FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

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WHOSE BANK IS IT, ANYHOW?

An address by

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Good morning. It is a real pleasure to have this opportunity to address so many community bankers from around the nation.

The banking industry is in the news on almost a daily basis: we hear about entry into the business by new competitors, deposit interest rate deregulation, volatile interest rates, a troubled worldwide economy, bank failures, problem banks, proposals for expanded powers, new disclosure requirements, pressures for reforms in the regulatory and deposit insurance systems, foreign loans, and geographic restraints. I will touch on many of these subjects today, beginning with the condition of the banking system and then turning to a number of regulatory reform issues.

I. THE CONDITION OF THE BANKING SYSTEM

It is no secret that we have experienced a significant increase in the number of problem banks and bank failures during the past year or so. Two points should be emphasized: a) the problems have been foreseen and b) they have been and will continue to be handled in a manner that maintains public confidence in the system.

We have experienced four successive years of economic stagnation and extraordinarily high and volatile interest rates, following more than a decade of rampant inflation. Even in the best of times, banks will suffer loan losses if they are aggressively meeting the credit needs of their communities. However, one of the insidious effects of inflation is that marginal borrowers or marginal projects obtain financing on the assumption that continuing inflation will make them viable. These borrowers and projects are the first and hardest hit by high interest rates and an economic slowdown.

During 1981 we handled 10 bank failures, and at the end of that year we had 220 banks on our problem bank or watch list. Early in 1982 I asked our regional directors to forecast the number of banks that would fail in their regions during 1982 and to estimate the number of problem banks we would have by the end of the year. They forecast between 40 and 50 failures; we actually experienced 42. They estimated we would have 375 banks on our problem list by year-end; we actually had 370. The point is, while we cannot forecast each and every failure, we have a pretty good feel for the magnitude of the problems and are able to prepare ourselves to deal with them in an orderly way.

So far this year there have been 10 bank failures, and there are currently about 425 banks on our problem list. We expect the number of problem banks to continue to grow throughout the year and the failure rate to equal or exceed last year's total.

Despite the extraordinary cost of handling recent bank failures -- about a billion dollars in each of the past two years -- the deposit insurance fund continues to grow and is stronger than ever. At the beginning of 1981, the fund totalled $11 billion; today it exceeds $14 billion, after absorbing the full impact of over 60 failures. Our revenue this year from assessments and interest on our investments will approach $3 billion.

In sum, the banking system is experiencing problems, but none that have not been expected or cannot be managed. Our personnel have faced long hours and many sleepless nights, but the safety net has held; stability has been maintained.

II. REGULATORY AND INSURANCE REFORMS

The important question is where do we go from here -- what changes do we need to make in our systems of regulation and insurance to maintain a strong, profitable and stable banking system in the years and decades ahead? We are convinced that substantial reforms are badly needed.

From the 1930s through most of the 1960s, competition in the financial services field was tightly controlled. Price competition was restricted by Regulation Q. Product competition was curtailed by limiting the asset powers and permissible activities of banks and other intermediaries. Entry into the business was carefully regulated, as was expansion. It was rare for a bank to encounter difficulty; only a half dozen or so banks failed each year, almost always due to fraud or insider abuse.

You do not need anyone to tell you this has all changed. The current economic climate is anything but benign; banks and borrowers can no longer count on economic expansion, inflation or stable interest rates. Deposit interest rate controls have been almost completely dismantled in response to market pressures. Product distinctions among banks, S&Ls and other intermediaries are barely discernible. Restrictions on entry and expansion have been eased.

The new environment offers exciting opportunities for well-managed banks of all sizes, particularly as we expand the range of permissible activities in such areas as insurance, real estate, securities, data processing and travel services. At the same time, it presents many challenges for our regulatory system.

How, in the absence of rigid, government-imposed restrictions on competition, do we control destructive competition and excessive risk-taking? How do we insure

that deposits flow to the vast majority of banks that are prudently operated rather than to the marginal banks which are willing to make the highest risk loans and pay the highest rates for deposits?

We have two options. We can adopt countless new laws and regulations to govern every aspect of your operations and hire thousands of additional examiners to monitor and enforce compliance. Or, we can seek ways to increase marketplace discipline.

The FDIC clearly prefers to allow the marketplace to function to the maximum possible extent. We are flatly opposed to unnecessary regulations.

A. Disclosure. For the marketplace to perform its disciplinary function, it must have information. This is the reason we have decided to make public the new call report data on interest-rate sensitivity and nonperforming loans and why we are considering additional disclosures covering such matters as insider-lending practices and enforcement actions.

We are attempting to turn the spotlight on marginal, high-risk banks. We believe this will deter unsound banking practices and destructive competition. If problems nonetheless arise, troubled banks will either correct them promptly or will fail more quickly, causing less damage.

It may seem harsh, but we cannot coddle marginal banks. To do so would undermine the vast majority of banks that are operating prudently by making sound loans, maintaining adequate capital ratios and paying reasonable rates for their deposits. That we will not do.

B. Large Depositor Risk Sharing. The other ingredient essential to instilling marketplace discipline is the risk of loss. Although the explicit coverage under our deposit insurance system is limited to $100,000, in practice we have for years been providing implicit 100% coverage for depositors and other creditors at most banks, particularly the larger ones.

This has resulted from our practice of merging failed banks into other banks. Under current law, we are required to make all general creditors whole when we arrange a merger (or "purchase and assumption transaction").

We have a strong preference for handling bank failures through mergers; it is ordinarily the least expensive and least disruptive method. We nevertheless abhor the side

effect of providing 100% deposit insurance coverage; we are convinced it has eroded marketplace discipline and provided larger banks a substantial competitive advantage.

Prior to the Penn Square Bank failure, it was generally believed the FDIC would never pay off depositors in a bank larger than $100 million. That episode has obviously caused people to raise their estimate of the size limit, but most still believe there is a limit beyond which we will not go.

As a practical matter, they may be right. It is not, as some people think, a matter of money. The percentage of insured deposits in most large banks is comparatively modest and paying them off would not be prohibitively expensive. The problem is that billions of dollars of uninsured funds would be tied up for years in a bankruptcy proceeding, possibly causing severe repercussions throughout the economy.

We are currently searching for solutions to this dilemma. One possible approach may be to modify the deposit insurance system to provide 100% coverage for the first $100,000 in deposits and a smaller percentage -- say 75% -- for all deposits over $100,000. This would be the coverage whether we paid off depositors or arranged a merger.

Another possibility would be to maintain the insurance limit at $100,000 and, at the time of failure, pay that amount, plus an amount equal to the estimated ultimate recovery on the uninsured portion. Again, this could be accomplished by a direct payoff or by transfer of the deposits to another bank.

Either approach would solve a number of problems. We could continue to arrange mergers for failed banks. Enough of the deposits would be made immediately available to minimize the economic repercussions, but there would be some risk of loss; we would not provide a complete bailout for the largest creditors. Either proposal would eliminate the competitive inequity between large and small banks and provide customers an incentive to select the soundest institutions, not just the largest ones or the ones that pay the highest interest rates.

C. Regulatory System. In addition to this and other possible reforms in the insurance system, such as risk-related premiums, some fundamental changes in our regulatory system must also be considered. We believe the current regulatory system is inefficient and inequitable.

Why, for example, should state banks be burdened by two layers of regulation while national banks operate with one layer? How can we continue to justify an entirely different

regulatory system for S&Ls now that they have commercial lending and transaction account authorities? Why should mergers be subject to antitrust review by both the banking agencies and the Justice Department? Why should the banking agencies enforce the securities laws with respect to banks when the SEC has responsibility for bank holding companies and other businesses? Why should the banking agencies enforce Truth-in-Lending and other consumer laws with respect to banks, while the FTC oversees nonbank firms? Does it make any sense to have a parent bank holding company examined and regulated by the Federal Reserve when the lead bank is examined and regulated by a different agency? How can we rationalize different insurance agencies for banks and S&Ls? How can we justify disparate capital adequacy standards for S&Ls and banks and for banks of different sizes? Why should S&Ls and banks operate under different reporting and disclosure rules? Why should we permit a retailer or a steel company to own a federally-insured S&L with banking powers while prohibiting a bank from owning a steel company or a retailer? Why is it permissible for a securities firm to own a bank, but not the reverse?

The short answer to these and many other similar questions is that the current regulatory system is not rational. All of the issues I have just raised are inextricably intertwined and should be addressed through comprehensive reform. Intellectually, this is not nearly as complicated as it might appear at first blush.

First, we need to redefine the term "bank" and reconsider the range of activities in which it or its affiliates may engage. It may be appropriate to define a bank as any institution which offers either transaction accounts or any type of federally-insured deposit. In our opinion, a bank should be permitted to engage, either directly or through a subsidiary, in the full-range of financial services, including much broader authority than at present in securities, real estate, travel agency, insurance and data processing activities. It follows that any company engaged in such activities should be permitted to own or affiliate with a bank and that any company engaged in impermissible activities should not. Nonconforming companies already affiliated with banks or S&Ls could be given 10 years to either conform or divest.

Second, the various financial agencies at the federal level should be consolidated and all regulation should be organized along functional lines. To be specific, the regulatory functions of the Federal Home Loan Bank Board, the Federal Reserve, and the Comptroller of the Currency should be consolidated into an independent agency headed by

a board. That agency would license and regulate all federally-chartered banks and S&Ls and their holding companies. State-chartered institutions would be licensed and regulated by their state authority, preserving our dual banking system.

Under this concept, the FDIC would remain as a separate, independent agency with insurance responsibilities for all state- and federally-chartered banks and S&Ls. It would have the right to examine and take enforcement actions against any insured institution or its affiliates. It would focus its examinations on problem and near-problem institutions and merely spot check the others. The FDIC would not be concerned with branch applications and other types of regulatory activities.

Some bankers object to the merger of the FDIC and FSLIC insurance funds because they fear that the cost of resolving some of the problems in the S&L industry will reduce the assessment rebates available to banks. This objection can be easily met by computing the rebates on a separate basis for a few years after the merger.

Finally, securities regulation with respect to banks, S&Ls and holding companies would reside exclusively in the SEC. Antitrust enforcement would reside exclusively in the Justice Department, and consumer compliance matters would reside exclusively in the FTC.

III. CONCLUSION

I have covered a lot of ground today -- perhaps too much. To deal with so many major topics in a speech of reasonable length, I have had to simplify some of the issues and abbreviate the discussion of our positions on them.

My objective today has not been to convince you that our insurance and regulatory systems ought to be changed in precisely the manner I have outlined. Rather, I hope I have persuaded you that the systems are inadequate and inequitable and that you should actively support major reforms.

All of the issues I have outlined today are under serious consideration. The FDIC will soon submit a report to Congress on the insurance questions. The Treasury will likely propose in the not-too-distant future its ideas for expanded powers for banks or bank affiliates. The Vice President's Task Group is reviewing a number of options for reform or restructuring of the regulatory agencies. The Senate Banking Committee plans to conduct hearings this spring covering all of these subjects.

If we have the wisdom and political courage to tackle these issues, I believe we can look forward to a strong, profitable and responsive financial system. It will be a system in which well-managed institutions of all sizes will be able to compete on an equal footing and prosper.

Some people believe we should maintain essentially the current regulatory structure and eschew increased market discipline. Pursuit of this course will inevitably lead to more and more regulations and bureaucracy. The largest institutions will continue to grow larger simply because they are big. The unregulated will thrive at the expense of the regulated.

The FDIC is firmly committed to the maintenance of a strong, dynamic banking system under private ownership and control. We believe that advocates of government restrictions and controls must be made to bear the burden of proof that they are necessary.

The decisions we make on these subjects over the months and years ahead will have profound effects on the financial system for decades to come. The battle lines are being drawn. Simply put, the issue is who will control the destiny of your banks: you or the government?

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