FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

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FDIC CHAIRMAN IDENTIFIES KEY ISSUES IN RESTRUCTURING OF DEPOSIT INSURANCE

"Whether some banks should be considered 'too-big-to-fail,' and whether the deposit insurance funds should be merged, are threshold issues that must be addressed in developing a deposit insurance system for the '90s," said Federal Deposit Insurance Corporation Chairman L. William Seidman in remarks delivered today to The Garn Institute of Finance.

Mr. Seidman pointed out that since the 1984 rescue of Continental Illinois National Bank & Trust Company the FDIC has intervened in every case to prevent the failure of major banking organizations. While such government intervention should represent a "wipe out" of shareholders and management, said Mr. Seidman, "the critical issue for the FDIC, or whoever has to make the decision, is should this policy of rescuing banks that are too big to be allowed to default on obligations to depositors and the bank creditors be continued."

Mr. Seidman noted that recently FDIC assistance has been limited to failing banks and not extended to bank holding companies or holding company creditors. Acknowledging that the distinction between banks and holding companies has confused some, particularly foreign observers of the U.S. banking system, Mr. Seidman stated: "We must make it clear to all creditors that banks and bank holding companies are separate legal entities, which will be treated as such when rescue decisions are made."

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The FDIC must consider institutional size, uninsured and exposed liabilities, and the impact a particular bank's failure would have on the stability of the financial system in reaching a decision, Mr. Seidman said. He noted it is undesirable to set forth rigid rules in this area. "This process inevitably must take place on an ad hoc basis, where a variety of factors are examined."

With respect to merger of the deposit insurance funds, Mr. Seidman said: "The FDIC would prefer to go it alone. That's based on the fact that it is one of the few examples of a government institution that is able to save up for a rainy day, weather one of the worst storms in the banking industry's history, and be dry and ready for the next storm."

If a merger of deposit insurance funds is determined necessary by Congress, Mr. Seidman suggested that any consolidation follow these guidelines:

- All insured institutions should be regulated according to common standards.
- If a separate thrift industry is preserved, it should be insured by a separate insurance fund within the merged institution.
- Any new deposit insurance agency should be financially independent, as the FDIC is today, with no government subsidies.
- The insurance agency should be independent of chartering authorities and have the ability to determine, in all appropriate cases, which applicants should be denied deposit insurance.
- Banks should not be asked to pay for resolving the savings and loan industry's problem cases.
- The governing board of the insurance agency should be chosen in the same manner, and operate under the same rules, as the FDIC Board of Directors.

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Remarks by

L. William Seidman
Chairman
U.S. Federal Deposit Insurance Corporation

Before

Garn Institute Deposit Insurance Forum

November 14, 1988

It's a pleasure to take part in this important discussion of deposit insurance.

It surely is an appropriate time to address the the future of our insurance systems.

As I'm sure you have noticed, the FDIC has been dealing with a few banking problems these last few years.

In fact, the FDIC will handle more total banking assets in 1988, than it dealt with during its first 50 years! This includes the cost of First Republic, First City, and MCorp -- representing three of the four most costly transactions ever.

Despite dealing with a record number of problems, the financial condition of the FDIC fund remains in good financial shape. Based on current estimates, the fund will end the year with a $15 to $16 billion net worth. Although the FDIC will suffer an operating loss of $2 to $3 billion this year -- our first operating loss ever -- we expect to return to the black next year. We base that calculation on the projected cost of handling the approximately 150 to 175 failures and assistance transactions we anticipate for next year.

Given that none of the problem institutions we see on the horizon are over $3 billion in assets, we estimate that our fund will end 1989 with an increase of about a half a billion dollars in net worth.

I'm pleased to report that the FDIC is emerging from this difficult period ready to deal with any foreseeable problems in the banking system.

Of course, the FDIC is not the only insurance agency in Washington facing unprecedented claims. The problems of the FSLIC are no longer just the concern of federal officials and academics. They are now common discussion around the country, and the subject of numerous reports and editorials in the media.

The scope of the problem seems to be finally sinking in. Imagine a potential government bailout that could be more costly than the rejuvenation of Europe through the Marshall Plan, plus the combined costs of the federal assists provided to Chrysler, Lockheed, <u>and</u> New York City!

It's clear that without proper safeguards, deposit insurance can turn into a very expensive undertaking. It is time to make sure we agree on what we want it to accomplish, and the methods used to achieve those objectives.

Today I'd like to address two key issues -- threshold issues in any look at improving the deposit insurance system. These issues will be a key to our FDIC deposit insurance recommendations to the new Administration. They are:

-- Should there be a "too-big-to-fail" policy in the U.S. banking system, and if so, should the FDIC have the job and the duty to save big bank creditors?

-- And should the insurance funds be merged?

First, to what extent should the federal government prevent our largest banks from failing?

Let me make it clear in using the common term "too-big-to-fail", I'm not applying it to shareholders and management of any institution big or small. Any government action still means a wipe out as far as they are concerned.

So, are there instances when a banking enterprise, because of its size, regional importance, international position, or other factors, is literally too big to be allowed to default?

The extent to which the United States stands behind its largest banks is an issue closely followed by investors and banks around the world.

The question of how the government should react when a private enterprise deemed "too-big-to-fail" becomes threatened, was confronted in the 1970s -- but in a context outside the banking arena. Notable examples of how the government solved this question in the last decade include Lockheed Aircraft, the Chrysler Corporation, and New York City.

The Federal government has evolved a number of informal criteria for intervention in such cases.

These criteria include the threat of unemployment; the possibility of a harmful "domino effect" on suppliers and consumers; the threat to national security of a disastrous impact on regional and national economies; and, of course, the political clout of the institution's congressional representation.

Broader ill effects have also been explored. These include lessened domestic competition, the threat of foreign firms moving in, and what the disappearance of such major players would do indirectly to our domestic and international environment.

The "too-big-to-fail" question became a banking issue when Continental Illinois was taken over by the FDIC in 1984.

At the time, the Comptroller of the Currency testified before Congress that certain banks did fall within the same "too-big-to-fail" criteria as Lockheed and Chrysler.

All of the deposits and other liabilities of Continental Illinois' banks were protected against loss by the FDIC, and so were the holding company creditors. The bank's senior management and common shareholders, of course, received no such protection. In the end, they lost their jobs and their investment.

However, in a technical sense, neither the Continental Illinois bank nor its parent holding company closed or technically failed. Instead they were recapitalized. This led to the "too-big-to-fail" designation, which included both the holding company and its banks.

It was assumed, though never made official government policy, that there were 10 to 12 banks that were too-big-to-fail in the sense that all creditors would be protected -- bank and holding company creditors alike.

In certain ways this was also true fo~ smaller banking problems. In almost all bank failures all depositors are in fact protected. Since 1984, in 78 percent of the failures involving over 99 percent of the deposits of failed institutions, all depositors received 100 percent protection.

This result was dictated by fact that it provided the lowest cost way for the FDIC to handle the problem banks. Those instances in which depositors were not protected primarily involved small banks where no buyer could be found to assume the deposits.

The largest bank failure in FDIC history where depositors actually took losses was Penn Square Bank, a $500 million dollar institution.

Earlier this year the FDIC dealt with First Republic in Texas, an enterprise comparable in size to Continental Illinois.

This time both the forty-one banks owned by First Republic BankCorporation, and the holding company, _were_ allowed to fail, and then _were_ closed and sold. Yet, all depositors and other Bank creditors were protected against loss. And, as with Continental Illinois, bank stockholders and management were _not_ protected by the deposit insurance fund. However, the too-big-to-fail doctrine and the protection of the deposit insurance fund did not extend to the holding company and its creditors.

The too-big-to-fail doctrine was held applicable to banks only. The FDIC bridge bank authority provided the vehicle to achieve this result.

When dealing with large banks, the critical issue for the FDIC, or whoever has to make the decision, is which banks are too big to be allowed to _default_ on obligations to depositors and bank creditors.

When addressing this issue we make a few basic assumptions.

First, the banking system is special because it plays a critical role in the economy -- by allocating credit, by acting as a safe depository for funds, and by its role at the center of the payments system.

Second, given that the banking system is special, and needs to be protected as a whole, it is necessary to protect certain creditors of larger institutions to avoid destabilizing the overall system.

Third, allowing a major bank to default could destabilize the international financial system. Today we have a global financial system. If the United States were to become the only industrialized nation to allow depositors and creditors of a major bank to suffer loss, would that undermine the international financial system, to say nothing of the competitive position of U.S. banks?

Fourth, allowing a major bank to default and requiring the FDIC to pay off insured depositors, could also prove very costly for the FDIC, and require huge cash outlays.

If we had allowed First Republic to close down, and paid-off its depositors, the FDIC would had to have paid out billions of dollars more in cash up front than our estimated aggregate cash outlay of less than 4 billion dollars. We also would have acquired billions of dollars of assets to liquidate, greatly increasing our total cost for the transaction.

And there is a real question of whether it is technically feasible to close a gigantic institution, with the massive scope of its ever-changing portfolios, without freezing insured as well as uninsured funds for a considerable period.

Some have argued that the risks of allowing larger banks to default are worth taking, and we are certainly _not_ implying that we would not liquidate a bank larger than Penn Square. But it is certainly easier to advocate taking risks from the sidelines, than when you have _The Watch_.

The bottom line in this discussion is that _nobody really knows what might happen if a major bank were allowed to default_, and the opportunity to find out is not one likely to be appealing to those in authority or to the public. Combining cost factors with unacceptable risk, most large banks likely are going to be handled in a manner that protects all depositors and other general creditors.

Given that conclusion, how do we know where to draw the line delineating which banks are so significant that they cannot be allowed to default? This process inevitably must take place on an ad hoc basis, where a variety of factors are examined.

These factors include the sheer size of the institution; the amount of uninsured and exposed liabilities; the cost to the FDIC, including whether another cost-effective solution is available; the perceived effect on the stability of the banking system; the extent of the international orientation of the institution; and the anticipated effects on the local and national economies.

Beyond articulating these broad criteria, it is neither wise, nor practical, to set forth rigid rules in this area. To maintain some market discipline, it is perhaps the best judgement not to provide absolute assurance in advance.

When applying the federal safety net, even stretched to contain the too-big-to-default doctrine, it is critical to keep in mind that this policy is designed to protect only banks.

Under current policy guidelines, this federal protection does not extend to nonbanking activities or bank owners, including bank holding companies. That, of course, was not the case when Continental Illinois had its problems, and we protected holding company creditors.

Our view that we must limit the extension of the safety net to banks is the reason we allowed First Republic's holding company to default on its obligations last summer.

Recently, I received a letter from a foreign bank that discussed our handling of First Republic. I quote from that letter:

"In our opinion the confidence of international banks as well as other investors in the U.S. banking system has been under some strain over the past years through events known to you. The rescue operation mounted in favor of Continental Illinois Corp. some time ago was successful in containing this development.

"To uphold investors' confidence in the U.S. banking system must have been the leading motive for the rescue operation in favor of First RepublicBank Dallas, and this objective alone can justify the expense of such a vast amount of public funds. This purpose is, however, utterly confounded if the interests of holders of senior debt issued or guaranteed by the bank holding company are sacrificed."

Our answer to this letter is: You must understand that you can rely on our big banks to be supported, but not their holding companies. Thus, our policy is certainly not a reason for anyone to lose confidence in the American banking system. Because holding companies -- a somewhat unique concept to the U.S. -- are regulated with respect to capital by the Federal Reserve Board, many abroad have had difficulty understanding that holding company creditors are not protected.

We must make it clear to all creditors that banks and bank holding companies are separate legal entities, which will be treated as such when rescue decisions are made.

In fact, we believe the law should reflect this concept explicitly. Our proposed "Emergency Consolidation" legislation would assure that the banking assets of a failing muti-bank holding company system are appropriately applied toward solving problems in a subsidiary bank prior to requiring the expenditure of FDIC funds.

Legislation of this type is absolutely essential for the protection of the insurance fund, and will be of the highest priority on the FDIC's legislative agenda when the next Congress convenes.

The credit markets are already recognizing this policy, and are requiring higher returns on holding company debt when compared to direct bank debt. The credit ratings of bank holding companies are on the decline relative to bank credit ratings, reflecting less reliance on implicit Federal guarantees. In our view this emerging discipline represents a healthy and efficient development in the marketplace, which will be counteracted when holding company credit positions, on their own, support better ratings.

While the too-big-to-default idea makes good sense on many levels, it obviously has some troubling features.

First and foremost it prevents the markets from directly disciplining large banks to the extent they would if the policy did not exist. We have found no answer to this fact. But we do point out that the markets are still active observers, as was clear with First Republic before we took action.

Moreover, this policy arguably gives preferential treatment to our largest banks because of the role they play in the economy, disadvantaging a few smaller banks that are not afforded similar protections.

We are endeavoring to reduce that problem by using failure resolution methods that protect all depositors and bank creditors whenever feasible -- and we achieved that in over 74 percent of the cases since 1976.

But of course this extends, rather than reduces, insurance coverage, and gets us near to 100 percent coverage for all. That is why I said too-big-to-fail is a threshold issue in talking about the future of deposit insurance.

Once it is determined that some banks are too large to default, the question becomes: which government branch is responsible for resolving the situation?

Is it appropriate for the FDIC, with its finite resources, but considerable expertise in the field, to play this role? Or, should the Federal Reserve Board or the Treasury Department assume a greater part of the burden given their vast resources and responsibility for overall economic stability?

In our study we have looked at how this issue is handled abroad. Most industrial countries have some form of protection for their largest institutions. Although there is considerable variation among countries, normally it is the central bank or treasury that plays the dominant role in handling bank failures.

Under our system, it would appear that the FDIC is as good a candidate as any. We have saved up for these kind of problems, and have money in the "bank." The FDIC is well experienced, and it is usually the largest creditor with the most to gain by a cost-effective solution. The FDIC is also in the position to take quick action -- a factor not as important when dealing with supporting other types of industries, like an auto maker.

If the FDIC is the ultimate provider of resources to the banks in the financial system, then for overall stability it must remain solvent and viable. This is a far broader responsibility than conferred on the FSLIC, <u>and is an important factor to consider when talking of mergers of the insurance funds and taxpayer liabilities.</u>

That leads me to the issue I'd at least like to address -- the merger of the insurance agencies. We are still studying the issue, and I have no definitive position to give you. What I can say now is:

The FDIC would prefer to go it alone! That's based on the fact that it is one of the few examples of a government institution that is able to save up for a rainy day. It has not only done so, but it has used its savings to weather one of the biggest storms ever, and emerge from the tempest dry and ready for the next storm.

Perhaps government should preserve this unusual specimen -- as they say "if it ain't broke, don't fix it."

If we do face a merger, than we believe these guidelines should be followed.

First, all insured institutions should be regulated according to common standards.

Second, if a separate thrift industry is to be preserved, it should have a separate insurance fund. The risk factors of the banking and thrift industries generally vary widely, and that dictates a separate fund for each.

Third, any new deposit insurance agency should be independent as the FDIC is today. The FDIC operates almost like a private insurance company -- banks pay us premiums to insure their deposits, and we use those premiums both to build up our deposit insurance fund, and also to cover our operating expenses. No outside government subsidies are provided.

The FDIC is a success story today to a considerable extent because of this independence and freedom from political pressure. Without this independence, the FDIC might be prevented from taking the swift action system stability demands.

Fourth, the insurance agency should be independent of chartering authorities and have the ability to determine, in appropriate cases, what institutions should be denied insurance.

The power to determine who should be insured is the power to deny institutions the right to behave in an unsound manner. The agency insuring does not create new powers, but only prevents unwise activities. This creates a powerful built-in incentive to control risks.

Fifth, banks should not be singled our to pay for the problems of their competitors in the S & L industry.

And sixth, the governing board of the agency should be chosen in the same manner, and operate under the same rules, as the FDIC Board.

You can be assured that the FDIC wants to see the thrift insurance problem solved, and an improved system put in place for all insured institutions. We stand ready to help in any and every way we can.

My time is about up.

I'm reminded what that great statesman, Henry Clay, had to say about long-winded speakers.

Mr. Clay took a fellow Member of Congress to task because his colleague's speeches tended to go on and on.

The offended Congressman took umbrage, and replied, loftily: "Mr. Clay, <u>you</u> speak for the <u>present</u> generation -- but <u>I</u>, sir, speak for <u>posterity</u>!

"Yes," replied Mr. Clay, "But <u>you</u>, sir, seem determined to <u>keep</u> <u>talking</u> until <u>your</u> audience arrives!"

On that note, I'll bring my comments to a close!

Thank you.