APPENDIX

A number of reforms have been suggested by the FDIC and others. The following represents the FDIC's views on many of them.

Discipline

There are two principal ways to achieve greater discipline in the banking system: through depositors and/or through the suppliers of capital. A third, complementary approach would be to implement risk-based deposit insurance premiums.

Depositors

Some suggest that the FDIC revert to the insured deposit payoff method for handling bank failures in order to instill greater discipline. The problem is, it simply will not work in large banks.

Take Continental Illinois for example. At the time of its near collapse, it had only $3 billion or so in insured deposits. With over $16 billion in its insurance fund at that time, the FDIC could have paid those depositors their money. But other creditors holding nearly $37 billion in claims, including some 2,300 small banks with $6 billion in claims, would have had their funds tied up for years in a bankruptcy proceeding. With nearly a million deposit accounts to process, even insured customers would have had to wait a month or two before receiving their funds. Finally, the FDIC would have been forced to liquidate a $30 billion loan portfolio.

Because of these types of problems, last year the FDIC developed and tested the modified payoff technique. It retains many of the advantages of a merger of a failed bank, while imposing a degree of discipline on large depositors. Insured accounts are sold through a competitive bid process to another bank, preserving some franchise value and minimizing the disruption to smaller depositors. Many loans and other assets are transferred to the acquiring institution, reducing the burden on the FDIC's liquidation staff. Instead of forcing uninsured depositors to await the liquidation of assets before receiving any funds, the FDIC conservatively estimates the present value of the receivership's ultimate collections and makes these funds -- say 60 or 70 cents on the dollar -- available immediately. Additional payments are made if and when collections warrant.

Though the modified payoff technique does not require legislation, some have suggested legislative alternatives along the same lines. To remove the uncertainty regarding the distribution to uninsured depositors, for example, Congress could provide that a fixed minimum percentage be paid -- say 80 or 90 percent of amounts over the $100,000 limit. A number of variations on this theme are possible.

While the modified payoff technique and similar approaches to depositor discipline have considerable appeal, there are major drawbacks. First, it is difficult to envision policymakers actually being willing to utilize the technique in a very large bank. Market participants will probably never be convinced it will be employed unless and until it actually is.

Second, to the extent the technique is effective in bringing about discipline, it could be very disruptive. If we had never travelled down the path toward de facto 100 percent coverage in larger banks (not to mention thrifts) -- if all general creditors at Bank of the Commonwealth, Franklin National, U.S. National, First Pennsylvania and Continental Illinois had not been made whole -- the financial system would almost certainly be stronger today and less dependent on the implicit safety net. But we have traversed far along that path, and it will be extremely difficult to reverse course any time soon.

Third, the technique might not provide much discipline for the vast majority of banks. Some 12,000 banks are $100 million in size or smaller. Their deposits are nearly 95 percent fully insured or secured.

Fourth, the benefits of the exercise would largely be negated unless funds placed by money brokers and other institutional investors were denied insurance coverage. Otherwise, they will simply package and distribute the funds so as to obtain full insurance coverage.

Suppliers of Capital

On balance, the FDIC believes the disadvantages of depositor discipline, at this stage, probably outweigh the advantages. We would prefer to look to the suppliers of capital as our principal source of market discipline.

We have informally proposed that the minimum capital requirement for banks be increased from 6 percent to 9 percent over time -- say one-half percent per year for six years. The minimum primary capital requirement would be set at 6 percent with banks being permitted, but not required, to have the additional 3 percent in the form of subordinated debt.

A well-run bank would be able to raise the subordinated debt at little or no net cost -- i.e., the funds would cost the bank about the same as they would yield when invested in loans or other assets. A bank that took greater than normal risks would have to pay a premium for the subordinated debt. A bank that took excessive risks would not be able to obtain the subordinated debt at any price and would thus be precluded from

growing. In this fashion, the marketplace would impose a very real discipline on bank behavior. Subordinated creditors, who unlike stockholders do not share in the rewards of successful risk-taking, will be very discerning in providing and pricing capital.

This proposal does not require legislation. It could be accomplished through regulation. But competitive equity would dictate that all three federal banking agencies, plus the Federal Home Loan Bank Board, act in unison. That does not appear likely in the absence of Congressional direction.

If the proposal were implemented, the FDIC could discontinue its efforts to achieve greater depositor discipline. We would recommend leaving the de jure insurance limit at $100,000, but we would in fact provide 100 percent coverage by endeavoring to arrange mergers for failed banks of all sizes.

The 9 percent capital proposal would equalize the treatment of large and small banks and minimize the disruptions from failures, while restoring discipline. The failure rate would almost certainly be reduced significantly, and the FDIC's losses at failed banks would be minimized.

The principal disadvantage of the proposal is that many banks and thrifts would be forced to raise a considerable amount of capital and/or restrict their growth. The burden would fall primarily on thrifts and large banks. A recent FDIC study, using year-end 1984 data, indicates a capital shortfall of $49.1 billion among FDIC-insured institutions, with $5.7 billion of the shortfall in the primary capital component. Banks could meet the higher standards over time by restricting growth, retaining earnings, issuing new capital or a combination of the three.

Some smaller banks have commented that the requirement would be especially onerous for them because, unlike large banks, they do not have ready access to the capital markets. We do not find this argument persuasive. First, as a group the 12,000 banks under $100 million in size currently have average primary capital equal to 9.1 percent. While many are below 9 percent, their deficiency is comparatively modest. Second, to the extent the deficiency cannot be met through retained earnings, controlled growth and the issuance of stock, it can be met through the private placement of subordinated debt with traditional institutional investors such as correspondent banks, insurance companies and pension funds.

While the proposal has drawbacks, particularly for thrifts and larger banks, the FDIC believes that implementation of it is entirely feasible, given a reasonable phase-in period. The advantages appear to outweigh the disadvantages.

Risk-Related Premiums

The FDIC's deposit insurance reform legislation proposes risk-related insurance premiums as a third method for increasing discipline in the system. Today, all banks -- the best and the worst -- pay the same price for deposit insurance. This not only subsidizes excessive risk-taking, it is patently unfair.

Currently, banks pay a premium of 1/12 of one percent of domestic deposits for deposit insurance. The FDIC then deducts its losses and operating expenses and rebates 60 percent of the balance to the banks. Except for the past four years, when the FDIC's insurance losses have been extraordinarily high, the net premium after the rebate has averaged about 1/27 of one percent.

The FDIC proposes to divide banks into two or three risk categories based on an objective formula that measures such factors as capital, non-performing loans and/or interest-rate exposure. All banks would continue to pay the same basic charge for insurance (i.e., 1/12 of one percent), but the FDIC would be permitted to vary the rebate among the various risk categories of banks. Assuming a resumption of normal rebates, this would mean that a high-risk bank would pay a net premium of 1/12 of one percent, while a well-run bank might pay on the order of 1/30 of one percent. The FDIC's net income would not be affected.

In addition, the FDIC proposal calls for problem banks to pay the FDIC a charge for the increased cost of supervision they require, not to exceed 1/12 of one percent. Thus, a problem bank's total payments to the FDIC could be 1/6 of one percent, or nearly five times the 1/30 of one percent paid by a normal-risk bank.

Unlike some proponents, the FDIC does not view a risk-based premium system to be a panacea -- just a substantial improvement over the status quo. It would be less arbitrary and considerably more fair than the current system. It would provide a significant, though not overwhelming, financial incentive for banks to avoid excessive risk-taking and to correct their problems promptly. Perhaps as important, it would send a strong signal to a problem bank's management and board of directors.

Some people have criticized the FDIC's proposal because the financial penalty it would impose is perceived to be too modest and because the proposal does not have a sound actuarial basis. The FDIC acknowledges both problems but does not believe they should preclude moving forward. There is no actuarially sound basis for computing deposit insurance premiums at this time, nor will there be in the foreseeable future. We are able, today, to allocate the cost of deposit insurance more fairly than is done under the fixed-rate system. The FDIC feels

strongly the time has come to implement a modest proposal along the lines suggested. After a few years' experience, we may well come back to the Congress for authority to undertake a more ambitious program.

Assessment Base

Two major categories of risk exposure for banks -- foreign deposits and off-balance-sheet liabilities -- are not included in the deposit insurance assessment base today, raising questions of fairness and soundness.

Foreign Deposits

When the FDIC was established more than 50 years ago, foreign deposits were comparatively insignificant and were excluded from both insurance coverage and assessments. Two things have changed in the intervening years. First, foreign deposits have grown to nearly 50 percent of total deposits at the top 10 banks. Second, through its actions at Franklin National, First Pennsylvania and Continental Illinois, the FDIC has provided de facto 100 percent coverage of foreign deposits. In view of this, is it fair to exempt foreign deposits from the assessment base? For example, Citibank in 1984 paid FDIC assessments of $18.5 million on $30 billion of domestic deposits but none on $49 billion in foreign deposits, while Bank of America paid $40 million on domestic deposits of $59 billion and none on foreign deposits of $30 billion. At the same time, thousands of smaller banks throughout the nation paid FDIC assessments on their entire deposit base.

Last year Senator Proxmire introduced a bill to include foreign deposits in the assessment base and lower the basic premium on all deposits from 1/12 of one percent to 1/15 of one percent. The proposal would be revenue neutral to the FDIC but would shift approximately $120 million per year in premiums from smaller to larger banks. The FDIC believes that unless Congress develops an acceptable means for assuring that foreign depositors are not protected by the FDIC when a large bank founders, the bill introduced by Senator Proxmire would represent a significant improvement in the assessment system.

Off-Balance-Sheet Liabilities

Our nation's banks, primarily the large ones, have hundreds of billions of dollars in off-balance-sheet liabilities, which are not subject to FDIC assessments or capital requirements. Yet if these banks fail, the FDIC will likely be forced to accept the exposure represented by many of these potential or contingent claims. It seems rather obvious this situation is neither fair nor actuarially sound. The question is what to do about it.

One answer is that the regulatory agencies should undertake closer scrutiny of off-balance-sheet risks and factor them into the agencies' capital requirements in some fashion. The FDIC and the Comptroller of the Currency began work on this project last year.

But another important step should also be taken. The FDIC's deposit insurance reform bill would establish a uniform set of creditor priorities for all FDIC-insured banks, supplanting a hodgepodge of laws throughout the country. An important aspect of this legislation is that it would subordinate off-balance-sheet claims, such as standby letters of credit. This would protect the FDIC against loss and also impose a degree of discipline by encouraging the holders of these claims to be more careful in the selection of their banks. Finally, it would facilitate the handling of failures through mergers by allowing the FDIC to ignore these claims in calculating its "cost test."

If the FDIC's proposal to subordinate off-balance-sheet claims is not enacted, we believe that at least some of these claims, such as standby letters of credit, must be included in the assessment base.

Merger of the FDIC/FSLIC

The FDIC believes that a merger of the FDIC and FSLIC would create a stronger insurance system with greater resources, a larger income stream and a more diversified risk base. It would also facilitate interindustry takeovers of foundering institutions and unify the procedures for handling insurance claims.

The FDIC feels strongly that banks and thrifts should be required to abide by equivalent standards with respect to capital, accounting and disclosure. The FDIC would oppose any legislation to merge the funds which did not include a mandate to phase in common standards in these areas over a period of years.

If the funds were merged, the Federal Home Loan Bank Board would remain the primary supervisor of S&Ls. The FDIC's role would be comparable to the role it plays in national banks -- cooperatively examining larger and troubled institutions and generally helping to provide oversight.

Many bankers are opposed to a merger of the funds because they fear their institutions will be assessed to cover the cost of handling S&L problems. S&L executives have expressed the same concern in the opposite direction. We believe these objections can be overcome by calculating bank and S&L insurance rebates on a separate basis for each industry for a period of years until common standards on capital, disclosure and accounting are fully phased in.

Other Issues

Lender of Last Resort

The Committee has specifically requested our suggestions for changes in the Federal Reserve's lender of last resort function. We believe it is a misnomer, as the system is structured today, to label the Federal Reserve as the lender of last resort.

The Federal Reserve does not place funds at risk through its discount window. All such loans to banks or thrifts are more than adequately secured. Increasingly over the years, the FDIC has become the banking industry's lender of last resort in the sense that it is the only agency at risk.

Consideration should be given to authorizing, even directing, the Federal Reserve to make discount window loans available to solvent institutions on an unsecured basis. If there are overriding policy reasons for not implementing this change, then at a minimum we believe the Federal Reserve should be directed to obtain, before granting a secured loan, certifications from an institution's primary supervisor and its insurer that the institution appears to be solvent and that the extension of credit would be in the public interest.

Role of Private Insurance

Even before the recent debacles in Nebraska, Ohio and Maryland, the FDIC was opposed to private or even state-backed deposit insurance plans. The track record for state and private deposit insurance plans in this country, dating back to before the Civil War, is dismal. The plans simply do not have the size, diversity of risk, regulatory authority or the personnel to weather a serious storm.

We believe that any institution which holds itself out to the public as a bank and accepts deposits should be required to obtain FDIC insurance. If a state or private plan wishes to provide secondary coverage above the FDIC insurance limit, we would have no objection, though we believe participation in the secondary plan by individual institutions should be voluntary.

Risk-Based Capital Requirements

Some commenters have suggested that the regulators ought to implement risk-based capital standards to control excessive risk-taking. The FDIC is sympathetic to these efforts, but some words of caution are in order.

It should be recognized that the agencies already employ risk-based capital standards. The federal banking agencies have for the first time in history adopted a uniform minimum capital

standard for banks of all sizes. The minimum standard is applicable only to well-run banks. Banks with above-normal loan problems, weak earnings, poor management, excessive interest-rate exposure, a high growth rate or sizeable off-balance-sheet exposure are required to meet a higher capital standard on a case-by-case basis.

What the commenters apparently mean when they refer to a risk-based capital standard is that the agencies should develop an objective formula to substitute for the case-by-case analysis described above. If a formula could be developed that most people would agree is reasonable and does not create perverse incentives, the FDIC would be supportive.

This subject has been debated for decades, however, without a consensus being reached. The FDIC and the Comptroller of the Currency launched a joint study in this area last fall, but an acceptable formula is not in sight.

Finally, we should note that the 9 percent capital proposal discussed earlier offers some real advantages over a formal risk-based capital formula. By allowing investors in subordinated debt to gauge and price bank risk, the 9 percent proposal would be far less rigid than any formula established by regulatory fiat, would be less likely to result in perverse incentives and would be less likely to embroil the agencies and the industry in interminable debates about the precise formula to be applied.

Adequacy of the FDIC Fund

During the FDIC's first 47 years it handled $9 billion worth of failures and suffered insurance losses of $500 million. During the past 4½ years, it has handled nearly $30 billion in failures, excluding Continental Illinois, and its insurance losses have averaged $1 billion per year. Even while absorbing these record losses, the fund has grown dramatically by over 50 percent from $11 billion at the beginning of 1981 to over $18 billion today. The fund has never been stronger, with an average maturity in its investment portfolio of 2-1/3 years and portfolio market appreciation of $400 million. Gross income from assessments and interest will top $3 billion in 1985 and net positive cash flow is expected to exceed $5 billion.

Some commenters have suggested that the insurance fund be authorized to draw upon general revenues. The FDIC believes this is unnecessary and unwise, and we are adamantly opposed to it. The federal deposit insurance system was designed to be a self-help safety net supported solely by industry assessments. Except for the original seed money, which was repaid with interest before 1950, the system has not utilized a penny of taxpayer funds, and the FDIC is committed to maintaining that tradition.

Enforcement Authority

The FDIC's deposit insurance reform bill would streamline the procedures for instituting enforcement actions against banks and their officers and directors, while maintaining due process safeguards. It would also provide the FDIC the full range of enforcement powers over all insured institutions as unanimously recommended by the Vice President's Task Group on Regulation of Financial Services. We believe these measures are essential and urge their prompt enactment.

FDIC Control Over Activities of State Banks

Suggestions are increasingly being made that because state banks operate with federal deposit insurance, the federal government or the FDIC in particular should be granted the authority to determine the permissible scope of their activities. The FDIC is greatly troubled by this notion.

Our nation has been well served for over a century by the dual or state/federal chartering system. It has been enormously valuable in helping to foster an innovative financial system. The states, for example, invented the checking account, experimented with the NOW account, led the way on various consumer protection measures and are now at the forefront in dismantling geographic restraints and breaking down outmoded, anticompetitive product-line barriers. At other times in our history, particularly in the 1960s, the federal government has led the way.

We believe the federal government must be extremely careful not to undermine the dual chartering system, the validity of which Congress recognized as recently as 1978 when savings banks were given the federal charter option under the Financial Institutions Regulatory Act and again in 1982 when the option was expanded under the Garn-St Germain Act. There have been very few state initiatives about which the FDIC has any concerns. We believe we already have the authority to promulgate appropriate safeguards in the few areas that are of some concern.

Our approach has been to carefully avoid prohibiting any activities but to require that certain of them -- for example, securities underwriting -- be conducted in separately capitalized and funded subsidiaries or affiliates. We are comfortable that these and other safeguards we have developed provide adequate protection for our insurance fund.

If it should ever be determined that we require additional authority to proceed along these lines, we would not hesitate to request legislation. We are fully cognizant of the need to preserve the integrity of our insurance fund and of the unique role it plays in maintaining stability throughout the financial system.