

APPENDIX

The Subcommittee has requested the FDIC's views on a number of specific issues:

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 all bank failures in order to instill greater discipline. 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 would not impose discipline. That is 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. As it now stands, they will 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 -- up to 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 appeal, it is 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 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. 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, we believe the disadvantages of depositor discipline probably outweigh the advantages. It appears 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.

Suppliers of Capital

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 -- whether on or off the balance sheet -- 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.

We recently published a proposed system for implementing risk-based deposit insurance. We have already received a number of comments from bankers about the system, and they are overwhelmingly supportive.

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 risk categories (normal and above normal) utilizing both the examination process and the results of a statistical technique called probit analysis. The probit test would objectively measure key financial ratios relating to factors such as capital, loan performance and earnings. For a bank to be placed in the above normal risk category, it would have to fail the objective probit test and be rated 3, 4 or 5 under the CAMEL rating system, which is derived from on-site examinations.

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 between the risk categories of banks. Assuming a resumption of normal rebates, this would mean that a bank in the above normal risk category would pay a net premium of 1/12 of one percent, while a normal risk bank would pay less than 1/27 of one percent (it would receive a pro rata share of the rebate forfeited by the above normal risk banks). 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 roughly five times the amount 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 current 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 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 regulatory 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. All three federal banking agencies are working on this project.

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 failed 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

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. Depending on what is meant by those who advocate risk-based capital standards, the FDIC is very leery.

It should be recognized that the agencies already employ risk-based capital standards in the sense that poorly performing banks are required to maintain more capital than well-run banks. 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. Some have suggested that certain types of activities should be subjected to higher or lower capital requirements based upon the perceived degree of risk inherent in the activity.

This type of system, in our judgment, would be very difficult to implement and has the potential to be highly mischievous. First, there is no objective way to accurately measure levels of risk among different asset categories. Whether a given type of activity is risky (e.g., mortgage lending) is dependent in large part on the quality and experience of the management conducting the activity. Second, perception of risk is of necessity colored by past experience; we unfortunately do not have the ability to see around the next economic corner. Some of the most troubled loans on the books of banks today were perceived by most people to be some of the best loans five or six years ago. Third, we are very concerned that a system of assigning different levels of capital to various types of loans or activities could someday be misused as a device to allocate credit toward or away from certain sectors. Fourth, as contrasted with the 9 percent capital proposal, a risk-based capital system fails to address the central issue of how to handle the failures of large and small banks in an even-handed fashion. Fifth, no formal system of risk-based capital can be designed which will operate as accurately or as fairly as the current informal system under which our examiners use the on-site examination process to evaluate risk levels in banks and make demands for additional capital (above the minimum requirement) on a case-by-case basis. Sixth, we believe that under the 9 percent capital proposal, the suppliers of subordinated debt will be far more discerning about pricing levels of risk (whether on or off the balance sheet) than any arbitrary formula we could devise. Finally, it will be extremely difficult to obtain interagency agreement on a complicated risk-based capital formula. It has taken the three federal banking agencies nearly fifty years to arrive at a uniform policy on capital, and we would be distressed to see the agreement fall apart within a year of its adoption.

There is one variant of a risk-based capital system that avoids most of the pitfalls mentioned above and, therefore, has considerable appeal. This system, called the "simplified risk asset ratio," would largely exclude U.S. Treasury securities from capital requirements but would include some or all standby letters of credit (in all cases, the current 6 percent minimum requirement would be retained). While this proposal requires some further study, it appears feasible and may represent a significant improvement over the current capital formula. The FDIC is participating in an interagency study of this and other approaches to risk-based capital.

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 over \$35 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 70 percent from \$11 billion at the beginning of 1981 to over \$19 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.

Market Value Accounting

There is substantial logic in favor of using market value accounting. If bank balance sheets appropriately reflected the value of loans and investments and various intangibles, balance sheet net worth would be an accurate reflection of the true worth of an institution. Capital standards could be applied in a more uniform fashion and the marketplace could readily gauge the net worth of an institution. Implementing such a system for 20,000 banks and thrifts, however, would be very difficult. There are many assets on the books of banks and thrifts whose value could (and perhaps should) be adjusted to reflect interest rate changes. These adjustments are simplest for investments and, indeed, most large banks publish information on market value appreciation or depreciation of their investment securities. Market value adjustments for performing, quality fixed-rate loans may not be too difficult, either. However, the degree of difficulty increases immensely when we adjust assets for quality. Generally, there is not much of a market for very risky performing and nonperforming loans, and placing reasonable values on these assets may be impossible.

Also, many bank franchises have considerable nonbalance sheet value because of a strong customer base, comparatively low-cost liabilities, operating efficiencies, location, competitive and other factors. These would be extremely difficult to measure. In principle, one might argue that these

intangibles are reflected -- along with asset quality and interest rate-associated depreciation -- in the market value of an institution's stock. However, the market value of the stock of an institution with deposit insurance also reflects some value of that insurance. Thus, stock values are an imperfect gauge. Moreover, the vast majority of bank stock does not actively trade in the market and, in the case of thrifts, many are not stock institutions.

A gradual movement toward market value accounting would probably be in the public interest. However, it must be appreciated that even partial market value accounting adjustments might suggest that a very large percentage of the thrift industry is insolvent.

Examiner Staffing and Compensation

During the past several years, the FDIC's examiner workforce has been somewhat reduced in size due to two factors. First, the agency made a decision to reduce the frequency of its examinations of small, nonproblem banks, relying to a greater degree on state examinations of these institutions. This resulted in some FDIC regions being overstaffed, which was corrected through a hiring freeze. Second, as the number of bank failures increased dramatically in 1982-84, a significant number of FDIC examiners transferred to the Division of Liquidation, which experienced enormous growth.

The FDIC, by design, now focuses the vast majority of its examination resources on larger and troubled banks, irrespective of charter, and only samples non-troubled, smaller banks. Because the number of failed and troubled institutions has grown dramatically over the past three years and shows no signs of easing, there is a need to increase examiner staffing to keep pace with the workload. Earlier this year, the FDIC's Division of Bank Supervision was authorized to increase its examiner workforce by 40% over the next 12 months from about 1,500 to 2,100.

In view of the differences in pay between the public and private sectors, I am amazed by the quality of personnel the FDIC has been able to attract and retain. The pay differentials have been widening, and I believe that effective supervision requires more competitive rates of compensation than presently exist, particularly at the upper levels. The FDIC, as an independent agency, has some flexibility on the salaries and benefits it can give employees, but we feel constrained in deviating too far from general government policies. We would welcome an expression from Congress that we should have more flexibility in setting competitive compensation rates.

The following tables provide the information requested by the Subcommittee on staffing patterns, turnover rates and compensation levels for FDIC examiners:

SELECTED PERSONNEL STATISTICS FOR FDIC FIELD EXAMINERS

<u>Year</u>	<u>Average Number of Field Examiners</u>	<u>Field Examiner Turnover Rate</u>	<u>FDIC-wide Turnover Rate</u>
1975	1,655	8.9%	Not Available
1976	1,756	10.1%	13.3%
1977	1,844	8.2%	11.2%
1978	1,960	9.3%	16.6%
1979	1,929	9.8%	13.4%
1980	1,859	10.1%	13.8%
1981	1,856	8.5%	12.8%
1982	1,773	7.7%	7.8%
1983	1,678	9.7%	7.0%
1984	1,578	13.1%	7.0%

Division of Bank Supervision Field Examiner Salaries: Actual and Adjusted for Changes in the Consumer Price Index

<u>Year</u>	<u>Actual Salary Levels</u>			<u>Adjusted Salary Levels*</u>		
	<u>GG-5</u>	<u>GG-12</u>	<u>GG-14</u>	<u>GG-5</u>	<u>GG-12</u>	<u>GG-14</u>
1975	\$10,111	\$21,970	\$34,916	\$10,111	\$21,970	\$34,916
1976	10,543	23,166	37,343	9,965	21,896	35,296
1977	11,287	24,799	39,975	10,015	22,004	35,470
1978	11,907	26,167	42,171	9,808	21,554	34,737
1979	13,868	27,995	45,126	10,265	20,722	33,402
1980	15,129	30,543	49,229	9,869	19,924	32,113
1981	15,850	32,013	51,596	9,368	18,920	30,494
1982	16,491	33,290	53,661	9,182	18,536	29,878
1983	16,491	33,290	53,661	8,900	17,965	28,959
1984	17,064	34,621	55,807	8,837	17,929	28,901
1985	17,750	35,835	57,759	8,875	17,918	28,880

The GG-5 columns are entry level salaries. GG-12 is the highest grade which the majority of field examiners attain. The GG-14 columns are effectively the maximum salaries available to a limited number of field examiners, typically those having significant management responsibilities. It could take 18 years of successful performance at the GG-14 grade before reaching these levels.

* Adjusted salary levels show the purchasing power of the salaries stated in 1975 dollars.