COMPETITIVE INEQUITIES IN OUR FINANCIAL MARKETS

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PRESENTED TO THE
BANK ADMINISTRATION INSTITUTE'S
FIRST ANNUAL LEADERSHIP AND COMMUNICATIONS FORUM

SCOTTSDALE, ARIZONA
October 11, 1985

Good morning. It's a pleasure to be here for the First Annual Leadership and Communications Forum. I commend the Bank Administration Institute for providing a forum for the discussion of leadership and planning issues critical to the banking industry.

Rarely have the challenges facing bank management been so great. Seldom has the need for effective leadership been so essential. In past years banks led a much more sheltered existence. A bank could survive, and perhaps even prosper, without its management having a clear vision for the bank's future. No longer are satisfactory results so easy to obtain.

Today, the race for high earnings is conducted at a much faster pace. Without a clear concept of the course you must follow, you will be left behind. The race has moved off the jogging course and on to the fast track, where running in place means falling behind, and too many wrong turns can lead to an early withdrawal.

Just as Mary Decker Slaney would not begin a race without a preconceived strategy, neither should you. In certain respects, however, her task is much easier than yours. When Mary Slaney enters a race she knows that her competitors will all start the same distance from the finish line and be bound by the same rules. The obvious fairness of this approach provides her with a measure of comfort that you, as bankers, do not have.

Your jobs are complicated by the fact that banks face a variety of competitors, many of which operate under different, and generally less stringent, guidelines. S&Ls have less demanding capital requirements and are not subject to the same degree of regulatory oversight. Financial conglomerates, such as Sears, American Express, and most recently, Ford Motor Company, have a free hand to offer commercial products and a full array of financial services, and are not subject to arbitrary geographic constraints.

Even within the banking industry there are inequities that place some at a clear disadvantage. Ironically, prudently-run banks are penalized under the current rules. Banks that operate in a safe and sound manner have greater difficulty in attracting deposits compared to high-rolling banks that need not pay rates that accurately reflect their greater level of risk-taking. Similarly, large banks historically have operated under a different set of rules than small banks.

As bank executives you recognize that inequities exist -- that some are treated better than others. Over the short run you must do your best to plan for, and clear, the hurdles in your path -- even if some of your competitors are able to circumvent the obstacles. Over the longer run, you should not passively accept competitive inequities. As Chairman of the FDIC, one of my guiding principles was that whatever financial system evolves should be fair and equitable to both the general public and financial institutions. As banking leaders you too must try to eliminate the inequities in our financial markets. While much needs to be done in this regard, a great deal has already been accomplished. I'm very grateful that I've been able to play a role in reducing some of the inequities.

Last year witnessed the imposition of uniform capital standards for banks. This was a major step forward. For the first time all three federal agencies acknowledged that preferential treatment should not be accorded large banks with regard to capital requirements. All banks now must maintain primary capital of at least 5-1/2 percent of assets and total capital equal to or greater than 6 percent of assets.

In the same vein, it has been claimed by some that large banks have been afforded preferential treatment by the bank regulatory agencies in the assessment of potential problem loans and in the imposition of enforcement actions. I don't believe that such a case can be made quite as strongly today. The FDIC and the Comptroller of the Currency have become more aggressive in ensuring that all banks, including the larger ones, set aside reserves that accurately reflect the quality of their loan portfolios and in taking enforcement actions whenever appropriate.

There has also been limited progress toward achieving a more even-handed treatment of small and large institutions in failing-bank situations. The perception that uninsured depositors at large banks are not exposed to any risk of loss was shaken somewhat by the 1982 failure of Penn Square National Bank. For the first time uninsured depositors in a large bank (in this case, over $500 million in total assets) did not receive de facto 100% deposit insurance protection.

I don't mean to imply that all inequities in the treatment of small and large banks have been eliminated. A number of issues remain unresolved.

One example is the exclusion of foreign deposits from FDIC assessments. When the FDIC was established more than 50 years ago, foreign deposits were comparatively insignificant and were excluded from both insurance coverage and assessments. Today, foreign deposits represent nearly 50 percent of total deposits at the nation's top 10 banks. Moreover, through its actions at Franklin National, First Pennsylvania and Continental Illinois, the FDIC has provided de facto 100 pecent coverage of foreign deposits. In view of this, is it fair to exempt 50 percent of a large bank's deposit base from FDIC assessments while thousands of smaller banks throughout the nation pay FDIC assessments on their entire deposit base?

Moreover, we have not yet implemented a method for ensuring that the failure of a very large bank will be handled in a manner consistent with the failure of a smaller bank. The FDIC has suggested some possible approaches, but they are not yet in place.

While some differences remain in the treatment of small vis-a-vis large banks, an even greater inequity is that there is too little differential treatment between banks that are excessive risk takers and banks that are operated in a safe and sound manner. The Penn Squares and UABs of our nation's banking system have been allowed to pursue their wildest fantasies without being forced to pay costs that reflect their greater level of risk taking. This works to the detriment of both the general public and the vast majority of well-run banks, not to mention the FDIC.

It's time to rectify this inherent unfairness and bring greater discipline into our nation's banking system. The bank regulatory agencies undoubtedly have a large role to play in this regard, and some actions like the implementation of risk-related insurance premiums and a stronger bank examination force can help. However, I don't believe the regulatory agencies alone can or should be expected to provide all the discipline required in a deregulated environment.

The marketplace must assist in exerting some discipline on our banking system. There are two general ways this can be done. First, we can pull back from the concept of 100 percent depositor protection, or second, we can find new ways to impose discipline through bank capital accounts.

The idea of greater depositor discipline has considerable appeal, but there are some major drawbacks. For one thing, most banks under $100 million (there are about 12,000 of them) would be virtually unaffected because 95 percent of their deposits are fully insured or secured. Their depositors wouldn't impose discipline. That's the way it should be, because efforts to increase depositor discipline should be focused on the "sophisticated" investor. But that brings up another problem. With the help of money brokers, sophisticated depositors, such as financial institutions and institutional investors, will look for ways to get under the insurance umbrella. And, as it now stands, they'll probably be successful.

Another major obstacle blocking the way for depositor discipline is that deposit payoffs simply cannot be used 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.

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. 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.

While the modified-payoff technique and similar approaches to depositor discipline have considerable appeal, it's difficult to envision policymakers ever actually using the technique in a very large bank. Market participants will probably never be convinced it will be employed unless and until it actually is.

Before the modified-payoff could be used in a big bank, many issues would have to be resolved. The technique would require insuring adequate safeguards to the nation's payment system. The Federal Reserve would have to be willing to provide aggressive liquidity support to viable banks to minimize any ripple effects of a large failure. Even then, completing a modified-payoff in a very large bank would entail a number of other problems, ranging from administrative details, such as more extensive recordkeeping requirements for banks to enable the FDIC to promptly identify uninsured funds, to more fundamental issues, such as finding a merger partner and being able to act before uninsured funds are gone. There are other important considerations: What would be the impact on the bank CD market or the financial markets in general, domestic and foreign? Will solvent banks recover from a "run" even with Federal Reserve support? What are the economic implications of such support if extensively applied? Until issues such as these are thoroughly addressed, the FDIC is likely to remain reluctant to adopt an "across-the-board" policy regarding the modified-payoff.

On balance, I believe the disadvantages of depositor discipline probably outweigh the advantages. It may be preferable to look to the suppliers of capital as our principal source of market discipline and as a means of handling all failed banks in an even-handed fashion.

The FDIC has 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.

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 FDIC could discontinue its efforts to achieve greater depositor discipline and could effectively provide 100 percent coverage for depositors by endeavoring to arrange mergers for failed banks of all sizes.

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. I 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, I believe that implementation of it is entirely feasible, given a reasonable phase-in period. The advantages appear to outweigh the disadvantages.

The capital issue brings me to another inequity that I would like to discuss -- the implementation of uniform supervisory rules for banks and thrifts. The FDIC's current capital requirement is much higher than the net worth percentages that are required for FSLIC-insured institutions. Accounting standards and asset valuation techniques widen the disparity. Competitive equity dictates the need for common capital and accounting standards. Parity should be achieved by raising the standards for FSLIC-insured institutions rather than lowering them for banks. The thrift industry faces significant problems, and it would not be feasible to implement the requirements overnight. However, it's important that we start moving in the right direction. My support for a merger between the FDIC and FSLIC insurance funds as one solution to the thrift industry's problems is based in part on my belief that it would result in the implementation of uniform supervisory rules, which in the end would benefit both banks and thrifts.

As a final point, I would like to briefly discuss the competitive inequities between banks and non-depository institutions. It seems clear to me that the time has come to eliminate many of the product and geographic constraints imposed on banks. The only financial intermediaries constrained in any way by the Glass-Steagall Act, the Bank Holding Company Act or the McFadden Act are bank holding companies and commercial banks. To allow banks to cope with the cost of liability deregulation and to remain competitive with non-depository institutions, banks should be permitted to engage, either directly or through subsidiaries or affiliates, in a full range of financial services. One has to wonder why commercial banks, which are so essential to the delivery of financial services, cannot provide a full range of insurance, securities and real estate-related services, or must resort to uneconomical legal devices in order to provide them.

Conclusion

I have touched on a wide range of issues this morning. The common theme is that many of the problems result from competitive inequities and most of the proposed solutions are designed to create a more equitable competitive environment. With this guiding principle in mind, it should not be difficult to determine how to proceed. You may not agree with my proposed solutions, but I hope you will judge them on the basis of whether they will lead to a more equitable and responsive financial system.