



NEWS RELEASE

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DEPOSIT INSURANCE LIKELY TO BE HIGH ON NEXT PRESIDENT'S AGENDA, SAYS SEIDMAN

FDIC Chairman L. William Seidman today said he thinks it is likely the next president will take up the future of the deposit insurance system early in a new administration. Mr. Seidman said that approach would be in accord with the traditional advice to new chief executives: "Get the tough ones behind you in the first 100 days."

Mr. Seidman, in remarks today to the National Council of Savings Institutions, said the FDIC has made the subject of deposit insurance improvements its top research project for 1988. The FDIC, he said, has begun a comprehensive review in this area, the results of which will be made available to the incoming administration after the November elections.

One of the most important issues the FDIC study will address, said Mr. Seidman, is the question of the FDIC and FSLIC insurance funds. Mr. Seidman reiterated that the FDIC does not favor their merger. However, if Congress and the new administration decide a consolidation of the insurance agencies is necessary, he said, it is important to develop a framework for considering the issues involved.

Commented Chairman Seidman: "The FDIC is in solid shape to handle the problems in the banking industry, but we do not have resources to handle the significant problems in both industries."

Mr. Seidman said the FDIC's study of deposit insurance also will examine other issues. They include deposit insurance pricing and the question of risk-

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related premiums, supervisory mechanisms and the use of the market to control risk, possible adjustments in insurance coverage and the use of deductibles and private coinsurance schemes.

A final area of analysis will involve procedures for handling problem and failing banks. This review will encompass the fair treatment of large and small banks, and the possible expansion of the use of open bank assistance in the manner of the Reconstruction Finance Corporation of the 1930s. This approach would involve providing capital to salvageable banks. These institutions would still be solvent, but clearly in trouble; help would be provided until they recovered financial strength.

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Remarks by

L. William Seidman
Chairman
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Before

The National Council
of Savings Institutions

Toronto, Canada

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A Federal Deposit Insurance System for the 90s

Thank you for inviting me to address the National Council's 1988 Annual Conference here in Toronto. My topic for this morning is "Improving Deposit Insurance Systems."

It has been said that only the foolish and the dead never change their opinions. To prove we are not dead, we at the FDIC try to stay open minded to the need for change. Change in the deposit insurance system is an area that receives our special attention.

There are still industry executives and government officials who fail to recognize that the financial world has changed, and that the deposit insurance system needs to adapt to those changes. They are still saying "Frankly my dear, I don't give a damn" about what is happening out there, when they should be saying; "I don't think we're in Kansas anymore, Toto."

The National Council has, and can, play an important role in providing leadership in modernizing our deposit insurance system.

Deposit insurance could well be called "the issue that has been studied to death, but still refuses to die."

The search for improvement in the deposit insurance system seems to have a lot in common with the search for a flu vaccine: by the time you think you have a cure, the virus has changed its spots. You're back near where you started. In the words of the great Yogi Berra: "It's deja vu all over again."

Just since the start of the 1980s, major deposit insurance studies have been conducted by Congress, the General Accounting Office, the insurance funds themselves, as well as by many private sector authorities.

The FDIC's last study on this topic was published in 1983. At that time, our major conclusion was that to ensure long-term safety and soundness of the banking system, market discipline needed to be increased. We explored different mechanisms for achieving that result, and we actually began to cut our supervisory staff in anticipation of success through this approach. It was argued that the "Invisible Hand", to some extent, could replace the capable hands of our examiners.

My friend former Secretary of Treasury Bill Simon, a great exponent of the market system, used to say even Adam Smith's "Invisible Hand" is an unwarranted intrusion in the market place.

We didn't go quite that far, but we were headed in that direction.

Some of the ideas we explored included:

- (1) exposing some depositors to loss in every bank failure;
- (2) closing all banks that failed so that uninsured depositors would receive no insurance benefit -- Continental changed our thinking here;
- (3) forcing banks to sell subordinated debt to allow the market to evaluate a bank's performance;
- (4) implementing a system of risk-based premiums in imitation of private sector insurance rates; and
- (5) requiring greater disclosure of information to the public.

We also examined the possibility of encouraging the private sector to offer excess insurance coverage, although our

conclusion was that the FDIC should not take an active position in the development of such a market.

Given that the FDIC and others have completed their studies in the past five or six years, it might seem that we have relatively current findings available with which to work today.

But, in reality, a great deal HAS CHANGED for banks, thrifts, and for the deposit insurance system since these studies were completed. And these changes have demonstrated that many of the earlier suggestions simply do not seem desirable in today's environment.

Let me give some evidence of the changed environment:

-- In 1981, just seven banks failed and three large mutual savings banks were assisted. By 1985, the numbers grew to 119 failures and one assisted bank. And in 1987, 201 banks failed or received assistance -- a post-Depression record. Unfortunately, we may break that sad record in 1988. The losses these banks incurred tend to indicate it may be better to give than to lend since it can often cost about the same thing!

-- In 1981, the FDIC recorded just 196 problem banks. In 1987, that number soared over 1600, but settled back to just above 1,500. It appears that this figure will remain near 1500 in 1988.

-- Strains on the banking system, combined with the growth of banking deposits, have reduced the FDIC's ratio of reserves-

to-insured deposits from \$1.24 for every \$100 of bank deposits in 1981, to \$1.10 last year.

-- The problems with Continental Illinois and other large troubled institutions with significant amounts of uninsured liabilities have demonstrated the special problems of handling failures of large banks. For example, using a closing and modified pay-out to handle First Republic would have left billions of dollars of uninsured liabilities, billions of dollars of deposits to pay, and billions of dollars worth of assets for the FDIC to sell. What a closing and modified payout in First Republic would have done to the stability of the system, fortunately, we will never know. These problems also demonstrate the need for improvement in the system so that uninsured depositors in large banks do not receive better treatment than those in smaller banks.

Unfortunately, not just the banking industry, but also the thrift industry and the FSLIC, have suffered during the last few years. Now, I don't want to violate our eleventh commandment, "Thou shall not speak ill of thou's fellow insurer." But I'll make a few points:

-- At the end of 1987, the United States had 3,147 federally insured thrifts with assets of \$1,252 billion. Of these, according to the Council's numbers, about 443, with \$126 billion in assets, had negative net worth and negative income under GAAP principals. That total increases to 506 if just negative net worth is examined. Approximately 121 of these thrifts, with \$47 billion in assets, are in Texas.

-- In 1987, the \$6.6 billion in profits recorded by the two-thirds of the thrift industry that is making money, was more than offset by the \$13.4 billion loss recorded by the least profitable third of the industry.

The history of both the FDIC and FSLIC raises the question of what improvements should be proposed for "today," not just for yesterday's world. It also demonstrates that some of our earlier conclusions are no longer appropriate. Too much depositor discipline under current conditions can create unacceptable instability in the system.

The lesson is that as long as federal deposit insurance is provided so institutions can borrow on the credit of the United States, strict governmental supervision, as well as market discipline, must be in place.

Thus, almost all our prior recommendations designed to increase market discipline have not been adopted. Reliance on subordinated debt financing, modified pay-outs, or coinsurance were good ideas whose time had not come -- and probably never will! Current political realities prevent the reduction of the federal "safety net". People want their deposits protected, and they want the government to do the protecting. Government wants the banking system to function at all times. And it is not at all clear that more depositor discipline is good for the system. After all, excess depositor discipline caused the creation of the "safety net". As Caesar observed, "All bad precedents began as justifiable measures."

What is needed now is to look for improvements to meet the world that change has wrought.

That is why the FDIC has designated a study of how to improve deposit insurance as its top priority research project for this year. While our study will largely take place in the context of banking and the FDIC, many of our thoughts should also be germane to the FSLIC and the institutions it insures.

This new study follows in the footsteps of our study released last year that examined restructuring the banking industry. We

called that study our "Mandate For Change." It played a part in promoting the analysis of issues reflected in the banking reform bills now moving through Congress.

We hope that our new study -- "A Deposit Insurance System For The 90s" -- will help focus the debate on what we use to call deposit insurance reform.

In order to get the right answers, you must first ask the right questions. I want to take this opportunity to raise some of the issues for the 90s with you at this time.

-- One priority will be reexamining deposit insurance pricing. Would a system of risk-related premiums do a better job than our current system of fixed, uniform pricing? Would a change to such a system do more harm than good to current industry stability? Can we find a formula that will be mechanical, accurate, and defensible?

-- Supervisory mechanisms to control risk will be another area explored. As we enter an environment providing banks with greater powers, how will supervision adapt? Are our present supervisory resources, such as examination procedures, off-site monitoring systems, and supervisory sanctions adequate? How can we best employ these resources? And, once problem banks have

been identified, are our present regulatory powers and procedures appropriate to deal with institutions that pose a high risk to the insurance fund?

-- How can the market be used to better control risk in today's environment? Is depositor discipline really alive and well despite insurance and big bank protection? Will risk-based capital standards control risk-taking, and better maintain financial stability? How far should the federal depository "safety net" be extended?

In recent months one of the key limits on how far the "safety net" extends has already come into focus. The FDIC's treatment of certain large Texas banks demonstrates our resolve not to extend the "safety net" to holding companies.

To paraphrase Harry Truman, our message is: "The safety net stops here...with the bank."

Last month the FDIC guaranteed that all depositors and other general creditors of First Republic's banks will be fully protected, but we made it clear that these guarantees DO NOT extend to the holding company creditors or shareholders.

The world is not standing still as our study progresses -- and in fact, the changes taking place out there underline the need for this type of review.

-- With regard to handling problem and failing banks, how can we handle these failed banks so as to treat large and small banks more equitably? How do we minimize the extension of the "safety net" to nonbank entities, and, at the same time, uphold the public's confidence in the banking system? Should the FDIC expand its open bank assistance efforts to banks that are in trouble, but are not yet about to fail? Some people would like to see the FDIC operate more in the manner of the Reconstruction Finance Corporation ("RFC") of the 1930s. Such an RFC approach would involve providing capital to salvage banks and their holding companies that are still solvent but are clearly in trouble. That capital would be repaid when these banks can get back on their feet. The forbearance policy and net worth certificates we used for some of the National Council's members proved cost effective for the FDIC, and they were a modified RFC-operation -- but with no private shareholders involved.

-- Of course no look at deposit insurance would be "for real" without addressing the question of merger of the FDIC and FSLIC funds.

Is the merger of the two funds an adequate and wise solution to the FSLIC's problems? If such a merger needs to take place, how might it be structured?

The future of our deposit insurance system -- both the FDIC and the FSLIC -- is a problem likely to be high on the agenda of our next President. It is only prudent to examine all the options at this point, including how the merger issue should be approached if one is deemed unavoidable. A new president, whoever he is, may want to act on this problem early in his honeymoon period, following the good advice, "Get the tough ones behind you in the first 100 days." We hope our study suggesting improvement in the federal deposit insurance system will be helpful to either Mr. B or Mr. D.

After all we should not forget Abraham Lincoln's sage advice, "Things may come to those who wait, but only those things left by others who hustled."

Some questions to be answered regarding a merger are:

First, what is the real cost of fixing FSLIC. Estimates that start at \$20 billion and go much higher have been made.

Second, if a merger of the funds is pursued, how should it be undertaken? Should it be conducted in two or more stages, or all at once?

-- How do we create a politically independent, balanced executive board for the merged institutions?

-- What efficiencies, if any, can be gained by merger of administrative aspects of the funds, such as supervision and property disposal?

Third, where are the resources to undertake the task of restructuring the funds?

The FDIC is in solid shape to handle the problems in the banking industry, but we do not have resources to handle the significant problems in both industries. Is it clear that any combining of the insurance funds, down the road, will have to involve some level of taxpayer or other assistance?

These are difficult issues that the federal deposit insurance system must address.

Both banks and thrifts should share a common goal -- reach some joint conclusions soon -- before next January at the latest.

It has been said, "The art of progress is to preserve order amid change, and to enhance change amid order." That certainly describes our challenge.

Progress in improving the federal deposit system should command our and your attention NOW!

Let us get ahead of the curve with a plan for improving Federal Deposit insurance that is designed for the financial system of the 90s.

Once more, I would like to thank you for inviting me to address your group.