

APPENDIX II - ANALYSIS OF AMERICAN BANKERS

ASSOCIATION DEPOSIT INSURANCE REFORM PROPOSAL

The American Banker's Association has presented a deposit insurance reform proposal for consideration by Treasury. The FDIC welcomes constructive proposals from all sectors of the public. This paper is an effort to contribute to the serious consideration that the proposal deserves.

The paper begins with a summary of the ABA proposal. Section II enumerates the benefits of the proposal. For the most part, these benefits are well recognized and speak for themselves. Subsequent sections of this paper describe some of the FDIC's concerns regarding the proposal. That these concerns are described in greater detail should not be construed as casting judgement on the merits of the proposal. Rather, these concerns are expressed in an effort to advance the public policy discussion in the most constructive way.

Section III discusses the potential systemic aftershocks of a major bank failure in which losses are imposed on uninsured depositors. Emphasis is placed on three avenues through which the effects could spread beyond the initial institution: correspondent balances; the impact on similar or neighboring solvent institutions; and disruption of the payments system. A key element of the ABA proposal is to minimize these aftershocks by developing computer systems at large banks that would enable the FDIC to resolve a failure at such an institution overnight.

Section IV examines the demands on bank operations created by the requirement that the FDIC make an overnight determination of insured balances and impose losses on uninsured balances in time to reopen the bank the next morning. It will be very difficult for these complex procedures to take place in the limited time frame at large banks. Developing, implementing, maintaining and monitoring these systems may be very costly. The section closes with a discussion of the specific method that the ABA recommends be used to calculate the exposure of uninsured depositors of failed banks.

Section V closes the paper with a discussion of market discipline in the banking industry and possible effects of increased reliance on depositor discipline in moderating risk. The section ends with a summary of issues that need to be considered before implementing the ABA's proposal or other measures of deposit insurance reform.

I - Summary of ABA Proposal

The proposal changes FDIC failure resolution policy. A new procedure, called "Final Settlement Payment", would be mandated. The mechanics are as follows:

1. Failed institutions would be placed in receivership at the close of a business day. Overnight, a determination would be made of exactly which deposits are eligible for insurance. The key to enabling this to occur in a large bank failure is the proposed development computer programs and data bases at all large banks that would automate this process.
2. The following business day, a new entity assumes all insured deposits. This entity would either be an acquiring institution or a bridge bank.
3. The successor institution would also assume a fixed percentage of all uninsured deposits (approximately 85% - 95%). This percentage would be adjusted over time and is intended to reflect the FDIC's average rate of recovery of assets in past failure resolutions.
4. Uninsured depositors would not have any further claim on the assets of the receivership. Any gain or loss on the disposition of receivership assets would remain with the FDIC. For example, if the FDIC's experience was to collect 92% of all receivership assets, all uninsured depositors in the next failure would receive 92% of their funds immediately. If the FDIC subsequently recovered more than 92% of this specific bank's assets, it would keep the excess. Similarly, if the FDIC recovered less than 92% in the specific instance, it would absorb the added loss.

Other elements of the ABA proposal include:

- * The elimination of deposit brokerage. (A pending ABA report will elaborate on this topic).
- * The continued improvement in the strength of the bank examiner corps.
- * The suggestion that additional attention be paid when granting new bank charters and supervising newly chartered banks.
- * An appeal to bank regulators in other industrialized nations to develop depositor protection programs that incorporate market discipline and allow for depositors

in major institutions to suffer losses in the event of failure.

II- Benefits of ABA Proposal

The ABA proposal mandates that uninsured depositors face losses in bank failures. It also resolves many of the administrative hurdles that reduce the likelihood that losses will be imposed on uninsured depositors in major banks. The result could be the following public welfare gains:

- * Increased levels of depositor discipline. This should act to encourage safe and sound banking practices and discourage excessive risk taking by bank managements.
- * The elimination or reduction of the systemic risks that would occur in a major bank failure.
- * The equalization of the treatment of depositors at large and small institutions.
- * The minimization of costs to the insurance fund and to the banking industry which finances the fund.
- * A greater reliance on market forces, as opposed to governmental intervention, to control bank risk.

III - Systemic Risks in Large Bank Closings

Caution needs to be exercised when considering policies concerning failure resolution of major banks. These cases have a greater potential of triggering larger economic disruptions or crises. At the same time, over protection of these institutions can distort the efficient allocation of resources in the economy. Areas of concern regarding systemic risk in major bank failures are discussed in this section. Three avenues are considered through which the destabilizing effects of a major bank failure can spread through the financial sector or the larger economy.

1. Impairment of correspondent banks.
2. The effects of market perception on neighboring or similar banks.
3. Disruption of the payments system.

1. Correspondent Banks

The ABA proposal will impose a haircut on all large depositors in the event of a bank failure. If other banks are among the newly shorn depositors, these banks may face losses which could: 1) create liquidity problems or; 2) exceed net worth.

Large banks tend to be net borrowers from smaller banks. These moneys may originate from correspondent banking activity (clearing checks, safekeeping of securities, etc.) or through Fed funds borrowings. Large banks also hold extensive balances with each other, often as a result of check clearing arrangements. Thus, a large bank failure could affect many other institutions.

The ABA suggests that one reason that the FDIC was reluctant to impose losses on depositors at Continental was because of the large number (976)¹ of banks that held deposits over \$100,000. The ABA proposal, because it envisions the overnight adjustment of account balances and the normal functioning the next day of a successor institution, would not cause direct liquidity problems for the banks holding deposits at the failed institution. However, if the losses imposed on the banks is great enough to impair net worth, the correspondent banks could suffer from runs by uninsured depositors, or even insolvency.

The ABA argues that, because depositor losses would be a fraction of the total uninsured balances, the impact on the net worth of a correspondent bank would be minimal. In the case of Continental, if a 30% haircut had been imposed, 6 banks would have faced losses greater than their capital, and 22 other banks would have incurred losses greater than 50% of their capital. Had the haircut been only 10% (which is closer to expected the level that would be set under the ABA proposal), only 2 banks would have suffered losses greater than 50% of capital, neither of which would have exceeded capital.

One reason that small banks hold correspondent balances at large banks in their district is to clear checks (see Attachment A on the check clearing system to learn about options available to small institutions). By their nature, these activities involve large amounts of money. If an economic downturn adversely affected all major banks in a region, a small bank might be hard pressed to find a completely safe, major,

¹ The numbers cited in this paragraph, and the next, are from the ABA proposal.

local bank to use for these services². For example, 9 of the 10 largest banks in Texas were closed or assisted during a 3 year period. It is easy to imagine a community bank moving its check processing business from one failing bank to another, taking several haircuts which, in total, cause insolvency.

Another conduit through which banks would be exposed to losses from another bank's failure is the Fed funds market. This market is primarily overnight loans from banks with excess reserve balances to banks with deficient reserves. The general pattern of Fed funds lending is for large, urban banks to be net borrowers on this market and for small, rural banks to be net lenders.

In their proposal, the ABA envisions this market acting as an adjunct to the Federal Reserve's role as lender of last resort. The ABA argues that banks are among the depositors who are best able to judge the viability of competing firms. If the public flees otherwise healthy banks, and moves funds into institutions that it believes are stronger, the recipients of these funds could rechannel this money to the threatened institutions via the Fed funds market. Thus, the ABA sees other banks providing both market discipline and market stability.

There is a concern, however, that these two roles may be mutually exclusive. Bank runs can become self-fulfilling. Even if a bank believes that, absent a run, another bank is financially sound, given that a run is taking place, it would be uncertain about the viability of the exposed bank. The exposed bank's survival will depend on the behavior of its remaining depositors and the willingness of other institutions and the central bank to lend to it. A bank lending Fed funds could not accurately measure these factors, and would not want to risk the possibility of an overnight loss. A system which imposes losses on bank creditors of failed institutions in order to increase market discipline, may not be compatible with the goal that banks provide stable funding during panics.

² Small banks could utilize the local Fed for check clearing. However, it may not be wise policy to drive this business away from major banks in distressed regions. This activity can be profitable, and the risks are uncorrelated to those within a loan portfolio. Check clearing operations are driven by scale economies, so taking business away from a troubled bank would reduce revenues without an equivalent short term reduction in costs, further weakening the firm.

2. Effects on Similar / Neighboring Institutions

One other mechanism through which the effects of an individual bank failure could spread to other institutions would be from a change in the behavior of depositors at an otherwise healthy bank. Under the ABA plan, depositors with uninsured funds would have incentives to run. Therefore, if a particular bank failed due to credit problems in a distressed region or industry, depositors at banks in the same market might fear that their institution is also at risk and begin running.

The ABA plan assumes that there will be greater stability among worried depositors under their plan than if depositors were uncertain of the extent of their potential loss. It is not clear that the volatility of a deposit base is a function of the fractional loss that would be felt in a failure. A depositor who observes a potential failure/run would want to join in the run as long as the transaction cost of moving funds is less than the potential loss from staying in the bank. In other words, if depositors at bank A feared that they might lose 30% of their funds in a failure, and depositors at bank B feared that they would lose 10% of their funds in a similar situation, both banks would experience the same deposit drain if transaction costs are minimal (which they are for transaction and money market balances).

The ABA system would continue to protect banks from runs by small depositors. However, it would expose the industry to the possibility of runs on otherwise healthy institutions by uninsured depositors. In many large banks, runs of small depositors are not threatening. Continental Bank, for example, failed when large overseas depositors lost confidence.

This proposal might impair the ability of banks to provide services which involve large flows of funds. The reasons that correspondent banks might take check clearing activity away from a troubled bank are discussed above. Corporate users of check clearing services would have similar incentives to bypass the entire banking industry. Lockbox operations are an important non-credit source of revenue for banks (the risks of which are uncorrelated with the risks in a loan portfolio). A corporation using such a service directs its customer's payments to a post office box which is rented and controlled by the corporation's bank. The bank continuously collects the mail that has been delivered to the box, quickly deposits the funds into the corporation's account, and immediately enters the check payment into the collection system. Two criteria guide the choice of lockbox processor. One is optimal geographic location to minimize the time that payments from the corporation's customers are in the mail. The other important criteria is the ability of the bank to rapidly collect payment on the checks it processes. This ability is a function of the breadth of the correspondent

network maintained by the bank. Therefore, large banks have an advantage in providing this service.

If a lockbox customer became concerned about the viability of the bank providing the service, it would not be able to quickly end its exposure to losses at that bank.³ At present, because there may be a wide spread perception that regulatory policy will protect large depositors at the large bank providers of lockbox service, corporate customers may be minimally concerned about this potential exposure. However, if a large bank failure occurred in which lockbox customers experienced losses, corporations might be tempted to use providers of these services outside of the banking industry. Private lockbox servicers do not offer economic advantages over bank providers (in fact, because banks have monopoly access to the payments system, private firms could not match the funds availability offered by banks). This potential movement of business out of banks would be solely to avoid losses during an unexpected bank failure. Therefore, it would not be a form of discipline directed at a poorly run institution. Rather, it would be a flight from the entire industry.⁴

3. Payments System Integrity

Much of the ABA's proposal is concerned with maintaining the integrity of the payments system. The three major components of the system are CHIPS, Fedwire and check processing networks. The ABA makes recommendations concerning CHIPS that would reduce disruptions to that system. However, such reforms involve the possibility of CHIPS participants sharing a loss that would occur if a member failed while in an overdraft position. The risk of such losses is an unavoidable consequence of the operation of such a payment network. However, it emphasizes the vulnerability that the entire system has in the event of a major bank failure. CHIPS participants will have adjusted their exposure levels so

³ Many lockbox arrangements involve custom-made processing agreements. Negotiating these terms with new potential providers may take time. Once a new provider is selected, it may take 90 days or more for previously mailed invoices to be paid. During that time the firm is still exposed to the risk of failure of the old bank.

⁴ The checks processed in a lockbox would still have to be deposited in a bank for clearing. However, the other services provided by bank lockbox departments, including direction of remittances to optimal post offices and the capture and reporting of accounts receivable data, could be provided by non-bank firms. The final step, entering the check into the payments system, could be quickly redirected if the clearing bank's viability was threatened.

that potential losses there are sustainable. However, if any of these participants have additional exposure to the failed bank from other inter-bank activity, its own viability may be threatened and its own depositors might start running. We must be cautious about establishing policies which might mandate additional losses on these institutions.

Fedwire

An important element of the Fedwire system is payment finality - an institution receiving funds is guaranteed payment by its Federal Reserve bank, even if the institution that originated the transfer subsequently defaults on its obligation to its own Federal Reserve bank. Payment finality enables a bank to immediately credit the account of its customers receiving electronic payments. This permits the funds to be immediately used for other payments or investments and increases the efficient allocation of capital resources in the economy. Payment finality prevents a bank failure from affecting other banks that transacted business with it prior to failure. The risk is transferred to the Federal Reserve banks or, if the intra-day credit is fully collateralized, to the FDIC, uninsured depositors and unsecured creditors.

The Federal Reserve Board has developed policies during the past several years that are aimed at reducing its potential exposure to losses from Fedwire operation. Banks are restricted in the amount that they may overdraw their reserve accounts at any moment in time. These restrictions are tightened as the viability of an institution is threatened.

It may be difficult to balance the ABA's desire to wait until the close of business before declaring a bank insolvent with the Fed's requirements to protect itself from Fedwire risk. An interesting question is what should happen if the Fed refused Fedwire transactions from a failing institution which, facing a run, had exceeded its daylight overdraft limits. Depositors in the bank would be unable to withdraw their funds. What would be the legal standing of a customer who had requested a funds transfer before a bank was declared insolvent at the close of the business day, but whose funds were not wired due to the Fed's refusal to accept debit transactions from the failing bank? Would this depositor be subject to a haircut from the liquidator? Does such a potential event add to instability by increasing the likelihood that uninsured depositors will run quickly instead of waiting for events to develop?

Check Clearing

The rest of this section describes the disruptions that would be likely to occur to the check collection system if a

major bank were closed for several days during a failure resolution. The ABA proposal resolves most of these problems by suggesting that failed banks be re-opened the next morning. Section III describes why it may be difficult to develop the necessary systems to accomplish this. Given the disruptions described below, it may be prudent to develop the necessary technology before establishing certain policies.

The check clearing system has a certain amount of resiliency built into it. Deposit-taking institutions provide their customers with provisional credit when receiving checks. If the check is later dishonored, and returned to the bank of first deposit, the customer's account is debited. Because of the large volume of dishonored checks, systems have been built to minimize potential losses to deposit taking institutions. The recent implementation of Regulation CC holds out hope for further improvement to this system.

Approximately 1% of checks written are dishonored by the drawee bank.⁵ In order to return these checks, they are manually encoded with magnetic ink with the amount and the code for the bank of first deposit (Determined by searching the back of the check for a specific endorsement stamp). The encoding permits rapid movement through the clearing network back to the point of origin. Checks dishonored due to bank failure could be handled through these channels - even in the case of large banks - though not without imposing great strain. Essentially, the work load of the clerks performing this task would increase 100 fold. Deposit taking banks are entitled to timely notification by telephone or wire if items over \$2,500 are to be dishonored. It would be difficult to make timely notification if all large items drawn on a major bank were to be returned since again, the workload of the clerks performing this function will have increased 100 fold.

Delays in processing these returned items could lead to losses to the banking sector. The bank of first deposit, absent timely notification or presentment of the dishonored check, will be providing its customers with access to the deposited funds within 2 to 5 days⁶. If notice of the return arrives late, the funds may have left the bank, and the customer be unavailable or unable to refund the money (the customer may have also released goods or payments under the assumption that the deposited check was honored). Under the Uniform Commercial Code, the bank of first deposit can protest to the drawee bank if the return was

⁵ Bank Administration Institute Survey of the Check Collection System Bank Publishing, Rolling Meadows, 1987 page 33.

⁶As mandated by Regulation CC.

not initiated timely (within 36 hours),⁷ Ultimately, one of the two banks will have to absorb the loss.

In order to protect themselves from accepting checks drawn on large banks that are about to fail, many deposit taking banks, or their check clearing agents, could program their computer systems to refuse items drawn on such banks. At present, customer access to funds deposited by check is based on the geographical location of the check, and the transportation schedules to those parts of the country. If final settlement payment methods were mandated in all bank failures, and banks in the check collection chain were at greater risk due to late return of items drawn on failed banks, banks would wish to delay the availability of good funds to depositors based credit worthiness of drawee banks. This would mimic, in miniature scale, the discounting of bank notes that occurred during the Free Banking Era. However, because Regulation CC would prohibit such delayed availability, the bank of first deposit might refuse the check, and return it to the depositor for manual collection. In this manner, the efficiency of the check payments system could begin to deteriorate.

In the case of a major bank failure, the check processing system could be affected in other ways. Section I briefly discussed the difficulties, in a world of haircuts, faced by small institutions in need of check clearing services. Major disruptions would occur if a significant provider of these correspondent services was unable to accept deposits while closed for failure resolution. In some markets, there may not be sufficient outside capacity to handle the volumes processed by the major provider. Other local banks would suffer financial loss as it would take longer for them to convert check deposits into good funds. Any delay in entering their checks into the collection stream will also delay their learning which items were dishonored by the drawee bank.

Significant disruptions would occur in other sectors of the economy. Customers of failed banks might find that payments they had made (including those made before the bank failed but which were still in process) to suppliers and employees were being dishonored. This could cause hardship, especially if the checking account balances remained frozen and alternative sources

⁷ It would be possible to pass some of the processing burden on to the local Fed in its role of "Returning Bank" under Regulation CC. Unencoded (raw) items can be presented to the Fed, at an earlier deadline, for processing and entry into the automated stream. Regulation CC is unclear as to whether liability for delayed processing of raw returns exposes the Fed to potential losses if it is unable to process these items within standard time frames.

of funds were unavailable. If a firm had a lockbox arrangement, as well as its checking accounts, at the failed bank, both existing funds and new receipts could be tied up or frozen. These disruptions would act to increase the social cost of a bank failure.

IV - Operational Considerations

The ABA proposal resolves much of the systemic risk posed by a major bank failure by assuming that conditions can be established which enable the FDIC to calculate the insurance level of each depositor, apply appropriate haircuts to the uninsured balances, and open a bridge bank the next morning. Under such a scenario, the following procedures would need to be performed:

- 1) Account balances are aggregated by some type of coding that links like ownership categories together.
- 2) Owners with aggregate balances over \$100,000 are reported.
 - a) Using complex decision rules⁸, the computer assigns the full amount of the haircut to the depositors' excess balances. Or
 - b) FDIC Liquidators pick and choose which balances to reduce.
- 3) Reductions are posted to the accounts. The transactions are balanced.
- 4) Reports are produced listing the reduced accounts.
- 5) Notices are generated to inform customers about their haircuts. These notices would have to identify all of their accounts.

Because the FDIC would be depending on the computer systems to perform these tasks flawlessly the first time that they are put into operation, exacting compliance verification procedures would be required. At minimum, full dress rehearsal tests would

⁸ The decision rules become complex if they do anything other than apply the loss equally across a single depositor's accounts. Some writers suggest applying the haircut to accounts with long maturities first in order to minimize disruptions to the payments system. The depositor would object if his longest term account was locked into a favorable interest rate compared to contemporaneous rates.

have to be conducted during bank exams in order to have any confidence that the systems would work if needed.

Even if these programs were created, and were operational, it is uncertain that there would be time to execute them. It is easy to imagine that a bank shuts down when the Tellers go home. This is far from the truth. Major banks have operations going on 24 hours a day. In fact, most of the day's transactions are not posted to the customers' accounts until overnight processing begins. A typical bank operations schedule is described in Attachment B. The ABA envisions that the complex special programs complete their operation between the time that normal processing is completed and the start of the next business day. This may not be possible in the case of a large bank even if the closing were postponed until the weekend.

The ABA proposal also acknowledged that all current bank accounts would have to be re-coded to specify the ownership relations that determine insurability. Such labor intensive activity could be even more costly to banking firms than developing the new computer programs that the ABA plan would require.

It appears that the costs to the banking industry of implementing this proposal would be considerable. The FDIC is very sensitive about the imposition of costly regulatory burdens. Ultimately, a healthy industry will expose the insurance fund to less stress. However, the FDIC welcomes the development of such systems to the extent that they can be completed in a cost effective manner. These systems have the attractive feature of reducing the cost of the FDIC's option to pay off or transfer a failed bank's insured deposits. To the extent that administrative and technical problems can be addressed and resolved in advance of the crisis atmosphere of a major bank failure, the costs of a payoff will be reduced.

Final Settlement Payment

The FDIC has serious reservations about the ABA's proposed method of applying losses in bank failures. Because their plan requires that a failed institution be re-opened the next day, the ABA would not base the percentage loss on the expected recovery of the remaining assets. Estimating the recovery rate could take several days or weeks. Instead, the payment would be based on the rate of recovery on assets in past resolutions.

In a final settlement payment, as described in the ABA proposal, a single payment is immediately made to all uninsured depositors and unsecured creditors. A final settlement payment differs from past methods in that depositors and unsecured creditors at one bank may receive less than what they would have in a straight or modified payoff. The difference would be given

to their counter-parts at failed banks in which recovery is worse than normal.

The legality of seizing property in excess of recovery costs from uninsured depositors and unsecured creditors in some failures is questionable. Although the ABA does not anticipate that the FDIC would make a profit across resolutions, it anticipates that the FDIC will make a profit in some resolutions.

V - Market Discipline

All business enterprises, including banks, are subject to market discipline. This discipline is enforced through the actions of several different economic agents including: customers, suppliers, employees, equity owners, and creditors. This section will begin with a description of how these agents act on commercial firms and on banks without deposit insurance. The causes of depositor runs in such an environment are then described. Deposit insurance prevents such runs, but at a cost of introducing new distortions. Several proposals have been advanced which seek to minimize these distortions by increasing the reliance placed on depositor discipline. These proposals involve the imposition of losses on large depositors of failed banks. This section ends with a discussion of the effectiveness of limitations of such policies.

Agents of Market Discipline

When the long term viability of a commercial firm is questioned (because of technological changes, loss of key employees, changing markets, etc.), the firm will have trouble maintaining its size. At the margin, customers will begin using competing firms or substitute goods in order to avoid future disruptions (spare parts, quality of service, etc.). Capable employees will start leaving for greener pastures. Financing will dry up for expansion projects, or only be available at high interest rates making fewer projects worthwhile. Suppliers will begin to focus more attention on other customers, perhaps resulting in a deterioration of the quality of resources. It will become difficult to attract new equity owners into the firm. Those whom remain intensify their scrutiny of the directors and top officials in order to maintain the value of their investment. There is constant pressure on the firm to reduce its operations. Unit costs may be driven up as scale economies are lost.

When the firm's short term viability is questioned, more direct pressure is placed on its cash flow. Customer defections will accelerate. Employees are laid-off in an effort to reduce expenses. Banks and other creditors will refuse to renew credit lines. Suppliers will demand payment in advance. If the firm is unable to withstand the pressure, and becomes inviable, it will

enter voluntary or involuntary bankruptcy. At this time, outstanding obligations will be resolved in an administrative proceeding in which all creditors of comparable standing are dealt with equally. It is important to note that, although individual creditors may try to obtain as much payment as possible in advance of a bankruptcy declaration, their claims are generally not payable on demand. Therefore, there is no analogy to a bank run in a commercial firm. All of the agents of market discipline assist commercial firms with bright prospects and place obstacles in front of firms with dim prospects. These forces affect growth rates over the long term. Commercial firms do not walk along a razor's edge, facing certain death if they ever stumble.

The forced exiting of inefficient or obsolete firms improves the performance of the overall economy. Because banking is a vital sector of the economy, it is important that the vigor of the industry be maintained and enhanced through similar free market operations.

Depositor Runs

When the long term viability of a bank is questioned, (even in a world of deposit insurance) various market forces work to restrict the growth of the firm. Bank customers will also begin moving business to competing firms for many of the same reasons that the customers of a commercial firm do. The negotiation of credit arrangements is often firm specific and complex. Businesses will want to avoid having to repeat this process with the new owners of a bank's assets. The value of some bank products, specifically letters of credit, are tied to the bank's credit-worthiness. As this diminishes, customers of the bank are likely to establish relationships with other institutions. Employees will have the same set of incentives to leave as their counterparts in the commercial sector. In a bank, investors include equity holders, unsecured debt holders, and deposit holders. Equity holders and unsecured creditors in a bank will behave the same way as their counterparts in a commercial firm. Thus banks are subject to much the same discipline as commercial firms. The difference is in the actions of deposit holders, of whom there is no equivalent in a commercial enterprise.

Deposit holders can behave as customers (purchasing services from the bank), suppliers (funding is the raw material of a bank), and investors. Demand deposit holders are distinctive in holding callable debt. This distinguishes them from most debt holders of commercial firms. Their actions will differ from those of a commercial debt holder when the viability of the debt issuer is questioned.

A deposit holder has an incentive to liquidate deposits from a troubled institution if transactions costs are less than

potential losses. Demand deposit holders face virtually no transactions costs. Therefore, any time that the solvency of a bank is questioned, uninsured depositors can be expected to run. The flight of depositors' funds could cause an otherwise viable bank to collapse because bank assets are illiquid. A bank that must sell its assets to honor the withdrawals will have to accept fire sale prices. As these discounts erode the net worth of the bank, a deposit run can become a self-fulfilling prophesy and lead to the collapse of the bank. Thus, a depositor who observes a panic run on his bank would have every incentive to join in the run, contributing to the bank's demise.

Deposit Insurance

The implementation of a deposit insurance system eliminates the incentives that depositors would otherwise have to run from troubled institutions. However, the improved stability does not come without a cost. Insured depositors face little incentive to monitor the riskiness of their institution. Bank managers can assume greater risks in their asset portfolio without experiencing an equivalent increase in the cost of funds raised by deposit. The additional risk is borne by the insurer. This moral hazard can be reduced through vigorous supervision. It can also be reduced through the activities of the other market agents previously mentioned.

Therefore, whenever it is believed that the banking industry has transferred an excess amount of risk on to the insurer, several policy responses are possible. Increased regulation and supervision is one avenue. Placing more risk on different market agents would also alleviate the pressure on the insurance fund. The ABA supports the efforts made by the FDIC to improve the training given to bank examiners and to increase their level of compensation. The ABA proposal also advocates that more explicit risk be shouldered by depositors by imposing losses on uninsured depositors in all failures.

Depositor Discipline

Dependence on depositor discipline to relieve the burden on the insurer can create undesirable side effects. These include: 1) an increase in systemic instability; 2) a loss of flexibility in limiting the economic damage of a major bank failure and 3) a competitive disadvantage for the US banking industry. In addition, 4) it is unclear that the bank deposit market is well suited to imposing discipline on banks.

1) Systemic Instability

A policy regime that mandates losses on uninsured depositors introduces instability because it increases both the possibility of bank runs and the ripple effects of the bank failure. As the

pool of uninsured depositors increases, the likelihood of bank runs also increases, as does the potential for damage in any individual run. When failures occur, the losses imposed on uninsured depositors will have economic repercussions. These include possible impairment of correspondent banks, disruptions to the payments system, and damage to the local economy as firms and individuals adjust to their losses. Once again, the greater the pool of uninsured depositors, and the greater the loss at the failed bank, the greater the economic impact will be.

2) Regulatory Flexibility

Any policy that imposes mandatory losses on uninsured depositors only has meaning if it is expected to apply to all bank failures, including the largest. It is difficult to imagine that those who are ultimately responsible for macroeconomic stability would abandon the flexibility to handle a truly large bank failure on a case-by-case basis. If legislation prohibits the FDIC from acting with discretion, other government bodies - either the Federal Reserve Board or the Department of Treasury might act to support a major failing bank. In this event, uninsured depositors will be treated better than they would have been by the FDIC. The reality that the largest banks are more likely to receive such treatment will continue to influence market behavior, providing major banks with a competitive advantage over smaller institutions and reducing the effectiveness of depositor discipline on those large banks.

3) International Competitiveness

A policy of mandatory losses on uninsured depositors must be reconciled with policies followed by bank regulators in other major industrialized countries. Large depositors would have great incentive to transfer their funds into institutions that are believed to have more government support than others.

The ABA urges other nations to adopt policies that would place large depositors at risk in the major banks of their respective countries. The FDIC will host an international conference of bank regulators this fall. An ultimate goal of the conference is to start a process that will lead to international co-ordination of failed bank policy. It would be imprudent to institute mandatory haircut proposals before international agreements are reached.

4) Effectiveness of Depositor Discipline

Although the FDIC believes that depositor discipline can play a role in maintaining a sound banking industry, it is important to recognize limitations on the extent to which an institution's riskiness will be reflected in deposit rates. These limits are illustrated when the informational content of a

bank's share price on the equity markets is compared to the informational content of a CD rate. The opinions of industry analysts will be fully incorporated into stock prices, because equity markets include short sellers as well as call and put option writers. The actions of investors who believe a firm's shares are overpriced will lower the share price of the bank's stock. However, only one position can be taken in a bank's certificates of deposit. A financial agent who believes that a bank has begun to pursue riskier or ill advised policies can not affect the market for the bank's certificates. There is correspondingly less information in the rates a bank would have to pay on uninsured deposits, reducing the value of the discipline imposed by those rates.

The ABA mentions that depositors would make better use of evaluations published by private bank analysts. While such a result would be an improvement, it is important to recognize that there are limits to the information provided by these firms. In many cases, analysts' forecasts are based on bank financial statements and analyzing performance based on key ratios compared to peer groups. This type of analysis offers some insight into a bank's current performance, but does not indicate as much about a bank's prospects. Bad loans and fraud continue to be the major causes of bank failure. Bad loans look good - and very profitable - for a long time before they turn sour. Only a few years before failing, Continental Bank was hailed as a model bank organization. The type of analysis required to determine the quality of a loan portfolio is so intrusive, it is doubtful that it could be performed by agents other than bank examiners. Even if the bank were willing to submit to the intrusion of such analysis, the need to maintain confidentiality of customer information may prevent a third party from making an accurate assessment of individual credits. Private analysis is not a substitute for the information reflected in a market generated price in which each analyst takes a monetary position.

Summary

1. There are many worthy goals of the ABA proposal, including the effort to overcome some of the technical and administrative problems in large bank failures, the equalization of the treatment of depositors at banks of different sizes, and the reliance on market forces instead of government intervention to control banks with excessive risk.
2. Banks, even under 100% deposit insurance, face forces of market discipline. Deposit insurance reduces the systemic instability of depositor runs at the cost of enabling bank managers to transfer risk to the insurer.

3. The ABA proposal recommends that depositor discipline be increased through the imposition of mandatory haircuts on uninsured depositors at failed banks. While the FDIC is in favor of reducing its exposure to loss, it is concerned that attempts to augment market forces through increased depositor discipline will extend the potential instability of bank runs and of aftershocks following a failure.
4. The FDIC is also concerned that, without international agreements, mandatory haircuts could result in a funding advantage for foreign banks which are perceived as being fully insured de facto.
5. Any system of mandatory haircuts must recognize the reality that, in truly large bank failures, those who are ultimately responsible for macroeconomic stability will retain the flexibility to handle the situation on a case-by-case basis. To the extent that depositors anticipate such intervention, the effectiveness of haircut proposals will be mitigated.
6. The FDIC has doubts about the legality of the method the ABA recommends to determine the percentage of loss to impose on uninsured depositors of failed banks. Any determination of the amount of loss to impose on uninsured depositors in a failed bank should reflect the conditions of the specific bank. A system which pays a fraction of uninsured balances based on experience in past failures would be questionable if, in individual cases, uninsured depositors received less than they would have in an ordinary payout.
7. Banks may not be able to quickly redesign computer systems and re-code account data to accommodate the overnight processing demands of the final settlement payment procedure. In addition, the costs to the industry appear to be considerable. However, the FDIC welcomes any development which reduces the cost of opting to pay off or transfer the deposits of a failed bank.

ATTACHMENT A - CHECK CLEARING SYSTEM

Whenever a bank's customer writes a check against his account balance, the check will eventually be physically presented to the bank for payment. The check may arrive from the following sources:

- 1) The check is presented over the Teller window for payment or deposit into another customer's account.
- 2) The check is included with other checks deposited by a correspondent bank for credit to the correspondent's account.
- 3) The check is received from a local bank clearinghouse in which member banks exchange checks drawn on each other. Members make daily settlement payments with the clearinghouse.
- 4) The check is presented by the local Federal Reserve Bank. The bank's reserve account at the Fed is debited for the amount of checks presented.

Whenever a bank receives a check drawn on another institution (as a deposit or payment) it must enter the item into a processing stream that ends at the drawee bank. Ultimately, the check will reach its destination through one of the above channels. The item may pass through several intermediaries before reaching the drawee bank.¹ These intermediaries may include correspondent banks, the Federal Reserve Bank in the initial bank's district, or the Federal Reserve Bank in the drawee bank's district.

Clearing items drawn on banks across the country can be costly. Banks are willing to incur this cost in order to avoid float loss. A depositing bank will attain funds for the check on the day that the intermediary expects to receive funds for the check. Because checks received throughout the day constitute large sums of money, the lost interest on a single day's delay can be significant. Therefore, banks are more concerned with the clearing time offered by correspondent banks than with the fees they charge.

As a bank's check volume grows, it becomes cost effective to build faster processing systems and more elaborate transportation networks. As these systems and networks grow, check clearing services can be offered to other institutions. Fixed costs are a significant component of these operations. High speed processing

¹ The average check is handled by 2.4 financial institutions according to Bank Administration Institute, op cite.

equipment and air transportation couriers can handle an additional check at a low incremental cost. Smaller banks are therefore unable to replicate the check clearing system of larger banks. In order to clear their items, they must piggyback onto another local institution's system.

Large banks around the country establish relationships with each other. Each bank will accept checks drawn on smaller, local banks that it receives from other large banks across the country. These checks are then cleared through local clearinghouses or other local channels.

In some markets, correspondent check clearing is very competitive with several banks offering services. In other markets, small local institutions and large banks in other regions are limited to one or two major providers.

Checks in process create large correspondent balances. If these balances were subject to a mandatory haircut in the case of the failure of the intermediary, banks would be among the first to run whenever there was a question about the viability of the intermediary. In some markets, alternative processors have the capacity to absorb the fleeing business without much disruption. In other markets, adequate alternatives may not exist.

ATTACHMENT B - BANK OPERATIONS TIMETABLE

The overnight processing schedule of a major bank might look like the following (obviously some banks will have two or three hour differences in start or completion times for certain functions):

- 3:00 PM Bank officially closes for the day. Tellers stop posting transactions on the current day's date. Lockbox Department (may have different cut-off time altogether) continues preparing transactions already in the building on current date. New deposits will be processed with tomorrow's date. Wire transfer desk closes.
- 9:00 PM Bank starts receiving large deposits of checks for clearing from local correspondents. Will be on receiving bank's books as tomorrow's activity.
- 10:00 PM Today's transactions from the branches and Lockbox Departments have probably been posted to a batch file. Lockbox Department begins to receive a large quantity of deposits from Post Office. These will be processed on next day's date. This inflow will continue until about 8:00 AM.
- 11:00 PM Batch file of day's transactions begins to post to customer file. May take some hours. Processing of checks received during the day continues until morning deadline at clearing house. Processing of items on tomorrow's date (from correspondents and Lockbox) continues until the following close of business.
- Midnight Bank begins to receive deposits from major correspondents around the country to clear local items. Such deposits continue until slightly before clearing house deadline. If any checking account statements are going to be prepared the next day, system will begin sorting the appropriate checks into account number order. This processing could continue until the following afternoon.
- 3:00 AM (or later) Transactions have posted to appropriate accounts, system determines which inclearing items from previous day are potential return items.
- 5:00 AM System pulls out potential return items from previous day's work. Prepares reports for printing (balances, potential overdrafts, late payments, etc.).

- 8:00 AM Bank receives transmission from Fed indicating the amount of items drawn on major accounts at controlled disbursement banks. Information is relayed to customers (generally by 10:00 AM) along with balance information from previous day and preliminary information about lockbox receipts for today that are already processed.
- 9:00 AM Bank open for business. Tellers receive deposits, make withdrawals. Wire transfer desk open. System begins printing account statements for accounts with yesterday cut-off dates.
- 10:00 AM Clearing house deadline. Inclearings received and posted to batch file for final posting at night.
- 2:00 PM Deadline for account officers to make pay/return decisions concerning previous day's inclearings. Information about these decisions is input into the system during the next few hours.
- 9:00 PM Regulation CC deadline to enter previous day's return items into system.