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FEDERAL DEPOSIT INSURANCE
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STATEMENT ON

DEPOSIT INSURANCE AND
SUPERVISORY REFORM

PRESENTED TO

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
UNITED STATES SENATE

BY

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Mr. Chairman, members of the Committee, it is a privilege for me to lead off this series of hearings on deposit insurance reform and related supervisory issues.

It is not hyperbole to characterize the changes now taking place in the financial system as revolutionary. A structure put into place a half century ago, at the nadir of the Great Depression, is crumbling. In part this is occurring by design, but in larger part it is caused by the forces of economics and technology. The central question facing government today is not whether change will or should continue but, rather, how to insure that the financial structure that eventually results will best serve the public interest.

Deposit insurance has been an integral part of the financial system for over a half century, responsible in considerable part for the depository institution structure that has evolved and the nature of supervision and regulation of depository institutions. It is, therefore, impossible to consider any government action to fundamentally alter the financial structure without addressing the role of the insuring agencies.

Mr. Chairman, you have assembled many distinguished witnesses to testify at these hearings. They will offer a variety of opinions on how best to reform the system. At one end of the spectrum, some will likely advocate that we dismantle much of the governmental infrastructure and place virtually total reliance on market forces. At the other end, some will likely espouse a greatly expanded role for the government, particularly at the federal level.

We believe that each of these represents an extreme point of view. Proponents of the first approach would turn the clock back to 1925 and pretend the financial collapse of 1929 did not occur. Proponents of the second approach would turn the clock back to the 1960s and pretend the past quarter of a century did not occur.

We must endeavor to strike a balance. The collapse of 1929 did occur, and it taught us a lesson we must never forget: the government has a vital role to play in maintaining financial stability. At the same time, we must also recognize that in many respects we overreacted to the trauma of the Great Depression. We were not sure exactly what to fix so we fixed everything in sight, including some things that did not need fixing. We were far too zealous in our efforts to stifle competition and innovation.

Surely, if we have learned nothing else during the past couple of decades, we have learned that the marketplace will not indefinitely tolerate unnecessary and inefficient restraints. Either the restraints themselves or the businesses subject to them will be eliminated.

Deposit interest rate controls are one example. The marketplace forced their elimination. If we had taken much longer to receive and act on the market's message, the damage to our nation's banks and thrifts would have been beyond repair.

There are other artificial barriers to competition that should be reduced substantially or abolished. They are weakening the regulated firms and denying the public the fruits of a fully competitive and responsive financial system. Specifically, I have in mind the restraints on interstate banking, the Glass-Steagall Act and the Bank Holding Company Act.

Since this hearing is not directed primarily at those issues, I will not dwell on them except to state that there are far better and less invidious ways to control potential abuses and concentration of economic resources. I am convinced that each of these three barriers to competition will eventually meet with the same fate as interest rate controls.

The FDIC remains totally committed to deregulation of financial services. It is good for banking, it is good for consumers and it is good for the nation.

But it is essential to recognize that deregulation -- i.e., the dismantling of artificial restraints on competition -- necessarily requires that we strengthen our supervision of banks and that we reform our system of deposit insurance. To fail to do either is a prescription for disaster.

A deregulated environment is more complex, faster paced. It requires more skilled, better trained examiners and analysts. It requires more reliable and sophisticated offsite monitoring systems to enable us to spot potential problems more quickly and better target our scarce personnel resources. Once abuses or unsound practices are uncovered, enforcement actions must be swift and strong.

The FDIC is moving aggressively in each of these areas. We are increasing staff, spending nearly $10 million per year to train our personnel and are deploying them where they are most needed. Major efforts are under way to improve our offsite monitoring and analysis systems. Our enforcement activities have increased fivefold in the past four years and the actions, including fines and removal of officers and directors, are considerably stronger. When banks fail, we are relentless in our pursuit of civil and criminal sanctions against the perpetrators.

While these efforts are critically important, we cannot and should not place total reliance on them. Promulgating countless new regulations to govern every aspect of bank behavior, and hiring thousands of additional examiners to enforce

them, would be prohibitively expensive, would undercut the benefits sought through deregulation, would favor the unregulated at the expense of the regulated and would ultimately fail.

We must seek new ways, in the absence of rigid government controls on competition, to limit excessive risk-taking and abusive practices. We must enlist the support of the marketplace to instill a greater degree of discipline in the system. To accomplish this, we must reform the deposit insurance system.

The collapse of the banking system in the 1930s provided the impetus for the FDIC, even though the measure was opposed by President Roosevelt and the American Bankers Association. They believed the system would be too costly and would subsidize marginal, high-risk institutions at the expense of the well-managed firms. A compromise was agreed upon to provide modest coverage of $2,500 per depositor. Larger, more sophisticated depositors remained at risk and were expected to supply the necessary discipline.

Most of the early bank failures were handled by the FDIC as payoffs of insured deposits only. Depositors over the insurance limit were exposed to loss.

Eventually, the FDIC developed and employed more frequently the purchase and assumption transaction, whereby a failed bank was merged into another bank with FDIC financial assistance. The procedure offered some advantages. It was less disruptive because it automatically continued banking services for the failed bank's customers, and it tended to be less expensive to the FDIC because it preserved some of the franchise value of the failed bank.

An unfortunate side effect was that all depositors and other general creditors were made whole, thereby undermining discipline, but this flaw was of little concern in those relatively tranquil days. Only a handful of very small banks failed each year. Interest rate controls prevented banks from bidding for funds, so customers continued to have the incentive to do business with the banks that were perceived to be strong and could offer the best and most convenient services.

The deposit insurance system was largely transformed, through the purchase and assumption technique, into a system of <u>de facto</u> 100 percent coverage. The perception of 100 percent coverage became particularly pronounced with respect to larger banks when the FDIC infused capital into Bank of the Commonwealth in 1972; arranged mergers for United States National Bank in San Diego, Franklin National Bank and a few other sizeable banks during the mid-to-late 1970s; and infused capital into First Pennsylvania in 1980 and Continental Illinois in 1984.

While de facto 100 percent coverage, or the perception of it, might not have been cause for much concern in the 1960s, it is enormously troubling in the decontrolled rate environment of the 1980s. How, in a deregulated environment where most depositors do not believe they are at risk, do we insure that funds flow to the vast majority of banks that are prudently operated instead of to the high flyers that pay the highest rates? The answer is clear: we need to restore an element of discipline in the system.

So one major objective of deposit insurance reform in a deregulated environment should be to achieve greater market discipline. This can be accomplished in any one or more of three ways: pull back from de facto 100 percent depositor coverage, find new ways to impose discipline through the capital accounts and implement risk-related premiums. These policy options are discussed in more depth in the appendix to our statement.

A second major objective of deposit insurance reform should be to achieve greater fairness in the system. The fairness issue takes two forms. First, there is the question of how bank failures can be handled so as not to discriminate or give the appearance of discriminating against smaller banks. Second, there is the question of how to allocate the cost of the deposit insurance system in an equitable fashion. For example, is it fair that the best bank in the country pays the same price for deposit insurance as the worst bank? Is it fair to exempt from assessments nearly two-thirds of the deposits of Citibank, while exempting only one-third of the deposits of the Bank of America and none of the deposits of the vast majority of the banks? Is it fair to require well-run banks to pay for the extra cost of supervising problem banks? These issues and a number of others, together with our recommendations for dealing with them, are also discussed in the appendix.

Next, there is the question of disclosure. If we place people -- whether depositors, suppliers of capital or both -- at risk in banks, they are entitled to full disclosure regarding the financial condition and practices of the banks. It is as simple as that. There are only two kinds of information about a bank that we believe should not be disclosed. We believe in strict confidentiality of customer information. We would also protect from public disclosure the ratings by bank regulatory agencies. The ratings represent our opinion, not fact. They are sometimes wrong, on either the low or high side, yet they would be accorded overwhelming weight by the public.

Whatever policies are adopted for banks in terms of capital, disclosure and depositor discipline, the rules must be applied equally to savings and loan associations. Partly for this reason, but mostly because of the need to strengthen the

federal insurance system, we favor a merger of the FDIC and FSLIC. Our views on this are spelled out in more detail in the appendix.

Mr. Chairman, members of the committee, I thank you for this opportunity to testify on these matters of vital importance to our nation. We at the FDIC have long felt that the issues of deregulation, improved supervision and deposit insurance reform are inextricably intertwined. We cannot deal with one without addressing the others. This hearing is the first, that I can recall, that has attempted to pull them together.

If you are successful in this effort -- if you are able to enact a balanced, comprehensive measure that proceeds with deregulation, strengthens the supervisory process and reforms the deposit insurance system -- there is no question in my mind that the financial system will be made infinitely stronger. It will be a more stable and equitable system in which well-run institutions of all sizes will prosper and be fully responsive to the needs of the American public.

I and the FDIC will be more than pleased to assist you in this effort in any way possible.

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