have grown in importance, notably foreign exchange obligations and interest rate swaps.<sup>27</sup> FDIC data show that the major types of off-balance sheet activities grew in dollar terms from 58 percent of bank assets in 1982 to 116 percent in 1989 (Figure 16 in Chapter I).

Another activity of growing importance to commercial banks is the "securitization" of assets. The securitization process involves selling individual loans or pieces thereof, as well as the pooling of similar types of small loans and then using the pools as the collateral, or backing, for the issuance of securities to ultimate investors. Securitization is a by-product of modern information technology which permits a highly complicated transaction to be executed in an extremely efficient manner, especially when compared to the traditional deposit-to-loan intermediation costs of banks. This represents yet another example of new competition for the traditional bank, as credit is extended via securitization of assets rather than bank lending. On the other hand, securitization of assets is also attractive to banks as a source of both interest and fee income and as a means to move capital-intensive assets off their balance sheets.

Securitization originated with mortgages and has now spread to other types of assets as well--automobile loans, consumer loans, credit card receivables, mobile home loans, and commercial loans. Commercial banks are major sellers of mortgages to various government agencies that then package the mortgages into mortgage-backed securities (MBS). As of mid-year 1990 there was over \$800 billion in government-agency MBS outstanding; plus over \$100 billion private-label MBS outstanding. With respect to non-mortgage securitized assets, there was over \$60 billion in original issuances outstanding in the public market at mid-1990, with perhaps an equal volume in the private market.<sup>28</sup>

In summary, the difficulties encountered by banks in recent years are apparent in a number of ways. For example, in spite of a strong economy in the 1980s, the business of banking has become much less stable and profitable as evidenced by declining return on assets (ROA), declining market share, declining equity value, and increased failures (Table 6 and Figures 7, 9, and 5 in Chapter I).

#### **D. The Current Market Environment**

##### **1. New Activities For Banks**

In response to their eroding market position, U.S. banks have been innovative in developing businesses in which they retain some regulatory freedom. For example, bank credit cards and automatic teller machines have revolutionized the payments system for the convenience and benefit of the American consumer.

Moreover, to increase non-interest income, banks have expanded their fee generating businesses like mortgage banking, financial advisory work, and other services. In this respect, FDIC data show that non-interest income has grown from under 10 percent of interest income in 1982 to about 16 percent in 1989 (Figure 15 in Chapter I), although there are now signs of a significant slowdown in the growth of fee income.<sup>29</sup>

In addition, as competition erodes their traditional lines of business, banks have sought to expand into businesses in which they were prohibited (or "protected") from competing. These include securities, insurance, and other financial services in which natural synergies exist with core banking businesses. At the same time, diversified financial companies have aggressively sought to expand into the most attractive banking lines of business. In both cases the motivation is to provide the full range of financial products and services demanded by sophisticated customers.

Despite statutory and regulatory impediments, these efforts to expand into new lines of business have succeeded in part. A limited degree of statutory change, particularly at the state level, combined with regulatory and judicial interpretations of existing law, have produced a new patchwork quilt of rules and exceptions. This new "system" allows some new activities (discussed below) and new geographic expansion (as discussed in Chapter XVII).

### **Securities Activities**

It has long been argued that commercial banking and investment banking are complementary activities and that the Glass-Steagall separation of these activities was unnecessary, especially given the securities markets reforms of the 1930s.

As a general matter, securities activities include the underwriting and dealing of corporate and government securities, the brokerage of securities, and investment advisory services.<sup>30</sup> Only the underwriting and dealing activities remain significantly segmented from commercial banking pursuant to the Glass-Steagall Act.

**Investment Banking.** Investment banking firms specialize in bringing the debt and equity issues of their clients to market. To do so successfully the underwriter must have a thorough knowledge of the credit quality of the client firm. In addition, the underwriter must be aware of the conditions attendant to the marketing of other similar issues. Given its assessment of the general economic environment, the underwriting firm will decide upon the timing, pricing, and distribution of client securities.<sup>31</sup>

The risk to the underwriter is related to the market price of the security and the length of time the security is held. A loss to the underwriter may occur if the market price of a security declines relative to the underwriter's target price, or if the price of the security in the secondary market declines while the underwriter retains a substantial inventory of the security. In either case, the longer a security is held, the greater is the probability of an adverse price movement. While the investment banker has to make some investigation into the creditworthiness of the securities underwritten (to hold them even for a short period of time), it is really the investor who bears the credit risk.<sup>32</sup>

On balance, underwriting risk is much less a function of the quality of the underlying securities than it is of the underwriting firm's ability to correctly price (including allowance for compensation, management fees, risk taking, etc.) and quickly and efficiently distribute the underwritten securities.

Commercial Banking. Commercial banks have traditionally been involved in a number of activities that require skills and procedures similar to those of the investment banker. Commercial and industrial (C&I) loans, private placements, and lease financing can be arranged only after the bank has become thoroughly familiar with the credit quality of the client firms, made a judgment about the future prospects for that firm, and assessed the potential impact of the general economic environment.

C&I loans have historically represented the core business of commercial banks. The major risks of such loans involve: (1) the credit risk of a borrower being unable to repay the loan subject to its original terms and conditions; and (2) the interest rate risk associated with an increase in loan funding costs relative to loan income. In either case, the market value of the loan to the holding commercial bank will decline. This risk is not dissimilar to that of the investment bank facing a decline in the price of an underwritten security, except that the commercial bank might carry this risk over the entire, and frequently considerable, term-to-maturity of the loan.

Commercial banks also are engaged in functions similar to the securities distribution function of investment banks. Loan participation arrangements and syndications typically require the lead (managing) banks to line up others in the industry to commit beforehand to the assumption of certain portions of the credits extended. Similarly, commercial banks making private placements must locate private investors willing to purchase the securities of their client firms upon mutually acceptable terms and conditions.

Commercial banking organizations have gained considerable experience in underwriting general obligation municipal securities (GOs) in the domestic market as well as underwriting and dealing in corporate debt and equity securities overseas.<sup>33</sup> Underwriting municipal GOs, in fact, is considered by some analysts to be riskier than underwriting corporate securities. Municipals are issued in serial form with each maturity constituting a relatively minor sum and being traded separately. As a result the ability to hedge positions is limited, liquidity is restricted, and prices and yields tend to be more volatile than in the corporate securities market. Nevertheless, U.S. banking organizations have been successful participants in underwriting and dealing municipal GOs for many years. To a limited degree, the same is true for U.S. banking organizations which have long been involved in underwriting and dealing corporate securities abroad.<sup>34</sup>

Taking these factors into consideration suggests that commercial banking organization already possess to a considerable degree the skills and experience required for undertaking the full range of securities activities. This natural "synergy" may explain why other countries have not found it necessary to prevent their banks from combining investment and commercial banking businesses. It may also explain the persistent erosion of the Glass-Steagall Act in the U.S. marketplace.<sup>35</sup>

Current Status. Banks now have the ability to engage directly or indirectly in a broad range of securities activities, although with numerous restrictions. They can engage with few limits in the underwriting and dealing of U.S. government and agency securities, general obligation municipal bonds, agency-guaranteed mortgage-backed securities, and certain kinds of municipal revenue bonds. In addition, they may engage in private placement activities, discount and full service brokerage, and financial advisory services. A recent court decision upheld the validity of the Office of the Comptroller of the Currency's decision to permit banks to securitize loans that they have originated or purchased. Moreover, banks may serve as investment advisors, transfer agents, shareholder servicing agents, and custodians for mutual funds.

Through recent interpretations (in 1987 and 1989) by the Federal Reserve of Section 20 of the Glass-Steagall Act, bank holding companies may establish nonbank subsidiaries that derive up to 10 percent of their revenue from a wide range of otherwise prohibited, or "ineligible," securities activities--including underwriting of and dealing in commercial paper (CP), mortgage backed securities (MBS), municipal revenue bonds (MRBs), securitized assets, and corporate bonds and equities.<sup>36</sup> As of mid-1990, about 30 bank holding companies had established such "Section 20" subsidiaries (Table 2).

Table 2

Section 20 Subsidiaries <sup>1</sup>

(As of June 22, 1990)

Banking organization	Initial order
<b>Boston District:</b>	
Bank of Boston Corp.....	8/88
Bank of New England .....	7/87
Fleet/Norstar Financial Corp .....	10/88
<b>New York District:</b>	
Amsterdam-Rotterdam Bank of N.V.....	6/90
The Bank of Nova Scotia <sup>2</sup> .....	4/90
Bankers Trust N.Y. Corp.....	4/87
Barclays Bank PLC <sup>3</sup> .....	1/90
Canadian Imperial Bank of Commerce <sup>2</sup> .....	1/90
Chase Manhattan Corp. <sup>3</sup> .....	5/87
Chemical N.Y. Corp.....	5/87
Citicorp <sup>2</sup> .....	4/87
The Long-Term Credit Bank of Japan, Ltd.....	5/90
Manufacturers Hanover Corp.....	5/87
Marine Midland Banks.....	7/87
J.P. Morgan & Co. <sup>2</sup> .....	4/87
The Royal Bank of Canada.....	1/90
The Sanwa Bank, Ltd.....	5/90
The Toronto-Dominion Bank.....	5/90
Westpac Banking Corp .....	3/89
<b>Cleveland District:</b>	
Huntington Bancshares, Inc .....	11/88
PNC Financial Corp.....	7/87
<b>Richmond District:</b>	
First Union Corp.....	8/89
NCNB Corp.....	5/89
Sovran Financial Corp.....	2/90
<b>Atlanta District:</b>	
Barnett Banks .....	1/89
South Trust Corp .....	7/89
<b>Chicago District:</b>	
The Bank of Montreal <sup>2</sup> .....	5/88
First Chicago Corp.....	8/88
<b>St. Louis District:</b>	
Liberty National Bancorp .....	4/90
<b>Minneapolis District:</b>	
Norwest Corp .....	12/89
<b>San Francisco District:</b>	
Security Pacific Corp. <sup>2</sup> .....	5/87

<sup>1</sup> Authorized to underwrite and deal in certain municipal revenue bonds, mortgage related securities, commercial paper, and asset-backed securities.

<sup>2</sup> Also has corporate debt and equity securities powers.

<sup>3</sup> Also has corporate debt securities powers.

Source: Federal Reserve Board.

However, strict "firewall" requirements have been established to limit transactions between the insured bank and its securities affiliate. The purpose of firewalls, generally, is to (1) limit risk to the bank, (2) limit bank subsidiaries to nonbank affiliates, and (3) prevent conflicts of interest and related abuses. In practice, the Section 20 affiliates only benefit the very largest banks, and only in a limited way because of the revenue limitations and these strict firewalls.

Finally, it should be noted that Section 8 of the International Banking Act of 1978 "grandfathered" the securities activities of approximately 18 foreign banks (Table 3), while by 1990 twenty-three states had authorized state-chartered bank affiliates to engage in securities underwriting activities beyond those permitted national banks and bank holding companies (Table 4). However, the exercise of securities activities directly by state banks is still generally limited by the Glass-Steagall Act.

Credit Suisse/First Boston. On November 9, 1990, the Federal Reserve Board appeared to signal a more lenient approach with respect to combinations of investment banking and commercial banking when it approved the purchase of majority control of CS First Boston, Inc. by CS Holding of Switzerland. CS First Boston owns The First Boston Corp., a major U.S. investment banking firm; CS Holding owns Credit Suisse, Switzerland's third largest bank. The Federal Reserve's decision is notable in that this is the first case of a foreign firm, not to mention a commercial bank, taking majority ownership of a major U.S. investment bank. The quid pro quo for the approval of the transaction appears to have been CS Holding's \$800 million recapitalization of CS First Boston, including an infusion of \$300 million in equity into First Boston Corp.<sup>37</sup>

### **Insurance Activities**

Second to securities activities, insurance is generally considered the financial activity closest to banking. Insurance, like banking, is a financial intermediation process--taking premiums, rather than deposits, from a large retail base; investing the funds in financial assets and loans; and eventually repaying the proceeds to the policyholder rather than the depositor.<sup>38</sup>

Insurance products are highly complementary to many existing bank products, providing opportunities for additional sources of profit based on greater value added per customer and delivery cost efficiencies (this is particularly true for larger banks with extensive retail branch banking systems). It is argued, for example, that comprehensive and cost-effective "packages" for bank customers could be built around mortgage loans and mortgage insurance, automobile loans and auto insurance, small business loans and "key individual" insurance, and corporate credit

Table 3

**Grandfathered Securities Affiliates of Foreign Banks  
Under Section 8 of the International Banking Act**

Bank	Securities affiliate	Percent
Julius Baer.....	Julius Baer Securities .....	100
Campagne Financiere de Paribas.	A.G. Becker/Warburg .....	100
Bayerische Hypotheken Bank.	ABD Securities.....	25
Berliner Handels and Frankfurter Bank.	BHF Securities.....	100
Bayerische Vereinsbank.....	Associated European Cap- ital Corp.	95.1
Cho Heung Bank.....	Korean Associated Securi- ties.	9.1
Commerzbank.....	Europartners Securities .....	40
Credit Lyonnais.....	Europartners Securities .....	40
Credit Suisse.....	Swiss American Corp.....	100
	Swiss American Securities, Inc. (First Boston).	80
Deutsche Bank .....	Atlantic Capital Corp .....	100
Dresdner Bank.....	ABD Securities.....	75
	German American Securi- ties (inactive).	100
Long Term Credit Bank .....	Sanyo Securities (Tokyo) .....	5.44
Societe Generale (France).	Hudson Securities .....	100
Swiss Bancorp.....	Basle Securities Corp .....	100
Union Bank of Switzerland.	USB Securities, Inc .....	100
Westdeutsche Landesbank.	RWS Securities.....	100
Bank Hapoalim .....	Ampal (best efforts for parent).	100

Note: Securities affiliates were grandfathered under Section 8 of the International Banking Act of 1978.

Source: Federal Reserve Board.



Table 4

## State Authorization of Selected Expanded Activities for State-Chartered Banks,\* May 1990

Insurance underwriting	Insurance brokerage	Real estate equity participation	Real estate development	Real estate brokerage	Securities underwriting	Securities brokerage/no underwriting
Delaware	Alabama	Arizona	Arizona	Georgia	Arizona	Arizona
Idaho	California	Arkansas	Arkansas	Iowa	California <sup>4</sup>	Connecticut
North Carolina	Delaware	California	California	Maine <sup>16</sup>	Delaware	Delaware
South Dakota	Idaho	Colorado	Colorado	Massachusetts	Florida	Florida
Utah <sup>1</sup>	Indiana <sup>13</sup>	Connecticut	Connecticut	New Jersey	Idaho	Georgia
	Iowa <sup>14</sup>	Florida	Florida	North Carolina	Indiana <sup>5</sup>	Idaho
	Nebraska	Georgia	Georgia	Oregon	Iowa	Indiana <sup>17</sup>
	New Jersey	Kentucky	Kentucky	Utah	Kansas <sup>6</sup>	Kansas
	North Carolina	Maine	Maine	Wisconsin	Maine	Iowa
	Oregon	Massachusetts	Massachusetts		Massachusetts	Maine
	South Carolina	Missouri	Michigan		Michigan	Michigan
	South Dakota	Nevada	Missouri		Missouri <sup>7</sup>	Minnesota
	Utah	New Hampshire	Nevada		Montana <sup>8</sup>	Nebraska
	Washington <sup>15</sup>	New Jersey	New Hampshire		Nebraska <sup>9</sup>	New Jersey
	Wisconsin	North Carolina	New Jersey		New Jersey	New York
	Wyoming	Ohio	North Carolina		North Carolina <sup>10</sup>	North Carolina
		Pennsylvania	Ohio		Pennsylvania <sup>11</sup>	Ohio
		Rhode Island	Oregon		Puerto Rico <sup>12</sup>	Pennsylvania <sup>16</sup>
		South Dakota	Rhode Island		Tennessee	Texas
		Tennessee <sup>2</sup>	South Dakota		Utah	Tennessee
		Utah	Utah		Washington	Utah
		Virginia	Virginia		West Virginia	Vermont
		Washington	Washington			West Virginia
		West Virginia	West Virginia			
		Wisconsin <sup>3</sup>	Wisconsin <sup>3</sup>			

\* Expanded activities above those permitted national banks and bank holding companies under the bank holding company act. Extent of practice unknown.

<sup>1</sup> Grandfathered institutions.

<sup>2</sup> Banks not allowed to be active partners in real estate development.

<sup>3</sup> Wisconsin: Enacted expanded powers legislation 5/86. New legislation authorized the Commissioner of Banking to promulgate rules under which state banks may engage in activities that are authorized for other financial institutions doing business in the state.

<sup>4</sup> Underwrite mutual funds; law silent on other securities.

<sup>5</sup> Underwrite municipal revenue bonds and market mutual funds and mortgage backed securities.

<sup>6</sup> Underwrite municipal bonds.

<sup>7</sup> Underwrite mutual funds and may underwrite securities to extent of the state legal loan limit.

<sup>8</sup> Limited to bonds.

<sup>9</sup> Underwrite U.S. government securities.

<sup>10</sup> U.S. government, federal farm act bonds and general obligation bonds of state and political subdivisions.

<sup>11</sup> Underwrite municipal and mortgage related securities to extent permitted savings banks.

<sup>12</sup> May underwrite bonds of the U.S. and Puerto Rican governments, their political subdivisions and instrumentalities, and agencies.

<sup>13</sup> Cannot broker life insurance, all other types permitted.

<sup>14</sup> Property and casualty only.

<sup>15</sup> Banks located in small towns (5,000) may conduct insurance agency activities without geographic limitations.

<sup>16</sup> May own or operate brokerage firm established for the purpose of disposing of bank-owned property.

<sup>17</sup> May conduct discount brokerage.

Source: Conference of State Bank Supervisors.

relationships and corporate life or property/casualty insurance.<sup>39</sup>

**Agency Activities.** A study completed recently by the United States General Accounting Office (GAO) provides strong support for bank entry into agency activities. According to the GAO, the selling of insurance by banks would prove beneficial to consumers through reduced costs and increased convenience. Specifically, some reduction in the costs of marketing and selling insurance to consumers might be achieved through economies of scope -- that is, the cost efficiencies that are realized by the joint marketing (or cross-selling) of two or more products. And perhaps more important than marketing cost efficiencies may be the reduction in consumers' transaction costs that would come with "one-stop-shopping" for banking and insurance services.<sup>40</sup>

With respect to potential conflicts of interest, the GAO found that "three factors work to control conflict situations and limit their abuse: competition, banking internal controls, and regulatory oversight." Also, the GAO found that "coercive tie-ins have not been a widespread problem in banks selling credit insurance and in those banks already allowed to sell all forms of insurance." Furthermore, if practices of these types were to become serious, additional control measures could be introduced (such as disclosing the voluntary nature of insurance purchases and separating insurance marketing from the credit approval process).<sup>41</sup>

Finally, the GAO found that permitting banks to sell insurance would promote competition in insurance markets with no risk to the safety and soundness of banks. The competitive capabilities of banks are enhanced by (1) the existence of branch offices that represent a powerful distribution system for insurance products, (2) access to customer information derived from other financial services offered by the bank, and (3) the cost efficiencies that accompany economies of scope and scale. All of these factors would be expected to decrease the cost and increase the availability of insurance products to consumers. With respect to safety and soundness, the GAO concludes that "The insurer underwriting the policies bears the financial risk of losses under policies sold by the bank. To the extent that banks' sales of insurance are profitable, selling insurance could enhance banking safety and soundness."<sup>42</sup>

**Current Status.** National banks, state banks and bank holding companies traditionally have been authorized to engage in only a very limited range of insurance activities. National banks, under the "incidental powers" clause of the National Bank Act, may engage in the underwriting and brokerage of credit life accident and health insurance. Section 92 of the Act authorizes general insurance brokerage in towns of fewer than 5,000 persons.<sup>43</sup>

For many years the Federal Reserve narrowly interpreted Section 4(c)(8) of the BHCA to restrict bank holding companies from engaging in insurance activities. Later attempts by the Federal Reserve to interpret the BHCA somewhat more liberally created a Congressional reaction; the result was the Title VI provisions of the Garn-St Germain Act of 1982. Title VI amended Section 4(c)(8) to state explicitly that it is not closely related to banking or managing or controlling banks for a bank holding company to provide insurance as a principal, agent or broker.<sup>44</sup> Nevertheless, Congress did permit some grandfathering of existing insurance activities, and it provided limited exceptions similar to those applicable to national banks (*i.e.*, underwriting and brokerage of credit related insurance, insurance agency activities in towns of fewer than 5,000 persons, and a "small holding company exception" for firms less than \$50 million in assets).

In recent years, however, banks have made some progress in seeking expanded insurance authority. The Comptroller of the Currency, in some cases subject to ongoing litigation, has permitted national banks to underwrite and sell title insurance, property insurance related to loan collateral, and financial guaranty insurance; national banks may also broker fixed-rate annuities and sell insurance nationwide from a branch in a qualifying small town.<sup>45</sup>

The expansion of banking and insurance has been undertaken most broadly at the state level. This is permissible because the insurance restrictions of the BHCA do not apply to state banks directly, and it remains uncertain whether they apply to the subsidiaries of banks.<sup>46</sup> Currently, 17 states (if pending approval by Virginia is included) authorize insurance brokerage activities, and five states insurance underwriting activities, that go beyond those permitted for national banks and bank holding companies (Table 4). The most significant of the recent state laws has been passed in Delaware, which now permits state-chartered banks to engage in both agency and underwriting activities, although the Federal Reserve has prohibited a bank holding company from permitting a bank subsidiary to exercise any powers granted under the law.<sup>47</sup>

### Foreign Activities

Adding to the patchwork nature of U.S. banking regulation is the fact that the international operations of U.S. banks are governed by a distinct statutory and regulatory regime implemented through the Federal Reserve's Regulation K. In general, U.S. banking organizations abroad can engage in a wider range of activities than they can in their own domestic market. Such activities include: general insurance agency and brokerage services; underwriting credit insurance, life insurance, and motor vehicle insurance; performing management consulting

services; operating a travel agency; managing mutual funds; and engaging in limited underwriting, distributing, and dealing in corporate debt and equity securities.<sup>48</sup> The fact that U.S. banks, under U.S. law, have engaged safely in a greater range of activities abroad than domestically has long raised questions about the rationality of U.S. bank regulation.

The foreign activities of U.S. banks grew rapidly in the 1970s and early 1980s. But in recent years it not only stopped, but reversed itself. Part of the explanation for this is the nature of current regulation itself. For one thing, the Glass-Steagall separation of commercial and investment banking bars U.S. banking organizations from marketing foreign securities to their principal pool of investors in the United States. And Regulation K limits equity underwriting by U.S. banking organizations to only \$2 million per underwriting issue per subsidiary. Several subsidiaries of a banking organization may each underwrite up to \$2 million of the same issue, but the aggregate amount of any issue that may be underwritten by a consolidated banking organization is restricted to \$15 million. These limits, in particular, are viewed as precluding securities affiliates of U.S. banking organizations from acting as lead underwriters or taking competitively significant positions in equity issues while imposing substantial operating costs (prompting the Federal Reserve in August 1990, to issue proposal for public comment to substantially ease existing Regulation K restrictions). These factors, which do not apply equally to foreign institutions, undermine the competitiveness and profitability of U.S. banks abroad.<sup>49</sup>

Another part of the explanation for the decline in the foreign activities of U.S. banking organizations reflects the changing economic environment. It has been suggested that U.S. banks are withdrawing from foreign markets (1) in order to take advantage of expansion opportunities in the domestic market (e.g., by purchases of troubled thrifts), (2) because of unfavorable experience with LDC loans, and (3) because of a trend to sell off assets as a means of meeting higher loan loss reserves and building up capital-asset ratios to meet the Basle Accord requirements.<sup>50</sup>

### **Summary**

The persistent efforts made by banking organizations to expand into nontraditional activities that are highly complementary to their core businesses have met with limited success. As a practical matter, however, this success has been achieved in a piecemeal, inefficient, and often irrational manner. The most significant recent development with respect to securities activities was the grant of new underwriting authority for Section 20 subsidiaries. But that grant of authority carried with it revenue limitations and other restrictive firewalls that

reduce potential benefits, especially for any but the largest firms. There also has been some progress with respect to insurance, primarily limited to state banks. Finally, the efforts of U.S. banks to engage in broader activities abroad have lost much of their former attractiveness in light of still-cumbersome regulatory restrictions and a rapidly changing economic environment.

## **2. Product Expansion by Nonbank Firms**

The efforts of banks over recent years to break out of their segmented markets has been matched by the diversification efforts of other providers of financial services.

### **The Insurance and Securities Industries**

The Model Insurance Act. In the late 1950s and early 1960s, the insurance industry, like the banking industry, was undergoing rapid structural change prompted by a surge of acquisitions of insurance companies by nonfinancial firms. But because the McCarran-Ferguson Act of 1945 relegated the regulation of the insurance industry to the states, it was left up to the National Association of Insurance Commissioners (NAIC) to draft a "model" insurance act for consideration at the state level.<sup>51</sup>

The Model Act adopted by the NAIC, and most state legislatures, was intended to put a brake on takeover activity and financial consolidation via insurance companies. In many respects the Model Act resembled the Bank Holding Company Act in its establishment of criteria for acquisitions and new activities. But the Model Act did not, in fact, prohibit acquisitions of insurance companies by nonfinancial firms. Furthermore, the Act did not prohibit the activities that insurance companies, other than life insurers, could engage in through subsidiaries. On balance, this was interpreted by many as implicit approval of new financial combinations.<sup>52</sup>

In particular, the securities activities of insurance companies were not as tightly restricted as was the case for BHCs, and the former rapidly became significant participants in the management of mutual funds, pension funds and other securities-related activities.<sup>53</sup>

Public Ownership of Securities Firms. The pressures for change in banking and insurance in the 1960s also affected the securities industry. Securities firms had always been required to be structured as partnerships, a form of ownership that was increasingly found wanting in terms of the capital needed to process and finance a rapidly growing volume of transactions. Under pressure from its member firms, the New York Stock Exchange (NYSE) amended its rules in the late 1960s to permit member firms to sell shares to the public to raise capital. Notably, along

with this capital-raising enhancement came the flexibility to diversify into other activities via affiliations and acquisitions. The alignment of securities firms with insurance companies and other financial and nonfinancial enterprises soon became commonplace.<sup>54</sup>

### **Affiliations with Limited-Service Banking**

Commercial firms have long been permitted to acquire thrift institutions. Sears Roebuck is the traditional example of a commercial firm that also owns an insured thrift institution. Ford and Westinghouse are the best examples of a "new wave" of commercial firms interested in diversification through ownership of insured thrift institutions. For example, Ford Motor Company owns First Nationwide Bank, a San Francisco thrift institution with over \$20 billion in assets; Westinghouse Electric in 1990 acquired the United Federal Bank and the Enterprise Savings Bank, both in Illinois, and now has a 20-branch network with about \$800 million in assets.<sup>55</sup>

Through legal loopholes that have opened and closed over the years, commercial companies also have acquired a significant number of limited-service banks. This was made possible by an earlier definition of "bank" under the Bank Holding Company Act. Specifically, a bank was defined as an institution that both accepted demand deposits and made commercial loans. This permitted any business organization to simply eliminate one or the other of the two activities to own and operate an insured bank without being subject to the restrictions of the Act.<sup>56</sup> These so-called "nonbank banks" were attractive to a wide range of business organizations seeking to capitalize on the efficiencies and "synergies" that come with offering largely complementary services.

By the mid-1980s, firms such as General Electric, Textron, ITT, Gulf & Western, John Hancock, Prudential Bache, American Express, Merrill Lynch, Dreyfus, Household, Beneficial, Sears Roebuck, J.C. Penney, McMahan Valley Stores, Bankers Trust Corporation, Bank of Boston Corporation, and others had established nonbank banks (Table 5).

The Competitive Equality Banking Act of 1987 (CEBA) closed the nonbank bank loophole by amending the BHCA to define the term "bank" to include (1) an institution with FDIC insurance, or (2) an institution not insured by the FDIC that both accepts deposits and makes commercial loans. Existing nonbank banks were grandfathered subject to certain limitations on their growth and activities. But other commercial and financial companies have been prohibited from expanding into banking. Still, the result is that there now exist a number of major diversified firms that own both banks and other financial and commercial concerns.

Table 5

Nonbank Banks Reporting Pursuant to CEBA <sup>1</sup> and Still In Operation Listed Alphabetically by Holding Company

Holding company	Subsidiary
Advest Group, Inc., Hartford, CT .....	Advest Bank, Hartford, CT
Aetna Life and Casualty Company, Hartford, CT .....	Liberty Bank & Trust, Gibbsboro, NJ
American Express Company, New York, New York .....	Boston Safe Deposit and Trust Co., Boston, MA
American Express Company, New York, NY .....	Advisory Bank & Trust Co., Minneapolis, MN
	American Express Centurion Bank, Newark, DE
Archer-Daniels-Midland Co., Decatur, IL .....	Hickory Point Bank and Trust, Decatur, IL
Bear Stearns Companies, Inc., New York, NY .....	Custodial Trust Company, Trenton, NJ
Bessemer Group, Inc., New York, NY .....	Bessemer Trust Co., N.A., New York, NY
	Bessemer Trust Co., Woodbridge, NJ
Capital Holding Co., Louisville, KY .....	First Deposit National Bank, Tilton, NH
Chrysler Corporation, Highland Park, MI .....	Automotive Financial Services, Inc., Highland Park, MI
Citadel Holding Corporation, Glendale, CA .....	Fidelity National Trust Co., Sherman Oaks, CA
CityFed Financial Corporation, Bedminster, NJ .....	City Trust Services, N.A., Elizabeth, NJ
Co-operative Bancorp, Acton, MA .....	Co-operative Bank of Concord, Concord, MA
	Quincy Co-operative Bank, Quincy, MA
Commercial Credit Co., Baltimore, MD .....	City Loan Bank, Lima, OH
	Commercial Credit Bank of Dallas Addison, TX
	Commercial Credit Bank, Baltimore, MD
	Commercial Credit Savings Bank, Pittsburgh, PA
	First National Bank of Wilmington, Newark, DE
Continental Corporation, New York, NY .....	International Central Bank & Trust Corp., Irvine, CA
Drexel Burnham Lambert Group, Inc., New York, NY .....	Commercial Trust Company, Hato Rey, PR
	Harbor Trust Co., Hoboken, NJ
Dreyfus Corp., New York, NY	Dreyfus Consumer Bank, East Orange, NJ
Eaton Vance Corporation, Boston, MA .....	Investors Bank & Trust Co., Boston, MA
Fidata Corporation, New York, NY .....	Fidata Trust Co., Massachusetts, New York, NY
	Fidata Trust Co., New York, New York, NY
First American Financial Co., Santa Ana, CA .....	First American Trust Company, Santa Ana, CA
First Boston, Inc., New York, NY .....	Universal Trust Co., Puerto Rico
First Franklin Corporation, Toccoa, GA .....	Liberty Bank & Trust, Toccoa, GA
FMR Corporation, Boston, MA	Fidelity Bank & Trust Co., Salem, NH
	Fidelity Management Trust Co., Boston, MA
Franklin Resources, Inc., San Mateo, CA .....	Pacific Union Bank & Trust Co., Menlo Park, CA
General Electric Company, Stamford, CT .....	Monogram Bank, Blue Ash, Ohio
Goldman, Sachs & Co., New York, NY .....	Broad Street Bank and Trust Co., Boston, MA <sup>2</sup>
Greyhound Financial Corp., Phoenix, AZ .....	Greyhound Commercial Bank, Washington, DC <sup>2</sup>
Gulf & Western, Inc., New York, NY .....	Associates National Bank, Concord, CA
Home Group, Inc., New York, NY .....	Premium Bank, Oceanside, CA
ITT Financial Corporation, St. Louis, MO .....	Lyndon Guaranty Bank of New York, Rochester, NY
	Lyndon Guaranty Bank of Ohio, Columbus, OH
J.C. Penny Company, Inc., New York, NY .....	J.C. Penny National Bank, Harrington, DE
John Hancock Subsidiaries, Inc., Boston, MA .....	First Signature Bank & Trust Co., Boston, MA
Leucadia National Corp., New York, NY .....	American Investment Bank, N.A., Salt Lake City, UT
Lomas & Nettleton Financial Corp., Dallas, TX .....	MBank USA (Lomas Bank USA), Wilmington, DE
Marsh & McLennan, Cos., Inc., New York, NY, and The Putnam Cos., Inc., Boston, MA.	Putnam Fiduciary Trust Co., Boston, MA
McMahan's Valley Stores, Carlsbad, CA .....	Western Family Bank, N.A., Carlsbad, CA
Merrill Lynch & Co., Inc., New York, NY .....	Merrill Lynch Bank & Trust Co., Plainsboro, NJ
Montgomery Ward & Co., Inc., Chicago, IL .....	Clayton Bank & Trust Company, Clayton, DE
Prescott Holdings, Inc., Cleveland, OH .....	Prescott Merchants Bank, Washington, DC <sup>2</sup>
Prudential Insurance Co. of America, Newark, NJ .....	Prudential Bank & Trust Company, Atlanta, GA
Sargent Investors, Inc., Cranston, RI .....	Domestic Safe Deposit Co., Cranston, RI
Sears, Roebuck and Co., Chicago, IL .....	Greenwood Trust Company, New Castle, DE
	Hurley State Bank, Hurley, SD
Seperverde Holding Company, Flourtown, PA .....	Firsttrust Savings Bank, Flourtown, PA
Society Corporation, Cleveland, OH .....	SBC Corporation, Washington, DC <sup>2</sup>
State Savings Bank, Columbus OH .....	Century Bank, Cincinnati, OH
Sun Life Assurance Co. of Canada, Wellesley Hills, MA .....	New London Trust Co., New London, NH
Textron, Inc., Providence, RI .....	AVCO National Bank, Irvine, CA
Travelers Corp., Hartford, CT .....	Massachusetts Co., Inc., Boston, MA
TSO Financial Corporation, Horsham, PA .....	Colonial National Bank USA, Horsham, PA

<sup>1</sup> The Competitive Equality Banking Act of 1987.<sup>2</sup> Indicates subsidiaries which were not open as of March 5, 1987. No determination has been made as to the status of these under CEBA.

Source: House Committee on Banking, Housing and Urban Affairs Task Force on the International Competitiveness of U.S. Financial Institutions.

### 3. The Convergence of Finance and Commerce

All of the events discussed above have accelerated a trend towards the convergence of financial and commercial activities. This is a trend that started with trade credit, or the sales finance activities of retailers and certain manufacturers, to finance purchases by individuals and households. Thus major retailers such as Sears Roebuck established finance arms to provide their customers with the credit required to finance purchases from their stores; auto manufacturers such as General Motors established finance arms to provide credit to the buyers of their automobiles; and appliance makers such as General Electric established finance arms to underwrite customers' purchases of their goods. According to one report:

The commingling of consumer finance and commerce became the rule, rather than the exception, until the 1970s when banks acquired a larger share of the market through their finance subsidiaries and credit card operations.

As the links between finance companies and banks proliferated, those between finance companies, commercial enterprises and other financial intermediaries also expanded. Thus, financial intermediaries found themselves competing head-on with both financial and nonfinancial entities outside of their traditional lines of business. As a result, pressures built for a further expansion of the range of activities for individual financial sectors.<sup>57</sup>

The convergence of financial and commercial activities has progressed to the extent that a relatively large number of diversified financial firms can now be identified. The prototypical firm may well be Sears Roebuck, which combines a large scale retail operation with a full offering of financial services (including consumer credit for customers, the nationally distributed "Discover" credit card, Allstate insurance, an insured thrift institution, a limited service "nonbank bank," and the Dean Witter securities firm). Other well-known firms that combine a diverse range of financial services under a single umbrella are American Express, General Electric, Prudential Insurance, Merrill Lynch, and Gulf & Western Industries (Table 6).

The existing combinations of commerce and finance discussed above are not always the product of an intentional statutory and supervisory framework, which has been traditionally biased towards rigid segmentation. Rather, a number of these combinations have been the result of persistent market forces that were able to take advantage of statutory and regulatory gaps.



Table 6  
Selected Diversified Financial Conglomerates

Firm (principal business)	Insurance	Real estate	Securities	Depository institution	Other financial *
Aetna Life & Casualty (Insurance).....	X	X			X
American Can Company (Manufacturing).....	X	X	X	X	X
American Express Co. (Diversified Financial).....	X		X	X	X
American General Corp. (Diversified Financial).....	X	X	X		X
Armco Inc. (Steel).....	X			X	X
Avco Corp. (Defense Contracting).....	X			X	X
BankAmerica Corp. (Banking).....	X	X	X	X	X
Beneficial Corp. (Consumer Finance).....	X			X	X
Borg Warner Corp. (Manufacturing).....	X		X		X
Chrysler Corp. (Manufacturing).....	X	X			X
Citicorp (Banking).....	X	X	X	X	X
Control Data Corp. (Computers).....	X			X	X
Equitable Life Assurance Society of the U.S. (Insurance).....	X	X	X		X
Ford Motor Company (Manufacturing).....	X	X		X	X
General Electric (Manufacturing).....	X	X	X		X
General Motors Corp. (Manufacturing).....	X	X			X
Greyhound Corp. (Transportation).....	X				X
Gulf & Western Industries Inc. (Commercial Conglomerate).....	X	X		X	X
Household International Corp. (Consumer Finance).....	X			X	X
ITT (Commercial Conglomerate).....	X		X		X
Merrill Lynch Co. (Securities).....	X	X	X	X	X
National Steel Corp. (Steel).....		X		X	X
Parker Pen Company (Manufacturing).....	X			X	X
J.C. Penny Company (Retail).....	X	X		X	X
Prudential Insurance Company of America (Insurance).....	X	X	X	X	X
RCA Corp. (Electronics).....	X				X
Sears Roebuck & Co. (Retail).....	X	X	X	X	X
Transamerica Corp. (Insurance).....	X	X			X
Westinghouse Electric Company (Manufacturing).....		X			X

\* Other includes: credit cards, consumer lending, financing, leasing, factoring, investment advisory services, mutual fund management, data processing services, purchasing of installment contracts, trust services, venture capital services, merchant banking, pension fund management, travellers' checks, and money orders.

Source: Subcommittee on Telecommunications, Consumer Protection, and Finance, *Restructuring Financial Markets: The Major Policy Issues*, July 1986, pp. 201-202.

The development of these broadly diversified firms has often proven beneficial to the economy at large, and financial markets in particular. Most important has been the ability and willingness of such firms to strengthen the capital positions of their financial services subsidiaries: Ford continues to provide capital for its thrift operations, while Prudential Insurance and American Express do likewise for their securities firms. The stability brought to the financial markets in this way is a net benefit to the economy overall.

The holding-company structure has been commonly used by many diversified firms to combine a wide range of activities under one corporate parent. These activities include deposit-taking, lending, securities, insurance, and others. Only banking organizations remain prohibited from doing likewise.

### E. Global Competition

The consequences of the antiquated regulatory regime under which U.S. financial institutions operate is made even more apparent when considered within the context of the global marketplace. It was not all that long ago, perhaps only 10 or 15 years, that the question of the international standing of U.S. financial institutions was of little concern. As was the case for the U.S. economy in general, domestic financial institutions, most notably commercial banks and securities firms, dominated the global rankings. In recent years, however, the international standing of domestic financial institutions seems to have eroded noticeably, a perception supported by the weight of the empirical findings.

#### 1. Erosion of International Stature

##### The Decline of U.S. Firms

**Asset Size.** The data show that as recently as 1983, three U.S. commercial banks were in the rankings of the world's top twenty banks in asset size. But by year-end 1988, no U.S. commercial bank was ranked among the world's top twenty; Citicorp, the largest U.S. bank, held the twenty-fourth position (Table 7). Furthermore, in 1983 U.S. banks accounted for 16.5 percent of the assets of the top thirty banks, whereas in 1988 they accounted for less than three percent of top thirty banks' assets. Over the same time span, Japanese banks just about doubled their representation in the top twenty rankings, increasing from eight firms in 1983 to fifteen firms in 1988. French and U.K. banks filled the remaining five places.<sup>58</sup> Finally, when measured in terms of the share of international bank assets by nationality, the data show that the U.S. banks' share fell from 26.4 percent in December 1984 to only 14.6 percent in June 1990 (Table 8). Moreover, only four U.S. banks

Table 7

The World's Twenty Largest Banks Ranked by Assets

(As of December 31, 1988)\*

Country	Number of banks in top twenty	
	1983	1988
United States .....	3	0
Japan .....	8	15
France .....	4	3
United Kingdom.....	3	2
Germany.....	1	0
Canada .....	1	0

Firm	Country
1. Dai-ichi Kangyo Bank, Ltd .....	Tokyo, Japan.
2. Sumitomo Bank, Ltd .....	Osaka, Japan.
3. Fuji Bank, Ltd .....	Tokyo, Japan.
4. Sanwa Bank, Ltd.....	Osaka, Japan.
5. Mitsubishi Bank, Ltd .....	Tokyo, Japan.
6. Industrial Bank of Japan, Ltd.....	Tokyo, Japan.
7. Norinchukin Bank.....	Tokyo, Japan.
8. Tokai Bank, Ltd .....	Nagoya, Japan.
9. Mitsui Bank, Ltd.....	Tokyo, Japan.
10. Mitsubishi Trust & Banking Corp .....	Tokyo, Japan.
11. Credit Agricole Mutuel.....	Paris, France.
12. Sumitomo Trust & Banking Co., Ltd.....	Osaka, Japan.
13. Banque Nationale de Paris.....	Paris, France.
14. Barclays Bank Plc.....	London, U.K.
15. Mitsui Trust & Banking Co., Ltd .....	Tokyo, Japan.
16. National Westminster Bank Plc.....	London, U.K.
17. Credit Lyonnais .....	Paris, France.
18. Taiyo Kobe Bank, Ltd.....	Kobe, Japan.
19. Bank of Tokyo, Ltd .....	Tokyo, Japan.
20. Long-Term Credit Bank of Japan .....	Tokyo, Japan.

\* The largest U.S. bank, Citibank, ranked 24.

Source: American Bankers Association, *International Banking Competitiveness*, March 1990, p. 8.

Table 8

International Bank Assets by Nationality of Bank \*

(Amounts in billions of dollars; shares in percent)

Parent country of bank	December 1984		June 1989	
	Amount	Share of total assets	Amount	Share of total assets
United States.....	594.5	26.4	672.0	14.6
Japan.....	517.9	23.0	1,735.9	37.6
France.....	200.7	8.9	390.2	8.4
United Kingdom.....	168.9	7.5	246.9	5.3
Germany.....	143.2	6.4	359.5	7.8
Italy.....	90.6	4.0	209.6	4.5
Switzerland.....	82.9	3.7	170.7	3.7
Other.....	450.7	20.1	833.6	18.0
Total.....	2,249.4	100.0	4,618.4	100.0

\* International bank assets are defined to include claims in foreign and domestic currencies of bank offices on nonlocal customers and claims in foreign currencies on local residents.

Source: Federal Reserve Board.

account for about 50 percent of these assets, and 10 banks account for slightly more than 80 percent.<sup>59</sup>

**Market Capitalization.** A similar story emerges from rankings of the world's largest financial firms in terms of market capitalization, a good measure of an institution's ability to weather adversity and invest for the future. Market capitalization is closely tied to a bank's overall operating performance and asset quality. When an institution's earnings falter or its asset quality deteriorates, investors sell its stock, reducing market capitalization. In this case, as of late 1989, Japanese firms held all top twenty positions. The largest U.S. financial firm was American Express, ranked twenty-first with a market capitalization of \$15.2 billion. The largest U.S. banking organization was Citicorp, ranked thirty-second with a market capitalization of \$9.5 billion, a mere 11 percent of the \$86 billion capitalization of top-ranked Industrial Bank of Japan (Table 9).<sup>60</sup> Other data show that of the world's top fifty banks in terms of market capitalization in 1988, only two were U.S. banks, while 31 were Japanese.<sup>61</sup> However, Japanese banks' capital includes a large proportion of shareholdings in companies, which declined in value dramatically in 1990, and there are now signs that both U.S. and Japanese banks may lag the growth of financially stronger European banks in the 1990s.<sup>62</sup>

**Overseas Offices.** Another measure of the declining international position of U.S. banks is reflected in the change in the number and assets of overseas branches. Recent data show that assets reached a peak in 1981 at \$390 billion; branches peaked at 916 in 1985. But by 1988, assets had fallen to \$318 billion, and the number of branches had fallen to 849. This trend is continuing.<sup>63</sup>

**Performance Considerations.** Size comparisons alone are insufficient when assessing the international competitiveness of U.S. financial institutions. It is equally important to examine performance data, including asset growth, equity ratios, earnings, and productivity. However, an analysis of these types of data for U.S. financial institutions does not provide a clear picture.

On the one hand, there is some evidence that those U.S. banks in the world's top fifty perform better than their counterparts from Japan and Europe. In 1988, the average return on assets (ROA) of U.S. banks in the top fifty was 0.95 percent, or nearly four times that of their Japanese, and twice that of their European, counterparts. With respect to return on equity (ROE), the U.S. banks averaged 18.38 percent in 1988; the average for Japanese banks in the top fifty was 12.47 percent, and 10.30 percent for the European banks.<sup>64</sup>

Table 9

**The World's Largest Financial Firms Ranked by  
Market Capitalization\***

(As of October 1989)

Firm	Country	Market capitalization (in billions of dollars)
1. Industrial Bank of Japan.....	Japan.....	\$86.2
2. Sumitomo Bank .....	Japan.....	67.9
3. Dai-Ichi Kangyo Bank .....	Japan.....	66.9
4. Fuji Bank .....	Japan.....	61.5
5. Mitsubishi.....	Japan.....	60.7
6. Sanwa Bank.....	Japan.....	50.6
7. Nomura Securities.....	Japan.....	45.6
8. Long Term Credit Bank .....	Japan.....	34.1
9. Tokai Bank .....	Japan.....	33.2
10. Mitsui Bank .....	Japan.....	32.6
11. Mitsubishi Trust .....	Japan.....	25.2
12. Taiyo Kobe Bank.....	Japan.....	24.6
13. Bank of Tokyo .....	Japan.....	24.1
14. Sumitomo Trust .....	Japan.....	23.2
15. Daiwa Securities.....	Japan.....	21.7
16. Nippon Credit Bank.....	Japan.....	19.7
17. Nikko Securities.....	Japan.....	18.8
18. Daiwa Bank.....	Japan.....	16.9
19. Mitsui Trust .....	Japan.....	16.1
20. Yamaichi Securities.....	Japan.....	15.5

\*The largest U.S. financial firm, American Express, ranked 21 (\$15.2 billion). The largest U.S. banking organization, Citicorp, ranked 32 (\$9.5 billion).

Source: American Bankers Association, *International Banking Competitiveness*, March 1990, page 9.

On the other hand, analysis by the Federal Reserve Bank of New York suggests that, on balance, internationally active U.S. banking organizations fall in the middle of the pack of the major internationally active banks of other countries (based on comparative 1985-88 averages of real asset growth, real revenue growth, return on assets (ROA), return on equity (ROE), capitalization, and productivity). And, in terms of the same indicators, internationally active U.S. securities firms were found to be consistently lagging the performance of their Japanese competitors.<sup>65</sup>

### **Foreign Firms in the U.S.**

As foreign banks expanded their presence on a worldwide basis, they expanded most notably in the U.S. Federal Reserve data show that foreign-controlled banking offices increased their assets in the U.S. from \$22.8 billion in 1972 to almost \$734 billion as of June 1990, the largest part of which increase was accounted for by Japanese institutions. Indeed, Japanese banks now dominate the list of the major foreign banks with operations in the United States.<sup>66</sup>

Foreign-controlled banking offices in mid-1990 accounted for about 20.4 percent of U.S. banking assets, 13.8 percent of deposits, and about 29.4 percent of commercial and industrial loans, up from shares of 14 percent, 10 percent, and 20 percent, respectively, in 1983 (Figures 4, 5 and 6).

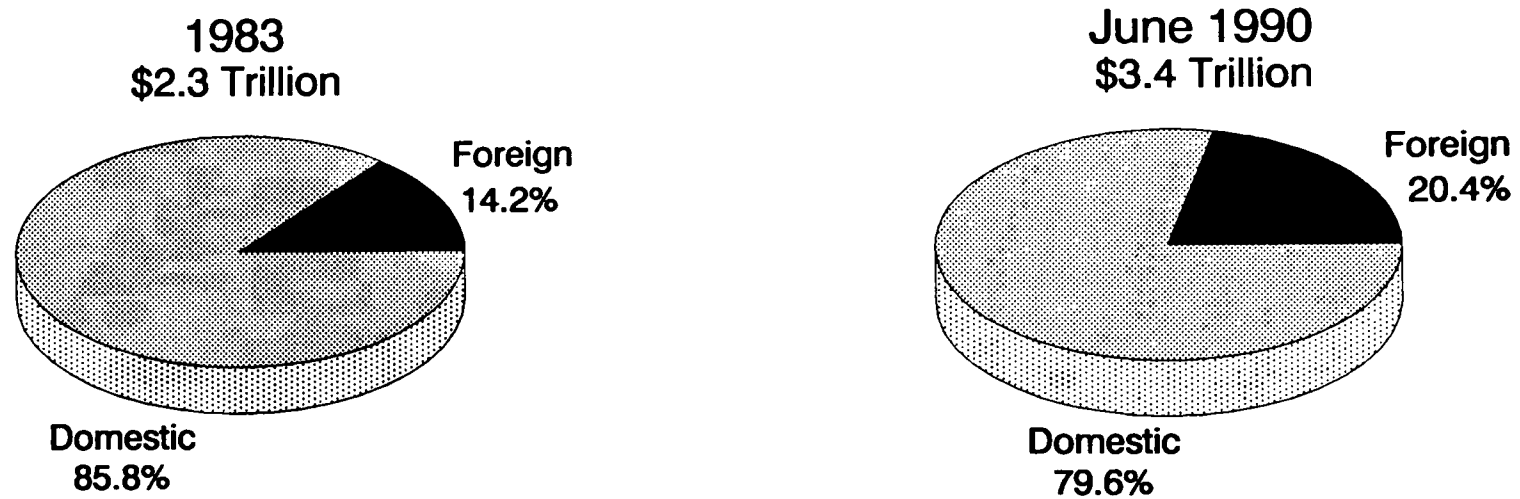
The U.S. offices of foreign-controlled banks numbered 721 as of June 1990, consisting of agencies (227), branches (362), banks (99), Edge/Agreement Corporations (23), and investment companies (10).<sup>67</sup> And as noted earlier in this paper, under the grandfathering provisions of the International Banking Act of 1978, 17 foreign banks have major U.S. securities affiliates (e.g., Credit Suisse/First Boston).

## **2. The Implications of EC '92**

Most major industrialized countries outside of the United States permit their banking organizations to engage in a wide range of services, including combinations of banking, securities and insurance (Table 10).<sup>68</sup> These models of diversified financial institutions can be expected to grow in importance under the auspices of EC '92.

The new European Community (EC) program for financial services is based on the principle of "mutual recognition." This involves harmonization of essential supervisory rules among the member countries, and agreement to recognize the validity of each other's national laws, regulations, and supervisory practices that have not been harmonized.<sup>69</sup>

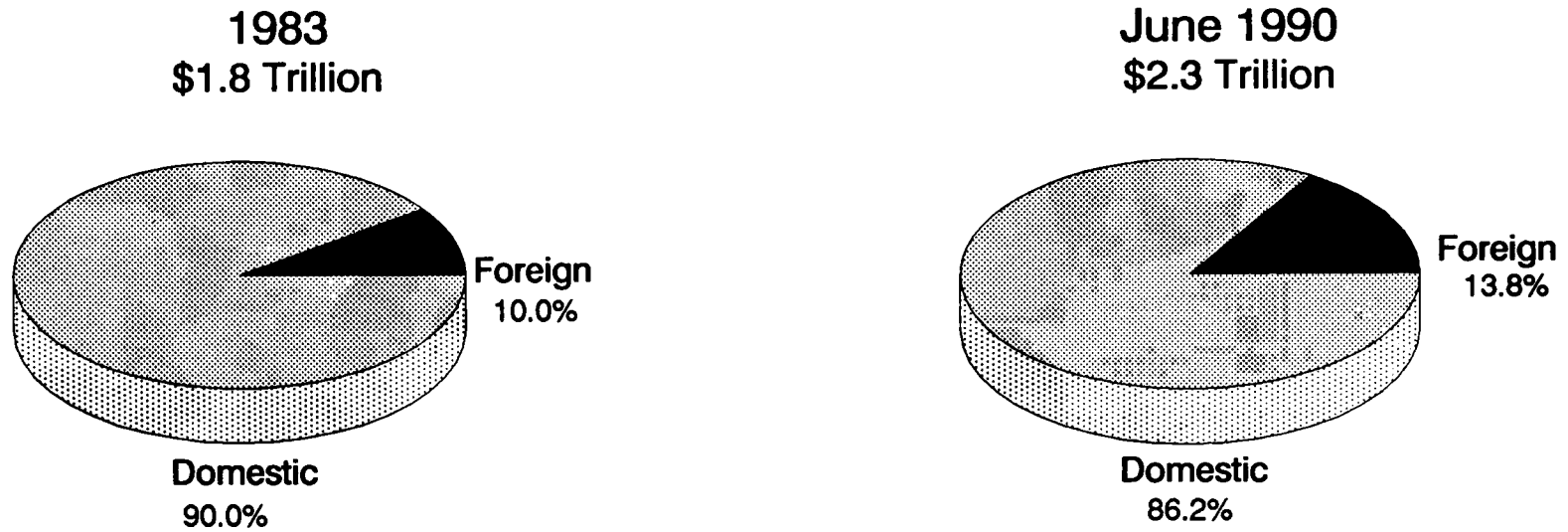
Figure 4  
Foreign Bank  
Marketshare in the United States  
by Assets



Sources: Federal Deposit Insurance Corporation, American Banker, and Federal Reserve Board.

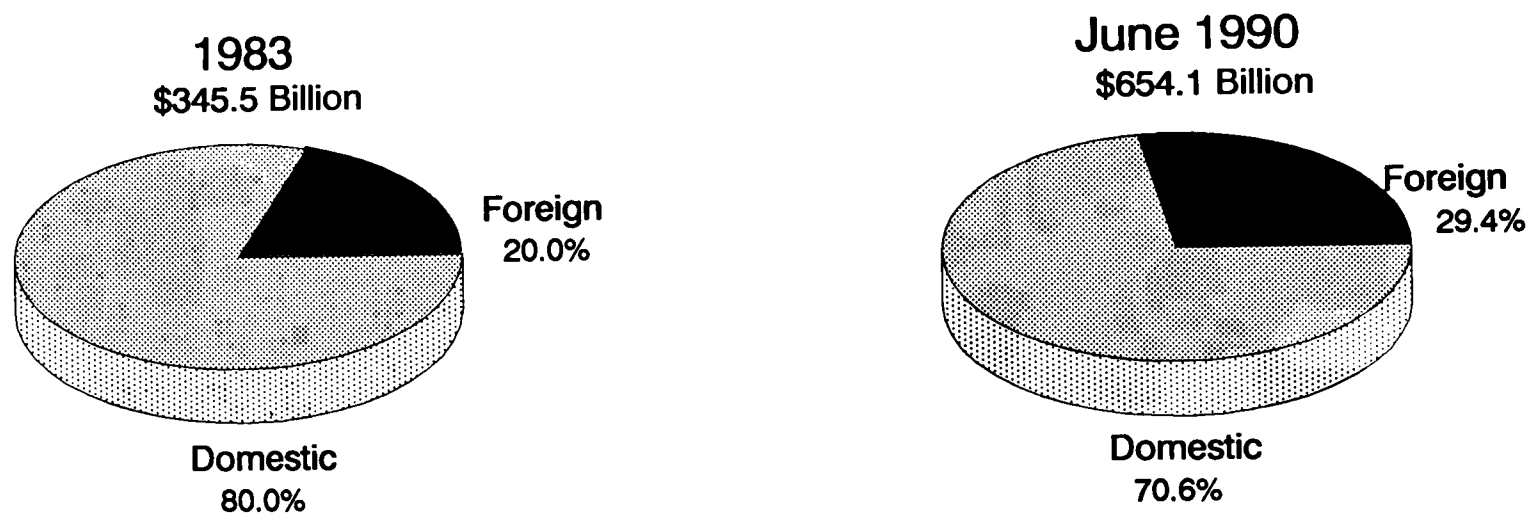


Figure 5  
Foreign Bank  
Marketshare in the United States  
by Deposits



Sources: Federal Deposit Insurance Corporation, American Banker, and Federal Reserve Board.

Figure 6  
Foreign Bank  
Marketshare in the United States  
by Commercial and Industrial Loans



Source: Federal Reserve Board and the American Banker.

Table 10

## Limits on Services of Commercial Banks

Are banks allowed to provide these services?	Belgium	Canada	France	West Germany	Italy	Japan	Luxembourg	Netherlands	Switzerland	United Kingdom	United States
<b>Insurance:</b>											
Brokerage.....	Y	N	Y	Y	N*	N	Y	Y	N	Y	N*
Underwriting.....	Y	N	N*	Y*	N*	N	Y	N	N	Y*	N
<b>Equities:</b>											
Brokerage.....	Y	Y*	Y	Y	Y	N	Y	Y	Y	Y	Y
Underwriting.....	Y	Y*	Y	Y	Y	N	Y	Y	Y	Y*	N
Investment.....	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y*	N
<b>Other underwriting:</b>											
Government debt.....	Y	Y	Y	Y	Y	N	Y	Y	Y	Y*	Y
Private debt.....	Y	Y*	Y	Y	Y	N	Y	Y	Y	Y*	N
<b>Mutual funds:</b>											
Brokerage.....	Y	Y	Y	Y	Y	N	Y	Y	Y	Y	N
Management.....	Y	Y*	Y	Y	Y	N	Y	Y	Y	Y	N
<b>Real estate:</b>											
Brokerage.....	Y*	N	Y	Y	N	N	Y	Y	Y	Y	N*
Investment.....	Y	Y	Y	Y	Y	N	Y	Y	Y	Y	N
<b>Other brokerage:</b>											
Government debt.....	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Private debt.....	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y

Notes: N = No; N\* = No, with exceptions; Y = Yes; Y\* = Yes, but not directly by the bank.

Source: American Bankers Association, *International Banking Competitiveness*, March 1990, page 82.

Based on minimal harmonization of rules, a financial institution established in any member country (the "home country") may provide certain financial services through branch or across borders in any other country in the Community (the "host country"). The provision of these financial services is regulated by the home country. This entire process is often referred to as the "single passport." The Second Banking Directive of the EC establishes a single passport for credit institutions (banks), while the proposed Investment Services Directive would do the same for nonbank investment firms.

The proposed Investment Services Directive, which has not yet been adopted, would allow an investment firm established in the EC to establish branches or provide investment services throughout the Community without further authorization. These would include brokerage activities, securities dealing, and portfolio management. The directive also would liberalize membership rules for exchanges involving stocks, financial futures, and options.

#### **The Second Banking Directive**

The Second Banking Directive, which will take effect on January 1, 1993, will allow EC banks to engage in activities associated in the U.S. with commercial and investment banking, including underwriting and trading of securities, portfolio management, and advising on mergers and acquisitions (Table 11). Within limits, EC banks will also be permitted to hold for their own account shares in non-financial institutions. In short, it will be possible for any bank established in the EC to engage in universal banking throughout most of Europe.

Moreover, EC banks may undertake an even broader range of financial activities than those subject to mutual recognition in the Second Banking Directive, with the permission of their home country supervisors and subject to local rules in each member state. Selling and underwriting insurance is such an activity. As banks provide their services cross-border, it is widely expected that some movement towards convergence of national regulations will take place and that through market forces the most flexible system will set the standard that others will follow.

In conclusion, it has been stated with respect to the Second Banking Directive that "the action the EC has taken would be comparable to the removal of Glass-Steagall, McFadden, the Bank Holding Company Act, and many state laws and regulations in the United States."<sup>70</sup>

**Table 11**

**Activities Authorized for European Community Banks  
by the Second Banking Directive**

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Deposit taking and other forms of borrowing.  
Lending.  
Leasing.  
Payments devices (credit cards, electronic funds transfer, point of sale, travelers checks, and bank drafts).  
Guarantees and commitments.  
Trading on their own account or for customers in money market instruments, foreign exchange, financial futures and options, exchange and interest rate instruments, and securities.  
Participations on issues of shares, bonds and other securities.  
Corporate advice, arranging mergers and acquisitions.  
Money brokering.  
Portfolio management and advice.  
Safekeeping of securities.  
Credit reference services.  
Safe custody services.

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Source: American Bankers Association, *International Banking Competitiveness*, March 1990, page 26.

## **Strategic Implications**

European banks and other financial firms already are making adjustments in anticipation of 1992. These adjustments include numerous cross-border and cross-industry transactions. For example: Deutsche Bank recently acquired Morgan Grenfell of the U.K. and Bank of America's Italian franchise; Credit Lyonnais bought a bank in Italy; Banco Hispano Americano bought a five percent stake in Commerzbank; the U.K.'s Lloyd's Bank purchased controlling interest in Abbey Life; Dresdner Bank entered into a partnership with the Allianz insurance agency; and Banque Nationale de Paris has formed an alliance with the largest French insurance company Union des Assurances; among others.<sup>71</sup> All of these moves clearly indicate that European financial firms intend to consolidate into larger, diversified, and cross-border entities in order to successfully compete in domestic and foreign markets. This is happening at a time when U.S. financial firms are withdrawing from international markets, selling off diverse product lines, and generally downsizing assets.

### **F. Conclusions: The Need for Financial Modernization**

Conceptually, financial intermediaries are little more than portfolio managers. In effect, they invest their assets in an array of financial activities according to their competitive advantage, the degree of acceptable risk, the demands of the marketplace, the structure and cost of their funding, and so on. In the current regulatory environment, however, financial services firms are often constrained in their ability to respond to developments in the marketplace.

The market environment in which all financial intermediaries must now operate has been revolutionized from that known just a few years ago. Technology and customer sophistication have combined to create a demand for new products deliverable on both a national and international scale. Active portfolio management requires discretionary ability to diversify investments and funding sources as dictated by a changing environment. Clearly, if all financial services firms were able to adjust in a rational manner, there would be no issue of financial institutions restructuring. But this is not the case.

The central problem facing the U.S. financial services industry today is that long-standing regulation has prevented all classes of financial institutions from structuring their asset and liability portfolios so that natural synergies can be realized. As already seen, these barriers to the efficient use of resources have been most notable, and most costly, with respect to the nation's federally insured depository institutions, especially commercial banks. The need for financial modernization in the U.S. has given rise in recent

years to a large number of financial reform proposals by various parties.

## **1. Alternative Reform Proposals**

As discussed in this chapter, banking organizations, other financial services firms, and even commercial and industrial entities have been intertwined in various manners and degrees over time. However, no consensus on how the financial services industry should be structured, or on the proper degree of integration between firms offering financial services and "commercial" business, has emerged in the U.S.

The financial reform models that are receiving serious attention currently can be grouped into one of three basic classes: (1) the U.S.-style holding company, in which banking activities are carried out in a banking subsidiary of the holding company, and non-banking activities are carried out in separate subsidiaries of the holding company; (2) the English and Canadian-style universal bank, in which banking activities are carried out in the bank, non-banking activities are carried out in direct subsidiaries of the bank, and no separate holding company exists; and (3) the German-style universal bank, in which a single entity engages in all banking and securities activities directly but through segmented departments.

### **The U.S. Bank Holding Company**

The bank or financial services holding company is almost unique to the United States. As discussed earlier, these companies are formed to circumvent geographic restrictions on branching and to engage in certain operations that may be prohibited for banks directly. Almost all of the larger bank holding companies have subsidiaries and affiliates in states outside of the states in which they are headquartered, including operations abroad.

Because foreign banks are (to a large extent) permitted to combine banking and securities activities, they do not need holding companies to consolidate control. However, holding companies do exist in France and Belgium for the purpose of integrating banking and commercial activities.

### **The European Universal Banks**

Under a universal banking system (British or German), financial integration exists to the extent that a single institution can provide the entire spectrum of financial services. Banking laws in the United Kingdom generally impose very few restrictions on the activities in which banks may engage or the investments they may make. Most securities and insurance activities are carried out in subsidiaries of the bank, although

this is a tradition that appears to be changing in favor of the German style of banking. There is no statutory limitation on investments by U.K. banks in industrial companies; however, such investments are not common. Therefore, there is a limited combination of banking and commercial activities. Supervision of the British universal bank is a responsibility shared by the Bank of England (BOE) and the Securities and Investment Board (SIB), with the former assuming primacy in areas of overlapping jurisdiction.

The German model is arguably the most liberal in the world and is generally perceived to be the model for the future in the European Community. Any institution engaging in banking activities is defined as a bank. Included in the permissible activities of a German bank are the taking of deposits, consumer and commercial lending, securities underwriting and trading, mutual fund operations, and investment counseling. With a banking license, any entity is permitted to hold large equity shares in commercial, industrial and insurance companies. However, by law these activities must be engaged in within different departments of the bank. Supervision of the German universal bank is highly consolidated, with the Federal Banking Supervisory Office (FBSO) under the Finance Ministry serving as the primary supervisor.

## **2. Major Public Policy Considerations**

Financial services modernization in the United States is clearly needed for all of the reasons examined in this paper, and the major models outlined above provide alternatives to be considered. Within the context of modernization, the major public policy objective must be to insulate the insured bank in such a way that the federal safety net is not extended to nontraditional activities, exposing the federal deposit insurance fund and the taxpayer to increased risk of loss. Other public policy objectives should include enhancing the overall safety and soundness of the financial system, increasing the capital base of the banking industry, advancing functional regulation, promoting efficient resource allocation (including the prevention of unfair competition related to safety net subsidies) and positioning U.S. financial institutions as stronger competitors in the global marketplace.

### **Insulating the Insured Bank**

In a 1987 study, the GAO examined in detail the issue of insulating banks from the risks posed by expanded activities.<sup>72</sup> Three structural approaches commonly taken to achieve insulation were examined, including bank departments, bank subsidiaries, and bank holding company subsidiaries. "Insulation" was measured in terms of the degree to which different organizational structures established legal, economic, and "market perception" separation of the insured bank from the unit offering expanded activities.



Legal separation requires that the courts recognize the independence of the entities involved, in short, that: (1) each corporate unit be separately financed in a manner sufficient to withstand normal business strains; (2) the day-to-day business operations, including books and records, be separately maintained; (3) formal barriers between the management structures of the units be maintained; and (4) the two units not be publicly represented or advertised as being one entity.<sup>73</sup> Economic separation is achieved to the extent the bank and the nonbank unit are separately and adequately funded, the assets of the two units are not commingled, and transactions between the two are done on the basis of rates and terms comparable to those with non-affiliated parties.<sup>74</sup> Finally, according to the GAO, "even if legal and economic separation are attained, full insulation requires that the public recognize the separate nature of the bank and the affiliate performing the nontraditional activity." This, in turn, means that the relationship between the bank and its affiliate cannot be represented in an unclear or ambiguous manner to the public.<sup>75</sup>

Of the three organizational structures the GAO examined, it found the bank department to be the least effective at achieving insulation. This is largely because the bank department is not a legally separate unit from the insured bank. The GAO found that bank subsidiaries and bank holding company subsidiaries generally afforded a good degree of legal and economic protection to bank deposits, although "neither fully protected the bank from market perception risk."<sup>76</sup>

The separation of insured banks from the risks of expanded activities has as its major advantage the protection of insured deposits and the federal deposit insurance fund. Separation is also important to prevent the transfer of safety net subsidies from the bank to its affiliates in order that competitive equity be maintained. Appropriate legal protections would limit a bank's potential loss only to the amount of its investment; economic separation would limit a bank's ability to financially assist its affiliate, thereby protecting bank liquidity and solvency while assuring fair competition; and market perception protections minimize the risk of the public confusing the problems of the nonbanking unit with the bank, avoiding potential runs on the bank.<sup>77</sup>

But complete insulation does not come without significant disadvantages. For example, a rigid structural approach to separation might impose prohibitive legal, administrative, and personnel costs on some banking organizations, especially small ones. And excessive restrictions on marketing activities can largely defeat the benefits from the synergies of providing a range of products. In fact, the GAO concluded that, "depending on its scale and potential profitability, banks might choose not to conduct a new activity if an imposed insulation structure were

too expensive or inconvenient. In addition, if they could not use their established names and reputations, they might not see much value in conducting new activities."<sup>78</sup>

For all of the foregoing reasons it can be argued that the firewalls applied to expanded bank activities should be kept to the minimum necessary to protect insured deposits and prevent unfair funding subsidy. The most important of these are funding firewalls which, in fact, already exist to some degree in the form of restrictions on the dividend payments of banks and the transactions restrictions of Sections 23A and 23B of the Federal Reserve Act. Particular attention should be focused on what limits, if any, in addition to these would be necessary to limit the exposure of the bank.

### **Safety and Soundness**

Allowing financial intermediaries, and banking organizations in particular, to engage in expanded activities subject to appropriate insulation and funding firewalls is consistent with safety and soundness and the protection of depositors and taxpayers. New financial products and services would enhance, not jeopardize, safety and soundness of the financial system by giving financial intermediaries the opportunity to compete effectively and profitably, pursue their natural expertise in the production and distribution of related services, attract the capital needed for long-term financial strength, and generally to evolve with the marketplace. Most importantly, the banking industry must be permitted to adapt to a changing environment if it is to continue to be a vital component of the national economy.

### **Functional Regulation**

To the extent possible, financial services modernization ought to be conducive to, and encourage, functional regulation in order that largely comparable activities offered by different financial institutions are regulated on an equivalent basis. This would help to eliminate certain drawbacks of the current system of "institutional regulation," in which a single agency is primarily responsible for enforcing the various regulations that may apply to the various activities of a given firm. Institutional regulation often involves duplication of regulatory efforts among various agencies (e.g., five separate agencies regulate the securities activities of banks and thrifts). Also, institutional regulation can result in the non-uniform regulation of comparable activities when different types of institutions compete across industry lines, as is now commonplace.<sup>79</sup>

## **Efficient Resource Allocation**

Allowing financial intermediaries to offer a wide range of financial products and services would have a positive effect on all types of economic activity, not just the financial services sector. For example, banking organizations could offer customers additional -- and innovative -- financial products and services that formerly were offered only by securities and insurance firms, among others. Nonbank financial firms could expand the types of financing they can offer and develop new products based on their unique perspectives of the financial marketplace. For businesses and consumers there would be more financial vendors offering a greater variety of products at competitively lower prices. The resulting efficiencies would benefit the corporate and household consumers of financial services, while a more stable stream of income across financial services firms would contribute to the overall stability of financial markets.

## **Global Competition**

A final consideration in the restructuring of the U.S. financial system is the need to be competitive in the global marketplace. Without question, the U.S. banking system appears to be the most restricted among the developed economies. Most other industrialized nations permit comprehensive combinations of banking and finance as well as varying degrees of banking and commerce. The European Community is acknowledged as setting the trend for the future with the adoption of the highly flexible "universal" banking license, which is not burdened with numerous and counterproductive firewalls. Financial services modernization in the United States that ignores these facts of the global marketplace will fail to reverse the declining competitiveness of U.S. institutions.

## Endnotes

<sup>1</sup> Hutchinson, Harry D., Money, Banking, and the United States Economy, 4th ed., Prentice-Hall, Inc., Englewood Cliffs, N.J., pg. 59.

<sup>2</sup> Ibid., pp. 59-60.

<sup>3</sup> Ibid., pg. 60.

<sup>4</sup> Auerbach, Robert D., Money, Banking, and Financial Markets, Macmillan Publishing Co., Inc., New York, 1982, pp.84-85, 451-452.

<sup>5</sup> Ibid., pp. 456-457.

<sup>6</sup> Ibid., pg. 458.

<sup>7</sup> Mishkin, Frederic S., Money, Banking, and Financial Markets, Little, Brown and Company, Boston, 1986, pg. 327.

<sup>8</sup> Ibid.

<sup>9</sup> Hutchinson, op. cit., pg. 84.

<sup>10</sup> Department of the Treasury, Deposit Interest Rate Ceilings and Housing Credit, August 1979, pg. 34.

<sup>11</sup> Ibid., pp. 34-35.

<sup>12</sup> Working Group of the Cabinet Council on Economic Affairs, Recommendations for Change in the Federal Deposit Insurance System, January 1985, pp. 3-4.

<sup>13</sup> American Bankers Association, Commercial Banking and the Glass-Steagall Act, Washington, D.C., 1982, pp. 32-33.

<sup>14</sup> Ibid., pg. 34.

<sup>15</sup> Ibid., pp. 49-51.

<sup>16</sup> Subcommittee on Telecommunications, Consumer Protection and Finance of the Committee on Energy and Commerce, U.S. House of Representatives, Restructuring Financial Markets: The Major Policy Issues, Washington, D.C., July 1986, pg. 72.

<sup>17</sup> Ibid., pp. 53-56.

<sup>18</sup> FDIC regulations permit insured state-chartered nonmember banks to affiliate with or acquire as a subsidiary any company engaged in the business of issuing, underwriting, selling

or distributing securities as permitted by state law for such banks. (12 C.F.R. 337.4) These regulations provide that a securities subsidiary must meet certain requirements and is limited to underwriting certain types of "investment quality" securities; however, if the subsidiary has been in operation for five years it can underwrite any security. Direct investment in a securities subsidiary is not counted toward such bank's capital. Loans and other extensions of credit by an insured state nonmember bank to a securities subsidiary or affiliate are subject to the loan limitations and other restrictions of section 23A of the Federal Reserve Act (12 U.S.C. 371c). The FDIC's regulations have survived legal challenge. In Investment Company Institute v. FDIC, the district court determined that Section 21 of the Glass-Steagall Act does not apply to the securities activities of subsidiaries or affiliates of state nonmember banks. Investment Co. Inst. v. FDIC, 606 f. Supp. 683 (D.D.C. 1985), aff'd, 815 f.2d 1540 (D.C. Cir.), cert. denied, 484 U.S. 847 (1987).

<sup>19</sup> Hutchinson, op. cit., pg. 105.

<sup>20</sup> Association of Bank Holding Companies, The Supervision and Regulation of Bank Holding Companies: An Assessment of Objectives and Implementation, Washington, D.C., 1978, pp. 39-40.

<sup>21</sup> Ibid., pg. 40. In particular, according to Savage, "The law laid down these conditions for receiving a permit: (1) bank holding companies, as well as their subsidiary banks, were subject to examination; (2) all subsidiary banks were subject to examination individually and in conjunction with the examination of other subsidiary banks and the holding company; (3) individual or consolidated statements of condition of subsidiary banks were to be published and made available to the regulators; (4) the holding company had to maintain a reserve fund of marketable assets that would eventually grow to 25 percent of the par value of bank stocks owned by the holding company; (5) employees of bank holding companies were subject to the criminal penalties applicable to bank employees for crimes such as false entries; (6) securities companies were to be separated from bank holding companies within five years; and (7) bank holding companies could not pay dividends from funds other than their net earnings." See, Savage, Donald T., "A History of the Bank Holding Company Movement, 1900-78," in The Bank Holding Company Movement to 1978: A Compendium, Board of Governors of the Federal Reserve System, Washington, D.C., 1978, pp. 36-37.

<sup>22</sup> Fischer, Gerald C., Bank Holding Companies, Columbia University Press, New York, 1961, pg. 68.

<sup>23</sup> Association of Bank Holding Companies, op. cit., pg. 41.

<sup>24</sup> Source of data, the Investment Company Institute.

<sup>25</sup> Lockett, op. cit., pp. 99-101.

<sup>26</sup> Mishkin, op. cit., pp. 231-233.

<sup>27</sup> Chessen, James, "Third Quarter Update: Bank Off-Balance Sheet Activity," Regulatory Review, Washington, D.C., November/December 1987, pp. 1-8.

<sup>28</sup> As reported in a special supplement, "Asset Securitization," in the American Banker, June 8, 1990.

<sup>29</sup> According to a report in the American Banker, noninterest income growth dropped from an average of 14.1% per year from 1985 to 1989, to an annualized 5.9% for the first nine months of 1990. Furthermore, fee income could be expected to drop further due to (1) the impact of a slowing economy on areas such as corporate finance and consumer banking, and (2) the lack of new fee-based businesses such as mutual funds and insurance. See, American Banker, Monday, January 7, 1991, pg. 5.

<sup>30</sup> Commercial Banking and the Glass-Steagall Act, op. cit., pg. 8.

<sup>31</sup> J.P. Morgan & Co., Incorporated, Rethinking Glass-Steagall, 1984, pp. 13-14.

<sup>32</sup> Ibid.

<sup>33</sup> Ibid., pg. 15.

<sup>34</sup> Ibid.

<sup>35</sup> According to Fischer and others, "Commercial banks, particularly the large ones, are well positioned to expand their securities activities. They possess large customer bases, trained staffs, and financially sophisticated computer systems. These firms can provide multiple services economically. In addition, some banks engage in a full range of investment banking services overseas, since United States statutes permit United States banks to follow local law. The effect of bank entry into securities activities would probably be twofold, involving enlargement of the market and, for at least some banks, success in competing with nonbank competitors. Thus, commercial banks view additional securities activities as a source of potentially high revenues for little outlay and as a vehicle for attracting additional customers." See, Thomas G. Fischer, William H. Gram, George G. Kaufman, and Larry R. Mote, The Securities Activities of Commercial Banks: A Legal and Economic Analysis, Federal Reserve Bank of Chicago, SM-85-2, 1985, pg. 471.

<sup>36</sup> Tortoriello, Robert L., Glass-Steagall Act: Current Issues Affecting Bank Underwriting, Dealing and Brokerage Activities, Cleary, Gottlieb, Steen & Hamilton, New York, 1990, pp. III-4 - III-12.

<sup>37</sup> See The Wall Street Journal, Wednesday, November 14, 1990.

<sup>38</sup> Dufey, Gunter and Adrian Tschoegl, International Competition in the Services Industries: Institutional and Structural Characteristics of Financial Services, Graduate School of Business Administration, The University of Michigan, 1986, pp. 117-119.

<sup>39</sup> American Bankers Association, Assessment of Business Expansion Opportunities for Banking, Washington, D.C., 1983, Chapters 4-5.

<sup>40</sup> United States General Accounting Office, Banking Powers: Issues Relating to Banks Selling Insurance, Washington, D.C., September 1990, pg. 17-19.

<sup>41</sup> Ibid., pp. 19-26.

<sup>42</sup> Ibid., pp. 27-36.

<sup>43</sup> Lehr, Dennis J., "Recent Court and Agency Decisions Help Pave the Way Toward Further Integration of Banking and Insurance," BNA's Banking Report, Vol. 50, Washington, D.C., May, 14, 1990, pp. 827-828.

<sup>44</sup> Bogaard, William J., "Bank Holding Companies: Definition, Regulation and Permissible Activities," Banking Law and Regulation 1989, Practising Law Institute, 1989, pg. 168.

<sup>45</sup> Lehr, op. cit., pp. 828-829.

<sup>46</sup> Ibid. Also, Bogaard, op. cit., pp. 166-167.

<sup>47</sup> Delaware's intention has been threatened by the Federal Reserve's order of September 5, 1990. Under Federal Reserve rules, a state bank's subsidiary within a holding company may engage without permission in any activity in which the bank itself may engage. But given the strict firewalls required by the Delaware law, the Federal Reserve determined that the bank itself could not effectively engage in the insurance activities and prohibited the subsidiary from doing so.

<sup>48</sup> Saulsbury, Victor L., "Activities of U.S. Banking Organizations Abroad," Regulatory Review, FDIC, Washington, D.C., October-November 1986, pp. 1-13.

<sup>49</sup> See the report of the Committee on Banking, Finance and Urban Affairs, Task Force on the International Competitiveness U.S. Financial Institutions, Washington, D.C., 1990, pp. 182-18

<sup>50</sup> Ibid., pp. 33-35.

<sup>51</sup> Subcommittee on Telecommunications, Consumer Protection and Finance, op. cit., pg. 77.

<sup>52</sup> Ibid., pg. 77.

<sup>53</sup> Ibid., pp. 77-78. Specifically, "Even the more restrictive provisions in the Model Act governing life insurers--provisions remarkably similar to the "closely related test in the Bank Holding Company Act--allow these intermediaries to act as broker-dealers for their own account (but not for the public), to manage investment companies (mutual funds) and set commingled accounts for variable annuity and variable life insurance programs. Comparable powers were denied banks under the 1970 Act and the competitive position of insurance companies as managers of investment funds was enhanced."

<sup>54</sup> Ibid., pg. 78.

<sup>55</sup> American Banker, January 2, 1991.

<sup>56</sup> Subcommittee on Telecommunications, Consumer Protection and Finance, op. cit., pg. 82.

<sup>57</sup> Ibid., pg. 79.

<sup>58</sup> American Bankers Association, International Banking Competitiveness...Why it Matters, Washington D.C., March 1990, pp. 7-10.

<sup>59</sup> Committee on Banking, Finance and Urban Affairs, op. cit., pp. 28, 31.

<sup>60</sup> American Bankers Association, International Banking Competitiveness, op. cit., pg. 9.

<sup>61</sup> Committee on Banking, Finance and Urban Affairs, op. cit., pg. 30.

<sup>62</sup> American Banker, Thursday, December 27, 1990, pp. 1, 8.

<sup>63</sup> Ibid., pp. 29, 31-32.

<sup>64</sup> Ibid., pp. 30-31.



<sup>65</sup> Federal Reserve Bank of New York, "The Performance of Internationally-Active Banks and Securities Firms Based on Conventional Competitiveness Measures," New York, May 1990, as appended to the Statement of E. Gerald Corrigan before the United States Senate Committee on Banking, Housing and Urban Affairs, May 3, 1990.

<sup>66</sup> U.S. Department of Treasury, National Treatment Study, Washington, D.C., 1990, pg. 81.

<sup>67</sup> Ibid.

<sup>68</sup> American Bankers Association, International Banking Competitiveness, op. cit., pp. 72, 82.

<sup>69</sup> Statement of Nicholas F. Brady, Secretary of Treasury, before the Senate Committee on Banking, Housing and Urban Affairs, July 25, 1990.

<sup>70</sup> Committee on Banking, Finance and Urban Affairs, op. cit., pg. 343.

<sup>71</sup> American Bankers Association, International Competitiveness in Banking, op. cit., pp. 5-6, and Committee on Banking, Finance and Urban Affairs, op. cit. pp. 325-326.

<sup>72</sup> United States General Accounting Office, Bank Powers: Insulating Banks From the Potential Risks of Expanded Activities, Washington, D.C. April 1987.

<sup>73</sup> Ibid., pp. 19-20.

<sup>74</sup> Ibid., pp. 20-21.

<sup>75</sup> Ibid., pp 22.

<sup>76</sup> Ibid., pp. 4. In a subsequent study of Glass-Steagall, however, the GAO concluded that the bank holding company subsidiary provided the best quotient of legal, economic, and market perception insulation.

<sup>77</sup> Ibid., pp 24.

<sup>78</sup> Ibid., pp. 4.

<sup>79</sup> See Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services, Washington, D.C., July 1984, pg. 39.

## **Chapter XIX**

### **REFORM OF THE REGULATORY STRUCTURE<sup>1</sup>**

#### **A. Introduction**

This chapter focuses on restructuring the U.S. regulatory system for insured depositories and is organized as follows: Section B reviews the existing system; Section C presents the most prominent arguments for and against its restructuring; Section D outlines previous restructuring proposals, including the 1984 Report of the Task Force on Regulation of Financial Services, which is reviewed in greater detail because it is the most recent joint Administration/regulatory agency study of reform; and Section E summarizes the responsibility for bank regulation and supervision in the G-7 nations and Switzerland.

#### **B. Existing Regulatory System**

The current federal financial regulatory system for insured depositories is complex, with three agencies having responsibility for regulation and supervision of commercial banking organizations (the Office of the Comptroller of the Currency (OCC), an office of the Treasury; the Board of Governors of the Federal Reserve System (Federal Reserve); and the Federal Deposit Insurance Corporation (FDIC)). There are separate agencies for thrift institutions (the Office of Thrift Supervision (OTS), an office of the Treasury) and credit unions (the National Credit Union Administration (NCUA)). (See Figure 1.) These federal agencies are discussed at greater length below.

##### **1. Banks and Bank Holding Companies**

Under the current system, overseeing the nation's 12,500 insured commercial banks is largely divided among the Federal Reserve, OCC, FDIC, and state agencies.<sup>2</sup> Banks with a national charter are regulated and supervised by the OCC. State-chartered banks that are members of the Federal Reserve System (state member banks) are regulated and supervised by the Federal Reserve and their state agency. State-chartered banks that are not members of the Federal Reserve System (state non-member banks) are regulated and supervised by their state banking agency, and supervised by the FDIC if federally insured.<sup>3</sup> The FDIC also can examine all banks it insures for insurance purposes.

The number and respective asset share of the three different types of banks is shown in Table 1 below.

**Table 1**

Distribution of Insured Commercial Banks  
(June 1990)

<u>Type</u>	<u>Number</u>	<u>% of Banks</u>	<u>Assets (\$ billions)</u>	<u>% of Bank Asset</u>
National Banks	4,066	32.5%	\$1,992	59.3
State Member Banks	1,020	8.2	567	16.9
State Non-Member Banks	<u>7,414</u>	<u>59.3</u>	<u>801</u>	<u>23.8</u>
Total	12,500	100.0%	\$3,360	100.0

Only 3 percent of the banks have more than \$1 billion in assets, but they hold slightly over 70 percent of all bank assets. Most banks are small institutions (over 74 percent have \$100 million in assets or less).

Bank holding companies (BHCs) are regulated and supervised by the Federal Reserve, even though in most cases it does not regulate or supervise the subsidiary bank.<sup>4</sup> The BHC has become the dominant organizational form of U.S. banking companies, with 70 percent of all U.S. banks now owned by BHCs. This is due in part to the BHC's ability to provide a means of interstate banking as well as geographic expansion intrastate where states have prohibited branching, as well as to operate non-bank affiliates across state lines. Accordingly, the number of BHCs has risen from only 53 in 1956, when the Bank Holding Company Act was enacted, to 5,878 as of year-end 1989, although there has been no meaningful growth since 1985. BHCs own or control banks with assets in excess of 90 percent of the total assets of domestically-chartered banks.

## 2. Thrifts and Thrift Holding Companies

There are several categories of thrift institutions.<sup>5</sup> However, except for 463 state-chartered savings banks with \$233 billion in assets (as of September 30, 1990) regulated by the FDIC and insured by BIF, all thrifts are regulated by the OTS. State-chartered thrifts are also regulated by the states. Few thrifts are organized in holding company form,<sup>6</sup> but, unlike the bank system, "unitary" and "multiple" thrift holding companies operate under substantially different regulatory restrictions. As of September 30, 1990, there were 2,389 thrift institutions not assigned to the Resolution Trust Corporation holding \$1.0 trillion in assets.

### **3. Credit Unions**

Credit unions are regulated and supervised under a dual federal-state system similar to that for banks and thrifts. The 8,658 federally-chartered credit unions holding \$128 billion of assets are supervised solely by the NCUA<sup>7</sup>. The 4,445 state-chartered credit unions holding \$67 billion of assets and insured by the National Credit Union Share Insurance Fund (NCUSIF) are supervised by both state and federal authorities. The 1,508 state-chartered non-federally insured credit unions holding \$21 billion of assets are supervised solely by their respective state authorities.

In addition to its regulatory and supervisory functions, the NCUA administers the NCUSIF, created in 1970, and the NCUA Central Liquidity Facility, established in 1979 to improve the financial stability of credit unions by meeting their liquidity needs.

Federal insurance is mandatory for federally-chartered credit unions, but is not required for most state-chartered credit unions. Only 16 states require credit unions to participate in the federal share insurance program.

#### **C. Arguments For and Against Regulatory Restructuring**

No one creating a regulatory system today from scratch would design the current structure. It effectively began with the establishment of the OCC pursuant to the National Bank Act of 1863 (modified in 1864) under President Lincoln, added other component parts in the early 20th century, and was largely completed with the Bank Holding Company Act in 1956 (as amended in 1970). It has never been comprehensively overhauled, even though technology, information flows, global competition, private sector innovation, and consumer sophistication have completely transformed the world of financial services from the time of the Great Depression and previously differentiable financial service providers have become increasingly similar.

The ultimate goals of regulatory restructuring must be to ensure a safe and sound U.S. financial system, efficient competition among financial service providers, and protection for the consumer, all through effective regulation and supervision. Major benefits that could be secured from restructuring the current regulatory system are described below, as well as potential concerns.

## **1. Arguments For Restructuring**

Proponents of regulatory reorganization focus on the considerations of accountability, efficiency, consistency, consumer benefits, and separation of the regulatory and insurance functions.

### **Greater Accountability**

Fewer agencies would clearly fix responsibility and accountability for regulation of financial institutions on specific regulators and provide a focal point for Administration, Congressional, and public concerns regarding regulatory policy. Presently, all regulators except the OCC and OTS are independent agencies, thereby requiring extensive coordination to bridge policy differences.

### **Greater Efficiency**

Fewer sources of rulemaking would eliminate the overlap and duplication of activities among the several agencies, thereby enhancing operating efficiency. Depositories would no longer need to satisfy different sets of rules, examiners, legal interpretations and so on, such as in the case of a bank facing different regulation than its BHC, even though the bank may represent virtually all the organization's assets. Otherwise, fragmented regulatory decision-making and delayed supervisory action can impair regulatory effectiveness.

### **Greater Consistency**

Fewer sets of rules to implement would make regulatory practices and requirements more consistent. Conflicting statutory provisions for which the regulators are responsible, such as the definition of "bank," can cause delay in the application of regulations. Differential treatment of institutions, resulting in potential inequities, would also be reduced or eliminated. Otherwise, this problem will be intensified as the traditional distinctions between depository and other financial service institutions continue to erode, causing more and more institutions to become subject to multiple regulatory agencies; instead, competitors in a single product area should face a common set of regulatory requirements. Moreover, the handling of problem institution cases, which frequently require extensive coordination among several regulatory agencies, would be facilitated. Inconsistencies in the regulation and supervision of BHCs and subsidiary banks would also be reduced, as a single agency that oversaw both would have more complete information. Finally, tendencies toward "competition in laxity" and "forum shopping" would decrease.

This could also improve international coordination with those in charge of regulation and supervision abroad, resulting in greater harmonization of statutory language and regulatory interpretations, higher collective confidence in supervisory actions, and more coordinated management of crises.

### **Greater Consumer Benefits**

Simplifying the regulatory and supervisory structure, resulting in significantly reduced duplication of activity performed by federal and state agencies, should reduce the cost burden on the regulated institutions. (It should be done, of course, with an eye toward a positive cost/benefit approach.) This could be especially helpful for smaller banks or BHCs where the current regulatory costs may be disproportionately larger. Such cost savings should benefit the consumer.

### **Separation of Regulator and Insurer**

There is an essential conflict in having a single regulatory agency simultaneously promote and protect an industry. The regulator/supervisor is often more receptive to new business opportunities and innovation for the depositories it oversees, even though such activities and products could entail risk, as they might well allow the institutions to better adapt over the long run to evolving demands for financial services. The insurer, by contrast, has an immediate and proper goal of ensuring a high level of solvency of the insurance fund. This approach favors a minimum of bank failures and, therefore, arouses concerns that such new activities and unproven products could cause an unfortunate and unnecessary increase in calls on the insurance fund. Separating the regulation and supervision functions from the insurance function would eliminate the perceived conflict of interest. Although such separation may lead to some redundancy (the insurer needs some examination authority to carry out its responsibilities), it could reduce the likelihood of inattentive supervision. Where no evidence of resulting regulatory lapses is evident, alternative approaches should at least ensure the consistent treatment of all federally insured depository institutions with regard to regulation and supervision as well as insurance. This approach would recognize the Administration's responsibility for taxpayer exposure through deposit insurance.

## **2. Arguments Against Restructuring**

Arguments against regulatory reorganization generally center on the themes of concentration of power, reduced innovation, and disruption of supervision.

## **Concentration of Power/Lack of Diversity**

The existence of fewer agencies would concentrate regulator power in the remaining ones, raising the danger of arbitrary or inflexible behavior. A single Federal regulator, for example, might favor the type of institution making up the preponderance of those it regulates, i.e., federally-chartered institutions over state-chartered ones, thus potentially undermining the "dual banking system" and "states rights." Agency pluralism, on the other hand, may be useful, since it can bring to bear on general bank supervision the different perspectives and experiences of each regulator, and it subjects each one, where consultation and coordination are required, to the checks and balances of the others' opinions.

### **Reduced Innovation**

Agency diversity increases the chances that innovative approaches to policy problems will emerge. Different approaches and even competition among regulators may be superior to the single agency approach. A sole regulator, not subject to challenge from other agencies, might tend to become entrenched, conservative, and shortsighted.

### **Disruption of Supervision**

A major reorganization could disrupt or undermine the effectiveness of ongoing supervision, thereby putting a strain on regulatory resources that should be devoted to resolving problems faced by the depositories.

## **D. Previous Restructuring Proposals**

### **1. Proposals Other Than the Bush Task Group Report**

Since the late 1930s numerous proposals have been put forward by both governmental bodies and private groups for reorganization of Federal regulation of depository institutions. The Bush Task Group on Regulation of Financial Services is discussed at greater length in Section E below.

In 1949 a Task Force of the Commission on Organization of the Executive Branch of Government (the Hoover Commission) suggested that: (1) the OCC more properly belonged under the Federal Reserve than in the Treasury; (2) the functions of the FDIC should be transferred to the Federal Reserve; and (3) all federal bank supervision should be combined, preferably in the Federal Reserve. (The Hoover Commission itself made no recommendations.)

In 1961, the Commission on Money and Credit recommended that the supervisory functions of the OCC and the FDIC be transferred to the Federal Reserve.

In 1965, legislation (H.R. 6885) was introduced by Chairman Wright Patman of the House Banking and Currency Committee to consolidate all federal regulatory activities of banks as well as insurance in the Treasury.

In 1971, the Hunt Commission recommended that: (1) an "Administrator of National Banks" assume the OCC's supervisory responsibilities; (2) an "Administrator of State Banks" assume the Federal Reserve's and the FDIC's supervisory responsibilities; and (3) a "Federal Deposit Guarantee Administrator" assume the FDIC's insurance responsibilities.

In 1975, the FINE Study recommended combining the supervisory and examination function of the FDIC, Federal Reserve, OCC, the FHLBB (now OTS) and the NCUA into a single "Federal Depository Institutions Commission."

In 1981, legislation (S. 1721) was proposed to consolidate the FDIC, the Federal Savings and Loan Insurance Corporation (now the SAIF) and the NCUSIF into one Federal deposit insurance fund.

In 1984, the Depository Institution Affiliation Act was introduced in Congress to accomplish more modest structural reform. The Act would have established a National Financial Services Committee consisting of the Secretary of the Treasury, the Chairmen of the Federal Reserve, FDIC, SEC and CFTC, the Comptroller of the Currency, the Secretary of Commerce, and the Attorney General. The Committee was to establish uniform principles and standards for the examination and supervision of financial institutions and other providers of financial services.

These reorganization proposals, although not an exhaustive list, have generally centered on depository institutions. (In addition, in 1989, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 made significant changes in the regulation, supervision, and insurance of thrifts.) Ongoing developments in the financial service markets suggest that this restricted focus is no longer appropriate, as depository and non-depository institutions have come to engage in similar activities and compete in the same markets. Nevertheless, recommendations of the Bush Task Group report will be reviewed at length because it was the last thorough government and agency-wide effort at studying this matter.



## 2. Proposals of the Bush Task Group On Regulation of Financial Services

In December 1982, the Task Group on Regulation of Financial Services was created to review the federal system for regulating financial services and to make appropriate legislative recommendations. The Task Group was chaired by then-Vice President George Bush, with members drawn from the Administration and heads of all the federal financial regulatory agencies. In July 1984 it released its report, Blueprint for Reform. (Legislation to implement its recommendations was introduced in 1987.)

The Task Group tried to achieve the best possible balance of the three goals it considered essential: safety and soundness, consumer protection, and competition and efficiency. Accordingly, the Task Group proposals sought to strengthen the regulatory structure through streamlining, improving accountability, increasing efficiency, and reducing cost so as to provide substantial and lasting benefits for both the American financial system and the American public. The Task Group's structural reform recommendations concerning banks and BHCs included the following.

The three existing federal bank regulators would be reduced to two by eliminating the FDIC's role in regulating and supervising state non-member banks. In almost all cases, the federal agency that regulates and supervises a bank would have similar responsibility toward its parent BHC.

A new "Federal Banking Agency" (FBA) would be created within the Treasury, enlarging the existing OCC, and regulating all national banks and their BHCs (except "international class" BHCs). Authority to establish BHC permissible activities would be transferred to the new FBA from the Federal Reserve, although it would maintain a limited veto right over new activities. The establishment of prudential standards for BHCs (such as leverage ratios) and enforcement of the Bank Holding Company Act would be a joint responsibility of the Federal Reserve and the FBA.

The Federal Reserve would be responsible for federal regulation of all state-chartered banks and their BHCs. The Federal Reserve would continue to supervise the BHCs of the very largest domestic banks, as well as those with significant international activities and foreign-owned institutions.

The FDIC would focus exclusively on providing deposit insurance and administering the deposit insurance system, with its responsibilities for routine examination, supervision, and regulation of state non-member banks transferred to the Federal Reserve and, perhaps eventually, to state agencies. The FDIC would assume new authority to review issuance of insurance to all

banks, to examine all troubled banks and sample non-troubled firms in conjunction with the primary supervisor, and to take enforcement action against violations of federal law concerning unsafe banking practices in any bank examined by it after the primary regulator failed to take such action upon its prior request.

Current federal supervision of state-chartered banks (and their holding companies) would be transferred to state regulatory agencies once they had been certified as properly qualified, thereby creating new incentives for states to assume a stronger role in supervision.

### **Role of the Treasury**

Since the creation of the OCC in 1863, the Treasury has played an integral role in the regulation of the nation's banking system. This role is both direct, through the OCC's supervision of national banks, and indirect, through the Treasury's primary responsibility for developing and implementing the Executive Branch's domestic and international financial policies, many of which have a significant impact on financial institutions. The Task Group concluded that the Treasury should therefore continue to play a major role in the regulation of the nation's banking system. Furthermore, as the department of the Federal Government with the principal responsibility for financial matters, the Treasury should help develop government policy affecting the commercial viability of the banking system.<sup>8</sup>

### **BHC/Bank Regulation**

Two principal Congressional motivations for enactment of the Bank Holding Company Act were to prevent banks from acquiring "commercial" firms (and vice versa) or engaging in most non-banking businesses through the BHC device, and to control the interstate expansion of affiliated banking organizations. The Task Group believed these objectives did not require any particular agency to handle supervisory responsibilities under the statute.

The Task Group proposed eliminating the current fragmented system under which banks and their BHCs are generally regulated by different agencies. Instead, in almost all cases, the regulation of a bank and its BHC would be unified under a single federal agency. The FBA would regulate national banks and their BHCs, while the Federal Reserve would regulate state-chartered banks and their BHCs.<sup>9</sup> There would be two exceptions. The Federal Reserve would continue to regulate and supervise all "international class" BHCs. Since 35 of the 50 companies which would have so qualified in 1984 were anchored by national banks, they would have continued to have a different regulator for their BHCs than for their national bank subsidiaries.

The second exception covered multi-bank holding companies that have both national and state-chartered subsidiary banks. The BHC would be subject to the regulator of the largest subsidiary bank, although any such BHC desiring a single federal regulator could convert all its subsidiary banks to the same form of charter, either national or state.

In most cases, the agency charged with supervising the solvency of the banking institution would have direct supervisory authority over all of that bank's affiliated companies. Therefore, "forum shopping" between regulators, by assigning transactions to the BHC or the subsidiary bank, would not take place as the regulator would have authority over all such transactions.

The Task Group decided that two different federal agencies were not necessary for supervision of state-chartered banks. Since the aggregate asset share of state member and non-member banks was almost equal, either the FDIC or Federal Reserve could logically assume all federal regulatory responsibility for these institutions; the Task Force recommended the Federal Reserve. However, many of these state non-member banks were expected ultimately to be examined and supervised solely by state authorities pursuant to the proposed certification program.

#### **Summary**

To summarize, the major recommendations emerging from the Bush Task Group were as follows:

- o Reducing the number of federal regulators.
- o Having a bank and its BHC regulated and supervised by the same regulator.
- o Retaining the dual banking system.
- o Eliminating FDIC regulation and supervision of banks, while enhancing its authority to act as the insurer.
- o Preserving the Administration's substantial role, through the Treasury, in policy-making for the nation's banking system.
- o Maintaining a meaningful role for the Federal Reserve to back up its responsibilities as a central bank.

## **E. Responsibility for Bank Regulation and Supervision in G-7 Countries and Switzerland**

In the G-7 countries and Switzerland, the respective Finance Ministries and central banks are responsible for bank regulation and supervision in varying degrees, with the Finance Ministries playing a prominent role. In Japan the Minister of Finance has a direct, primary role in bank supervision. In Germany, Canada, and Switzerland independent banking commissions that are formally organized under the Ministry of Finance are the primary supervisors of financial institutions. In the United Kingdom, France, and Italy the central banks are primarily responsible for bank supervision, although in the latter two countries the Minister of Finance chairs broad policy committees on financial structure and banking regulation. The situation in each individual country is explored at greater length below.

In Japan, the Ministry of Finance has responsibility for bank licensing, regulation and supervision. Such bank supervision, including direct examination responsibility, is shared with the Bank of Japan, which has entered into broad supervisory agreements with all individual banks and many other financial institutions as a condition of access to bank credit services and payment facilities.

In Germany, bank regulation and supervision are the responsibilities of the Federal Banking Supervisory Office (FBSO), an agency of the Finance Ministry with a relationship similar to that between the OCC and the Treasury. For certain regulatory changes the concurrence of the Bundesbank is required. In addition, commercial banks regularly report to the Bundesbank, which in turn analyzes these supervisory reports and shares its findings with the FSBO. Both the FBSO and the Bundesbank have authority to undertake bank examinations, but both normally rely on independent auditors to perform this function.

In Canada, bank regulatory policy is determined by the Finance Ministry. Bank regulation and supervision are the responsibility of an independent agency, the Office of the Superintendent of Financial Institutions, whose head is appointed by the Finance Minister.

In Switzerland, bank regulation and supervision are the duty of the Federal Banking Commission, which is independent of the Government and the Swiss National Bank, but administratively comes under the Ministry of Finance.

In the United Kingdom, although the legislative framework for supervision is established by the Treasury, bank regulation and supervision are the responsibility of the Bank of England, whose Governor is appointed by the Prime Minister.

In France, policy for overall bank regulation is established by the Committee for Bank Regulation, which is chaired by the Finance Minister, with the Governor of the Bank of France as Vice Chairman. Bank supervision is the primary responsibility of the Banking Commission, of which the Governor is chairman and a high ranking Finance Ministry official is Vice Chairman. The Governor is nominated by the Finance Minister.

In Italy, bank supervision is the responsibility of the Bank of Italy. Policy decisions of the Government are made by the cabinet-level Inter-Ministerial Credit and Savings Committee, chaired by the Minister of Treasury. The Treasury Ministry has responsibility for inspecting the Bank of Italy.

## Endnotes

<sup>1</sup> This chapter draws heavily from the Blueprint for Reform: Report of the Task Group on Regulation of Financial Services (July 1984). All data are as of June 30, 1990, unless otherwise indicated. "Regulation" refers to the establishment of rules, and "supervision" to their enforcement through an examination of operations.

<sup>2</sup> The Federal Reserve, as of December 31, 1990, had an estimated 1,691 employees engaged in bank regulation or supervision. The estimated comparable employment for the OCC, as of June 30, 1990, was 2,736; for the FDIC - 3,190 (excluding 5,130 employees in its liquidation function); for the OTS - 3,302; and for the NCUA - 888 (year-end 1989).

<sup>3</sup> Virtually all commercial banks are insured by the FDIC through the Bank Insurance Fund (BIF). Insurance is mandatory for national and state member banks, but remains optional for state non-member banks. However, all states except Rhode Island require commercial banks to be federally insured. The Rhode Island legislature reportedly is considering making federal insurance mandatory for its banks as well.

<sup>4</sup> Although there are both "one-bank" and "multi-bank" holding companies, the 1970 amendments to the Bank Holding Company Act eliminated any regulatory difference.

<sup>5</sup> "Thrift institutions" include several different types of federal or state-chartered institutions originally designed to promote thrift or savings by individuals. The 1,659 savings and loan associations (almost evenly divided between state and federal charter) comprise 67.7 percent of the number of thrift institutions, and hold 49.6 percent of aggregate thrift assets. All federal thrifts and many state thrifts are insured by the FDIC through the Savings Association Insurance Fund (SAIF).

Savings banks represent the other basic category of thrift institution. Prior to the Garn-St Germain Act of 1982 there were no federally-chartered savings banks, as the Federal Home Loan Bank Board (FHLBB, now the OTS) did not have authority to issue any charters other than for S&Ls. As of December 31, 1989, there were 18 savings banks operating under federal charter holding \$34 billion in assets. State-chartered savings banks have assumed a variety of different forms in different states, and the states have been issuing savings bank charters for over 100 years.

<sup>6</sup> This is largely attributable to the 56.7 percent of non-conservatorship SAIF-insured thrifts that are organized in the traditional mutual form of ownership. Moreover, traditionally broad investment powers of thrift service corporations have been utilized instead of holding companies for engaging in a wide

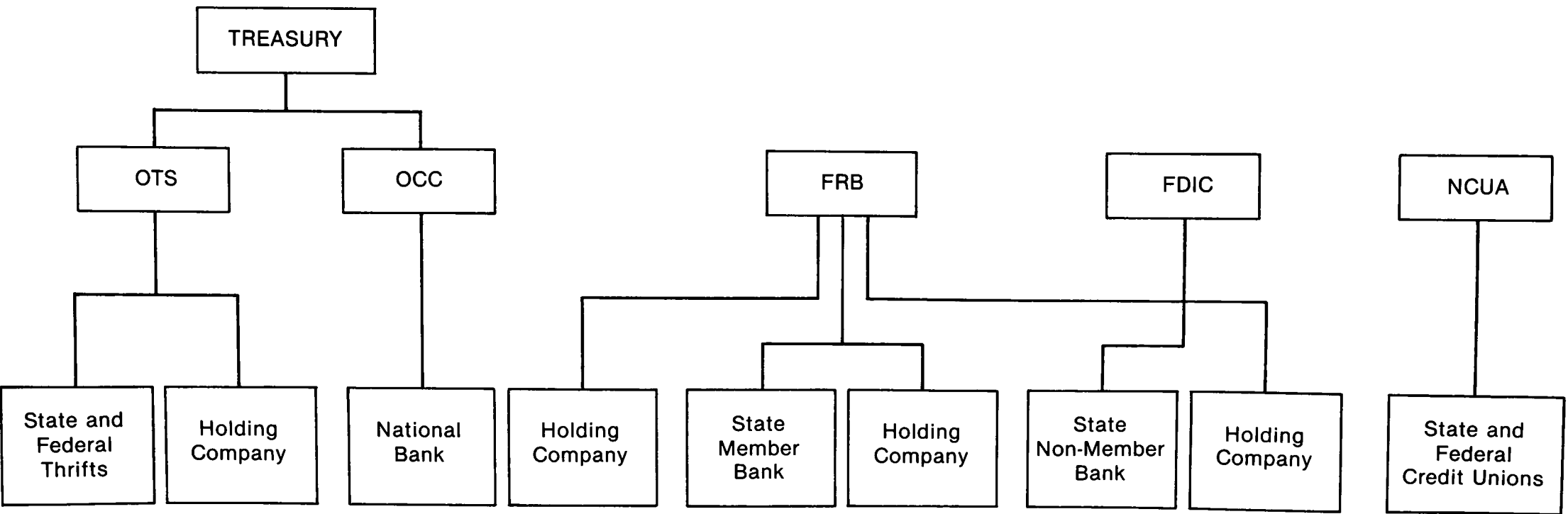
range of financial and non-financial activities. As thrifts increasingly convert from the mutual to stock form of ownership the use of thrift holding companies can be expected to grow significantly.

<sup>7</sup> Approximately 90 percent of the \$216 billion U.S. credit union assets were held by federally-insured credit unions.

<sup>8</sup> In 1989 Congress further confirmed the importance of Treasury's role in the financial regulatory system by making the OTS part of the Treasury.

<sup>9</sup> To the extent that state agencies became fully certified a state-chartered bank and its BHC could also be exclusively supervised and examined by its state regulatory agency rather than the Federal Reserve.

Figure 1  
Current Federal Regulation and Supervision of Insured Depositories  
and their Holding Companies





## Chapter XX

### BANKRUPTCY EXEMPTIONS

#### A. Introduction

Title X of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) directs the Secretary of the Treasury to investigate, review, and evaluate the impact on the deposit insurance funds of varying state and federal bankruptcy exemptions and the feasibility of: (1) uniform exemptions; (2) limits on exemptions when necessary to repay obligations owed to federally insured depository institutions; and (3) requiring borrowers from federally insured depository institutions to post a personal or corporate bond when obtaining a mortgage on real property.

The magnitude of losses incurred in failed banks and thrifts in recent years has increased the importance of maximizing recoveries on assets in liquidation. Bankruptcy exemptions limit the amount of funds available to satisfy creditors. That, combined with the perception that some of the defaulting debtors are "getting off easy," has prompted suggested changes in the law governing bankruptcy exemptions.

This chapter is organized as follows: Section B discusses the policies underlying bankruptcy exemptions; Section C explains the exemptions contained within the United States Code; Section D analyzes the reform proposals listed in FIRREA in light of the general underlying policies and the existing federal exemptions, and Section E provides a summary.

#### B. Policies behind Exemption Provisions

Exemption laws limit the amount of a debtor's property available to satisfy debts owing to general unsecured creditors. The exemptions do not directly relate to deposit insurance reform per se. Instead, the issues surrounding the proposed changes to exemption provisions relate to asset quality risks. Preventing bad loans and providing better recourse against insolvent borrowers are crucial to reducing asset quality risks, which are directly affected by the amount of property available to satisfy the obligations. The goal of reducing asset quality risk in insured institutions is often in conflict with the states' interests in bankruptcy exemptions for debtors.

Only individuals, not corporations, can utilize the state and federal exemptions. When an individual is in bankruptcy, the property available to unsecured creditors is limited by "exemptions" provided for in the United States Bankruptcy Code. The Code sets out the maximum value of federal exemptions, which include \$4,500 of personal property, \$7,500 for a residence, \$1,200 for an automobile, and \$750 for tools of trade. However, the Code also allows each state to opt to define its own exemptions. As will be discussed later, the dollar amounts of the exemptions differ greatly from state to state.

The three possible reforms of the exemption provisions<sup>2</sup> found in FIRREA would reduce asset risk by increasing the amount of property available to satisfy debts.

The basic function served by federal and state exemptions is essentially the same: to assure that a debtor is left with certain basic necessities that may not be liquidated to satisfy the claims of creditors without the debtor's consent.<sup>3</sup> This goal has lengthy historical precedent: since antiquity, certain debtor property has always been exempt from creditor collection action, even where the legal regime provided for harsh debt collection practices.<sup>4</sup>

The states and the federal government have implemented this policy in a wide variety of ways.<sup>5</sup> Some exhibit a pro-creditor bias and provide for limited exemptions, while others provide for more generous exemptions. Exemptions often reflect the basic nature of a state's economy.<sup>6</sup> For example, predominantly agrarian states often provide for a more generous protection of the family farmland. Table 1 provides some examples of differences in exemptions in several states.

Exemptions in federal bankruptcy law have historically served an additional, crucial function. Under the Constitution, only the federal government can enact a scheme of bankruptcy that relieves debtors from contractual obligations.<sup>7</sup> The states are prevented from providing such relief by the constitutional prohibition against states passing laws which impair contracts.<sup>8</sup> It has thus been the unique power of the federal government to provide debtors with a "fresh start"--relief from their creditors to enable them to start again debt-free. The fresh start and the federal government's unique power to discharge the debtor from legal obligations has always been a central tenet of federal bankruptcy policy.

This discharge would be meaningless if the debtor was left with nothing. For this reason, the current Bankruptcy Code, following the precedent of previous federal bankruptcy acts, exempts certain property to provide the debtor with basic necessities. This is true even if relief from the debt is not granted due to fraudulent conduct by the debtor.<sup>9</sup>

Table 1

Comparison by Select States of the Maximum Limits on Exemptions That a Debtor May Claim <sup>1</sup>

Asset	California	Florida	New York	Pennsylvania	Texas	Federal
Bank deposit.....	\$750.....	\$0 <sup>2</sup> .....	\$5,000.....	\$0 <sup>2</sup> .....	\$0 <sup>2</sup> .....	\$0 <sup>2</sup>
Residence.....	\$45,000.....	Unlimited up to 160 acs. rural; ½ ac. in muniapacity.	\$10,000.....	\$0 <sup>2</sup> .....	Unlimited up to 200 acs.	\$7,500
Personal property ....	Unlimited.....	\$1,000.....	\$5,000.....	\$300 <sup>3</sup> .....	\$30,000.....	\$4,500
Autos.....	\$1,200.....	0 <sup>2</sup> .....	\$2,400.....	0.....	Included in the personal property computation.	\$1,200
Tools of trade.....	\$5,000.....	0 <sup>2</sup> .....	\$600.....	0.....	Unlimited.....	\$750
Wages.....	50 percent.....	Unlimited.....	50 percent.....	Unlimited while in the hands of the employer.	Unlimited.....	0

<sup>1</sup> This chart is very generalized for the purpose of illustration. It assumes joint bankruptcy debtors with dependents, and that the various eligibility conditions required by the each state are satisfied, but does not address various exceptions recognized by each state.

<sup>2</sup> These are included in the computation for the personal property exemption.

<sup>3</sup> In Pennsylvania, property held in tenancy by the entirety (community property) is exempt in an unlimited amount.

Source: 7 Collier on Bankruptcy (15th ed. 1989).

Until the Bankruptcy Reform Act of 1978, Congress had not provided uniform federal exemptions since the Bankruptcy Act of 1841. In the Bankruptcy Act of 1867 and in the Bankruptcy Act of 1898, Congress chose to incorporate state exemptions. As noted above, the 1978 Act does not impose a mandatory set of federal exemptions, but allows the states to opt-out of the federal system.<sup>10</sup>

There are a number of reasons for this reliance on state exemptions, but the most frequently stated policy in favor of this structure is that a debtor's needs for a fresh start vary from region to region and that the state legislatures are better able to determine these regional differences than Congress.<sup>11</sup> A farmer in Nebraska, for example, will need different assets for his fresh start than a factory worker in New York City. Thus, Congress incorporated this regional expertise into bankruptcy acts over the years, rather than devising a system of nationally applicable exemptions. This is continued in the Bankruptcy Reform Act of 1978, where Congress permits the states to elect their own sets of exemptions, rather than the federal exemptions provided in Section 522(d).<sup>12</sup>

### C. The Bankruptcy Code's Exemption Provisions

Section 522 of the Bankruptcy Code contains the provisions governing exempt property. The section permits debtors to choose between two sets of exemptions: (1) federal law, which lists a variety of types of property that are exempt under the Bankruptcy Code; and (2) the exemptions of the debtor's domiciliary state. Section 522(b)(1), however, allows each state to require a debtor in a bankruptcy case to use the exemptions provided by the state in which the debtor is domiciled; this is the so-called "opt-out" provision. Unless the state specifically prohibits it, a debtor may choose between the exemptions of his domiciliary state or the federal exemptions.

Thirty-seven states have enacted the prohibition created by the "opt-out" provision of Section 522.<sup>13</sup> With so many states opting out of the Section 522 exemptions, the available exemptions vary widely from state to state. For example, Texas' homestead exemption allows a debtor to protect a homestead of up to 200 acres for a family, with no limit on value, and personal property worth \$30,000.<sup>14</sup> Pennsylvania, an example of a state with considerably less generous exemptions, protects personal property consisting only of Bibles, wearing apparel, school books, and \$300 of other property.<sup>15</sup>

States with very generous homestead exemptions are "debtors'-havens." Savvy debtors and debtors' attorneys in those states are prone to abusing the homestead rights. One specific example in Texas involved a former President and Chairman of the

Board of a failed bank. While he was still on the bank's board, the bank loaned him \$500,000 to make improvements on his home and had a \$23,000 security system installed in the house. The bank neglected to perfect its lien on the homestead. When the former President and Chairman of the Board declared bankruptcy, he successfully claimed the home and improvements as homestead. The FDIC objected, but three years later the bankruptcy judge has yet to rule on the homestead claim. The former president is now in jail for bank fraud, and the FDIC has a restitution judgment for \$4 million, which he has no money to satisfy.

Abuses of the exemptions are difficult to detect for a number of reasons: for example, many debtors engage in pre-bankruptcy planning. They transfer property to their friends and relatives before filing; and/or they convert their secured debts to unsecured debts and pay-off valid liens on homestead property. Pre-bankruptcy planning, if done correctly, is perfectly legal.

In addition to the abuses being difficult to detect, they are also difficult to prove for a number of reasons. First, states with generous homestead exemptions exhibit a bias towards debtors generally. Such states are more tolerant of debtors' abuses. Second, debtors' abuses are expensive for a creditor to prove. They are fact-oriented and require proof of a bad intent by the debtor. The proof nearly always requires extensive tracing of sales and loan proceeds. As a result, creditors avoid litigation over exemptions except where an abuse is patently obvious, or where the debtor's flamboyant lifestyle contradicts a claim of insolvency.

Because many abuses cannot be detected and successfully proven, the FDIC has not attempted to measure the amount of its losses involved in exemption abuses. However, the amount is believed to be significant, if the experience in Texas (where the FDIC/RTC combined have claims in a majority of the bankruptcy cases) is any indication.

#### **D. Analysis of Reform Proposals**

This Section analyzes the bankruptcy exemption reform proposals listed in FIRREA.

##### **1. Uniform Exemptions**

The proposal for uniform mandatory federal exemptions (without the current provisions for the states to opt-out or the debtor to choose state exemptions) would repudiate the long-standing policy of incorporating state exemptions rather than imposing a federal scheme. The consideration of this issue during the debates over the Bankruptcy Code in 1978 once again resulted in the adoption of state exemptions through the opt-out

provision of Section 522(b)(1), in explicit recognition of the states' interest in "regulating credit within the states . . . ." <sup>16</sup> Thirty-seven states have chosen not to allow debtors to choose the federal exemptions, <sup>17</sup> an indication of strong national sentiment against uniform federal exemptions.

Since this proposal is directed toward deposit insurance reform, the proposal's ability to serve such reform must be considered. Presumably, the reason for creating a system of mandatory federal exemptions would be to minimize the loss to the deposit insurance funds resulting from borrowers of insured depository institutions declaring bankruptcy and exempting assets. While uniform exemptions more favorable to lenders might serve this end, such exemptions would also reach debtors for whom insured depository institutions are not major creditors or against whom such institutions do not have significant claims. Uniform exemptions tailored to meet the needs of the depository insurance funds could thus skew the bankruptcy process, perhaps penalizing debtors who have not contributed to the current problems in the bank and thrift industries, and will not contribute to the losses at insured depository institutions.

There are nevertheless strong arguments for a system of uniform, or nearly uniform, exemptions. The public comments received on this issue stated that a uniform bankruptcy law should be adopted so that depository institutions in separate states would be on an equal footing. Although it has been well settled that the federal government may constitutionally incorporate state law exemptions as part of a uniform system of bankruptcy laws, <sup>18</sup> it has been argued that a set of mandatory federal exemptions would better satisfy the Constitution's requirement of "uniform Laws on the subject of Bankruptcies throughout the United States." <sup>19</sup> Furthermore, mandatory federal exemptions could correct some of the worst disparities in the current system of state exemptions, such as those discussed above in the comparison between Texas and Pennsylvania. States with more generous exemptions go well beyond the Bankruptcy Code's policy of providing the debtor with the basic necessities for a fresh start.

If uniform exemptions were created, it would not always reduce asset quality risk in insured institutions. Borrowers and lenders could enter into contracts explicitly stating that only the collateral would be seized in the event of default (non-recourse loans).

## **2. Limitations on Exemptions**

The second proposal would limit bankruptcy exemptions. Three possible examples are considered here: (1) limits on the value of the property exempted; (2) limits on the type of

property exempted; and (3) limits based on the conduct of the debtor.

### **Limitations on Value and Limitations on Property Type**

Any attempt to create limitations based on value or type of exempt property would effectively impose mandatory federal exemptions. Such an effort would thus suffer from the same problems and have the same advantages described above.

The problems, however, might be mitigated by targeting a small number of exemptions which are typically abused and leaving the remaining exemptions to the state. For example, Congress could limit the size of homestead exemptions or other exemptions for real property, which is usually the most valuable asset in an individual debtor's estate. Another limitation could specify that for property to qualify as homestead property, it cannot have been acquired by the borrower within two years prior to filing, except through foreclosure, inheritance, or devise.<sup>20</sup>

Other exemptions could be left in place, subject to a maximum aggregate value. Thus, regional views as to the basic necessities for a fresh start could be left in place, but limits would be imposed on those specific exemptions which most seriously drain the deposit insurance funds.

### **Limitations Based on Debtor Conduct**

The third type of limitation--based on the conduct of the debtor--could be used to permit certain exempt property to be liable for debts arising from misuse of loan proceeds. As the state and federal exemption laws stand today, every individual debtor is entitled to exemptions. The Bankruptcy Code excepts certain debts from the bankruptcy discharge, including debts arising from certain types of fraudulent conduct<sup>21</sup> and for willful and malicious acts by the debtor.<sup>22</sup> However, Section 522(c) provides that exempt property is not "liable" for debts excepted under Sections 523(a)(2) (actual fraud and false financial statements); 523(a)(4) (fraud, defalcation while acting as a fiduciary, larceny, or embezzlement); or 523(a)(6) (willful and malicious injury to property). Section 522(c) could be amended to permit exempt property to be liable for such debts, as it currently does for excepted debts for certain taxes<sup>23</sup> and for support of spouse, former spouse, or child.<sup>24</sup> Such an amendment covering officer and director misconduct was signed into law on November 29, 1990, in the Crime Control Act. Under the terms of the Act, officers and directors of failed depository institutions who have defrauded the bank or thrift may not claim any property as exempt. Therefore, former officers and directors of failed institutions, such as the Texan described above, will no longer be able to keep substantial assets from their creditors.

Another type of limitation might focus on the misuse of bankruptcy planning devices. For example, to the extent that the value of exempt property is enhanced during a certain time period prior to the filing of a bankruptcy petition, such value would not be exempt under Section 522. This proposal could be analogized to the avoidance provisions in Section 547 of the Bankruptcy Code, which prevent a debtor from preferring one creditor over another, as it would essentially prevent the debtor from favoring himself over other creditors.

### **3. Bonds to Secure Commercial Loans from Insured Institutions**

The proposed requirement for bonds to secure commercial loans would assure that an insured depository institution will be fully repaid on its commercial loans and full repayment will not be defeated by a debtor taking exemptions under the Bankruptcy Code.

The proposal could avoid barriers to loan repayment imposed by the Bankruptcy Code's exemption provisions by making a third party--the surety--liable for the debt. However, it is important to note that bankruptcy exemptions are only available to individuals and many commercial loans do not involve individual credit. Therefore, the bonds would only avoid the problems of exemptions where the borrower is an individual debtor or where an individual's credit is behind the loan to a business entity--for example, where an individual guarantees repayment of a loan to a corporation, or where the lending institution has recourse against the general partner of the borrower. Exemptions would not be a factor in repayment of the loan in cases involving acquisition, development, and construction loans to limited partnerships or corporations, secured only by the land and construction for which the loan was made, if the loans were made without recourse to the corporate principals, general partners, or guarantees by individuals where individual assets are not involved.

Where the borrower is not an individual, bonds would achieve the goal of decreased asset risk and would be a precaution against fraud by corporate borrowers and principals of the borrowers. Conceivably, a statute could require the principals of a corporate or partnership borrower to post a bond against their fraud in connection with the loan or their default for any reason. Nothing in the Bankruptcy Code's exemption provisions prevents such a requirement. A bond would remove the risk of fraud to the lender and shift it to the bonding company. The bonding company would then be subrogated<sup>25</sup> to the rights of the lender and would have to attempt to collect from the principal.



## E. Summary

The broad bankruptcy exemption provisions in some states can foster abuse by debtors and deny the FDIC and other creditors the ability to challenge borrowers' rights to claim exemptions. If Congress were to require uniform bankruptcy exemptions or one of the other possible exemption reforms discussed above, asset quality risk for new assets could improve. This would increase the FDIC's ability to maximize recoveries on assets it acquires when resolving insolvent institutions.

It should be noted, however, that even if Congress enacted mandatory exemptions with limited values, borrowers and lenders could enter into contracts which explicitly state that only the collateral can be seized in the event of default (i.e., non-recourse loans). Lenders will always know what the exemption provisions are and can act accordingly when making the loan. Changes to the provisions, therefore, will not, in and of themselves, prevent risky lending behavior on the part of lenders.

However, further expansion of the limitations on a debtor's right to exemptions (such as those recently enacted) would help careful lenders and the federal depository insurance funds reduce their losses from loans to dishonest borrowers.

## Endnotes

- <sup>1</sup> 11 U.S.C. 101, et seq.
- <sup>2</sup> 11 U.S.C. 522.
- <sup>3</sup> Vukowich, Debtors' Exemption Rights, 63 Geo. L.J. 779 (1974).
- <sup>4</sup> Note, The General Exemption of Section 522(b)(5) of the 1978 Bankruptcy Code, 49 U.Chi.L.Rev. 564, 568-69 (1982).
- <sup>5</sup> See e.g., Vukowich, Debtors' Exemption Rights.
- <sup>6</sup> Id.
- <sup>7</sup> U.S. Const., art. 1, Section 8, cl.4.
- <sup>8</sup> U.S. Const., art 1, Section 10, cl.1.
- <sup>9</sup> 11 U.S.C. 523(a)(2); House Report 95-595 at 126.
- <sup>10</sup> Koffler, Bankruptcy Clause and Exemption Laws, 58 N.Y.U.L. Rev. at 23.
- <sup>11</sup> House Report 95-595 at 126.
- <sup>12</sup> Koffler, Bankruptcy Clause and Exemption Laws, at 58 N.Y.U.L. Rev. at 29.
- <sup>13</sup> 3 Bankr. Serv. (L. Ed) Section 22.120 et seq.
- <sup>14</sup> Tex. [Property] Code Ann. Sections 41.002-42.003.
- <sup>15</sup> 42 Pa. Cons. Stat. Ann. Sections 8123-24.
- <sup>16</sup> House Report 95-595 at 126.
- <sup>17</sup> 3 Bankr. Serv. (L. Ed.) Section 22.120 et seq.
- <sup>18</sup> See e.g., Hanover National Bank v. Moyses, 186 U.S. 181 (1902).
- <sup>19</sup> U.S. Const. art. 1, Section 8, cl. 4.
- <sup>20</sup> "Devise" is the act of granting property by will. "Inheritance" is the general term for property received either by will or the laws of inheritance when no valid will exists.
- <sup>21</sup> 11 U.S.C. 523(a)(2) and (4).
- <sup>22</sup> 11 U.S.C. 523(a)(6).

<sup>23</sup> 11 U.S.C. 523(a)(1).

<sup>24</sup> 11 U.S.C. 523(a)(5).

<sup>25</sup> "Subrogate" is a term of art defined as the substitution of one creditor for another, along with a transfer of the claims and rights of the original creditor. To illustrate, if a bonding company paid a claim to the lender to cover a debtor's default, the bonding company would then "step into the shoes" of the lender. The bonding company would be substituted for the original lender and could attempt to recover its losses from the debtor.

## **Chapter XXI**

### **FOREIGN DEPOSIT INSURANCE SYSTEMS**

#### **A. Introduction**

The institutional framework within which banking and financial systems operate has become increasingly international in scope over the last 20 years. Much of this is due to extensive technological advances that have facilitated the rapid transfer of capital across international boundaries. Expediting the flow of capital naturally opens new investment opportunities, and projects in one region may now be funded with resources generated elsewhere. However, along with these new opportunities, a new interdependence among nations is created; this has given rise to the concern that financial instability in one country could have a considerable and damaging effect on the banking community worldwide. An important consequence of this concern has been expanded cooperation and coordination among banking regulators internationally and methods by which countries promote domestic stability are inspected and studied abroad.

This chapter is organized as follows: Section B briefly places the use of deposit insurance in an international context; Section C describes the structure and organization of foreign deposit insurance systems; Section D analyzes the manner in which distressed banks are handled by Canada, France, Germany, Italy, United Kingdom, and Japan; and Section E provides a conclusion.

#### **B. International Use of Deposit Insurance**

One mechanism which is used to enhance financial stability is deposit insurance; the United States instituted its system for insuring deposits through the FDIC in 1933. Although the FDIC is the longest-running deposit insurance system in operation, at least 29 other countries now offer depositors some type of protection program.<sup>1</sup> At times, as was the case in the United States, nations have implemented or enhanced their systems as a response to a major banking crisis. Germany, for example, strengthened its Deposit Security Fund after it could not adequately deal with the Herstatt failure in 1974; the British system began in 1979 as a result of the secondary banking crisis of the mid 1970s; and the collapse of Banco Ambrosiano may have been a contributing factor in the creation of the Italian system.

Although the focus of discussion in this chapter is on industrialized nations, it is noteworthy that deposit insurance exists in many developing nations as well. Of the 29 countries surveyed, no less than 12 are non-industrialized. However, Talley and Mas (1989) indicate that many have encountered an obstacle which plagues systems in industrialized countries as well: undercapitalization and the resulting inability to deal with large-scale losses. The Turkish fund was bled dry almost immediately upon its inception in 1960 by the need to liquidate six banks; loans from the central bank required 18 years to repay, and the system was replaced by the current one in 1983. There is much evidence that the same insufficient financing also afflicts the programs of the Philippines and Kenya.

It is important to articulate at the outset that many countries that have recently instituted coverage schemes still rely primarily on central bank funding and cash infusions from other, healthy institutions in order to handle troubled banks, with the deposit insurance system itself often playing a relatively minor (as compared with the FDIC) role. This reliance on coalitions involving the private sector and fashioned by the central bank imparts a much more informal nature to the process than that found in the U.S. As such, one might wonder whether the safety net is therefore less dependable abroad. As will be discussed in this chapter, this does not appear to be the case; the ability and willingness of authorities abroad to marshal public and private resources quickly and decisively to prevent the disorderly collapse of important financial institutions has been solid. Examples in which depositors, in the presence or absence of explicit coverage, have been hurt are rare, and are usually limited to those who have an additional relationship, such as shareholder, with the institution. Furthermore, there are proposals currently being considered to formally diminish the safety net in this country. Among these is a suggestion to impose mandatory losses on all uninsured depositors following bank failures. If implemented, this "haircut" proposal could have the effect of creating an environment in the U.S. in which the safety net would be clearly narrower than those found abroad.

### **C. Structure and Organization**

Essential differences in the structure of insurance systems include the following: (1) whether membership is voluntary or compulsory; (2) whether they are administered by government agency, private industry, or through a joint public and private arrangement; (3) the methods by which they are funded; and (4) the amounts and types of deposits covered.

**Table 1**  
**Characteristics of Foreign Deposit Insurance Systems**

Country	Insuring agency	Year established	Membership	Administration
Argentina.....	Deposit Insurance Scheme (Central Bank).	1979	Voluntary.....	Officially Sponsored and Administered.
Austria.....	Deposite Guarantee Fund.....	1979	Compulsory ....	Industry Arrangement.
Belguim.....	Rediscount & Guarantee Institute.....	1985	Voluntary.....	Officially Sponsored and Administered.
Brazil.....	N/A.....	1989	( <sup>1</sup> ) .....	Joint Administration.
Canada.....	Canada Deposit Insurance Corporation.....	1967	Compulsory ....	Officially Sponsored and Administered.
Chile.....	Superintendent of Banks & Financial Institutions.	1986	Voluntary.....	Officially Sponsored and Administered.
Colombia.....	Financial Institutions Guarantee Fund.....	1985	Compulsory ....	Joint Administration.
Denmark.....	Deposit Guarantee Fund.....	1987	Compulsory ....	Industry Arrangement.
Finland.....	Deposit Guarantee Funds.....	1969	Compulsory ....	Industry Arrangement.
France.....	Deposit Guarantee Fund.....	1980	Compulsory ....	Industry Arrangement.
Germany (Federal Republic).	Deposit Security Fund.....	1966	Voluntary.....	Industry Arrangement.
	Savings Bank Security Fund.....	1969	Compulsory ....	Industry Arrangement.
	Credit Cooperatives Security Scheme.....	1976	Compulsory ....	Industry Arrangement.
India.....	Deposit Insurance & Credit Guarantee Corp..	1961	Compulsory ....	Industry Arrangement.
Ireland.....	Deposit Protection Account (Central Bank).	1989	Compulsory ....	Officially Sponsored and Administered.
Italy.....	Interbank Deposit Protection Fund.....	1987	Voluntary.....	Industry Arrangement.
Japan.....	Deposit Insurance Corporation.....	1971	Compulsory ....	Joint Administration.
Kenya.....	Deposit Protection Fund Board.....	1985	Compulsory ....	Officially Sponsored and Administered.
Netherlands.....	Collective Guarantee Scheme.....	1979	Compulsory ....	Joint Administration.
Nigeria.....	Nigerian Deposit Insurance Corporation.....	1988	Compulsory ....	Officially Sponsored and Administered.
Norway.....	Deposit Guarantee Fund.....	1961	Compulsory ....	Joint Administration.
Paraguay.....	Sistema Nacional de Ahorro Y Prestamo para la Vivienda.	1971	Voluntary.....	Officially Sponsored and Administered.
Philippines.....	Philippine Deposit Insurance Corporation...	1963	Compulsory ....	Joint Administration.
Spain.....	Deposit Guarantee Fund.....	1977	Voluntary.....	Officially Sponsored and Administered.
Sweden.....	Deposit Insurance Fund for Savings Banks.	N/A	N/A .....	Industry Arrangement.
Switzerland.....	Deposit Guarantee Scheme.....	1984	Voluntary.....	Officially Sponsored and Administered.
Trinidad and Tobago.	Deposit Insurance Corporation.....	1986	Compulsory ....	Industry Arrangement.
Turkey.....	Turkish Deposit Insurance Fund.....	1983	Compulsory ....	Joint Administration.
United Kingdom.....	Deposit Protection Fund.....	1982	Compulsory ....	Officially Sponsored and Administered.
United States.....	Federal Deposit Insurance Corporation.....	1933	( <sup>2</sup> ) .....	Officially Sponsored and Administered.
Venezuela.....	Bank Deposit Guarantee & Protection Fund.	1985	Compulsory ....	Officially Sponsored and Administered.
Yugoslavia.....	N/A.....	N/A	N/A .....	N/A

<sup>1</sup> Compulsory for universal banks, voluntary for other financial institutions.

<sup>2</sup> Compulsory for all national banks and most chartered banks.

Sources: This table is similar to one appearing in Bartholomew and Vanderhoff (1990) and uses information received from the Organization for Economic Cooperation and Development, Federal Deposit Insurance Corporation, International Monetary Fund, Congressional Research Service, Ufficio Italiano Dei Cambi, and annual reports of the Danmarks National Bank, Deposit Insurance and Credit Guarantee Corporation of India, and Japanese Deposit Insurance Corporation.

## 1. Membership and Administration

Table 1 presents data for the 29 nations offering some form of deposit insurance. There are 31 systems listed, as Germany maintains separate funds for savings banks and credit cooperatives. Membership in nine countries is on a wholly voluntary basis; some systems demand that particular institutions join, and those not so required may opt to belong at their own discretion. In Germany, commercial banks must join the Deposit Security Fund, but savings banks and credit cooperatives may decline membership in their respective systems. Japan and the United Kingdom both require institutions to participate in the insurance programs.

Eleven systems, including the United Kingdom's, are officially sponsored and administered by the government. In the U.K., the fund is run by a board consisting of three members of the Bank of England, as well as other members appointed by the Governor of the central bank. However, these administrators have no other bank supervisory role. Seven systems, including the Japanese system, are collectively operated by the public and private sector, and twelve are private industry arrangements. All three of Germany's funds are among this latter group. One possible advantage of direct government administration is the greater degree of credibility inherent in the guarantee. Market participants must have faith in the insurance scheme for it to be effective, and the government's promise is generally considered to be more trustworthy. However, Woodward (1989) and Bartholomew and Vanderhoff (1990) both suggest that depositors commonly believe that the government will not permit a private insurance scheme to fail.

## 2. Methods of Funding

Table 2 provides information on the financing procedures for the various programs. Two primary means of funding insurance systems exist: in the first, premiums are assessed regularly to maintain the fund, while in the second levies are imposed only following bank failures. Those nations using the latter method, referred to as ex post funding, include Austria, Chile, Italy, the Netherlands, Switzerland, and France. Under these arrangements, there is no "fund" per se, and money is collected to repay depositors as needed after a failure. In France, assessments are made based on the size of the bank's deposits. If necessary, the Association of French Banks, which administers the system, can require contributions from the preceding two years, as well as advances on the next two years. The Chilean system is funded by its Treasury Department directly from the budget. No premiums are ever assessed on banks or depositors. As such, it becomes immaterial whether membership is voluntary or compulsory.

Table 2

## Insurance Coverage and Pricing Schemes for Foreign Deposit Insurance Systems

Country	Insurance coverage limit (domestic currency)	U.S. dollar equivalent (as of July 6, 1990)	Premium pricing scheme
Argentina.....	100% of deposits up to A\$ 100,000,000, 90% above that amount.	( <sup>1</sup> )	0.03% of total deposits.
Austria.....	\$ 200,000 .....	17,185	Unfunded Arrangement.
Belgium.....	BF 500,000.....	14,706	0.02% of specified liabilities.
Brazil.....	N/A .....	N/A	N/A
Canada.....	C\$ 60,000.....	51,582	0.1% of insured deposits.
Chile.....	100% of demand deposits, 90% other deposits up to 120 UF.	( <sup>1</sup> )	Unfunded Arrangement.
Colombia.....	75% of Col\$ 200,000 ( <i>i.e.</i> , Col\$ 150,000.....	309	0.5% of required reserves on deposits.
Denmark.....	kr. 250,000 .....	39,708	Max. 0.2% of total deposits; starting in 1989, total annual contributions of all members is kr. 700 mil. until fund reaches kr. 3 billion.
Finland.....	FM 500,000 .....	128,966	Between 0.1% and 0.05% of total assets.
France.....	FF 400,000.....	72,033	Collected as needed, assessments based on deposits.
Germany (DSF)....	30% of the "liable capital of bank concerned per depositor".	( <sup>1</sup> )	0.03% of total deposits.
(SBSF).....	100% of deposits and credits.....	( <sup>1</sup> )	0.03% of "claims on customers".
(CCSS).....	100% of deposits and credits.....	( <sup>1</sup> )	complex premiums and mutual guarantees.
India.....	Rs30,000 .....	1,722	0.04% of total deposits.
Ireland.....	80% of first IRP 5,000, 70% of next IRP 5,000, 50% of next IRP 5,000.	16,206	0.2% of deposits.
Italy.....	100% of first L 200 mil., 75% of next L. 800 mil.....	659,385	Unfunded Arrangement.
Japan.....	Y 10,000,000.....	66,212	0.012% of covered deposit balance.
Kenya.....	Kshs 100,000.....	5,519	0.1% of deposits.
Netherlands.....	G 35,000.....	18,800	Unfunded Arrangement.
Nigeria.....	N. 50,000.....	11,765	0.93% of deposits.
Norway.....	Unlimited.....	( <sup>1</sup> )	0.015% of total assets.
Paraguay.....	G 5,000,000 .....	4,803	.25% of deposits
Philippines.....	P 15,000 .....	662	0.0667% of total deposits
Spain.....	Pts 1,500,000.....	14,789	.2% of deposits.
Sweden.....	N/A .....	( <sup>1</sup> )	Fund at such a level that in recent years annual contributions considered to be necessary.
Switzerland.....	SF 30,000.....	21,406	Unfunded Arrangement.
Trinidad & Tobago.	TT\$ 50,000.....	12,225	N/A
Turkey.....	TL 3,000,000.....	1,142	0.3% of insured deposits.
United Kingdom...	75% of deposit balance up to L 20,000.....	35,730	progressive levy with the effective rate not to exceed 0.3% of domestic sterling deposits.
United States.....	\$100,000.....	100,000	0.195% of domestic deposits as of January 1, 1991.
Venezuela.....	B 250,000.....	5,296	0.25% of deposits.
Yugoslavia.....	Unlimited.....	( <sup>1</sup> )	N/A.

<sup>1</sup> Information unavailable.

Sources: This table is similar to one appearing in Bartholomew and Vanderhoff (1990). The sources of information are the same as for Table 1, with the addition of the Philippine Deposit Insurance Corporation.



Nineteen systems, including the Japanese program and all three of Germany's funds, are financed through a regular assessment of premiums. The particular rates vary widely, as do the bases upon which the payments are charged. These include total deposits, domestic deposits, insured deposits, total assets, and required reserves on deposits. In Finland, for example, the Bank Inspectorate establishes the participation premiums levied on the banks, which can range between 0.01 and 0.05 percent of total assets. In addition, some troubled banks in Finland are permitted to forego the premium altogether if such a waiver is deemed necessary by the Bank Inspectorate.

The United Kingdom levies a premium on its banks on the basis of deposits; the minimum contribution is L10,000, and the maximum is L300,000. Additional contributions may be required if the fund is stressed, but the total payment of one bank may not exceed 0.3 percent of the deposit base.

Norway assesses payments equal to 0.015 percent of total assets, but only until the paid-up capital of the fund is a full two percent of the bank's aggregate deposits from non-bank customers. The Spanish system's premiums are 0.2 percent of deposits, and the Bank of Spain contributes an annual amount equal to the aggregate contribution of the banks. Furthermore, the central bank may also advance up to four times its yearly contribution to the fund if it becomes necessary.

A similar procedure exists in the German fund for commercial banks, where the stated annual premium level is 0.03 percent of the total (non-bank) deposit liabilities. However, these premiums may be doubled if it is required.

It is important to note that no system uses risk-based premiums. Changes in premium rates and structures occur regularly, however, and some countries, in addition to the United States, may be studying this possibility at the present time. Systems that are funded by ex post assessments do not charge premiums, but could alter the payment structure according to the riskiness of a bank's portfolio. Finally, some funds do have access to alternative means of financing, such as the central bank or government treasury.

### 3. Coverage Limits

Table 2 also shows the various coverage limits in terms of the domestic currency and the U.S. dollar equivalent. Only Norway, the German savings bank and credit cooperative funds, and Yugoslavia provide completely unlimited coverage. Argentina has no ceiling, but covers only 90 percent of deposits above A\$100,000,000. Chile offers 100 percent coverage on any level of demand deposits, but only 90 percent coverage on other types of deposits. Limits may be constrained in practice, however, either

by provisions in the law or by the resources available. In Norway, for example, the fund's Board of Directors determines in each separate case the amount, type, and conditions of any support that may be forthcoming. Even in some countries having a stated ceiling, actual coverage may be at the mercy of the fund's resources. In Belgium, for example, deposits are insured to BF500,000, but only if sufficient money is available. In Germany, too, disbursements may be restricted by the fund's resources, and decisions concerning the payout are made on a bank-by-bank basis.

The concept of co-insurance (*i.e.*, some stated percentage of deposits is covered) is used in five countries, but only Ireland and the United Kingdom have no lower limit below which deposits are 100 percent insured. In the U.K., for example, only 75 percent of deposits up to L10,000 are insured (and above this level they are entirely uninsured). Under such a system, even the very small saver is at risk, and every depositor has an incentive to run on a troubled bank.

A unique insurance scheme is found in Germany's Deposit Security Fund for commercial banks. The coverage limit is 30 percent of the bank's stated equity capital, based upon the last quarterly report. This implies that coverage will decline as the level of capital diminishes. Thus, depositors have a strong incentive to remove funds from a suspect bank whose capital, and so coverage levels, are decaying. Naturally, the withdrawals themselves will exacerbate the bank's problems.

#### **4. Types of Deposits Covered**

Table 3 provides data concerning the types of deposits covered by the various systems. Seven of the 23 countries for which information is available insure interbank deposits. Deposits held by nonresidents are covered by every system. In part, this may be to remain competitive in the international market, for without this insurance a flight of foreign capital could ensue. Indeed, the resolution of the Al-Saudi Banque in France (discussed fully in the next Section) concluded with all foreign depositors being completely protected, while some domestic depositors lost money. However, none of the sources surveyed for this chapter indicated any statutory difference in coverage between residents and nonresidents.

Ten of the 22 countries, for which there is information, cover deposits denominated in foreign currency. Eleven do not, and the coverage in Ireland is provisional. Again, roughly half, or nine of 16 countries cover deposits in domestic branches of foreign banks, while the remaining seven do not. Conversely, only five of 17 systems explicitly cover deposits in foreign branches of domestic banks. However, insurance of these deposits may be implicit, as it is usually larger banks which maintain

Table 3

## Selected Characteristics of Deposit Protection

Country	Coverage of interbank deposits	Coverage of deposits held by nonresidents	Coverage of deposits in foreign currency	Coverage of deposits in domestic branches of foreign banks	Coverage of deposits in foreign branches of domestic banks
Argentina .....	N	Y	N	—	—
Austria .....	N	Y	Y	N	N
Belgium .....	N	Y	N	N	N
Brazil .....	N	—	—	—	—
Canada .....	Y	Y	N	—	N
Chile .....	N	Y	N	Y	N
Colombia.....	Y	Y	—	—	—
Denmark .....	—	—	—	—	—
Finland .....	—	—	—	—	—
France.....	N	Y	N	Y	N
Germany (DSF).....	N	Y	Y	Y	Y
(SBSF).....	—	—	—	—	—
(CCSS).....	—	—	—	—	—
India .....	N	Y	N	N	N
Ireland.....	—	—	P	—	—
Italy.....	N	Y	Y	*	Y
Japan .....	N	Y	N	N	Y
Kenya.....	Y	Y	—	—	—
Netherlands.....	N	Y	Y	Y	N
Nigeria.....	Y	Y	Y	Y	N
Norway.....	Y	Y	Y	Y	Y
Paraguay.....	N	Y	N	N	—
Philippines .....	N	—	Y	—	—
Spain .....	N	Y	N	—	N
Sweden.....	—	—	—	—	—
Switzerland.....	N	Y	N	Y	N
Trinidad & Tabago.....	Y	Y	Y	Y	N
Turkey .....	N	Y	Y	N	N
United Kingdom .....	N	Y	N	Y	N
United States .....	Y	Y	Y	Y	N
Venezuela.....	—	—	—	—	—
Yugoslavia.....	Y	Y	Y	—	—

\* Permissible, but none have yet elected, coverage.

Note: N=No, Y=Yes, P=Provisionally, —=Information Unavailable.

Source: This table is similar to one appearing in Bartholomew and Vanderhoff (1990); the source of information is the Federal Deposit Insurance Corporation.

foreign branches. Institutions of this size may be deemed "too big to fail" by market participants, and depositors may believe they are safe even in the absence of explicit coverage. Several proposals which advocate charging domestic banks insurance premiums based upon the level of foreign deposits are now being considered in the U.S. (see Chapter VI). Finally, all of the systems for which information is available insure a deposit's accumulated interest.

Virtually every major industrialized country now has some system of national deposit insurance, although there are exceptions. Australia has no nationwide system, but several of its states have official and industry-based support arrangements for building societies and credit unions. New Zealand has no system for commercial banks and is eliminating the government guarantee of deposits at trustee banks. In Luxembourg, Greece, and Portugal, there is neither any system of insurance, nor any movement toward implementing one.

#### **D. Handling Distressed Banks**

In the United States, when the need to handle a distressed institution arises, the FDIC is generally a key figure in the operation. As mentioned previously, this is not the case abroad, where the action taken by authorities often involves a joint endeavor of public and private entities.<sup>2</sup> Frequently, the central bank is the dominant player, providing liquidity directly and arranging for emergency injections of cash, sometimes from other, healthy institutions in the system. This section is devoted to a discussion of actual bank and nonbank insolvencies in some major foreign countries during the last 25 years and the manner in which each crisis was handled by the government.

##### **1. Canada**

The financial regulatory system in Canada was overhauled in June 1987. Concerns over the adequacy of the existing system arose in 1985 when two bank failures brought to public attention the weakened condition of the Canada Deposit Insurance Corporation (CDIC), established in 1967. Although no Canadian banks failed between 1923 and 1985, twelve trust companies had required CDIC action since its inception. Eight of these were during 1983 and 1984. At year-end 1984, the CDIC deposit insurance fund registered a deficit of C\$871 million (\$638 million).

In March 1985, the government of Canada announced a C\$255 million (\$187 million) plan for handling Canadian Commercial Bank (CCB) of Edmonton, Alberta, the country's tenth largest commercial bank with C\$3 billion (\$2.2 billion) in assets. CCB was on the brink of insolvency following a rapid deterioration of

its loan portfolio, primarily energy-related loans in the U.S. and real estate loans in recession-ridden western Canada. The support package consisted of a C\$75 million (\$55 million) capital infusion from the CDIC and a combined C\$180 million (\$132 million) contribution from the Alberta and federal governments and Canada's "Big Six" commercial banks.<sup>3</sup> In return, participants were to receive stock warrants and 50 percent of future profits until the capital infusion was repaid.

Unfortunately, six months after announcing the rescue of CCB, the Canadian government was forced to seek court orders to liquidate it. In addition, the government took control of another institution, Northland Bank of Calgary, a C\$1.4 billion (\$1.0 billion) bank. The change in the government's position toward CCB was prompted by an examination of the bank's assets during the summer of 1985, which concluded that almost 40 percent of the bank's loans were "marginal" or "unsatisfactory," and many should not have been made in the first place. Thus, instead of restoring confidence in CCB, the bailout drew attention to its problems and to those of other regional banks, causing deposit withdrawals. By September 1, when the Bank of Canada withdrew its support from CCB and Northland, the central bank had pumped in C\$1.8 billion (\$1.3 billion) in secured short-term loans to shore up the two banks, both of which were eventually liquidated.

Parliamentary authority was given to compensate completely all depositors, both insured and uninsured, and none lost any money. Part of the justification for this arose from the fact that officials in Ottawa had encouraged depositors not to withdraw their funds and that consequently the government was obliged to cover losses. The final cost to the Canadian government was approximately C\$430 million (\$315 million) on uninsured deposits and almost C\$900 million (\$660 million) altogether. Furthermore, none of the initial C\$255 million (\$187 million) outlay was ever recovered. Although it is not clear how much of this came from the Big Six commercial banks, it is apparent that they suffered some loss.

Following these two failures, three other Canadian banks experienced difficulty before year-end. First, attention was drawn to the C\$4.2 billion (\$3.1 billion) Montreal-based Mercantile Bank. Fearing another government-sponsored bailout attempt, Ottawa instead encouraged the Big Six banks to provide a safety net in the form of short-term loans, while Mercantile looked for a more permanent solution. This proved to be a takeover by National Bank of Montreal. Similarly, the Canadian subsidiary of California's Security Pacific Bank took over Morgan Bank of Vancouver in November of 1985. Finally, Continental Bank with C\$6.2 billion (\$4.5 billion) in assets suffered a serious run on deposits. However, the bank's asset base was declared sound, and liquidity provided by the Bank of Canada and the Big

six banks prevented further runs. In none of these cases did any depositors suffer losses.

The major legislative results of the Canadian banking crisis were the creation of the Office of Superintendent of Financial Institutions as an integrated regulatory body with greater supervisory powers than those of the former agencies and a strengthening of the CDIC's role in providing deposit insurance for the general public. Additionally, the federal government has signed agreements with the provinces of Quebec and Ontario designed to facilitate the regulation of securities subsidiaries of federally regulated financial institutions.

## 2. France

In early October 1988, the French government announced plans to resolve a Paris bank, Al Saudi Banque, which had lost approximately FF2.1 billion (\$330 million), half its loan portfolio. Although deposit protection in France is limited to FF400,000 per depositor, in arranging the rescue of Al Saudi Banque, the Bank of France insisted that all foreign depositors be reimbursed in full. The central bank believed that this was necessary to promote Paris as an international financial center.

The agreed-upon rescue plan called for interest-free deposits from Al Saudi's major creditors, as well as smaller interest-free deposits from the remainder of the French banking industry. Ultimately, all domestic and foreign depositors were reimbursed in full.

## 3. Germany

The 1974 collapse of Bankhaus I.D. Herstatt was, in fact, the culmination of years of concern in international banking circles over the vulnerability of interbank lending, concern which began almost as soon as the Euromarkets were created in the early 1960s. At the time of failure, Herstatt was one of Germany's largest privately-owned banks, with assets of approximately \$900 million. By June of 1974, Herstatt had incurred losses from foreign exchange trading that were large enough to send the bank's management to the Bundesbank for help. Efforts to reorganize Herstatt failed when the authorities realized that poor recordkeeping at the bank precluded them from ascertaining the true degree of loss within a short period of time. These losses eventually amounted to nearly \$500 million. The central bank closed Herstatt on June, 26, 1974 at 4:00 p.m. local time, while New York banks were still trading, leaving many foreign banks exposed.

Following the Herstatt closing, Germany's commercial banks set up a fund to pay off depositors with less than \$8,000; all depositors with accounts exceeding this maximum lost some portion

of their funds. Remaining creditors approved a plan apportioning losses among three categories of creditors: German banks received 45 percent of their claims, foreign banks received 55 percent of claims, and small creditors received 65 percent of claims. In return, creditors waived any rights to sue Hans Gerling, majority owner of Herstatt's stock, who sold or surrendered as collateral all shares of his stock in the institution.

Within a month of Herstatt's collapse, regulations were approved in Germany to effectively prevent a repetition of the excessive foreign exchange dealings that had brought the bank down. Other changes in banking legislation quickly followed, including the prohibition of granting a new license to a single private banker, the authorization to conduct routine audits, and compulsory deposit insurance schemes. In addition, the German government created a liquidity bank as a precautionary measure to maintain confidence in the banking system and the central bank.

International banking supervision was also strengthened as direct result of the Herstatt collapse. In September 1974, the Group of Ten central bank governors met in Basle, Switzerland. They formally established a framework to ensure the long-term health of the international banking system under the auspices of the Basle Committee, also known as the Cooke Committee, after its chairman. In December 1975, the Committee issued the Basle Concordat, which attempted to establish guidelines for supervising banks that operate in more than one country. The concordat assigns primary responsibility for supervising liquidity and solvency to the host authority, but acknowledges that parent authorities have a moral commitment to supervise the solvency of foreign branches of their banks.

In 1983, the concordat was tested in Germany when Schroeder, Munchmeyer, Hengst & Co. (SMH) reached the brink of insolvency, due primarily to loans extended by its subsidiary in Luxembourg. These loans were to a single company, IBH Holdings, which had been Europe's largest construction company, but which now teetered on the edge of bankruptcy. IBH defaulted on the loans, totaling almost DM900 million (\$405 million), about one-third of all of SMH assets. Furthermore, it was revealed that SMH actually held a nine percent equity stake in IBH. In making these loans, SMH violated, at the least, the spirit of the law which limited a bank's loans to a single borrower to 75 percent of capital. Given SMH's position, this would have totalled DM83 million (\$37 million), far short of the almost DM900 million actually loaned. SMH circumvented the law by lending through its Luxembourg subsidiary, as the details of subsidiary lending did not have to be reported.

The German authorities felt it necessary to intervene, in part because the overall health of European banks was in doubt

due to excessive lending to less developed countries. At the request of the Bundesbank, a group of German banks came to the aid of SMH with sufficient funding. Twenty banks converted some DM630 million (\$284 million) of their revolving credit lines to SMH into subordinated debt, and the deposit guarantee fund contributed some cash. The existing management was ousted, and the banks assumed control. Three months later, Lloyd's Bank International paid DM100 million (\$45 million) for parts of SMH's commercial banking business and all of the investment banking business. Reportedly, no depositors (insured and uninsured) lost any money, although it is clear that at least some of the creditor banks' DM630 million was never recovered.

One result of the failure was a toughening of regulations. The Finance minister asked that restrictions on lending be altered to cover partially owned domestic or foreign subsidiaries, and this was enacted in 1985.

#### 4. Italy

Another bank to face problems associated with one of its Luxembourg affiliates was Italy's Banco Ambrosiano. In June 1982, the Bank of Italy appointed a special board to run the Milan bank after a request for an explanation of a \$1.3 billion irregularity was not adequately answered. In addition to a large domestic empire of banks, insurance companies, and a publishing group, Banco Ambrosiano, through its Luxembourg subsidiary, operated 12 foreign banking and service corporations. Italian authorities were trying to ascertain the use to which the \$1.3 billion in unsecured loans to 15 Panamanian shell companies had been put.

In dealing with this crisis, the Bank of Italy determined that its responsibility did not extend to bailing out Banco Ambrosiano Holdings (B.A. Holdings), the Luxembourg subsidiary 70 percent-owned by the Milan bank. This subsidiary was parent to the Central and South American operations at the heart of the controversy. Complicating matters further was the existence of "comfort letters" issued by Istituto per le Opere di Religione (IOR), the Vatican bank, endorsing the loans to the front companies, many of which appeared to be direct subsidiaries of the IOR. Approximately half of the amount in question had been borrowed on the Euromarkets directly by Banco Ambrosiano. These liabilities were covered by a seven-bank safety net (three of which were state owned) formed at the instigation of the central bank. There is no indication that these banks were creditors of Banco Ambrosiano. By late July, however, Banco Ambrosiano Holdings, the Luxembourg affiliate, had defaulted on some \$400 million in borrowings.

The link between the parent bank and its international subsidiaries was further severed later that summer when the



Italian authorities placed Milan's Banco Ambrosiano in liquidation, having determined the impracticality of all other alternatives. A new bank, called Nuovo Banco Ambrosiano, was set up and capitalized at the equivalent of \$432 million by the seven Italian banks forming the initial rescue group. The new bank's assets excluded "foreign subsidiaries and other activities regarding relationships between those foreign subsidiaries." The Bank of Italy continued to maintain its distance from the non-Italian liabilities, pending some statement from the Vatican bank clarifying its own role in the affair. The full extent of losses incurred by the banks forming the safety net is not clear. Reportedly, domestic depositors were protected, and, although coverage may not have been complete, it definitely exceeded that provided to creditors of the Luxembourg affiliate.

The Italian authorities' refusal to aid the Luxembourg subsidiary angered European bankers who had lost money to B.A. Holdings, many of whom accused the Bank of Italy of reneging on the Basle Concordat. Other bankers disagreed, however, asserting that the Concordat applied only to the supervisory duties of central banks, not to their roles as lenders of last resort. Furthermore, the Concordat was vague on the subject of foreign subsidiary holding companies, which, unlike branches, are legally separate entities from their parents. Banco Ambrosiano Holding's status was even more ambiguous because it was a nonbank holding company and not wholly-owned by the Italian parent. Hence, neither the Luxembourg nor the Italian banking authorities were legally empowered to supervise it. It is noteworthy, however, that the German handling of SMH, which occurred the following year, represented a different attitude, as authorities there assumed full responsibility for the Luxembourg affiliate.

Settlement with B.A. Holdings' creditors was finally reached nearly two years after the Bank of Italy first assumed control of the parent bank. The Vatican bank, although cleared of any wrongdoing in the matter, agreed to pay approximately half of the \$500 million settlement out of a sense of "moral obligation." The remaining funds were raised through the sale of the Ambrosiano group's assets. Most of the settlement (\$406 million) went to the 120 foreign bank creditors of B.A. Holdings, while Italian creditors of the parent bank received \$100 million. Altogether, creditors received about 67 percent of their claims.

In 1987, Italy's deposit insurance system was created. The ability of this fund to withstand financial crisis was tested in the case of Cassa di Risparmio di Prato, a Tuscan savings bank taken over by the Bank of Italy in September 1988. Cassa di Prato had incurred 1,400 billion lire (\$999 million) in bad debts, over half of which were considered unrecoverable. After its condition became known, a run on deposits reduced the bank's deposit base from 2,200 billion lire (\$1.57 billion) to 1,650 billion lire (\$1.178 billion).

Previous supervisory actions, including three "inspections," a mandated management change in 1987, and capital injections, first by other local savings banks, then by the Guarantee Fund itself, had failed to save the bank. Italian authorities announced plans to launch an 1100 billion lire (\$785 million) lifeboat for Cassa di Prato, which was immediately met with controversy. The original rescue plan favored by the central bank and the Deposit Guarantee Fund called for contributions of 650 billion lire (\$464 million) from the Guarantee Fund, 350 billion lire (\$250 million) from other Tuscan savings banks, and the remaining 100 billion lire (\$71 million) from a group of six national banks. However, several banks balked at being called upon to provide additional capital beyond their original contributions and objected to the fact that the Guarantee Fund would end up owning control of Prato. As a result, the Deposit Guarantee Fund has assumed the entire rescue burden. With its capital already depleted by a previous 200 billion lire (\$142.8 million) capital injection to Prato, the Guarantee Fund promised to provide 800 billion lire (\$571 million) immediately and possibly 300 billion lire (\$214 million) more when it is recapitalized by Italy's banks. As a result of these measures, the fund currently controls 75 percent of the bank's capital.

## 5. United Kingdom

Prior to 1979, the Bank of England had no formal licensing powers. It simply supervised those institutions that were recognized as banks on a voluntary basis. Recognition as a bank was achieved over time and required that a company be treated as a bank by other banks, including the Bank of England.

Basically, this informal method of licensing banks worked well for many years. It took considerable time for institutions to reach banking status, and their business was generally confined in the earlier years to those who knew them and were capable of judging the risks in dealing with them. However, in the late 1960s and early 1970s, a large number of new institutions grew very quickly and developed business relationships with other banks and the general public before achieving full recognition by the Bank of England. These unregulated "secondary" banks were primarily engaged in high-rate consumer lending and lending for property development, two areas where money was in great demand.

A little-publicized crisis developed among these banks, which began in November 1973 with a liquidity crisis at London & County Securities. The company did not have a good reputation in financial circles, and confidence broke down completely when a respected banker, who had been recruited to strengthen the operation, resigned after a few months. Emergency assistance was arranged by its clearing bankers in consultation with the Bank of England, but money market lenders rapidly became reluctant to

renew their lendings to a range of institutions thought to be in similar positions.

Over the next several months, a committee composed of representatives of the primary clearing banks, and nicknamed "the lifeboat," recycled back to those secondary bank's that were deemed healthy the funds necessary for them to meet maturing deposit obligations. The amounts required to support a given bank were apportioned among the clearing banks pro rata to their total deposits, with the Bank of England providing 10 percent of the total pooled funds. Ironically, there were no runs by public depositors; rather, a loss of confidence developed in the wholesale money markets so rapidly that the authorities feared it would spread to the banking system proper. By 1974, when property values fell due to the failure of several well-known development companies, it became clear that some of the secondary banks being supported were no longer viable. By this time, the Support Group was the main creditor at these banks, although some outside deposits from the general public remained. It was felt that it would be bad policy if a liquidation caused depositors to lose money, particularly since they had probably relied on the involvement of the Bank of England and the clearing banks in leaving their funds on deposit. Therefore, the Bank of England offered to acquire for face value all such remaining deposits, except those made by the people operating the institution or their close relatives.

By March 1974, some 21 secondary banks had been granted support amounting to around L400 million (\$936 million), and eight had been liquidated. Confidence continued to wane, however, and threatened even some recognized banks. Five additional passengers climbed aboard the lifeboat, and, toward the end of the year, the L1,200 million (\$2.8 billion) limit of shared risk support agreed on by the clearing banks was reached. Again, the Bank of England was obliged to shoulder the additional burden which was, fortunately, modest and short-lived.

Later that year, while much of the banking world's attention was focused on bank failures in the U.S. and Germany, two of the United Kingdom's fully fledged banks with significant international obligations began to experience problems. These were Slater Walker Ltd. and Edward Bates & Sons Ltd., both of which quietly received substantial aid from the Bank of England. Slater Walker eventually became a subsidiary of the central bank, while Bates was taken over by a major U.K. bank and a group of Middle Eastern investors who provided several capital injections over the years.

The secondary banking crisis caused significant losses for the institutions involved in the rescue operation. The Bank of England is believed to have lost L100 million (\$234 million), while the clearing banks lost an estimated L50 million (\$117

million) from their lifeboat operation. However, no depositors who were not also shareholders in the institutions lost any money, although some shareholders did lose deposits. One was a quasi-official organization known as Crown Agents which reportedly lost millions of pounds.

As a consequence of this crisis, legislation was toughened considerably. The Banking Act of 1979 strengthened the supervisory role of the Bank of England and required deposit-taking institutions to obtain from the central bank either recognition as a bank or a license to accept deposits.

Five years later, however, in 1984, the Bank of England again was forced to arrange a lifeboat, this time to save Johnson Matthey Bankers (JMB). One of five officially recognized bullion dealers on the London gold market, JMB was collapsing under the strain of L250 million (\$338 million) in loan losses. The central bank opted to purchase JMB for L1 and immediately injected L100 million (\$135 million) in funds. Furthermore, the parent company of JMB, Johnson Matthey Plc, was persuaded to add L50 million (\$67.5 million) in financing (the most it could offer and still remain viable). Also created was a L150 million (\$203 million) emergency fund with half the money coming from the Bank of England and half from a group of U.K. clearing banks and members of the London gold market. Through a process of reorganization, and the installation of new management and accounting staff, a rehabilitation of the bank was accomplished. In 1986, it was sold to an Australian bank for L67.5 million (\$91.1 million). The insurance and futures brokering businesses were also sold for L5.5 million (\$7.4 million) and L1.8 million (\$2.4 million), respectively. Thus, the central bank recouped 75 percent of its initial L100 million (\$135 million) outlay, excluding potential costs to the emergency fund. When the fund was established, it was agreed that the Bank of England would first recover the L100 million, and subsequent costs would then be borne equally by (1) the central bank and (2) the U.K. clearing banks and members of the gold market who contributed to the fund. The final cost to these institutions will depend upon how much can be recovered from the troubled assets that remain to be sold.

Partly as a result of this affair, the 1979 regulations requiring institutions to obtain status from the Bank of England as either "recognized banks" or "licensed depository institutions" were toughened in 1987, and this distinction was eliminated; all banking institutions would be regulated in the same fashion. In addition, banks must now report exposures exceeding 10 percent of capital to the Bank of England and may no longer lend more than 25 percent of capital to any one borrower.

These new rules have been tested recently following the June 1990 failure of British Commonwealth and Merchant Bank (BCMB)

with assets of about L430 million (\$780 million), a subsidiary of British and Commonwealth Holdings (BCH). BCMB was considered a sound, well-capitalized bank, but faced a liquidity crisis when its owner, BCH was forced to write-off L550 million (\$990 million) in loans to one of its other subsidiaries. Fear of a run on the bank led to attempts to create a L100 million (\$180 million) lifeboat with funds from the major clearing banks. However, three of these banks, Lloyds, Midland, and Standard Charter refused to participate in the lifeboat, and it never came to fruition. As a result, the Securities and Investment Board (SIB) banned its members from depositing money with BCMB. As some L110 million (\$198 million) of deposits were from securities firms regulated by the SIB, their order was a crushing blow, and the bank went into administrative receivership on June 3.

Much debate has centered on the handling of depositor and creditor funds, which were frozen in June and remained so until the beginning of October. As of October 1, some depositors began receiving funds, although it is not clear to what extent. It is believed that the delay will be over once BCH is sold, but the only bid so far is from a Turkish conglomerate, the Cukorova Group. The purchase requires Bank of England approval, and the central bank reportedly has doubts about the suitability of Cukorova as owners. This is because the Turkish group is a highly diversified conglomerate, and the Bank believes that BCMB's initial problems stemmed from its ownership by a similarly diversified group, BCH. However, since Cukorova's bid of some L\$40-50 million (\$72-\$90 million) is reportedly the highest by far, negotiations continue.

## 6. Japan

In Japan there has not been a major bank failure since World War II, although in 1965 the Bank of Japan engineered a plan to aid a nonbanking institution, Yamaichi Securities. During the stock market boom of 1958-1961, many securities houses traded and purchased stocks for their own account. Furthermore, they often financed their dealings with funds borrowed from commercial banks. When, in 1961, the Japanese authorities tightened credit in response to a trade deficit, stock prices fell, and the securities houses tried to support prices through their own purchases. This could only be successful as a temporary measure, however, and when the Kennedy Administration imposed taxes on capital leaving the U.S., investment in Japanese stocks by U.S. citizens fell. A final blow was dealt to the market when the Bank of Japan further strangled credit by raising reserve requirements.

As a result of these shocks, large losses were posted by the three biggest securities firms in Japan for the third quarter of 1964. Yamaichi lost 3.5 billion yen (\$9.7 million) and by the spring of 1965 could no longer service its debt. The firm owed a

great deal of money to Japan's commercial banks, and possibly because of this risk to the banking system, the central bank intervened. Under Article 25 of its charter, the Bank of Japan may, with the approval of the "competent" minister (in this case the Minister of Finance), take action deemed necessary for the protection of the credit system. This action, consisting of large, unsecured loans to Yamaichi through various commercial banks, was actually a very successful arrangement. Although the agreement permitted the securities firm 18 years to repay the loans, a new, reorganized Yamaichi made its final payment only four years later, in September 1969. Furthermore, loans to a second firm, Oi Securities (now Wako Securities following restructuring), were also completely repaid by 1969.

As a consequence of this crisis, changes in the Securities Transactions Law were enacted, taking effect in 1965. These included a strict licensing system for securities firms, a separation of brokering and dealer operations, and more stringent capital requirements.

#### E. Conclusion

The FDIC is by far the most active deposit insurance agency in the world. It is the only one that engages in prudential supervision of the banks it insures, and its role in resolving failed institutions greatly exceeds that of any foreign agency. With the exception of Spain, the FDIC is alone in its authority to extend de facto coverage by arranging purchase and assumption transactions, financially assisted mergers, or to provide direct aid to banks deemed "essential" to their communities. By contrast, foreign deposit insurance agencies are more peripherally involved in the resolution process; crises are generally handled by the central bank, operating in conjunction with a consortia of private sector financial institutions. Only in Canada did the insurance fund play more than a marginal role and remain viable; yet the support package was primarily assembled and funded by the Bank of Canada, as well as the typical cluster of healthy banks. Although the Italian fund played an important part in the Cassa di Prato affair, and now controls a majority of the bank's capital, this is a relatively rare example in which rescue efforts involving the private sector failed.

It is not simply the lesser role of the insurance programs abroad that provides a noteworthy contrast to the U.S. system. It is of interest that the central banks can, in fact, so readily and successfully organize a support group composed of private sector institutions. Losses, which in the U.S. would be incurred by the insurance fund, are generally absorbed by the central banks and private institutions abroad. Some observers, such as E. Gerald Corrigan, President of the Federal Reserve Bank of New

York, attribute this enhanced power of moral suasion among foreign central banks, at least to some extent, to history and tradition: that is, it has been done that way for many decades. Furthermore, he contends that it may be true that in nations where a handful of banks dominate the banking system, that handful may feel more directly threatened by potential dangers of a systemic nature than do institutions in the U.S. Finally, the need to coordinate agreement among such a small number of institutions greatly reduces the task facing the central bank. There is some truth, asserts Mr. Corrigan, to the rumor that "one of the most potent tools available to the Bank of England in times of stress is the Governor's eyebrow."<sup>4</sup>

Given that there are, in fact, these differences in the handling of distressed institutions, important questions arise: do these differences translate into a different method of treating the depositors of a failed institution? Would not private banks try to pass at least some of the costs on to depositors?<sup>5</sup> The answer to the last question is: not to a great degree. As in the United States, perhaps the most decisive element in the decision process is apprehension over systemic risk, and this is a fear that foreign banks may feel more acutely than their U.S. counterparts. This clearly influenced the German handling of the SMH incident, Canada's resolution of Canadian Commercial and Northland Banks, and the U.K.'s handling of the secondary banking crisis. In each of these cases, the central bank and private institutions lost a great deal of money, while depositors (who were not also shareholders) did not. There are also other factors that motivate the protection of depositors. Canada and the U.K. both acted as they did partially because the federal governments had publicly encouraged individuals not to withdraw their funds. Hence, the governments believed they had assumed a moral obligation to provide protection.

This is not to say that depositor and creditor protection has been absolute. Herstatt is the classic example of severe depositor loss. Italian authorities permitted creditors of Banc Ambrosiano's Luxembourg affiliate to suffer losses, while domestic depositors of the parent bank in Milan were protected to a much greater degree. Finally, many depositors of England's British Commonwealth and Merchant Bank are still waiting for their funds to be made available. But depositor protection is not absolute in the United States either. Unless the FDIC deems a bank "essential" to its community, it can protect all deposits fully only if such a transaction is less expensive than a liquidation of the bank and payoff of only the insured depositors; this is the FDIC's statutory cost test.<sup>6</sup> Over the years 1985-1989, approximately 21 percent of bank failure resolutions were handled in a manner that imposed some loss on uninsured depositors.<sup>7</sup> Typically, this involved smaller ("non-essential") banks, whose failure was not considered a threat to the overall health of the financial system.

In sum, although the resolution process is more formal and legalistic in nature in the U.S. than abroad, the net results are often very similar. In the words of Mr. Corrigan, "With the sole exception of the Herstatt failure in 1974, I am unable to find any case in which the authorities have been willing to permit the sudden and disorderly failure of an important . . . banking or non-banking institution."<sup>8</sup>



## Endnotes

<sup>1</sup> For excellent discussions of foreign deposit insurance systems, see Bartholomew and Vanderhoff (1990) and Bartholomew (1989). Much of the next section draws heavily on these papers.

<sup>2</sup> Even in nations in which insurance funds are privately administered, the systems themselves have a much smaller role than in the U.S.

<sup>3</sup> Canada's Big Six Commercial Banks are the Bank of Montreal, the Bank of Nova Scotia, Canadian Imperial Bank of Commerce, the National Bank of Canada, the Royal Bank of Canada, and Toronto Dominion Bank.

<sup>4</sup> Corrigan (1990), pg. 17.

<sup>5</sup> French and Italian banks, in the cases of Al-Saudi Banque and Cassa di Prato, respectively, did balk at initial plans proposed by the central bank. French authorities ultimately managed to formulate a plan involving the private institutions, while in Italy the insurance fund assumed the burden.

<sup>6</sup> See Chapter I for a description of the FDIC's cost test.

<sup>7</sup> See Chapters I and III of the Report.

<sup>8</sup> Corrigan (1990), pg. 13.

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