STATEMENT ON

H.R. 3535, INTEREST ON DEMAND DEPOSITS; BROKERED DEPOSITS; AND H.R. 4053, COMPULSORY FEDERAL DEPOSIT INSURANCE

PRESENTED TO

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

BY

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Mr. Chairman, I appreciate the opportunity to express our views on H.R. 3535, the Demand Deposit Equity Act of 1983, and share with you some of our concerns about brokered deposits. We commend your effort in addressing these issues which have become even more relevant in our rapidly changing financial environment.

To begin with, I would like to discuss the reasons we support the thrust of H.R. 3535 and then outline some of our concerns with this legislation. I will then turn to the issue of brokered deposits. Finally, I will touch on the issue of comprehensive deposit insurance for all commercial banks.

INTEREST ON DEMAND DEPOSITS

Historical Perspective

The prohibition on the payment of interest on demand deposits dates back to the Depression Era of the 1930s. The Banking Acts of 1933 and 1935, in effect, prohibited the payment of interest on any demand deposit offered by any depository institution.

The 1930s was a period of great turmoil for both the banking system and the economy as a whole. Congress responded to the banking crisis by enacting major legislative reforms, primarily designed to discourage bank risk-taking and to ensure the safety and soundness of the commercial banking system.

In the case of demand deposits, it appears that a prohibition on the payment of interest had three general motivations. First, there was a concern that interest payments on demand-type balances resulted in an adverse flow of funds from rural to money-center areas, causing a diversion of investment funds and

serving to encourage stock market speculation. Second, it was thought that such payments resulted in increased bank risk due to: (1) enhanced volatility of their liability structure and (2) increased credit risk generated due to bank investments in riskier assets to afford the high interest payments on demand deposits. Finally, some suggested the prohibition would save banks money, thereby encouraging them to participate in the newly created federal deposit insurance system.

Comment on the Prohibition

Critique of Reasons for the Prohibition

For the most part, the concerns of the 1930s no longer have relevance in today's marketplace. Funds can be shifted from rural to money-center areas via mechanisms independent of demand deposits. For example, through the federal funds market a bank can loan large sums of money to other depository institutions on an overnight basis. The rate paid on these deposits is market determined. In addition, excessive stock market speculation has never really been a problem since the 1930s.

Certainly the allowance of interest payments on demand deposits will, in some sense, increase bank risk; however, this must be viewed in its proper perspective. After October 1 of this year, virtually all other types of deposit categories will be free of interest-rate ceilings. In this respect the mandate given the Depository Institutions Deregulation Committee (DIDC) is nearly complete. In many ways the same criticisms which could be applied to the payment of interest on demand deposits regarding enhanced volatility and credit risk can also be applied -- perhaps even to a

greater extent -- to the removal of rate ceilings from other deposit categories. But in establishing the DIDC, Congress found that "limitations on the interest rates which are payable on deposits and accounts discourage persons from saving money, create inequities for depositors, [and] impede the ability of depository institutions to compete for funds . . . ."[1] In other words, Congress implicitly determined that the benefits from time and savings deposit deregulation outweigh the potential costs. We agree with this determination and believe the same logic applies to the payment of interest on demand deposits.

A removal of the prohibition will involve transitional costs for depository institutions, particularly smaller commercial banks. However, we feel safe in concluding that these costs can be absorbed. In the long run, the proper adjustments will be made to pricing structures so as to minimize any adverse impacts.[2]

With respect to the argument that a reduction in bank costs is necessary to pay deposit insurance premiums, in our judgment the benefits to depository institutions from federal deposit insurance far exceed the cost of the premium. Institutions pay much less than if such insurance were offered by the private sector.

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[1] Depository Institutions Deregulation and Monetary Control Act of 1980, Section 202(a)(1).

[2] A more detailed examination of these costs is included in the DIDC staff memorandum titled "The Payment of Interest on Demand Deposits," which was attached to the August 4, 1983, letter sent to your Committee recommending a removal of the prohibition.

Economic Inefficiencies and Inequities

Over the years we have found the prohibition has led to both economic inefficiencies and inequities among bank customers. Since interest payments in the form of cash are expressly prohibited, banks generally have found ways to offer payment in the form of "free" services, such as not charging for check clearing services, the establishment of more convenient banking locations and advice on financial planning.

This form of compensation is less efficient than direct cash interest payments. It can be supposed that most customers would get a higher level of satisfaction from a direct cash payment as opposed to having the same money put into services which are then offered to the customer at no cost. Additionally, the lack of pricing of services generally leads to their overuse. We believe that removal of the prohibition would result in depository institutions charging explicit prices for most of the services they offer. This should enhance economic efficiency.

The prohibition also creates inequities. Large corporations -- through shrewd cash management techniques -- have been able to skirt the prohibition by investing excess demand balances in short-term investment vehicles such as certificates of deposit, federal funds and repurchase agreements. Funds are shifted in and out of demand accounts on a daily basis. The practical result is that interest is earned on demand deposits.

Smaller businesses often lack the knowledge and/or the quantity of funds necessary to accomplish this. Therefore, an

inequity between small and large businesses exists. In 1980 Congress found that "all depositors, and particularly those with modest savings, are entitled to receive a market rate of return on their savings . . . ."[3] We believe a similar finding with respect to the small businessperson could be made.

Increased Competition from Nondepository Institutions

Finally, I might add that the increased involvement of nondepository institutions in the banking business will continue to develop at a rapid pace. You are all well aware that securities firms provide attractive alternatives to the checking account through so-called "Cash Management" or "Asset Management" accounts. Not only do they offer virtually all of the features -- such as direct payroll deposit and telephone bill paying services -- that bank checking accounts offer, but it is also likely that they will offer some form of "deposit" insurance.

We are involved in a critical transition period in which financial institutions of all types are positioning themselves for the marketplace of tomorrow. We strongly believe that all institutions should enter this competition on an equal footing.

Rate Ceiling Authority on Demand Deposits

We do, however, have one suggested amendment to this legislation.

Removal of the prohibition has implications for the interest-rate ceilings remaining on passbook savings deposits and on

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3 Depository Institutions Deregulation and Monetary Control Act of 1980, Section 202(a)(2).

NOW accounts with balances of less than $2,500. Since, from the depositor's viewpoint, interest-bearing demand deposits could be viewed as an alternative to both passbook savings and NOW accounts, a removal of the prohibition would limit the effectiveness of existing ceilings on these accounts. There is approximately $325 billion in passbook savings deposits and about $90 billion in NOW accounts subject to rate ceilings.

Unless it is the intent of your Committee to alter the mandate given the DIDC and accelerate the deregulation process, we would recommend that the DIDC be given authority to establish rate ceilings on demand deposits. Of course, this authority would expire in 1986 when the DIDC itself is disbanded; however, we think it is necessary to initially establish ceilings on demand deposits -- which would probably be identical to those already existing on NOW accounts -- to insure an orderly phaseout of the remaining rate controls.

Conclusion

H.R. 3535 not only provides for interest payments on demand deposits but it also would allow thrifts to offer these deposits to all corporate customers. Currently, federally chartered thrift institutions are limited to offering demand deposits to "those persons or organizations that have a business, corporate, commercial, or agricultural loan relationship with the association . . . ." [12 U.S.C. Section 1464 (b)(1)(A)]

We have no objection to this expansion in thrift powers; however, it does raise important equity issues. If we are going to give thrifts additional powers -- making them more like commercial

banks -- should we not also require thrifts to make disclosures like commercial banks, conform to General Accepted Accounting Principles in presenting financial statements, and meet the same capital adequacy standards as banks?

This partially illustrates the need to consider the issue of interest on demand deposits as part of a larger legislative package. Moreover, we cannot continue to deregulate the liability side and not deal with the asset side. Finally, we are reluctant to proceed further with deregulation without making some changes in the regulatory and insurance systems. We are rapidly outpacing the ability of these systems to cope with deregulation.

We have provided a detailed statement to the Senate Committee on Banking, Housing and Urban Affairs, outlining the issues that we feel should be covered in any comprehensive legislative package. I would like to quickly list some of these major items.

Commercial banks should be given expanded powers to enhance services to the public and provide an additional source of income to banks. Antitrust restrictions should be revised to provide greater flexibility for small-bank mergers yet, at the same time, show greater concern for the implications of mergers between large firms. Interest payments should be made on required reserve balances to provide greater equity between depository institutions and their close competitors. We must revise the regulatory structure to provide more consistency and effectiveness in the regulation of depository institutions. Finally, we support a reform of the deposit insurance system to enhance market discipline.

Let me now turn to the issue of brokered deposits.

BROKERED DEPOSITS

Historical Perspective

Money brokering is not a new phenomenon. Money brokers have existed for many years, matching investors with financial institutions seeking funds. However, it was not until 1974, when interest rates reached double-digit levels and investors actively began searching for the highest rates, that money brokers became a common medium to invest money.

Over the years, the nature of the money broker's role as a financial intermediary has changed. Traditionally, money brokers channeled investor funds into larger financial institutions. Beginning in 1980, however, the role of the broker took on a different cast -- that of the mass-market developer. This transformation was the result of several factors, including the financial deregulation movement, the growing sophistication of investors and economic developments.

The deregulation movement was an important catalyst in creating new demands for brokers' services. As deposit-rate ceilings and other restrictions were eased and lifted, financial institutions found themselves under increased pressure to compete for available funds. The pressure upon small- and medium-sized institutions was especially acute. Unlike large, money-center institutions, they lacked easy access to national money markets. Recognizing the expanded opportunities thus created by the deregulation movement, money brokers began to offer their services to a wider array of financial institutions.

The increased sophistication among investors, a phenomenon which had grown steadily since the mid-1970s, likewise presented brokers with expanded opportunities. Money brokers stressed the advantages they could offer to investors who were intent upon maximizing the return on their funds.

Economic developments during the past several years also played a role in the expansion of the demand for brokers' services. As interest rates soared in 1980 and 1981, brokers brought investors to financial institutions that were losing deposits to money market mutual funds.

The failure of Penn Square Bank in July 1982 also had a major impact on the role of money brokers. Penn Square's collapse -- the largest deposit payoff in FDIC history -- gave investors a renewed incentive to obtain full federal deposit insurance.

In an environment in which purchased funds will constitute a growing source of loan and investment flows, money brokerage firms will continue to flourish. In September 1982, for example, one money brokerage firm established a computerized exchange for CDs issued by financial institutions. Efforts such as these are indicative of the expanded role that money brokers have come to play.

Broker Activities
Pro and Con

Legitimate Role of Brokers

Many money brokers have performed responsibly. The benefits they have provided to both financial institutions and investors need only to be highlighted here. A financial institution that uses a broker's services to market its certificates of deposit

can realize important cost savings through reduced staffing and paperwork requirements. Another advantage is that the institution gains flexibility with respect to the amounts and maturities of the CDs it issues. This flexibility, in turn, can enable an institution to better match its assets and liabilities. Most important, perhaps, is the access to national money markets that a broker can provide, particularly for small and medium-sized financial institutions.

Money brokers also provide obvious benefits to investors. By telephoning a broker, an investor can easily and quickly obtain CD rate and term quotations offered by a large number of institutions.

Existing Problems

Despite the useful role played by money brokers, problems exist. This is not surprising, particularly in light of the diverse and unregulated nature of the money brokerage industry. Allegations have been made that some brokers have lured unsuspecting investors by offering high interest rates that are not actually available. Charges also have been levied that some brokers have deceived borrowers by quoting nonexistent low rates. Undoubtedly, specific instances of fraud can be cited, as is the case with any industry. While the FDIC obviously does not condone such fraudulent practices, our concerns with respect to brokers' activities are more broadly based.

First, the fact that money brokers can rapidly move large amounts of funds into and out of financial institutions has made it increasingly difficult to accurately assess the condition of

individual financial institutions. As an insurer, the FDIC is particularly concerned that the useful lives of weakened financial institutions sometimes are being prolonged artificially through the use of insured brokered deposits. One of the traditional "fail-safe" mechanisms limiting the damage caused by unscrupulous or incompetent bankers is they literally "run out of money" with which to perpetuate their misdeeds. This, of course, is somewhat less true in banks that the public perceives to be too large for the FDIC to pay off. But, with the use of insured brokered deposits, that safeguard system is overridden even in the smaller banks, greatly enhancing their capacity for creating losses for creditors and the federal deposit insurance fund.

The FDIC's concern about the misuse of brokered deposits is real. Our analysis indicates that many of the 72 commercial banks that failed between February, 1982 and mid-October, 1983 had substantial brokered deposits.[4] Overall, brokered deposits constituted 16 percent of the total deposits held by the 72 banks that failed; some of the failed banks relied even more heavily on brokered funds. In three separate instances, brokered deposits constituted more than 60 percent of the failed bank's total deposits. In nineteen other instances, brokered deposits constituted between 20 percent and 50 percent of the failed bank's total deposits. The presence of brokered deposits complicated this

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[4] Data pertaining to brokered deposits in closed banks for the period February, 1982 through mid-October, 1983 are attached.

agency's ability to deal with the problems at those banks while they were still open.

The FDIC is concerned about the erosion of market discipline caused by the practice of brokers segmenting investor funds into blocks that qualify for full federal deposit insurance coverage. While this practice is currently legal, and certainly desirable from the perspective of both the broker and investor, it eliminates any incentive for either party to closely examine the condition of institutions receiving brokered funds. Ironically, this situation was exacerbated by an increase in the deposit insurance limit in 1980 to $100,000, the level at which deposits were exempt from interest-rate ceilings.

Possible Solutions to Problems
Created by the Misuse of Brokered Deposits

While the problems created by the misuse of brokered deposits can be readily identified, solutions are less obvious. Efforts to resolve the problems I have outlined have proven especially difficult due to several factors. First, we have been hampered by inadequate knowledge about the precise movement of brokered funds. I shall discuss shortly the steps that the FDIC has taken to rectify this problem. Second, our task in searching for solutions also has been complicated because of the need to assess and balance frequently competing concerns.

While a particular approach might resolve one problem, it could create other problems. For example, if deposit insurance coverage were modified with respect to brokered deposits, some measure of market discipline might be restored. On the other hand,

liquidity sources in the market might be reduced, particularly for relatively small institutions. Clearly, the advantages and disadvantages of each course of action need to be carefully considered.

Currently, several approaches are under active consideration at the FDIC and the Federal Home Loan Bank Board (as operating head of the FSLIC) for addressing the problems created by the increased prevalence of brokered deposits in insured institutions. These approaches, which are summarized below, follow two general avenues: intensified monitoring and supervision of broker activity or reduced insurance coverage for brokered deposits. Some of the proposed solutions would require Congressional action, while others would not.

Intensified monitoring and supervision of broker activity could be accomplished in several ways. First, the suppliers of brokered funds could be required to register with the FDIC and the Bank Board and be subject to reporting requirements. This approach would require legislation. Second, the users of brokered deposits could be monitored. The FDIC has already taken steps in this direction by requiring all FDIC-insured institutions to report quarterly on the volume of their brokered deposits, starting with the September 1983 Call Report (the Bank Board plans to implement a similar requirement).

Increased monitoring of brokered deposits would help focus regulatory efforts on those institutions with the greatest potential for abuse. However, we are mindful that it places an increased reporting burden on banks that are using brokered deposits

prudently. Moreover, the ability to monitor brokered funds will not resolve the more serious long-term problem, i.e., the loss of market discipline by creditors.

To address the longer-term problem of restoring market discipline eroded by the proliferation of brokered deposits, the FDIC and the Bank Board are considering whether to recommend to the Congress that insurance coverage on brokered deposits be modified. Several options are under discussion. One approach would be to remove insurance coverage from broker-arranged deposits. Another possibility would be to treat brokers as principals with total insurance limited to $100,000, regardless of the individual rights of ownership. A third approach would be to give brokered deposits different insurance coverage, such as 75 percent coinsurance with no $100,000 floor.

Despite our deep concern about the erosion of market discipline, we recognize that modification of insurance coverage on brokered deposits will not be totally effective in restoring market discipline. The ability of enterprising individuals to find ways to circumvent regulatory efforts should never be underestimated. Moreover, modification of insurance coverage solely for brokered deposits would not resolve problems caused by certain governmental units and institutional investors that can funnel large volumes of fully insured trusteed or custodial deposits directly to high-risk institutions. The FDIC and the Bank Board are discussing amendments to our respective statutes and/or regulations to address this problem.

While a number of actions may be appropriate to resolve the broker issue, we believe it prudent to evaluate additional information before recommending any specific course of action. We have, in conjunction with the Federal Home Loan Bank Board, solicited comments from the public on the nature of deposit-brokering activities and the manner(s) in which to deal with such practices.[5]

Given the complexity of the issues I have outlined in my comments on brokered deposits, we would like to take the time to evaluate the information we will be receiving from banks, thrifts, brokers and the public before making specific recommendations. Our findings and recommendations will be forwarded to you as soon as possible.

COMPULSORY FEDERAL DEPOSIT INSURANCE FOR ALL COMMERCIAL BANKS

Mr. Leach has requested comment on H.R. 4053. This bill would require that the deposits of all commercial banks be insured by the FDIC. Our response will be brief and to the point.

We do not believe all commercial banks in this country should be required to obtain federal deposit insurance. The extent of current coverage is sufficient to enable us to ensure the stability of the banking system as a whole (only approximately 500 commercial banks out of 15,241 currently operate without insurance). It would seem that requirements for mandatory coverage of state-chartered banks (all national banks and bank subsidiaries of holding companies must have insurance) is a matter best left to the individual states.

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[5] Attached is a copy of an Advance Notice of Proposed Rulemaking.

We note that H.R. 4053 presents some technical problems which need to be clarified. These relate to the definition of both a commercial bank and commercial loans and to enforcement powers which would be necessary in the event some commercial banks eventually elect not to join the FDIC. We, of course, offer our assistance in the resolution of these matters.

Conclusion

Once again, we commend your efforts in examining the issues before us today. The financial services industry is undergoing a major transition which makes major reforms all the more urgent. We understand the difficulty of addressing these issues, yet we must also recognize that change is needed to allow all financial institutions to serve the needs of the public.

Thank you again for this opportunity to appear. I will be pleased to respond to any questions you or members of your Committee may have.