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STATEMENT ON

DEPOSIT INSURANCE REFORM.

PRESENTED TO the

Senate COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS,
~~UNITED STATES SENATE~~

BY

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Washington.

Mr. Chairman, I am pleased to have an opportunity to appear before this committee to discuss deposit insurance reform. You have held a number of hearings where a great many views on this subject have been expressed. We have considered these and our own experience, especially our recent experience. We at the FDIC have concluded that, while the basic deposit insurance system is performing well, there is an urgent need for selective change.

In my testimony, I will indicate where I believe changes are necessary. These changes will include those requiring Federal legislation, those requiring state legislation and those that can be implemented by the FDIC under existing law.

Last year there were 120 bank failures and FDIC-assisted mergers and, very likely, we will see at least that many this year. In 1984 there were 79 bank failures; in 1983, 48; and in 1982, 42. During the entire decade of the 1970s there were only 76 bank failures. As of March 3, there were 1,196 banks on the FDIC's problem list. This number has increased steadily since the spring of 1981, when there were 200 banks on the problem list. This dramatic change has provoked many questions about the condition of the banking system, the handling of bank failures, the role that deposit insurance has played and the role that it should play in the future.

Banking System Problems

Bank failures have increased primarily because of weaknesses in the economy. While the overall economy has performed well during the past three years, performance has been uneven, leaving some parts of the country and some industries especially depressed. Weaknesses are likely to persist during the next year or more in energy and agriculture and in several foreign countries that are significant bank borrowers, and parts of the banking system will continue to be hurt by these strains.

During this same period, the banking environment has undergone considerable change. Deposit rate ceilings were deregulated. Competition among domestic banks and between banks and other institutions (including foreign banks competing in the U.S.) has increased. The effect of increased competition has been uneven; in some cases, banks previously insulated from competition have encountered significantly reduced margins in the marketplace; some banks have seen investments in branches and other facilities become redundant in the face of technological change and greater price competition.

Economic and competitive forces have made it more difficult for some banks to operate profitably. In some instances, reduced spreads on safe activities induced banks to take more risk and this led to increased loan losses. Years of operating in a very comfortable economic and competitive environment may have led some banks to become complacent in assessing risk and controlling expenses. An exact distribution of the causes of current problems is not possible. In our system, such problems are exacerbated by branching and other geographic restrictions which limit diversification possibilities for banks and lead to excessive exposure to a single industry.

Banks and regulators are adjusting to what has been happening. There is considerable evidence that banks are placing more stress on loan quality. And regulators have sought to get on top of problems earlier, especially in the case of large banks. However, many of the current problems will be around for some time, and they may get worse. They reflect weaknesses in existing loans on the books of banks and weakened financial conditions of those borrowers.

Deposit Insurance

What has been the role of deposit insurance in this process? The existence of high deposit insurance coverage (including what is perceived to be 100 percent *de facto* coverage for large banks) has probably contributed to expansion and precarious funding by some banks. While some maintain that high insurance coverage has contributed to risk taking, I doubt that deposit insurance has been a major contributor to the problems we currently face. For that reason I do not believe the system is in need of fundamental change that would impose greater risk on depositors or substantially increase capital requirements of banks.

The insurance system has been seriously tested in recent years and for the most part it has performed well. Federal deposit insurance has fully protected most (though not all) depositors from bank failures; it has significantly reduced disruptions associated with bank failures; and it has generally preserved confidence in the banking system.

Clearly, the system has not performed perfectly, and this has become more apparent as the number of failures has increased. Problems in the insurance system have been identified in at least four areas:

- The operation of the deposit insurance system has not always treated similar depositors in large and small banks in the same way, causing some to assert that the system is not altogether fair.

- While the insurance system has lessened secondary effects of failures, the current methods of handling of bank failures may have placed too many assets in a liquidation mode, cutting off borrowers from bank services and, possibly, increasing the cost of handling failures.

- The current system does not provide the FDIC with all the essential tools for smooth, efficient handling of large bank failures.

- The system does not provide a means of assessing those institutions that expose it to greater risk a premium that is commensurate with that risk. Additionally, the current system and the manner in which failed banks have been handled has sometimes given a free ride to some bank creditors -- they receive the benefits of deposit insurance without paying for it.

Of course, we operate with certain handicaps in the banking system that sometimes make private sector resolution of problems through acquisitions more difficult. In some states, branching restrictions significantly limit the feasibility or practicality of one bank acquiring another, failing, institution. Limitations on interstate acquisitions substantially reduce options in dealing with large, troubled banks. And in some instances, limitations on what banks can do limit the attractiveness of bank charters and of banks as acquisition candidates.

During the remainder of my statement I will address in greater detail each of the suggested weaknesses in the deposit insurance system and how I propose the system be improved. In several key areas, I believe, Federal legislation is needed. In some instances changes in FDIC procedures within our existing statutory authority are necessary. I will also discuss some proposed "reforms" which I consider to be unnecessary or counterproductive at the present time. My recommendations will focus on practical ways to improve failure management and on ways to improve the efficiency and fairness of the insurance system.

<u>Fairness Issue</u>

During the past 20 years a majority of bank failures and all failures of large banks (those with assets over $500 million) have been handled through purchase and assumption transactions (P&As). In these transactions <u>all</u> deposit and most other liabilities to general creditors[1] are assumed by an acquiring bank so that such creditors come out whole regardless of the size of their claim. In contrast, when a bank is liquidated through a payoff, only <u>insured</u> depositors are paid by the FDIC. Uninsured depositors, the FDIC (standing

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[1]The exception has been general creditor obligations, where they exist, in state-chartered banks located in states that have depositor preference statutes.

in place of insured depositors) and other general creditors, are paid pro rata from the proceeds of receivership collections. In most cases they do not receive the full amount of their claims. Thus, uninsured depositors and other general creditors are not likely to come out whole in a payoff, whereas they do in a P&A.

Most payoffs have occurred when there have been no institutions interested in acquiring the failed bank (typically where branching is restricted) or where fraud or contingent liabilities have made it extremely difficult for the FDIC to estimate loss and effect a P&A. Until the Penn Square Bank, N.A., in Oklahoma City was paid off, the largest bank paid off by the FDIC had liabilities of less than $100 million.

Modified Payoff

In the spring of 1984, the FDIC effected a number of so-called modified payoff transactions. Failing banks were closed and insured depositors were paid. However, the form of payment was the transfer of their accounts to another institution which usually acquired the premises and certain other assets of the failed bank. Most checks in process were paid as is done in a P&A and most depositors probably were unaware of the difference. However, the liabilities of uninsured depositors and other general creditors were not assumed by the acquiring bank. The FDIC made a conservative estimate of the present value of future receivership collections and advanced funds to the receivership so that a cash advance could be made almost immediately to uninsured general creditors.

The modified payoff preserved many of the advantages of the P&A transaction. It was less disruptive than a straight payoff, while still retaining some depositor discipline from uninsured depositors and other bank creditors. Some of the value of the failed bank's deposits and facilities were preserved and these were sold through a bid process as in a P&A. The cash advance to uninsured creditors removed some of the "sting" of a reduced payoff, although uninsured depositors were still exposed to some loss. The modified payoff worked from the standpoint of mechanics -- it clearly was superior to a traditional payoff because it conserved FDIC personnel and financial resources and was less disruptive to the community.

The FDIC was in the process of examining the modified payoff in April 1984 when Continental came along and the decision was made not to use a modified payoff. Since then, the modified payoff has been used infrequently, usually in situations where a P&A was not feasible.

Paying off Continental was never considered to be a serious option. The need for a major decision came very quickly. Paying off Continental would have taken a considerable amount of time and caused substantial disruption in financial markets. Mechanically, it did not appear possible to determine all account balances promptly to allow any payments and the amounts involved were too large to be handled in the normal fashion. A substantial volume of depositor, lender and borrower relations would have been disrupted. Moreover, there might have occurred significant liquidity problems for many major U.S. banks and, very likely, some permanent disruptions in borrowing and deposit relations among many financial institutions. Once it became apparent that a giant bank could not be handled as a modified payoff under current technology and market conditions, it seemed unfair to pay off smaller failing banks, and systematically expose large depositors to loss in such institutions.

It is important to note that, even before the Continental situation occurred, many at the FDIC did not consider the modified payoff to be an unqualified success or the way to go in the future. Many were skeptical about "depositor discipline." Depositors generally have ample notice to get out of a troubled bank without incurring any loss. Once unfavorable news becomes public, they have no incentive to stay with a troubled bank, even if they think it is likely to survive and turn itself around. Actually, the increased probability of depositor loss would make it difficult for a troubled bank to turn itself around. Depositor discipline has always been a two-edged sword, which requires considerable disciplining in and of itself.

In the case of a large bank with extensive overseas branches, under current conditions it is doubtful that the FDIC could control the liquidation of assets and the disposition of their proceeds in foreign countries. This further limits the feasibility of effecting a modified payoff for a really large bank.

If we could and did pay off a large failing bank, what would be the impact on the system and on other banks funding primarily through uninsured creditors? Lots of assets would be tied up in liquidation as would the claims of many depositors and lenders. Flights of deposits from large institutions perceived to be at risk might be considerable. So, too, would be the potential disruption and risk to the system. Some say we eventually would have a better system, although they might concede that it may be difficult or impossible to get from here to there. I'm not so sure it would be a better system. It is apt to be more unstable and depositor discipline has its limits in an environment where most liabilities are very, very short-term, funds can be readily transferred, leverage is substantial, and information is easily transmitted. After all, the FDIC and the Federal Reserve System were created because of the problems of too much depositor discipline at one time. In the future, systems might be developed to pay off large banks more easily and the banking environment might become less vulnerable to large payoffs. At such time, it might be appropriate to revisit depositor discipline.

If universal modified payoffs are neither feasible nor, at the present time, desirable, how can we improve the fairness in the system so that depositors in large and small banks that fail are treated the same? A preferable alternative is to do P&As wherever feasible and eliminate those impediments to effecting them. A principal impediment is restrictive branching statutes which limit potential bidders for failed banks. Since May 1984, when initial assistance was given to Continental, there have been 41 payoffs of failed banks; 36 of these occurred in states that have substantial restrictions on branching.

Partly in response to this situation, several states have liberalized permissible branching in failed bank situations. However, more needs to be done

-- possibly a Federal override permitting the establishment of a branch in connection with a P&A acquisition, regardless of state branching law or permission for the FDIC to charge higher insurance assessments in these states.

Under existing law the FDIC is required to meet a cost test in choosing a P&A over a payoff, selecting the former only in situations where it appears to be the cheaper alternative. Where significant contingent claims exist (liabilities for loan commitments, law suits, off-balance-sheet guarantees, possible unbooked claims, etc.) it becomes extremely difficult to estimate costs. The FDIC typically must protect an acquiring institution from such claims to get them to bid. Should the claims become established as general creditor obligations, the FDIC would have to pay such claims in full, subsequent to a P&A transaction where the failed bank is not subject to a state depositor preference statute. It is frequently difficult to estimate with any precision which contingent claims will ultimately be established, and this complicates estimating P&A costs.

Sometimes a failing bank will have obligations for unsecured borrowings. These general creditor obligations have creditor status equal to depositors where depositor preference is not applicable. In order to do a P&A these obligations must be assumed by an acquiring bank (<u>i.e.</u>, they must be given equal treatment to deposits). No deposit insurance premiums are paid on such obligations even though they benefit from the deposit insurance system and the way bank failures are handled.

<u>It is therefore recommended that a Federal depositor preference statute be enacted.</u> This would prefer depositors to other bank creditors,[2] including those creditors who might establish claims in connection with letters of credit, other guaranties, law suits, etc. It would apply to all FDIC-insured banks. This would substantially simplify the FDIC's cost calculations and facilitate satisfying the P&A cost test; it would reduce the cost of handling failed banks; it may result in increased FDIC assessment income; and, in some instances, it would create a class of creditor which might serve to discipline banks and monitor risk.

This is an important proposal that has implications for remedying to some degree each of the problem areas I have suggested exist within the deposit insurance system.

In a P&A under depositor preference, an acquiring bank could only assume deposit liabilities. The FDIC would be entitled to recoup its outlays (including foregone interest) before nondeposit claimants receive anything. This would probably cause some realignment of creditor relationships. Some loans to banks might be shifted to deposits -- but the bank would then be required to pay insurance premiums on them. Standby letters of credit or other guaranties from weak institutions would have diminished marketability, and this would be a salutary development.

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[2] It may be appropriate to place liabilities related to employment and other similar services on a par with deposits. An alternate version of this proposal would involve three categories of preferences: deposits, balance sheet liabilities, and contingent claims.

A depositor preference statute would reduce the FDIC's cost in handling bank failures and make it considerably easier to meet the cost test necessary to justify a P&A. It would also mean that general creditors would look carefully at the financial position of the banks, thus creating an increased element of market discipline on the institution.

A depositor preference statute would raise some interesting questions with respect to certain existing bank liabilities. Some institutions have resorted to collateralized nondeposit borrowing as a means of raising funds cheaply in the marketplace. If the collateral is substantial, such borrowings would acquire a preferred status in liquidation and this could weaken the FDIC's creditor position, raising FDIC losses. It may be appropriate for such borrowings to be treated as deposits for purposes of calculating deposit insurance premiums so that they not become a vehicle for circumventing that expense of operation.

The treatment of foreign branch deposits is an issue of greater quantitative importance. Foreign branch deposits currently exceed $300 billion, account for about 15 percent of bank deposits and a much larger percentage for money center banks. If we prefer foreign deposits to other bank creditors like domestic deposits, they should be subject to insurance assessments. An alternative would be to prefer domestic deposits and not subject deposits in foreign branches to assessment. This would expose them to increased risk in the event of failure (they would be outside the P&A process). While foreign central banks might control the liquidation of overseas assets and affect the status of creditors, there might still be considerable uncertainty about the position of overseas deposits.

Disposition of Failed Bank Assets

The FDIC needs legislation which will provide it with more time to handle failed or failing institutions. In a P&A transaction the FDIC has generally provided an acquiring bank with book assets, less a premium that is bid, equal to assumed liabilities. The makeup of book assets has varied. Until recently, most P&As were relatively "clean." Book assets assumed consisted of physical facilities (appraised value), securities at market value, performing installment loans and, sometimes, residential real estate loans. To bring assets up to assumed liabilities (less premium), the FDIC inserted cash, removing classified loans and most or all commercial loans. This "clean bank" P&A simplified the bidding process and minimized the burden placed on bidding banks. However, it left the FDIC with a considerable loan collection task. In some instances, values associated with ongoing loan relationships were lost and this also probably cost the FDIC.

Those borrowers who were not sufficiently strong or established may have had difficulty getting new financing to pay off the FDIC. In its liquidation capacity the FDIC is naturally reluctant to provide additional financing to borrowers in situations where a bank holding a similar loan might be willing to provide such financing. Thus, borrowers may be cut off from needed banking services and, ultimately, the loss to the FDIC not only may be increased, but the economic activity in the area may be reduced.

Since last spring the FDIC has sought to pass more assets in P&As. In current P&A transactions most performing loans of all types are initially passed. The acquiring bank is typically given an opportunity to put back some share of such loans to the FDIC at book value within the first few months of the transaction. Some additional loans can be sold back to the FDIC at a discount. These changes have served to reduce the volume of assets our Liquidation Division acquires from failed banks. Nevertheless, the FDIC still acquired about 35 percent of the loans of banks that failed last year. (We currently own about $9 billion in book value loans taken in connection with bank failures and assistance transactions.) We expect the changes to reduce losses associated with handling failed banks because marginal loans are likely to have greater value in the hands of banks where financing is available.

We are currently reevaluating our policies and developing procedures and incentives to pass not only all unclassified loans, but pass or develop incentive arrangements so that collections on nonperforming loans can be done by acquiring banks or other private institutions. This will probably require some testing of new procedures and some imagination. It would be our goal to reduce the cost of handling bank failures, to reduce the FDIC's involvement in collections and in potential adversarial relationships with borrowers and, in some instances, provide borrowers from failing banks with ongoing banking service. To the extent that passing more assets can reduce our cost it will tilt the results of the cost test in the direction of more P&As.

In order to get banks to take more assets of failing banks it will be necessary to give more information on loan portfolios to failing banks. This would require stretching out the P&A process and, in some cases, keeping a failing bank operating for a longer period of time after potential bidders have been contacted. To prevent a run during this period, the FDIC might put a subordinated note into the failing bank, imposing some restrictive conditions on its operation. However, that may not always be feasible and management of the failing institution may not always be cooperative. For such situations we are considering legislation to enable the FDIC to control the operation of an open institution through conservatorship powers in order to provide time for potential bidders to review the bank's loan portfolio.[3] This could ultimately reduce the cost and disruption of disposing of a failing bank. Under certain circumstances, where the range of potential bidders is large (say, where interstate acquisitions are feasible), a satisfactory shopping process could lead to the disposition of the bank with minimal FDIC financial involvement and, possibly, on an open bank basis.

As regional and interstate banking become the pattern in the country, more time to assemble bidders is necessary, and this further argues for providing more time for the FDIC.

Large Bank Failures

Over the past two decades, several large banks have failed, received direct assistance to avert failure or been merged while on the brink of failure. These transactions have involved special arrangements, emergency state legisla-

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[3]In the case of some failing banks, including those with significant contingent liabilities, it may be preferable to have the FDIC keep the bank's operations intact by means of a "bridge bank", as described below.

tion and difficult negotiations in an uncertain environment. Available options have sometimes been limited. Several changes are needed, I believe, to increase options and provide for more flexibility to handle future failures of large banks.

Ideally, when a large bank gets into difficulty, the resolution of its problems would be handled through recapitalization or a private sector merger. And, ideally, supervisory pressure will be applied early enough so that FDIC assistance isn't necessary to solve the problem. However, restrictions on interstate branching and acquisitions frequently limit options for private sector solutions (as I have suggested, branching and geographic restrictions also contribute to concentrations and the development of problems in the first place). Interstate compacts enacted by states have materially expanded options. However, they still don't go far enough. The Garn-St Germain Act of 1982 provides for interstate acquisitions of failed banks with assets of $500 million or more. That provision has materially increased FDIC options in several bank failures. Last month the interstate provision was used in a Florida failure and the provision has apparently saved the FDIC a substantial amount of money. The interstate provision of Garn-St Germain is scheduled to expire April 15 and it is very important that, at a minimum, Congress extend that provision. However, we believe the interstate provision should be materially broadened.

Once a bank fails, its value to a potential acquiror is substantially diminished. FDIC options are reduced and potential costs are materially increased.

We recommend that Congress permit the interstate acquisition of failing banks that have assets of $250 million or more.

In restrictive branching states the value of out-of-state entry may be very limited if the subsequent acquisition of other institutions in the state is not permitted. If a large bank is part of a holding company system, failure of that bank would only permit the interstate acquisition of that single-office institution under existing law as opposed to the other parts of the holding company. In such a situation it would be logical to permit the interstate acquisition of bank holding companies where one or more banks in the system is in danger of failing, the bank(s) satisfy the size requirement, and the failing institution(s) account for a significant share of the holding company assets. Another approach would be to permit the interstate acquisition of one or more failing banks, and thereafter allow the acquiror the same expansion rights enjoyed by banks or bank holding companies within the state.

The extension of the interstate acquisition provision to include failing banks and also bank holding companies would enable these institutions to actively shop for mergers with out-of-state and foreign banking institutions while there is still some chance of saving the institution without FDIC involvement. That could substantially lessen our task and conserve on our financial and personnel resources. In some instances, FDIC assistance may be necessary to effect a transaction. However, that is likely to be considerably less than the cost to the FDIC if we wait for the institution to close. Even where an open bank transaction is not possible, the shopping process will materially increase the amount of information available to potential bidders and facilitate a closed bank transaction.

When a very large bank fails, options may still be very limited, even when interstate and international possibilities are considered. That was evident in the Continental assistance transaction. It will be difficult to put together a satisfactory purchase and assumption in a short period of time unless the FDIC is willing to buy out a substantial volume of troubled assets, an option which is not desirable.

What is needed in these circumstances is a method to "bridge" the gap between the failed bank and an orderly purchase and assumption transaction in which the FDIC does not have ongoing responsibilities for many troubled assets. It would be desirable for the bank to be closed and promptly reopened and run under the oversight of the FDIC (presumably using hired managers or contracting with another bank to manage the institution). After an appropriate period, when asset problems have been sorted out, the extent of problems can be accurately gauged, and potential purchasers can make an informed judgment, the FDIC could seek to sell the repositioned bank to another institution or a private investor group. Another option would be for an interested banking organization to make an investment in the bank and manage it for the FDIC under some profit-sharing arrangement with the FDIC. In either case, the objective would be to return the bank to the private sector in an orderly manner.

Present law does not allow the FDIC to operate a full-powered bank even on a transition or bridge basis. Legislation should be enacted so that the FDIC can be empowered to own and operate a bank for a limited period of time in those circumstances which I have described. Such a "bridge bank" would have all the powers that national banks enjoy, as well as certain special protections currently afforded Deposit Insurance National Banks. The "bridge bank" would operate as an entity separate from the FDIC and with a separate board of directors. The FDIC should be authorized to operate it for a reasonable period of time, consistent with the transitional nature of the institution. These characteristics should allow the FDIC to maintain some franchise value of the failed bank, while arranging for an orderly transfer of assets and avoiding a windfall to shareholders.

A depositor preference statute would also facilitate the handling of a large, failed bank. Such institutions sometimes have considerable nondeposit liabilities, particularly in connection with guaranties, other off-balance-sheet activities and litigation. Depositor preference, the expansion of the Garn-St Germain interstate provision and providing the FDIC with authority to operate a "bridge bank" would materially increase our options for handling large bank failures and, over time, lessen our costs, while contributing to the stability of the system.

Risk-Related Deposit Insurance Premiums

Currently, all FDIC-insured 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.

We favor legislation to establish a system of risk-related insurance premiums. Such a system would penalize some risk-taking in the banking system and, at the same time, would be more equitable. A risk-based system would be less arbitrary in that currently all banks -- the best and the worst -- pay the same price for deposit insurance. It would also provide a significant 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.

Last September, the FDIC requested comment from the banking industry and the general public on a specific risk-based premium proposal. Under that proposal, the FDIC would use objective statistical techniques based solely on Call Report-generated data to rate banks as having either a normal or an above-normal level of risk. Banks would be rated on financial variables (measured as a percent of total assets) like primary capital, loans more than 90 days past due, nonaccruing loans, net chargeoffs, and net income. Those banks rated as having above-normal risk would have been subject to a second testing screen. If a bank were rated as having above-normal risk based on the Call Report test and it had a composite CAMEL rating of 3, 4 or 5, it would have received no assessment credit. The above-normal risk banks which had a composite CAMEL rating of 1 or 2 would not have been denied their assessment credit but would have been subject to additional financial review.

So far, the FDIC has received more than a hundred comment letters addressing this proposal. The majority of them are supportive of the concept of risk-based premiums, although many recommendations were offered for revising the proposed system.

After considering these comment letters and reviewing the initial proposal, we would suggest some modifications. We would still propose that risk be measured first by a test based on Call Report ratios and then by a CAMEL screen which is used only to exempt banks with a 1 or 2 rating from a high risk category indicated by the statistical data. Our tests show this type of use of CAMEL ratings to be very effective in classifying banks. We are continuing research to determine whether a wider range of financial variables would enhance our measurement of risk and the likelihood that an individual bank will become a problem to the FDIC. Since almost all insolvencies stem from credit quality problems, our formula is slanted heavily in that direction. Although other factors, such as liquidity, are important factors in a bank's operations, they often are more difficult to quantify, and incorporating them into formulas has not improved predictive results. Nonetheless, further research in this area may lead to an alternative list of financial variables to be included in any final proposal. As more data become available on off-balance-sheet risk, the incorporation of these data might improve predictive results.

We recognize that our proposed measure of risk classifies banks according to currently observable problems rather than by a system designed to measure risk before credit quality problems arise. The latter approach conceptually would be preferred; however, such measures of risk are difficult to construct and often result in subjective determination of what should be classified as a risky behavior or activity.

We now propose that those banks the system determined to be risky would actually pay a higher premium (up to 2/12 of one percent) rather than just forfeiting their assessment credits. This would assure that riskier banks would pay significantly more even in times when the assessment credit is low or nonexistent. In the future, after the system is more refined, the FDIC may wish to ask for authority to charge even higher premiums to the riskier banks.

We believe two assessment classes are adequate for our initial system. From the beginning, the thinking at the FDIC has been to start simple and then, with experience, work toward a more sophisticated system. In the future, we may wish to fine-tune the system and divide banks into more than two risk classes. At this juncture the FDIC favors legislation that would provide it with broad discretion to implement a risk-based premium system without locking ourselves into specific variables or risk classes.

The current assessment base is deposits in domestic offices of FDIC-insured banks. As already noted, present P&A procedures provide full coverage to nondeposit general creditors who do not pay insurance assessments. If a depositor preference statute is enacted, nondeposit creditors would not have to be covered in a P&A. However, some bank borrowings and other obligations may be shifted to deposit relationships to upgrade their creditor position. To the extent this occurs, the FDIC assessment base will be broadened and assessment income will be increased.

Most of my comments thus far have been concerned with "failure management" -- how to handle failing and failed banks in a manner that will minimize their cost and their disruptive impact on the economy. I have also discussed improvements in the financing of the deposit insurance system. The FDIC is also concerned with preventing bank failures or at least preventing too many failures and allowing banks to become so insolvent that they become a significant drain on our resources.

Independent Bank Supervisory System

It is critical that we, along with other Federal and state supervisors, maintain high quality supervision and strive to improve that quality. Banking and finance have become more complicated in recent years. Increased competition and a more uncertain environment have made banking more difficult and, apparently, more risky. It is extremely important that bank supervision keep pace with changes in the banking environment.

Deregulation has increased bank options with respect to what products banks can offer, where they choose to offer them and how they price them. It may have increased the potential for conflict of interest between "banks" and their corporate owners. Deregulation does not imply that we can relax supervision. The opposite is closer to the truth. As I have suggested, increased competition among banks and between banks and other institutions (including nonbank banks) has placed strains on bank earnings and, possibly, encouraged risk taking. At this time, when demands on supervision are increasing, it is critical that we train and expand a quality staff to examine and supervise banks so that current and potential future problems are controlled. Otherwise, the cost to the FDIC and the economy will soar. It is particularly important that neither Gramm-Rudman-Hollings nor OMB apportionment prevent the buildup of a capable supervisory staff in the Federal bank regulatory agencies nor limit the independence and flexibility of bank regulatory agencies.

We need Federal legislation ensuring that adequate independent bank supervision is provided by responsible agencies. We are convinced that bank supervision must play an even larger role in monitoring risk and reducing the exposure of the deposit insurance system and our economy to unnecessary risk. Supervision must be increased as deregulation provides bankers with the needed opportunity to use their judgment in making business decisions. For the first time in over fifty years, the Office of Management and Budget has asserted new jurisdiction over three of the four regulatory agencies, attempting to overturn a half century of independent operations. The Congress should act swiftly to maintain the competence and flexibility of the regulatory agencies. Otherwise, the operation of the Comptroller, the Bank Board and the FDIC will be adversely affected to a significant degree.

Supervision is not the only way to prevent excessive risk in the system. There has been much discussion during the past two years about various kinds of market discipline. I have indicated that, at this time, we don't know a way to use increased depositor discipline to improve the system. However, market discipline can come in many ways. The relatively high failure rate of the past few years has imposed losses on bank stockholders and subordinated creditors and job loss to bank managers; it has not been an altogether painless process. If depositor preference is enacted, an additional class of bank creditor will be exposed to loss. Risk-based insurance premiums will impose higher costs on those banks operating at higher risk. Capital requirements which have been raised in recent years impose a cost and discipline on the system. They would be raised again if additional capital requirements are found necessary as we examine a risk-based capital requirement. To the extent that future conditions warrant higher capital requirements, that presents a further opportunity to enhance market discipline.

Financial Condition of the FDIC

The FDIC's insurance fund is adequate to handle the problems of the day and those likely to be faced in the near future. The FDIC's Deposit Insurance Fund, its net worth, currently is about $18 billion, and its assets include about $16 billion of U.S. Treasury securities. The size of the fund relative to insured and total deposit liabilities of banks remains high by historical standards. The fund is currently 1.22 percent of insured deposits, well above the average for the past 10 years, despite record numbers of insured bank failures during the past two years. The fund's growth during the last two years has slowed as a result of losses and reserves established in connection with bank failures. These losses have resulted in insured banks receiving only small assessment rebates for 1983 and 1984 operations. They will receive no rebate for 1985, although, to a large extent, this reflects higher loss estimates in failures occurring prior to 1985.

Last week, the FDIC added $2.3 billion to its allowance for insurance losses. However, only $600 million related to the 1985 failures. $1.3 billion related to the 1984 assistance transaction with Continental Illinois Corporation. While that transaction still has several years to run, our loss reserve reflects our assessment of likely ultimate loss on loans that have or might be put to the FDIC exclusive of potential future gains or losses on our stock investment in Continental. It is important to emphasize that we have attempted to conservatively account for all projected losses and commitments related to failures and assistance transactions. This includes estimates of our ultimate losses on assets acquired in connection with all failures as well as losses related to commitments in connection with assisted mergers. We have also established reserves for those savings banks with outstanding net worth certificates where the FDIC seems likely to incur a loss.

While we believe the Deposit Insurance Fund and the basic assessment rate for satisfactorily performing banks are adequate at present, the assessment system and the long-run strength of the fund would be materially enhanced by enactment of our recommendations on risk-based insurance assessments and depositor preference.

I believe that the FDIC's balance sheet conservatively reflects our exposure from past bank failures. It is more difficult to be absolutely certain about the adequacy of our reserves for meeting future failures. Nevertheless, past experience suggests that current reserves are adequate.

While our fund is coping with today's rapidly changing and difficult conditions in the banking field, we urge swift action to help the insurance system to be better prepared for future challenges.