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BEFORE THE

FEDERAL HOME LOAN BANK
OF SAN FRANCISCO

EQUITABLE ALLOCATION OF FEDERAL INSURANCE PREMIUMS

SAN FRANCISCO, CALIFORNIA
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I am pleased and honored to address the annual conference of The Federal Home Loan Bank Board of San Francisco.

Our meeting today is fortunate for me. I am working my way through the wide range of issues confronting the financial services industry. Regardless of the type of charter your institution may hold, or whether we are regulators or regulatees, we share a common goal: A stable, sound and prosperous financial system. Being here gives me an early opportunity to hear some of your views about how that goal can be achieved.

Today I would like to discuss the assigned topic of risk-related premiums. Before I do, let me make a few comments on the relationship of FSLIC and the FDIC.

Faced with a seemingly impossible task, the FSLIC has shown a remarkable ability to survive. It has had to support a massive industry restructuring. In dealing with the problems caused by credit risk, interest rate risk, and some irresponsible managements, the FSLIC has at times shown boldness and imagination despite its limited personnel and financial resources. On more than one occasion the FDIC has borrowed ideas from some of the solutions forged by FSLIC to treat ailing thrifts.

According to retiring head of the fund Peter Stearns, the S&L Fund has serious financial troubles. He says that it is inescapable that at some point the FSLIC will require assistance. Although I have known Peter a long time and I admire his abilities, I do not know whether this is true.

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What I do know is that the funds of the FSLIC and FDIC are not separable in the public's mind. Their credibility depends on the performance of both funds and thus they have an inescapable interest in the success of both funds. No action can be more destructive to credibility than public attack and counter attack by the two agencies. At the FDIC we have taken a pledge to speak no evil of the FSLIC and instead do whatever possible to support its efforts to improve its position. We seek its survival, not its merger. We applaud the many recent actions of the Bank Board designed to strengthen the thrift system. We too have our savings banks, and we know how costly and difficult the problem can be. We are optimistic that current conditions will contribute to a real recovery for well run thrifts.

We shall be ready to be of whatever aid we can be under the circumstances. If Congress should decide we should take additional actions to be of assistance, we will be prepared to do so. In the meantime, as I have said, we at the FDIC have a strong interest in FSLIC meeting its problems successfully. We are all federal insurers. We need to bolster each other -- publicly and privately -- for the good of the system.

Now to my assignment -- equitable allocation of federal insurance premiums. If the past is any guide, a risk-related premium system would rank high on our list of reforms helpful to the insurance system.

We would like to see a system which more nearly reflects a market approach to insurance, a market that charges higher premiums for higher risks. Since we are a de facto monopoly, our system can seek only to simulate in a crude way, a true market rate approach. To this end, however, we recently sent out for comment a proposed risk-related premium system applicable to commercial banks.

We think that what the FDIC is proposing represents a workable system that can be improved as we all gain further experience in this area. It attempts to use market type criteria to evaluate risk to determine premium levels.

The FDIC has not made any proposal relating to risk-related premium structure for FDIC-insured thrift institutions. Before we are able to formulate such a proposal, we must come to grips with the realities of the situation -- the problems facing many thrifts (low capital levels, excessive interest rate risk and earnings insufficient to recapitalize within a reasonable time frame) exist and cannot easily be resolved in a short period of time. While we have not resolved many of the relevant issues, the FDIC in the near future likely will proposed a risk-related premium system for thrifts not dissimilar to the commercial bank proposal. However, implementation may be phased in over time, in much the same manner as the FDIC has applied capital regulations to the thrift industry.

At this point, it may be informative to review briefly the FDIC proposal relating to commercial banks. Under this proposal, the FDIC would use a two-pronged test. A bank must fail both tests to be automatically placed in the high risk category. The first test is an objective statistical model, based solely on Call Report data, to classify banks as having either normal or above-normal risk. This is the so called probit or statistical test. Banks that pass this test will not be put in the high premium class.

The second test is the CAMEL ratings. Banks with ratings of 1 or 2 (the highest) will not be put in the high risk group. Those that are rated high risk on the statistical test AND rated 3, 4 or 5 -- will receive no assessment credit.

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Banks having a composite CAMEL rating of 1 or 2 and which are rated as above-normal risk by the statistical test will receive the rebate, but they will be immediately subject to additional financial review. If our analysts are satisfied that the bank is indeed a 1 or 2, the process will stop there. If the analyst finds significant areas of weakness in the bank, it will be promptly scheduled for an FDIC examination. These exam results will be available before the next risk-related assessment cycle begins. These banks will be high risk rated and will lose their rebate in that next cycle in the event their CAMEL rating is lowered below 2 and they still fail the statistical test.

As I indicated earlier, the risk-related premium system for thrifts most likely will parallel this general framework with a different probit model.

The risks presently inherent in the thrift industry are somewhat different than those in commercial banks. Specifically, the commercial bank system does not include a measure of interest rate risk which, we believe, should be part of a system applied to thrift institutions. We will begin to collect information to measure savings banks' risk exposure beginning with the Call Report for Year-end 1985, and should have sufficient data by 1987 for a separate model.

The FDIC does not view a risk-based premium system to be a panacea -- just a substantial improvement over the status quo. It has problems:

--It's retroactive,

--It's hard on those institutions that already are experiencing difficulties,

--It's arbitrary and will need frequent adjustment.

In its favor, 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. As important, it would send a strong signal to a problem bank's management and board of directors by making a finding of higher risk status and attaching a cost to the finding.

Perhaps most important, it would focus the FDIC's primary attention on its risk as an insurer of all of its customers in the same way a market system would. This should be beneficial to every aspect of its operations.

Another suggestion for regulatory change is a system of risk-based capital requirements. <u>Some have posed this idea as a substitute for risk-based premiums.</u> It seems to me there is no reason to take this position; <u>they are not mutually exclusive.</u> One deals with insurance premiums while the other can deal either with capital requirements or premiums of depository institutions. The risk-based capital requirements plan bases an individual bank's capital standard on the type of activities that the bank undertakes. Activities deemed to entail greater risk would require larger capital reserves while investment in low risk, highly liquid assets would need little or no capital.

It should be recognized that the agencies already employ risk-based capital standards. Recently 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. Such

concerns could also be a factor in determining premiums by providing an additional penalty for high-risk operation. My choice would be to use the capital risk factor to determine capital requirements rather than premium levels.

Thus, we believe that a risk-based capital system has merit. The FDIC used it in its supervisory program, but the risk evaluated is an overall judgment rather than a judgment based on defined asset groups. Perhaps the system can be refined and we look forward to studying the suggestions which the Federal Reserve, the Bank Board and others will be making in this area. Our only concern is that we regulators retain a certain neutrality when espousing our ability to predetermine risks by narrow asset classifications.

My first impression on arrival at the FDIC was that a risk-based premium system was ideologically sound but probably more trouble than it was worth.

As you can see, more study and listening to many others has changed that view. We stand ready to continue to listen and learn, but the more I hear the more I'm convinced that a risk-based premium system is a sound theoretical concept doable and worth doing.

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