



# **Deposit Insurance in a Changing Environment**

A study of the current system of deposit insurance pursuant to Section 712 of the Garn-St Germain Depository Institutions Act of 1982, submitted to the United States Congress by the Federal Deposit Insurance Corporation

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**Federal Deposit Insurance Corporation**  
April 15, 1983

**Board of Directors:**

**William M. Isaac, Chairman**  
**C.T. Conover, Director**  
**Irvine H. Sprague, Director**



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D. C. 20429

OFFICE OF THE CHAIRMAN

April 15, 1983

Honorable Jake Garn, Chairman  
Committee on Banking, Housing, and Urban Affairs  
United States Senate  
Washington, D.C. 20510

Honorable Fernand J. St Germain, Chairman  
Committee on Banking, Finance and Urban Affairs  
House of Representatives  
Washington, D.C. 20515

Dear Mr. Chairmen:

In accordance with Section 712 of the Garn-St Germain Depository Institutions Act of 1982, we are transmitting a copy of the deposit insurance study required by the Act. We commend you for this legislative mandate.

The present deposit insurance system has served the country well during the past 50 years. It has fostered public confidence in depository institutions and stabilized the financial system. However, the time has come to look ahead. New technologies, new entrants into financial markets, deregulation and economic circumstances require that we consider whether the current system is equal to tomorrow's challenges.

Your foresight in initiating this review is appreciated, and we are pleased to be a part of the effort. We trust the enclosed study will contribute to an intelligent, informed discussion of the issues.

Sincerely,

A handwritten signature in dark ink, appearing to read "William M. Isaac", is written over a light-colored background.

William M. Isaac  
Chairman

Enclosure

## FOREWORD

Last fall I was informed by a member of our Congressional liaison staff that Congress wanted to place into the Garn-St Germain Act a requirement that the three Federal deposit insurance agencies individually study possible reforms to the deposit insurance systems and procedures. We were elated. The concerns we had been expressing were being heard; we had a forum.

The banking system -- indeed, the entire financial-services industry -- has been undergoing profound change in recent years. New technologies, economic circumstances and marketplace innovations have rendered obsolete the basic regulatory constraints fashioned a half-century ago and have forced deregulation upon us.

Frankly, the FDIC welcomes deregulation. If approached sensibly by government and industry leaders, it will greatly benefit the American public and the banking industry, possibly after a painful transition for some banks. If mishandled, however, deregulation could be a prescription for disaster.

We must seek new ways, in the absence of rigid government controls on competition, to limit destructive competition and excessive risk-taking. There are only two alternatives. We can promulgate countless new regulations governing every aspect of bank behavior and hire thousands of additional examiners to enforce them. This approach would undercut the benefits sought through deregulation, would favor the unregulated at the expense of the regulated, and would ultimately fail.

The FDIC much prefers the other alternative: seeking ways to impose a greater degree of marketplace discipline on the system to replace outmoded government controls. This is one of the two major themes of this Study.

The second is that in a deregulated environment the regulatory and insurance systems must be as effective, efficient and equitable as possible. The current systems are woefully inadequate on all three counts.

The Study, which contains a wealth of information about the financial and regulatory systems, is divided into two sections. The first section contains the body of the Study and the second section the appendices. The seven chapters in the first section are conveniently organized, and each contains an executive summary at the beginning. Ahead of Chapter I is an overall executive summary, which presents the Study's major findings and conclusions.

The Study was prepared solely by FDIC staff, although comments were received from a wide variety of sources in the financial community and elsewhere, and Dr. Carter H. Golembe provided valuable advice. It has been a monumental undertaking, particularly in view of the time frame for completion and the press of other business.

I would like to express appreciation to the FDIC's management group under whose general guidance the Study was prepared: Margaret L. Egginton, Deputy to the Chairman; Stanley C. Silverberg, Director of the Division of Research and Strategic Planning; James A. Davis, Director of the Division of Liquidation; Thomas A. Brooks, General Counsel; Robert V. Shumway, Director of the Division of Accounting and Corporate Services; and, most especially, James L. Sexton, Director of the Division of Bank Supervision. Heartfelt thanks are due also to Mary T. Mitchell, Associate Director of the Division of Bank Supervision, and her deputy, Jesse G. Snyder, under whose direction the Study was prepared. Finally, words cannot adequately express appreciation for the efforts of the staff members listed on the pages following this Foreword who devoted thousands of hours researching and preparing the Study.

A number of major reforms are suggested in the Study. We believe they are urgently needed. We do not expect, however, that they will be implemented without extensive debate. We hope the Study will contribute toward an intelligent, informed discussion of the issues.

The FDIC celebrates its 50th anniversary this year. It has served our Nation extraordinarily well thanks to the untiring service of thousands of people like those who prepared this Study. I know of no more competent and dedicated group of people in or out of government.

Our singular objective at the FDIC is the maintenance of a sound, responsive financial system under private ownership and control. It is toward that end we offer this Study.

William M. Isaac,  
Chairman

April 15, 1983

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A LITERATURE ON RISK RELATED INSURANCE SYSTEMS FOR COMMERCIAL BANKS

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B LITERATURE ON FAILURE PREDICTION MODELS FOR COMMERCIAL BANKS

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D ASSESSMENT PROCEDURES AND ISSUES

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E THE FINANCIAL STATEMENTS OF THE  
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## PROLOGUE

"On March 3 banking operations in the United States ceased. To review at this time the causes of this failure of our banking system is unnecessary. Suffice it to say that the government has been compelled to step in for the protection of depositors and the business of the nation."

As President Franklin D. Roosevelt spoke those words to Congress on March 9, 1933, the Nation's troubled banking system lay dormant. The clamor of an excited public had subsided; the panic was over. The President had brought the financial chaos to an end by the proclamation of a "Banking Holiday," and only the sounder institutions would be allowed to reopen.

The reasons the banking system lay in ruin were many and varied, but an important immediate factor was a volatile and anxious public that was heavily at risk and was so sensitive to news and unfounded rumor that the spontaneous "run" became a commonplace horror for bankers.

Across a span of 50 years exists a very different problem. The hyperliquidity and extreme caution of once-burned bankers has gradually given way to highly-leveraged, aggressive banking practices. Regulators and bankers debate in academic terms the proper level of capital, and of liquidity, while bank creditors, whose interests are supposedly at stake, watch with little interest, if any at all.

There are, some believe, two kinds of banks -- small ones, which are perceived as having risk for creditors, and large ones, which are not generally so perceived and which can experience one well-publicized adversity after another, and yet compete with the best banks for funding. Moreover, the paucity of useful disclosure allows banks with very different degrees of soundness to be held in equal esteem by those who supply their funding.

The discipline of 1933 was meted out with little precision or fairness. Federal deposit insurance was wisely interposed against the passing of such irrational and ruinous judgment. But in 1983, the burden of discipline has fallen too heavily on the deposit insurance system, and financial institutions no longer behave as though the quick and efficient reaction of the marketplace is to be feared.



If the Nation's marginally-operated banks incur no penalty, then a corollary is that good banking practice receives too little credit and recognition. It is of no small consequence that, while this indifference is growing, deregulation and enhanced banking powers are heightening the need for a more discerning and rational market.

This fundamental inconsistency is what this Study is about.

James L. Sexton,  
Director, Division  
of Bank Supervision

April 15, 1983

CONTENTS

		Page
	EXECUTIVE SUMMARY	iv
Chapter		
I	THE CURRENT SYSTEM OF DEPOSIT INSURANCE AND ITS IMPACT ON THE STRUCTURE AND OPERATIONS OF BANKS . . . . .	I-1
	Executive Summary . . . . .	I-1
	Introduction . . . . .	I-2
	Historical Overview . . . . .	I-2
	The Period 1942 - 1972 . . . . .	I-4
	The Period 1972 - Present . . . . .	I-5
	The FDIC and Current Banking Structure . . . . .	I-6
II	RISK-RELATED INSURANCE PREMIUMS . . . . .	II-1
	Executive Summary . . . . .	II-1
	Introduction . . . . .	II-2
	Merits of Risk-related Premiums . . . . .	II-2
	Costs and Tradeoffs . . . . .	II-4
	General Approach . . . . .	II-5
	Focus of Risk Evaluation . . . . .	II-5
	Available Data Sources . . . . .	II-7
	CAMEL for Risk Premiums . . . . .	II-8
	Proposed Approach . . . . .	II-9
	Risk Measurements . . . . .	II-10
	Capital . . . . .	II-10
	Credit Risks . . . . .	II-11
	Interest Rate Risks . . . . .	II-13
	Moral Hazards . . . . .	II-15
	Liquidity . . . . .	II-16
	Premium Determination Dates . . . . .	II-16
	Appeals Process . . . . .	II-16
	Size and Risk . . . . .	II-17
	CAMEL and Supervisory Costs . . . . .	II-21
III	MARKET DISCIPLINE AND THE FEDERAL DEPOSIT INSURANCE SYSTEM . .	III-1
	Executive Summary . . . . .	III-1
	Introduction . . . . .	III-4
	Risk Sharing and Insurance Protection . . . . .	III-4
	Modified Payoff . . . . .	III-4
	Coinsurance . . . . .	III-6
	Capital Standards . . . . .	III-7
	Depositor Preference . . . . .	III-9
	Administrative and Operational Considerations . . . . .	III-10

Chapter		Page
IV	PUBLIC DISCLOSURE PRACTICES . . . . .	IV-1
	Executive Summary . . . . .	IV-1
	Introduction . . . . .	IV-2
	Functions of Disclosure . . . . .	IV-2
	Enhance Market Discipline . . . . .	IV-2
	Protect Bank Depositors and Other Customers . . . . .	IV-3
	Other Considerations Bearing on Disclosure . . . . .	IV-4
	Reporting Burden on Banks . . . . .	IV-4
	Public Nonuse of Data . . . . .	IV-5
	Potential Public Overreaction to Disclosures . . . . .	IV-7
	Adequacy of Disclosures . . . . .	IV-7
	Information Currently Available to the Public . . . . .	IV-7
	Available Information and User Needs . . . . .	IV-10
	Data Withheld From the Public But Available to Regulators . . . . .	IV-11
	Reports of Examination . . . . .	IV-11
	Administrative Actions . . . . .	IV-11
	Country Lending Survey . . . . .	IV-12
	FDIC Position on Public Disclosure . . . . .	IV-13
	Educate the Public . . . . .	IV-13
	Make More Information Available to the Public . . . . .	IV-14
	Evaluate Agency and Public Data Needs . . . . .	IV-16
V	ADEQUACY OF THE INSURANCE FUND AND REVISIONS TO ASSESSMENT PROCEDURES . . . . .	V-1
	Executive Summary . . . . .	V-1
	Introduction . . . . .	V-2
	Financial Operations of the FDIC . . . . .	V-2
	Determining the Adequacy of the Deposit Insurance Fund . . . . .	V-3
	Borrowing Authority . . . . .	V-8
	Assessment Procedures . . . . .	V-8
VI	MERGER OF THE DEPOSIT INSURANCE FUNDS . . . . .	VI-1
	Executive Summary . . . . .	VI-1
	Introduction . . . . .	VI-2
	Arguments for Merging the Funds . . . . .	VI-2
	Similarities of Insurers . . . . .	VI-2
	Insurance Premiums . . . . .	VI-2
	Regulatory and Supervisory Powers . . . . .	VI-3
	Insurance and Supervision . . . . .	VI-4
	Similarities of Insured Institutions . . . . .	VI-4
	Risk Diversification and Strength of the Funds . . . . .	VI-5
	Changes in Charters and Interindustry Mergers . . . . .	VI-7
	Reporting and Surveillance . . . . .	VI-8
	Separation of Insurance From Chartering and Regulation . . . . .	VI-8
	Arguments Against Merging the Funds . . . . .	VI-9
	Conflict With Other Public Policies . . . . .	VI-9

Chapter		Page
	Loss of Industry Orientation . . . . .	VI-10
	The Question of Equity . . . . .	VI-10
	Public Confidence . . . . .	VI-10
	Merging the Funds . . . . .	VI-10
	Single Pool . . . . .	VI-11
	Separate Pools . . . . .	VI-11
	Phase-in . . . . .	VI-12
	Supervisory Framework . . . . .	VI-12
VII	OPTIONAL EXCESS DEPOSIT INSURANCE . . . . .	VII-1
	Executive Summary . . . . .	VII-1
	Introduction . . . . .	VII-1
	Demand For Excess Coverage/Money Brokers . . . . .	VII-1
	The FDIC as Suppliers of Excess Coverage . . . . .	VII-2
	Semipublic Suppliers of Excess Coverage . . . . .	VII-3
	Banks as Self-Insurers . . . . .	VII-4
	Private Insurance Companies . . . . .	VII-4
	Capacity Constraints . . . . .	VII-5
	Inability to Assess and Control Risk . . . . .	VII-5
	Other Potential Barriers . . . . .	VII-7
	Diversification of Risk . . . . .	VII-7
	Safety and Liquidity Considerations . . . . .	VII-7
	Settling Depositor Claims . . . . .	VII-8
	Alternatives for Private Sector Expansion . . . . .	VII-8
	Public Demand and Government Involvement . . . . .	VII-9

#### APPENDICES

A	LITERATURE ON RISK-RELATED INSURANCE SYSTEMS FOR COMMERCIAL BANKS
B	LITERATURE ON FAILURE PREDICTION MODELS FOR COMMERCIAL BANKS
C	EXISTING DISCLOSURE VEHICLES
D	ASSESSMENT PROCEDURES AND ISSUES
E	THE FINANCIAL STATEMENTS OF THE FEDERAL DEPOSIT INSURANCE CORPORATION
F	SMALL DEPOSITOR PROTECTION
G	STATE DEPOSIT INSURANCE PROGRAMS

## EXECUTIVE SUMMARY

### INTRODUCTION

It is not hyperbole to characterize the changes now taking place in the financial system as revolutionary. A structure put into place a half century ago, at the bottom of one of the Nation's greatest Depressions, is crumbling, and a new structure is rapidly taking shape. In part this is occurring by design but in larger part it is because of the forces of economics and technology. The central question facing the government today is not whether change will or should continue but, rather, how to assure that the financial structure that eventually results is one that will best serve the public interest.

Deposit insurance has been an integral part of the financial system for almost a half century, responsible in considerable part for the depository institution structure that has evolved and the nature of the supervision and regulation of depository institutions. It is, therefore, impossible to consider any government action taken in connection with the changing financial structure without addressing the role of the insuring agencies. Congress recognized this when, in the Garn-St Germain Depository Institutions Act of 1982 (henceforth Garn-St Germain), it directed those agencies to address themselves to insurance issues likely to be of significance in the new financial environment. This report sets forth the views of the FDIC, the first of the deposit insurance agencies to be established and by far the largest in terms of assets, potential insurance liabilities and personnel.

Perspective is useful. Briefly, a group of Federal statutes adopted in the early and mid-1930s -- the most important of which probably were the Banking Act of 1933 (including, among other provisions, the establishment of the FDIC), the Home Owners' Loan Act of the same year, the Securities Act of 1933 and the Securities Exchange Act of 1934 -- were responsible for establishing a financial structure that was neatly-compartmentalized and tightly-regulated. The powers of financial institutions were carefully differentiated and in some instances were made highly specialized, so that, for example, only investment banking houses were able to underwrite corporate securities and only commercial banks could offer demand deposit services. In general, what was contemplated was a system of specialized financial institutions, with some necessary overlap.

For depository institutions, the cost of raw materials, i.e., of deposits, was regulated for the first time at the Federal level, with a zero interest ceiling applied to demand deposits, and administratively-determined ceilings applied to savings and time deposits. Also for depository institutions, geographic expansion was constrained within state boundaries (and within the states, continued to be governed by state law). Entry into the business of accepting deposits became more tightly-regulated as a result of the establishment of the deposit insurance programs.

Separate regulatory systems were created or maintained. Institutions such as the SEC, the FDIC and the FHLBB were created in the various pieces of legislation of the early 1930s. Coordination among such agencies in different fields was not a matter of primary concern; the various groups of financial institutions were believed to be sufficiently insulated by reason of their carefully-drawn spheres of activity to make any special provision for coordination unnecessary.

The rationale for the establishment of the kind of system described was clear -- Congress and the Administration were determined to make impossible a recurrence of the catastrophic financial collapse of 1930-1933. Underlying much of the new legislation was a pervasive belief -- which extended to nonfinancial fields -- that a root cause of the economic collapse had been excessive competition. The system devised was intended, among other things, to restrain competition, not only among financial industry groups but even within the banking industry itself.

As with any set of regulations superimposed on an essentially competitive business, some erosion occurred over the years in the various lines of demarcation and in other constraints. However, the system remained essentially unchanged until the late 1970s, when it began to disintegrate rapidly. The major reasons for that development include the communications-computer revolution, the long period of inflation and high interest rates, the 180-degree change that had occurred in the attitude of government toward competition among financial institutions (now viewed as a desirable objective rather than something to be prevented), and entrepreneurial vigor on the part of the managers of financial institutions, particularly as the financial demands from the public became larger and more complex.

The kinds of change that have taken place recently are well known. Deposit interest regulation has largely disappeared; the powers of the thrift institutions were substantially expanded when it became apparent that specialization in long-term fixed lending to purchasers of residential properties could not be sustained in a period of high and volatile market interest rates; and in a variety of ways the new financial technology is utilized to do business over broader geographic areas than were contemplated in the legislation of a half century ago. We are rapidly reaching a situation in which virtually any financial service may be offered by any financial institution on a nationwide basis. Deregulation -- the more usual term for the dismantling of the system constructed in the early 1930s -- is in full swing.

The adoption of a deposit insurance program in 1933 was outside of the mainstream of financial reform legislation of the time. The insurance legislation was not a part of the Administration's program and many persons, both within and outside of the Administration, held out little hope for its success. The record of state attempts to operate deposit insurance systems, a record extending back more than a century prior to 1933, was not encouraging.

The result was far different from what pessimists expected. The significance of the deposit insurance legislation is perhaps best illustrated by the fact that two of the Nation's leading economists, persons whose views are usually thought of as being at opposite ends of the economists' spectrum, are as one on the importance of the deposit insurance sections of the Banking Act of 1933. Professor Milton Friedman has observed: "Federal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic and, indeed in our view, the structural change most conducive to monetary stability since state banknote issues were taxed out of existence immediately after the Civil War." (A Monetary History of the United States, 1963). Professor John K. Galbraith has described the creation of the FDIC in the following terms: "The anarchy of uncontrolled banking (was) brought to an end not by the Federal Reserve System ("FRS") but by the obscure, unprestigious, unwanted Federal Deposit Insurance Corporation . . . in all American monetary history no legislative action brought such a change as this." (Money: Whence It Came, Where It Went, 1975).

Not only has deposit insurance, which was quickly extended to savings and loan associations by the Congress and later to credit unions, been a positive force for monetary stability, but it has also given to government a direct financial stake, of a type and magnitude not found with respect to any other industry, in the future course of deregulation.

In Garn-St Germain, Congress directed the three Federal agencies insuring deposits or share accounts to address seven specific questions, as follows:

1. The current system of deposit insurance and its impact on the structure and operations of depository institutions;
2. The feasibility of providing depositors the option to purchase additional deposit insurance covering deposits in excess of the general limit provided by law and the capabilities of the private insurance system, either directly or through reinsurance, to provide risk coverage in excess of the general statutory limit,
3. The feasibility of basing deposit insurance premiums on the risk posed by either the insured institution or the category or size of the depository institution rather than the present flat-rate system;
4. The impact of expanding coverage of insured deposits upon the operations of insurance funds, including the possibility of increased or undue risk to the funds;
5. The feasibility of revising the deposit insurance system to provide even greater protection for smaller depositors while fostering a greater degree of discipline with respect to large depositors;
6. The adequacy of existing public disclosure regarding the condition and business practices of insured depository institutions, and providing

an assessment of changes which may be needed to assure adequate disclosure;

7. The feasibility of consolidating the three separate insurance funds.

Each of the items on which the FDIC and its sister agencies were asked to comment touches on an important aspect of the insurance program. The discussion that follows summarizes the FDIC's views and recommendations with respect to the noted questions, placed in the broader context of deposit insurance reform. For it seems evident that in posing its specific questions, important as they are individually, Congress was really raising the fundamental question of whether the deposit insurance program now in place should be altered in order to accommodate, or to help shape, the sweeping changes that are taking place in the Nation's financial system.

#### DEPOSIT INSURANCE OBJECTIVES

An inquiry on the role that deposit insurance should play in a deregulated environment must begin with the objectives of the insurance program. This is essential to determining whether or to what extent significant reform is necessary, and whether any recommended changes will serve the public interest.

The subject of deposit insurance was debated in the U.S. Congress for at least 50 years prior to its adoption in 1933, and deposit insurance systems had been instituted at various times by 14 states between 1829 and 1917, several of which continued until about the 1930s. From this extensive record, two public policy objectives have emerged with consistency: first, that deposit insurance should protect depositors of modest means from the consequences of bank failure and, second, that such insurance should protect communities, states, or the Nation against the economic consequences of bank failure.

The first of these objectives requires little in the way of elaboration. Whether, as in the early 19th century, it was because there were many individuals who could not distinguish among the circulating banknotes that they were compelled to accept in the form of wages or, as in 1983, because individuals require a place to deposit savings or for paying small checks, it is a fact that there are large numbers of persons whom society has, in effect, compelled to use banking facilities, and yet these people have little ability to protect themselves against the risk of a bank's closing. Probably there has never been a better statement of this particular objective, or at least one made more elegantly, than by a committee of the New York legislature in 1819, when that state was about to adopt the Nation's first deposit insurance system:

The loss by the insolvency of banks falls generally upon the farmer, the mechanic, and the laborer, who are least acquainted with the condition of banks and who, of all others, are most illy able to either guard against or to sustain a loss by their failure. (New York Assembly Journal, 1829, p. 439).



The second objective has been stated in a variety of ways. One of these takes account of the fact that the liabilities of the Nation's commercial banks comprise a major portion of the circulating medium, and thus holds that the principal purpose of deposit insurance is to prevent destruction of the circulating medium because of bank failure. This particular kind of statement was probably more applicable to the state insurance systems of the 19th century, and to the conditions that prevailed in the early 1930s. Today, one is more likely to hear the objective framed in terms of safety of the payments mechanism, or of the severe contractive effect, in a fractional reserve banking system, that would ensue if there were a stampede toward the conversion of deposits into cash.

However stated, this second objective of deposit insurance relates to the contribution that deposit insurance makes to financial stability, and it is that contribution to which Messrs. Friedman and Galbraith, quoted earlier, made reference. Indeed, in much of the academic literature, the financial stability role of deposit insurance is identified as the only significant objective assigned to the deposit insurance program.

Those who sought deposit insurance legislation in 1933 saw other benefits to be obtained, of more immediate and practical importance. One, rather clearly, was the idea that government intervention in the form of a deposit insurance program might introduce some stability into a chaotic situation and help restore public confidence in a banking system that had virtually collapsed. Today most would agree that maintenance of public confidence in banking is simply an alternative formulation of the financial stability role played by the FDIC.

There was also the strong belief in 1933 that only a deposit insurance program would enable smaller independent banks to survive and compete successfully with larger banking institutions. Thus, among the most vigorous supporters of the deposit insurance legislation were the Nation's smaller banks, particularly in the middle west, the plains states, and the southeastern states -- areas particularly hard hit by bank failures.

The FDIC managed to satisfy the cluster of aspirations and objectives sought by those who had put the insurance legislation in place; this, as was mentioned earlier, was to the surprise of many if not most observers. Confidence in the banking system did in fact reappear, even though initial insurance coverage was only \$2,500 per depositor (quickly raised to \$5,000, where it remained until 1950). The record of depositor protection has been outstanding: over a period of 49 years, the FDIC has made disbursements to protect over six million depositors in the 620 insured bank failures since 1933, resulting in recovery by depositors of \$19.7 billion, or 98.9 percent of insured and uninsured deposits in failing banks.

It would be difficult to argue that the past 50 years have not witnessed periods of monetary or financial instability. Nonetheless, such instances

have not been caused or exacerbated by monetary "panics" or by the waves of bank failures that had plagued the American economy for a century and a half prior to 1933. Indeed, the total number of insured bank failures since 1933 has not been very much greater than the average number of bank failures in any single year during the prosperous period of the 1920s, and of course far below the failure record of the early 1930s when, during the period 1930-1933, some 9,000 commercial banks closed their doors.

Numerous factors have played a part in shaping the present banking structure, and deposit insurance is not the least important among them. To the extent that preservation of that structure may be characterized as an objective of deposit insurance, it is an objective attained. The banking structure in 1983, whether viewed in terms of number of banking institutions or their distribution by size (size in "real" terms, of course), does not differ significantly from that which was in place on January 1, 1934, the date that Federal deposit insurance became effective.

When the record of the past half century is viewed in terms of policy actions taken by the FDIC or by the Congress, it is evident that the financial stability objective has been of special importance. Initially, the only authority provided by the Congress to the FDIC was to arrange for the payment of depositors, up to the insurance maximum, after a bank was closed and placed in liquidation. In 1935 an almost innocuous and certainly well-intentioned change in the law gave to the FDIC authority to facilitate mergers among insured banks whenever the FDIC could find that the merger was likely to eliminate a weak institution. It was thought that by doing so the FDIC would be able to avoid larger disbursements at some future time, when many such banks could be expected to fail. By the late 1940s, assisting weak banks to merge had gradually been transformed by the FDIC into an alternative method of handling failing banks, and by the middle 1960s, the modest merger-assistance program had become thoroughly integrated into FDIC procedures for protecting depositors, complete with cost tests, the use of receiverships in arranging assisted mergers, and the introduction of "premiums" and bidding procedures. What emerged is what is known today as the purchase and assumption transaction (P&A).

During the past 30 years, the majority of bank failures, and practically all larger bank failures, have been handled through the P&A. In this kind of transaction, the FDIC replaces the bad assets with cash and all deposits and other nonsubordinated liabilities of the failed bank are assumed by another (existing or new) bank. As a result, no general creditor incurs any loss, despite the closing of a bank. On a few occasions the FDIC has provided direct assistance to banks that were open but would otherwise have failed. Recently it has also provided direct assistance to facilitate open-bank mergers of failing savings banks. In these transactions, like P&As, all depositors are made whole.

Various reasons account for the frequent use by the FDIC of the P&A when handling a distressed bank. In most instances a P&A is actually less expensive to the FDIC than simply paying insured depositors only the amount of

their insured deposits, because the acquiring institution is frequently willing to pay an attractive premium to acquire a failing bank, once its bad assets have been purchased by the FDIC. For purposes of this discussion, however, the key point is that the P&A enables the FDIC to implement its monetary stability objective in a way that might be impossible if the FDIC had only the option of paying insured depositors directly.

The P&A transaction is almost always less disruptive for individual depositors, bank loan customers, local merchants, and the general community. Going beyond this, and particularly if the distressed institution is of large size, a P&A is almost dictated for the FDIC if the FDIC is to prevent disruptive consequences to financial markets. The failure of a large banking institution might well bring down other commercial banks and at the same time so adversely affect public confidence as to initiate the kind of banking crisis that deposit insurance had been intended to prevent.

The development and increasing use of the P&A transaction as one of the two principal ways of protecting depositors of failing banks was accomplished largely by administrative action on the part of the FDIC. Most recently, however, Congress has implied that it, too, accords special importance to this objective. In Garn-St Germain, for example, the authority of the FDIC to provide assistance to distressed insured banks, which authority under earlier law had hinged upon a finding that the continued operation of the institution was essential to its community, was changed so that the criterion is now a finding that "severe financial conditions exist which threaten the stability of a significant number of insured banks or of insured banks possessing significant financial resources . . ." (Section III of Garn-St Germain).

In assessing the objectives that should guide deposit insurance policy in the future, heavy weight must be placed on the financial-stability objective. Indeed, that objective already is, or may soon become, "first among equals." And, it is this objective of maintaining financial stability that will pose the tough questions for planning the role that the insurance system should play as deregulation proceeds.

#### DEPOSIT INSURANCE IN A DEREGULATED ENVIRONMENT: THE PROBLEM

Deregulation of financial institutions is, in itself, an important public policy objective. Prior Administrations have made this clear (for example, in a January 1981 Report of the President), but none more so than the present Administration. Put most briefly, the objective might be stated as follows: consistent with the need to maintain a sound financial system, means must be found of removing those constraints from commercial banks and from other financial institutions that prevent the public from obtaining the benefits of competition among all financial institutions.

Against this background, what is the problem posed for, and by, deposit insurance? Banks, after all, have been able to fund themselves for many years

with deposits that are Federally-insured; what difference does it make if now, or soon, these funds are purchased at market rates rather than regulated rates, or over broader geographic area, or if they may be employed in a variety of new financial services?

To a certain extent, of course, even before the pace of deregulation picked up so dramatically, the fact that privately-owned and competitive financial institutions were funded in substantial part by liabilities insured by an agency of the Federal government posed problems. This was the reason for the adoption of an extensive system of supervision and regulation of banks. What has changed is that a significant contraction in the scope of regulation has commenced while the government's deposit insurance obligation gives no evidence of contracting; indeed most signs point to further expansion of that obligation. One might have thought that the logical relationship would be a concurrent reduction both in regulation and in the government's exposure under the deposit insurance program, but this does not appear to be happening.

Until the 1970s, the FDIC's use of the P&A could have been regarded as nothing more than a commendable financial innovation, enabling the FDIC to provide the essential protection for depositors of failing banks in a manner that was least disruptive to the affected communities and most calculated to preserve financial stability. For many years, close observers of deposit insurance speculated openly that the FDIC, having developed the P&A, would be compelled to use it in any case involving a large distressed bank. Events during the 1970s have borne this out. There have been a fairly sizable number of large distressed insured banks, more than a few in the multibillion dollar category and, with one exception (Penn Square Bank), all large cases have been handled through either a P&A or direct assistance. Although it is not possible to say precisely when attitudes in the business and financial community began to change, there seems little question that sophisticated users of banking services are increasingly aware that the FDIC's options are indeed limited.

The scope of the government's insurance obligation has also been expanding in other ways. Insurance coverage, which was raised to \$10,000 in 1950, is now set by statute at \$100,000 per depositor -- a ten-fold increase. If change had been restricted to that called for by inflation (measured by the Consumer Price Index), insurance coverage today would be only about \$40,000 per depositor. Moreover, it is not unusual to hear suggestions that coverage per depositor be increased even further, but rarely or ever are there suggestions that it be reduced.

In Garn-St Germain the Congress further broadened the insurance responsibility in that capital assistance programs for failing depository institutions were added to the functions of the insurance agencies. The point to be made here does not relate to the merits of such action but is simply that this action by the Congress is still another indication that the breadth of the insurance commitment on the part of the Federal government tends to continue growing, at a time when regulation which buttressed that commitment is diminishing.

The problem is that deposit insurance may come to exert a perverse effect -- furthering rather than containing financial instability. This may happen if the combination of government underwriting of deposit risk and the natural tendency of institutions to trade on this advantage is not checked by offsetting constraints imposed by government, or by the market, or both. An increasingly fragile financial structure might be unable to resist even minor shocks. The not insignificant side effects could be a substantial increase in the cost of insurance, or the prevention of such fragility could call for the slowing down or end of the deregulation process. Put somewhat differently, comprehensive government insurance of liabilities is inconsistent with deregulation of the institutions responsible for those liabilities; it is unlikely that government can allow deregulation to proceed much further without addressing the insurance connection. Yet, to check the deregulation movement would mean the thwarting of an important public policy objective -- the attainment of more effective competition among financial institutions.

#### DEPOSIT INSURANCE IN A DEREGULATED ENVIRONMENT: SOME POSSIBLE SOLUTIONS

If, as the FDIC believes, meaningful deregulation requires, at the same time, significant reform of the ways in which the deposit insurance programs now operate, then a variety of possibilities exist. Deregulation may also call for a restructuring of the insurance agencies, a subject that Congress asked the FDIC to address and which is considered in the following section. This section is concerned with possible reform internal to FDIC, or to its procedures, and in the course of the discussion will address the specific questions posed by the Congress in the Garn-St Germain Act.

Reform recommendations, the FDIC's and those of others, can be grouped in various ways. One that has some attraction is to consider, first, those that call for action by the government (i.e., primarily by the FDIC) and, second, those that look to the private sector for assistance. Before looking at each of these groups, comment on a quite different matter may be useful.

#### Special Reform Proposal

It has been suggested that banking organizations can be deregulated without the need of altering the insurance system, at least so far as product and geographic deregulation is concerned, by providing that new activities be conducted outside of the bank, in affiliated institutions, and that dealings between the bank and its affiliates be prohibited or strictly regulated. Deposit insurance would relate only to the bank, which would, in effect, be sealed off from the other affiliates in the holding company.

There is fairly extensive literature dealing with this kind of reform, and it is one that has recently been suggested to the Congress by the Treasury Department. Although no precise tabulation has ever been made, the weight of opinion seems to be that it is impractical to think that the future of the bank can be separated from the future of the company of which it is a part. The public, it is argued, will inevitably view the institution as one.

There is, on the other hand, the contention that real separation has never been actively attempted or pursued by regulatory authorities, and that the proposal is in fact workable, not only as a matter of law (about which there is little question) but also in practice. Regardless of the respective merits of the argument, this is a reform that lies outside the purview of this report. Nor does it deal directly with problems posed by interest-ceiling deregulation. It is, nonetheless, a reform that is certain to be before the Congress, and should not be overlooked.

### FDIC Initiatives

Few reform proposals have had as long and as respectable a history as that which calls for risk-related premiums. Specifically, it is argued that the fact that the deposit insurance assessment rate is the same for all banks (1/12th of one percent of assessable deposits, less a net assessment income credit based on FDIC expenses and losses) means that there is no penalty attached to those banks that pose undue risk to the deposit insurance fund compared to those operated in more conservative fashion. Most limits on bank activities, and much bank supervision, could be dispensed with, it is argued, if each bank's insurance assessment were to be related to the risk that it assumes in the use of its deposits.

The theory is difficult to reject; but implementation is impractical. As pointed out in Chapter II of the study, the FDIC has concluded that establishment of an "ideal" risk-related premium system is not feasible. Among other reasons, it would entail unrealistic data requirements and would require more advanced risk quantification techniques than are currently imaginable. Even if these problems could be overcome, the authority over banks that would then devolve on the FDIC -- much of it necessarily judgmental in nature -- is far greater than is tolerable for any governmental agency in an economic society based on free-enterprise principles.

It is the FDIC's view, however, that simple fairness dictates some moderate differentials in deposit insurance rates to reward sound management and to penalize bank managements that refuse to conform to the most elementary standards of acceptable bank behavior. Accordingly, the FDIC proposes a risk-related premium program that is limited in scope with the maximum premium differential equal to the assessment credit. Also, the FDIC will seek authority to charge banks for any disproportionate amount of supervisory time required to correct problem bank situations.

It is possible that the limited program envisioned by the FDIC will, over time, evolve into a program that more closely meets the objectives of an "ideal" system. However, it is impractical, and possibly harmful, to attempt at this stage to institute a full-blown, risk-related assessment program.

### Private Sector Initiatives

In the FDIC's view, better solutions to the problem set forth earlier are to be found in mobilizing the resources of the private market. A variety of possibilities exist. Several of them are quite promising.

Disclosure -- In one sense, the most useful of all reforms is not a reform but simply an extension of an existing practice. Specifically, the FDIC has concluded that there should be significant improvement in the disclosure of information to the public. How effective this will be will depend in part on the interest in, or usefulness of, the data, which in turn will depend on the extent to which additional risk is shifted from the FDIC to the private sector. However, even if no other change were made, to the extent that there is already a degree of private sector surveillance of banks, improved disclosure would enhance that surveillance.

The specific disclosure recommendations made by the FDIC are set forth in Chapter IV of the study. A policy statement has been developed, setting forth minimum standards for bank disclosure, encouraging banks to meet those standards and also encouraging uninsured depositors to request necessary information. A key element of the proposal would be management's narrative analysis of the bank's results of operations and financial position.

Bank Call Reports are presently in the midst of major revisions which will make their content more comprehensive for purposes of risk analysis. Two additions to these documents will provide the regulators and the public with data on credit-risk (loan quality) and interest-rate risk, areas not previously covered in these reports. An issue of competitive equity remains, however, as savings and loan associations do not disclose data on loan quality. The FDIC is also considering whether to adopt a policy under which there would be public knowledge of banks against which it has taken statutory enforcement actions. The FDIC would publish the final orders it issues in the Federal Register, on or around their effective dates.

Reducing effective insurance coverage -- If insured depository institutions have an incentive to act in a more risky fashion than the market would permit in the absence of insurance, and the only thing that has prevented this in the past has been the set of statutory and regulatory constraints on bank behavior, then it would follow that deregulation would pose financial stability problems for the FDIC and the Nation. A common sense approach to this problem would be to cut back on the de facto level of insurance coverage in order that some important portion of deposit liabilities is placed at risk. This should result in better policing of bank risk-taking proclivities by the private sector. In fact, the feasibility of obtaining more effective discipline from bank depositors, particularly those with larger balances, is precisely one of the matters that Congress has directed the insurance agencies to examine.

How might such a reduction in de facto insurance coverage be obtained? Such a result could be accomplished if the FDIC were simply to abandon use of the P&A and direct assistance procedures, and follow a policy henceforth of only paying depositors in failed insured banks the amounts of their deposits up to the statutory ceiling of \$100,000. Institution of such a policy would unquestionably attract attention from large depositors, and yet would be perfectly consistent with the public policy objective of protecting unsophisticated depositors with modest balances.

There are several problems with this approach. One is that it would expose communities in which bank failures occur to needless distress. For reasons given earlier, the P&A is a better way in which to handle a bank failure and still avoid the disruptive consequences of such a closing. Much more importantly, however, adoption of the program mentioned above would seriously impair the FDIC's ability to achieve its second public policy objective, namely, to protect against the destabilizing effects of bank failure. No one can be certain, of course, what the result would be, but many competent observers believe that if the FDIC were to place all uninsured depositors at substantial risk, then the failure (or even reports of serious difficulties) of large banks might set off a chain of problems, threatening otherwise sound institutions. Put another way, such a program would make more likely the occurrence of bank runs that would have destabilizing effects like those that the FDIC was established in 1933 to prevent.

But between the two extremes of flat 100 percent insurance coverage for all depositors and rigidly paying off depositors only up to the insurance maximum, various possibilities exist for achieving worthwhile reform. That which appears most attractive to the FDIC is that the P&A transaction continues to be used in most instances, but that it be modified so as to introduce some risk-bearing by depositors with sizable balances.

Specifically, the FDIC is considering use of a procedure where, following a bank closing, the FDIC would make an immediate appraisal of the assets and an estimate of the ultimate recovery. This estimate would then be used in determining the extent to which depositors are protected in the failed bank. To illustrate: assume that in the case of a particular failed bank the FDIC estimates that recovery on assets would equal 80 percent of all claims by depositors (or by the FDIC on behalf of depositors it has paid) and other general creditors. The FDIC could then structure a transaction very much like the current P&A, but only insured deposits and, in this case, 80 percent of uninsured deposits and other liabilities would pass to the acquiring bank along with a similar volume of failed bank assets and cash (less any premium that the acquiring bank might be willing to pay). A variant on this approach, considered in Chapter III of the study, would provide by statute a fixed percentage recovery (such as 75 percent) on deposit balances over \$100,000 irrespective of the ultimate recovery on assets.

A transaction modified in either of these ways would retain many of the advantages of the present P&A transaction. Some, though perhaps not all, of the goodwill and deposit relationships of the former bank would be preserved. While uninsured depositors would lose a portion of their funds, they would keep immediate access to most of their funds. If the ultimate recovery exceeds 80 percent, uninsured creditors would receive additional payments. Should the FDIC's ultimate recovery fall short of its initial estimate, then, presumably, the FDIC's share of the loss would exceed that of uninsured general creditors (in a regular P&A, it should be remembered, the FDIC bears all of the loss).



A modified P&A, while still providing uninsured depositors with a substantial portion of their deposits, would nevertheless expose them, as well as other general creditors, to risk, and thus persuade them to be more selective in their choice of banks, or to be more vigilant in monitoring the activities of the banks they select. It should be possible to use the modified P&A even in banks of quite large size, since under the proposed program even the largest uninsured depositors would receive, immediately, a very substantial portion of their deposits.

There is a risk entailed, even with this modified approach. Some observers with whom the FDIC has consulted have warned that any exposure to risk by large depositors may have destabilizing effects. It might, for example, bring back the problem of bank runs. In the FDIC's view, the program suggested is sufficiently modest to be unlikely to have such adverse consequences. Moreover, if, as many of these same critics point out, large depositors are already aware of their risk and monitor it closely; the change should not have the kinds of consequences suggested.

Nongovernment deposit insurance -- It is often suggested that the private insurance industry might be capable and desirous of shouldering a larger portion of the deposit insurance burden, now borne almost entirely by Government. Moreover, if the FDIC is successful in modifying its P&A procedures along the lines described earlier, additional insurance may be eagerly sought after by large depositors. Possibly these were among the reasons Congress asked for a discussion of the feasibility of offering excess coverage at the option of the purchaser, and of whether such excess coverage, if needed, could be provided by the private insurance industry.

For the FDIC itself to offer excess coverage would be redundant (the FDIC, for all practical purposes, now insures virtually all deposits) unless such an offer were part of a program to replace the P&A and other procedures, *i.e.*, unless it were viewed as part of a return to a policy of providing insurance protection solely through deposit payoffs up to the insurance maximum. The major problem with FDIC participation in such an arrangement would be that of pricing the additional risk for the same reasons mentioned in the earlier discussion of risk-related premiums. If the FDIC felt confident that risk could be priced appropriately in this situation, then of course it would be confident that it could be done for all deposits.

Private insurance companies would face a similar problem of risk pricing. But quite apart from pricing problems, there are serious capacity constraints that suggest that private insurance coverage will continue in the future to remain as it is now, namely, fairly narrow in scope and focused on individual customers or selected institutions. As pointed out in Chapter VII of the study, the FDIC has discussed the subject with representatives from a selected group of companies and finds little reason to believe that comprehensive insurance programs can be made available from the private sector.

It may be premature to reach a conclusion on this. If the FDIC is able to modify its P&A procedure, new demands for excess insurance coverage might stimulate the development of private industry initiatives. Such a possibility should not be dismissed. To the extent that the private sector is capable of offering additional insurance coverage, this would add to the strength of the market forces policing banking and the FDIC would of course welcome such a development. However, the FDIC recommends that this be left to the free play of the market, without subsidization from the FDIC.

Increasing the risk of junior creditors -- Enhanced market discipline of banks may be obtained in other ways than by increasing depositor risk. From the standpoint of market discipline, intermediate and long-term subordinated debt affords certain advantages over deposits. Subordinated lenders are apt to be more sophisticated -- more used to evaluating credit risk. Once having made the loan or investment, they generally cannot flee during adversity without incurring some loss. In a sense they have to view the borrower's (bank's) operations from a longer-term prospective. Unlike stockholders, their return is fixed and they generally do not receive any benefit from increased risk. Unlike depositors, they cannot count on being bailed out at the time a bank fails. If and when a bank does fail, subordinated debtors provide a protective cushion to the FDIC between insolvency and FDIC loss.

The fashioning of a proposal wherein junior creditors could play a larger part in applying market discipline to banks is not difficult. It could be done, for example, through administration of capital adequacy standards and might provide for required minimum levels of capital relative to assets, with the designation of a specific portion that could be in subordinated debt. This of course would be a significant step. The FDIC does not recommend this approach at this time, but considers it worthy of serious consideration.

#### A Summary and Tentative Assessment

In the final analysis, proposals intended to enable the FDIC to fulfill its public interest objectives in a changed financial environment must reflect a judgment on possibilities, rather than certainty as to how best to proceed. Some recommend that nothing be done; that the FDIC await the unfolding of events. The FDIC is convinced that the risks to the system in maintaining the status quo are unacceptably high. Its core conclusions and recommendations may be summarized as follows:

1. The success of deposit insurance may be attributed in part to extensive regulation of banks, including constraints on interest payments, powers, and expansion opportunities;
2. The responsibilities of the deposit insurance system are expanding at a time when regulation is contracting, setting up a potentially dangerous situation;

3. Merely to institute new and more extensive supervision and regulation of banks would choke off the present deregulation movement, which carries with it the promise of a more competitive financial system; to attempt to price deposit insurance so as to adequately compensate for new risk that may be assumed by banks seems to be impractical, although a modest step in that direction is recommended;
4. Accordingly, it is appropriate that the private sector assume some modest portion of the risk now borne fully by government. Of the various ways in which this could be accomplished, the most attractive appears to be a modified payoff transaction, combined with better financial disclosure by banks, the institution of a depositor preference statute and possibly some control over deposit brokerage.

Any transfer of risk to the private sector is possibly destabilizing. To a certain extent this is intended and desirable. Banks unable to handle the new opportunities presented by deregulation should not be protected from market discipline. Whether the destabilizing consequences may be too great is a question that will be debated. The potential for massive, systemic problems is far greater, in the FDIC's judgment, if changes along the lines recommended are not implemented.

It will also be asked how, if the FDIC is not capable of instituting a risk-related premium system, can the private sector be expected to evaluate banks properly. The FDIC is, after all, in a far better position to reach judgments on the condition of individual banks because of its better access to information, including examination reports, that is not available to the private sector.

There is some plausibility to this contention. In part the FDIC is suggesting rectifying the situation by improving the flow of information to the private sector through more extensive disclosure. But the question remains and raises more fundamental issues.

The FDIC can continue, and intends to continue, to utilize its supervisory powers to work with individual banks in the solution of problem situations. It will continue to utilize its enforcement powers where cooperation cannot be attained. The FDIC can go further, of course, but then one comes up against the question of who should be making banking decisions and what kind of banking system we desire.

If because of its better access to information about individual banks, the FDIC is compelled to inject itself into bank management to an extensive degree, then we will be approaching a banking system which is essentially government-directed. The market's judgment on occasion may be harsh, but it is the kind of judgment that has served the Nation well over the long run.

The FDIC is not, obviously, suggesting that banking be thrown open to the unrestricted consequences of market driven decisions. What it is suggesting amounts to a modest move toward coresponsibility or coinsurance between the public and private sectors. Under such a program, the FDIC believes that deregulation of the financial system can proceed.

#### TOWARD A MORE EFFICIENT INSURANCE SYSTEM

Deregulation, current and prospective, has posed some knotty conceptual issues relating primarily to the extent to which responsibility for the safety and soundness of the banking system should be apportioned between government and the private sector. These are the questions addressed thus far, but Congress has posed several others that are of equal importance as the financial system moves into new and uncharted territory: quite apart from the subject of market discipline of banks and the broad role of deposit insurance, just how strong are the insurance funds today; how strong are they likely to be in the future; and does it make any sense to continue to have separate insurance funds for different types of depository institutions? Chapters V and VI in the study address these questions in specific detail.

#### FDIC Capabilities

The strength of a deposit insurance program is determined by a mixture of elements, many of which are not susceptible to actuarial scrutiny. The known condition of individual banks at any point in time must be weighed against possible swings in public confidence in the banking system in response to unpredictable events; the size of the insurance fund in dollars or in relation to its potential deposit liabilities may seem too large or too small depending upon one's estimate of the future state of the national or world economy. Other illustrations could be given.

Recognizing these unusual characteristics of a deposit insurance system and the impossibility, in any scientific sense, of reaching conclusions as to the adequacy of a deposit insurance fund, it is nonetheless reassuring that the Nation's deposit-insurance system has worked so well over a half century, which includes periods of economic stability, of sharp recession, and of burgeoning inflationary growth. If not to the satisfaction of actuaries, the insurance record does, after all, count for something, and it is laid out in Chapter V. The conclusion is that the income flow and the size of the FDIC's deposit insurance fund, relative to its potential liabilities, are adequate today and should be adequate in the future, always assuming of course that the institutions whose liabilities are insured will receive the proper degree of supervision from the market and/or from government.

#### Merger of the Deposit Insurance Funds

Congress has asked that the FDIC comment on the "feasibility of consolidating the three insurance funds." The FDIC believes some consolidation is not only feasible but eminently desirable. The qualification "some consolidation"

relates only to its belief that the limited role and small size of the typical credit union makes it unnecessary to bring the National Credit Union Share Insurance Fund into a consolidated agency, at least at this time.

The FDIC recommends the consolidation of the FSLIC and the FDIC. There are, of course, long-standing links between insurance and supervision, which make it difficult to treat the merger of the insurance funds in isolation. Accordingly, the FDIC recommends the severance of those links where they are no longer useful or practical, together with a strengthening and a modernization of the regulatory structure where it seems necessary because of the changing financial environment. Specific discussion of these recommendations is provided in Chapter VI of the study. The recommendations themselves may be summarized as follows:

1. The Federal Savings and Loan Insurance Corporation ("FSLIC") and the FDIC should be merged into a new agency or entity, under the direction of the FDIC;
2. The new insurance agency should be separated from the applications process and from all regulatory functions not directly related to safety and soundness;
3. The new insurance agency should have authority to require reports of, conduct examinations of, and take enforcement actions against, all its insured banks and thrifts and their affiliates;
4. A single agency should be established for chartering and regulating all federal banks and thrifts, and for regulating holding companies; such new agency to be separate from the insurance agency; and
5. Greater reliance should be placed on state supervisors for primary supervision and corporate applications from state-chartered depository institutions.

The foregoing recommendations may be divided between those relating directly to the merger of the insurance funds and those which go further to suggest a reorganization of the supervisory and regulatory structure at the federal level. The principal arguments for both sets of recommendations are briefly reviewed below.

#### Merger of the Insurance Funds

It is difficult to argue that the insurance funds of the FSLIC and the FDIC should be separately maintained when the functions of the thrift institutions and commercial banks are so similar that virtually the only distinction that can now be found in present law between the two types of institutions is in the nature of the insurance attached to the liabilities of each. Not only are the depository institutions involved now almost indistinguishable in the powers they possess, but they are also beginning to come together, in some instances, in larger financial organizations, a trend that doubtless will accelerate in the future.

The deposit insurance funds are similar in many respects, as is described in the study. Possibly more important, the public interest objectives of deposit insurance are identical for the two funds, namely, to protect the Nation against the destabilizing consequences of the failure of depository institutions, and to assure depositors, particularly those least able to sustain losses due to bank failure, that their deposits will be made immediately available.

For those who may desire, for one reason or another, to keep the funds separate, it is always possible to put together a group of technical arguments or to cite difficulties that will be encountered. However, once it is decided to consolidate, solutions are readily available to meet any difficulties. The study provides a variety of options from which a selection might be made. A few items are possibly worth noting here.

The study recommends that the FSLIC be merged into the FDIC. This is not a crucial recommendation; thought could be given to creating a new insurance agency. It is simply more practical to consider utilizing the FDIC as the receiving agency in this case since it already supervises an important body of thrift institutions (mutual savings banks); insures approximately two-thirds of all Federally-insured deposits; is an independent agency rather than simply one of the operating arms of a larger agency, as is the case with the FSLIC; has by far the largest fund and administrative staff; and has the greatest name recognition.

The two deposit insurance funds could be administered separately, or joined. A phase-in program can be instituted to meet transitional problems, if any. Administration of the new agency could be by a board with representation designed to assure that any special interests of existing agencies are met.

The recommendations for change in the supervisory structure are likely to encounter greater debate. Reorganization of the Federal regulatory system has been one of the longest running debates in Washington, surfacing almost immediately after the present structure was put into place in 1933. Moreover, whereas much of the debate in the past centered on simply combining those agencies dealing with banks, today there is no need to exclude from such proposals the Federal Home Loan Bank Board ("FHLBB"), which is chartering and supervising depository institutions with powers virtually identical to those of banks.

Under the approach recommended by the FDIC, certain important changes can be accomplished: (1) the insurance agency would no longer be involved in the applications process or in any other regulatory matters affecting depository institutions except those that relate directly to safety and soundness considerations; (2) the dual or state/federal banking system would be preserved, even strengthened; (3) the chartering agencies would have the primary supervisory responsibilities; the new insurance agency would retain examination authority over all insured institutions but would focus on problem and near-problem institutions, only sampling the sound institutions; (4) provision would be made for Federal Reserve Board ("FRB") representation on the insurance agency board; possibly, depending on the form of reorganization,

the FRB could also be represented on the board of the consolidated regulatory agency; and (5) sole responsibility for the resolution of competitive factors in merger and acquisition cases would reside in the Attorney General's office, which is the principal enforcer of the antitrust laws, while the SEC would handle all securities matters and the Federal Trade Commission ("FTC") all consumer compliance matters.

These recommendations would accomplish significant changes. One in particular perhaps deserves further comment: the removal of the FRB from supervisory and regulatory responsibilities, except to the extent that the FRB is represented on the board of the new insurance agency or the board of the consolidated regulatory agency.

The relationship between regulation and the central bank was not a matter of major significance until about 1970. In 1913, the creation of a central bank was intended as a means to extend Federal government supervision to state-chartered banks, most of which were assumed to be receiving little effective supervision. Most state banks, however, elected not to join the FRS. When bank holding company supervision was provided for in 1956 and placed in the FRB, Congress was dealing with only 47 institutions holding approximately 8 percent of all commercial bank deposits. As matters now stand, the FRB is the sole regulatory agency for bank holding companies, which number in excess of 4,000 and represent approximately 85 percent of all bank assets, and the Board continues as the regulator of state-chartered member banks.

The connection between regulation and the central bank has posed two kinds of problems. The first revolves around the question of the appropriateness of combining monetary policy interests with regulatory responsibilities. Perhaps the classic formulation of the issue was by a governor of the FRB (J. L. Robertson) in 1963: "In appraising the soundness of long-term investments, bank examiners should never be obliged to switch from rose-colored glasses to black ones, and back and forth again, in an effort to implement the monetary policy of the moment." To be sure, much depends upon what is meant by "monetary policy," but to the extent that monetary policy is thought to be aided by being able to influence expansion policies of depository institutions, particularly commercial banks, there will be inevitable occasions when monetary policy and regulatory procedures and objectives become thoroughly intermixed.

A second problem also involves a conflict of objectives. It can be argued that regulatory policy on occasion is held hostage to monetary policy objectives. For example, at a time when bold innovative action might be called for in the regulation (or deregulation) of depository institutions, the political side-effects of adopting such a course of action, as possibly affecting the independence of the central bank as a monetary agency, might well, and quite understandably, lead the central bank to defer taking needed regulatory actions.

The FDIC suggests that responsibility for the conduct of monetary policy should be the principal concern of the FRB. This requires that the FRB have sufficient access to information about depository institutions. Representation on the board of the new insurance agency and/or consolidated regulatory agency should satisfy this need; if not, procedures can and should be adopted to assure that the removal of the FRB from direct regulatory authority does not hamper, and indeed may improve, the flow of necessary information to it.

The FDIC recognizes that the proposals set forth in this final section represent sweeping changes for the current system of deposit insurance and supervision. These changes are, however, no less sweeping or dramatic than those taking place in the financial-services industry. The deposit insurance and supervisory framework can no longer afford merely to react to evolutionary change. It must be structured and equipped to deal with the dynamics of the financial-services industry of today and of the future.



CHAPTER I

THE CURRENT SYSTEM OF DEPOSIT INSURANCE  
AND ITS IMPACT ON THE STRUCTURE AND OPERATIONS OF BANKS

	Page
Executive Summary . . . . .	I-1
Introduction . . . . .	I-2
Historical Overview . . . . .	I-2
The Period 1942 - 1972 . . . . .	I-4
The Period 1972 - Present . . . . .	I-5
The FDIC and Current Banking Structure . . . . .	I-6

## CHAPTER I

### THE CURRENT SYSTEM OF DEPOSIT INSURANCE AND ITS IMPACT ON THE STRUCTURE AND OPERATIONS OF BANKS

#### EXECUTIVE SUMMARY

The FDIC was established in a time of financial crisis to restore confidence in the banking system. Most observers agree that the FDIC has experienced extraordinary success in maintaining the stability of banking, and many have argued that it has been too successful. Before Federal deposit insurance became a reality, there were concerns expressed that insurance would effectively remove banks from the discipline of the market. These same concerns have been voiced with increasing frequency to the present time.

Since the FDIC began operations, some portion of failed bank situations have been handled in ways that have provided de facto 100 percent insurance coverage to all depositors and general creditors. In recent years the vehicle used has been the purchase and assumption transaction (P&A), whereby all liabilities of general creditors (including uninsured deposits) are transferred to an assuming bank. Since the early 1960s, most failed insured banks have been handled by the P&A route. Especially in large banks, there probably is the perception among depositors of minimal risk of loss, and therefore there are few incentives to choose between banks based on financial condition.

During the early years of FDIC operations, a lack of market discipline probably was of little significance. Bankers who survived the Depression were extremely cautious. Although the FDIC handled approximately 400 bank failures from 1934 through 1942, risk in the system probably was not great. Most of the banks that failed during this period were small, and the book losses realized by FDIC were minimal.

The same conservative philosophy to some degree was prevalent throughout the next three decades. Banking was changing, but only 110 banks failed from 1942 to 1972. The economy was growing and much of the restrictive legislation passed in the 1930s was still in place.

In more recent years, banking behavior has changed in many respects. In terms of performance, earnings have become more volatile, and loan losses have risen dramatically. Banking markets have become more competitive, and traditional lines of commerce have begun to blur. The economy during this period has been relatively weak, and more unstable. As a result, the banking system has

become more risky, and the risk is likely to increase as the process of deregulation intensifies. In a deregulated environment, the existence of market discipline is likely to become more important to a well-functioning financial system.

## INTRODUCTION

There is concern today that the Federal deposit insurance system has removed most market restraints on the ability and willingness of bank management to pursue actions that would not be tolerated in a less economically secure environment. This concern is predicated upon several factors. First, since the early 1960s the FDIC has handled most failed and failing bank situations through merger into a stronger institution, which provided de facto 100 percent insurance to all depositors and other general creditors. Until Penn Square Bank failed in mid-1982, no bank with assets of \$100 million had been dissolved by way of a payoff of insured deposits. Second, as the powers of banks and bank holding companies expand further and banking markets become more competitive, banks will be under more pressure to maintain profit margins and increase risk-levels. Third, there is considerable evidence that risks in banking already have increased. Increased leverage; primarily at larger banks, and apparent undue concentrations of credit to troubled sectors are often cited as examples.

The purpose of this chapter is to sort through the available evidence to determine the effect of the deposit insurance system on the structure of banking and operating practices of banks. To place recent developments in better perspective, the first section deals with the events preceding the Banking Act of 1933 and chartering of the FDIC, and developments through 1941. The banking environment and FDIC operations during the post-war years through 1972, and from 1972 to the present are then considered, with the final section devoted to a discussion of the current role of Federal deposit insurance and its effects on the current banking structure.

## HISTORICAL OVERVIEW

Much of the early history of the U.S. monetary and banking system is characterized by instability and crises. By 1900, however, what was thought to be a relatively stable dual system of state and national banks had evolved. While credit quality problems probably existed, it was generally recognized that one of the major weaknesses of this system was the absence of a vehicle to prevent liquidity crises from developing. A severe panic in 1907 laid the foundation for the creation of the Federal Reserve System in 1913.

Even with a "lender of last resort" in place, liquidity problems persisted. While member banks had access to borrowings from the Federal Reserve Banks, state banks had to rely on correspondents to supply liquidity. For a number of reasons, including the large proportion of small, rural banks in the system and limited communications facilities available at that time, liquidity remained a major problem. Many banks, seeking to accommodate cash demands or increase liquidity, reduced credit extensions and, in some cases, liquidated

assets. This had the effect of reducing cash available to the community which, in turn, placed additional cash demands on banks. Banks were forced to further restrict credit and to liquidate assets, thereby depressing asset prices and further exacerbating the liquidity problems. As more banks were unable to meet withdrawals and were closed, depositors became more sensitive to rumors. Bank "runs" became more common.

Although the decade of the 1920s was generally prosperous, an average of about 600 banks per year failed between 1921 and 1929. While most of these were small, rural institutions, depositors lost an aggregate of approximately \$560 million (or about 35 percent of deposits in failed banks) during this period, and had a considerably larger amount of funds tied-up in bankruptcy proceedings. As more banks failed, the volume of assets being liquidated became significant. This activity further depressed asset prices, and added to the problems of banks attempting to gain liquidity.

Between the time of the stock market crash in the fall of 1929 and the end of 1933, about 9,000 banks were closed with an aggregate loss to depositors of about \$1.3 billion. The banking and financial system had almost collapsed, and both the manufacturing and agricultural sectors were operating at a fraction of capacity.

The FDIC was established within this economic climate to help restore confidence in the banking system.<sup>1/</sup> By almost any measure, the FDIC has been extraordinarily successful in maintaining stability of the system: bank "runs" soon became a thing of the past; the money supply, both on a local and national basis, ceased to be subject to contractions because of bank failures; liquidation of failed bank assets no longer disrupted local or national markets; and, a significant proportion of community assets no longer was tied-up in bankruptcy proceedings.

Many observers of FDIC operations believe that the Federal deposit insurance program has been too successful, and has effectively removed the necessity for depositors, and perhaps other general creditors to exercise much discretion in the placement of funds in banks.<sup>2/</sup> The literature of the 1930s suggests that these issues were of concern at that time. There was a fear that the complacency of depositors would encourage lax management practices and a general deterioration in credit quality. Additionally, there was concern that deposit insurance would adversely affect the quality of state bank supervision. From its inception, bank examinations have been used by the FDIC to control risks within the system.

<sup>1/</sup> Although the FDIC represents the first attempt at Federal deposit insurance, several states had deposit insurance programs in effect prior to 1933. The earliest program was established by New York in 1829. By 1930, there were no state programs in existence. For a comprehensive review of these programs, refer to Appendix G.

<sup>2/</sup> This topic is reviewed briefly later in this chapter and discussed in more depth in Chapter III of this study.

The early years of the FDIC's existence were not a period of risk-taking by banks. Bankers who survived the Depression were extremely cautious. Legislation enacted in the 1930s limited bank behavior, essentially to insulate banks from competing with one another too aggressively. Entry was limited by cautious behavior on the part of regulators and by a still depressed economy.

With the exception of the recession years of 1937-1938, the economy expanded throughout the 1930s from the low point reached in 1933. Nevertheless, the FDIC handled approximately 400 bank failures from 1934 through 1942. Most of these were small banks, with the FDIC realizing an aggregate book loss of only about \$24 million as a result of these failures. Without the presence of Federal deposit insurance, the number of bank failures undoubtedly would have been greater and the bank population would have been reduced. The presence of deposit insurance also may have limited the necessity for some banks to merge, and may have indirectly encouraged retention of restrictive state branching laws. It had been recognized for some time that a branch banking system potentially was more stable than unit banking because of the ability to geographically diversify the deposit base. As the failure rate began to increase during 1929, many states moved to liberalize branching restrictions; from 1929 to the enactment of the Banking Act of 1935 (authorizing a permanent Federal deposit insurance system), 13 states enacted laws providing broader branching powers for banks. After 1935, it was almost 30 years before any state again liberalized branching. However, limited financial incentives prevailing during most of the 1930s also probably served to reduce bank mergers.

#### THE PERIOD 1942 - 1972

During World War II, government financial policies and private sector restrictions produced an expanding, very liquid banking system. Bank failures declined significantly (only 28 insured banks failed in the period 1942-1945). Banks emerged from World War II in very liquid condition. Loan losses were practically nonexistent. In fact, many banks experienced sizable recoveries on previously charged off loans.

During the next three decades banking behavior by present standards continued to be very conservative. In general, economic performance was favorable, with recessions reasonably mild and short in duration, and the number of business failures and the volume of loan losses at low levels. This was a period of general prosperity, with a secularly increasing GNP, generally low levels of unemployment and, after the Accord in 1951, a relatively stable price level. Until about 1960, banks continued to operate in an insulated, safe environment. Gradually, banks began to change the way they operated, and some of the restrictions began to be dismantled. The Depression experience ceased to be a dominant force influencing bank management. Still, during the 30 years from 1942 to 1972 there were only 110 failures of FDIC-insured banks, with total book losses aggregating \$40 million from the FDIC's beginning through 1972.

It would be an oversimplification to think of this period as being uniform. Banking changed substantially in this 30-year period. Beginning in the early

1960s, some states started to liberalize branching laws. Additionally, the bank holding company vehicle was used increasingly to enter new product markets, and the appearance of negotiable certificates of deposit represented a dramatic shift in bank funding strategy. However, from the standpoint of the FDIC's role and perceived depositor risk, this was a period in which bank failures and their possible occurrence were not very important.

It is difficult to assess the impact of the FDIC on bank structure or the operation of banks with respect to risk. Undoubtedly, the bank examination and supervisory role of the regulatory agencies contributed to the lack of risk in the system during these years. However, a stable economic climate and a vivid memory of the experience of the 1920s and 1930s were contributing factors. On balance, it would be hard to argue that deposit insurance played a dominant role in affecting bank structure in this period.

During this time, there was some concern about how the presence of deposit insurance might limit market discipline. There was occasional discussion about variable-rate premiums, but it was conceded that the 1930s experience might not be relevant, and bank failures and loan losses were too infrequent to provide the bases for any statistical analysis. Whether because of their own conservative behavior, existing legislative constraints or the behavior of bank supervisors, most banks operated during much of this period at a level of risk where market discipline probably did not matter. Indeed, statistical studies relating equity prices to capital ratios and other risk measures suggested that they had not been important or discernible in explaining bank stock prices.

#### THE PERIOD 1972 - PRESENT

In more recent years banking behavior has changed in many respects. From a performance standpoint, earnings have been more volatile. Loan losses have risen dramatically, and even in some very good years (1977-1978) they never returned to the low 1960s levels. More and more bank funding has involved purchased money, even for moderate sized banks. Demand balances have become relatively less important and, in the case of the household sector, most of these now pay interest. Cheap deposits, in general, have become scarce. Banks have entered new product markets, geographic expansion possibilities have broadened, and traditional banking services are now being offered by some financial conglomerates. Some of these things have developed suddenly while others reflect a regulatory and competitive environment that has been gradually changing.

It is difficult to determine what precisely reflects changing bank behavior and what can be explained by the economic environment. The changing behavior of banks has made the industry more vulnerable to economic conditions. However, in a more stable environment, like that of the 1950s and 1960s, current behavior might not have placed significant strains on the system.

The performance of the economy of the past 10 years has not been very strong. Real growth has been sluggish, averaging approximately 1.4 percent from the

first quarter of 1973 through the first quarter of 1983. Recessions have been more severe, and the downturn from which the economy is just emerging is by far the most severe in the post World War II period. Business bankruptcies recently surpassed any level reached prior to the 1930s.

The economy also has been subject to various shocks that have affected banking and business in general. The effects of the rapid increase in oil prices beginning in 1973, and the subsequent role of U.S. banks in recycling petrodollars may continue to be a problem for some time to come. The more recent deflation in oil prices is causing loan problems for banks heavily into certain energy related credits (this is similar to the problems related to real estate development projects in the mid-1970s). High interest rates accompanying the change in Federal Reserve monetary policy that began in October 1979, have precipitated major loan problems in the commercial banking system, and have, in combination with an unduly heavy emphasis on fixed rate, long-term lending, caused more severe problems in the thrift industry.

Bank failures have increased during the past decade and, more dramatically, recently. There is a greater sense of bank exposure and risk of failure that exists not just among those who regulate and follow banks but with the general public as well. As a result, bank depositors and other bank creditors have had reason to be concerned about exposure and the value of deposit insurance. Consequently, the level of insurance coverage and the manner in which failed banks are handled has become very important.

#### THE FDIC AND CURRENT BANKING STRUCTURE

There is concern that the manner in which the FDIC has handled most bank failures in the past has removed a perception of risk from depositors and other general creditors. Since 1960 about three-fourths of failed commercial banks and, until Penn Square Bank, all failures over \$100 million in size have been handled through purchase and assumption transactions (P&As). In P&As all deposits (including uninsured deposits) and other liabilities of general creditors are assumed by a new or existing bank. Thus, despite a bank failure, all depositors and other general creditors are made whole in a P&A. In those cases where the FDIC pays off a bank, depositors are made whole up to the basic insurance limit. Uninsured depositors and other general creditors usually incur some loss, especially when foregone interest is taken into account.<sup>3/</sup>

The P&A has certain advantages over a payoff. The FDIC generally recovers a premium for the assumed deposits, banking site, etc., that it puts up for bids. Banking services are continued and performing loans of the failed bank are purchased by the acquiring institution. There is minimal disruption to the community, little depositor inconvenience and little risk of any secondary effects on other depository institutions.

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<sup>3/</sup> The topics of market discipline, handling of failed and failing bank situations, and alternative means of increasing market participation in risk evaluation of banks are analyzed in Chapter III.

The FDIC has been reluctant to pay off a large bank because it would involve a substantial cash outlay and it could tie up substantial depositor claims for a long period of time. As long as the market perceives that the FDIC will not pay off a large bank, these banks are able to acquire deposits on risk-free terms despite their capitalization and loan quality. Risk has been encouraged or at least not restrained by the behavior of uninsured depositors. There is little evidence, at least from any analysis during the past several decades, that depositors have ever played a very important role in influencing bank behavior. However, for reasons already cited, bank risk-exposure has become an important issue and deposit insurance does play an important role.

One area where FDIC insurance has clearly been very important during the past few years relates to failing mutual savings banks. Because of their large portfolios of long-term fixed-rate mortgages and bonds, many mutual savings banks incurred substantial losses and capital depletion when interest rates rose so dramatically in 1980-1982. When these institutions approached book insolvency, the FDIC merged these institutions into others and provided financial assistance. Failures were predictable and came as no surprise to much of the financial community. However, because such a large share of deposits was fully insured it became apparent to most that it would be too disruptive and too expensive to pay off any of these institutions. As a result, deposit outflows in anticipation of failure remained modest.

To some extent this situation (and a similar situation for many S&Ls) was facilitated by the increase in insurance coverage to \$100,000 in 1980. This represented a significant departure from previous changes in insurance coverage, which had generally been more modest and more or less in line with growth in money GNP. The increase to \$100,000 was not designed to keep pace with inflation. Rather, it recognized that many exposed institutions had sizable amounts of large CDs outstanding. The \$100,000 limit facilitated their retaining some of these or replacing them with ceiling-free \$100,000 CDs (in 1980 only deposit accounts with balances of \$100,000 or more were ceiling-free). This increase in insurance coverage provided a vehicle for smaller or moderate-sized banks to compete for funds in regional markets, or through the use of brokers, in national markets.

In retrospect, the increase in the basic insurance limit to \$100,000 has been a mixed blessing. On the one hand, it stabilized deposits in troubled bank situations and, in particular, it facilitated the orderly handling of savings bank problems. On the other hand, it also has facilitated participation of large CDs, so that fully-insured accounts within the system could significantly increase. This could hamper any efforts to place large depositors at risk.

Elsewhere in this study alternative means to impart some semblance of market discipline to the banking industry are explored. Chapter II addresses topics related to the feasibility of providing discipline through use of a risk-related deposit assessment scheme, and Chapter III explores the desirability of various other means to impart discipline by shifting risk to depositors or



to subordinated creditors. Chapter IV looks at the role of public disclosure in aiding depositors to make an informed judgment regarding the safety of banks. Chapter V discusses the adequacy of the Federal Deposit Insurance Fund, and Chapter VI recommends merging the Federal Savings and Loan Insurance Fund into it. Finally, Chapter VII analyzes the potential for private sector insurance companies to provide discipline by providing excess deposit insurance coverage.

CHAPTER II

RISK-RELATED INSURANCE PREMIUMS

	Page
Executive Summary . . . . .	II-1
Introduction . . . . .	II-2
Merits of Risk-related Premiums . . . . .	II-2
Costs and Tradeoffs . . . . .	II-4
General Approach . . . . .	II-5
Focus of Risk Evaluation . . . . .	II-5
Available Data Sources . . . . .	II-7
CAMEL for Risk Premiums . . . . .	II-8
Proposed Approach . . . . .	II-9
Risk Measurements . . . . .	II-10
Capital . . . . .	II-10
Credit Risks . . . . .	II-11
Interest Rate Risks . . . . .	II-13
Moral Hazards . . . . .	II-15
Liquidity . . . . .	II-16
Premium Determination Dates . . . . .	II-16
Appeals Process . . . . .	II-16
Size and Risk . . . . .	II-17
CAMEL and Supervisory Costs . . . . .	II-21

## CHAPTER II

### RISK-RELATED INSURANCE PREMIUMS

#### EXECUTIVE SUMMARY

The "ideal system" with premiums tied closely to risk is simply not feasible. Such a system would require the FDIC to be given an extreme amount of authority. Moreover, it would entail unrealistic data requirements and much more advanced risk quantification techniques than are currently imaginable.

Even though the "ideal" is not feasible, the FDIC believes that a lesser system based on reasonably sound measures of risk has merit. Relating premiums to risk would reduce the inequity in the current system whereby low-risk banks subsidize the activities of high-risk banks and discourage excessive risk taking in an environment that is likely to encourage it.

Because so few banks have failed, there is little meaningful empirical evidence to support development of any type of comprehensive risk-based insurance system. A system could be based upon perceptions of risk rather than actuarial evidence but, because banks have no viable alternatives for deposit insurance, the FDIC believes such efforts should proceed cautiously. Therefore the FDIC proposes a program that is very limited in scope but one that should reduce some of the inequity in the current system and also provide the basis upon which to build a more comprehensive system.

The proposed system would have only three risk classes; normal, high, and very high. The vast majority of all banks would fall into the normal risk class. It is envisioned that the maximum premium differential would be the assessment credit. However, to ensure that the premium differentials do not drop to insignificant levels, the FDIC might be given authority to vary the assessment rate to reflect risk.

The proposed plan would focus on credit risk and interest-rate risk as they relate to capital. The latter has been the primary cause in all mutual savings bank failures and the former has been the major cause of most commercial bank failures. This system should be sufficient at the beginning and would be particularly appropriate should there be a merger of the insurance funds.

Credit risk will be measured by the dollar volume of classified assets and interest rate risk will be measured by computing the present value of potential changes in future pretax earnings resulting from a dramatic point change in interest rates.

Finally, the FDIC also seeks authority to alter the present system whereby banks with high-risk CAMEL ratings (*i.e.*, a composite rating of 3 or worse) are not charged for the disproportionate amount of supervisory time and attention they require.

## INTRODUCTION

It is feasible to implement a program whereby insurance premiums more closely reflect the risk which insured institutions pose to the insurance fund. There are practical limitations on how accurately risk can be quantified but if approached carefully, a system can be structured that would offer worthwhile advantages over the current system. This chapter describes a program that is very limited in scope but which will reduce some of the inequity in the current system. It will also provide a basis upon which to build a more comprehensive system.

## MERITS OF RISK-RELATED PREMIUMS

Federal deposit insurance provides an environment of public confidence for depository institutions to help ensure stability in the Nation's financial system. The word "Federal" implies that insured deposits enjoy a credit quality comparable to risk-free United States Government securities. Insured deposits are less expensive and more reliable than alternative funding sources and clearly are less influenced by the financial strength of the insured institution.

Commercial banks and mutual savings banks pay for insurance as prescribed in Section 7 of the Federal Deposit Insurance Act. They are all assessed at the base rate of 1/12th of one percent of total domestic deposits (after adjustments for transactions in process).<sup>1/</sup> The amount paid by any one institution depends solely upon its deposits and not the risk it poses to the insurance fund.

The fact that the present assessment structure does not consider individual bank risk is an undeniable flaw -- but one that has not caused much concern until fairly recently. Since the 1930s, the level and variation of risk-taking within the banking industry has been very low because it has been closely controlled through regulation and supervision. Bank markets and products have been protected and banks have been sharply limited in the amount of risk-taking in which they can engage. Of no less importance has been a relatively stable and growing economy. Overall, so few banks showed evidence of operating in an unsafe manner that failure risk quantification hardly seemed necessary.

<sup>1/</sup> Banks can receive a credit that significantly lowers the assessment rate. The credit amount represents a fixed percent of net assessment income, *i.e.*, the assessment revenues remaining after FDIC operating expenses and allocations for insurance losses. The percent, currently 60 percent, depends upon the size of the insurance fund relative to insured deposits.

The banking industry is still very sound but the incidence of failures has been on an upward trend.<sup>2/</sup> During the 20 years preceding 1975, the number of failures averaged only 4.2 per year but this increased to 10 for the period 1975 through 1981. Last year there were 34 commercial bank and eight mutual savings bank failures -- the highest rate since 1940. The rise in failures should not be viewed with alarm. Even last year the 34 failed commercial banks accounted for only 0.13 percent of all domestic deposits held by about 14,400 such banks. Considering the economic and competitive environment, the failure rate is still very low and speaks well to the role of deposit insurance as a stabilizer and the willingness of banks to self-insure through reserves, earnings retention and capital. Nevertheless, economic realities and competitive pressures, and the deregulation they demand, mean banks will be under greater pressure to take risks. The prospect of rising risk-levels and attendant increases in failures enhances the appeal of risk-based premiums.

Academic critics of the current system have argued that the progress of deregulation is limited because premiums do not reflect risk. The proper measurement of risk would in theory allow the complete dismantling of all existing regulations and capital standards. Under the "ideal" system, the insurance fund would be adequately compensated for risk-taking, and insurance could then be raised explicitly to 100 percent (market discipline by uninsured depositors would no longer be necessary) to eliminate any noticeable impact on the economy that a failure might have. However, because deposit insurance on a major scale virtually requires a Government monopoly, pricing premiums to truly reflect risk would place an extreme amount of authority in the hands of the insurer. Moreover, the development of the "ideal" system would require much more advanced measurement techniques than are currently imaginable and access to virtually free and perfect information.<sup>3/</sup> Because of these requirements, it is unlikely that the "ideal" system will ever be constructed and therefore some explicit regulation will probably always be necessary. Even if the "ideal" is infeasible however, the FDIC believes that a limited risk-based system should be implemented -- one that relates premiums to reasonably sound measures of risk.

Risk-related premiums would reduce the inequity of the current system whereby high-risk banks pay the same rate as low-risk banks. This becomes increasingly important as insurance losses on failures drive up the effective assessment rate. For 1981 and 1982 the net assessment rate after credit was 0.076 and 0.074, respectively. This compares to an average of 0.036 for the preceding five-year period. Since insurance losses are eventually passed on to insured banks, safely run banks not only pay a higher risk-adjusted rate than precariously run banks but they must also absorb the costs when the risk-takers fail -- and they are failing more frequently.

<sup>2/</sup> For the purpose of this chapter, failure refers to any case where FDIC funds were required. Several cases were handled through open bank mergers with FDIC assistance. In a few cases the FDIC provided financial assistance directly to the troubled bank to prevent a failure.

<sup>3/</sup> A discussion of the literature on the potential benefits of accurate risk measurement is provided in Appendix A.

Risk-based premiums would also force bank managements to consider the impact of their decisions from the insurer's (or potential creditor's) standpoint. Insured depositors have no reason to be concerned about the safety of their funds and therefore provide no discipline regarding their use. Unfortunately, the problem goes even further. With the evolution of liability management, many larger banks have dramatically increased their reliance on the money markets for funding through such vehicles as large uninsured deposits. Access to these markets eased the funding problems of many banks, but increased reliance on volatile and rate sensitive liabilities also introduced new elements to funding risk. More importantly, though, the suppliers of these funds, who have the potential to provide some discipline, also appear somewhat indifferent to risk in larger banks because of the conviction that the FDIC or some other arm of the Federal government will intervene to prevent them from suffering any loss. The combination of deregulation, little market discipline, and a flat-rate insurance premium, may well cause the incidence of excessive risk-taking to reach an intolerable limit. The development of an insurance system that assesses and charges for risk, as informed creditors might, would help ensure this does not occur.

There are two other issues discussed more fully in other sections of this study that affect the need for risk-related premiums. First, adoption of the FDIC's proposal for risk-sharing by large depositors will reduce the need for risk-based premiums since large depositors will begin to take a more active role in disciplining banks. There would still be inequities depending upon how fully-insured funds are used, but uninsured depositors should help control the overall level of risk-taking. Second, the use of risk-related premiums will facilitate a recommended merger of the Federal deposit insurance funds. Thrifts are highly susceptible to interest rate changes while commercial banks are more likely to suffer from problems in the loan portfolio. To the extent one group perceives another to be much riskier, the resistance to a merger will increase. A premium structure that factors in the risk of each group should help reduce concerns about possible inequities with such a merger.

#### COSTS AND TRADEOFFS

While risk-related premiums are conceptually appealing, particularly in an environment of deregulation, there are costs and tradeoffs to consider. The supervisory costs necessary to apply risk measurements could be very substantial depending upon the comprehensiveness and precision desired. Some risks, such as "moral hazards," can be evaluated only through onsite examinations. Even if premiums were to be based solely on reported data, onsite verification of reported data will still be necessary.

In addition to increased supervisory costs, a risk-based system could entail an expensive appeals program. The larger the number of risk categories or types of risks measured or the more subjective risk measurements are, the more voluminous appeals could become. Procedures will have to be developed and resources will have to be allocated to process complaints in a consistent manner.

The cost of an incorrect risk evaluation also must be considered. No feasible system will always be right -- the risk will be overestimated in some banks and underestimated in others. Moreover, if disclosure of an FDIC risk-rating occurs, the cost of an error could be much greater than the premium differential. Such information would likely be given very high credibility by depositors.

Finally, it must be recognized that inaccurate risk premiums might also result in some unintended and perhaps undesirable industry behavior. Banks inclined to be risk-takers may seek higher risks in areas not covered by the rating scheme in order to offset higher insurance costs. Moreover, if the system misprices risk, the result could be a less than optimal allocation of bank resources. If premiums are too low, banks may engage in excessive risk-taking and this will limit the extent to which deregulation can proceed. If premium differentials are too high, the FDIC will be overcompensated for incremental risk-taking, and bankers will be improperly discouraged from taking risks. In other words, premiums could become implicit restrictions that obviate efforts to deregulate the banking industry.

#### GENERAL APPROACH

A less than "ideal" risk-premium system will entail certain costs, but it is the FDIC's view that they are outweighed by the potential benefits. However, these costs do argue for certain features: the system should rely as much as possible on observable characteristics; the measurement techniques should be kept as understandable as possible; and the limitations of the plan should be acknowledged and investors should be encouraged to perform their own analysis. Finally, the standards should be set to minimize the extent to which errors of overpricing risk occur.

It may be impossible to develop a comprehensive risk-based system based on failure experience. So few banks have failed that the actuarial base is very limited and much of it is no longer relevant due to changes in the banking industry and its environment. It is not essential that an FDIC-devised system have statistically proven empirical support, but, recognizing that banks have no viable alternatives for deposit insurance, it should at least embrace concepts that appear reasonable to most knowledgeable parties. Even this will take time. There is no experience to go on and while the literature abounds with discussions about the concept, there has been little analysis of how to quantify risk and even less on how such a system would be implemented.<sup>4/</sup>

#### FOCUS OF RISK EVALUATION

The underlying cause in most bank failures is poor management and the end result is usually exhaustion of capital -- but the means for getting there are different. The 135 failure and assistance cases occurring during the 12-year

<sup>4/</sup> The literature on risk measurement approaches is briefly reviewed in Appendix B.

period, 1971 through 1982, were reviewed to identify the major causes of failure.<sup>5/</sup> All failures of mutual savings banks were attributed to interest-rate risk, which results from maturities and repricing intervals mismatched between assets and liabilities. Most commercial bank failures resulted from a combination of factors. These factors could generally be grouped under credit losses, poor funds management, and fraud and embezzlement. In each case, the factors that played a major role in the bank's failure were identified.

The table below shows how frequently the different types of causes were noted under the column headed "Major." The column shows, for example, that heavy loan losses were noted in 77.4 percent of the cases and that serious liquidity problems were noted in 36.3 percent of the cases. Note that this column would total more than 100 percent reflecting that many banks fail for more than one reason. Because of this, an effort was made to determine the one cause in each case that seemed to be the most important. The frequency distribution using only this one cause for each bank is shown under the column headed "Primary."

TABLE 1  
CAUSES OF FAILURE  
COMMERCIAL BANK FAILURES 1971-1982  
Causes as a Percent of Number of Failures

<u>CAUSES OF FAILURE</u>	<u>1971-1982</u>		<u>1980-1982</u>		<u>1982</u>	
	<u>Major</u>	<u>Primary</u>	<u>Major</u>	<u>Primary</u>	<u>Major</u>	<u>Primary</u>
<u>Credit Quality Losses</u>						
Loans	77.4%	61.3%	82.7%	67.3%	76.5%	55.9%
Insider Loans	36.3%	14.5%	26.9%	9.6%	26.5%	14.7%
<u>Poor Funds Management</u>						
Interest Rate Risk	20.2%	4.8%	19.2%	5.8%	17.6%	8.8%
Liquidity	36.3%	2.4%	30.8%	1.9%	17.6%	2.9%
<u>Fraud and Embezzlement</u>						
Internal	13.7%	11.3%	15.4%	11.5%	17.6%	14.7%
External	7.3%	5.6%	5.8%	3.8%	5.9%	2.9%
Number of Cases (Including Assistance Cases)	124		52		34	

<sup>5/</sup> This includes 124 commercial banks and eleven mutual savings banks. The commercial banks include four assistance transactions. One bank that failed eleven years after receiving assistance was counted twice. Of the remaining commercial bank cases, only 31 were depositor payoffs and the rest were closed bank purchase and assumption transactions or open bank assisted merger transactions. There were no payoffs of mutual savings banks.



The table shows that loan losses account for most commercial bank failures. Significant losses on insider loans were frequently noted but, interestingly, they were not considered the primary reason for failure in very many cases. Interest-rate risk caused relatively few commercial bank failures but it has become more significant as a primary cause of failure. Liquidity problems were noted in many failure cases. These were situations where banks were unable to generate funds through normal operations or at reasonable costs. Except for a few unusual cases, however, liquidity problems only accelerated, not initiated, the demise of the bank. Usually they reflected mounting concerns by creditors over risk in the borrowing banks. Internal theft does not show up as a significant factor in very many failures, but such diagnosis can be difficult to make, particularly in cases involving losses on insider loans that may have been made under false pretenses. The most frequently noted type of external fraud involved the bank paying on uncollected funds -- usually in a check-kiting scheme. Here again, though, it could not be determined to what extent credit losses resulted from misrepresentations by customers.

Disregarding either national or local economic catastrophe, the major risks faced by a bank today can be summarized as follows: credit risks (potential losses from defaults on debt obligations); interest rate risks (potential deterioration of interest margins from adverse interest rate movements); liquidity risks (potential losses from untimely asset liquidations or abnormally-high interest costs incurred to meet funding requirements); and moral hazard risk (the potential for losses from theft or defalcation). No doubt there are other risks and more will surface as banks move toward new business ventures either directly or through affiliates. These will have to be factored into a risk-rating plan as they show evidence of increased significance. At the beginning, though, focusing on the known major causes of bank failure is appropriate to inaugurate a risk-based system.

#### AVAILABLE DATA SOURCES

While listing the major risks is not very difficult, measurement is an entirely different matter. There are not sufficient data for rigorous quantification of these risks at this time. The FDIC relies on two major sources of information for risk appraisal and each has its own strengths and weaknesses; bank prepared financial statements, known as Call Reports, and examination findings.

Call Reports include the Report of Condition containing balance sheet data and the Report of Income containing earnings data. These standardized forms are compiled by banks as of periodic reporting dates and then forwarded to the FDIC. The scope and reporting intervals depend upon the size of the bank but all banks file balance sheets each quarter and income reports at least semiannually. This frequency and standardization makes Call Reports particularly useful for assessing industry trends and making peer group comparisons to monitor the performance of individual banks. The major deficiency of these reports concerns the reliability and comprehensiveness of largely unaudited reported data. Certain types of data such as the quality of internal controls are not captured. Moreover, historical cost based accounting

does not always portray the current financial condition of a bank. Call Reports may obscure underlying inconsistencies in accounting practice; they also contain errors. These errors usually result from confusion or efforts to minimize preparation time, but sometimes they result from attempts to overstate financial positions. This last type of error would likely increase if premiums were based solely on Call Reports.

Recent steps have been taken to improve the scope and quality of Call data. The reports have been expanded to include valuable information about credit risk and interest rate sensitivity. Moreover, the FDIC has sponsored extensive training seminars to familiarize bankers with the new forms and increased emphasis has been given to examination review of the reasonableness of filed reports. While total reliance cannot be placed on Call Reports, they can be used to evaluate risk and to assign premiums.

The examination report is the most reliable source of information available about a bank's financial condition. It reflects firsthand knowledge of a bank and its competitive environment compiled by highly-skilled and unbiased examiners. It is the only means to evaluate nonreportable attributes such as the quality of management and internal controls. It provides an assessment of risks in assets and liabilities to a degree of accuracy that would probably be impossible to match with a reporting system -- even a substantially expanded one. The examination process has proved to be a very effective means of meshing quantitative and qualitative characteristics to produce a comprehensive assessment of a bank's overall condition. As evidence of this, it is noted that 75 percent of the commercial banks which failed over the last 12 years were rated worse than satisfactory by examiners some two years or more before failure. By comparison, the yearly average for all insured banks rated less than satisfactory during this period was only about ten to 15 percent. Furthermore, the examination process was at least partly responsible for encouraging many of those banks to return to satisfactory risk-levels.

#### CAMEL FOR RISK PREMIUMS

In view of the effectiveness and reliability of the examination process, it is intuitively appealing to rely on this source for premium determination purposes. Perhaps the simplest approach would be to base premiums on the Uniform Interagency Bank Rating System. Under this system (known as CAMEL) a bank receives a rating of 1 (good) to 5 (bad) for each of five areas -- capital, assets, management, earnings and liquidity -- as well as a composite rating reflecting the examiner's overall assessment. The FDIC has rejected the idea of basing premiums on CAMEL ratings for several reasons:

- o The examination process requires the expensive allocation of skilled human resources which places practical limitations on how often and when banks can be examined. CAMEL ratings are assigned during onsite examinations and may not reflect current conditions, since the interval between comprehensive examinations could be as long as three years. Moreover, considerable pressure would be exerted by banks with low ratings for reevaluations before the premium setting date.

- o If premiums were based on CAMEL ratings, it might cause a deterioration in the generally open rapport between examiners and bank managements. Most bankers are willing to discuss their problems at an early stage with examiners but there are few, if any, monetary costs involved. They might be less open about potential problems in order to minimize insurance costs. If bankers became less free with their information, the examination process would have to be expanded significantly in order to remain effective. The costs of doing this would be very substantial.
  
- o The CAMEL rating is heavily weighted by subjective factors, but providing examiners this important flexibility means allowing a certain amount of inconsistencies. Moreover, some differences in examination philosophies exist among the regulatory agencies. These differences would probably open up the CAMEL process to considerable controversy. Banks undoubtedly will attempt to compare their scores with other banks in terms of relative earnings and capital ratios. Challenges to ratings will be difficult to defend and the FDIC might eventually be forced to adopt rigid guidelines for assigning CAMEL ratings. The resulting loss of examiner discretion might be detrimental to the reliability of the rating.

Overall the FDIC believes that the use of subjective data gathered during the examination process should be minimized for risk-rating purposes and Call data should be relied on to the extent possible. Both sources should be used initially, and as experience is gained the content as well as the weight given to the information will require modification.

#### PROPOSED APPROACH

Given the limitations of available data, the FDIC believes the best approach is to first design a narrow scope program that focuses on those characteristics closely linked to failure risk. A basic program could serve the objectives of encouraging positive behavior and reducing some of the obvious inequities in the current system. Moreover, it would represent a first step which would provide experience and initiative for a more comprehensive system over time.

The FDIC proposes a system of risk-related premiums that initially would have only three risk categories: normal, high and very high -- with the vast majority of banks falling into the normal category. In other words, the program would focus primarily on banks that appear to be risk outliers.

The program will consider only credit risks and interest rate risks by using the approach discussed below for relating these risks to capital. For reasons discussed later, moral hazard and liquidity risks cannot be reasonably measured at this time, and thus will not be considered in assigning risk classes.

Until more experience is gained, the FDIC believes the premium differential should be kept fairly small to avoid overpricing risk. The maximum risk

premium would probably be limited to the amount of the assessment credit that insured banks would normally receive from the FDIC. Usually, this represents 60 percent of the amount left over from gross assessments after deduction of FDIC operating expenses and insurance losses. Insurance losses have been large the last two years resulting in very small credits, but even in more typical years credit would amount to only about .04 percent of an average bank's assets or less than four percent of operating income before taxes. The loss of the credit should not be an unduly severe penalty on a bank but would provide some incentive for reducing risk. Using the assessment credit minimizes the potential damage on marginal institutions. When industry losses are large, safely run banks step up their contribution to the fund. On the other hand, the continuation of large insurance losses could reduce the size of the credit to where it was viewed with considerable indifference by banks. In order to ensure that a risk-based system does not become meaningless, the FDIC might be given some authority to vary the base assessment rate as well as the assessment credit to reflect failure risks.

While the details of risk measurement are explained in more detail below, the premium differential and risk classification would be along the following lines. Banks assigned to the very high risk class would be those operating with dangerously low capital ratios or those viewed as having both high credit risk and high interest rate risk. Banks in this risk class will forfeit their entire assessment credit. Banks assigned to the high risk class would be those having either high interest rate risk or high credit risk. These banks would forfeit half their assessment credit. All other banks would be in the normal risk class and would receive their entire credit.

#### RISK MEASUREMENTS

In the proposed approach, a bank's capital position would be the central factor in risk classification. The following sections describe the role of capital and the anticipated methods for relating measures of credit risks and interest rate risk. In addition, moral hazards and liquidity risks, which are not covered by the proposed plan, are discussed in more detail.

##### Capital

Capital is very important to the FDIC because it provides a protective cushion that reduces the potential exposure to the insurance fund. Capital accounts represent a form of self insurance against failure and as such should be considered in any plan to relate insurance premiums to risk.

Few subjects are more controversial than how capital should be evaluated. The FDIC defines capital essentially as recorded tangible equity and valuation reserves less examination-determined losses. Admittedly other factors are important when measuring capital such as risk-levels, current values of assets and liabilities, and the existence of contingencies or other so called "off balance sheet" items. In some cases, book capital accounts may have no significant relationship to the potential exposure to the fund. Still, the exhaustion of book capital is usually the event that triggers failure. The FDIC is

evaluating alternative capital measures but prefers to use the current capital definition until there is agreement upon a better one.

The FDIC's stated position on capital is that a well-run and well-diversified bank should maintain capital accounts equal to at least five percent of total assets. It is recognized, however, that this view is not universally held and that a number of large banks are operating at capital to asset ratios less than five percent. There is a level, though, below which risk of insolvency (i.e., failure) becomes pronounced. This level is not the same for all banks, but to determine it would require very precise means for comprehensively measuring all risks. This is simply not possible. Nevertheless, because the proposed plan would attempt to measure risks relative to capital and because there is no clear consensus about capital adequacy, the FDIC is considering an initial benchmark capital ratio of three percent for risk premium purposes only. Any bank falling below this level would be viewed as operating with capital so dangerously low that it automatically will be placed in the highest risk category. It should be understood, however, that a threshold of five percent would be more appropriate and that the FDIC would probably raise it to that level over the next few years.

Banks with capital ratios greater than the benchmark-level will be accorded risk-ratings by relating potential risk exposure to their capital accounts. In other words, the smaller the capital accounts, the fewer risks a bank will be able to take without an increase in premiums.

#### Credit Risks

Given that loans comprise a major portion of the asset structure of most commercial banks and present the greatest credit risk, it is not surprising that excessive loan losses, predominantly on business loans, have caused most commercial bank failures. Excessive loan losses usually reflect poor credit judgment and generally unsound lending and collection practices. In most failure cases, loan losses were attributed to self dealing, speculative lending and the failure to diversify credit risks.

Self-dealing usually manifested itself in insider loans which were discussed earlier. It is worth reemphasizing that most loans to insiders are of very high quality. Nevertheless, they do represent a potential conflict of interest that could inhibit the exercise of prudent credit practices. Speculative lending refers to the making of loans with known high risks with the hope of increasing overall loan yields. Examples of this activity noted in a number of failure cases included loans to speculative real estate ventures or loans outside the bank's normal trade area. Credit diversification refers to the extent the loan portfolio is composed of loans whose performance is influenced by common factors. Often, banks that failed suffered loan losses attributable to a particular group of borrowers or type of business.

Call Reports can be used to monitor credit risks. The reports provide data about a bank's loan loss history, the bank's estimate of the allocation needed

to provide for expected losses, and the volume of delinquent and restructured loans. There are limitations on the reliability of Call-based measurements. Banks have different policies regarding when to account for a bad loan -- and banks will undoubtedly be tempted to delay loss recognition in order to avoid higher risk premiums. Furthermore, past loan losses do not necessarily reflect the current situation. Moreover, the fact that a loan is delinquent does not mean it has higher than normal risk -- there might be mitigating factors such as the existence of collateral or guarantors; conversely, the fact that a loan is not past due does not mean it is sound.

The examination process provides the most comprehensive review of credit quality because examiners skilled in credit analysis can consider nonreportable factors. However, using examiner classifications to relate credit risks to insurance premiums does present problems that must be addressed. As discussed earlier, communications between examiners and bankers could deteriorate to the detriment of the examination process. Further, inconsistencies in examination intervals and examiner judgments could discredit the entire premium system. One way to reduce inconsistencies would be for the FDIC to conduct at least yearly loan examinations of any insured institution that has or appears to be approaching unacceptable credit risk-levels. The use of FDIC examiners on all loan reviews either independently or in conjunction with other bank regulators would help ensure uniformity. Another step discussed later would be to establish a centralized system for evaluating complaints and appeals from bankers concerning classification decisions. These actions will not eliminate problems with using examination findings but should help to reduce concerns about potential inequities.

At this point, the FDIC would propose using examiner asset classifications both in the determination of capital by subtracting estimated losses and in the overall determination of credit risk. Credit risk would be measured by the dollar volume of assets classified Substandard and one-half of those classified Doubtful (it is presumed that the remaining portion of the doubtful loans and all loss loans will be charged off). When the volume of such assets exceeds 70 percent of capital, credit risk will be considered unacceptably high. Admittedly, the use of 70 percent is judgmental and may change if ongoing research at the FDIC indicates another level would be more appropriate. Regardless, any bank with low quality assets exceeding 70 percent of its adjusted capital would be much more exposed to credit risk than its peers.

While examiner loan evaluations provide the best available means for assessing credit risk, the FDIC is still studying the feasibility of using other information. Analyses conducted so far of banks' reported loan loss experience and examination compiled loan delinquency information indicate that there is a significant correlation with examiner assessments of loan risk. However, efforts to use these data to predict examiner classifications have not yet produced results with an acceptable level of error. In other words, it appears that relying on past loss experience or total loan delinquencies would significantly overstate problems in many banks and understate them in others. Ongoing research, however, will probably yield better results. For example,

the new Call Reports will provide more consistent information on loan delinquencies and restructured debt than what is currently compiled on examination files. If loan problems can be predicted with reasonable accuracy, the FDIC would consider relying on Call Reports to assess loan risk. At a minimum, the information would be used to monitor for possible inconsistencies in examination asset classifications.

The FDIC is also evaluating the desirability of collecting new types of objective information to assess credit risks. One area where meaningful information is particularly scarce is loan diversification. A bank with a well-diversified loan portfolio is insulated from one source of serious problems. Unfortunately, credit diversification, as important as it is, is difficult to evaluate. The examination process compiles information on concentrations of credit but the definition varies on what constitutes a concentration. Most of the banks that failed due to loan problems were not well diversified, yet relatively few were cited for credit concentrations. The FDIC is considering the feasibility of collecting data on loan balances by industry or subindustry grouping and on the size distribution of loan portfolios. Information on out-of-territory loans may also be valuable. Losses on loans outside the bank's trade area were noted in a significant number of cases. These types of data are already reviewed during the examination process but they are not compiled in a format useful for risk prediction models. One solution would be to include such information on Call Reports, although the reporting burden could be substantial. Another approach would be to collect the information in a consistent format through full or limited scope examinations. This would pose some problems with examination frequencies but would still represent a substantial improvement.

#### Interest-Rate Risks

Interest-rate risks originate from situations where a bank's assets are more or less sensitive than its liabilities to changes in interest rates. Such imbalances, commonly referred to as interest rate gaps, mean that unanticipated interest rate movements will result in unexpected gains or losses. These risks have become increasingly important in recent years due to high and volatile interest rates and the increased reliance by banks on interest rate sensitive funding sources. Benefits of large amounts of fixed-rate low cost deposits and controlled competition are quickly disappearing. The problems that serious and long-term interest rate mismatches have caused the thrift industry are well known.

Fortunately, many of the potential problems of subjectivity and inconsistency that impede or prohibit measurement of other types of risk are not as severe for interest rate risks. There are a number of ways to measure rate risks. Perhaps the most common methods measure the potential impact of short-term interest rate changes on earnings. These methods focus on short-term gaps such as the asset/liability mismatch in maturities or repricing intervals occurring within a three-month or one-year time frame.

When looking at failure risk, both the magnitude and duration of interest-rate gaps must be considered. It is important to recognize that sustained rises in interest rates can affect earnings for years to come. Some institutions may be taking risks so major that a substantial adverse movement in interest rates would quickly devastate their earnings and threaten their viability. In other institutions, however, it may take several years before the full extent of the damage is realized. Therefore, the FDIC intends to measure interest-rate risk by looking at several time horizons.

The FDIC is now collecting information on interest-rate mismatches in the new Call Reports. These reports show the volumes of most interest sensitive assets and liabilities maturing (or subject to repricing) over a three-, six- and 12-month and five-year period. The FDIC is considering an approach which would estimate the relative impact on capital of a 250 basis point change in interest rates over each of these intervals. This would be done by computing the present value of the cumulative change in earnings over each time horizon and establishing for each a ratio to capital at which risk would be considered unacceptably high. Currently, the following levels are being considered for high risk determination:

<u>Time Horizon</u>	<u>Present Value Impact to Capital (%)</u>
1 year or less	20% or More
5 years	50% or More

Admittedly, these levels are judgmental and research is ongoing to see if others might be more appropriate. However, based on estimates constructed using old Call Reports, there are relatively few commercial banks taking interest rate risks of such magnitudes. Any institution exceeding these parameters would clearly be a risk outlier.

It does appear that a large percentage of mutual savings banks would fail the five-year standard if applied now, and undoubtedly many S&Ls would do the same. This may not be the case by the time a risk program is implemented. Call Reports of mutual savings banks (and other thrifts) need to be revised to collect better data on rate sensitivity. Moreover, time will be needed to evaluate the quality of reported data. In all likelihood, the error rate for the first few reports will be very high; it will take time for banks to become comfortable with the new formats. Probably, it will take two years before the risk measurements can be put in place. By that time, many thrifts should have been able to restructure assets and reduce rate risks. Regardless, risk measurement should be consistent for all insured institutions.

While the new Call Reports provide much improved detail about interest rate sensitivities, risk measurement will still require making a number of major assumptions. First, the reports show only aggregate data for years two through five so the assumption will probably be made that equal amounts mature or are repriced each of those years. Second, the average life of certain



deposits, such as passbook savings accounts, will have to be estimated. Currently, a 20 percent yearly runoff is being considered. Third, the discount rate must be approximated to compute the present value of estimated changes in future earnings. Probably a rate tied to three to five-year Treasury obligations will be used. Making assumptions along these lines will undoubtedly distort risk-levels for some institutions. Moreover, even if the potential risk is measured correctly, some banks may be using vehicles such as interest rate futures to hedge or protect themselves against adverse movements. Similarly, some, including those that appear to have no significant rate risk, may be using such vehicles to speculate on interest rates movements. Another problem is that some institutions will take high risks but move to minimize rate risks for reporting dates only.

While relying on Call Reports to measure rate risks will require making certain assumptions that may result in some inaccuracies, they should provide a reasonable means of identifying most high risk takers. If it appears that using the new Call Reports results in an unacceptable error rate, it may be necessary to expand the data collected. Realistically, though, there will always be a need for an onsite examination to control for reporting errors and abuses, and there will need to be an appeals program to hear complaints about inaccurate measurements.

#### Moral Hazards

Moral hazards include both external and internal hazards. External hazards concern the possibility of dishonest acts committed against a bank and its employees by the general public. Robbery, burglary and forgery are the most common causes for these losses and banks generally control them by maintaining security devices, keeping exposed cash and negotiable securities at a minimum, and maintaining adequate insurance coverage. Internal hazard, which concerns the risk of losses from embezzlements or defalcations and other unethical practices, such as using imprudent standards for insider loans, generally poses a far greater threat to a bank's solvency than external hazards. Protection requires clear records and effective internal controls supplemented by fidelity coverage.

It is virtually impossible to evaluate moral hazards without visiting a bank and then using a fair amount of subjectivity. Internal controls and adherence to them must be evaluated onsite. Information could be collected on the volume of insider loans to measure the potential exposure arising from conflicts of interest. Evaluating the risk requires reviewing the credit quality of the loans because often such loans are among the best in a bank.

Risk premiums, in and of themselves, are not likely to discourage dishonest intentions; however, they could be used to induce banks to maintain an effective program of internal controls. Premiums might be tied to the quality of risk controls or to the credit quality of insider loans, but whether or not this could be done fairly and consistently is not clear and will require further study. The FDIC's view at this time is that, while conceptually desirable, relating moral hazards to risk premiums is not feasible.

### Liquidity

Liquidity is an elusive concept even though poor liquidity was noted in a significant number of failure cases. Interestingly, liquidity problems have been noted with decreasing frequency -- for example, such problems were noted in about 40 percent of the cases occurring during 1971 through 1979 but only 31 percent of those occurring over the last three years. This probably reflects the increased availability of funding from other than traditional deposit sources, the phasing out of Regulation Q, and perhaps increased stability of the deposit base through increases in deposit insurance limits. Banks may not need to maintain the same levels of liquidity they did in prior years, but reliance on large and potentially volatile liabilities increases the need to consider liquidity in asset management. Most of the failure cases where liquidity problems were noted involved a high reliance on borrowings or volatile deposits coupled with a deterioration in asset quality.

There are a number of important variables to consider when evaluating liquidity; the credit quality and marketability of assets, the dependence on potentially volatile deposits to fund loans, and the strength of earnings. There has been some success in relating these variables to examiners' assessments of liquidity, but the feasibility of combining these factors for premium determination purposes is still uncertain.

### PREMIUM DETERMINATION DATES

Risk classification would be determined yearly for all banks as of December 31. The bases would be the year-end Call Reports and the most recent examination report. Call Reports will be used for capital and interest risk computations and examination reports for credit risk and adjustments to capital. To ensure consistency each bank would have the option of submitting a year-end status report on the total amounts of Substandard, Doubtful or Loss classifications that have either been charged off or collected since the last examination. These reports will be used to compute year-end risk ratings and will be verified at subsequent examinations. This should not impose a significant burden on the banking industry since only those banks with a high risk ratings would need to file and only then when it would move them to a lower risk category.

There may be some question about the fairness of using examination data because some banks are examined more frequently than others. It is true that riskier banks are examined more frequently because of the greater need to monitor risk. On the other hand, these banks will have more opportunities to show improvement and reduce their premiums. The FDIC believes all banks in the high risk classes should be examined at least yearly and that limited scope examinations should be conducted annually to monitor risks in banks that appear to be approaching high risk thresholds.

### APPEALS PROCESS

It is likely that many banks receiving a high risk designation will seek to appeal. The FDIC believes they should have that right because both Call and examination data have their limitations; assumptions made to compute interest-rate risk or examiner error may result in significantly overstated risks in some banks.

Appeals might be processed in the following manner. Requests for reclassification would go first to the regional offices of the appropriate banking agency. However, to ensure consistency, the final decision would be made at the FDIC Washington Office. Regions would be given the authority to reduce risk-ratings in situations where review indicates examiner error.

SIZE AND RISK

A sensitive issue in any risk-rating plan is whether the same standards should apply to all banks regardless of size. This becomes very controversial if, as the FDIC believes it should, the plan factors in capital ratios. Large banks typically are much more leveraged than small banks, which means they have a proportionally smaller cushion to absorb losses. Still, even though their capital ratios are higher, it is often argued that small banks have comparatively more failure risk. Smaller banks are more likely to be controlled by a small number of owners who have more freedom (i.e., less accountability) to engage in self-serving practices. Small banks may be less able to implement a strong system of internal controls and thus may be more vulnerable to fraud and embezzlement. They also may be less able to diversify credit risk since their customer base is usually smaller and more homogenous, and more loans are likely to be large relative to capital. Finally, the absolute dollar amount needed to cause failure is relatively small and easier to lose for whatever reason.

The table below shows the distribution of commercial bank failure cases by size deciles over the last 12 years. The size deciles refer to the commercial banking industry for commercial bank failures.

TABLE 2  
 SIZE OF FAILED COMMERCIAL BANKS 1971-1982  
 Size Decile at Time of Failure

Size Decile	Commercial Banks*	
	Number	Percent
1 (Smallest)	29	23.4%
2	18	14.5%
3	13	10.5%
4	11	8.9%
5	10	8.1%
6	9	7.3%
7	6	4.8%
8	5	4.0%
9	2	1.6%
10 (Largest)	21	16.9%
	<u>124</u>	<u>100.0%</u>

\*Including Assistance Cases.

In order to allow for the effects of growth over a long period, the relative size of failures over the last 12 years was evaluated by determining the size percentile in which each bank was when it failed. Banks that were among the smallest ten percent in the industry were allocated to the first decile; those falling in the tenth to the twentieth percentiles were put in the second decile and so on up to the tenth decile for the largest banks.

There does appear to be a relationship between size and failure risk. The number of failures clearly decreases moving from the first to the ninth percentile. However, the large number of failures (including assistance cases) in the tenth decile appears to contradict arguments that larger banks are inherently safer. Commercial banks in the tenth decile had assets greater than \$100 million in terms of 1982 dollars. Five of these were within the two highest percentiles when they failed, with inflation adjusted assets over \$1 billion each. The two largest failures had assets of over \$5 billion in 1982 dollars. All of the banks in the tenth decile were large enough to have diversified credit risks and to have adopted strong internal controls and policies.

The reasons for failure are compared among different size deciles in Table 3. Loan losses were the most important factor for all size groups although the frequency with which they cause failure appears to decline as the size groups increase. Again, the notable exception to this trend is the tenth decile. The relatively high incidence rate of credit problems in the large banks appears to mean that even if large banks are more able to diversify, some do not. The incidence of insider loan losses does not appear to follow any particular pattern. Larger banks are also susceptible to losses arising out of insider abuse and conflicts of interest. There does appear to be some merit to the argument that very large banks can better handle risks of thefts or embezzlements. Below the tenth decile there is no obvious pattern to these types of "moral hazards."

Interestingly, liquidity and interest rate sensitivity problems appear more common in large bank failures and suggest that the competitiveness of large bank markets may make such banks more susceptible to funds-management risks. Larger banks rely more heavily on noncore deposits than smaller banks. When things start to go bad (i.e., interest rates turn up sharply or assets turn sour) this source of funds is usually the first to dry up. Presumably this negative reaction by uninsured depositors and creditors is a danger for all banks, even the very largest. However, no bank larger than \$10 billion has ever failed or needed assistance, and it may be that in very large banks this risk is less severe. This observation relates to the market discipline issue addressed elsewhere in the insurance study.

There may be other factors to explain the apparent relationship between size and failure risk. Almost half of the failures were new banks, i.e., established less than five years, or banks taken over by new management within the five years preceding failure. By comparison, the average number of banks

TABLE 3

CAUSES OF FAILURE BY SIZE  
COMMERCIAL BANK FAILURES 1971-1982  
Size Decile at Time of Failure

Cause	SIZE DECILE											
	I(Small)		2-3		4-5		6-7		8-9		10(Large)	
	Major	Primary	Major	Primary	Major	Primary	Major	Primary	Major	Primary	Major	Primary
Number of Loans	83%	66%	77%	65%	81%	62%	60%	47%	57%	43%	86%	66%
	31	10	26	10	38	19	67	27	43	29	33	10
Sensitivity	14	0	10	3	24	9	13	0	14	0	48	14
Ratio	35	0	36	3	24	0	33	0	29	0	57	10
Number of Personal	17	17	19	13	5	5	20	13	29	28	0	0
Number of Personal	7	7	10	6	5	5	13	13	14	0	0	0
Number of	100	100	100	100	100	100	100.0	100.0	100	100	100	100
Number of Cases		29		31		21		15		7		21
(Including Assistance Cases)												

Causes are shown as a percent of the number of failures for each size group. Major refers to all causes noted in each failure. Since most banks fail for more than one reason, the total of the "Major" column exceeds 100 percent. Primary refers to the one cause in each case that seemed most important.

meeting these criteria amounted to only about one-third of all insured banks. In effect, a little more than one-third of the industry accounts for almost half the bank failures. This disproportionately high ratio suggests that these banks have a significantly higher likelihood of failing than other banks.<sup>7/</sup>

The majority of the failures that involved new banks or new management were small commercial banks. Table 4 shows the number of such cases for the failures occurring over the last 12 years broken down by size decile.

TABLE 4  
 SIZE OF COMMERCIAL BANK FAILURES 1971-1982  
 Size Decile at Time of Failure

Size Decile	New Bank*		New Ownership*		All Other		All Banks*	
	No.	%	No.	%	No.	%	No.	%
1 (Smallest)	6	40	15	37	8	12	29	23
2	3	20	6	15	9	13	18	15
3	1	7	2	5	10	14	13	10
4	1	7	3	8	7	10	11	9
5	2	13	2	5	6	9	10	8
6	-	-	3	8	6	9	9	7
7	-	-	3	8	3	4	6	5
8	1	7	2	5	2	3	5	4
9	-	-	1	2	1	4	2	2
10 (Largest)	<u>1</u>	<u>7</u>	<u>3</u>	<u>8</u>	<u>17</u>	<u>25</u>	<u>21</u>	<u>17</u>
Total	15	100	40	100	69	100	124	100

\*Including Assistance Cases.

Note: Percent totals may not add due to rounding.

<sup>7/</sup> Approximately 12 percent of the failures were new banks compared to an industry yearly average of 8 percent; approximately 37 percent of the failures experienced control changes compared to an industry estimate of 28 percent which was based on available figures for nonmember banks. Thus it appears 36 percent (8 percent + 28 percent) of the industry accounted for 49 percent (12 percent + 37 percent) of the failures and the remaining 64 percent of the industry accounted for 51 percent. This suggests the failure incidence rate is 71 percent higher for new or control change banks ((49/36) - (51/64)).

The table shows that the apparent relationship between size and failure risk diminishes significantly when considering only the size distribution for all failures other than new banks or banks with new ownership.<sup>8/</sup> On balance, it is not clear that smaller banks with established track records are significantly riskier than larger banks, and relating premiums to the size of a bank does not seem appropriate. Rather than use size as a proxy for risk, it is preferable to focus directly on the risk source. However, there does appear to be merit to using more conservative risk standards for newly-established banks and possibly ones recently taken over by managements without established track records. One problem, though, is to establish standards that do not pose undesirable entry barriers to the industry. This matter will require further study.

#### CAMEL AND SUPERVISORY COSTS

CAMEL ratings, for reasons discussed previously, are not considered appropriate for risk premium determination. Nevertheless, they clearly influence the level of supervisory effort allocated to an individual bank. Banks with ratings worse than 2 usually require more detailed and more frequent examinations. Moreover, other costs are incurred relating to closer offsite review or costs in preparing legal documents. Supervisory administrative costs are borne by all banks, but the FDIC believes that the additional costs incurred when a bank receives a high risk-rating should be borne by that bank. The FDIC recommends that it be allowed to charge any banks with a composite CAMEL rating of 3 or worse for these additional supervisory costs. This would not only serve the interest of fairness by reducing the cost to well run banks but would most certainly provide an incentive for others to improve.

<sup>8/</sup> It is not known, however, to what extent failure can be attributed to new ownership. In some cases, banks already in distress were purchased by investors hopeful of salvaging them.

CHAPTER III

MARKET DISCIPLINE AND THE FEDERAL DEPOSIT INSURANCE SYSTEM

	Page
Executive Summary . . . . .	III-1
Introduction . . . . .	III-4
Risk Sharing and Insurance Protection . . . . .	III-4
Modified Payoff . . . . .	III-4
Coinsurance . . . . .	III-6
Capital Standards . . . . .	III-7
Depositor Preference . . . . .	III-9
Administrative and Operational Considerations . . . . .	III-10



## CHAPTER III

### MARKET DISCIPLINE AND THE FEDERAL DEPOSIT INSURANCE SYSTEM

#### EXECUTIVE SUMMARY

The present level of insurance coverage and the manner in which most bank failures are handled have created a situation where most banks' exposure to market discipline is greatly diminished. Consequently, the FDIC believes risk-taking by banks is not sufficiently restrained. Several alternatives are suggested to significantly improve market discipline.

Among those who have followed FDIC behavior in recent years there has been a general perception that the FDIC would not pay off a large bank -- at least not one with assets of several billion dollars. While the FDIC has used a "cost test" to determine whether to use a purchase and assumption ("P&A") or a payout, close decisions involving larger banks have invariably resulted in the choice of the former because they are easier to implement (operationally), are less disruptive and are less likely to threaten the survival of other banks.

The widespread use of the P&A approach has clearly resulted in a number of positive public benefits; however, some less desirable consequences have evolved. In practice, the FDIC has effectively provided large depositors in large banks with a much greater degree of insurance protection against loss than has been provided to large depositors in relatively small banks. Even focusing only upon small banks, the FDIC's choice between assisted deposit assumption and payoff can result in uncertainty and inequity for large depositors. In the case of a P&A, the large depositor suffers no loss or disruption; in a payoff, the losses can be quite large and potentially damaging. This "gamble" on the choice of supervisory approach and the significant disparity of outcome is of concern.

As the use of assisted deposit assumptions has become more common and increased numbers of depositors and investors continue to be shielded from losses in large banking organizations, the public's perception of the relative safety of funds appears to have become altered. Many believe that no large American bank will be paid off even if it were allowed to fail, and have acted accordingly. In addition to driving large depositors from smaller to larger banks, this growing perception of almost absolute safety of funds in large institutions is having the effect of removing the consideration of bank risk from business decisions. As funds placement becomes a more yield-driven choice and one which is less impacted by bank risk evaluation, there is a resultant erosion of the normal forces of market discipline.

The FDIC has not been in a position to pay off a very large bank in a relatively short period of time. The sheer mechanics of balancing a large number of accounts, handling offsets, and determining precise insurance coverage would probably take one to two months for a multibillion dollar bank. Some of the problems could be lessened by keeping bank offices open to pay off insured deposits by setting up a Deposit Insurance National Bank. But there are other, potentially more serious, problems.

The traditional manner of paying off a large bank requires a substantial cash outlay by the FDIC. Thus, a single bank failure could tie up a large share of the assets of the deposit insurance fund and materially undermine confidence in the FDIC. A more serious consequence arises because a payoff would tie up a substantial volume of financial claims and, very likely, there would be severe repercussions in financial markets. Large depositors and other general creditors would have to wait for a long time, probably several years, before they received a substantial share of their funds even though their ultimate dollar loss might be small.

If it is true that the FDIC will not pay off a large bank, then uninsured depositors and other general creditors are not at risk if they confine their "exposure" to large banks. Many uninsured depositors are not particularly familiar with FDIC procedures and have little understanding of their potential exposure (that is borne out from interviews with large depositors, including those who had potential exposure in banks that were closed). However, many bank analysts and financial advisors are sufficiently familiar with FDIC history and attitudes to conclude that there is practically no general creditor risk in large banks. Assuming this is reflected in depositor behavior, the likely impact on banking will be that depositors with large amounts at risk are likely to favor large banks. Large banks, moreover, are apt to have an edge in competing for certificates of deposit ("CDs") in national markets even where moderate-sized (though not fully-insured) deposits are involved because they generally will be able to buy funds cheaper than smaller banks.

Large banks are not the only beneficiaries of the present insurance system and the manner in which bank failures are handled. In the case of most smaller banks, a very large percentage of deposits is fully-insured. Most retail deposits are in accounts of less than \$100,000, and by the use of joint accounts and those held in different capacities, that figure can expand several times. Business depositors frequently have outstanding loan balances that can be off-set against deposits not covered by insurance in the event of a payoff so that they have little actual exposure. Recently, brokers have provided a source of funding for banks whereby larger time accounts are participated to a large number of banks in \$100,000 lots to provide full insurance for CD customers desiring to invest up to several million dollars. This provides the smaller bank with access to regional or national deposit markets for the price of a moderate commission. The investor receives a higher rate and the spread between CD rates at large and small institutions is narrowed.

As a result of these phenomena, few depositors are exposed to any risk and have reason to be concerned about the financial condition of their banks. When banks fail, stockholders and, in some instances, subordinated creditors lose their investment. However, losses to depositors have been infrequent and relatively small. Because most bank funding derives from sources that are not exposed to loss in the event of failure, banks may be insulated from the effects of increased risk. Their behavior is not constrained significantly by the behavior of their principal creditors. This is in contrast with the risk-restraining role that creditors (including banks) exert upon other private enterprises.

The absence of creditor restraint has probably existed within the banking system for quite some time. Recently, however, its importance has been increasing for several reasons. Bank leverage, particularly at large institutions, has been increasing for years. Interest ceilings on deposits are being dismantled. Banking organizations are expanding into new activities, in response to inroads by nonbank competitors, and into new locations. These forces have all contributed to a more risk-intensive, less-constrained environment which is likely to be less forgiving of faulty financial and credit judgments.

The economic environment has also presented difficulties for banks. Interest rates have fluctuated substantially causing extreme problems for some banks and thrifts and their customers. The severity of the recent U.S. recession has also had a major impact on loan losses, increasing the number of problem banks and bank failures. Some of these factors and others have contributed to substantial U.S. bank exposure in their overseas lending. Thus, while the absence of significant depositor restraint on bank behavior may not be a new phenomenon, its importance appears to be much greater today than during any time in the past.

There are several possible ways in which the absence of sufficient market restraint on bank risk might be successfully addressed. First, a system of risk-related insurance premiums could be adopted, as recommended in Chapter II, so as to appropriately reflect and compensate for the level of risk exposure in a particular institution. However, while the FDIC favors a risk-related premium system, it does not believe that risk can be measured precisely enough to set insurance premiums to entirely compensate for the level of risk exposure in a particular institution.

Thus, the FDIC recommends adoption of procedures that would result in reduction in the de facto level of insurance protection for "uninsured" depositors and general creditors. By introducing an element of loss-sharing, large creditors and investors would be more risk-sensitive and more selective in their choice of banks; therefore, market discipline could be increased significantly. In addition, or perhaps alternately, it may be appropriate to look increasingly to bank stockholders and subordinated noteholders to supply this discipline through a larger "capital" cushion composed of equity and subordinated debt. This chapter focuses upon these issues and other related topics.

## INTRODUCTION

Federal deposit insurance has worked well to limit the secondary effects of bank failures and to increase the public's confidence in the banking system. Insured depositors have not had to concern themselves with the condition or safety of their depository institutions. However, because of the manner in which the FDIC has handled most bank failures, most uninsured depositors have not had to concern themselves with the condition of their bank either.

During the past 20 years, the majority of bank failures and practically all larger bank failures have been handled through purchase and assumption transactions ("P&A"). In such transactions, all deposits and other nonsubordinated liabilities of the failed bank are assumed by another (existing or new) institution. As a result, no general creditor incurs any loss despite the closing of a bank. On a few occasions the FDIC has provided direct financial assistance to open banks that would otherwise have failed and has provided direct assistance to facilitate open-bank mergers of failing savings banks. These transactions, like P&As, make all depositors "whole."

By contrast, in a payout the FDIC settles only insured depositor claims up to the statutory limit. The assets of the failed bank are transferred to a receiver, and the depositors who had in excess of \$100,000 have a claim on the receivership for the uninsured portion of their deposit. They share pro rata on receivership recoveries with the FDIC (standing in place of insured depositors) and other general creditors of the failed bank. In most payouts uninsured depositors incur some loss, particularly when their foregone interest is factored into the calculation. A majority of payouts have involved situations where, because of restrictions on bank expansion or other factors, there were no interested bidders or where there was fraud and uncertainty about unbooked liabilities or other contingencies that made it impossible to make reasonable estimates of the costs involved.<sup>1/</sup>

## RISK-SHARING AND INSURANCE PROTECTION

Modified Payoff

The main problem with a bank payoff, especially in the case of a large institution, is that a potentially large volume of assets and uninsured creditor claims can be frozen in bankruptcy proceedings for a long period of time. There is a means available whereby a substantial volume of funds can be made available to bank depositors and creditors in a short period of time, while exposing uninsured depositors and senior creditors to some risk of loss. This

<sup>1/</sup> Prior to the failure of Penn Square Bank in 1982, the banks paid off by the FDIC since 1960 had average deposits of less than \$8 million, with the largest payout being Sharpstown State Bank (about \$60 million) where there were large potential claims related to lawsuits over securities violations.

approach would not require enabling legislation and would entail the increased use of the bank payoff option, coupled with many of the advantages of a P&A transaction.

Upon a bank's closing and the establishment of a receivership, the FDIC (in its corporate capacity as insurer) could take two actions. First, insured-depositor claims would be satisfied as rapidly as possible as is the current payoff practice. Second, an "advance" of additional funds to all remaining valid claimants would be made, equivalent to the FDIC's estimate of the total value of bank assets to be recovered in liquidation.

It is envisioned that the insured-deposit settlement and the additional "advance" of other funds could generally be facilitated by transfer to an operating institution (partial assumption of liabilities) or by transfer to a newly-chartered interim bank. This would serve to lessen the public disruption by making funds readily available and should preserve some of the "goodwill" value of the failed bank when coupled with a limited purchase of assets.

The amount of the "advance" would vary on a case-by-case basis and would be calculated on a percentage formula (ranging from zero to 100 percent). The percentage chosen would be estimated by the FDIC based upon the anticipated total value of liquidating dividends which would ordinarily have been distributed to general creditors after an orderly liquidation. This sum would be made available to all valid general creditors to meet their liquidity needs and to ease the impact of the bank closing. Receivership certificates would be issued for all remaining claims.

In some instances the net realized asset value from a bank liquidation would be less than the sums initially advanced by the FDIC fund. Unless the FDIC's initial estimates prove to be significantly in error, this amount should be relatively low. The most practical response would be for the FDIC to forego an attempt to subsequently recover this sum and to simply allow the insurance fund to bear the modest additional expense. If the net realized asset value exceeds the amount of the original advance, this amount would be distributed on a pro rata basis to the holders of receivership certificates.

From the FDIC's perspective, the advantages lie in the flexibility of this approach and in the potential for increasing creditor discipline. The drawbacks lie in the operational and administrative complexity and the possibility of public dissatisfaction with the FDIC's initial estimates of loss. From the perspective of conserving the deposit insurance fund and because of uncertainty, some might assume that there could be a tendency to underestimate probable net recovery.

While legislation would facilitate the modified payoff approach, the FDIC can begin to use this approach without Congressional action. This would allow experimentation to determine whether the policy seems to bring about desired

results and to determine whether there are latent downside risks. It would provide an opportunity to learn from experience without giving up options and locking the FDIC into a program that could not be easily revised.

### Coinsurance

A variation of the modified payoff approach is to statutorily mandate a coinsurance provision. For example, deposit balances up to some basic insurance limit (say, \$100,000) would be fully insured, with deposit balances above this limit subject to 75 percent coverage (i.e., the depositor provides "coinsurance" on 25 percent of the excess balances). The workings of this system are basically the same as the modified payoff alternative discussed above, except that nondeposit general creditors will not be covered, and depositors will know the proportion of uninsured funds that will be immediately available if the bank should fail.

The major advantages of the coinsurance option compared with the straight modified payout approach are: (1) it eliminates the uncertainty and possible controversy associated with making an estimate and the ultimate recovery in receivership assets; and (2) it provides uninsured depositors with assurance they will receive a relatively high proportion of their funds, thereby lessening the possibility of adverse market reaction.

The arguments against both of these proposals fall into three groupings. First, they may not have much impact. Smaller banks and thrifts already are so very heavily insured that it would have only a modest effect on them. For intermediate-sized to regional banks, it is argued, CD brokers will expand their activities so that these banks will greatly increase their insured deposits, resulting in very little depositor risk exposure. It is extremely difficult to gauge the market potential for brokering large CDs. Certainly the Penn Square Bank failure stimulated the expansion of this market and the perception of more general depositor exposure could bring in new firms, expand advertising and dramatically increase the size of the market. It is also argued that until a multibillion dollar institution is actually closed, that possibility would have limited credibility so that the effect of implementing the proposal might actually be to increase the advantage of the very large bank.

A second set of arguments, directly counter to the first, is that implementing such a proposal will expose the banking system to too much risk and uncertainty. It is argued that depositors will not base their response to the increased risk through cautious, studied analysis of banks. Because deposits can flee quickly and because depositors have little incentive to stay with banks exposed to adverse publicity, deposit flights may be significant and destabilizing. As a result liquidity crises and failures may be precipitated too easily, even under marginal circumstances. Banks experiencing moderate but well-reported problems could be denied the opportunity to recover. Even with Federal Reserve funding, damage to deposit relationships obtained at greater cost and promotional effort perhaps would be difficult to repair.

Finally, it is argued, implementation could lead to overly conservative banking practices. If the market responds to the perception of bank risk, banks may be forced to react by pursuing cautious loan, capital and expansion policies. This could adversely affect the provision of banking services, innovation, and the financing of a growing economy.

#### CAPITAL STANDARDS

Economic and financial events of the past several years have demonstrated that a sound net worth position is the only true measure of a firm's ability to withstand protracted adversity and uncertainty. This is particularly true in the case of depository institutions. To the extent that deregulation increases uncertainty, the need for a strong capital base in financial institutions takes on even greater significance. Although subordinated debt is not considered by the FDIC in evaluating the adequacy of capital in a bank (because it is not available to absorb losses in a going concern), subordinated debt does have utility as a funding source for financial institutions and importance to an insurer and uninsured creditor as it provides an additional cushion in the event of failure. Importantly, to the extent the debt is rated and priced to reflect financial risk, it can be a mechanism for imposing market discipline. In this vein, an argument can be made that it would be desirable for every financial institution to have a minimum amount of subordinated debt in its liability structure.

It may be desirable to look increasingly to stockholders and subordinated creditors for the application of market discipline to banks. Bank stockholders typically lose their investment when a bank fails, and this is frequently the case for subordinated creditors where they are present.

From the standpoint of market discipline, subordinated debt affords certain advantages over deposits. Subordinated lenders are apt to be more sophisticated -- and comfortable in evaluating credit risk. Whereas most uninsured deposits mature within a few months or can be withdrawn on demand, subordinated lenders typically are in a very different situation. Once having made the loan or investment, they generally cannot flee during adversity. They have to view borrower (bank) operations from a longer-term perspective. Unlike stockholders, their return is fixed and they generally do not receive any benefit from increased risk. Unlike depositors, they cannot count on the probability of being completely protected at the time a bank fails. If and when a bank does fail, subordinated note holders provide a protective cushion to the FDIC and other general creditors.

Banks could be required to maintain a minimum protective cushion to support deposits (such as ten percent) which could be met by the use of a combination of equity and subordinated debt.<sup>2/</sup> Bank regulators, however, might still

<sup>2/</sup> Such a requirement would need to be phased-in over a reasonable time frame to permit the financial markets and the banking system an appropriate adjustment period.

require some minimum ratio of equity to deposits, perhaps five percent. Smaller banks that already have a high equity ratio or might have limited access to debt markets might choose a higher proportion of equity to meet the ten percent minimum. Larger banks that are well-rated might be able to obtain as much as one-half of this cushion from debt markets in the form of subordinated funding. As banks grow they would be required to add proportionally to their "capitalization". Those heavily dependent on debt would have to go to the market frequently to expand their cushion and to refinance maturing issues. Thus, they would be exposed periodically to the results of their performance and, possibly, to the reactions of rating services.

Depositors would be significantly insulated because of the increased size of the protective cushion. Yields on bond issues traded in the secondary market would also provide them with information on the market's valuation of their institution. Large institutions with good internal controls and audits and a reasonable degree of agency monitoring should provide a sufficient cushion so that depositor loss would not occur frequently, even when banks fail.

For this system to work, it would be necessary to enforce such minimum capital requirements rigorously. Penalties would have to be imposed when banks fall below minimum levels. There are a number of details that would have to be resolved under this general scheme and many areas where market adjustments may be difficult to anticipate. Many banks currently are far below suggested cushion levels. There would have to be an appropriate transition period if this proposal were implemented.

Banks facing difficulty will undoubtedly have trouble increasing their capital or debt levels. Some might be forced to seek mergers.

Exactly what qualifies for subordinate notes will have to be worked through rationally. There may have to be limits placed on acceptable default provisions, and acceleration of maturities cannot be allowed. Provisions where debtholders receive some equity interest and exercise some management control such as in the selection of members of the board of directors, however, may be quite appropriate as may convertability to common stock under some circumstances. Maturity selection should take into consideration the desirability of frequent exposure to market judgment. The total debt perhaps should mature serially (such as one-third every two years).

It is difficult to estimate how much debt relative to equity the market will deem to be appropriate and at what interest rate. Even if the cost is moderately high, this will not necessarily have a significant adverse effect on earnings. Suppose, for example, a bank has to pay two percent more for its borrowing than it earns on the proceeds of the acquired funds (a fairly high cost). Even if the bank borrows five percent of its assets, its cost would be  $.05 \times .02$  or 10 basis points, before tax, on assets.

The capital markets' ability to supply the "new" equity/debt must be considered. If the funding is mostly debt or preferred stock, there will be a need for pension funds, insurance companies and others to be willing to hold



the debt. From the standpoint of making demands on the economy's "savings," that is not necessarily an issue. Funds would be transferred from others into banks which, in turn, will have these same funds to lend out. Some limitations, apart from existing single borrower limits and direct reciprocity arrangements, may be necessary to address the issue of banks acquiring the debt of other banks. Given reasonable safeguards along these lines, interbank transactions should not pose serious problems as long as reasonable equity standards were maintained.

There are some major attractions to the proposal discussed above. It could provide a vehicle for substantially increasing market discipline without the potential disruption and uncertainty of expanded payoffs. In many instances recapitalization and voluntary merger will occur in place of failure. This proposal is likely to work better and have more credibility than a payoff where the largest banks are concerned. Implementing of capital standards would not preclude using more payoffs according to the modified formats discussed above.

Th FDIC is not prepared to endorse this concept at this time. A number of details would have to be worked out before it could be implemented, but it appears to warrant consideration in addition to, or in lieu of, the risk-sharing proposals considered above.

#### DEPOSITOR PREFERENCE

At the present time, depositors are considered general creditors in bank liquidations except in a few states in which their claims specifically on the assets of a failed state-chartered bank are preferred over those of other general creditors. Significant benefits would derive from the standpoint of increasing market discipline from granting depositors and certain other creditors preference since the potential loss exposure of selected creditors would be increased. In addition, it would facilitate the use of the payoff/cash-advance option in handling bank failures.

There are several categories of nondeposit general creditors that may be present when a bank fails. These include nonsubordinated lenders. If a depositor preference were legislated such lenders might choose to become depositors. While that would not materially affect a bank's balance sheet, the deposit assessment base would be increased, as would be appropriate.

General claimants on a bank might include unpaid employees, claims arising from mechanics' liens, claims arising from torts, etc. Because of the special nature of these claims and the fact that the claimants have no reason to be concerned about a bank's condition, there would be no reason to prefer depositors over these claimants.

However, those claims which are generally categorized as "contingent" should be subordinated to depositors. These might arise, for instance, in connection with standby letters of credit and nonperformance by the failing bank with

respect to commitments or loan participations. These would be related to commercial transactions with financial institutions and other businesses. If depositors were preferred to these claimants, the latter would have to be more concerned about whom it does business with, provides guarantees, etc. The FDIC believes that such increased concern would be appropriate and would act as a check on bank risk in some areas.

In the payoff/cash-advance transaction, a depositor preference over the latter category of contingent claims would enable the FDIC to make a more substantial cash advance in some cases. (In some instances depositor recoveries are significantly reduced because of questionable guarantee arrangements which were unknown to the depositor or beyond his or her comprehension.) It would also favorably affect ultimate depositor recovery and FDIC recovery at the expense of the contingent claimant.

It would be necessary to spell out carefully through legislation who would be preferred. On balance, the FDIC believes this would improve the fairness of the system and increase market discipline.

#### ADDENDUM

##### Administrative and Operational Considerations

Coupled with any change (or in the absence of any change) in the FDIC's method of resolving a failing bank situation, the administrative and operational obstacles associated with a relatively large bank closing must be addressed. While implementation of any of the previously enumerated approaches would add some additional operational burden, the FDIC's system is flexible enough to adapt to such a change. However, the underlying mechanics of effecting a rapid settlement of claims when a relatively large institution is involved impede the goal of providing the banking public with timely availability of usable funds. Such considerations have been and continue to be a major constraining factor.

Simply stated, the FDIC is not capable of handling the payoff of a very large banking organization under present procedures if "next business day" access to funds by depositors is to be accomplished. The tradeoff between increased cost to the insurance fund and potential disruption caused by delay in settlement may be a major obstacle to the effective use of these loss-sharing approaches on a consistent basis.

A number of time saving procedures and improved methods of dealing with the operational problems involved with the closing of a large banking institution are currently being explored. Chief among these considerations is an increased emphasis upon planning and coordination of the liquidation effort before a bank closing. Specific recommendations, some of which may require enabling legislation, follow:

1. Recordkeeping and Reporting

Analysis of an institution's deposit structure and the accurate assessment of the FDIC's insured-deposit liability is essential in preparing for any bank closing and subsequent payoff. For example, the current practice of aggregating individual depositor balances in a closed bank (to distinguish between insured and uninsured funds) is a time-consuming and highly labor-intensive task. The increased use of automated equipment and specialty computer software packages in this area has a great potential for time savings.

To be effective, however, certain modest changes in bank recordkeeping and reporting requirements may be necessary. For insured institutions with deposits greater than \$1 billion and for those rated 3, 4 or 5 under the Uniform Interagency Bank Rating System, records could be maintained which would provide for a "central locator file" (or equivalent) and reports on the institution's insured deposit liability could be submitted periodically to the FDIC. By limiting these requirements to only a small number of relatively large institutions (most of which already maintain some form of a central index file for their own internal use) and to poorly-managed institutions, the increased reporting and bookkeeping burden would be held to a minimum and would be borne only by those few institutions which pose the greatest level of potential exposure to the deposit insurance fund.

2. Modify Insurance Coverage

Over time, a cumbersome and rather complex system for determining individual insurance coverage has evolved. Increased coverage can be achieved by the utilization of individual accounts held in different rights and capacities, to obtain insurance protection for deposits which aggregate to substantially more than \$100,000. A simplification of these rules, which serve to encourage "account splitting," to provide for only a maximum \$100,000 coverage for each individual or business entity, per bank, would have several favorable effects.

First, because it would represent a roll back of insurance protection for a few individuals with large deposit balances, it would serve to increase market discipline as account splitting would be less advantageous. Second, it would be more easily understood by both bankers and the general public and could reduce the volume of litigation involved. More importantly, however, it has the potential to significantly decrease the time involved in processing of accounts in a bank closing situation. Calculation of insured coverage would be greatly simplified and could be more rapidly processed by automated equipment programmed to sort by bank customer number. This would greatly facilitate the settlement procedure, and the time savings would be substantial in a relatively large bank.

### 3. Passthrough of Existing Contractual Arrangements

Certificates of deposit and other "time" deposit accounts are contractual arrangements whereby the depositor is not generally able to demand funds until a stated date or the passage of a known and certain period of time. The "event" of a bank closing may negate these contracts, effectively rendering them payable upon demand. If the stated contractual terms of these accounts could be clearly permitted to "pass through" to another operating institution in any subsequent deposit assumption transaction, their value would generally increase. This would facilitate the transfer of large blocks of funds, permitting a more rapid settlement of other claims.

### 4. Subordinated Claims and Financial Assistance

The FDIC has been and remains reluctant to utilize the deposit insurance fund to neutralize normal free-market forces by assisting in the preservation of those institutions which have proven to be unable to compete effectively on their own. Direct financial assistance to an open bank, under Section 13(c) of the Federal Deposit Insurance Act, aimed at avoiding the disruptive consequences of a failure, accrues to the benefit of subordinated creditors and shareholders who should be expected to sustain a loss as a consequence of poor management practices. The increased prevalence of subordinated debt in a bank's liability structure (as discussed in this chapter) can render unfeasible an open-bank merger involving a troubled institution because these creditors cannot be compelled to incur a loss unless the bank is closed.

Assistance might still be granted and serious disruption avoided in a manner which will not benefit stockholders and subordinate creditors in an insolvent institution. This can be accomplished by effecting a phantom merger transaction with a newly-chartered bank which has been capitalized by the granting of FDIC financial assistance. The new institution would assume the liabilities of the closed bank and purchase its high-quality assets. As the estimated value of an insolvent bank's assets will not exceed the liabilities assumed, shareholder claims will have been effectively eliminated.

The new institution could be operated by the FDIC (utilizing the closed bank's records, facilities and appropriate personnel) until such time as its affairs can be terminated in an orderly fashion or sold to and recapitalized by a new group of investors. Use of this interim vehicle would be intended to only delay the normal free-market resolution of an insolvent firm; it would avoid disruption to funds flows and bank customers while penalizing those investors who have chosen to bear a risk of loss.

### 5. FDIC as Receiver for all Insured Institutions

Section 11(c) of the Federal Deposit Insurance Act provides that the FDIC shall be appointed receiver for any National bank closed by the Comptroller

of the Currency. This authority should be expanded to include all FDIC-insured state-chartered institutions.

In practice this would not represent a significant change as the FDIC is nearly always appointed receiver when an insured state bank is closed. Occasionally, however, the decision to appoint the FDIC is delayed until immediately prior to closing and may involve factors other than who may be better able to protect the interests of creditors.

It is important for the FDIC to know sufficiently in advance of a bank closing that it will be appointed Receiver in order to plan for the orderly liquidation of assets and processing of claims. Planning takes on even greater importance to carry out concepts such as modified coinsurance where the increased procedural difficulties must be resolved quickly. Since the FDIC usually has, by far, the largest claim in closed bank liquidations, it is only appropriate that the FDIC be appointed the receiver for all insured banks.

6. Brokers

The emergence of brokers who perform a deposit-parceling function for the purpose of maximizing deposit insurance coverage undermines efforts to establish discipline in the banking system through risk-sharing by large depositors. The FDIC believes the activities of such brokers must be controlled as an integral part of any risk-sharing proposal and is considering a number of alternatives for correcting this problem. The FDIC is particularly concerned about the practice of some brokers of placing fully-insured funds in banks at random without credit analysis or, worse yet, placing them in known problem banks and collecting a higher fee.

CHAPTER IV  
PUBLIC DISCLOSURE PRACTICES

	Page
Executive Summary . . . . .	IV-1
Introduction . . . . .	IV-2
Functions of Disclosure . . . . .	IV-2
Enhance Market Discipline . . . . .	IV-2
Protect Bank Depositors and Other Customers . . . . .	IV-3
Other Considerations Bearing on Disclosure . . . . .	IV-4
Reporting Burden on Banks . . . . .	IV-4
Public Nonuse of Data . . . . .	IV-5
Potential Public Overreaction to Disclosures . . . . .	IV-7
Adequacy of Disclosures . . . . .	IV-7
Information Currently Available to the Public . . . . .	IV-7
Available Information and User Needs . . . . .	IV-10
Data Withheld From the Public But Available to Regulators.	IV-11
Reports of Examination . . . . .	IV-11
Administrative Actions . . . . .	IV-11
Country Lending Survey . . . . .	IV-12
FDIC Position on Public Disclosure . . . . .	IV-13
Educate the Public . . . . .	IV-13
Make More Information Available to the Public . . . . .	IV-14
Evaluate Agency and Public Data Needs . . . . .	IV-16

## CHAPTER IV

### PUBLIC DISCLOSURE PRACTICES

#### EXECUTIVE SUMMARY

Improved disclosure of bank financial and operating information will help focus stronger market discipline on risk taking by banks. Such discipline can serve as an important supplement to federal regulation and supervision of institutions.

The chapter concludes that more and better information should be made available to the public. To facilitate this process, FDIC has developed two proposed policy statements and is presently in the midst of instituting major revisions to the Reports of Condition and Income ("Call Reports") to obtain more comprehensive data for risk analysis. One of the proposed policy statements encourages banks to disclose, and uninsured depositors to request, relevant information relating to bank condition and performance. The proposal sets forth a minimum standard for bank disclosure. A key element of this disclosure is management's narrative analysis of the bank's results of operations and financial position. The FDIC is also considering a policy of publishing in the Federal Register final statutory enforcement actions taken against banks. Additions to the Call Reports will provide the regulators and the public with data on credit and interest-rate risks, areas not previously covered in these reports. An issue of competitive equity remains, however, as savings and loan associations do not disclose data on loan quality.

Bankers should not look with fear at the FDIC's emphasis on disclosure. Better disclosure will protect sound, well-run institutions by distinguishing them from the minority in the industry that have been willing to take excessive risks. Informed depositors will be better able to identify and avoid these marginal banks, which will promote more stability in customer relationships at the better banks.

The public currently has an extensive amount of bank financial data available from various sources, including Call Reports and, from certain banks, disclosures mandated by Federal securities laws. Banking organizations devote considerable time and expense to preparing reports to which the public has access. This chapter discusses the adequacy of existing disclosures, the ability and willingness of the public to understand available information, and the need for improved disclosure. The chapter makes the point that the information should be pitched to the level of a reasonably sophisticated depositor investing amounts that exceed the statutory insurance limit. It is these and larger institutional depositors who may be expected to provide market discipline on banks.

Bank customers whose funds are fully protected by deposit insurance cannot be expected to assess bank risk. In a survey of large depositors, the FDIC found that many lack the skill to perform such an assessment. Other large depositors who have the resources to analyze the available bank data have little incentive to do so because they perceive no risk in dealing with large banks. They believe that the FDIC will handle the failure of a large bank in the way that will protect all depositors, insured or not. This large depositor attitude is an important competitive and disciplinary factor that must be acknowledged and addressed. The ideal solution is to expose large creditors to loss in fact, not just in theory. Clear and meaningful disclosure to bank customers who are at risk, in turn, is an essential corollary to the exposure to increased risk.

Financial advisors and sophisticated bank customers generally regard the information presently available to them as adequate for analysis of the country's largest banking organizations, but for small institutions the financial data is less complete. Even for the analysis of risk in large banks, these data users would benefit from more data on loan quality. The examination process and other supervisory activities provide the regulatory agencies with information on bank condition and performance, including loan quality, which is withheld from the public. The chapter reviews this situation and certain issues relating to public availability of such data.

## INTRODUCTION

Disclosure is the process by which information concerning a bank's financial condition and performance, its management, and its policies and philosophies is made known to the public at large. Disclosure can occur at the institutional level or through the release of information by the regulatory agencies. Regardless of the source for disclosure of data, its availability may be the result of specific legal or regulatory requirements or of voluntary action on a bank's part.

## FUNCTIONS OF DISCLOSURE

### Enhance Market Discipline

The market's ability to make informed investment decisions requires full and fair disclosure of relevant information. Market participants can then assess the degree of risk associated with an investment in, or other relationship with, a bank. Based on an evaluation of the condition of an institution, market participants may demand an appropriate risk premium to boost the return on investment to a level which is commensurate with the perceived risk. If the market's general consensus regarding the condition of a particular bank causes it to seek an inordinately large risk premium or to withdraw from existing business relationships with the institution, the bank's cost of doing business will increase and its ability to continue as an operating enterprise may be reduced. To ensure that it remains viable, the bank's expected response to such a situation would be to strive to restore its financial condition to a more acceptable level and to temper those managerial policies responsible for its increased risk.



Market participants who are at risk in their relationships with a bank will exercise some discipline on the bank's behavior toward risk. This discipline would be intended to restrain the bank from taking excessive risks and engaging in destructive competition. The success of market discipline as a means to keep banks operating in a safe and sound manner is directly proportional to the value of the information available to market participants.

Under the concept of large depositor risk-sharing, the disclosure of relevant information takes on added importance. If a risk-sharing scheme is adopted by the FDIC, one can no longer assume that there is no risk to uninsured depositors in a "large" bank because of a perception that the FDIC would not pay off such a bank. Large depositors will therefore need adequate and timely financial disclosures in order to assess their risk exposure. Banks that possess a low risk of failure will be deemed acceptable depositories by large depositors or their financial advisors. As a bank moves toward a position of perceived excessive risk, an increasing number of large depositors will remove its name from their lists of acceptable banks. It is the bank's understanding of this cause-and-effect relationship that will serve as a deterrent to risky banking practices.

#### Protect Bank Depositors and Other Customers

In the deregulated environment in which banks are now operating, uninsured depositors as well as other creditors and customers need to protect their interests more than they have in the past. In previous years, most bank failures could be attributed to either fraud or excessive loan losses. While banks will continue to be exposed to these types of losses, the potential for loss resulting from interest rate risk has gained increasing prominence due to the volatility of market rates and the increasing volume of deposits free of Federally-imposed interest rate ceilings. In addition, some banks are exhibiting a greater willingness to make more risky investments which, while generating higher returns, are more likely to experience repayment problems.

Banking is also becoming more competitive both within the industry itself and with other providers of financial services. Individual institutions must work harder to retain depositors and borrowers due to increasing competition from banks in the local, regional, national or international markets. Thrift institution powers have been expanded so that savings banks and savings and loan associations are beginning to closely resemble commercial banks. Securities firms offer alternatives to bank deposits and the banking industry has responded by providing a limited securities-brokerage function.

Hence, many factors have contributed to the increased risk of failure within the banking industry. The post-World War II record number of failures in 1982 (42) presages the higher volume of bank closings that can be expected in an era of deregulation. As deregulation progresses, the conditions giving rise to a payoff may occur with somewhat greater frequency, and the perception that the government will normally protect all general creditors may fade. It will no longer be sufficient for uninsured creditors to ignore risk and look only for the highest return that is offered by a spectrum of financial institutions.

OTHER CONSIDERATIONS BEARING ON DISCLOSURE

Reporting Burden on Banks

Banks incur significant costs in collecting, preparing and transmitting information which they are currently required to report to regulatory agencies, their stockholders, and the public at large. This reporting burden varies from bank to bank depending on such factors as total assets, type of charter, number of stockholders, holding company affiliation, and relationship with independent public accountants. These factors determine the type and frequency of reports designed for external users.

The incremental cost to banks of preparing reports for external users increases as the reported information loses utility to the bank. For example, there is very little incremental cost of external reporting if what is reported is identical to data already used internally by bank management. Reporting costs increase, however, when internally used data must be adjusted to present it in conformity with specific reporting requirements. Finally, the cost is greatest when the bank must collect and prepare data which is of no practical utility to management itself.

The Reports of Condition and Income are the primary reporting vehicles for bank disclosure to the Federal bank regulatory authorities. Because these reports are used for a variety of purposes and by many different users, portions of the data required to be reported are not precisely the same as data used internally by bank management and, in some instances, are of little or no use to bank management. Hence, the banks' preparation burden and costs for these reports are significant.

As an insurer, the FDIC seeks to limit its financial exposure by monitoring the condition and performance of banks. Call Reports are important in this regard; their content provides uniform input for computerized surveillance systems designed to identify banks warranting special attention. Hence, the banks' preparation costs for a significant portion of these reports can be regarded as an indirect cost of FDIC insurance.

For many banks, particularly small institutions, the financial information contained in the Call Reports, which is publicly available, represents the only financial statement to which depositors and other customers may have access. Since banks are obligated to submit the Reports of Condition and Income to the regulatory agencies for supervisory purposes, banks experience no additional reporting burden when the agencies disclose this data to the public upon request. Nevertheless, there are certain other Federally-mandated reporting requirements applicable to banks for which the regulatory agencies themselves are not the intended beneficiaries.

In particular, some banks are required to file reports under the Federal securities laws with their Federal bank regulatory agency whose responsibility is to act as a repository for this information and to assure the public's accessibility to the data. A degree of similarity exists between the prescribed

content of Call Reports and the periodic financial reports required under the securities laws. In fact, the securities disclosure rules governing the form and content of bank financial statements reference the Call Report instructions. The practical effect of this cross-referencing is to limit the cost of reporting to these banks by allowing them to utilize figures developed for Call Reports in financial reports required by securities laws.

Nevertheless, the Federal securities laws impose additional reporting burdens and costs on banks subject to the regulations promulgated thereunder. Only about 680 of the approximately 14,400 insured commercial banks currently fall within the reporting requirements of Federal securities laws. However, a steadily growing number of commercial banks, now approaching 18 percent of the total population, are indirectly falling within the jurisdiction of the Securities and Exchange Commission ("SEC") through their parent holding companies. These banks therefore indirectly incur a portion of their parents' cost and burden of complying with the SEC's registration, disclosure, and periodic reporting requirements.

There are potential diseconomies involved in expanding disclosure beyond what is currently made available. The existing compliance costs to the banking system inherent in assembling data for external scrutiny is significant. Potential informational demands on banks may encounter diminishing returns at some future date. The utility of these external demands must be measured by cost/benefit analysis.

#### Public Nonuse of Data

Integral to the disclosure issue is an analysis of the willingness and ability of the public to comprehend bank financial data. It is important to realize that the public is not homogeneous but consists of several distinct sectors of which only a few may be at risk in their relationships with banks. The largest sector can be designated "the general public" and would be composed of most individuals, small businesses, and other small local entities that are unsophisticated users of financial information. The remainder of the public consists of such groups as bankers, corporate treasurers, institutional investors, fund managers, municipal treasurers, and other large depositors as well as rating firms and other financial advisors which are typically, although often erroneously, described as sophisticated.

A theory has been advanced stating that the public does not make use of presently available bank financial information because they are unaware it exists. This argument is persuasive with respect to the general public. However, for the most part, the general public is exposed to little if any risk in its dealings with banks. In contrast, two surveys conducted by the FDIC reveal that a portion of the public, very small perhaps in terms of number but large in terms of the funds it controls, is very aware of currently disclosed data. Nevertheless, the FDIC found that certain supposedly sophisticated large depositors are in fact no more knowledgeable than the general public.

Even in those cases where the public is cognizant of the bank financial information available to it, the information will not be utilized if the public does not know how to analyze it. Our surveys indicate that the general public and the treasurers of many smaller corporations and governmental units have little understanding of basic bank financial information. Apparently, it is only the truly sophisticated data users, including institutional investors, investment banking firms, rating firms, large money funds, large banks, and large corporations, that possess the proper analytical skills for evaluating risk in banks.

While advanced techniques of financial analysis are largely unknown to all but these most sophisticated of bank customers, there has been an increasing recognition during the past few years among corporate treasurers and other customers with extensive banking relationships of the importance of assessing bank performance and the need for understandable information concerning the condition of banks. In lieu of developing the internal resources to perform bank analysis themselves, many customers of this type have opted to rely on credit ratings of individual banks prepared by firms which specialize in bank analysis. However, other less-sophisticated uninsured depositors continue to lack both an awareness of bank data availability and the ability to use and understand the data. This situation can be alleviated by educating these customers and by making disclosures less technical, yet more comprehensive and informative.

A final factor purporting to explain the public's disinterest in bank financial data relates to the general perception of risk and the role of deposit insurance. As addressed in Chapter III of this study, the perception of risk does not appear great, especially in the larger banks. The degree to which the recommendations concerning risk-sharing are adopted will affect both the demand for information and the motivation to analyze and understand it.

To the extent that the market will seek out bank financial information in the form that is most understandable, the most efficient and cost-effective mechanism for accomplishing this objective may be through the continued growth of professional services provided by private sector bank rating firms. These firms can apply their expertise in analysis and translate bank financial data into a form which is clear and understandable to the average well-informed user.

Rating firms analyze the condition of selected banks, including virtually all the largest commercial banks, at their clients' request. While expanded utilization of rating services may ultimately provide enhanced public understanding of the condition of large banks, it does not address the issue with respect to smaller (under \$500 million) institutions. This is particularly troublesome in view of the small bank uninsured depositors' risk that a failure will lead to a payoff rather than a purchase and assumption, given the FDIC's present choices for handling a closed bank.

### Potential Public Overreaction to Disclosures

Bankers often express concerns that public misinterpretation of information regarding bank condition will cause overreaction and runs on banks. News of initial depositor withdrawals as a result of problems, real or imagined, at a bank would feed on itself and lead other depositors to lose confidence. The snowball effect of this could result in the bank's failure. However, the FDIC is not aware of any instance in modern times where a sound bank has faced liquidity pressures due to unfounded depositor concerns.

If more creditors are placed at risk due to some form of risk-sharing arrangement, that fact alone will add some volatility to banking. Given, then, that some degree of public lethargy will give way to awareness and interest, the best protection against spontaneous loss of confidence is twofold: (1) greater care by bankers to avoid unnecessary asset concentrations, lax lending, excessive leverage, and other conditions which could act against the welfare of the bank; and (2) a systematic, dependable disclosure of information, which will eliminate the data vacuum which is too often filled by rumor or ill-considered and poorly-presented half-truths. There are few, if any, institutions which so profoundly affect the public interest, but are so universally misunderstood, as banks. In the FDIC's view, the public has a need and right to make its own judgments with respect to banks. Moreover, it is in the long-run best interests of banking to combat the existing mystique and misunderstandings.

### ADEQUACY OF DISCLOSURES

An important function of the FDIC, especially in an era of deregulation, is to promote public confidence in banks and in the system as a whole. Implicit in the role of maintaining public confidence is ensuring that adequate information relating to bank condition is disclosed to the public.

Moreover, as deregulation of banking and other financial services proceeds, the overall level of risk to which bank customers' funds are exposed can be expected to increase. The concept of adequacy from a public policy standpoint is relative, i.e., it is a function of the volume of funds at risk within a bank. Hence, as the percentage and absolute dollar amount of uninsured deposits in and other general creditor claims against a bank increase, so does the need for information to assess the amount of risk in the bank. The present reporting rules for financial institutions have been designed so that the quantity of publicly-available data is generally more extensive for larger banking organizations than for smaller ones. The practical effect of this is positive, since the greatest volume of uninsured deposits and other liabilities are found in the largest banks.

### Information Currently Available to the Public

All commercial and mutual savings banks insured by the FDIC are required to file Reports of Condition and Reports of Income with their primary supervisory authority at a prescribed frequency. Commercial banks file these reports on a

quarterly basis whereas mutual savings banks file quarterly Reports of Condition and semiannual Reports of Income. These Call Reports consist of a balance sheet, income statement and supporting schedules on preprinted forms provided to each institution by the Federal agencies.

While the general content of the Call Reports is similar for all commercial banks, differences do exist in the level of reported detail based on a bank's size and the nature of its business. A single set of report forms is applicable to all of the approximately 300 mutual savings banks insured by the FDIC. Call Reports present numerical data relating to bank condition and performance without any provision for the inclusion of narrative explanations to discuss the underlying factors influencing the reported results. The financial information contained in these reports is not required to be audited although their correctness is attested to by bank directors and/or an authorized officer of the bank. The Federal banking agencies have made the Call Report data for individual banks publicly available for ten years.

These Reports of Condition and Income have traditionally been used for the collection of general statistical and research-oriented information and their content reflected such usage. More recently, the Call Reports have assumed greater importance in the supervisory process and are the principal data source for automated surveillance systems such as the FDIC's Integrated Monitoring System. Efforts to improve the value of the Call Reports for monitoring the safety and soundness of individual banks between examinations are discussed later in this chapter.

Since December 1981, the Uniform Bank Performance Report ("UBPR"), a separate document which brings together a wealth of financial ratios derived from the most recent and four preceding Call Reports, has also been made available to the public on an individual bank basis. For each ratio presented, the UBPR also contains the median ratio as of the most recent Call date for a reference group of the bank's peers together with the percentile level at which the bank's ratio falls within the peer group. This comparative data adds to the UBPR's value because it shows the relative standing of a bank to a user who may not fully grasp the meaning of all of the ratios in the report.

Titles VIII and IX of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 ("FIRA") prescribe an annual reporting requirement for all insured banks with respect to loans to insiders. Each bank must submit to its primary Federal bank regulator specified information on the indebtedness of principal shareholders and executive officers who were indebted to the bank or its correspondent banks in the past calendar year. Both the reporting bank and its bank regulator are required to make the report available to the public on request.

The next level of disclosure affects banks with publicly-held securities rather than all insured banks. In 1964, amendments to the Securities Exchange Act of 1934 ("1934 Act") extended its coverage to banks with more than \$1 million in total assets and a class of equity securities held by more than 500 stockholders or with a class of securities listed on an exchange. Section 12(i) of

the 1934 Act assigns the related enforcement authority over banks to the three Federal bank regulatory agencies. Each agency has issued comparable regulations setting forth the registration, disclosure, and periodic reporting requirements for bank issuers of such securities. These disclosures are designed essentially for the use of investors in bank stock and subordinated notes and debentures but are also relevant to others, such as uninsured depositors. Less than five percent of the 14,400 insured commercial banks are "registered" under the 1934 Act.

Bank holding companies are subject to certain regulatory reporting and securities disclosure requirements that parallel those for banks. Companies reporting under the Bank Holding Company Act of 1956 submit financial reports to the Federal Reserve System ("FRS"). This information is generally available to the public. The Annual Report of Domestic Bank Holding Companies (Form Y-6) contains comparative consolidated (with certain exceptions) and parent only financial statements as well as comparative statements for each nonbank subsidiary. However, the Y-6 lacks such data for bank subsidiaries of the parent holding company. The holding company must also report certain specified data on its organizational structure in the Y-6. Additionally, holding companies with total consolidated assets of \$50 million or more file the Bank Holding Company Financial Supplement (Form Y-9). As with the Call Reports, the Y-9 consists of preprinted forms for the balance sheet and income statement. The forms must be prepared annually or semiannually depending on the size of the holding company.

The SEC administers the reporting and disclosure requirements of the 1933 and 1934 Acts with respect to bank holding companies. Holding companies must register any public sale (excluding certain small sales) of debt or equity securities with the SEC and provide a prospectus with content similar to that of an offering circular to each prospective purchaser. Publicly-held holding company securities must be registered with the SEC in accordance with the same criteria that applies to registered bank securities. Subsequent to registration, the holding company must provide its stockholders with proxy statements and annual reports (including financial statements) and must file quarterly financial information and other disclosures with the SEC on a prescribed basis. All of this information is available to the public.

Full and fair disclosure under the Federal securities laws requires disclosure of any outstanding cease-and-desist order along with a description of the underlying conditions within the bank which gave rise to the order. This applies not only to bank disclosure materials but also to filings by SEC-registered bank holding companies. Should the extent of supervisory action against a bank be limited to an informal agreement such as a Memorandum of Understanding, the policies of the FDIC limit the required disclosure to a discussion of the material factors underlying the provisions of the memorandum. Voluntary disclosure of the existence of a memorandum is not discouraged.

The FDIC began to publish summaries of its statutory enforcement actions approximately six years ago. Effective January 1, 1980, the Federal Financial

Institutions Examination Council ("FFIEC") extended this policy to actions taken by all five member agencies. While the name of the bank involved and other identifying details are deleted from each summary, a large depositor or other person who closely follows a particular institution could fairly readily connect it to a specific summary and then request a copy of the actual order via the Freedom of Information Act ("FOIA"). Since final orders are available through FOIA requests, albeit in a "sanitized" condition, the FOIA can also be considered a disclosure vehicle. A response that no order is outstanding against a specific bank could represent a form of limited assurance regarding the condition of that bank.

More complete descriptions of existing public disclosures appear in Appendix C.

#### Available Information and User Needs

In order to gain an awareness of procedures used to monitor bank condition and to determine whether the financial and other bank data presently available satisfies the needs of its users, the Division of Bank Supervision staff conducted two surveys. The first was a telephone survey of 55 persons, including treasurers of major U.S. corporations, institutional investors, municipal treasurers, and uninsured depositors in banks receiving FDIC financial assistance. The second involved meetings with representatives from three firms prominent in the field of bank analysis and ratings.

According to the surveys, the amount of publicly-available data on banks exceeds that which bank customers other than sophisticated users can comprehend. Sophisticated users would like to receive more data in specific areas. More and better data on loan quality, particularly on foreign loans, is considered very desirable. In addition, these groups stated that a universally-accepted and consistently-applied definition of the term "nonaccrual loan" needs to be developed to improve comparability. Sophisticated users who wish to keep their assessments of bank condition current must also struggle with the length of time between the end of a reporting period and the date when the financial information for this period is publicly released. To overcome these difficulties, many corporate treasurers, fund managers and rating firms take advantage of their status as holders of, or advisors to holders of, large amounts of bank deposits and contact management directly when they need to gain answers to unresolved questions relating to bank condition.

Finally, the financial data that users regard as adequate today may not satisfy their informational requirements for a proper analysis of bank risk in the future. Disclosure is an evolutionary process, changing in response to the financial markets' demands for data. As banks gain more freedom to enter into new activities and as the impact of deregulation continues, the content of bank disclosures may need to be very different than it is at present.



Data Withheld From the Public But Available to Regulators

As part of their supervisory and enforcement activities, the bank regulatory agencies assemble but withhold from the public a considerable amount of information bearing on bank condition and performance. Such data may be compiled through the examination process or related bank contact or may be reported directly by banks.

Reports of Examination

Through the authority to conduct examinations of banks, the three bank regulatory agencies have a powerful tool for assessing an individual institution's exposure to risk. Examiners employ procedures and methods designed to permit them to evaluate the bank's capital adequacy, asset quality, management, liquidity position, and earnings capacity. Examiners present findings with respect to the bank's overall condition in the form of summary comments and conclusions that inform the reader of the bank's problems and serve as a guide for needed corrective action. Public access to reports of examination, in whole or to selected parts, would therefore provide a clear indication of the problems and weaknesses which the bank's primary Federal regulator views as significant.

The bank regulatory agencies have always maintained the confidentiality of reports of examination and resisted attempts to gain disclosure of their contents. The basis for the agencies' position is that the examiner's comments and conclusions, adverse classifications of loans and other assets, and other reported information reflect subjective judgments made by their examination staffs rather than formal determinations made by the agency acting through its board of directors.

Examiners form their judgments through discussions with a bank's officers and its board of directors and a review of bank records and documentation. The public disclosure of subjective judgments of examiners would be an inconsistent type of disclosure which would be subject to perhaps widely ranging interpretation depending upon the sophistication of the reader. Moreover, as the length of time between examinations increases, comments and data from the latest report of examination may tend to lose their relevance and may no longer accurately portray the bank's condition.

Administrative Actions

Congress has given the bank regulatory agencies broad enforcement powers to complement their examination function. Through these means the agencies seek to fulfill their mission of promoting strength and stability in the banking system. Examination findings reveal the extent to which varying degrees of corrective measures are needed at an institution. For a bank regarded as having no more than modest weaknesses that are correctable in the normal course of business, the supervisory response is limited. However, once a bank exhibits a combination of weaknesses that are moderately-severe or worse, the

regulatory agencies presume that administrative action, formal or informal (depending on the seriousness of the situation), is necessary to assure that the desired corrections are achieved.

Informal administrative actions generally take the form of Memorandums of Understanding which address specific matters in need of correction within an institution. These documents are usually drafted at the regional level and jointly signed by an appropriate regional official and by the bank's board of directors. The three banking agencies may also initiate formal administrative actions by exercising their statutory enforcement powers. Such actions include cease-and-desist orders as well as suspension and removal orders. The FDIC Board of Directors also has the power to terminate insurance. In addition, the bank regulatory agencies possess the authority to assess civil money penalties for violations of certain statutes.

Routine disclosure of both formal and informal agreements is not made as a matter of policy by the regulatory agencies. On the other hand, as discussed above, the FOIA provides a vehicle for indirect disclosure of formal agency actions. Such a procedure is not an efficient method for ensuring that all market participants are aware that a final order has been issued against a bank. This inefficiency can be eliminated through greater public access to final orders issued at the conclusion of formal actions.

The effect of increased disclosure of such final orders would be to subject banks against which these actions have been taken to potentially greater public scrutiny. Institutions which have been poorly-managed would be less able to hide their condition under a veil of secrecy. Greater disclosure would aid large depositors and other bank customers in their evaluation of bank performance by giving a clear indication of those institutions whose managements have been unable or unwilling to prudently direct the affairs of their banks. In a deregulated environment, therefore, public knowledge of those banks against which final orders have been issued will protect well run banks by distinguishing them from their more marginal competitors. Such information will reassure depositors and other bank customers and promote the stability of their relationships with sound institutions.

Since the vast majority of insured banks do not actively participate in the market for uninsured funds, these banks could claim that the absence of uninsured depositors and other nondeposit creditors eliminates their customers' need to be aware of enforcement actions. Even so, it is doubted that the public would be indifferent to the presence of an administrative action against the local bank. To the extent that is true, the discipline the FDIC seeks to achieve would result.

#### Country Lending Survey

The banking agencies presently collect information semiannually on cross-border lending by selected U.S. banks. Approximately 160 banking organizations submit these data which are then aggregated by country, including profiles on

type of borrower and maturity. These aggregated data are made available to the public upon request. Additionally, publicly-available data include separate totals for three size groups: the nine largest banks, the next 15 largest, and all other reporters. Information on the gross capital funds of these groups is also provided so that a user may calculate the exposures relative to capital funds for each of the groups.

The bank regulatory agencies are presently studying proposals to increase both the reporting frequency (to quarterly) and the amount of information which would be made publicly available. This latter proposal would have each reporting bank identify those countries in which it had large exposures, e.g., those in excess of one percent of total assets, for release to the public upon request.

There are problems associated with the disclosure of foreign lending, including the fact that its relevance and potential impact are dependent upon developments beyond our own borders and are, therefore, difficult to assess properly. Nevertheless, the extent of bank exposures to the transfer risk and the exchange rate risk associated with this type of lending suggests that country-lending data are relevant to the analysis of the overall financial condition of a bank. The SEC reached that same conclusion late in 1982 when it issued Staff Accounting Bulletin No. 49 concerning disclosure of cross-border lending to countries that are experiencing liquidity problems.

#### FDIC POSITION ON PUBLIC DISCLOSURE

The FDIC's conclusions regarding the public disclosure of information lead in three directions. These measures do not represent a one-time resolution of the issue. Rather, they illustrate the framework for an appraisal process that continuously recognizes that information deemed relevant to the public's analysis of risk changes in a dynamic and evolving banking system.

#### Educate the Public

The present system of limited deposit insurance places many depositors' funds at risk. By adopting a large depositor risk-sharing approach to insurance, the public perception that all or most uninsured deposits are riskless should dissipate and be replaced by an awareness of the need to evaluate bank risk. An evaluation of a bank's condition can succeed only where disclosures are informative to the user and go beyond bare numerical data that are devoid of explanatory comments.

The Federal Deposit Insurance Act and other statutes do not appear to contain legal authority for the Federal bank regulatory agencies to impose a blanket requirement that all banks provide a minimum level of disclosure to uninsured depositors. Such disclosures would permit uninsured depositors to make informed financial decisions with respect to the placement of their funds.

Some observers might argue that the FDIC should explicitly seek such authority in conjunction with the adoption of any plan to increase risk-sharing by large

depositors. The responsibility for providing relevant disclosures to the public properly rests with those institutions that are seeking to maintain or enlarge their share of the market and not with the Federal bank regulatory agencies. For this reason, and in the absence of clear authority to issue a regulation in this area, the staff has proposed that the FDIC adopt a Statement of Policy that would encourage the voluntary provision of financial data by banks to their depositors and other interested customers.

The proposal also suggests a minimum standard of bank disclosure that is basically designed to help educate the public by identifying the types of information that the FDIC believes are relevant to an assessment of bank risk. At the same time, to minimize the burden on banks, the policy statement attempts to limit the amount of information recommended for disclosure that is not already maintained by banks.

A key element of this disclosure is management's narrative analysis of the bank's results of operations and financial position. The policy statement sets forth general guidelines for subjects that may warrant inclusion in this narrative, but provides management with considerable flexibility in determining the scope of the discussion. This offers management the opportunity to comment upon the raw numbers in its Call Reports which, if analyzed without the benefit of such a discussion, might lead the user to an inappropriate interpretation of the bank's condition. As such, management's narrative might be viewed as an educational device that would help to introduce the less-sophisticated reader to the mechanics of financial analysis.

#### Make More Information Available to the Public

The financial information contained in bank Reports of Condition and Income has been publicly available for ten years. Supervisory usage of this Call Report data has greatly increased during the past several years as offsite computer based surveillance systems have become more sophisticated. To date, however, the Reports of Condition and Income have essentially corresponded to a balance sheet, income statement, and supporting schedules which, as noted earlier, fail to provide sufficient information for a complete analysis of bank risk. In order to enhance the usefulness of the Call Reports as a supervisory and surveillance tool, the Task Forces on Supervision and on Reports of the FFIEC undertook an evaluation of these reports, and in June of 1982 proposed substantial revisions to the Reports of Condition and Income. In addition to reformatting most of the existing report schedules, the FFIEC proposal recommended the addition of certain new schedules and other selected data items, which will supply the regulatory agencies with information needed to strengthen the supervision/surveillance process.

The new key elements of the Call Report package are a separate, self-contained report on past due, nonaccrual, and renegotiated loans and leases and schedules for reporting on interest rate sensitivity and on certain commitments and contingencies. The past due loan report was implemented as of December 31, 1982. Initial collection of the new Report of Condition schedules is planned for June 30, 1983. Additionally, quarterly submission of Reports of Income by all

banks regardless of size commenced on March 31, 1983. The reporting burden imposed on banks by these new requirements, the interest rate sensitivity schedule in particular, is a concern because they represent a significant increase in paperwork burden.

The public availability of the existing Call Report documents has not been a subject of significant objection in recent years. However, the new information already approved by the Office of Management and Budget for collection in 1982 and 1983 is regarded as highly-sensitive by much of the banking industry. This is especially true for the past due loan data which the three Federal banking agency members of the FFIEC will make available to the public commencing with the reports filed as of June 30, 1983. Bankers also object to disclosure of data on their nonperforming loans for reasons of equity. They compete directly for funds, including deposits in excess of the insurance limit, with savings and loan associations; however, the public does not have access to past due loan data for these thrifts. The FDIC believes that comparable disclosure rules should apply to savings and loan associations and all other groups that are in competition with banks.

Public availability is also planned for the new Report of Condition schedules on interest-rate sensitivity and on commitments and contingencies. Here, too, bankers expressed opposition to the disclosure of these Call Report schedules. Their stance that release of such information would have an adverse competitive impact is clearly at odds with the FDIC's view that dissemination of such data to the market properly promotes the competitive posture of sound, well-managed banks.

The previous discussion of administrative actions delineated various arguments for and against public awareness of the existence of statutory enforcement actions taken by the bank regulatory agencies against individual institutions and their directors, officers or employees. The FDIC believes that the ameliorating effect that such disclosure would have on the quality of bank management outweighs the potential for harm that has been theorized but for which we find little support.

Hence, the staff has developed a proposed Statement of Policy under which the FDIC would publish in the Federal Register all final orders issued under its statutory enforcement authority. Publication of actions taken would occur on or about each order's effective date. The FDIC's termination of a previously published order would also be printed in the Federal Register. As presently drafted, this policy would become effective six months after its formal adoption by the FDIC Board of Directors.

Adoption of this policy will not only further the fundamental purpose of the FOIA, which is to broaden the public's access to government records, but will also enhance the supervisory efforts of the FDIC. Facing the specter of unfavorable disclosure, bank management may be less likely to engage in activities which could be found to be hazardous. For those few banks where the initiation of statutory enforcement action becomes necessary, awareness of final orders will allow the market, in concert with the FDIC, to exert pressure

on such banks to correct the practices, conditions or violations cited therein and to attract and retain competent personnel to properly manage bank affairs.

At this stage of the drafting, the proposal's coverage is limited to insured state nonmember banks. The FDIC does not believe that other financial institutions and their directors, officers and employees should be excluded from the proposed policy and the participation of the OCC and the FRB will be solicited to facilitate uniform application of the policy to all Federally-insured banks. Other Federally-insured institutions should also be included.

#### Evaluate Agency and Public Data Needs

Insured banks face a multitude of reporting requirements imposed by various government agencies. The process of collecting, preparing and transmitting this information exacts a heavy burden, both in terms of time spent and expenses incurred, on each financial institution. If banks are to fulfill their reporting obligations in a satisfactory manner, it is incumbent upon the FDIC and other Federal agencies to exercise responsible behavior and review the continuing need for the reported information. The FDIC is already required to perform assessments of the practical utility of the data requested from banks at least once every three years as a result of the requirements of the Paperwork Reduction Act of 1980. The FDIC has committed itself to continue to reduce the bank reporting burden by promptly discontinuing the collection of data which is no longer relevant to its needs.

CHAPTER V

ADEQUACY OF THE INSURANCE FUND AND  
REVISIONS TO ASSESSMENT PROCEDURES

	Page
Executive Summary . . . . .	V-1
Introduction . . . . .	V-2
Financial Operations of the FDIC . . . . .	V-2
Determining the Adequacy of the Deposit Insurance Fund . . . . .	V-3
Borrowing Authority . . . . .	V-8
Assessment Procedures . . . . .	V-8

## CHAPTER V

### ADEQUACY OF THE INSURANCE FUND AND REVISIONS TO ASSESSMENT PROCEDURES

#### EXECUTIVE SUMMARY

The conclusion of this chapter is that the Fund has been adequate to handle failed bank situations and to maintain public confidence in the banking system. In the future, the manner in which the Fund is financed and the options available to handle failed banks probably will provide sufficient flexibility to absorb larger losses and preserve the historical relationship to exposure. While it is theoretically possible that losses could be large enough to impair the viability of the Fund, the likelihood of this occurring is sufficiently remote to not warrant adjustment to premium rates or other actions in anticipation of a worst-case scenario.

The Fund has grown each year since its inception, and there generally has been a remarkably consistent relationship between the size of the Fund and bank deposits. This relationship has persisted for several reasons. First, there are certain "normal" relationships within the economy that tend to link the longer term growth rate of gross income to the FDIC to the growth rate of bank deposits. Second, with the exception of the years prior to 1941, and 1981-1982, there were relatively few bank failures, with an average of about 5.5 failures per year. Finally, the FDIC's considerable discretion with respect to the handling of bank failures, has tended to minimize insurance losses and has resulted in a relatively small variance in loss rates. The extent to which the future banking environment is accompanied by larger numbers of bank failures and a different loss experience will determine whether these historical relationships persist. As long as the Fund is sufficient to fund losses and meet cash needs, its adequacy is more a matter of perception than the strict maintenance of a particular relationship to bank deposits or some other measure of exposure.

The assessment/rebate system has performed well. It has the advantage of cushioning the Fund in times of abnormal losses and inhibiting excessive growth in periods of low losses. The present system, however, results in some inequities.

The following recommendations are made:

- o The percentage of net assessment income returned to insured banks in the form of a rebate should be tied to the relationship of the Fund to total domestic and foreign deposits, not to the relationship of "insured" deposits as is currently prescribed.



- o The computation of assessable deposits should not include an adjustment for uncollected items (float).
- o The existing fixed limit on the FDIC's borrowing authority from the Treasury should be made more flexible. It is suggested that the amount be open to negotiation between the Secretary of the Treasury and the FDIC at the time borrowings are requested.

#### INTRODUCTION

The purpose of this chapter is to address the issues relating to the appropriate size of the Deposit Insurance Fund and the manner in which the Fund is financed. The chapter explores whether the present assessment arrangement is likely to be adequate in the future, whether it provides sufficient flexibility to accommodate a more variable and decontrolled environment, and whether the present method of levying assessments is appropriate.

#### FINANCIAL OPERATIONS OF THE FDIC

From the standpoint of financial operations, the FDIC operates in a manner similar to a casualty insurance company. Premiums collected from insured entities and income from investments are used to cover operating expenses, losses, and additions to reserves (net worth). In periods where expenses and losses exceed gross income, the net worth account is used to absorb the deficit. If, over the long-run, the funding is based on a well-founded actuarial basis, premium and investment income will be sufficient to cover expenses and losses, and to maintain net worth at a level deemed appropriate to absorb unanticipated losses.

While this description more or less reflects the way in which the FDIC operates, there are certain differences. Perhaps of most importance, casualty companies generally have some notion as to their risk exposure at any point in time. Actuaries spend considerable time and effort compiling statistics on the loss rates of various classes of insured, which in turn is translated into a premium structure that is reflective of anticipated future losses. For a variety of reasons, which are presented in Chapter II, loss experience related to deposit insurance operations is not amenable at this time to similar analysis.

In terms of the sources of income to the FDIC, insurance premiums (assessments) are collected from insured banks equal to 1/12th of one percent of assessable deposits, essentially deposits in domestic offices, less an adjustment for uncollected funds. After subtracting the FDIC's operating expenses and insurance expenses and losses incurred in handling failed banks, 60 percent of the remaining assessment income is rebated to insured banks in the form of a credit which is applied to the next year's assessment. Within limits, the rebate system allows the FDIC to vary the effective premium rate to account for present losses and to increase the Fund. Net premium income retained by the FDIC is added to the Deposit Insurance Fund. Appendix D contains a more detailed discussion of the assessment procedures.

In recent years the larger source of income has been the FDIC's portfolio of Treasury securities. Only a small portion of the FDIC's balance sheet is represented by fixed assets and equity in ongoing receivership estates. The majority of assets (and net worth) represents investments in U.S. Treasury obligations.<sup>1/</sup> Appendix E presents a more detailed description of the FDIC balance sheet and income statements.

#### DETERMINING THE ADEQUACY OF THE DEPOSIT INSURANCE FUND

There is no scientific way to determine the appropriate size of the Fund, either in terms of an absolute amount or in relation to some measure of exposure. The Fund has to be sufficient to cover losses and meet cash needs; beyond that, however, this basically becomes a philosophical issue which depends upon what contingencies the Fund should be expected to handle, and the perceptions of the public with respect to the ability of the FDIC to protect deposits and perhaps other bank liabilities under any "reasonable" economic scenario. From this standpoint, the Fund has been adequate in the past.

From a conceptual point of view, there are a variety of factors that should be considered in an evaluation of the adequacy of the Fund. One such factor is the relationship of the Fund to total exposure, which in some sense is a measure of the ability of the Fund to absorb losses in a worst case situation. While there are numerous problems with this type of measure, the concept has gained some degree of acceptance among those concerned with insurance matters and the general public.

Within the context of Federal deposit insurance, the relationship that probably has received the most attention is the ratio of the Fund to total "insured" deposits. As a practical matter, however, the concept of an aggregate level of insured deposits has little meaning because it is only in the case of a deposit payoff that each depositor is made whole only to the basic insurance limit. However, most bank failures have been handled by means of a purchase and assumption transaction (whereby the claims of all general creditors are transferred to an acquiring institution), or assistance has been provided to facilitate the merger of a troubled bank into a viable enterprise or, more infrequently, assistance has been provided directly to the troubled bank. In each of these cases, all general creditors were made whole. Moreover, even in the case of a payoff the available evidence suggests that in most larger banks, especially just prior to failure, many deposits above the insurance limit are either collateralized or have a potential offset against an outstanding credit.

<sup>1/</sup> Section 13(a) of the Deposit Insurance Act requires that the funds of the FDIC not in active use in deposit insurance operations be invested only in U.S. Government securities, or obligations guaranteed as to principal and interest by the U.S.

The present system has provided de facto 100 percent liability insurance for most depositors and other general creditors in insured banks. Viewed within this context, the ratio of the Fund to insured deposits underestimates the potential exposure of the Fund, and can lead to debates that have no real significance. For example, when there are discussions concerning raising the basic insurance limit, a question regarding the increased exposure of the Fund invariably arises; if liabilities are in most cases subject to 100 percent insurance, exposure is not necessarily increased.

Table I presents the size of the Fund and its relation to total domestic deposits (essentially the current assessment base), and total domestic and foreign deposits. It should be noted that both ratios exhibit a remarkable degree of stability over time.

In terms of maintaining public confidence, the historical ratios of the Fund to exposure must be judged to be adequate. Moreover, these ratios serve as the best guide to the appropriate size of the Fund. This leads to the second criterion for assessing the Fund adequacy -- is income sufficient to cover operating expenses and losses, and to contribute enough to the Fund to maintain relative stability in the exposure ratios? The data presented in Table I suggest that income has been sufficient for this purpose.

In every year since 1961, the major source of income to the FDIC has been earnings on its U.S. Treasury securities portfolio. Absent a cash need of catastrophic proportions or a precipitous decline in market interest rates, the relative importance of this source is likely to increase in the future as the size of the FDIC's securities portfolio continues to increase.

During the past few years market interest rates have been both relatively high and higher than the growth rate in bank deposits. As a result, despite sizable insurance losses in 1981-1982, the ratios of the Fund to deposits and liabilities have continued to grow, primarily from higher interest income on the U.S. Treasury securities portfolio. The average yield on the FDIC's portfolio increased from 7.72 percent in 1979 to 10.4 percent at year-end 1982.

The future relationship between market interest rates and bank deposits will depend upon several factors. One factor is the level of real interest rates that are likely to prevail. Market (nominal) and real interest rates are linked by means of inflationary expectations. Thus, everything else equal, earnings on the FDIC's securities portfolio will be directly related to the level of real rates. In recent years, the real rate of interest probably has been high relative to the previous 25 years' average and it is probable that these high rates will be maintained at least over the short-run. At some point, however, real rates will decline, perhaps approaching the post World War II norm. Counterbalancing the positive effect of higher interest earnings accruing to the Fund, however, is a probable increase in banking activities. As interest ceilings on deposits are completely dismantled, the share of financing that bypasses the banking system will be reduced. This suggests that for some adjustment period, other things equal, growth in bank deposits

TABLE 1  
EXPOSURE OF THE DEPOSIT INSURANCE FUND, 1934 - 1982

Year (December 31)	Deposit insurance fund (\$millions)	Ratio of deposit insurance fund to -	
		Total deposits in insured banks - Domestic	Domestic and Foreign
1982.....	\$13,770.9	.89%	.75%
1981.....	12,246.1	.87	.71
1980.....	11,019.5	.83	.68
1979.....	9,792.7	.80	.65
1978.....	8,796.0	.77	.65
1977.....	7,992.8	.76	.65
1976.....	7,266.8	.77	.66
1975.....	6,716.0	.77	.65
1974.....	6,124.2	.73	.64 <sup>1</sup>
1973.....	5,615.3	.73	
1972.....	5,158.7	.74	
1971.....	4,739.9	.78	
1970.....	4,379.6	.80	
1969.....	4,051.1	.82	
1968.....	3,749.2	.76	
1967.....	3,425.5	.78	
1966.....	3,252.0	.81	
1965.....	3,036.3	.80	
1964.....	2,844.7	.82	
1963.....	2,667.9	.85	
1962.....	2,502.0	.84	
1961.....	2,353.8	.84	
1960.....	2,222.2	.85	
1959.....	2,088.8	.84	
1958.....	1,965.4	.81	
1957.....	1,850.5	.82	
1956.....	1,742.1	.79	
1955.....	1,539.6	.77	
1954.....	1,542.7	.76	
1953.....	1,450.7	.75	
1952.....	1,363.5	.72	
1951.....	1,282.2	.72	
1950.....	1,243.9	.74	
1949.....	1,203.9	.77	
1948.....	1,065.9	.69	
1947.....	1,006.1	.65	
1946.....	1,058.5	.71	
1945.....	929.2	.59	
1944.....	804.3	.60	
1943.....	703.1	.63	
1942.....	615.9	.69	
1941.....	553.5	.78	
1940.....	496.0	.76	
1939.....	452.7	.75	
1938.....	420.5	.83	
1937.....	383.1	.79	
1936.....	343.4	.68	
1935.....	306.0	.66	
1934.....	291.7	.73	

<sup>1</sup> Foreign office data not available prior to 1974.

will be above normal. However, once that "adjustment" occurs, the FDIC expects a return to the growth path that is explained by economic aggregates.

Over the past 25 years, interest earnings have increased by a compound rate of one to one and one-half percent less than bank deposits. While this relationship may not hold over the shorter term for the reasons cited above, it may be a reasonable approximation for long-term behavior. Whatever the size of the shortfall, however, retained assessment earnings is the only other source available to stabilize the ratio of the Fund to deposits. The magnitude of this income depends on the dollar volume of deposits in the banking system (currently only domestic deposits are subject to assessment) and the magnitude of insurance losses.

In general, losses incurred by the FDIC in connection with failed banks have been modest. From 1934 to 1980, estimated losses and insurance expenses as reported by the FDIC amounted to only about \$400 million.<sup>2/</sup> This represented less than four percent of the assets of the failed FDIC-insured banks during that period and about the same percentage of gross assessments. These loss calculations, however, underestimate the true loss in that they do not adequately reflect the foregone interest earnings associated with FDIC advances to receiverships.<sup>3/</sup> If the data are adjusted to take account of foregone interest, losses would be raised by about five percentage points, resulting in a revised estimate of about nine percent of the assets of failed banks.<sup>4/</sup>

Considering the types of assets acquired from failed banks and the often long and protracted liquidation effort that follows, losses have been modest. Under most circumstances, banks do not get to the point where they are substantially insolvent before they fail. Also, before the FDIC becomes exposed, bank stockholders and subordinated creditors must suffer total loss.

In the last two years, the FDIC incurred substantial losses in connection with assisted mergers involving failing mutual savings banks. In 1981-1982, these losses amounted to about \$1.4 billion, which is comparable to the failed commercial bank loss experience of about nine percent of assets. It should be noted that in most of these transactions the FDIC did not advance cash to acquire assets. Present and projected future payments in connection with these assisted mergers were estimated when the transactions were affected and money costs were taken into account. While the ultimate costs of some of these

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<sup>2/</sup> These losses result primarily from the liquidation of assets the FDIC receives in transactions involving failed banks.

<sup>3/</sup> After December 31, 1982, all cash advances made in connection with a failed or failing bank will accrue interest at the average three-year U.S. Treasury bond rate.

<sup>4/</sup> Adjustments would have increased insurance expenses and raised the amount of assessment income retained by the FDIC. Thus, the actual treatment afforded these transactions reduced the amount of cash available for investment, and ultimately reduced the size of the Fund.

transactions will depend upon future interest rates, there is no downward bias associated with the \$1.4 billion loss estimate.

Although interest rates have declined and asset depreciation of savings banks has considerably lessened, the savings bank problem has not ended. However, as long-term assets approach maturity or are paid off and portfolios are shortened, this interest rate exposure will decline in absolute terms, and even more so in relative terms (relative to the size of the institutions and a growing FDIC). Commercial banks for the most part have only limited interest rate exposure. Overall, the potential loss exposure to the FDIC from interest-rate risks in FDIC-insured banks is likely to be considerably less important in the future.

It is difficult to confidently predict future FDIC insurance losses. To some extent they will be affected by possible changes in the deposit insurance system which may provide incentives for banks to curb risks. Losses will also depend importantly on the volatility in the economy and in financial markets.

Deregulation of deposit interest rate ceilings, expanded geographic competition, and other banking market changes are likely to increase risks in banking in general. In addition, the depth of the recent recession in the United States and abroad has increased the number of problem banks, amount of loan losses, and volume of nonperforming loans, all of which are likely to increase further with a lag of one to two years after economic recovery. Thus, future FDIC losses are likely to be relatively higher than those experienced between 1934 and 1980, when they amounted to about nine percent of gross assessments. However, the FDIC expects these losses to average considerably less than the 70 percent of gross assessments experienced in 1981 and 1982. While FDIC losses will depend on the number and size of future bank failures, it is important to keep in mind that FDIC experience suggests that these losses will run from nine to ten percent of the assets of failed banks.

The FDIC could sustain a relatively high loss rate in the future and, nevertheless, net assessment income would still add sufficiently to the growth of the Fund to cover any shortfall (one to 1.5 percent historically) between interest income and deposit growth. At present, the Deposit Insurance Fund is about 0.80 percent of the deposit assessment base. Gross assessments of 1/12th of one percent of deposits equal about ten percent of the Fund. The following calculations indicate that even if insurance losses average 40 percent of gross assessment income in the future, net assessment income would still add two percent a year to the Fund:

Assessments in basis points of assessable base	8.33
FDIC operating expenses	- .90
Losses (40%)	-3.33
Net before assessment credit	<u>4.10</u>
Credit (60%)	-2.46
Retained by FDIC	<u>1.64</u>
As a percentage of the Fund = $\frac{1.64}{0.80}$	= 2.05%

Under more extreme circumstances, the Fund could absorb considerable loss for a period of a year or two without seriously compromising its adequacy. The rebate system in essence places 60 percent of losses directly with insured banks; this provides a cushion to the Fund in absorbing insurance expenses. Further, if operating expenses and losses exceed gross assessment income, the excess is carried forward to subsequent years and is charged against gross income in the same manner as current losses. Moreover, current law ties the proportion of net assessment income returned to insured banks to the relationship of the Fund to total exposure.<sup>5/</sup> Thus, there may be situations where the ratio of the Fund to exposure declines, and perhaps where the size of the Fund actually declines, but the workings of the system tend to accelerate the rate of income accumulation until historical relationships have been restored. Nevertheless, there is some level of loss that would be judged to impair the viability of the Fund; if this should occur, it would be necessary to re-evaluate the current method of funding the FDIC.

The final factor to consider in evaluating the adequacy of the Fund is the ability to meet the potential requirements for large cash needs (liquidity). In most failed bank situations the ultimate loss is normally a reasonably small percentage of assets; however, there often is a need for an initial cash outlay equal to several times the loss. In the typical "clean bank" purchase and assumption transaction, for example, the acquiring bank will assume all nonsubordinated liabilities, and will purchase some assets which normally include banking house, cash, securities (at market) and some loans. Cash sufficient to make up the difference between acquired assets and assumed liabilities, less the premium paid by the acquiring bank, is advanced by the FDIC. Depending on the size of the failed bank and the amount of assets passed to the acquirer, the need for immediate cash could be sizable.

In addition to following an investment strategy that has explicitly considered anticipated cash needs, the FDIC has available, and has used, various techniques to minimize initial cash outlays. One of the earlier examples was in connection with the failure of Franklin National Bank of New York, where the FDIC assumed the \$ 1.7 billion borrowings from the Federal Reserve Bank of New York, and repaid the advance over a period of three years. More recently, most of the assistance provided to facilitate the merger of failing mutual savings banks has taken the form of future cash payments based on the relation of market interest rates and the average yield on the declining balance of assets acquired. In a few cases, the FDIC has provided longer-term promissory notes in lieu of immediate cash.

It has not been always possible or desirable to substitute future payments for cash up-front, but the FDIC has had considerable success in minimizing

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<sup>5/</sup> The Depository Institutions Deregulation and Monetary Control Act of 1980 authorizes the Board of Directors of the FDIC to make adjustments to the assessment credit to maintain the Fund between 1.25 and 1.40 percent of estimated insured deposits, and mandates adjustments when the Fund falls below 1.10 percent and exceeds 1.40 percent of insured deposits.

immediate cash outlays where appropriate. Additionally, the FDIC is currently experimenting with ways to induce acquiring institutions to purchase more assets than historically has been the case. The United American Bank, Knoxville, Tennessee, transaction, where all assets were passed to the acquiring bank under a guaranty from the FDIC, is a type of transaction that may be followed more frequently in the future.

#### BORROWING AUTHORITY

If an emergency situation were to develop, the FDIC does have the authority to borrow up to \$3 billion from the U.S. Treasury. This authority has never been used, and it is only in an extreme situation that this liquidity would be needed. There is logic, however, to revising the limit to reflect the growth of the Fund as well as the banking system, inasmuch as the current limit was legislated in 1947. At that time, the borrowing limit exceeded the Fund and represented approximately 1.9 percent of domestic deposit liabilities; at year-end 1982, this amount was less than 25 percent of the Fund and only 0.18 percent of domestic and foreign deposits. The FDIC does not recommend that the limit be increased to restore the coverage existing in 1947. Nevertheless, the borrowing limit should be more reflective of current exposure and the current size of the Fund, both because of the implications for public confidence and to provide a safety valve in the case of a banking crisis. To provide flexibility and to limit the statutory exposure of the Treasury, the FDIC recommends that the borrowing authority be whatever amount may be mutually agreeable to the Secretary of the Treasury and the FDIC at the time any borrowings are requested.

The conclusion that flows from this discussion is that the Fund has been adequate to handle failed and failing bank situations, and to maintain public confidence in the banking system. The way in which the Fund is financed provides sufficient flexibility to permit absorption of larger losses while preserving the historical relationship between the Fund and exposure. It is possible that losses could become large enough, or persist at an abnormally high rate over a long enough period of time to endanger the Fund or undermine public confidence in the FDIC. The occurrence of such an event does not appear likely at this time, and therefore it would be premature to adjust premium rates or take other actions in anticipation of a disaster scenario. In short, the current system works well in terms of generating sufficient revenue to handle losses and maintain public confidence in the system, and there are no reasons to believe that it will not continue to operate as well in the future.

#### ASSESSMENT PROCEDURES

As indicated in the preceding section, the current assessment system is basically sound and, in all probability, will meet the future funding requirements necessary for FDIC operations. Perhaps one of the most desirable features of this system is the rebate mechanism, whereby losses and expenses are shared by the FDIC and insured banks on a 40-to-60 percent basis. This has provided a cushion to the Fund in periods of abnormal losses, and a means to constrain excessive growth during periods of small losses.



The assessment base currently includes only deposits in domestic offices of insured banks. There may be merit to expanding this definition to encompass deposit liabilities in foreign offices of U.S. banks and International Banking Facilities. As discussed earlier, in situations where the FDIC uses a purchase and assumption transaction to handle a bank failure, these deposits are de facto 100 percent insured. Moreover, many foreign deposits are explicitly insured under existing law. Furthermore, if the FDIC institutes a policy of handling all or a majority of failed banks by means of a coinsurance approach, as discussed in Chapter III, explicit deposit insurance coverage of foreign and IBF deposits may act as a stabilizing influence. The FDIC considers current assessment income sufficient to meet insurance needs. Thus, if insurance coverage and assessments are expanded to include foreign office and IBF deposits in the future, it would be appropriate to reduce the assessment rate to offset the resulting increase in assessment income.

The International Banking Act of 1978 increased deposit insurance coverage and the assessment base by establishing procedures for the FDIC's insuring certain U.S. branches of foreign banks. Such insurance poses problems because the FDIC is not in a position to assess the conditions of the overall banking organization or to prevent the shifting of assets out of U.S. branches in times of financial difficulties. Necessary enforcement procedures by the FDIC may sometimes be impeded by legal and political problems. For these and other reasons the FDIC believes a reconsideration of the International Banking Act provisions relating to the insurance of deposits in domestic branches of foreign banks may be in order. In several areas of this study, recommendations designed to encourage risk restraint by banks appear to have no applicability to foreign branches. For example, it would be difficult to apply a risk-related premium system to a branch and it would be difficult to attain satisfactory disclosure unless it covered the entire banking organization. These considerations lend additional support for reevaluating the insurance of domestic branches of foreign banks.

There are two technical aspects of the assessment process that are in need of revision at this time. The first deals with the adjustment to deposits for uncollected items. The second relates to the percentage rebate based on the ratio of the Fund to "deposits."

For purposes of determining assessable deposits, banks are permitted to reduce total deposits to reflect the uncollected items (float) on their balance sheets (see Appendix D for a more detailed discussion). The stated rationale for allowing this adjustment is to eliminate double counting in determining the assessment base. Float is a creation of the clearing process, whereby an item (a check) is often credited to an account at the receiving bank prior to being debited by the bank upon which the item is drawn. Basing assessments on unadjusted total deposits, therefore, would assess these uncollected items twice, once at the receiving bank and again at the issuing bank.

There are several reasons why this adjustment is unnecessary and, in terms of the present procedures, inequitable. In the first place, for the purpose of deposit insurance coverage for an individual bank, unadjusted deposits is the

unit insured, not deposits adjusted for float. If a bank is closed, booked uncollected items are processed and added to the cash account, while items presented for payment are returned as being uncollectible. Thus, the exposure assumed by the FDIC is accurately reflected by the deposit balances on the books of the bank at the time of closing.<sup>6/</sup> Secondly, the current procedures permit a fixed percentage deduction for "demand" balances (16-2/3rd percent) and "time and savings" balances (one percent). This practice tends to reward those banks with a relatively small volume of clearings and penalize those banks with a large volume; this is clearly an inequitable treatment of insured institutions. Finally, the Federal Reserve Board has announced its intention to adopt rules and procedures designed to reduce the volume of float in the system and, more recently, has introduced some changes in the clearing process to accomplish this goal.

For these reasons, the FDIC recommends that the FDI Act (Section 7(b)(6)) be amended to delete the permissibility of an adjustment for float to total deposits for assessment purposes. This action will increase the assessment base moderately. Based on current data, the affect on assessment income would be minimal, amounting to about \$60 million per year.

The second recommendation relates to the statutory provision that ties the proportion of net assessment income rebated to the relationship of the Fund to "insured" deposits. As argued earlier, "insured" deposits is not a meaningful measure of exposure of the Fund, and on these grounds the FDIC recommends that Section 7(d)(1) of the FDI Act be amended to relate the assessment rebate to the ratio of the Fund to domestic and foreign deposits. The ratios that trigger a change in the rebate percentage currently in the Act, of course, would have to be changed to reflect the expanded base. Based on the historical relationships, an upper limit of 1.0 percent and a lower limit of 0.60 percent appear to be reasonable.

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<sup>6/</sup> This ignores unbooked items and unposted debits and credits. Normally, the amount involved in these categories is minimal.

CHAPTER VI

MERGER OF THE DEPOSIT INSURANCE FUNDS

	Page
Executive Summary . . . . .	VI-1
Introduction . . . . .	VI-2
Arguments for Merging the Funds . . . . .	VI-2
Similarities of Insurers . . . . .	VI-2
Insurance Premiums . . . . .	VI-2
Regulatory and Supervisory Powers . . . . .	VI-3
Insurance and Supervision . . . . .	VI-4
Similarities of Insured Institutions . . . . .	VI-4
Risk Diversification and Strength of the Funds . . . . .	VI-5
Changes in Charters and Interindustry Mergers . . . . .	VI-7
Reporting and Surveillance . . . . .	VI-8
Separation of Insurance From Chartering and Regulation . . . . .	VI-8
Arguments Against Merging the Funds . . . . .	VI-9
Conflict With Other Public Policies . . . . .	VI-9
Loss of Industry Orientation . . . . .	VI-10
The Question of Equity . . . . .	VI-10
Public Confidence . . . . .	VI-10
Merging the Funds . . . . .	VI-10
Single Pool . . . . .	VI-11
Separate Pools . . . . .	VI-11
Phase-in . . . . .	VI-12
Supervisory Framework . . . . .	VI-12

## CHAPTER VI

### MERGER OF THE DEPOSIT INSURANCE FUNDS

#### EXECUTIVE SUMMARY

Recent changes in the financial-services industry have created a more open and competitive environment for banks and thrifts and have thrust them into direct competition with each other. Not only have thrifts acquired powers previously reserved for commercial banks, they have been granted authorities which go far beyond those ever envisioned when Congress crafted our current insurance and regulatory systems 50 years ago. For example, a diversified corporation controlling a new savings bank charter issued by the Federal Home Loan Bank Board ("FHLBB") is free to engage in virtually any lawful activity, make any type of investment it wishes, and own controlling interests in almost any other company it chooses, any place in the world.<sup>1/</sup>

Separate regulatory and insurance systems for savings and loan associations and banks are becoming intolerable from the standpoint of competitive equity among like firms and from the standpoint of fostering the most effective and efficient regulatory system and the strongest possible insurance system. The FDIC suggests a number of reforms in this chapter, including:

- o Merging the Federal Savings and Loan Insurance Corporation ("FSLIC") into the FDIC;<sup>2/</sup>
- o Granting the FDIC authority to require reports from, take enforcement actions against, and conduct examinations of all Federally-insured banks and thrifts and their affiliates;
- o Removing the FDIC from the applications process and all other regulatory functions not directly related to safety and soundness; and
- o Establishing a separate, single agency for chartering and regulating all Federal banks, thrifts, and holding companies.

<sup>1/</sup> Vartanian, Thomas P. and Hawke, John D., Jr. "It Sounds Like a Banker's Fantasy, But It Isn't," The American Banker, April 13, 1983, Vol. CXLVIII, No. 72.

<sup>2/</sup> Consideration was given to including the National Credit Union Administration and its insurance fund (the "NCUSIF") in the reorganization, but this was rejected, at least at this time, as unnecessarily burdensome given the relatively small size of the NCUSIF and the average credit union and the limited direct competition between banks and savings and loan associations, on the one hand, and credit unions, on the other. The other reforms recommended in this study will be difficult enough to implement without including the NCUSIF and some 17,000 Federally-insured credit unions in a reorganization.

## INTRODUCTION

This chapter discusses the insurance and supervisory systems for banks and savings and loans and the most often cited arguments for and against a reorganization of these systems. On balance, the arguments show the necessity for a more rational system which would provide uniformity of deposit insurance, a coordinated system of supervision, and greater flexibility in dealing with troubled or failed banks and thrifts.

## ARGUMENTS FOR MERGING THE FUNDS

Similarities of objectives and functions for the deposit insurance agencies and a growing similarity in banks and thrift institutions all argue that a single fund is a logical alternative to the present framework. The future of the financial services industry will require a larger, better-diversified insurance fund and greater flexibility in dealing with troubled or failed institutions, particularly cross-industry takeovers. Merging the funds will also provide for less public confusion and greater public confidence in the deposit insurance system, and foster more uniformity of supervision. An additional important reason is that of separating the role of deposit insurance from chartering and regulation.

Similarities of Insurers

In basic form, the FDIC and FSLIC have very similar powers and functions. Both, either directly or through entities to which they are tied, exercise some control over the entry of an institution to their respective industries, regulate and supervise constituent institutions' activities, and oversee the closing and liquidation of a troubled or failed institution. Likewise, they assess deposit insurance premiums on constituent institutions to support these functions, but primarily to support an insurance fund to maintain the objectives of stability of the financial system and depositor protection.

The FSLIC is distinguished from the FDIC in that it has no separate governing board; it is governed by the FHLBB. Although the FSLIC is technically separate from the FHLBB, it has little administrative apparatus of its own and relies on the FHLBB for the services of examiners, legal staff, etc.

Insurance Premiums

Both agencies levy premiums (assessments) based on "domestic deposits." The FDIC has a statutory rate of 1/12th of one percent. The FDIC is required to credit 60 percent of the assessment to insured banks after deducting its operating expenses and insurance losses for the year. The "rebate" may be decreased to 50 percent in order to maintain the fund above 1.10 percent of insured deposits and increased to 100 percent if the fund exceeds 1.40 percent of insured deposits.

The FSLIC also has a basic assessment rate of 1/12th of one percent computed by reference to "all accounts of the insured members of the institution." This

contrasts with the FDIC's assessment formula, which is complex by comparison. In addition to its basic assessment rate, the FSLIC can ask for an emergency assessment up to an additional 1/8th percent of insured deposits if the fund falls below 1.0 percent of insured deposits. The FHLBB may also require FSLIC insured institutions to make deposits in the FSLIC's fund, up to one percent of total industry deposits, to prevent the depletion of the FSLIC fund. If the FSLIC fund rises above two percent of insured deposits, the FSLIC does not charge any assessment.

The following table summarizes the two assessment schemes:

	<u>Basic Rate</u>	<u>Supplemental</u>	<u>Rebate</u>	<u>Statutory Ratio</u>	<u>Borrowing Authority</u>
FDIC	1/12%	None	Yes	1.1 - 1.4%	\$3 Billion
FSLIC	1/12%	Up to 1/8%	No	1.0 - 2.0%	\$750 Million

One benefit of merging the two funds would be to unify assessments. As shown in the table above, the present assessment schemes begin with the same basic rate, but vary widely after that. The FDIC scheme defines assessable deposits differently than insured deposits.<sup>3/</sup> The FSLIC assessment scheme is simple and straightforward by comparison, using "insured accounts" as a base.

#### Regulatory and Supervisory Powers

While the two insuring agencies have similar regulatory and supervisory powers, distinctions exist in the way the agencies operate. The FDIC, while insuring approximately 14,700 commercial and mutual savings banks, is the Federal supervisor over only two segments -- some 8,900 insured state-chartered commercial banks which are not members of the Federal Reserve System ("FRS") (nonmember banks) and 300 insured mutual savings banks. The approximately 4,500 nationally-chartered banks are supervised by the Office of the Comptroller of the Currency (OCC), and some 1,000 insured state-chartered banks which are members of the FRS (member banks) are under the primary Federal supervision of the Federal Reserve Board (FRB).

The FDIC does, however, review all bank and bank holding company examination reports, and monitors all FDIC-insured institutions and bank holding companies (bank holding companies are supervised by the FRB). Further, by statute and through agreements with the FRB and OCC, the FDIC conducts joint and/or concurrent examinations of selected banks for which it is not the primary Federal supervisor and bank holding systems which include nonmember banks. By statute, all national banks and other banks which are members of the FRS must have Federal deposit insurance, and state laws generally require Federal deposit insurance as a condition to granting a charter.

<sup>3/</sup> Deductions are allowed for (1) cash items held by a bank drawn on itself; (2) one percent of "adjusted time and savings deposits"; and (3) 16-2/3 percent of "adjusted demand deposits." See 12 U.S.C. 1817(b).

The FSLIC has no examination personnel. Its parent organization, the FHLBB, directly supervises approximately 3,300 institutions which are nearly evenly split between Federal and state-chartered savings and loans, with a few Federal savings banks (a recent phenomenon which results when a state-chartered savings bank converts to a Federal charter). The FHLBB also supervises savings and loan holding companies (companies controlling FSLIC-insured savings and loans).

The FHLBB is the chartering authority for Federal savings and loans. Similar to the FDIC insurance requirements for nationally-chartered banks, all Federally-chartered savings and loans and savings banks are required to have Federal deposit insurance. State-chartered savings and loans must volunteer for insurance. All FSLIC-insured institutions belong to the Federal Home Loan Bank System (the "System"), and a member cannot leave without relinquishing its insurance.

Both the FSLIC and FDIC have direct examination and supervisory authority or a close and continuous link to those agencies with primary supervisory responsibility. It is that authority and linkage which should be preserved, not the structure of the of the insurance agencies.

#### Insurance and Supervision

More important than the similarities and differences of assessment, examination and supervision is the relationship between insurance responsibility and supervisory powers. The resulting insurance agency, however constituted, must have the authority to prescribe the conditions for insurance coverage, to fix the premiums levied, to use examination and surveillance techniques, and take enforcement action to safeguard its function and insurance fund. Regulatory and supervisory activities unrelated or marginally related to insurance such as routine applications need not be part of the insurer's responsibilities, but there should be no barriers implicit or explicit to the insurer's access to information and authority to discharge its responsibilities.

#### Similarity of Insured Institutions

During recent years thrift institutions have acquired powers which point toward the emergence of a homogeneous financial-services industry. All banks and thrifts can now offer "demand deposit" accounts and commercial loans.<sup>4/</sup> In addition, depositors often do not distinguish between institutions, and merging the deposit insurance funds would be in keeping with industry trends and create a less confusing framework to the public. Insurance coverages and procedures for handling failed institutions would be unified. This will be particularly important if the reforms recommended in this report, such as risk sharing by larger creditors, are to be implemented.

<sup>4/</sup> This does not include certain "nonbank banks" which have divested themselves of or do not exercise the power to make commercial loans so as not to be defined as a bank under Section 2(c) of the Bank Holding Company Act.

Events of the past two years have piqued the public's attention with respect to deposit insurance. Questions have arisen in the media regarding the ability of any one agency to handle the problems in any particular segment of the industry, particularly the thrift industry. Merging the FSLIC and FDIC insurance funds is one way of increasing public confidence by providing a larger fund with greater diversification of risk and at the same time reducing the likelihood of direct government subsidization.

#### Risk Diversification and Strength of the Funds

Although the term "depository institution" implies a basic similarity among all institutions that accept deposits, risk exposures currently differ for banks and thrifts. Both are exposed to managerial incompetence and self-dealing but banks, because of the better balance between the maturity structure of their assets and liabilities and greater flexibility in adjusting their interest rates to money and capital market conditions, have minimal intermediation risks. Risks in commercial banks are centered in loan losses and the escalating level of bank and nonbank competition.

Thrifts, on the other hand, as an industry do not show significant loan losses; their primary risk at present is one of interest rate. Interest paid by thrifts grew from 75 percent of operating revenues in the mid-70s to 85 percent in 1980, and 97 percent in 1981. The corresponding shrinkage in gross margins, from which operating expenses must be paid, depleted reserves (net worth) to dangerous levels and resulted in the failure of many institutions.

Table I indicates the financial positions of all banks and savings and loans each agency insures for the period 1974 through 1981. For the last five years, the most recent for which data are available, the equity (net worth) to assets ratio for banks has been stronger. The figures for 1980 and 1981 for FSLIC insured institutions reflect the severe impact high interest rates and disintermediation have had on thrifts due to their extreme vulnerability to interest-rate risk.

Table I

#### Condition of Insured Institutions

	FDIC INSURED		FSLIC INSURED	
	Income/ Assets	Net Worth/ Assets	Income/ Assets	Equity/ Assets
1981	.61%	7.0%	(.73)%	4.2%
1980	.69	6.9	.13	5.4
1979	.74	6.9	.67	5.6
1978	.70	6.8	.82	5.5
1977	.65	6.9	.77	5.5
1976	.64	7.1	.63	5.6
1975	.64	7.0	.47	5.8
1974	.65	7.4	.54	6.2



Owing to the similarities between savings banks and savings and loans, the 1980 and 1981 figures for FDIC-insured institutions are distorted as savings bank performance lowered that of the group. The table below shows income/assets for commercial banks, savings banks, and savings and loans for 1980 and 1981.

	<u>Commercial Banks</u>	<u>Savings Banks</u>	<u>Savings and Loans</u>
1981	.77%	(.93)%	(.73)%
1980	.80	(.17)	.13

By September 30, 1982, the net worth/assets ratio for all FDIC-insured mutual savings banks had declined to 5.2 percent and the net worth/assets ratio for all insured savings and loans had declined to 3.4 percent. By midyear 1982, some 500 savings and loans had net worth/assets ratios below the two percent minimum required by the FHLBB.<sup>5/</sup>

Merging the deposit insurance funds would have the effect of diversifying the present risks. That is, an industry systemic risk such as interest-rate risk, to which thrifts have been and still are vulnerable, would be less likely to jeopardize a combined fund.

Table II shows the respective fund balances and the ratio of each fund to insured deposits for the years 1974 through 1982. Notwithstanding a statutorily prescribed ratio and rebate (see the table on page VI - 3 of this chapter), the FDIC's fund to insured deposit ratio is higher than that of the FSLIC.

TABLE II

Size of the Respective Funds  
(In Millions)

	<u>FDIC Fund Balance</u>	<u>FDIC Fund/ Ins. Dep.</u>	<u>FSLIC Fund Balance</u>	<u>FSLIC Fund/ Ins. Dep.</u>
1982	\$13,771	1.21%	\$6,418	1.16%
1981	12,246	1.24	6,301	1.23
1980	11,019	1.16	6,462	1.29
1979	9,792	1.21	5,848	1.27
1978	8,795	1.16	5,328	1.26
1977	7,992	1.15	4,873	1.29
1976	7,268	1.16	4,480	1.37
1975	6,716	1.18	4,120	1.48
1974	6,124	1.1 <sup>o</sup>	3,791	1.60

<sup>5/</sup> Michael J. Moran, Thrift Institutions in Recent Years, Federal Reserve Bulletin, December 1982.

Table III shows the size, maturity structure, and market value of investment portfolios of each of the funds as of December 31, 1982.<sup>6/</sup> Federal statutes require that each of the agencies invest solely in direct obligations of the U.S. Treasury or securities fully guaranteed by the United States.

TABLE III

Investment Portfolios of the Insurance Funds  
(In Millions)

	Weighted Avg. Maturity	Book Value (Millions)	Market Value (Millions)	Depreciation (Millions)	Depreciation Book Value
FDIC	2.7 yrs.	\$13,252	\$13,320	\$(68)	(0.5)%
FSLIC	4.9 yrs.	5,325	5,017	308	5.8

( ) Denotes appreciation.

Based on the maturity structure of each of the portfolios, a merging of the funds could provide some flexibility with respect to liquidity needs, which in turn could enhance portfolio performance.

Changes in Charters and Interindustry Mergers

Beginning in 1978 several state-chartered insured mutual savings banks in New York converted to Federal savings banks. In order to facilitate these charter conversions, the FDI Act was amended to provide that FDIC would indemnify the FSLIC against certain losses incurred by the banks prior to conversion.<sup>7/</sup>

Beginning with all applications for charter conversion filed after October 15, 1982, the indemnification agreement between the FDIC and FSLIC became no longer applicable.<sup>8/</sup> Title I of the Garn-St Germain Depository Institutions Act of 1982 (Garn-St Germain Act) provides that the FDIC will insure any state-chartered mutual savings bank converting to a Federal charter until that bank shall be insured by the FSLIC. In effect, the Garn-St Germain Act has created a situation whereby institutions chartered by the FHLBB are insured by the FDIC. By passing that Act, Congress appears to have set the stage for a single fund insuring all banks and savings and loans regardless of charter or class.

In addition to charter changes, interindustry mergers can be expected to increase as banks and thrifts seek to gain access to each other's markets. A well-publicized example is the Citicorp, N.Y. acquisition of Fidelity Federal

<sup>6/</sup> Information supplied by the portfolio manager for each of the funds.

<sup>7/</sup> See Section 26 of the FDI Act, 12 U.S.C. 1831(c).

<sup>8/</sup> See Title I, Sec. 112, of the Garn-St Germain Depository Institutions Act of 1982.

Savings and Loan of San Francisco. As interindustry mergers gain wider acceptance, the rationale for a combined fund will continue to grow.

Moreover, the fractionalized supervisory framework will become more inefficient and less effective in dealing with organizations which include both banks and thrifts. The FDIC, for example, is already experiencing difficulties in monitoring banks which are affiliated by virtue of common ownership or control with savings and loan associations. Maintaining separate insurance funds and regulatory systems in light of what has taken place in the financial-services industry with respect to charter conversions, interindustry mergers and applications would appear to have already rendered the present system outdated.

#### Reporting and Surveillance

All Federally-insured commercial and mutual savings banks are required to submit periodic financial reports. With the expanded powers granted thrifts, future activities and reports should closely resemble those of banks. Merging the funds and reorganizing the Federal regulatory structure would have benefits in terms providing for uniform reporting requirements and improved data for research and analysis. Minimum data base standards could be established for all reporting institutions and the data made available to chartering agencies. Surveillance systems would likewise be combined and information centralized.

The FDIC's experience with state supervisors in this area has been successful and could be expanded. Forty states now use FDIC reporting forms (Reports of Condition and Income), and 17 states have computer terminal access to the FDIC's data base. New York State has abolished financial reporting for commercial and mutual savings banks as a result of its participation in this program.

#### Separation of Insurance From Chartering and Regulation

The present system whereby chartering, regulation and supervision are used to promote all aspects of an industry (individual institutions, housing and depositors), while at the same time these vehicles are used to protect an insurance fund, involves inherent conflicts. A consequence could be the subordination of safety and soundness considerations to those of promotion. The responsibility of an insurer is, and should be, singular -- stability of the system through the safe and sound operation of individual institutions and the prompt resolution of problems.

There frequently is, and should be, a healthy tension between the insurance and regulatory functions. The best way to achieve this is through a legal separation of the agencies performing these distinct functions. While having the chartering and insurance functions housed in a single agency provides flexibility for dealing with crises, such as have been experienced in the thrift industry during the past two years, it removes the discipline provided

by a system of checks-and-balances. During the past two years, the FDIC has handled more than 60 bank and thrift failures. These failures were dealt with swiftly and effectively, notwithstanding the absence of a chartering power. Indeed, the fact that the handling of those failures was subjected to review by a separate chartering authority imposed an important discipline on the insurer with respect to both identifying and resolving the problems.

#### ARGUMENTS AGAINST MERGING THE FUNDS

The arguments cited against merging the deposit insurance funds include potential conflict with other public policy objectives, such as convenient and adequate sources of funds for housing; loss of industry orientation; the proposition that stronger segments should not be asked to support or subsidize weaker ones; and the fear that a merger could shake public confidence.

These arguments against merging the deposit insurance funds are based on fears or perceptions founded in historical thought or evidence and fail to adequately consider the current and future financial-services industry. Prospective analysis would argue that the present system could be better structured and equipped.

#### Conflict with Other Public Policies

Raising the argument that merging the deposit insurance funds would conflict with other public policy objectives confuses the goals of deposit insurance with other public policy goals. The issue is whether a combined fund will be able to deal with future or potential failures of banks and thrifts. Home-ownership and home construction will be better served if the fund has greater resources, thereby strengthening public confidence in both banks and thrifts. In addition, to argue that deposit insurance, or the deposit insurance agencies, are in and of themselves direct instruments for the attainment of other goals fails to recognize the paramount objective of financial stability.

In order for funds to be available for housing, business development, and other financial needs public confidence in the financial system must be maintained and even enhanced. Merging the funds would achieve just that goal. While the present supervisory and insurance framework may have been appropriate when established, the rationale for continuing that arrangement is lost in today's environment. Promotion of the housing industry is now accomplished in ways -- tax benefits, developed secondary markets, mortgage companies -- unrelated to deposit insurance. Moreover, promotion of the housing industry is better served by providing a stable flow of funds to the mortgage market and is being accomplished through efforts to deregulate the liability side of thrifts' balance sheets.

Deposit insurance has helped provide a stable financial environment and must continue in that role. The relationship between insurance and stability, which has worked through the 50 years of deposit insurance, needs now to be reviewed and strengthened; merging the deposit insurance funds will not disrupt, but reinforce, that relationship.

### Loss of Industry Orientation

This argument is raised within the context of having an insurance agency which is properly attuned to the problems and changes occurring in the industry. As discussed earlier, the industry has changed. As distinctions in product lines blur, geographic barriers erode, and charter conversions, interindustry mergers and affiliations occur there is a rapid breakdown in the argument that an industry-oriented insurance system is necessary, and even greater reason to integrate the deposit insurance systems. The evolving industry, which is being fostered through efforts aimed at deregulation, is rapidly outpacing the present insurance and supervisory framework.

### The Question of Equity

One of the more vocal arguments against merging the deposit insurance funds, particularly from banks, is that of equity; that is, should commercial banks be asked, or required, to support troubled savings and loans. First of all, assessments paid by banks in the past are part of the Fund, which if dismantled, would revert not to the banks, but to the Treasury. As for the future, two points are noteworthy when considering this argument. First, fund consolidation could be phased in -- say within five years of merging the agencies -- to provide adequate lead time for the insuring agency to develop a risk-related insurance scheme (discussed in Chapter II). Under a risk-related system strong banks will not be supporting weak savings and loans any more than strong savings and loans will be supporting weak banks. Second, as thrifts exercise newly-acquired powers and institutions become even more similar, the insurance risks will track each other more closely. Thus, any problems of equity can be handled through a proper structuring of the merger during the transition period of the financial-services industry.

### Public Confidence

One argument against merging the deposit insurance funds is that it could shake public confidence in the deposit insurance system. This argument is weak at best, and a more persuasive point could be made that public confidence in the industry would be enhanced. The public could look to a larger fund (over \$20 billion), which would protect all insured deposits in all depository institutions. Moreover, such a system would be less confusing and disruptive. Depositors need not be concerned with the relative strength of a particular fund or the way in which its coverages or procedures differ from another fund.

## MERGING THE FUNDS

A merger of the funds could be accomplished by either creating a new deposit insurance agency for savings and loans and banks, or moving the insurance function under one of the present organizations. Creating a new organization would seem an unnecessary and disruptive approach, and several factors strongly suggest that merging the FSLIC into the FDIC is the better approach:

- o The FDIC is by far the larger and stronger fund and has the greatest name recognition.

- o The FDIC has experience with examining and supervising thrifts and evaluating consumer-oriented operations by virtue of its authorities over mutual savings banks. The FSLIC has no equivalent experience in dealing with commercial banks.
- o The FDIC presently insures over 80 percent of the number and 67 percent of the aggregate insured deposits of all Federally-insured banks and savings and loans.
- o The FDIC maintains an experienced Liquidation Division. At present, the Division is managing over 100 open liquidations in 34 states, the Virgin Islands, and Puerto Rico, with approximately 50,000 assets having an aggregate book value of some \$2.2 billion.
- o As an operating arm of the FHLBB, the FSLIC has almost no administrative apparatus.

The resources of the FSLIC could simply be consolidated with those of the FDIC resulting in a single pool of funds. Alternatively, the two funds could be kept separate under a common management, with bank-derived funds for bank-related problems, and S&L-derived funds for S&L-related problems. A third, and recommended, approach would be to bring the funds together under a common management, and phase in the merger of the funds.

#### Single Pool

The reserves of the FSLIC could be merged into the FDIC's with the resulting fund treated as a single unit and borrowing authorities each of the funds has could be reevaluated and consolidated. Cost savings would be realized by having administrative expenses of only one fund and investment portfolio.

One important issue related to risk-based assessments should be mentioned here. As indicated earlier, risk of failure in each type of institution is, in some respects, quite different. A risk-based assessment scheme developed under a unitary fund approach would need to be sympathetic to these differences so as not to unduly penalize one segment of the industry for high risks in another.

#### Separate Pools

The reserves of the FSLIC could be brought together under the management of the FDIC, but maintained and reported separately. The borrowing authorities each of the present funds has with the Treasury could be maintained separately to support the different pools. Each pool could serve as the basis for assessments on the institutions that contribute to it. To the extent (if any) that the FSLIC now has different investment powers from FDIC those differences could be retained. One pool would presumably be able to lend money to the other, enhancing portfolio performance by easing liquidity considerations. In addition, the same management cost savings attendant to a single pool approach could be realized.

The separate pools approach may also be the easiest one to accomplish. The existing accounts of the FSLIC and FDIC could be maintained, and banks and S&Ls could continue to be assessed in the familiar manner. This would not rule out the use of a risk-based assessment scheme, but could facilitate the development of customized schemes for each segment.

#### Phase-in

The funds could be brought together immediately under a common management and then be completely merged at a later date, say five years. As thrifts exercise more banking powers and portfolios come to resemble those of commercial banks, their risk of failure would more closely track that of banks, and the present assessment system could be made uniform.

A phased in merger achieves the same advantages as each of the other approaches with respect to reducing overhead (common management of investments) and allows for the gradual change in the present assessment system or the development of a workable risk-based scheme.

#### SUPERVISORY FRAMEWORK

A merger of insurance funds has implications for the structure of the supervisory framework and should be viewed as part of a comprehensive plan to more rationally define the Federal insurance and regulatory process. Reorganizing the Federal regulatory process, like merging the funds, could result in a structure similar to that now in place, or one more streamlined which would call for the combining of the chartering and regulation of Federal banks and thrifts. The primary supervision of insured institutions would be retained by the chartering agency.

The Federal financial regulatory structure could be consolidated to combine the functions of the FHLBB, FRB and OCC into a single agency. That agency should be governed by a board or panel and be independent of any other Federal agency so as to eliminate the potential for conflict. That agency would issue charters; act on corporate applications; and supervise all Federally-chartered banks and thrifts and holding companies. These functions would remain with the states for state-chartered banks and thrifts.

The FDIC would have the authority to conduct examinations, require reports, and take enforcement actions, although it would focus its attention on problem and near-problem institutions. The FDIC would not have regulatory authority with respect to branches, mergers, trust powers and the like. An examination could be made by the FDIC whenever necessary to determine the condition of an institution for insurance purposes. Under this program, the FDIC would concentrate on financial institutions with safety and soundness problems (those rated 3, 4 or 5 under the CAMEL rating system) and examine well-rated institutions (those rated 1 or 2) infrequently -- under a sampling program which would cover perhaps ten percent per year. The examination of a portion of well-rated institutions would provide the FDIC with information to judge the effectiveness of the chartering agencies' supervision and rating systems,

provide training for new examiners, and diminish the automatic assumption that an institution is in trouble because of the FDIC's presence.

Reorganizing the Federal regulatory framework would result in administrative cost savings in the form of reduced legal, research and support staffs, and consolidated regional offices. Examining staffs would remain at or very near current levels for the immediate future. With some 18,000 Federally-insured banks and savings and loan associations, including 12,000 which are state-chartered, the current field staffs would be necessary to support those states which are not yet able to meet the increased demands a reorganization would place on them.

The overall supervisory structure that might be formed as a result of the reorganization of the Federal regulatory system has implications for the proper role of the FRB. In general, the issue is whether the regulation of banks and bank holding companies is necessary to conduct monetary policy. The argument that the FRB needs general supervisory authority over 1,000 commercial banks (out of a total of some 14,400) and needs to regulate and supervise bank holding companies to augment or enforce monetary policy is not persuasive. Indeed, many informed observers perceive the potential for serious conflicts between bank supervision and the conduct of monetary policy.

Tools of monetary policy (open-market activities, reserve requirements, and operation of the discount window) do not require that the FRB directly supervise banks or bank holding companies. The basic need to carry out these activities is information. Reorganizing the insurance and regulatory functions would enhance that information base.

The FRB could continue to have access to bank data and information through representation on the Board of Directors of the FDIC and the new regulatory agency and, through this, would gain more direct access to data on other financial institutions; an increasingly significant factor as thrifts begin exercising more bank-like powers. The FDIC would thus have a three-member Board: two appointed members, one serving as chairman and the other as vice chairman, and an ex officio member from the FRB.

Other regulatory activities presently lodged in the banking agencies and the FHLBB could be reorganized along functional lines. For example, the SEC could be given exclusive jurisdiction over all securities matters relating to banks and thrifts (it presently exercises such jurisdiction over holding companies); the Justice Department could assume sole responsibility for antitrust enforcement; and the Federal Trade Commission could enforce compliance with consumer laws such as Truth-in-Lending.

The fact is that the current, fractionalized system of regulation and insurance for banks and thrifts is increasingly inefficient, ineffective and inequitable. Assuming it was justified when created 50 years ago, events have passed it by and it has outlived its usefulness. The system is in urgent need of a major overhaul.



CHAPTER VII

OPTIONAL EXCESS DEPOSIT INSURANCE

	Page
Executive Summary . . . . .	VII-1
Introduction . . . . .	VII-1
Demand For Excess Coverage/Money Brokers . . . . .	VII-1
The FDIC as Suppliers of Excess Coverage . . . . .	VII-2
Semipublic Suppliers of Excess Coverage . . . . .	VII-3
Banks as Self-Insurers . . . . .	VII-4
Private Insurance Companies . . . . .	VII-4
Capacity Constraints . . . . .	VII-5
Inability to Assess and Control Risk . . . . .	VII-5
Other Potential Barriers . . . . .	VII-7
Diversification of Risk . . . . .	VII-7
Safety and Liquidity Considerations . . . . .	VII-7
Settling Depositor Claims . . . . .	VII-8
Alternatives for Private Sector Expansion . . . . .	VII-8
Public Demand and Government Involvement . . . . .	VII-9

## CHAPTER VII

### OPTIONAL EXCESS DEPOSIT INSURANCE

#### EXECUTIVE SUMMARY

Most private insurance companies surveyed by the FDIC have indicated no interest in expanding their limited role in providing deposit insurance in addition to the statutory federal protection. Industry representatives said they have not developed the means of evaluating risk in banks or controlling industry exposure in the insurance of deposits.

At present, there is no federal prohibition on provision of deposit insurance by private industry. Some private insurers currently provide protection for specific depositors or deposits on a limited basis. The FDIC investigation into the feasibility of a comprehensive program of privately provided excess deposit insurance indicates that the matter should be left to the dictates of market forces. The existing FDIC system is adequately funded and capable of providing higher levels of insurance protection to depositors, but such an effort in an era of deregulation of the financial-services industry may serve to penalize well-managed institutions and to insulate high risk takers from normal market judgment. Increased private sector participation had been viewed as a means of introducing a new element of discipline on bank risk taking, as private insurers would seek to minimize their potential losses by independently performing risk evaluation and imposing pricing judgments consistent with perceived exposure.

#### INTRODUCTION

This chapter discusses the feasibility of providing depositors the option to purchase Federal deposit insurance in excess of the current limit and also the capabilities of the private insurance system, either directly or through reinsurance, to provide that coverage. The merits of the FDIC providing excess deposit insurance coverage are discussed first. Alternative suppliers of excess coverage, including semipublic insurance programs, the banking system itself, and private insurance companies, are then examined. These potential suppliers of excess deposit insurance are measured against the standards of increased depositor protection and greater market discipline. The latter standard is an important element for a healthier and more stable banking environment.

#### DEMAND FOR EXCESS COVERAGE/MONEY BROKERS

A substantial volume of domestic deposits in commercial banks is held in accounts which are in excess of the federally-insured limit. In the aggregate

there is an estimated \$419 billion in domestic uninsured balances; suggesting an adequate market exists for optional excess coverage.<sup>1/</sup> As shown in Table Fl, the proportion of insured deposits is inversely related to bank size.

Despite a substantial proportion of uninsured deposits in many large banks, the demand for excess deposit coverage for this group has remained limited. Failures of large banks have generally been handled by a "purchase and assumption" transaction ("P&A") creating a market perception that funds deposited in larger banks are not at risk.

Changes in the economic and competitive environment, coupled with deregulation, may result in more risk for the banking industry and an increase in bank failures. In Chapter III there are discussed changes which would introduce large depositor risk-sharing. The potential exposure under this concept may also increase demand for excess coverage.

There exist, however, other means for reducing depositor risk. Recently, especially after the Penn Square Bank failure, there has been increased activity by brokers that specialize in dividing large certificates of deposits among numerous insured banks. This has the effect of providing full insurance coverage for large depositors. If perceived risk in the system increases, and remedial action is not taken, this practice will present an easy way to obtain excess coverage. The FDIC is considering a number of alternatives for correcting this problem, particularly the practice of some brokers of placing fully-insured funds in banks at random without credit analysis or, worse yet, placing them in known problem banks and collecting higher fees.

#### THE FDIC AS SUPPLIER OF EXCESS COVERAGE

There is no doubt that the FDIC has both the capacity and other resources to provide excess deposit insurance to either banks or individual depositors. As discussed in Chapter III, most bank failures have been handled in a manner that has provided de facto 100 percent coverage for both depositors and senior creditors. Normally, a failed bank will be paid off if a P&A is not possible or if this action is clearly the least costly alternative for the FDIC; thus, the capacity of the fund to withstand loss has not been a factor.<sup>2/</sup>

Depending upon the pricing structure, there likely would be a demand for excess coverage provided by the FDIC. Depositors may want the coverage to reduce their perceived risk, whereas banks may want it as a substitute for pledging requirements, to gain access to more funding sources, to reduce effective costs of purchased money, or as a competitive weapon. Over the longer run, it is possible that competitive pressures would force most, if not all, banks to purchase excess coverage, resulting in explicit 100 percent deposit insurance.

<sup>1/</sup> Refer to Appendix F for a more detailed discussion.

<sup>2/</sup> Chapter V contains an analysis of the adequacy of the fund and alternative measures of exposure. The basic conclusion is that the fund is and probably will continue to be adequate to insure up to 100 percent of total deposits.

The overriding concern, and the theme of this study, is that the present structure of the Federal deposit insurance system has removed most incentives for depositors to choose banking relationships based on the assessment of risk. Until and unless the FDIC were able to price excess coverage to reflect individual bank risk, which seems a highly-remote possibility, discipline would be reduced.<sup>3/</sup> Thus, the FDIC would strongly oppose any attempt to provide 100 percent Federal deposit insurance coverage.

#### SEMIPUBLIC SUPPLIERS OF EXCESS COVERAGE

Deposit insurance or guaranty schemes have been a part of our heritage since the 1820s. In this century, only the Federally-initiated systems and a few state-chartered funds can be deemed to have been successful. Semipublic insurers possess the ability to provide excess deposit protection. This sector may expand, but discipline can be imposed only if coverage is provided or withheld on the basis of risk; the two plans described below do not contain this important element.

Joint industry and state-initiated systems represent the most extensive form of private sector participation at this time.<sup>4/</sup> Only a few of these programs, however, have attempted to offer complementary excess coverage in conjunction with the Federal systems. Characteristics for viable programs are examined in Appendix G. Discussed here are two which have many such characteristics and which offer complementary excess coverage in conjunction with the Federal systems. These illustrate approaches which have evolved embracing the umbrella concept.

1. The Mutual Savings Central Fund, Inc. ("Central Fund"): This state-initiated system comprises more than 150 mutual savings banks in Massachusetts. It provides full primary deposit coverage as well as a protection for deposit balances in excess of the FDIC insurance limits in some institutions. There are many similarities between this program and that of the FDIC as they both trace their origins to the early 1930s and have similar objectives.

Several member institutions, numbering among the state's largest, have elected to join the FDIC. Under a unique joint arrangement, primary deposit insurance protection to a maximum of \$100,000 per depositor is provided by the FDIC in such institutions, with all excess balances covered in full by the Central Fund's insurance program.

2. National Deposit Guaranty Corporation ("NDGC"): This organization was created by a special act of the Ohio State Legislature in 1973 for the purpose of protecting "share/deposit" balances in nonfederally-insured credit unions. The NDGC now operates in several states and

<sup>3/</sup> Refer to Chapter II for a discussion of risk-related insurance.

<sup>4/</sup> Refer to Appendix G for a review of these deposit insurance programs.

offers both a voluntary alternative to National Credit Union Share Insurance Fund ("NCUSIF") coverage and a complementary excess insurance protection for aggregate amounts over the NCUSIF insurance limits.

The NDGC employs a novel method of funding its insurance reserve. Essentially, a one-time refundable deposit of an amount equivalent to one percent of an institution's total "deposit" base is required for coverage by NDGC, assuming certain minimum standards of financial viability are met. Periodic accountings rendered by members are used, as a substitute for annual premium assessments, to maintain a reserve fund approximately one percent of NDGC's exposure level. While some may view this approach as a relatively costly means of obtaining protection, when contrasted with the Federal deposit insurance systems, a reserve fund can be quickly created and maintained to fund expansion and permit diversification.

#### BANKS AS SELF-INSURERS

The banking industry has demonstrated an ability and selective willingness to support individual institutions, thereby providing depositor protection. However, this support lacks the characteristics of an "insurance system." Even if banks could and would pool risks in some manner, the FDIC sees no way of avoiding a "domino effect," particularly in times of financial stress.

#### PRIVATE INSURANCE COMPANIES

Private sector deposit insurance coverage is offered by some casualty and surety companies on a limited basis. This coverage generally takes the form of a surety bond, essentially providing clients with a guarantee that their deposit in a specific institution will be recovered at a specific time. Such coverage is not prevalent and has been confined to selected insurance clients with deposits in relatively large insured commercial banks or insured subsidiaries of large banking organizations. This surety concept is highly selective and may not lend itself to widespread coverage of depository institutions.

It has been suggested by some industry representatives that private sector participation could be encouraged by utilizing or building upon the infrastructure provided by the FDIC or by some other form of indirect subsidy or reinsurance. However, if no independent evaluation of risk is performed to minimize exposure, no additional discipline upon bank risk will be forthcoming. One method utilized by insurance companies to control their risk, cancellation of existing coverage, may be destabilizing and favor larger banks over community-oriented institutions. Untimely or arbitrary cancellation of coverage, based upon nonrisk-related criteria, may have an even greater destabilizing effect.

Private sector insurance companies face a number of obstacles as they seek to enter or expand in the deposit insurance field on a broad scale. A limited capacity, the inability to assess and control risk so as to justify normal "risk-reward" standards, and other hurdles suggest their participation in providing excess deposit coverage will remain limited. Their role in providing a discipline on bank risk-taking will likewise be limited.

### Capacity Constraints

Most domestic insurers and reinsurers are constrained by governing state statutes and so-called "Treasury limits" to a maximum single exposure of not more than ten percent of capital and surplus.<sup>5/</sup> Under traditional approaches, which consider exposure levels on a "per facility" and "per event" basis, neither the primary nor reinsurance companies appear to possess a sufficient capital base to provide full excess deposit insurance coverage to many of the Nation's largest banking organizations.

In 1981 the aggregate capital and surplus of all domestic property and liability insurers was approximately \$68 billion, providing a theoretical maximum exposure limit (per individual bank) of about \$6.8 billion. Additional capacity afforded by domestic "reinsurance" organizations increases this maximum limit by no more than \$0.7 billion. Self-imposed maximum exposure levels of individual companies, including consideration of a company's existing exposure in banking organizations (other insurance liability and investments) also serve as constraining factors. A more realistic maximum capacity estimate would appear to be in the range of \$1 to \$2 billion per financial institution.<sup>6/</sup>

One of the largest insurance packages ever assembled in this country was to provide for the "atomic pool" to insure against losses relating to a nuclear accident. After approximately 30 years of effort, which included Federal sponsorship, the total capacity assembled now equals just over \$750 million of which only 42 percent is supplied by domestic insurers and reinsurers. Thus, this \$320 million package may represent a good approximation of the maximum available voluntary domestic capacity per facility, per insurable event.<sup>7/</sup>

Such capacity limitations clearly preempt blanket coverage of excess deposits for a large number of banks. For example, the FDIC estimates that two relatively large New York City based commercial banks each hold more than \$15 billion in uninsured domestic deposits, not to mention their foreign deposits and nondeposit liabilities. Numerous smaller institutions also have uninsured deposit levels which would appear to exceed the total (individual insurable unit) capacity of the domestic insurance industry.

### Inability to Assess and Control Risk

The evaluation and control of risk are important elements in a deposit insurance system. In recent years, the amount and type of financial data available

<sup>5/</sup> It should be noted that this discussion is limited to the "domestic" insurance and reinsurance market as most "foreign" insurers are either prohibited from or typically do not underwrite so-called "financial guarantees."

<sup>6/</sup> Based upon the work of C. Arthur Williams, Jr. (February 1983).

<sup>7/</sup> Based on data (as of January 1983) supplied by Mr. Walker S. Richardson, Senior Vice President, Liberty Mutual Insurance Company, Boston, Massachusetts.

regarding the banking industry have increased; however, comprehensive evaluation of bank risk requires an onsite review.<sup>8/</sup> Bank examination data pertaining to bank management and individual bank customers is not publicly available and there is no parallel private sector source of such information.

Federal bank supervisory authorities have means of assessing and controlling risk in financial institutions which are unavailable to private firms. Thus, the private sector would be unable to exert any real power to effect changes or institute an effective system of variable premiums to reflect risk. Insurance industry representatives indicated there is a preference for utilization of a single, flat-rate premium with applicants either "accepted" or "rejected". Insurance companies can be expected to exercise discipline only by refusing to offer coverage or by cancellation of existing coverage.

Both of these methods can have a destabilizing impact on banks and the banking system. Also, in practice, they may tend to favor large banking organizations over smaller, community-oriented institutions. If the decision to insure or not to insure is based upon risk-related criteria and judgments as to an individual institution's viability, market discipline may be achieved. Rapid (or untimely) cancellation of existing coverage, however, could still have serious implications. Individual community banks could be additionally threatened if such cancellations impel local customers to move their deposits to regional or money center institutions. If coverage were cancelled at a relatively large bank, the consequences could be far ranging and much more severe than suggested by the event itself.

Refusal to write insurance coverage or cancellation based upon nonrisk criteria, while defensible on business or economic grounds, could result in even greater destabilizing consequences. In the insurance industry, it is not an uncommon practice simply to refuse to renew some lines of coverage for all customers or to cease to write coverage to entire groups (or categories of customers) based upon nonfinancial criteria such as product line or geographic location.

Representatives of the insurance industry have indicated that they must retain the flexibility to refuse coverage and to cancel the insurance relationship without specifying the reasons for such a decision. They have expressed concern that this issue could lead to regulation over their business judgments and fear that they may be "pressured" to write or renew coverage. Private sector insurers do not want to be regulated (as to entry to or exit from this line of coverage), nor do they wish to assume the role of "regulator" to control bank risk. Also, insurers voiced concern as to the potential legal responsibility for damage to a bank resulting from the cancellation of coverage.

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<sup>8/</sup> Chapter IV of this study contains a more detailed discussion of the issues relating to public disclosure of such data.

Maintenance of the public trust in the basic safety of funds and soundness of the banking system is vital. Abrupt withdrawal of coverage could lead to depositor flight prompting incidences of bank runs which were prevalent in the 1930s. If private sector participation in the deposit insurance field is to become widespread and beneficial, private insurers must have a "graceful withdrawal" mechanism.

#### Other Potential Barriers

By comparing and contrasting some of the earlier insurance and guaranty programs with the Federal systems and considering comments made by representatives of both the insurance industry and banking community, the FDIC has identified other potential barriers to a higher level of private sector participation.

Diversification of Risk -- Banking is subject to uncertainties that are normally not regarded as commercially insurable. For example, the rate of bank failures can be related to fluctuations in the economic cycle which are, to a large extent, influenced by monetary and fiscal policies.

The ability to diversify risk among a large number of institutions in a variety of geographic locations and economic environments is an essential component of a stable insurance system. No one single event, economic setback or natural calamity should be able to impair the viability of insurance protection.

A relatively large market share is essential to achieving sufficient diversification rapidly. The required level of commitment, additionally aggravated by the difficulty of properly balancing the level of exposure and concentration of risk posed by multibillion dollar banking organizations, is another hurdle.

Safety and Liquidity Considerations -- All Federal deposit insurance plans explicitly limit investment of funds to United States Government obligations. The safety of the insurance fund and the ability to provide funds in an emergency must be assured.

As profit-motivated entities, insurance companies are more likely to seek higher-yielding investments which may be longer-term or riskier. Understandable as an appropriate business approach, this could result in a less-secure and less-liquid portfolio. In a serious financial emergency there could be a reluctance to liquidate these instruments. If the government does not advance the funds to cover the insurers' liability for an interim period, as suggested by industry representatives, public confidence could be eroded.

The ability of an insurer to sufficiently augment loss reserves through cash flow or borrowings is necessary. If premiums are raised beyond some reasonable level, stronger institutions would reject coverage, further reducing the cash flow from premium income. Moreover, alternate sources of funds, such as credit lines at commercial banks, could be inadequate or unavailable in times of severe economic difficulty for the banking industry at the very time they are needed.



Settling Depositor Claims -- While one of the goals of any effective deposit insurance program should be to minimize losses, bank failures will occur, and a set of practices and procedures for dealing effectively with this eventuality may be required. The Federal system has worked with little disruptive impact from a bank closing as it provides insured depositors with almost immediate access to their insured funds. The expectation of "minimum disruption" is a major stabilizing factor in the banking system. A private sector deposit insurer may be unable or unwilling to adhere to a costly practice of rapid claims settlement.

When bank failures occur, the liquidation effort and the payment of depositor claims are highly labor intensive, requiring large numbers of trained personnel for relatively short periods of time. Meeting these requirements could be cost prohibitive for an individual company. An industry-wide pooling effort, however, might succeed in establishing a workable and relatively efficient structure to handle such functions.

#### ALTERNATIVES FOR PRIVATE SECTOR EXPANSION

While there are obstacles to the widespread development of private sector deposit insurance programs, opportunities for expansion and experimentation are feasible by targeting market segments. The following approaches are presented as examples which would be modest in scope and would appear to offer some prospects for success.

1. Individual Bank Entities or Banking Organizations -- Coverage could be offered in a traditional form for all depositors of a bank (or group of affiliated banks) for a particular band of exposures greater than the Federal limits. This would establish a modest, but known exposure level which could be within capacity constraints.
2. Individual Business Enterprises -- Coverage could be marketed on a voluntary basis to only those corporations, businesses, trustees of funds, and individuals who typically maintain large (uninsured) balances in banks. Under this approach the insurer, or syndication, could structure a surety contract so as to limit the exposure only to selected third parties (banks or other financial intermediaries) which meet preset criteria as to financial strength.
3. Bank Entities for Allocation Among Deposit Customers -- Coverage of a maximum fixed-dollar aggregate could be marketed to individual banks or banking organizations whose management, in turn, would allocate this coverage among existing deposit customers and to attract new, relatively large depositors. This appears to be a quite flexible approach for all parties involved. It would (theoretically) lower total premium costs for the bank when compared with full umbrella coverage; it would allow individual depositors to choose whether or not to pay for additional protection; and it would establish maximum exposure levels for the contracting insurer.

The private sector can, and usually does, move to meet a need for services. The absence of widespread participation by non-Federal insurers indicates that either demand is modest or insufficient profit motive is present. Should demand increase, private sector deposit insurance products will likely develop on their own merit. The FDIC has established a dialogue with insurance industry representatives and remains willing to work with them to ease or remove obstacles.

#### PUBLIC DEMAND AND GOVERNMENT INVOLVEMENT

The question of what role, if any, the government should play in encouraging increased private sector participation or in the development of a new private sector insurance vehicle may be answered through several alternate courses of action which can be pursued. Each, however, requires a progressively higher level of government involvement.

The Federal deposit insurers could indirectly subsidize the private sector by providing basic infrastructure and logistical support -- data, risk evaluation and control, liquidity and liquidation -- on a permanent or temporary basis. A direct subsidy in the form of a "cap" or "stop loss" protection, reinsurance, or underwriting a private risk pool could also be supplied. These approaches, however, would increase the Federal insurance fund's own exposure level and could prove to be quite costly, without achieving a concomitant increase in discipline of bank risk-taking.

The questions as to equity and fairness also arise in any direct or indirect government assistance program which singles out a particular segment of the business community for subsidy or special treatment. If the existing Federal deposit insurance funds are used to support such a private sector endeavor, the net costs to the insured banking system (and ultimately, to the banking public) will increase. The result would, in effect, represent an involuntary transfer of capital from the banking industry to the insurance industry for the purpose of encouraging a more rapid development of a private sector product for which there may only be a limited demand.

## APPENDIX A

### LITERATURE ON RISK-RELATED INSURANCE SYSTEMS FOR COMMERCIAL BANKS

#### INTRODUCTION

The following is a review of the literature concerned directly with risk-related deposit insurance schemes for commercial banks. Since all of this literature deals either explicitly or implicitly with the advantages of such a system, we begin the review with an overall examination of the current system of fixed-rate assessments and compare it with the "ideal" risk-related system. This is followed by an examination of that portion of the literature which deals with risk measurement and the actual implementation of a risk-related deposit insurance system. The final section of this paper presents a discussion of issues yet to be resolved as well as our conclusions.

#### AN EXAMINATION OF FIXED AND RISK-RELATED DEPOSIT INSURANCE ASSESSMENTS

##### Current System

Because the current system of deposit insurance consists of fixed-rate assessments, it must be combined with a fairly extensive system of supervision and regulation in order to limit the exposure of the insurance fund. This supervision and regulation primarily involves the imposition of capital standards along with restrictions and enforcement procedures designed to maintain an acceptable level of bank asset quality. This system has been open to criticism on several fronts.

First, since all banks pay the same premium rate, healthy banks subsidize weak banks. It would be more equitable, it has been argued, if the FDIC charged each bank a premium which reflected the threat posed by the institution to the deposit insurance fund.

Second, extensive supervision and regulation limit the flexibility of bank management. In unregulated markets, managers can choose their desired trade-off between profitability and safety. For commercial and savings banks, this flexibility exists only within certain limits. This may be inefficient in the sense that banks may be restricted from certain activities which regulators feel are "too risky," even though the profitability of these activities may more than adequately compensate for the added risk. Moreover, some [21] argue that banks are required by regulators to maintain a greater than optimal level of capital. Others [17, 22] believe the level of capital is not excessive. If the amount of bank capital is too high, then an additional inefficiency occurs, since resources are shifted from more to less productive uses. The cost of this additional capital may exceed the combined benefit of the added capital to the institution and to society in general.

Finally, given the prevailing view that an optimal level of bank capital is difficult to determine, the standards imposed become somewhat arbitrary. That is, since bank risk is only roughly estimated, adequate levels of capital can only be approximated.

#### Risk-Related System -- In Theory

The ideal variable-rate insurance system would be designed so that insurance premiums would exactly reflect the expected cost of each institution to the insurance fund. Bank premium assessments would equal the probability of bank failure multiplied by the cost of failure to the insurance fund. Assuming for the moment that this ideal system could be developed, all of the previously mentioned shortcomings of the current system would be eliminated.

The system would be more equitable, since each bank would be charged a premium commensurate with the threat it posed to the insurance fund. Moreover, a risk-related system would also reduce the level of explicit regulation by replacing it with implicit price regulation. Many experts [6, 21, 22, 31] argue that deposit insurance substitutes for bank capital in maintaining depositor confidence in the banking system; therefore, the only significant role for bank capital is to protect the FDIC's risk exposure. If the FDIC can cover its exposure by basing premiums upon risk, conceivably capital standards would no longer be necessary.<sup>1/</sup> Similarly, restrictions on certain types of assets deemed excessively risky could be eliminated, since premium differentials could also compensate the FDIC for this type of risk exposure. Management at each bank could then decide whether or not to enter new product markets by weighing potential profits against the costs (including the mandated insurance premium) tied to such product expansion. Of course, at some point risks could become so great that the costs of providing insurance make them virtually uninsurable. Also the costs of measuring each risk (i.e., onsite examination and offsite monitoring) could well be prohibitive.

The replacement of explicit regulation with risk-related premiums would result in a more efficient allocation of bank resources. An optimal degree of risk-taking would result as bank managers would be able to adjust their risk-exposure according to their own judgment. Bankers could engage in heretofore prohibited activities as long as they are willing to pay to the insurance fund the expected cost of this risk. In this sense resources would be allocated

<sup>1/</sup> This would be true if bank failures were not disruptive to the economy. Under a system of partial insurance coverage, failures (particularly if large banks were involved) may be disruptive. However, this problem could be solved by the imposition of 100 percent deposit coverage. The loss of "market discipline" from such action would not be important since the risk of banks would be monitored by the proper pricing of insurance.

more efficiently yet, at the same time, the insurance fund would not be threatened (since it is assumed that the expected cost to the fund from each banking activity can be correctly measured and priced).

Furthermore, the arbitrary nature and the enforcement problems of the present system would no longer exist. For example, under the current system many banks are urged to increase their capital; however, the figures aimed at are, to a certain extent, arbitrary and compliance is not uniform. Under a variable-rate system with precisely determined risk measurements, subjective capital standards would be replaced with objective evaluations of the costs associated with various levels of capital. Moreover, compliance would not be an issue since regulations designed to minimize risk would be replaced by mandatory variable-rate premium assessments.

It is clear that a properly implemented risk-related insurance system (that is, one in which assessments closely approximate the expected cost of each bank to the deposit insurance fund) would be superior to our current system. However, risk-related systems have been criticized because of the difficulty of properly measuring risk (for example, the Hunt Commission Report [24]), and it is conceded that precise measurement is near impossible even if the insurer were to have the unlimited personnel and technological resources to perform the function. Thus, some regulatory constraints with respect to capital levels and banking activities will likely be required irrespective of how any risk-related insurance system is designed. The following section includes an examination of the literature regarding risk measurement and the implementation of a risk-related system.

#### LITERATURE REVIEW -- IMPLEMENTATION OF A RISK-RELATED DEPOSIT INSURANCE SCHEME

Although many have recommended that the FDIC adopt a risk-related insurance scheme, the literature contains very little regarding the actual implementation of such a system. As yet, no one has developed an adequate means to measure risk so that variable-rate deposit insurance could be meaningfully applied to all commercial banking institutions. Much of the discussion in the literature has been limited to mere suggestions and, therefore, does not contain details of how such a system would be actually implemented. Merton [19] has shown that option pricing theory can be applied to determine the value of deposit insurance. When someone purchases a put option they have bought the right to sell a specific number of securities at a specific price to the writer of the contract. The buyer of the put option has purchased the right to transfer assets owned (the securities) to the writer of the contract; hence, the writer is insuring the buyer from a price decline. (The buyer would not sell the stock to the writer if prices go up since the buyer can make more in the market.) Some insurance contracts resemble put options in the sense that purchasers buy the right to transfer their liabilities to the insurance company upon the occurrence of certain events. Just as the writer of the put option receives a fee for accepting the risk of receiving a lower value in the

event security prices decline, an insurance company accepts premiums for assuming the risk of the insured. In a sense, the value of a deposit insurance contract can be viewed in the same light as that of a put option; therefore, the pricing formula for put options can be used to price deposit insurance contracts.

McCulloch [18] used an option pricing model to estimate the value of deposit insurance to banks. The shortcoming of this study is that only interest-rate risk was considered. Based upon recent experience, interest-rate risk has played a major part in only a few bank failures.

Marcus and Shaked [15] employed option pricing theory to obtain estimates for the value of deposit insurance for 40 relatively large commercial banks (accounting for 50.5 percent of total commercial bank deposits) for both 1979 and 1980. Their particular methodology, however, requires the use of time series data on the stock prices of individual banks. Unfortunately, only a handful of bank stocks are traded in markets which are considered competitive. Therefore, this technique cannot be applied to the majority of banks. In addition, this method implicitly assumes that bank risk is measured by the market and is thus reflected in stock prices. The degree to which this process actually takes place is not clear.

Maisel [13] suggests that five types of risk be estimated to determine overall bank risk. These risks include: (1) interest-rate risk -- sensitivity of earnings to interest rate movements, (2) credit risk -- risk that assets will go into default or perform poorly, (3) moral hazard risk -- risk due to fraud or insider abuse, (4) operating risk -- risk that operating margins will deteriorate, and (5) diversification risk -- risk due to failure to diversify. From his analysis Maisel concludes that exact risk measurement is not possible. However, he states that certain risks (e.g., interest-rate risk) are quantifiable and that empirical estimates of risk can show orders of magnitude, which is all that would be necessary in order to implement a risk-related premium structure.

Scott and Mayer [27] suggest that bank failure prediction models may yield useful information relative to insurance assessment. These models use selected financial ratios in an effort to predict which banks are more prone to failure. If these models can accurately predict bank failure with sufficient lead time, the ratios used within the models may then serve as a basis for assessing risk. (A separate evaluation of this literature is provided below.) On a somewhat less ambitious scale, both Scott and Mayer, and Peltzman [22] have suggested the use of bank examination ratings as a basis for determining the risk of an institution. Examiners do use a uniform rating system (known as CAMEL) to grade the quality of capital, assets, management, earnings, and liquidity and to assign a "composite" or overall score ranging from 1 to 5. This could be used as a basis for assigning different insurance premiums but such a system would have several drawbacks.

First, a CAMEL-based system may be relatively expensive to properly implement. To the extent that it is desirable to assess the risk of banks on a yearly

basis, every bank would have to be examined annually. This is more frequent than is currently the case for the majority of banks and, therefore, would be more expensive than a system based solely on Call data. Additionally, this would conflict with current FDIC policy which is directed toward increasing the time between bank examinations. Second, the CAMEL rating system is somewhat subjective in that: (1) the ratings are based, to a large extent, on examiner judgment; and (2) banks are examined by different agencies, each of which does not necessarily view risk in the same light. Finally, the linkage of the CAMEL rating to the insurance assessment may create an adversarial relationship between bank examiners and management. The examiner/management relationship is important in determining CAMEL ratings, therefore, damage to this relationship may reduce the reliability of the ratings.

Peltzman also suggests that the cost of uninsured deposits may form the basis for assessing premiums. The notion being that riskier banks are forced to pay a higher rate for their uninsured deposits, thus, the market has provided a mechanism whereby risk can be measured. However, not all banks operate in markets competitive enough that their large certificate of deposit rates would provide useful information. Moreover, some banks may pay more for their deposits due to regional or other factors not related to their risk. Finally, it is not clear what deposits are perceived by the market as being uninsured. If the market feels that the FDIC will not pay off a large institution, then all of the deposits of these banks will be viewed as insured. Thus, risk premiums for large banks may underestimate actual bank risk.

#### CONCLUSION AND DISCUSSION

As a whole, the literature on risk-related deposit insurance systems strongly suggests that, depending upon the type of variable-rate insurance system that might eventually be implemented, it would be no worse than our current system and would, in all likelihood, improve the system in several ways. However, the literature provides little guidance with regard to the implementation of a system which would be applicable to all commercial banks. Although various approaches have been suggested, they all have serious drawbacks. It appears that despite its desirability, much additional empirical work must be completed before a comprehensive and reliable risk-related insurance system can be implemented.

#### Consequences of Improperly Measured Risk

Moreover, even with additional work, it is likely that bank risk can only be roughly estimated. This creates several problems which would not exist under the "ideal" variable-rate system. Variable insurance premiums are designed to create incentives to alter bank behavior. Improperly priced premiums may elicit behavior which is unintended and in some ways may even be perverse. For example, if premium differentials are too high, the FDIC will be overcompensated for incremental risk-taking, which will encourage bank managers to be overly conservative. If premium differentials are too low, excessive risk-

taking will occur. Either way, since the bank's cost from a given activity will not reflect the true cost of any incremental risk-taking, an optimal allocation of resources will not result.

Furthermore, since risk measurement is not exact, capital adequacy standards and restrictions against owning particular types of assets will, to a certain extent, remain in effect. That is, if premium differentials are too low, the situation will be similar to the current flat-rate assessment system in that the FDIC and other regulatory agencies will deem it necessary to impose certain controls to limit excessive risk-taking. If premium differentials are too high, implicit restrictions will be imposed since bank managers will not choose to maintain low levels of capital or to participate in certain markets due to the excessive penalties that would be incurred.

Finally, any system based upon approximate measures of risk will be less equitable than the "ideal" variable-rate plan. Imprecisely measured premium differentials either overcharge or undercharge banks for incremental levels of risk-taking. Moreover, to the extent that the number of risk categories is limited and banks with different levels of overall riskiness are grouped together and charged the same premium rate, a further inequity exists.

#### Comparison of Imprecise Risk-Related System to the Current System

Nevertheless, even though a variable-rate insurance system based upon imprecisely determined risk measurements may be less than ideal, it would still have several advantages over the current system. First, some regulation could be eliminated. The extent to which deregulation can occur depends upon the degree to which bank risk can be measured.

Second, if this regulation is reduced, bank management should have greater flexibility in choosing the desired tradeoff between profits and safety. This should lead to an improved allocation of resources. Where the riskiness of a particular activity is uncertain, premium differentials may tend to overcompensate for the risk involved. However, even if the premiums appear excessive, banks would at least be given a choice. Some bankers may feel they have enough of a competitive edge to make participation in certain new markets worthwhile. The degree to which premium differentials are accurately priced will determine the extent to which management flexibility will be enhanced and resource allocation improved.

Third, a risk-related system has the potential to be more equitable. The greater the number of risk categories into which banks can correctly be classified, the more equitable the system will be.

A final advantage of a risk-related system is that enforcement will be more uniform. While there may be some variation in regulation and supervision designed to curb excessive risk-taking, each insured institution would have to pay the mandated premium assessment rate.



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## APPENDIX B

### LITERATURE ON FAILURE PREDICTION MODELS FOR COMMERCIAL BANKS

#### INTRODUCTION

The feasibility of risk-related insurance assessments depends on the extent to which bank risk can actually be measured. Implementation of an equitable and justifiable variable-rate premium structure does not require exact measurements of risk but there should be some empirical or actuarial support for whatever system is employed to assign banks to particular risk classes. In order to shed light on the issues involved in measuring risk, this appendix examines the literature dealing with bank failure and problem bank prediction models. It should be noted at the outset that only commercial banks are referred to in this literature review. The analysis is not directly applicable to mutual savings banks since the characteristics of these two types of institutions differ.

These models attempt to differentiate between healthy and either failing or problem institutions on the basis of selected financial ratios. While the models have been developed primarily as a means to help bank regulatory agencies allocate examination resources more efficiently, they can provide useful information regarding the feasibility of a variable-rate insurance system. If bank failures can be predicted with a reasonable amount of lead time and accuracy, it should be possible to develop a system that relates premiums to failure risk. Failure and problem bank prediction models also yield useful information regarding which financial ratios are important in distinguishing healthy from failing banks.

#### SURVEY OF THE LITERATURE

A brief review of the problem bank prediction literature is provided below. Although it is not all inclusive, it provides a representative sample of the literature. The survey is divided into two subsections: one dealing with failure prediction models and the other covering problem bank prediction models.

##### Failure Prediction Models

This section includes a discussion of four studies in which failure prediction models have been constructed. The approach taken in these studies is basically the same; a group of actual bank failures is identified and various financial characteristics of these banks, one or more years prior to failure, are compared with financial characteristics from a group of banks that did not fail. Generally, each failed bank is paired with a solvent bank with similar nonfinancial attributes such as size, age and location. In a limited sense, this method allows the researcher to control for factors that otherwise might

distort the relationship between financial characteristics and failure. To the extent that these controlled attributes are important factors contributing to bank failure, the predictive ability of the model will be diminished.

The studies use various types of statistical techniques such as discriminant and logit regression analyses to distinguish the financial characteristics of failing from solvent banks. These statistical approaches are similar in the sense that they allow the researchers to test the importance of many financial ratios in a bank failure model simultaneously. The ratios are computed from bank income, Call and/or examination reports and were selected on the basis of their ability to explain bank failure. That is, the researchers used various combinations of financial ratios and ultimately selected the combination that yielded the best predictive results.

The statistical analysis produces an equation (or equations) which measures the likelihood of failure. As a test of the predictive capability of the model, the original sample of failed and nonfailed banks is reclassified, i.e., the financial ratios of each bank are "plugged" into the equation(s) of the model and each bank is classified as either a likely or nonlikely candidate for ultimate failure. Often a holdout sample (banks not in the original sample) is tested to help assess the model's predictive accuracy.

However, the model with the best overall classification accuracy is not necessarily the "best" model. It is important to distinguish between what statisticians call Type-I error (classifying a true failure as a nonfailing institution) and Type-II error (when nonfailures are classified as failures). In any model there is a tradeoff between the severity of each of these types of errors. Increasing the level of Type-I error means that the model will incorrectly classify more failures, whereas an increased Type-II error means that more nonfailures will be classified as failures. The importance of the different types of errors depends, to a large extent, upon the purpose for which the model will be used.

As mentioned previously, the failure prediction models developed to date were created to aid in the examination process. Thus, there was a desire to minimize Type-I error, since the inability to recognize a failing institution could become a costly mistake. On the other hand, a model developed in connection with a risk-related insurance scheme should be designed to minimize Type-II error. This would reduce the number of situations where banks would be charged an insurance premium intended for riskier institutions.

Meyer and Pifer Study -- This study [8] was completed in 1970 and was the first bank failure study to use modern statistical techniques. Their total sample consisted of 78 insured commercial banks, 39 of which were closed between 1948 and 1965. Failed banks were paired with solvent banks by size, age, location, and the primary regulatory agent. Data for paired banks were collected from bank income, Call and examination reports, for each of the six years prior to the failed bank's closing. Closed banks with incomplete records

and supervisory mergers of failing institutions were not included in the sample.

Meyer and Pifer conclude that even though many bank failures result from embezzlement and other financial irregularities, financial measures can, with a lead time of one or two years, accurately predict bank failures (80 percent success rate). However, when the lead time is greater than two years, financial variables are ineffective predictors. The financial ratios in their most effective prediction models include variables such as the ratio of operating revenue to operating costs and the growth in extensions of credit to directors, officers, employees and affiliates relative to total capital.

Sinkey Study -- This study [17] applied discriminant analysis classification procedures to derive single and multivariate failure prediction models for up to six years prior to bank failure. The 37 insured commercial banks that failed between 1970 and 1975 were paired with 37 nonfailed banks on the basis of deposit size, number of branches, and location. A holdout sample consisting of the 16 banks that failed in 1976 was used to test the accuracy of the multiple variable models.

The total operating expenses to total operating income ratio was Sinkey's best single discriminator, showing 75 percent accuracy in classifying the original sample one year prior to failure. Overall accuracy gradually declined to 65 percent six years prior to failure. The Type-I error was relatively high, ranging from 25 to 60 percent (40 percent one year prior to failure). The Type-II error ranged from nine to 35 percent. Upon further analysis, Sinkey concluded that the significantly lower profitability experienced by failed banks during the six years prior to failure was due to relatively high operating expenses rather than lower operating income.

As one would expect, the results improved when additional variables were included in the failure prediction models. The best multivariate model for the two years preceding failure included the same operating efficiency variable (total operating expenses/total operating income) as well as a measure of bank safety (investments/assets). Overall accuracy in classifying the original sample one and two years prior to failure increased to 82 and 75 percent respectively. The respective Type-I errors were much better, 18.18 and 11.54 percent. The overall accuracy rose to 93.75 and 87.5 percent when the holdout sample was tested. The prediction models three to six years prior to failure did not perform as well, achieving only slightly better than 50 percent accuracy in classifying the holdout sample (despite an 80 percent success rate in classifying the original sample).

Martin Study -- Martin [7] applied logit and multiple discriminant analysis to develop failure prediction models for the six-year period between 1970 and 1976. His sample included the entire population of banks (on average, about 5,600) which were members of the Federal Reserve System. Fifty-eight banks were included in the failed bank category (defined to include all banks which

closed, were involved in a supervisory merger or for which other emergency measures were used to resolve imminent failures). For testing purposes, a set of 25 financial ratios was chosen, representing asset risk, liquidity, capital adequacy and earnings.

Martin's most effective failure prediction model included four variables: net income/total assets, gross chargeoffs/net operating income, commercial loans/total loans, and gross capital/risk assets. Classification accuracy based upon data one to two years prior to failure was quite high for the 1973 to 1976 time period. For example, using 1974 data, Martin's logit model correctly classified 91.3 percent of the failures and 91.1 percent of the nonfailures which occurred in 1975 and 1976. However, as Martin correctly points out, this still implies that a relatively large number of nonfailures will be classified as failures.

The model is less accurate for the 1970 through 1972 period. However, reliable estimates for each of these years may be difficult to obtain due to the relatively small number of bank failures (12 in 1970, 12 in 1971, and 10 in 1972).

Rose and Scott Study -- The results of these first three studies seem to indicate that reasonably effective failure prediction models can be developed, but only with a lead time of one to two years. Rose and Scott [11] attempted to develop effective models for the 1970 to 1976 period with a lead time of up to nine years. Using multiple discriminant analysis they tested 110 financial ratios representing measures of profitability, liquidity, asset composition, capital structure, prices and expenses. Their best models achieved an overall classification accuracy of 75 percent for each of the two years prior to failure, however, accuracy rates declined to an average of 60 percent when data three to nine years prior to failure were used. Their most consistently important prediction variables were loans/total assets, net income/total capital, employee fringe benefits/total expenses and municipal securities/total assets. Each year the loan/asset ratio was the most important discriminating variable.

#### Alternative Approaches

Rather than dealing with failed banks, a number of researchers [14, 15, 16, 17, 19] have attempted to model a bank regulatory agency's list of "problem" banks. They cite two advantages to such an approach. First, problems associated with an inadequate sample size are avoided, since there are more problem banks than failed banks; and second, if a bank is classified as a problem bank prior to its actual failure, a model to predict such classifications may provide a longer lead time for corrective action.

However, from the standpoint of providing information for a risk-related insurance scheme, studying problem bank classifications may provide a smaller amount of information. Since many banks on the problem list do not fail and some banks fail without ever making the problem list, it cannot be assumed that the problem list accurately captures high risk situations. Therefore, a

model which successfully identifies problem banks may be less accurate in pinpointing risky institutions.

This does not, however, imply that such models are without use. It can be easily argued that, even though some high risk institutions are not classified as problem banks, on balance banks which are on the problem list are riskier institutions. Therefore, problem bank prediction models should yield useful information as to the financial ratios which are important in identifying risky institutions.

It is, however, more difficult to test the accuracy of a problem bank prediction model. In the case of failure prediction, the event (failure) which one attempts to model is easier to identify. With problem bank prediction models, one's ability to identify a problem institution is clearly limited by the reliability of the problem bank list.

Sinkey [16] has shown that the most effective variable in distinguishing problem from nonproblem institutions is the examiner determined net capital ratio (capital minus adversely classified assets divided by total assets minus estimated losses). An early warning system based solely upon the net capital ratio (NCR) was 95.4 percent accurate in classifying the original sample of 306 problem and nonproblem banks (Type-I error was 4.9 percent). However, these results merely prove an identity since examiners classify banks as problem institutions if their NCR is too low. It does not prove the NCR is effective in distinguishing between failed and solvent banks.

Problem bank prediction models based upon balance sheet and income statement characteristics have not been very successful, since there seems to be a large overlap between problem and nonproblem bank financial characteristics. As a result, some researchers [15, 18] have chosen to work with what is referred to as outlier analysis. Outlier tests generally start by dividing banks into different peer groups and then seek to locate atypical banks, those with financial characteristics well beyond peer group averages. However, this approach has several drawbacks. First, the implicit assumption that peer group averages are the desired outcomes makes it impossible to determine the vulnerability of particular peer groups or the banking system as a whole. Second, the decision on the allowable deviation from the peer group average is entirely a subjective process. Third, there has been little effort to determine to what extent outliers include banks that eventually fail or present abnormal risks. Finally, while other techniques are designed to determine financial variables which are indicative of bank risk, it is not clear which financial variables should be considered during the outlier evaluation process.

In a further attempt to avoid the problems associated with problem bank and outlier analysis, other researchers [4, 5, 6, 20] have attempted to develop models that distinguish banks "vulnerable" to failure from banks "resistant" to failure. However, it is not clear how "vulnerable" should be defined. Korobow and Stuhr [4] derive a composite ranking of banks by weighing various



financial variables they believe, on a theoretical basis, to be indicative of financial strength or weakness. Banks above an arbitrary cutoff point are considered resistant to failure while banks below the cutoff point are deemed vulnerable to failure. However, there is very little empirical evidence that these various definitions of bank vulnerability are closely related to the incidence of actual bank failure.

Some of the more recent studies [9, 10, 13] have been attempts to develop early warning systems which incorporate bank stock prices as an explanatory variable. According to the efficient market hypothesis, stock prices represent a firm's intrinsic value and any new information regarding that firm's condition will be quickly and accurately reflected in the price of its common stock. If this is true, and these studies suggest that it is, bank stock prices should be included with accounting and examination data in developing an early warning system. However, only a small percentage of banks have publicly traded stock. Therefore, at best this market information is useful in only a limited number of situations and could not provide much input for a variable rate deposit insurance system.

#### DISCUSSION OF CURRENT LITERATURE

In some instances, failure prediction models have, with a one- or two-year lead time, achieved over 90 percent accuracy in distinguishing between solvent and failing institutions. However, the usefulness of a particular prediction model in a risk-related insurance scheme depends largely upon its ability to minimize the Type-II error, since the overwhelming majority of banks would be more susceptible to this error rather than Type-I error. Studies to date have not emphasized minimizing Type-II error.

While prediction models may be fairly accurate in classifying banks from the sample and the time period from which they were developed, they may be far less accurate in predicting future bank failures since some ratios may be more reflective of risk at one point in time than another. However, few attempts have been made to see how well these models hold up over time.

The selection method for the various financial ratios has been based upon finding the combination that provides the best predictive capabilities for the sample period in question. Such a selection process provides little assurance that the model will predict with an equal degree of accuracy for a time horizon outside the sample period. A model based upon financial ratios selected because they should, in theory, affect bank failure, may prove over time to be a better predictor than a model where the ratios are selected in a more random fashion.

Moreover, there is no guarantee that the approach taken in these studies will produce a list of variables which is useful to a risk-related insurance system. For example, Rose and Scott found a negative relationship between the employee

fringe benefits/total expenses ratio and the likelihood of failure. They suggest that a low ratio may be indicative of poor quality management and a relatively high risk of employee embezzlement or fraud. However, if this ratio were used to help determine insurance assessments, many banks may be unfairly penalized since relatively low levels of fringe benefits may be offset by relatively high wages and salaries. Moreover, the inclusion of this ratio in a risk-related insurance scheme may create an incentive for bank management to raise fringe benefits at the expense of wages and salaries.

In attempting to construct a failure prediction model, one should determine the types of risks or problems inherent in commercial banking that contribute to bank failure, select financial ratios that can serve as proxies for each of these and then test the overall effectiveness of the model. These risks or problems include the following:

1. Credit risk -- The risk that loans or other assets will default or perform poorly. Historically, a large percentage of banks have failed because of excessive losses resulting from poor quality assets.
2. Interest rate risk -- Bank earnings are sensitive to interest rate changes whenever the maturity structures of assets and liabilities are mismatched. In recent years, as interest rates have become more volatile, institutions with excessive asset/liability maturity mismatches have failed in greater numbers.
3. Moral hazard risk -- Many banks have failed because of fraud, embezzlement or insider abuse.
4. Diversification risk -- Concentrations of assets and liabilities in specific product lines, industries, locations or with related groups of individuals or companies subject banks to a greater risk of failure. To a certain extent, diversification risk is interrelated with credit and liquidity risk. Asset concentrations increase credit risk while liability concentrations increase liquidity risk.
5. Liquidity risk -- Sudden demands for cash withdrawals may lead to insolvency if the bank has insufficient liquid assets to meet those demands.
6. Operational inefficiency -- While inefficiency may not itself cause a bank to fail, banks with abnormally high noninterest costs are more susceptible to failure in the event that other problems arise.

In addition to the consideration of ratios which may measure these types of risk, one should also account for the importance of bank capital. Banks with high levels of capital are better able to withstand a given level of losses than are banks with low levels of capital. Thus, it seems appropriate that capital adequacy should also be a factor in determining a bank's probability of failure.

In the past, the development of effective failure prediction models has been impeded by the relative lack of commercial bank failures. Between 1943 and 1977, only 193 banks failed, about 5.5 per year. However, between 1978 and 1982 69 insured commercial banks failed, a rate of about 14 per year. Research incorporating these data from the past few years should add considerably to our knowledge in predicting bank failure.

One remaining data limitation deals with the identification of small versus large bank failures. Since relatively few large banks fail (banks over \$1 billion), the data used to construct failure prediction models are drawn mainly from the smaller institutions. To the extent that it is "normal" for larger institutions to have different financial ratios, models developed on the basis of small bank data may not be applicable to the larger banks.

To summarize, it appears that much additional work needs to be done before bank failure prediction models may be used as a basis for a risk-related insurance scheme. As noted, all of the failure prediction models developed to date were developed for the purpose of assisting in the allocation of examination resources. This motive, however, has resulted in the development of models which have only limited application to insurance assessment problems. Failure prediction research used to assist the development of risk-related insurance assessments must be more sensitive to the informational needs of such a system.

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## APPENDIX C

### EXISTING DISCLOSURE VEHICLES

#### REPORTS OF CONDITION AND INCOME ("CALL REPORTS")

Every national, state member and insured nonmember commercial bank is required to file a Report of Condition and a Report of Income on a quarterly basis with its Federal supervisory agency. Every mutual savings bank insured by the FDIC is required to submit a Report of Condition quarterly and a Report of Income semiannually. These reports consist of a balance sheet as of the quarter-end date (March 31, etc.), a calendar year-to-date income statement, and supporting financial schedules. In addition, commercial banks over \$300 million in total assets file a Large Bank Supplement quarterly. This supplement contains detailed schedules on major asset, liability, income and expense accounts.

The information collected in the Reports of Condition and Income serves a variety of purposes within both governmental and private spheres. Governmental uses include: supervisory purposes, i.e., for monitoring the safety and soundness of individual banks; analysis of general banking developments needed as background for structuring supervisory policy; measurement by the Federal Reserve Board ("FRB") of monetary aggregates, of bank credit, and of flow of funds; analysis of bank credit and monetary developments needed as background for the formulation of monetary policy by the FRB; preparation of balance of payments and national income and product statistics by the Treasury and Commerce Departments; and analysis by various Government agencies of credit that serves the needs of agriculture, industry, housing, international trade and finance and consumers. Many of these governmental uses are paralleled by uses within the private sector, e.g., by the banking industry, by security analysts, and by the academic community. In some cases, an individual item in the reports may serve all or a number of these uses; in other cases, an item may be applicable only to one specialized use.

#### FILING REQUIREMENTS

##### Existing Requirements

Commercial banks file different versions of the Reports of Condition and Income based on whether the bank has any foreign offices or whether it has over \$100 million in total assets, as follows:

- o Banks, regardless of size, that have foreign offices file the most detailed reports. Foreign offices include branches or subsidiaries in foreign countries, branches or subsidiaries in Puerto Rico or U.S. territories and possessions, and Edge Act or Agreement subsidiaries.

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- o Banks, regardless of size, that have foreign offices file the most detailed reports. Foreign offices include branches or subsidiaries in foreign countries, branches or subsidiaries in Puerto Rico or U.S. territories and possessions, and Edge Act or Agreement subsidiaries.

International Banking Facilities ("IBFs") are not presently considered foreign offices. These banks utilize the FFIEC 014 - Consolidated Domestic and Foreign Report of Condition, the FFIEC 013 - Standard Report of Income, and the FFIEC 013S - Supplementary Information for the Consolidated Report of Income (a breakdown of selected income and expense items for domestic and foreign offices) and Domestic Office Substatement (a listing of assets and liabilities in such offices).

- o Banks that have only domestic offices (including IBFs) and have over \$100 million in assets file the second most detailed reports. These banks utilize the FFIEC 012 - Standard Report of Condition and the same form of the Report of Income (FFIEC 013) as above.
- o Banks that have only domestic offices (including IBFs) and under \$100 million in assets have the option of filing less detailed Reports of Condition and Income or of filing the same reports as larger banks that have only domestic offices. The abbreviated forms are FFIEC 010 - Abbreviated Report of Condition and FFIEC 011 - Abbreviated Report of Income.

Mutual savings banks report on forms which differ from those used by commercial banks. The same set of forms is used by each mutual savings bank regardless of its size.

#### Proposed Requirements

The commercial bank Call Reports are in the process of being revised and expanded to obtain information necessary to more efficiently monitor individual bank condition and performance. A separate set of forms is being proposed for implementation in 1984 for each of three different categories of banks:

- o Banks that have foreign offices. Foreign offices will include the same branches and subsidiaries as at present as well as IBFs. Any bank, regardless of size, whose only "foreign office" is an IBF will fall within this category.
- o Banks that have only domestic offices (i.e., no foreign offices as described above) and assets of \$100 million or more.
- o Banks that have only domestic offices and assets of less than \$100 million.

Again, the reporting requirements proposed for each of these classes of banks differ: the foreign office banks' report forms are the most detailed; the reports for domestic only banks of \$100 million or over eliminate foreign office detail; and the domestic only banks under \$100 million file a somewhat simpler report than the larger banks. Within the last group, domestic only banks under \$100 million, banks under \$25 million would be afforded further



simplification in a few specific areas. Banks under \$100 million would no longer have an option to file different reports. The Large Bank Supplement would be eliminated.

Revisions to the mutual savings bank Reports of Condition and Income are contemplated when the commercial bank forms changes have been completed.

#### New Requirements

In addition to the current and proposed filing requirements already discussed, commercial banks were required to report the amounts of their past due, non-accrual and renegotiated loans and lease financing receivables on a quarterly basis beginning December 31, 1982. The amount of detail in this report is keyed to the version of the Report of Condition the bank files.

Commercial banks will begin reporting two new schedules quarterly beginning June 30, 1983. Schedule J, "Repricing Opportunities for Selected Balance Sheet Categories," provides information on the bank's sensitivity to interest rate changes. Schedule L, "Commitments and Contingencies," contains information on off balance sheet transactions. The specific reporting requirements for these schedules are also keyed to the version of the Report of Condition the bank files.

#### CONTENTS OF REPORTS

##### Report of Condition

The Report of Condition forms for both commercial and mutual savings banks consist of a statement of condition as of the end of a quarter and a number of supporting financial schedules. For both commercial and mutual savings banks, these schedules show the components of the loan portfolio by loan type; the components of the securities portfolio by type of obligor and arrayed by maturity; the components of cash and due from bank accounts; and the components of other assets and other liabilities, if material. Also, a schedule of data used for deposit insurance assessment purposes is required as well as 30-day averages for certain asset and liability accounts. Commercial banks also prepare a schedule on deposit structure by form of deposit and type of depositor and report data on standby letters of credit. Mutual savings banks have additional schedules on maturity distributions of deposits and of borrowed funds as well as supplemental data on the market value of investment securities, pledged securities, certain types of interest bearing deposits, past due and nonaccrual real estate loans, real estate loan commitments, and estimated future real estate loan principal reductions.

##### Report of Income

The Report of Income for both commercial and mutual savings banks consists of a statement of income for the calendar year-to-date period and is supported by

a number of financial sections. These sections show the changes in the equity capital accounts and the allowance for possible loan losses during the period; the components of other income and other expense, if material; the components of the provision for income taxes and extraordinary items; and information on employees, subsidiaries and mergers.

#### Large Bank Supplement

The Large Bank Supplement for commercial banks consists of seven additional schedules which relate to statement of condition or statement of income accounts. These schedules present data on the remaining maturities of selected loans; the maturity distribution of deposits; the securities held in trading accounts; detailed loan loss experience and reconciliation of the allowance for possible loan losses; interest and fees on loans; short-term extensions of credit; and short-term borrowings.

#### AVAILABILITY OF REPORTS

The Call Reports are generally available to any interested person in hard copy or on computer tapes for a fee. The reports are due 30 days after the end of a quarter and are available to the public 75 days after the end of the quarter. There are only two portions of the reports which are not available to the public, the 30-to-89 day past due loan and lease amounts on the commercial bank reports (public availability of the past due loans report begins as of June 30, 1983) and some specific deposit data collected only in June from both commercial and mutual savings banks.

#### BANK PERFORMANCE REPORTS

The Uniform Bank Performance Report ("UBPR") and the Mutual Savings Bank Performance Report ("MSBPR") are analytical tools created for bank supervisory, examination and management purposes. They show, in a convenient format, the historical impact of management decisions and economic conditions on a bank's performance and balance sheet composition. The performance and composition data contained in the reports may be used as an aid in making decisions concerning the adequacy of earnings, liquidity, capital, asset and liability management, and growth management. Bankers and examiners alike may use these reports to further their understanding of bank financial condition and through such understanding become more effective in the performance of their duties.

A UBPR is produced for each insured commercial bank in the United States while an MSBPR is produced for each state-chartered mutual savings bank. The report is computer generated from a data base derived from public and, to a limited extent, nonpublic sources. It contains several years of data which are updated quarterly. Those data are presented in the form of ratios, percentages and dollar amounts computed mainly from Call Reports submitted by the bank. Each performance report also contains corresponding average data for the bank's peer group and percentile rankings for most ratios. These reports, therefore,

permit the evaluation of a bank's current condition and trends in its financial performance as well as comparisons of the bank's performance with that of its peer group.

#### SOURCE OF INFORMATION

The FDIC has the responsibility to maintain the UBPR production system (software and other support programs) and to produce the reports on behalf of the three banking agencies. The information generated in the report is taken from the Call Reports, other regulatory reports (Large Bank Supplements, for example) and a file maintained on an individual bank's structure (branches). The FDIC has also developed its own MSBPR production system since it alone among the three banking agencies has supervisory responsibility over mutual savings banks.

#### CONTENTS OF REPORT

The UBPR is divided into four parts: summary ratios; statement of income information; statement of condition information; and other information. The data provided within these parts is comprised of three groups: the individual bank's data; data for the peer group; and percentile rankings. The peer group data are derived from a group of banks with similar characteristics including asset size, branch versus nonbranch system bank, and metropolitan versus non-metropolitan location. There are essentially two formats utilized in the UBPR, one for banks under \$300 million in assets and another for banks over \$300 million.

The following is a listing and brief description of the UBPR pages.

Introductory page	Contains the bank's name, address, current peer group, any holding company affiliation, and a table of contents.
Page 1	Summary Ratios -- Selected earnings and balance sheet ratios and growth rates providing a synopsis of the bank's condition, performance and growth.
Page 2	Income Statement, Revenues and Expenses -- Historical statements of income in dollars on a tax equivalent basis with one-year and four-years percentage change for income and expense items.
Page 3	Relative Income Statement and Margin Analysis -- Major components of the income statement as a percentage of average assets and the amounts of average earning assets, yields on earning assets, and cost of funds.
Page 4	Noninterest Income and Expense Ratios -- Historical dollar amounts of noninterest income and expense items and these amounts as a percentage of average assets and operating income.

- Page 5            Balance Sheet, Asset Section -- Historical end of period amounts of assets, 30-day average assets, and one-year and four-years percentage change in asset items.
- Page 6            Balance Sheet, Liabilities and Capital Section -- Same as above, but for liability and capital accounts.
- Page 7            Balance Sheet, Percentage Composition of Assets and Liabilities -- The major components of the statement of condition are averaged and presented as a percentage of average total assets.
- Page 8            Analysis of Loan Loss Reserve and Loan Mix -- Historical dollar reconciliation of the loan loss reserve, ratios of provisions, chargeoffs, recoveries, net loan losses, and the reserve balance to asset and loan averages. Also, the principal categories of loans as a percentage of gross loans, and changes in the composition of asset, loan, and liability mixes.
- Page 8A           Analysis of Nonperforming Loans -- Not available to the public until the Call Reports as of June 30, 1983.
- Page 9            Sources and Uses of Funds -- Changes in specific balance sheet data by quarters and by year.
- Page 10           Margin Sensitivity Analysis -- End of period assets and liabilities categorized by market-rate versus fixed-rate, and expressed as a percentage of total assets.
- Page 11           Liquidity and Investment Portfolio -- Dollar information and ratios which indicate a bank's liquidity position, and the principal components of the investment portfolio as a percentage of total securities.
- Page 12           Capital Analysis -- End of period amounts, reconcilment of account changes during the period, and selected ratios.
- Page 13           Summary Information for Banks in State -- Dollar and ratio information for all banks in the state and by asset category of banks in the state.
- Page 14           Foreign Office Trends -- Where applicable, dollar amounts of the most significant types of assets and liabilities in foreign offices and related ratios.

It should be noted that the UBPR is being revised to incorporate the additional data to be collected in the new schedules to the Call Reports. All banks will

have a page related to nonperforming loans (page 8A) which will utilize the information filed by banks on past due, nonaccrual and renegotiated loans and leases. Quarterly income data is now being reported by banks and therefore all bank UBPRs can be updated quarterly. Finally, the new Schedule J, "Repricing Opportunities for Selected Balance Sheet Categories," and Schedule L, "Commitments and Contingencies," will be incorporated into the UBPR.

The tables in the MSBPR cover the same four areas as the parts of the UBPR. The report provides four columns of peer group data for comparison with the bank's data. The peer groups have been formed from (1) all mutual savings banks in the nation, (2) all mutuals in the state, (3) all mutuals in a geographic reference group, and (4) all mutuals in the nation with similar asset size. The percentile ranking that is provided relates to the bank's ranking within the national asset size peer group.

The following is a listing and brief description of the MSBPR pages.

Introductory page	Contains the bank's name, address, number of branches, peer group descriptions, and a table of contents.
Page 1	Summary Ratios -- Selected earnings and balance sheet ratios and growth rates and asset quality data providing a synopsis of the bank's condition, performance, and growth.
Page 2	Income and Expense Ratios -- Income statement elements as a percentage of average assets, cost and yield factors, ratios permitting an analysis of net interest margin, and overhead ratios.
Page 3	Balance Sheet Composition -- Individual asset, liability, and surplus accounts as a percentage of end of period total assets.
Page 4	Loan and Investment Analysis -- Loan categories as a percentage of total loans, securities by maturity as a percentage of total securities, subquality real estate loans as a percentage of real estate loans, ratios of provisions, chargeoffs, recoveries, net loan losses, and the reserve balance to loan balances, and comparisons of the book and market values of investments.
Page 5	Liquidity and Rate Sensitivity -- Ratios which indicate a bank's liquidity and rate sensitivity position and growth rates for selected balance sheet components related to liquidity and sensitivity.
Page 6	Balance Sheet History -- Historical end of period dollar amounts of asset, liability, and surplus accounts.

- Page 7            Balance Sheet History, Memoranda -- Historical end of period dollar amounts of time deposits and other borrowed money by maturity, 30-day averages for selected balance sheet categories, market values of bonds and stock, selected real estate loan data, and a reconciliation of surplus accounts.
- Page 8            Average Balance Sheet -- Average dollar amounts for individual asset, liability, and surplus accounts for the year to date.
- Page 9            Income Statement History -- Historical statements of income in dollars.

#### AVAILABILITY

Both the UBPRs and MSBPRs are available to any interested person for a fee approximately 90 days after the end of a quarter. Each bank is provided a copy of its own performance report free of charge. Commercial bank ratios using the 30- to 89-day past due loan and lease data will be provided to the regulator, but will be withheld from the general public.

#### INSIDER LOAN DISCLOSURES

Form FFIEC 003 was designed to be used by banks in fulfilling the annual insider loan reporting requirements imposed by Titles VIII and IX of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 ("FIRA"). The filing of the report is mandatory and the information contained therein is publicly available from the bank's regulatory agency as well as from the institution itself. Each reporting bank must list on this form (a) the principal shareholders of the bank, if any; (b) the names of executive officers and/or principal shareholders of the bank who were, or whose related interests were, indebted to the bank during the year, and the aggregate amount of such indebtedness for all named persons; and (c) the names of executive officers and/or principal shareholders of the reporting bank who filed a report with the bank at year-end on indebtedness to its correspondent banks during the year, and the aggregate amount of such indebtedness for all named persons.

Title IV of the Garn-St Germain Depository Institutions Act of 1982 authorized the Federal banking agencies to issue rules and regulations dealing with: (1) reporting and disclosure of loans by banks to their own executive officers and principal shareholders; and (2) reporting and disclosure of loans by correspondent banks to a reporting bank's executive officers and principal shareholders. These authorizations represent amendments to Titles VIII and IX of FIRA, the original provisions of which will remain in effect until such time as new regulations become effective.

## SECURITIES LAWS

The two Federal securities laws, the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act"), as amended, require certain public disclosures be made by banks and bank holding companies.

### PUBLIC OFFERINGS OF SECURITIES

The 1933 Act requires a company to disclose its officers, directors, principal shareholders, management's remuneration, and other business information and provide financial statements certified by an independent public accountant to potential investors before these investors buy the debt or equity of the company. Banks are specifically exempt from the 1933 Act, but bank holding companies, of which almost all large banks are a part, are covered by the requirements of the 1933 Act.

Bank holding companies must therefore register any public sale of securities (equity or debt) with the Securities and Exchange Commission ("SEC"), and provide a prospectus including the mandated information to each purchaser prior to the purchase of securities; however, exemptions exist for certain offerings of less than \$5 million.

Although exempt from the 1933 Act, banks with national charters under the Office of the Comptroller of the Currency's ("OCC") regulations, 12 CFR Part 16, must file and have declared effective an offering circular which is to be provided to every purchaser of the offering. This information is less extensive than that required by the SEC, and the financial statements need not be certified by an independent public accountant. Exemptions exist for sales of less than \$500,000 and an abbreviated form is available for sales under \$2 million.

State-chartered banks that are members of the Federal Reserve System ("FRS") have no Federal requirements governing them if they wish to sell securities to the public, with the exception of the general fraud prohibitions in Section 17 of the 1933 Act which apply to any bank or company in the United States. The FRB does not have any filing or offering circular requirements.

State-chartered banks that are not FRS members also have no Federal requirement to file or provide an offering circular. However, the FDIC has adopted a Statement of Policy Regarding Use of Offering Circulars in Connection with Public Distribution of Bank Securities which applies to state nonmember banks. The policy statement lists 12 basic topics which should be included in every offering circular.

Many sales of securities are effected through the use of offering circulars as a result of FDIC administrative actions requiring additional bank capital. Such orders generally mandate the use of an offering circular acceptable to the FDIC staff. In 1982, 38 offering circulars were submitted to the FDIC's Washington Office for suggestions or review.

PUBLICLY HELD SECURITIES

The 1934 Act requires that equity securities of companies with over 500 stockholders and \$1 million in assets be registered and that these companies provide their stockholders with proxy statements and with annual reports including financial statements. In addition, these "registered" companies must file quarterly reports and provide other information on current company events, officer, director and principal stockholder security transactions, and tender offers.

Although banks are not required to register or file this information with the SEC, bank holding companies must do so. Section 12(i) of the 1934 Act provides for banks to register and file periodic reports with their respective regulatory agency.

The following four categories of disclosure exist under the 1934 Act:

- Registered bank holding companies
- Registered banks
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Registered bank holding companies

- o Securities disclosure is regulated by the SEC.
- o Stock must be registered if a bank holding company has over 500 stockholders and over \$3 million in assets.<sup>1/</sup>
- o Approximately 2,600 or 18 percent of insured commercial banks are owned by registered bank holding companies.
- o A bank holding company must prepare proxy statements, annual reports (Form 10-K), and other periodic reports, as well as annual reports to stockholders.
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## SECURITIES LAWS

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Bank holding companies must therefore register any public sale of securities (equity or debt) with the Securities and Exchange Commission ("SEC"), and provide a prospectus including the mandated information to each purchaser prior to the purchase of securities; however, exemptions exist for certain offerings of less than \$5 million.

Although exempt from the 1933 Act, banks with national charters under the Office of the Comptroller of the Currency's ("OCC") regulations, 12 CFR Part 16, must file and have declared effective an offering circular which is to be provided to every purchaser of the offering. This information is less extensive than that required by the SEC, and the financial statements need not be certified by an independent public accountant. Exemptions exist for sales of less than \$500,000 and an abbreviated form is available for sales under \$2 million.

State-chartered banks that are members of the Federal Reserve System ("FRS") have no Federal requirements governing them if they wish to sell securities to the public, with the exception of the general fraud prohibitions in Section 17 of the 1933 Act which apply to any bank or company in the United States. The FRB does not have any filing or offering circular requirements.

State-chartered banks that are not FRS members also have no Federal requirement to file or provide an offering circular. However, the FDIC has adopted a Statement of Policy Regarding Use of Offering Circulars in Connection with Public Distribution of Bank Securities which applies to state nonmember banks. The policy statement lists 12 basic topics which should be included in every offering circular.

Many sales of securities are effected through the use of offering circulars as a result of FDIC administrative actions requiring additional bank capital. Such orders generally mandate the use of an offering circular acceptable to the FDIC staff. In 1982, 38 offering circulars were submitted to the FDIC's Washington Office for suggestions or review.

PUBLICLY HELD SECURITIES

The 1934 Act requires that equity securities of companies with over 500 stockholders and \$1 million in assets be registered and that these companies provide their stockholders with proxy statements and with annual reports including financial statements. In addition, these "registered" companies must file quarterly reports and provide other information on current company events, officer, director and principal stockholder security transactions, and tender offers.

Although banks are not required to register or file this information with the SEC, bank holding companies must do so. Section 12(1) of the 1934 Act provides for banks to register and file periodic reports with their respective regulatory agency.

The following four categories of disclosure exist under the 1934 Act:

- Registered bank holding companies
- Registered banks
- Nonregistered nonholding company banks
- Nonregistered bank holding companies

Registered bank holding companies

- o Securities disclosure is regulated by the SEC.
- o Stock must be registered if a bank holding company has over 500 stockholders and over \$3 million in assets.<sup>1/</sup>
- o Approximately 2,600 or 18 percent of insured commercial banks are owned by registered bank holding companies.
- o A bank holding company must prepare proxy statements, annual reports (Form 10-K), and other periodic reports, as well as annual reports to stockholders.
- o Financial statements
  - must be prepared according to generally accepted accounting principles with footnote explanations, and
  - must be certified by an independent public accountant.

<sup>1/</sup> Although the 1934 Act specifies \$1 million in assets, the SEC has exempted companies under \$3 million to account for inflation. However, both amounts are so low as to make it virtually irrelevant when discussing banks.

Registered banks

- o Securities disclosure is regulated by appropriate regulatory agency -- OCC, FRB or FDIC.
- o Stock must be registered if bank has over 500 shareholders and over \$1 million in assets.
- o Approximately 700 or five percent of insured commercial banks are registered banks.
- o Banks must provide proxy statement, annual reports (Form F-2), and other periodic reports, as well as annual reports to stockholders.
- o Financial statements:
  - must be prepared according to generally accepted accounting principles with footnote explanations, and
  - must be verified by the bank's principal accounting officer and internal auditor if not certified by an independent public accountant.

Nonregistered Nonholding Company Banks

State banks

- o Stock held by less than 500 stockholders or bank has less than \$1 million in assets.
- o Securities disclosure not regulated by Federal statute.
- o Approximately 9,500 or 66 percent of insured commercial banks are nonregistered state banks. Of these, approximately 1,000 are member banks and approximately 8,500 are nonmember banks. (These numbers include nonregistered banks owned by registered holding companies.)
- o Banks have no requirements for stockholder reports or proxy statements under Federal securities laws.
- o Publicly available financial information is in Call Reports.

National Banks

- o Stock held by less than 500 stockholders or bank has less than \$1 million in assets.
- o Annual report must be available to stockholders although not reviewed by OCC (12 CFR Part 18).
- o Approximately 4,200 or 29 percent of insured commercial banks are nonregistered national banks. (These numbers include nonregistered banks owned by registered holding companies.)

- o No other requirement for filing proxy statements or stockholders reports.
- o Other publicly available information is in Call Reports.

Nonregistered Bank Holding Companies

- o Stock in holding company held by less than 500 shareholders or holding company has less than \$3 million in assets.
- o Securities disclosure not regulated by Federal statute.
- o Bank holding company regulated in areas other than securities law by FRB under the Bank Holding Act of 1956, as amended.
- o Bank holding company must file Form Y-6 and, if over \$50 million in assets, Form Y-9 with the FRB, both of which are publicly available upon request.
- o Holding company has no requirement for proxy statements or annual reports to stockholders. Also, no filing of other public reports.
- o Financial statements must follow generally accepted accounting principles.

In addition to the requirements outlined above under the 1934 Act, all banks and bank holding companies are subject to the prohibitions in Section 10(b) and its related rules against the use of manipulative or deceptive practices and false and misleading information in the sale or purchase of securities. Section 14(e) and its rules apply to all tender offers including those for all bank and bank holding company stock.

STATE REQUIRED DISCLOSURE

The 50 states have varying requirements for disclosure of information by state-chartered banks.

The New York Superintendent of Banks, for example, has the authority to give final approval to the issuance of securities by state banks. Under this authority, the state staff reviews all offering circulars for these offerings. In addition, all banks whose securities are not registered under the 1934 Act must provide stockholders with an annual report including financial statements. The latter need not be certified by an independent public accountant, but must provide certain footnote explanations. Although there are no separate state call reports (New York uses the Federal Call Report data), state banks are required to publish their Call Report Statement of Condition semiannually.

Ohio statutes require quarterly publication of the balance sheet of the Report of Condition. Banks in Ohio must also file with the state a Summary Report by June 30 each year which lists directors and officers and contains a very brief summary of the balance sheet which is available to the public. The only other



publicly available information comes from various corporate applications. Banks must publish that an application has been filed with the state and, later, that the transaction has been effected. Only banks under administrative orders have their disclosure materials reviewed by the staff of the Superintendent of Banks prior to public offerings.

California law also requires the Report of Condition to be published quarterly, and the Report of Income is available upon request. Banks come under the General Corporate Code in California, and are required to hold an annual meeting each year and to provide an annual report to stockholders prior to the meeting which includes a balance sheet, income statement, statement of financial position, and an accountant's report or a certificate of verifying officer. If the bank wants to establish a stock option plan, increase authorized shares, or sell securities, a permit is needed from the state. Prior to issuing that permit, the staff of the California Superintendent of Banks requires and reviews the proxy statement or prospectus, as appropriate, used to effect the transaction.

#### DISCLOSURE UNDER THE BANK HOLDING COMPANY ACT OF 1956

Disclosure of the financial condition and organizational structure of bank holding company organizations is available from two reports submitted to the FRS, the Y-6 (Annual Report of Domestic Bank Holding Companies) and the Y-9 (Bank Holding Company Financial Supplement).

To the extent that the data is provided on a preprinted format (Y-9 in its entirety and Y-6 in portions), the information contained in the documents is available on computer tape for subscribers. Copies of either report may also be requested from the FRS. The Y-6 presents a broad and theoretically in-depth view of the structure and financial condition of a holding company. For analysis of the financial condition of a given bank within the holding company, however, the Y-6 is limited because it lacks detailed data for each individual bank subsidiary. Narrative disclosure of matters which could be considered vital to an in-depth analysis of the banks within the organization (such as administrative orders by regulatory agencies) is not required. However, information concerning subsidiaries, related interests, and loans to insiders is valuable to the analyst.

#### FORM Y-6 (ANNUAL REPORT OF DOMESTIC BANK HOLDING COMPANIES)

##### Filing Requirements

Must be filed by any domestic company that meets the definition of a "bank holding company" under the Bank Holding Company Act (a qualifying "foreign banking organization" would submit a Y-7).

A single report may be filed by tiered holding companies with specified items answered separately.

Report is due three months after the end of the organization's fiscal year.

#### Availability of Information

The reports submitted are available on an individual respondent basis.

The bank holding company may request in writing confidential treatment for information contained in the report by substantiating that release of such data would result in an invasion of privacy or result in substantial harm to the organization's competitive position.

The FRB may determine that the disclosure of such information (for which confidentiality is requested) is in the public interest.

#### Items Contained in Report

##### Financial Statements

Consolidated and parent only two year comparative financial statements, including balance sheets, income statements, changes in capital accounts and changes in financial position (consolidated financial statements need not be submitted by one bank holding companies with less than \$100 million in total banking assets).

##### Annual Reports

If prepared in the normal course of business, the bank holding company's (and any subsidiary's) most recent Form 10-K and annual report to shareholders.

##### Information on Subsidiaries (Schedule A)

Must be completed for each bank and nonbank (foreign and domestic) subsidiary of the bank holding company; grouping of subsidiaries engaged in consumer or sales financing or mortgage banking is permitted.

Structural data include identification of subsidiary, type of business engaged in, information on ownership of the subsidiary within the bank holding company's organization including types and percentages of voting shares owned or controlled, number of offices and countries in which offices are operated.

Financial data include information concerning investments in subsidiaries as well as certain intracompany transactions and selected balance sheet and income statement data of the subsidiaries.

Information Included on Regulated Investments (Schedule B)

Must be completed for each bank and nonbank (foreign and domestic) regulated investment which is not otherwise regarded as an investment.

Structural information includes ownership information within the holding company's organization, types and percentages of voting share ownership, and a description of the business activities.

Financial data includes information on the investment.

Activities of Parent Bank Holding Company (Schedule C)

Provides listing of business activities currently conducted by the parent company and lists whether they are conducted in the United States.

Provides listings of business activities commenced or terminated by the parent company during the year.

Provides number of existing offices and the change in this number over the last fiscal year.

Information on Terminations (Schedule D)

Provides information for any entity that ceased being a part of the bank holding company organization during the past year.

Organization Chart

Includes a chart showing the bank holding company's direct and indirect ownership or control of all its bank and nonbank subsidiaries.

Shareholders and Directors and Officers

A list of each shareholder that directly or indirectly owns, controls, or holds with power to vote five percent or more of any class of voting securities of the bank holding company along with the shareholder's country of citizenship and the number and percentage of shares owned or controlled.

A separate list of each principal shareholder, director, or executive officer together with the title or position of each within the holding company and/or other companies, principal occupation, and number and percentage of shares owned.

Insider Loan Information

If the aggregate of loans to insiders and their interests is more than ten percent of the equity capital accounts of the bank holding company, each loan

to an insider and his interests must be listed and the following disclosed: name and title of borrower, lending institution, date originated, original amount of the loan and current balance, original and current interest rate, description of collateral, and lending institution's interest rate on comparable loans to borrowers other than insiders.

FORM Y-9 (BANK HOLDING COMPANY FINANCIAL SUPPLEMENT)

Filing Requirements

Required of holding companies with total consolidated assets of \$50 million or more.

Bank holding companies with total consolidated assets of \$50 to \$100 million file parent only balance sheets and income statements at year-end.

Bank holding companies with total consolidated assets of \$100 to 300 million file consolidated and parent only balance sheets and income statements at year-end.

Bank holding companies with \$300 million or more in consolidated assets must file consolidated and parent only balance sheets and income statements at the end of the first six months of their fiscal year and at year-end.

Availability of Information

Publicly available after the bank holding company has released its financial statements to the public or 90 days after the end of the reporting period, whichever comes first.

Confidentiality is usually accorded during the interim; in some instances information can be released during this period with notification to the respondent holding company.

## APPENDIX D

### ASSESSMENT PROCEDURES AND ISSUES

#### BASIC ASSESSMENT RATE

In 1935, Congress set the basic annual assessment rate for deposit insurance at 1/12th of one percent of total (adjusted) deposits. Adoption of this rate was based upon a combination of factors rather than upon rigorous actuarial methods. It was calculated that during the period 1865-1933, an annual average assessment rate of about 1/7th of one percent of total deposits would have been required to cover the actual losses on deposit balances in failed banks. However, if certain "crisis" years in which losses were unusually high were eliminated, the necessary rate would have been lowered to 1/12th of one percent. Adoption of the lower rate was justified on the grounds that many banking reforms and improvements had occurred to strengthen the banking system and prevent bank failures. These included deposit insurance, better bank supervision, and revised banking laws.

#### ASSESSMENT CREDIT

In 1950, Congress reduced the effective assessment rate by providing for an assessment credit to banks. The credit was set at 60 percent of the FDIC's net assessment income (gross assessments minus administrative expenses and operating expenses and insurance losses). Legislation enacted in 1960 raised the credit to 66 2/3 percent and reduced deductions from assessable deposits for some banks. In 1980, the Depository Institutions Deregulation and Monetary Control Act provided for a reduction in the credit to 60 percent. The Act authorized the Board of Directors of the FDIC to make adjustments to the credit to maintain the Deposit Insurance Fund between 1.25 and 1.40 percent of estimated insured deposits. The Act also mandated adjustments when the Fund fell below 1.10 percent or rose above 1.40 percent of insured deposits.

#### METHOD OF ASSESSMENT COMPUTATION

Every insured bank pays its assessment twice annually based upon deposit calculations for the preceding two quarters. A certified statement and the payment due must be submitted on or before January 31 and July 31. Each bank's gross assessment for each semiannual period is the basic assessment rate (1/12th of one percent) multiplied by one-half of the average of its assessable deposits on the preceding two Call Report dates. Assessments are paid by drawing on the available assessment credit and paying the remainder in cash. If a credit is not used when initially available, it may be carried over to the bank's future assessment dates. Since credits declared by the FDIC become available

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to insured banks initially on July 1 of the following year, almost all cash assessments are received by the FDIC with the January payment.<sup>1/</sup>

Total deposits are adjusted in several ways to compute assessable deposits. Deductions from total deposits are permitted for unposted debits of items in possession of the bank. Reported demand deposits are adjusted upward by the amount of uninvested trust funds shown separately in the Report of Condition and by other unposted deposits. If the amounts of unposted items are not shown in the bank's records, they may be determined (for only a few banks at present) by an "experience" factor. For items in process that have not been collected (referred to as "float"), deductions of 16 2/3 percent of adjusted demand deposits, and one percent of adjusted savings and time deposits, are permitted.

#### SUMMARY OF TECHNICAL ISSUES

Some technical issues have been raised concerning assessment procedures. These involve the deductions for float, the procedures for averaging deposits, and the assessment of interbank deposits.

Because of operational problems in calculating the float allowance for individual banks, uniform percentage deductions were introduced in 1961. Fixed rate deductions involve some significant issues. Although NOW accounts and other new "transactions-type" accounts have come into use nationwide, traditional demand and savings time categories still are used for computing the float allowance. There is also an equity issue involved. For some institutions cash items run to 30 percent or more of demand deposits, while for others the existing system is advantageous since the actual cash items are below the allowed percentages. Because of this problem, and the fact that float does not affect the liability of the FDIC in a closed bank situation, the float adjustment should be deleted.

Under the deposit insurance legislation enacted in 1935, each bank calculated its assessment from the daily average of its deposits for the preceding six months. The Federal Deposit Insurance Act of 1950 changed the basis to the two date quarterly average used at present. The use of a two-date average of deposits may result in distortions due to irregular changes in deposits at the end of the period and in some cases, intentional distortions to reduce assessments. Use of the average of daily deposits would tend to eliminate or reduce

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<sup>1/</sup> Because the assessment credit was greatly reduced in 1981 and 1982 as a result of higher insurance losses, most of the assessments due on July 1, 1982 were paid in cash. This will occur also on July 1, 1983.

these distortions. However, use of daily average deposits would add to time and paperwork burdens for banks. Moreover, neither the current Call Report nor their proposed changes require all banks to report daily averages of demand and time deposits. On balance, the costs involved in using daily averages of deposits would outweigh the potential benefits.



## APPENDIX E

### THE FINANCIAL STATEMENTS OF THE FEDERAL DEPOSIT INSURANCE CORPORATION

#### INCOME AND EXPENSES

Table E1 contains the Income Statement of the FDIC.

Gross assessments are 1/12th of one percent of total (adjusted) deposits which amounted to about \$1.1 billion in 1982. Net assessment income is comprised of gross assessments less administrative expenses and provisions for insurance losses. Sixty percent of net assessment income is returned to banks in the form of an assessment credit. Net assessments represent gross assessments less the credit.

The other principal source of the FDIC's income is the interest on its portfolio of U.S. Treasury securities which was about \$1.4 billion in 1982. Most other income derives from interest earned on notes receivable which were acquired in assistance transactions.

In addition to its administrative expenses, the FDIC incurred interest expense on notes payable to acquiring banks and to the Federal Reserve that arose in connection with assisted savings bank mergers. Insurance expenses are those incurred in connection with the handling of failed banks, but not billable to specific liquidations. The FDIC's policy is to establish an allowance for losses on assets acquired at the time an insured bank fails and expense the provision for loss. These allowances are reviewed periodically or as conditions require.

The cost to the FDIC of future payments in merger assistance transactions such as income maintenance agreements and loss indemnifications with savings banks is the estimated present value of the future payments at the time of the transactions. Adjustments are made in the FDIC's costs during the course of the payment period to reflect expected changes in future cash payments.

Net income after subtracting expenses and losses from total income is the amount added to the Deposit Insurance Fund. In 1982, this increase was approximately \$1.5 billion.

#### ASSETS AND LIABILITIES

Table E2 contains the balance sheet of the FDIC.

The FDIC's assets consist of cash, investment securities, office buildings, and assets acquired in various assistance transactions involving failed banks. These assets totaled over \$15.2 billion at year-end 1982.

Cash received but not used to cover operating expenses or disbursements related to failing banks and liquidation activities is invested in U. S. Treasury securities. At year-end 1982, U. S. Treasury securities accounted for about 89 percent of the FDIC's total assets. The maturity structure of the securities portfolio as of year-end 1981 and 1982 were as follows:

	<u>1982</u>	<u>1981</u>
Less than 1 year	31.2%	34.3%
1-5 years	54.6	40.7
5-10 years	13.7	24.4
Over 10 years	0.5	0.6

Some assets of the FDIC are derived from providing capital assistance to banks. Notes receivable are sometimes acquired from insured banks in facilitating merger agreements, purchase and assumptions of failing banks, and in other assistance arrangements. Net worth certificates have also been acquired to maintain or increase the net worth of insured banks in accordance with the Garn-St Germain Depository Institutions Act of 1982. To qualify for this assistance, institutions must have a net worth equal to or less than three percent of assets and have incurred losses during the previous two quarters. Certificates are issued for a portion of the losses. In consideration for the purchase of a net worth certificate, the FDIC issues its nonnegotiable, floating rate promissory notes of equal principal value. By year-end 1982, the FDIC had assisted 15 insured mutual savings banks through the purchase of net worth certificates totaling \$174.5 million.

In a deposit payoff, the FDIC acquires a claim against the receivership of the closed bank and the FDIC receives a pro rata share of the proceeds from the liquidation of the assets. In a purchase and assumption transaction, the FDIC takes over the assets of the failing institution which are not taken by the acquiring bank. An allowance for losses is established to reflect the shortfall between the FDIC's advances and expected recoveries on assets to be liquidated. The 1982 figure of \$712 million under Equity in Acquired Assets reflects the FDIC's interest in failed bank assets, net of loss allowance.

The FDIC's liabilities totaled \$1.5 billion at year-end 1982. The principal liabilities are incurred in bank assistance transactions.

The FDIC's total assets less its liabilities equals the Deposit Insurance Fund, which amounted to about \$13.8 billion on December 31, 1982.

TABLE E1

## FEDERAL DEPOSIT INSURANCE CORPORATION

COMPARATIVE STATEMENT OF INCOME AND THE DEPOSIT INSURANCE FUND (In thousands)	For the twelve months ended	
	December 31, 1982	December 31, 1981
INCOME:		
Gross assessments earned	\$ 1,109,288	\$ 1,040,940
Less: Provision for assessment credits	96,553	119,024
TOTAL	<u>1,012,735</u>	<u>921,916</u>
Interest on U. S. Treasury obligations	1,116,216	985,417
Amortization of premiums and discounts (net)	253,750	130,043
TOTAL	<u>1,369,966</u>	<u>1,115,460</u>
Interest earned on notes receivable	79,178	31,924
Interest received on assets in liquidation	53,888	647
Other income	8,869	4,743
TOTAL INCOME	<u>2,524,636</u>	<u>2,074,690</u>
EXPENSES AND LOSSES:		
Administrative and operating expenses (net)	129,927	127,185
Merger assistance losses and expenses (net)	681,129	387,712
Provision for insurance losses (net)	126,436	320,412
Interest expense on FRB indebtedness	54,178	9,386
Nonrecoverable insurance expenses	8,162	3,396
TOTAL EXPENSES AND LOSSES	<u>999,832</u>	<u>848,091</u>
NET INCOME	<u>1,524,804</u>	<u>1,226,599</u>
DEPOSIT INSURANCE FUND - JANUARY 1	<u>12,246,140</u>	<u>11,019,541</u>
DEPOSIT INSURANCE FUND - DECEMBER 31	<u>\$13,770,944</u>	<u>\$12,246,140</u>

TABLE E2

## FEDERAL DEPOSIT INSURANCE CORPORATION

## COMPARATIVE STATEMENT OF FINANCIAL POSITION (In thousands)

ASSETS	December 31,	
	1982	1981
Cash . . . . .	1,335	382
Investments in U.S. Treasury Obligations . . . . .	13,559,481	12,236,398
Interest and Notes Receivable Related to Assistance . . . . .	742,165	430,317
Net Worth Certificates . . . . .	174,529	--
Other Receivables and Prepaid Items . . . . .	9,793	4,542
Equity in Acquired Assets (net) . . . . .	712,069	547,214
Land and Office Buildings (net) . . . . .	<u>34,153</u>	<u>22,932</u>
	15,233,525	13,241,785
LIABILITIES		
Accounts Payable, Liability for Accrued Leave, etc. . . . .	66,150	23,290
Due Insured Banks (Assessment Credit) . . . . .	96,181	128,872
Notes Payable . . . . .	836,579	462,531
Liability for Income Maintenance Agreements . . . . .	276,595	379,542
Promissory (exchange) Notes . . . . .	174,529	--
Unpaid Depositor Claims . . . . .	9,547	1,410
Allowance for Litigation . . . . .	3,000	--
DEPOSIT INSURANCE FUND . . . . .	<u>13,770,944</u>	<u>12,246,140</u>
TOTAL LIABILITIES AND DEPOSIT INSURANCE FUND . . .	15,233,525	13,241,785

## APPENDIX F

### SMALL DEPOSITOR PROTECTION

#### INTRODUCTION

Before concluding that various risk-sharing approaches discussed in Chapter III are desirable and feasible, the FDIC studied the potential impact on the small depositor. There is no doubt that, as a group, small depositors have fared extremely well under the present insurance framework. In the 620 failures of insured bank cases through year-end 1982, 99.8 percent of all depositors had their deposits paid in full and 98.9 percent of all deposits have been recovered. Moreover, estimates show that approximately 95 percent of all deposit accounts (as opposed to dollar volume) are still within the \$100,000 insurance limit, so even with a risk-sharing policy, the small depositor will remain adequately protected.

There are several types of uninsured deposits where increased insurance protection could be justified because the depositors are unable to analyze bank risk or they cannot control balances on a daily basis. These include transaction accounts such as payroll and lock-box accounts, unsophisticated depositors, depositors with limited banking choices, some pension funds as well as IRA and Keogh accounts. Methods for increasing deposit insurance coverage for those accounts were considered, but for most of the accounts identified, no effective way was found to isolate them from other similar accounts in the same deposit category. For example, payroll and lock-box accounts cannot be segregated by definition from other transaction accounts; therefore, any increase in insurance coverage for those two accounts would result in a similar insurance increase for all transaction accounts. As the deregulation of deposit accounts continues, even the definition of transaction accounts may be blurred with time accounts which would further complicate the identification problem. Only IRA and Keogh accounts were found to be isolated enough to permit increased insurance coverage without significantly reducing market discipline.

Increasing the statutory \$100,000 insurance limit was also considered and rejected because a higher limit would increase the potential for brokering insured deposits. This practice of dividing large deposits among banks to obtain maximum insurance coverage increases risk to the insurance fund and can thwart efforts toward market discipline.

#### SMALL DEPOSITOR DEFINED

The FDIC considers a "small depositor" to be one who is generally incapable of fully understanding bank risk and who may overreact to rumors concerning a bank's solvency. Small depositors also are likely to be more seriously affected by a loss incurred in a bank failure. They desire a reasonable rate of return, but their primary needs are safety and liquidity.

Protecting these unsophisticated depositors is basic to preventing bank runs. Unfortunately, it is difficult to know which depositors meet these criteria. When they are identified, it is even more difficult to protect only the unsophisticated without increasing protection for all similar deposit accounts.

For example, discussions with depositors in failed banks suggest that it may be incorrect to assume that all depositors with more than \$100,000 are necessarily sophisticated enough to provide any meaningful discipline and among those who are, some exhibit characteristics of the unsophisticated depositors simply because they have limited banking choices. Still others are limited because their needs for funding or other services restrict them to particular banks. None of these accounts can be easily isolated to permit increased insurance protection.

#### PRESENT PROTECTION LEVEL

In order to establish the adequacy of protection currently provided to small depositors, the amount of loss suffered by depositors of insured failed banks was reviewed. From 1934 through 1982, the FDIC disbursed nearly \$7.8 billion in the 620 closed bank cases and has absorbed potential losses of over \$1.8 billion. Depositor losses have totaled only \$51 million, or less than 0.3 percent of the total deposits held by all failed institutions. This nominal depositor loss is at least partly attributable to the number of FDIC-assisted deposit assumption transactions. Under a depositor risk-sharing alternative, losses would resemble, but not be as great as, those incurred in deposit payoff cases. While such losses can vary, on average all but about eight percent of uninsured balances are eventually recovered. This loss rate does not reflect the opportunity costs of not having access to funds during the several years needed for many liquidations. Adding these costs could at least double the loss rates.

Even if payoffs occur more frequently, most depositors with more than \$100,000 are sophisticated enough to protect themselves. Many can spread their funds among different banks and others will become more aware of the risk at their banks. There will still be some who will not be able to control their risks. These do not hold a significant portion of deposits, but it may be appropriate to consider ways of increasing their protection -- ways that do not thwart efforts to increase market discipline.

#### ESTIMATED UNINSURED DEPOSITS

In identifying unsophisticated depositors, the amount of uninsured domestic deposits was estimated and then an attempt was made to determine who holds the large deposits. Of the FDIC-insured institutions, mutual savings banks hold only about three percent in uninsured deposits, but aggregate uninsured deposits in commercial banks are significant, particularly in the larger institutions.

The percentage of large deposits varies with bank size, as shown in Table F1. The table shows that approximately 25 percent of the \$1.5 trillion in domestic

deposits held by commercial banks are in accounts with balances in excess of \$100,000. When foreign deposits are included, approximately 40 percent of all deposits held by commercial banks are in accounts with balances above the statutory \$100,000 insurance limit.

TABLE F1

PERCENTAGE OF  
COMMERCIAL BANK DEPOSITS  
WITH BALANCES ABOVE \$100,000  
March 31, 1982  
Report of Condition

Commercial Bank Size by Deposits (in Millions)	Large Domestic Deposits Percent*	Total Large Deposits Percent**
0.0 - 99.9	13	13
100.0 - 299.9	18	18
300.0 - 999.9	22	22
1,000.0 - 9,999.9	28	36
10,000.0 & over	43	71
All Insured Commercial Banks	25	40

\*Percent of total domestic deposits in domestic accounts above \$100,000

\*\*Percent of total deposits (domestic and foreign) in domestic accounts above \$100,000

Table F1 shows that a relatively small percentage of deposits in banks with less than \$100 million in deposits are in large accounts, while over 40 percent of domestic deposits in banks with over \$10 billion in deposits are in such accounts. Depositors in large banks have enjoyed full protection since no failure of a bank over \$1 billion in deposits has ever been handled through a payoff. In a depositor risk-sharing plan, the potential for loss exposure for a greater portion of the large bank depositor base is increased. To the extent that a risk-sharing plan results in less frequent use of assisted deposit assumption transactions for large banks, there will be higher and more uniform risk exposure for these depositors.

To assist in the analysis of uninsured deposit accounts, examiners from all three bank regulatory agencies collected domestic deposit data in about 350 commercial and mutual savings banks that were under examination between January 6 and January 21, 1983. The survey data were used to estimate uninsured balances by type of deposit and to gain some insight into the types

of depositors that hold large accounts. The results corresponded with estimates derived from more comprehensive surveys conducted in earlier years.

Tables F2 and F3 summarize the survey findings. Uninsured balances are shown for different depositor groups including deposits of individuals, partnerships and corporations (IPC); deposits of governmental bodies (Public Funds) and all others which are described later. For each group, demand and time and savings deposits were further broken down to reflect accounts between \$100,000 and \$250,000; and accounts over \$250,000. Amounts in Table F3 have been adjusted to reflect only the uninsured portion.

TABLE F2  
ESTIMATED NUMBER OF  
ACCOUNTS ABOVE \$100,000  
(In Thousands)

	Number of Accounts \$100,001 to \$250,000	Number of Accounts Over \$250,000	Total Number of Accounts Over \$100,000
Demand-IPC	250	123	373
Savings-IPC	143	15	158
Time-IPC	413	173	586
Public Funds-Dem	17	13	30
Public Funds-T&S	60	60	120
All Others	49	33	82
Totals	932	417	1,349

TABLE F3  
ESTIMATED UNINSURED DEPOSITS\*  
(In Millions)

	Accounts \$100,001 to \$250,000		Accounts Over \$250,000		Total Uninsured Above \$100,000	
	Amount	Percent	Amount	Percent	Amount	Percent
Demand-IPC	11,245	17	114,018	33	125,263	30
Savings-IPC	2,399	4	7,229	2	9,628	2
Time-IPC	46,433	69	124,253	35	170,686	41
Public Funds-Dem	1,167	1	14,549	4	15,716	4
Public Funds-T&S	4,273	6	51,221	15	55,494	13
All Others	2,216	3	39,753	11	41,969	10
Totals	67,733	100	351,023	100	418,756	100

\*Excludes the \$100,000 insured portion of each account.

Estimated Total U.S. Domestic Deposits	\$1,560 billion	100%
Estimated Insured U.S. Domestic Deposits	1,141 billion	73%
Estimated Uninsured U.S. Domestic Deposits	419 billion	27%



## LARGE DEPOSIT HOLDERS

Each of the six deposit categories in Table F3 was reviewed, first to identify the account holders within each category, and second to decide whether increased protection would be appropriate. This preliminary review revealed that only the Demand (IPC) and Time (IPC) accounts contained uninsured deposit holders who could realistically be considered for increased protection. The other categories were found to be almost fully protected or included only presumed sophisticated investors.

For example, most uninsured public deposits are protected through pledging requirements or preference statutes. These deposits do not need increased insurance protection although increased protection would reduce the need for pledging requirements. Savings accounts do not require increased protection because only four percent of the balances are exposed. Moreover, the phaseout of deposit regulations will continue to blur the distinction between savings deposits and other types of accounts. Isolating these accounts from others will be virtually impossible.

The All Others category includes deposits of foreign governments and official institutions, commercial banks in the United States, U.S. branches of foreign banks and agencies of foreign banks. All of these depositors should be sophisticated enough to analyze bank risk.

Time Deposits

The time deposit category is the largest of the six categories identified in the large depositor survey. The volume is estimated at \$170 billion or 41 percent of all domestic uninsured deposits. Virtually all of the uninsured time deposits are in time certificates of deposit (CDs). Table F4 shows an estimated percentage breakdown of the holders.

TABLE F4

Estimated Percentage Breakdown of the Large CD Market	
Households	25%
Business	15%
State & Local Government	15%
Money Market Funds	15%
Trust Departments	10%
Pension Funds	10%
Foreign	7%
Thriffs	3%
	<u>100%</u>

The table indicates approximately 75 percent of the CD market is composed of those who are considered sophisticated investors. The 25 percent composed of the households may include some unsophisticated depositors.

In order to evaluate depositor understanding of bank risk, a limited number of large CD investors were contacted. These included money fund managers, pension fund managers, individual and small business investors, and corporate treasurers. The money fund and pension fund managers claimed their investment decisions were made only after performing an extensive internal analysis of bank risk, often with input from bank rating services. This group confers directly with bankers and uses various forms of publicly-available information to assist in their analysis.

Corporate treasurers did not appear as thorough in their analysis of bank risk. Most did not conduct any in-depth analysis of the banks before investing in a bank CD because they view their CDs more as a temporary placement of excess funds than as an investment. Corporate treasurers appear well convinced of the de facto 100 percent insurance coverage for large banks. The treasurers surveyed indicated a belief that as long as a bank was fairly large there was little need to evaluate risk. Another reason treasurers cited for not looking at risk, especially with their primary bank, was that their companies are rarely in a net depositor position.

The majority of the individual and small business depositors interviewed exhibited a general lack of financial expertise to properly analyze a bank's financial condition. Some rely on personal contact with the banker; others rely on newspapers, other news media or rumor. What is not known is the effort they would make to become familiar with bank analysis techniques as a result of a risk-sharing plan.

#### Demand Deposits

Another category where increased protection might be appropriate is demand deposits. Based on the survey estimate, uninsured demand deposits total about \$125 billion, approximately 30 percent of the total uninsured. These figures are somewhat misleading; studies in closed banks indicate that as much as three-fourths of the business demand deposits are protected by loan offsets. This appears consistent with the results of the survey in which corporate treasurers stated they were rarely in a net depositor position.

Some corporate treasurers claimed that transaction accounts such as payroll and lock-box accounts cannot be controlled on a daily basis and that periodically they are substantially above insurance levels. They argued that certain bank relationships are necessary to conduct business and that transaction accounts should be viewed differently than CDs. These arguments have some merit particularly in view of the role transaction accounts play in the flow of commerce. The problem is that isolating these accounts for additional protection would be difficult now, and ultimately may become impossible.

INCREASING SMALL DEPOSITOR  
PROTECTION: OPTIONS AND POTENTIAL PROBLEMS

Several alternative options have been considered for increasing insurance protection for those uninsured depositors identified either as unsophisticated or as noninvestors. While each alternative has desirable benefits, the implementation of some options is hampered by the inability to isolate those accounts where protection may be appropriate and by the potential for increased deposit brokering activity. Outlined below are three of the options considered along with a discussion of deposit brokering activity.

Full Coverage of Transaction Accounts

There are arguments supporting full coverage for transaction (demand) accounts. Full coverage is consistent with the stability and protection objectives of deposit insurance and would not substantially increase exposure to the FDIC insurance fund. While total uninsured demand deposits stand at about \$125 billion, the vast majority is held in business accounts with up to three-fourths offset by loans. The net exposure is probably closer to \$50 billion and includes lock-box and payroll accounts which, as noted previously, could be considered for increased insurance coverage.

Demand accounts are least like investments and the owners should perhaps not be expected to exert the discipline of investors. Full coverage would also facilitate a less disruptive payoff or a much easier transfer to an assuming bank. Also, with full insurance protection, demand depositors would be less likely to exacerbate a situation by quickly withdrawing their funds or increasing loan balances. This would give a troubled bank more time to work out its problems.

The major, and probably fatal, drawback to this alternative is the previously mentioned blurring of deposit identification. As deregulation progresses, differentiation between accounts will likely depend on the Federal Reserve Board's definition of a transaction account. At present, transaction and nontransaction accounts are distinguished by the number of permissible monthly transactions. Nontransaction accounts are subject to much lower reserve requirements than transaction accounts. So long as a substantial difference is maintained and interest is not earned on reserve balances, it would be expensive for a bank to encourage any shifting of funds from nontransaction to transaction accounts in order to receive full insurance protection. A bank would incur higher costs in the form of rates paid and would be subject to a substantial increase in reserve requirements.

It is uncertain that the definition of transaction accounts will remain the same, that the present differential in reserve requirements between transaction and nontransaction accounts will remain large, or that the Federal Reserve will not begin paying interest on reserve balances. The result of change

would be that all depositors would opt for fully-insured transaction accounts, thwarting the discipline being sought. Given these uncertainties, this option is not recommended.

#### Increased Protection for IRA and Keogh Accounts

These accounts clearly fit the criteria of a small depositor and can easily be identified. Their present volume is minimal, but the accounts can be expected to reach present insurance limits quickly, particularly if allowable contributions are increased. Any market discipline provided by this group probably would not be based on sound financial analysis and therefore is not the type of discipline the FDIC is seeking. Raising the limits for these accounts could minimize uncertainty for this group and any concomitant destabilizing effects on the industry.

#### Risk-sharing for All Depositors

This alternative is discussed in Chapter III; however, a few points need to be made with regard to the depositor whose banking choices are limited or who cannot precisely control day-to-day balances. Risk-sharing would treat all depositors alike, eliminating the identification problem. It should increase market discipline because it would eliminate full protection where it now exists while at the same time increasing the basic insurance protection for all depositors in a payoff. However, because the proposal does treat all depositors alike, some could argue that those with noninvestment transaction accounts bear a disproportionate burden.

#### Brokering Insured Deposits

Advances in computer technology have greatly increased the potential role of brokers for marketing deposits to maximize yields and insurance coverage. Brokers can combine the accounts of many small depositors, i.e., accounts of less than \$100,000, and place them in \$100,000 blocks in banks at high yields. Further, brokers can take the funds of large depositors and distribute them among different insured institutions in amounts of \$100,000 or less; thus, providing full insurance coverage.

There is a role for brokers in the intermediary process, but transactions designed solely to allow depositors to earn high yields (in many cases in problem banks) yet pass all risk to the insurance fund are clearly inappropriate. Such activity has the real potential to undermine efforts to increase market discipline.

It is not clear at this point how extensive broker activity might become. There are certain market limitations and mechanical constraints on the total volume of large funds which could be fully insured by these programs. The level of bank demand for brokered deposits is one constraint. Additionally,

there are limitations on how easily very large amounts could be divided so as to provide the depositor with the degree of liquidity and flexibility desired. Nevertheless, there is concern that many institutions are being tempted to use insured brokered deposits to fund speculative activities.

To resolve this, several alternatives are being considered that would restrict the degree to which insured brokered funds can be made available to unsafe institutions. Until this problem is solved, any increase in the present \$100,000 insurance limit would encourage more broker activity, significantly increase exposure to the insurance fund, and impede market discipline.

## APPENDIX G

### STATE DEPOSIT INSURANCE PROGRAMS

#### SUMMARY

Fourteen states operated bank obligation insurance programs at various times prior to the adoption of Federal deposit insurance. The purposes of the early plans were twofold: (1) to protect communities from disruptions of the money supply resulting from bank failures; and (2) to protect individual depositors and noteholders against losses. In spite of the relative success enjoyed by some of the programs, all had ceased operations by early 1930.

Following the adoption of Federal deposit insurance, efforts were renewed at the state-level to establish separate insurance programs. At the present time, there exist 30 active state deposit insurance programs. Organizers of these programs have been motivated by philosophical considerations, economic incentives, and regulatory and supervisory considerations. The latter includes a desire to avoid Federal deposit interest rate ceilings.

An examination of the various defunct state programs indicates that the ability of such programs to succeed, all other things being equal, depends on several key factors: the quality of the supervision over the insured institutions; the adequacy of the insurance fund; the liquidity of the fund's resources and its access to other funding sources; and the diversification of the insurer's risks. Lessons learned from the past and present suggest that certain of the programs currently in operation are financially viable, based on their capitalization levels and other criteria, but some others could encounter financial difficulties because of undercapitalization and/or inadequate contingent funding sources.

This study examines state deposit insurance programs. In the first section the state insurance programs which operated prior to the adoption of Federal deposit insurance are summarized. The initial discussion concerns commercial bank deposit insurance programs, since thrift insurance at the state-level did not develop until the 1930s. In the second section the principal state insurance programs established after 1930 that are currently in operation are examined. The last section addresses a number of issues raised with respect to state deposit insurance programs.

#### INSURANCE OF BANK OBLIGATIONS, 1829 - 1866

In 1829, New York became the first state to adopt an insurance program designed to minimize the economic disruptions caused by bank failures. During the next 30 years five additional states followed suit: Vermont, Indiana, Michigan,

Ohio and Iowa. Despite their individual differences, the purposes of the six plans were similar: to protect communities from disruptions of the money supply resulting from bank failures and to protect individual depositors and noteholders against losses.

In striving to meet these goals, the states employed one of three approaches. New York, Vermont and Michigan each established an insurance fund. Indiana, on the other hand, made no provision for an insurance fund; instead, all participating banks were required to mutually guarantee the liabilities of a failed bank. The insurance programs adopted by Ohio and Iowa, in turn, were hybrids of the two approaches described above. While participating banks were bound together by a mutual guaranty provision, an insurance fund was available to reimburse the former after creditors of a failed bank had been paid. Table A1 summarizes the principal provisions of the six programs which operated between 1829 and 1866.

### Coverage

In the first four programs adopted, insurance coverage primarily extended to circulating notes and deposits. In New York, coverage was later restricted to circulating notes. In the case of Ohio and Iowa, insurance coverage from the outset only extended to circulating notes. However, none of the six programs placed a dollar limit on the amount of insurance provided an individual bank creditor.

The extension of insurance coverage to banknotes in all of the six programs reflects the importance of banknotes as a circulating medium during the period under discussion. Because it was common practice for banks to raise funds by issuing banknotes, fully one-half of the circulating medium prior to 1860 consisted of banknotes. In those states which limited insurance coverage to banknotes, the belief was that banks affected the circulating medium only through the issuance of banknotes. Additionally, it was believed that depositors could select their banks, whereas noteholders had considerably less discretion and thus were in greater need of protection.<sup>1/</sup>

### Membership

The original intent to include all banks in the individual state insurance programs gradually was thwarted after the appearance of the "free banking" movement in the 1830s.<sup>2/</sup> The movement produced an alternative for insurance of banknotes which permitted a bank to post bonds and mortgages with state

1/ Annual Report of the Federal Deposit Insurance Corporation for 1952,  
p. 61.

2/ The "free banking" movement developed in response to the void created by the closing of the Second Bank of the United States in 1836. To fill this void, many states enacted free banking laws designed to both ease entry restrictions and protect the value of the currency system.

officials in an amount equal to its outstanding banknotes. Banks taking advantage of this alternative were excluded from insurance except in Michigan. As the number of "free banks" increased, participation in state insurance programs declined. Table G2 shows the maximum number of insured banks in each of the six states and the obligations insured at such times.

#### Methods Used to Protect Creditors of Banks in Financial Difficulty

Ad hoc measures frequently were taken in some of the six states to protect creditors of banks in financial difficulty. Faced with the possible insolvency of several banks in 1837, New York State's Comptroller began redeeming their notes from the insurance fund. This action prevented the banks from failing and they eventually were able to reimburse the insurance fund. In 1842, New York faced a more serious crisis after the failure of 11 participating banks within a three-year period threatened the solvency of the insurance fund. The legislature authorized the State Comptroller to sell bonds sufficient to meet all claims against the insurance fund. The bonds were later redeemed from subsequent payments into the fund by participating banks.

Other states similarly grappled with the question of whether to assist or close a distressed bank. On several occasions, authorities in Ohio kept a number of distressed banks from closing by levying special assessments upon healthy participating banks. Indiana and Iowa also granted financial assistance to distressed banks.

#### Method of Paying Creditors of Failed Banks

Only the programs of Ohio and Iowa provided for immediate payment of insured obligations. Necessary funds were made available in those two states through special assessments levied on the sound participating banks. Creditors in New York, Vermont and Michigan were not paid until the liquidation of a failed bank had been completed. Indiana's program provided that creditors were to be paid within one year after a bank failed from liquidation proceeds and stockholder contributions. If the funds from these two sources were insufficient to cover the insured obligations, the other insured banks made up the deficiency in return for the remaining assets of the failed bank.

#### Assessments and the Insurance Funds

Data on assessment rates and adequacy of the insurance funds states are shown in Table G3. Assessments were levied on capital stock or insured obligations.

The average ratios of the insurance funds to total and to insured obligations varied considerably from state to state. Michigan had the lowest average ratio on both counts. However, in those states with higher average ratios, most of the income earned from investment of the insurance funds was proportionally returned to the participating banks.

At the time of their closings, the insurance programs of Vermont and Michigan were deficient by \$22,000 and \$1.2 million, respectively. (Vermont's assessment rate was 1/5th of one percent per annum; the rate in Michigan was 1/10th



of one percent.) The modest balance remaining in New York's fund was turned over to the State Treasurer; in Ohio and Iowa fund balances were rebated to the participating banks.

### Bank Supervision

Bank supervision was an essential element of the insurance programs which operated prior to 1866. The function of supervision was essentially twofold: (1) to reduce the potential risk exposure of the various insurance programs; and (2) to provide some measure of assurance to well-managed banks that unsound banking practices of badly-managed banks would not go completely unchecked.<sup>3/</sup> Table G4 summarizes the principal provisions relating to bank supervision in the six insurance states.

Better supervision of banks was achieved by the programs with mutual guaranty than by the simple insurance fund programs.<sup>4/</sup> Under the former, supervisory officials were largely selected by, and accountable to, the participating banks. Consequently, the officials were given wide latitude by the participating banks to check unsound banking practices because the latter knew that the cost of lax supervision ultimately would be borne by them.

### Demise of the Insurance Programs

Michigan's insurance program was the first to fail. Although the official end of bank obligation insurance in Michigan occurred in late 1842, the state insurance fund was insolvent for all practical purposes as of year-end 1838. Michigan's difficulties largely stemmed from the fact that the first bank failures occurred before a sufficient fund had been accumulated. The fate of the remaining five programs was sealed in 1865 when Congress levied a prohibitive tax upon state banknotes. In order to escape the tax, many state banks converted to national charters. Before long, state banknotes were driven from circulation.

## STATE INSURANCE OF BANK DEPOSITS, 1908 - 1930

As long as national banknotes, which were fully guaranteed by the United States Treasury, retained their relative importance in the circulating medium, the need for bank obligation insurance lost its urgency. However, as bank deposits overtook and then eclipsed national banknotes in importance as a circulating medium, efforts were renewed to provide for deposit insurance. Various proposals to that effect were introduced both in Congress and in state

<sup>3/</sup> Carter H. Golembe and Clark Warburton, Insurance of Bank Obligations in Six States, (Washington, D.C.: Federal Deposit Insurance Corporation, 1958), pp. I-9 - I-10.

<sup>4/</sup> Annual Report of the Federal Deposit Insurance Corporation for 1953, p. 59.

legislatures. As was the case earlier, proponents stressed the need to protect the money supply against disruptions caused by bank failures.

Between 1907 and 1917, eight states adopted deposit insurance programs. Seven of the eight states were located west of the Mississippi in predominately agricultural areas. Table G5 summarizes the principal provisions of the eight programs.

#### Coverage

Insurance coverage in the eight states only extended to deposits. Although the insurance programs were commonly known as "deposit guaranty" programs, the guaranty was that of a fund derived from assessments on the participating banks. In no instance did the state guarantee the deposits.

None of the states, except Kansas for a brief period, placed an insurance limit on the size of account or amount of deposits owned by a depositor. However, some restrictions were applied to various classes of deposits. Whereas demand deposits generally were covered in all eight states, protection of time and savings deposits varied somewhat. In Texas, for example, the guaranty was limited to noninterest-bearing deposits. In Washington, the guaranty law did not apply to mutual savings bank deposits. In all cases, interest rate restrictions were applied to insured time and savings deposits. Deposits bearing interest which exceeded permissible limits were barred from guaranty.

#### Membership

In Kansas and Washington, membership in the insurance program was voluntary; in the remaining six states membership was compulsory. None of the eight insurance programs included national banks. Although the law in five states authorized their participation, a ruling by the Comptroller of the Currency in 1908 forbidding national banks to join state insurance programs rendered such provisions inoperative.

Table G6 shows the maximum number of banks participating in each of the insurance programs and the amount of deposits in insured banks at the time of such participation.

#### Methods of Paying Depositors of Failed Banks

In two states, Kansas and Mississippi, the depositors of a failed bank received interest-bearing certificates. Dividends on these certificates were paid from liquidation proceeds. Upon final liquidation of all assets, the balance due on the certificates was paid from the insurance fund. Mississippi law stipulated that if the insurance fund was insufficient to pay the depositors, they were to be paid pro rata, and the remainder paid from subsequent assessments.

In the remaining six states, the deposit insurance law provided for immediate cash reimbursement by the fund, either in full or to whatever extent was practicable. In most instances, provision was also made for the issuance of certificates of indebtedness in the event there was insufficient money in the fund.

#### Role of Bank Supervision

A majority of the eight states granted requisite officials sufficient authority and power to regulate banks under their jurisdiction.<sup>5/</sup> For the most part, banking officials could enforce capital requirements and issue cease-and-desist orders to bring about corrections of various infractions. In four of the states, supervisory authorities could order the removal from office of bank officials for just cause. With regard to frequency of bank examinations, semiannual examinations were the norm.

Despite the various powers granted to banking authorities, supervision often proved to be lax. Because of understaffing and insufficient funding, examiner workloads frequently were untenable. In Kansas, for example, each examiner was scheduled to perform 200 bank examinations annually. In other instances, banking authorities were thwarted when they tried to enforce laws on the books. Texas authorities, for example, rarely were able to secure convictions in local courts against dishonest bank officers. In a few cases state banking authorities were the root of the problem. Successive banking commissioners in Kansas watered down existing supervisory powers. Oklahoma provided the worst example in that the bank commissioner's office itself became corrupt after 1919.

#### Assessments

All of the insurance programs derived the bulk of their income from assessments. Both regular and special assessments were based on total deposits. The assessments collected ranged from an amount equivalent to an average annual rate of about 1/8th of one percent (Kansas) to about 2/3rd of one percent (Texas). Some states permitted participating banks to retain their insurance assessments in the form of deposits, subject to withdrawal by order of the administrative agency of the fund. Other states provided for the physical collection of assessments by the administrative agency of the insurance fund or the state treasurer.

#### Adequacy and Termination of Insurance Funds

The economic events of the 1920s showed that all but one of the state insurance funds were inadequate. The depression of 1921 and the severe

5/ An in-depth discussion of the role of bank supervision appears in Clark Warburton's study, Deposit Insurance in Eight States During the Period 1908-1930 (Washington, D.C.: Federal Deposit Insurance Corporation, 1959).

agricultural problems which persisted throughout much of the decade resulted in numerous bank failures. The resultant claims on the various insurance funds generally exceeded accumulated assessment receipts. The insured deposits in the eight states which were never paid from any source ranged from none in Texas to 70 percent in South Dakota.

The first fund to cease operations was that of Washington in 1921. Even the Texas fund became insolvent after most of the participating banks withdrew. By early 1930 all of the funds had ceased operations.

#### STATE-LEVEL DEPOSIT INSURANCE DEVELOPMENTS, 1930 TO THE PRESENT

The collapse of the state deposit insurance programs, coupled with related business and economic developments during the early 1930s, resulted in renewed efforts to provide for nationwide insurance of bank deposits. Those efforts culminated in the passage of the Banking Act of 1933 and the creation of the FDIC. Under the Act, membership in the FDIC was mandatory for national banks and optional for state-chartered banks and mutual savings banks. Because many state-chartered banks soon joined the FDIC, the need to establish comparable state programs was largely obviated. Since 1933, only one state-level program to insure solely commercial bank deposits has been established.<sup>6/</sup>

In contrast to the willingness of state-chartered commercial banks to join the FDIC, mutual savings banks generally were reluctant to do so. Many savings bankers felt that the rates to be charged for deposit insurance were too high, particularly in view of their industry's historically low failure rate.<sup>7/</sup> At the same time, however, they recognized that the lack of deposit insurance could prove to be a competitive liability. Consequently, while some savings banks joined the FDIC, others sought to establish state-level programs. The Massachusetts Deposit Insurance Fund, created in 1934, was followed by the creation of a similar program in New York.

Efforts to establish other such programs lost their impetus after FDIC insurance rates were reduced in 1937. By the early 1940s, many mutual savings banks had joined the FDIC. Those enrolled in New York's Savings Banks Mutual Fund voted to liquidate in 1943 and then joined the FDIC. Their decision was prompted by fears that the state fund would prove inadequate in the event of a real emergency.<sup>8/</sup> While Connecticut established a savings bank insurance

<sup>6/</sup>The Pennsylvania Deposit Insurance Corporation, which currently insures four state-chartered commercial banks, was incorporated in 1980. A few state-level programs, such as the Rhode Island Share & Deposit Indemnity Corporation, insure both commercial banks and other types of financial institutions.

<sup>7/</sup>Weldon Welfling, Mutual Savings Banks (Cleveland, Ohio: Case Western Reserve University Press, 1968), pp. 95-96.

<sup>8/</sup>Adolph A. Berle, Jr., The Bank that Banks Built (New York: Harper & Brothers, 1959), pp. 71-72.

fund in 1943, the same year the New York fund ended operations, the Connecticut fund went out of existence in 1960 and its members joined the FDIC. The Massachusetts program, which is discussed more fully later, constitutes the only existing state-level deposit insurance program for mutual savings banks.

Insurance for savings and loan associations ("S&Ls") began at both the Federal and state-levels in 1934. At the Federal level, the Federal Savings and Loan Insurance Corporation ("FSLIC") was created under the Federal Housing Act. At the state-level, the Massachusetts Cooperative Central Bank, a liquidity fund for its member savings and loan associations, was granted deposit insurance authority in 1934. Subsequently, separate programs were established in the following states: Ohio (1956), Maryland (1962), Mississippi (1962), North Carolina (1967), and Pennsylvania (1979).<sup>9/</sup> While a variety of factors prompted the creation of these later state programs, a principal motivating force was the desire to escape the burdens imposed by Federal regulations, particularly interest rate ceilings. This issue is addressed in the final section of this appendix.

Credit union interest in share insurance manifested itself in 1940 in the enactment of legislation authorizing creation of a share insurance fund in New York.<sup>10/</sup> However, the legislation was never implemented. Although a credit union guaranty corporation operated in Illinois between 1956 and 1962, a sustainable program did not come into being until the establishment of the Massachusetts Credit Union Share Insurance Corporation in 1961. From 1967 to the present, 17 additional share insurance programs for state-chartered credit unions have been organized.<sup>11/</sup>

Insurance of industrial banks at the state-level is a relatively recent development. The first such program was begun in California in 1971. Since then, insurance programs have been established in five other states, all of which are located west of the Mississippi.

Currently, there exist 30 state-level insurance programs for depositors. The largest number of these programs (18) exist for credit unions. In addition,

<sup>9/</sup>Mississippi's program went bankrupt in 1976 after the failure of one of its members precipitated runs on other state insured S&Ls. A discussion of the Mississippi program appears in Gary Leff and James W. Park's article, "The Mississippi Deposit Insurance Crisis," Bankers Magazine, Summer 1977, pp. 74-80.

<sup>10/</sup>Donald J. Schaefer, "A Brief Deposit Insurance History," 1982 State Share Insurance Yearbook (Atlanta, Georgia: International Share and Deposit Guaranty Association, 1982), pp. 10-11.

<sup>11/</sup>1970 marked the creation of a Federal share insurance program for credit unions. Membership in the National Credit Union Share Insurance Fund ("NCUSIF") is mandatory for Federal credit unions and optional for state-chartered credit unions.

six programs insure depositors of industrial banks, four insure savings and loan associations, one program insures cooperative banks, one insures mutual savings banks, and one program insures solely commercial bank deposits. (One of these insurers, in North Carolina, insures both S&Ls and credit unions.) The number of insurance funds has been growing at a fast pace in recent years, with the California, Nebraska, and Pennsylvania programs having been created during the past five years. In the last two years, Pennsylvania has initiated separate insurance programs for savings and loan associations and previously uninsured commercial banks.

Table G7 shows the principal characteristics of the insurance programs for institutions other than credit unions. Table G8 compares the share insurance programs for credit unions in the U.S., Puerto Rico and Canada, all of which are members of the International Share and Deposit Guaranty Association, an affiliate of the Credit Union National Association. The financial aspects of state-level insurance programs are discussed below.

#### FINANCIAL CHARACTERISTICS OF STATE PROGRAMS

##### Resources

Each plan has its own means of acquiring and maintaining its insurance fund. The primary source of funds is the periodic, chiefly annual, premium. The second is the initial membership deposit, which is occasionally adjusted by assessments to maintain a certain predetermined ratio of insurance funds to insured deposits. The third source of funds is the earnings of the insurer, which, if not rebated or distributed in some form to the member institutions, represents an implicit premium.

The most clearly evident relationship regarding assessment costs is that they vary inversely with the size of the insurance funds. The least expensive insurance programs are the three national ones (FDIC, FSLIC and NCUSIF) and the two large ones in Massachusetts. Conversely, the smaller the fund, the greater the insurance cost burden. For example, the Pennsylvania Deposit Insurance Corporation, which is the smallest fund, levies a relatively large annual premium equal to one-sixth of one percent of deposits.

Some funds require that relatively high membership deposit levels be kept in lieu of, or in addition to, annual premiums. For example, North Carolina requires 1.25 percent, while Ohio and the Pennsylvania Savings Association Insurance Corporation both require two percent. Most of the credit union insurers require one percent. The opportunity cost of these membership deposits can be burdensome since the insured institution earns no income on these funds. For instance, if a member institution is required to maintain a one percent membership deposit, the opportunity cost can exceed the annual premium if interest rates exceed eight percent.

##### Liquidity Provisions

In addition to evaluating the explicit resources of an insurance fund (its size and assessment potential), it is necessary to examine its ability to meet

calls on its resources without significant risk of market loss. Most of the funds are quite liquid, having investment portfolios with short maturities or arrangements for back-up lines of credit. These sources of liquidity for the state insurance funds are:

1. Short-Term Investments: Most of the state insurance funds are fairly liquid. For instance, Massachusetts' Mutual Savings Central Fund's Deposit Insurance Fund maintains a portfolio limited to U.S. Treasury securities and government-agency obligations, 38 percent of which matures within one year and 69 percent within two years. The Liquidity Fund of MSCF, which is used to meet the borrowing needs of its members, is 90 percent invested in securities maturing within two years. The Central Reserve Fund of the Maryland Savings-Share Insurance Corporation is highly liquid with about 70 percent of its investments, all of which are in Treasury securities and government-agency obligations, having maturities under one year. The Ohio Deposit Guarantee Fund maintains an investment portfolio with more than 75 percent of its assets in Treasury and agency securities with maturities under two years. The Cooperative Central Bank of Massachusetts has, excluding those securities it purchased to facilitate mergers, a portfolio of Treasury and Agency securities, 80 percent of which have maturities of less than two years. Similarly, the Industrial Bank Savings Guaranty Corporation of Colorado is almost entirely invested in assets with maturities of less than two years. The Pennsylvania Deposit Insurance Corporation has its entire investment portfolio invested in certificates of deposit issued by four large banks, 70 percent of which matures within six months.
2. Additional Funding Sources: Most insurers have guaranteed themselves a borrowing back-up in the event the liquidity provided by their short-term assets becomes strained. Typical is that of the Maryland Savings-Share Insurance Corporation, which has established a guaranteed line of credit of \$98 million with several large commercial banks to provide immediate liquidity. These lines of credit are costly to the insurers because of the related commitment fees and compensating balance requirements. However, the insurers regard these lines as the equivalent of an inexpensive reinsurance program.

While a guaranteed line of credit is not technically reinsurance, it is considered to be the equivalent by many state insurers. The credit line keeps the fund in business after unusually large assistance payments have been made. Of course, the funds advanced must be repaid, but these borrowings would generally be collateralized by assets acquired by the insurer from a member institution as part of an assistance program. These assets would eventually be liquidated and the line of credit paid off. Similarly, several insurance funds have used reinsurance as an alternative to having back-up lines of credit.

3. Reinsurance: Broadly defined, reinsurance is any program that shifts some or all of the risk from a particular insurer to another insuring entity. Some state insurance funds engage in reinsurance of various types. Some

of the state-level insurance funds have taken out private reinsurance policies. Five of the state-level credit union insurers have done so. (See Table G8). Coverage ranges from \$2 million to \$14 million. One of these, the North Carolina Savings Guaranty Corporation ("NCSGC") also insures S&Ls. NCSGC has reinsurance coverage of \$14 million, with an \$8 million deductible. Apparently the \$14 million is the largest anticipated individual loss to which NCSGC estimates it is exposed. In addition to the reinsurance policy, NCSGC maintains a \$50 million line of credit with two major commercial banks for liquidity purposes. It should be noted that NCSGC is slightly above average in membership expenses and premiums.

Massachusetts' Mutual Savings Central Fund, which insures the total deposits of its member mutual savings banks, receives reinsurance-type benefits from the FDIC to the extent that some of its savings banks are members of both programs. In such instances, the FDIC provides insurance on deposits up to \$100,000, and MSCF covers balances in accounts larger than \$100,000.

Based on discussions with Mr. Charles C. Hogg, II, Executive Vice President and Chief Operating Officer of the Maryland Savings-Share Insurance Corporation, it appears that some comparison shopping has been done and outright reinsurance seems to be much more expensive than the alternative of establishing large lines of credit. Consequently, reinsurance programs are not prevalent. Presently, the only company offering reinsurance of deposit insurance is the Insurance Company of North America ("INA").

#### Handling Failing Institutions

State-level insurers have a distinct mode of operation in resolving problem situations. Insofar as state-level insurers are closely tied to the state financial institution supervisor, the former have timely access to examination reports. Thus, timely resolution of problems is the usual outcome.

The goal of assistance is to eliminate by merger a nonviable institution as soon as possible so as to minimize the amount of required assistance and, more importantly, to completely eliminate the possibility of a payoff of depositors. Assistance usually consists of low interest loans to the resultant institution. Occasionally, funds will be granted outright or granted in exchange for a failing institution's low-yielding or heavily depreciated portfolio (see examples in Table A7).

#### ISSUES RELATED TO STATE DEPOSIT INSURANCE PROGRAMS

The preceding examination of past and present state-level deposit insurance programs raises two questions. First, what has been the role of state-level deposit insurance programs? Second, are the existing programs financially viable? In addressing these, it is important to bear in mind the purposes of deposit insurance: (1) to minimize the economic disruptions caused by failures of financial institutions; and (2) to protect depositors against losses.



### Function and Role of State-level Deposit Insurance Programs

Since the early 1930s, organizers of state-level programs have been motivated by philosophical considerations, economic incentives, and regulatory and supervisory policy considerations. The latter includes a desire to avoid Federal deposit interest rate ceilings (Regulation Q). The function and role of existing state-level deposit insurance programs can be assessed in the context of these motivations.

The desire to operate free from Federal control has been, and continues to be, a major force underlying the establishment and existence of state-level deposit insurance programs. In many cases, this reflects a deep-seated aversion to Federal intervention in private business decisionmaking and a concurrent strong belief in states' rights. In other cases, it represents a desire to preserve a dual Federal-state system of financial intermediation and regulation. In some instances, the preference for state-level insurance has been financially motivated.

Economic factors have played an equally important role with respect to the establishment of state-level programs over the past 50 years. For example, organizers of the deposit insurance program for mutual savings banks in Massachusetts desired to offer member institutions lower assessment rates than those charged by the FDIC in the mid-1930s. Subsequently, state-level deposit insurers have sought to offer a realistic alternative to Federal insurance, based on premium cost.

Cost considerations apart from premium pricing have also enabled state-level programs to attract members. For example, one small Maryland savings and loan association several years ago switched to MSSIC because it preferred to keep its accounts on a cash basis and could not afford to simultaneously satisfy Federal accrual accounting requirements. In other instances, institutions have joined state-level programs in order to avoid the burdens and costs imposed by Federal paperwork requirements.

The state-level programs also have offered an alternative to the Federal insurers with respect to various regulatory and supervisory practices. An institution that is state-chartered and not federally insured can avoid Federal supervision and regulation. This may be viewed as beneficial if state laws are less restrictive than Federal statutes and/or state supervision is more lax than at the Federal level. In addition, many state-level insurers perform a booster role by actively promoting the interests of member institutions.

Over the years, state-level deposit insurance programs have provided an important mechanism by which member institutions (except those located in Massachusetts) have been able to circumvent interest rate ceilings imposed by Federal authorities. Federal authority to regulate interest rates (Regulation Q) dates back to the Banking Act of 1933. Under the Interest Rate Adjustment Act of 1966, thrift institutions were brought under Regulation Q. The Act gave the FDIC power to regulate interest rates paid by federally insured

mutual savings banks; comparable power over federally insured savings and loan associations was given to the Federal Home Loan Bank Board ("FHLBB").<sup>12/</sup>

As interest rates subsequently rose above Regulation Q ceilings, institutions desired to circumvent those ceilings in order to gain an edge over their competitors. By obtaining state insurance (except in Massachusetts), institutions could avoid Regulation Q ceilings altogether.

The strong motivation to escape the strictures of Regulation Q has contributed to the past growth of many of the state-level deposit insurance programs. However, as a result of the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, the interest rate advantage afforded by membership in state-level deposit insurance programs is rapidly disappearing. After interest rates are fully deregulated by 1986, this advantage will disappear altogether. Although the complete deregulation of interest rates may not cause member institutions to leave the state programs, it could perceptibly slow membership growth in those programs.

#### Viability of State-level Deposit Insurance Programs

In assessing the viability of state-level deposit insurance programs, historical perspective proves useful. An examination of the various defunct state programs suggests that the ability of such programs to succeed, all other factors being equal, depends on several key factors: the quality of the supervision over the insured institutions; the adequacy of the insurance fund; the liquidity of the fund's resources and its access to other funding sources; and the diversification of the insurer's risks. With respect to the first factor, the research undertaken by Clark Warburton amply documented the role played by bank supervision in the success or failure of the various insurance programs which existed prior to the adoption of Federal deposit insurance. The success enjoyed by the program in Indiana during the 1800s, for example, was due in large part to the high quality of bank supervision that existed in that state.

The ability of a fund to accumulate sufficient reserves before it is required to offer assistance is a second critical factor influencing its financial viability. This has been true historically and remains true today. Of the six insurance programs established between 1829 and 1858, both Vermont and Michigan encountered problems before they were adequately capitalized. Although Vermont's fund subsequently recovered, Michigan's collapsed under the strain. In the latter instance, all but one of the participating banks in the program failed soon after the fund was established. More recently, Mississippi's insurance program collapsed when its fund proved insufficient to handle the failure of Bankers Trust Savings and Loan Association of Jackson and subsequent runs on other member S&Ls.

<sup>12/</sup> The Act also applied to state insured thrift institutions in Massachusetts.

Lessons learned from the past and the present suggest that the programs to insure thrifts in Massachusetts, Maryland, and Ohio, and the industrial bank fund in Colorado are financially viable, based on their capitalization levels, although it is not clear that any of them could have survived the turmoil of the 1980-82 "thrift crisis" had the Federal deposit insurance funds not been available to maintain basic stability in the financial system. The Massachusetts Cooperative Central Fund has the highest ratio of insurance funds to deposits (3.52 percent), followed by MSSIC (3.42 percent), the Ohio Deposit Guaranty Fund (2.72 percent), the Massachusetts Mutual Savings Central Fund (2.56 percent), and the Industrial Bank Savings Guaranty Corporation (2.28 percent). These funds are relatively long-lived, thus having had sufficient time to accumulate reserves.

In contrast, recently established programs, particularly those that insure a limited number of institutions, would be hard pressed to handle potential problems in the near term. For example, the Utah Industrial Loan Guaranty Corporation and Pennsylvania Deposit Insurance Corporation have insurance funds to insured deposits ratios of 0.27 and 0.32 percent, respectively. Ratios this low, in the absence of other significant sources of funds, warrant concern.

Past history demonstrates the importance of liquidity as a factor affecting an insurance fund's viability. Several of the early state-level commercial bank deposit programs encountered problems because they lacked liquidity. New York's fund was provided with borrowing power about 15 years subsequent to its establishment, after insurance operations had temporarily broken down during the 1840s. The collapse of Mississippi's program provides a more recent example of what can occur when a fund is insufficient and access to liquidity sources is nonexistent or inadequate.

Currently, most funds have secured guaranteed lines of credit as a source of liquidity. The most secure borrowing power is that of the Federal insurers, FDIC, FSLIC, and NCUSIF, all of which can borrow from the U.S. Treasury. The Thrift Guaranty Corporation may borrow from the State of Hawaii. All other funds are constrained to borrowing from nongovernmental sources. Most have secured guaranteed lines of credit from commercial banks. Typically, the more established funds have the most significant borrowing lines. The Maryland Savings-Share Insurance Corporation has a \$98 million line of credit, the North Carolina Savings Guaranty Corporation has a line for \$50 million, and the Massachusetts Cooperative Central Fund has a line for \$53 million.

Reinsurance agreements constitute another source of liquidity. The Federal funds are implicitly reinsured by the full faith and credit of the U.S. government. Only one insurer has a policy from a private carrier: the North Carolina Savings Guaranty Corporation has a reinsurance policy with INA. The other four credit union insurance funds, which are reinsured by Aetna, will soon lose their reinsurance, if they have not already done so, since Aetna has left the deposit insurance field. However, the International Share and Deposit Guaranty Association is attempting to develop its own reinsurance affiliate.

An overall assessment of the viability of the current state-level programs suggests that some of the funds could encounter financial difficulties because of undercapitalization and/or inadequate lines of credit.

A final factor influencing the success of state-level programs is the diversity of the institutions in the insured population. Diversification of risk is the basic means by which an insurer seeks to limit potential exposures to its insurance fund. State-level programs may lack this diversification in any one of three respects.

A state insurance fund covers only institutions located within a relatively small geographic area. The economy of a state would be more likely to experience adverse conditions such as high unemployment over an extended period of time than would the economy of the nation as a whole. Loan credit quality throughout a single state or a major part of one could deteriorate, leaving a state-level insurance program with more distressed institutions than it could effectively deal with at one time.

Certain depository institutions suffer from limitations on their product lines which may restrict the types of loans or investments they are permitted to make. Their asset portfolios would tend to be less diversified and they would be less able to restructure their assets in response to a changing economic environment than institutions that do not operate under such restrictions. A program that insures institutions with narrow investment powers could find a large number in need of assistance simultaneously.

Finally, while the Federal deposit insurance programs insure thousands of banks, S&Ls, and credit unions, the membership bases of the state-level programs run from four banks in Pennsylvania to 601 credit unions in Wisconsin (see tables G7 and G8). The smaller the number of institutions a fund insures, the greater the impact on future assessment income and the fund's resources the withdrawal from membership of or failure of a single member institution will have.

#### Federal Government's Stance toward State-level Deposit Insurance Programs

In the past, the Federal government has not provided any assistance to state-level deposit insurance programs. When Mississippi's insurance fund was close to collapse and the state could not legally guarantee depositors' funds, the Governor attempted to obtain Federal guarantees similar to aid for natural disasters.<sup>13/</sup> After such guarantees could not be secured, the governor declared a banking holiday for all state-chartered S&Ls and called the legislature into extraordinary session to remedy the crisis. The legislature subsequently provided for a court appointed conservator to help associations to reopen and required the latter to obtain FSLIC insurance or its equivalent by a certain date.

<sup>13/</sup> Leff and Park, op. cit., p. 74.

Some observers have asserted that the Federal Reserve Board's ("FRB") actions in arranging a merger in 1982 involving the financially-troubled Scioto Savings Association, a state-insured S&L, were necessary to prop up the Ohio Deposit Guarantee Fund. Strong evidence exists, however, that the Ohio Fund had the necessary resources to liquidate Scioto had no merger partner been found. Consequently, the FRB's action in that instance did not constitute assistance to a state-level fund by the Federal Government.

While the Federal government has not assisted a state-level program in the past, there is no assurance that such assistance will not be requested in the future. As noted previously, several of the programs at the present time are financially vulnerable. Because of the possibility that serious problems encountered by a state fund could spill over and cause a loss of confidence in Federally-insured institutions in the state, it is appropriate to consider what forms of assistance could be offered by the Federal government under existing statutes.

As the lender of last resort, the Federal Reserve could open its discount window to a financially-troubled, state-insured institution or, conceivably, lend to a state fund directly. Some state fund officials already have discussed the feasibility of the second option informally with Federal Reserve officials.

Under Title II of the Garn-St Germain Depository Institutions Act of 1982, qualified state-insured institutions may request assistance from the Federal insurers (FDIC and FSLIC). To qualify for assistance an institution must meet certain criteria: (1) have net worth equal to or less than three percent of its assets; (2) have incurred losses during each of the two previous quarters; (3) have not incurred such losses because of mismanagement; (4) have net worth of not less than one half of one percent after the granting of assistance; (5) have investments in residential mortgages and mortgage-backed securities equal to at least 20 percent of its loan portfolio (including mortgage-backed securities); and (6) agree to the conditions set forth by the respective Federal insurer.

In exchange for granting assistance, the Federal insurers must require the relevant state fund which insures the institution receiving aid to meet two conditions. First, the state fund must agree to indemnify the Federal insurer for any losses which the latter may incur as a result of providing assistance. Second, during the period that assistance has been extended, the relevant state fund must maintain member institution assessments at a rate equivalent to that charged by the Federal insurer.

The FDIC does not believe a proliferation of small, undiversified insurance funds comports with sound public policy. Accordingly, the FDIC is strongly opposed to any form of Federal assistance to a troubled state fund, particularly assistance from the Federal Reserve or the Federal deposit insurance funds, which are supported by reserves and assessments from Federally-insured institutions. Thus, the most appropriate remedy for

handling a troubled state insurance fund would be to disband the fund and bring its member institutions under the umbrella of one of the Federal insurance programs, should they desire.

## TABLES

## Principal Provisions of Bank-Obligation Insurance Programs in Operation 1829 - 1866

State	Period of operation	Obligations insured	Banks participating	Assessments; size of fund	Payment of bank creditors
New York	1829-1866	1829-42, all debts <sup>2</sup> 1842-66, circulating notes <sup>3</sup>	All banks established or rechartered subsequent to passage of act <sup>4</sup>	Annually ¼ of 1% of capital stock to maximum of 3%. If fund reduced, annual assessment not to exceed above rate until fund restored to maximum	After completion of liquidation of failed bank
Vermont	1831-1866	All debts <sup>2</sup>	All banks established or rechartered subsequent to passage of act <sup>5</sup>	Annually ¾ of 1% of capital stock to maximum of 4-1/2%. If fund reduced, annual assessments not to exceed above rate until fund restored to maximum	After completion of liquidation of failed bank
Indiana	1834-1866	All debts <sup>2</sup>	Branch Banks <sup>6</sup>	No specific amount; special assessments as necessary	Within one year after failure, if liquidation proceeds and stockholder contributions insufficient
Michigan	1836-1842	All debts <sup>2</sup>	All banks established or rechartered subsequent to passage of act	Annually ¼ of 1% of capital stock to maximum of 3%. If fund reduced annual assessments not to exceed maximum	After completion of liquidation of failed bank
Ohio	1845-1866	Circulating notes	Branch Banks	Single assessment prior to opening of bank: 10% of amount of circulating notes. Thereafter assessments at above rate applicable only to additional circulating notes, if any, issued by bank	Immediately, through special assessments on solvent Branch Banks. Assessments to be repaid from insurance fund, and fund repaid from proceeds of liquidation of assets of failed bank.
Iowa	1858-1865	Circulating notes	Branch Banks	Single assessment prior to opening of bank: 12-½% of amount of circulating notes. Thereafter assessments at above rate applicable only to additional circulating notes, if any, issued by bank	Immediately, through special assessments on solvent Branch Banks. Assessments to be repaid from insurance fund and fund repaid from proceeds of liquidation of assets of failed bank

<sup>1</sup> In a number of cases the law was repealed subsequent to the terminal date shown above. In some of the first six States closing dates may have preceded date shown by one year.

<sup>2</sup> Included circulating notes, deposits, and miscellaneous liabilities; excluded capital accounts.

<sup>3</sup> Act of April 17, 1842.

<sup>4</sup> Free Banks, which were authorized in 1838, did not participate in insurance.

<sup>5</sup> Free banks, which were authorized 1851, did not participate in insurance. In 1842 participating banks were authorized under specified conditions to withdrawal from insurance.

<sup>6</sup> Branch Banks were essentially independent banks which possessed their own officers, distributed earnings to their own stockholders, and which collectively constituted the "State Bank" in these States.



Table G2

Maximum Number of Banks Participating in  
Insurance Systems, Six States, 1829-1866

State	Year or years during which number of participating banks was at a maximum	Participating banks		Obligations insured at or near time of maximum participation 1/	
		Number	Percent of all banks <sup>2/</sup>	Amount (in thousands)	Percent of all such obligations
New York ....	1840	91	57.2%	\$32,346	72.8%
Vermont .....	1841-48	13	72.2 <sup>3</sup>	1,936 <sup>3</sup>	69.9
Indiana .....	1857-64	20 <sup>4</sup>	52.6 <sup>5</sup>	7,816 <sup>5</sup>	78.2
Michigan ....	1837	47 <sup>6</sup>	83.9	1,403 <sup>7</sup>	59.0
Ohio .....	1850	41	71.9	8,407	76.0
Iowa .....	1864	15	100.0	1,440	100.0

<sup>1</sup>New York, Vermont, Michigan and Indiana, circulating notes plus deposits: Ohio and Iowa, circulating notes only. See note 7 for explanation of Michigan data.

<sup>2</sup>Excludes private banks.

<sup>3</sup>Data as of August 1847.

<sup>4</sup>Branch Banks of Bank of State of Indiana. Branch Banks of State Bank of Indiana, 1834-1856, numbered 13 at maximum, all of which were insured.

<sup>5</sup>Data for November 15, 1862. Deposits include individual and interbank deposits plus certificates of deposit.

<sup>6</sup>Estimated number in operation near end of year.

<sup>7</sup>Circulating notes only (estimated). Deposit information not sufficiently complete for estimation.

Source: Annual Report of the Federal Deposit Insurance Corporation for 1952.

Table G3

Insurance Funds and Assessments, States with Bank-Obligation  
Insurance Systems, 1829-1866<sup>1</sup>  
(Amounts in thousands)

	New York (1829-1866)	Vermont (1831-1866)	Michigan (1836-1842)	Ohio (1845-1866)	Iowa (1858-1865)
Insurance funds:					
Average Size .....	\$192	\$19	\$0.3	\$759	\$196
As percent of -					
Average total obligations .....	0.6%	2.0%	.09%	7.7%	8.4%
Average insured obligations .....	1.0	2.0	.09	11.5	21.4
Balance or deficiency at close of system ....	\$13	-\$22	-\$1,198	\$815 <sup>2</sup>	\$338 <sup>2</sup>
Assessments and fund income:					
Assessments and income available for insurance operations:	\$3,221	\$63	\$3	\$1,567	\$338
Assessments paid <sup>3</sup> ..	3,120	63	3	1,567	338
Interest received <sup>4</sup> .	101				
Used for insurance operations .....	3,208	44		722 <sup>5</sup>	
Refunded to banks or State <sup>6</sup> .....	13	19		845	338
Assessments necessary to cover insurance costs .....	\$3,208	\$66	\$1,198	722 <sup>5</sup>	
Equivalent average annual rate of assessments on total obligations:					
Paid	0.24%	0.2%	0.1%	0.8%	1.8%

<sup>1</sup>In Indiana the insurance system was one of mutual guaranty with no fund.

<sup>2</sup>Amount in fund in last year of full operation of insurance system.

<sup>3</sup>Assessments paid and used for insurance operations other than administrative expenses except in Michigan, where amount paid was completely absorbed by such expenses.

<sup>4</sup>In excess of amounts used to pay administrative expses and amounts paid to banks. In Vermont, Ohio, and Iowa such expenses absorbed the whole of investment income.

<sup>5</sup>Total of special assessments used to redeem notes of failed banks or aid operating banks plus estimated amounts secured from assets in insurance funds of failed banks. Recoveries from other assets of such banks by insurance system are not known.

<sup>6</sup>In New York paid into State treasury; in Vermont refunded to six banks withdrawing prior to close of system; in Ohio refunded to one bank withdrawing prior to close of system and to all banks at close of system; in Iowa refunded to all banks at close of system.

Table C-4

## Principle Provisions Relating to Supervision of Banks Participating in Bank-Obligation Insurance Systems, Six States, 1829-1866

State: Period of bank-obligation insurance	Supervisory agency	Bank examination	Condition reports	Enforcement powers of supervisory officials
New York 1829-1866	1829-37. Three Bank Commissioners; one appointed by Governor; two by banks. 1837-43. Three Bank Commissioners appointed by Governor. 1843-51. State Comptroller. 1851-66. Banking Department; superintendent appointed by Governor.	1829-43. Each bank three times per year; additional examinations if requested by three participating banks. 1843-66. Examination only when bank was believed to be insolvent or to have submitted false condition report.	1829-43. Annually to Bank Commissioners. 1843-66. Quarterly to Comptroller; Superintendent of Banking Department. Content expanded.	If bank insolvent or had violated law could apply to court of chancery for injunction against continued operation.
Vermont 1831-1858	1831-37. Three Bank Commissioners; one appointed by legislature; two by banks. 1837-58. One Bank Commissioner appointed by legislature. 1834-55. Board of Directors of the State Bank of Indiana; President and four directors appointed by legislature; one director by each Branch Bank.	Each bank once per year; additional examinations if requested by a stockholder or bank debtor.	Annually to Bank Commissioners.	If bank insolvent or had violated law could apply to court of chancery for injunction against continued operation.
Indiana 1834-1865	1856-65. Board of Directors of the Bank of the State of Indiana; four directors appointed by legislature; one director by each Branch Bank; president by Board.	Each bank twice per year; additional examinations if requested by directors of a bank.	Monthly to Board.	If bank insolvent, had violated law, or was mismanaging its affairs could close bank. Could regulate dividend payments. <sup>1</sup>
Michigan 1836-1842	1836-37. One Bank Commissioner appointed by Governor. 1837-40. Three Bank Commissioners appointed by Governor. 1840-42. Attorney General.	1836-40. Each bank three examinations if requested by three participating banks. 1840-42. Whenever requested by Governor.	Annually to Bank Commissioners; Attorney General.	Could establish ratio of loans and discounts to capital for any or all banks between limits 1.25 to 1.00 - 2.50 to 1.00. Loan of deposited funds exempted.
Ohio 1843-1866	Board of Control of the State Bank of Ohio; one member appointed by each Branch Bank; president by Board from outside its membership.	Left to discretion of Board; policy was to examine each bank once per year.	Quarterly to Board, policy to require monthly reports to Board.	If bank insolvent, had violated law, or any order of Board, could close bank. Could order any bank to reduce its circulation or liabilities to whatever level was deemed safe. Could determine proportion of reserve to be in vault cash. <sup>1</sup>
Iowa 1858-1866	Board of Directors of the State Bank of Iowa; three directors appointed by legislature; one director by each Branch Bank; president by Board.	Left to discretion of Board; policy was to examine each bank twice per year.	Monthly to Board.	If bank insolvent, had violated law, or any order of Board, could close bank. Could regulate dividend payments. Could order any bank to reduce its circulation or liabilities to whatever level was deemed safe.

<sup>1</sup>Not stipulated in law but assumed by agency.

Table G-5

## Principal Provisions of Deposit Insurance Programs Adopted by Eight States, 1907-1917

State	Deposits insured	Banks participating <sup>1</sup>	Assessment on insured depositories <sup>2</sup>	Payment of depositories
Oklahoma Act of 1908 <sup>3</sup> as amended or modified 1909, 1911, 1913	All deposits not otherwise secured and on which rate of interest was within limits specified by law	Compulsory for all State banks and trust companies	Annually 1/3 of IX until fund equalled IX of base. If fund reduced, special assessments at same rate annually <sup>4</sup>	In cash by Bank Commission immediately upon taking possession of bank taking fund insufficient. In 6 percent certificate of indebtedness to be paid in order of issue. After 1913 certificates sold at not less than par for purpose of securing cash for depositories
Kansas Act of 1909 as amended or modified 1911, 1921, 1923	All deposits not otherwise secured and on which rate of interest was within limits specified by law	Voluntary for all incorporated State banks. Trust companies and private banks excluded. Banks organized after passage of Act eligible to apply after operating one year	Annually 1/20 of IX of base less capital and surplus until fund equalled \$1 million. If fund reduced below \$500,000 special assessment for amount necessary	In interest-bearing certificates of indebtedness, reduced as proceeds of liquidation become available. Deficiency, if any, paid from fund
Nebraska Act of 1909 as amended or modified 1911	All deposits except money deposited on a collateral agreement or condition other than an agreement for length of time to maturity and rate of interest	Compulsory for all incorporated State banks	Semi-annually 1/20 of IX until fund equalled 1-1/2% of base. If fund reduced below IX assessment renewed and special assessments if necessary not to exceed IX of base in any one year	In cash from fund immediately after determination by the court of amount due depositories less cash immediately available to the receiver for such payments
Texas Act of 1909 as amended or modified 1921, 1923	Non-interest-bearing deposits not otherwise secured. Excluded public deposits, secured deposits, certificates of deposit, deposits made for the purpose of converting a loan into a deposit covered by the fund, certificates of deposit converted to non-interest-bearing deposits within 90 days of failure	All State chartered banks required to choose between guaranty fund system or bond security system	Annually 1/4 of IX of base until fund equalled \$5 million. If fund reduced below \$2 million, or below level of preceding January 1, special assessments not to exceed 2%	In cash immediately, out of cash in failed banks and fund
Mississippi Act of 1914	All deposits not otherwise secured nor bearing interest exceeding 6% per annum	Voluntary until May 15, 1915. Thereafter compulsory for all banks operating under State law including trust companies and savings banks	Annually 1/20 of IX of "average guaranteed deposit, less capital and surplus until fund approximated \$500,000 over and above initial contribution. If fund deposits, deposits not assessed at same rate not to exceed five in any one year	In interest bearing certificates of indebtedness, reduced as proceeds of liquidation become available. Deficiency, if any, paid from fund
South Dakota Act of 1915 as amended or modified 1921	All deposits not otherwise secured. Deposits could not pay interest in excess of 3% unless authorized by depository guaranty fund commission and in no case, more than 5-1/4% per annum	Compulsory for all State and private banks	Annually 1/4 of IX until fund equalled 1-1/2% of base. Re-assessed whenever fund reduced to IX of base	In cash immediately from fund. If fund deficient, Commissioner to issue certificates of indebtedness at 2% and not to exceed 1% if depositories secure cash for depositories
North Dakota Act of 1917 as amended or modified 1923	All deposits not otherwise secured and on which interest was within limits specified by law	Compulsory for every corporation in business of receiving deposits or buying and selling exchange except national banks	Annually 1/20 of IX until fund equalled IX of base. If fund reduced to 1-1/2% of base, assessments resumed. Special assessments at same rate at option of Bank Commissioners, not to exceed four per year	In cash from fund after certification of net amounts due depositories. If fund deficient, in certificates of indebtedness
Washington Act of 1917 as amended or modified 1921	Deposits subject to check or other forms of withdrawal and not otherwise secured. Payment of interest at rates higher than authorized by guaranty fund board subtracted from loss of insurance	Voluntary for all State banks including trust companies but excluding mutual savings banks	Annually 1/10 of IX until fund equalled IX of base. If fund reduced, special assessments not to exceed 1/2 of IX in any one year	In warrants on fund issued on proof of claim; if fund deficient warrants to bear 3% interest until paid

<sup>1</sup>National banks were prohibited from participating in State insurance plans by ruling in July 1908 of Attorney General of the United States.  
<sup>2</sup>In terms of percentage of average daily insured deposits for preceding calendar year, unless otherwise noted. Exclude initial payments or contributions where applicable.  
<sup>3</sup>The existing laws of Oklahoma were codified, revised and re-enacted May 25, 1908, with little change in guaranty law.  
<sup>4</sup>Special assessments in addition to regular annual assessment authorized 1914-1916.

Source: Annual Report of the Federal Deposit Insurance Corporation for 1932.

Table G6

Maximum Number of Banks Participating in  
Deposit Insurance, Eight States, 1908-1930

State	Year or years during which number of participating banks was at a maximum	Participating banks		Deposits of participating banks at or near time of maximum participation 1/	
		Number	Percent of all banks <sup>2/</sup>	Amount (in thousands)	Percent of all deposits in all banks
Oklahoma .....	1911	695	75.2%	\$ 61,509	50.7%
Kansas .....	1922	714	52.0	185,989	43.3
Nebraska .....	1921	1,011	84.3	272,256	57.8
Texas .....	1921	1,014	58.1	319,346	32.6
Mississippi ..	1921	309	90.9	144,528	77.8
South Dakota .	1921	566	80.6	174,231	67.0
North Dakota .	1920	720	80.6	151,531	66.4
Washington ...	1921	116	29.1	74,859	19.5

<sup>1</sup>For dates nearest beginning of indicated years.

<sup>2</sup>All banks include national, State, and private banks, regardless of eligibility for insurance under the various laws. Excludes trust companies not regularly engaged in deposit banking except for Oklahoma. Dates of data for various categories of uninsured banks used in computing percentages are not identical in some instances with dates of insured bank data.

Source: Annual Report of the Federal Deposit Insurance Corporation for 1952.

Table G7

## Comparison of Deposit Insurance Programs\*

	FDIC	FSLIC
Type of Covered Institution:	Commercial Banks, Mutual Savings Banks	Savings and Loan Associations
Incorporated:	1933	1934
Membership Deposit:	None	None
Annual Premium:	1/12% of deposits, with rebate credit, based upon FDIC net earnings	1/12% of deposits, with rebates which assure a reserve to total insured deposits ratio of at least 1.25%. No rebate credit.
Maximum Coverage:	\$100,000 per depositor per bank	\$100,000 per depositor per S&L
Number of Insured Institutions:	14,487 Commercial Banks 315 Mutual Savings Banks as of 12/31/82	3,311 as of 1/31/83
Aggregate Amount of Deposits Insured:	\$1,104,019 million est. as of 12/31/82	\$571,017 million as of 1/31/83
Total Assets- poration:	\$13.8 billion in deposit insurance as of 12/31/82	\$6.40 billion (insurance fund) as of 12/31/82
Reinsurance:	Treasury lines of credit, plus March 1982 Congressional resolution concerning backing of insurance funds by full faith and credit of US Government	Treasury lines of credit, plus March 1982 Congressional resolution concerning backing of insurance funds by full faith and credit of US Government
Gross Claims Paid in 1982 or Most Recent Year:	1982 - \$750 million spent in year to facilitate merger or closure of 42 institutions	1982 - assisted 47 mergers, for a present value expense of \$1.1 billion
Supervised By:	Independent agency within US Executive Branch	FHLBB
Ratio: Insurance Fund/Deposits:	1.25% - Insured deposits as of 12/31/82	1.12% - Insured deposits as of 12/31/82

\*1982 data unless otherwise indicated.

Table G7

Comparison of Deposit Insurance Programs\*  
(continued)

	Industrial Bank Savings Guaranty Corporation of Colorado	Maryland Savings Share Insurance Corporation
Type of Covered Institution:	Industrial Banks (Coverage Mandatory for all institutions)	Savings and Loan Associations
Incorporated:	1973	1962
Membership Deposit:	None	Assessed individually on new members, and are refundable upon termination of membership. Individual institutions may be required to increase their deposit.
Annual Premium:	If fund falls below the greater of \$3 million or 3% of total membership deposits, assessment will be 1/4% of savings deposits	
Maximum Coverage:	\$100,000 per depositor entity	\$100,000 "for each separate account"
Number of Insured Institutions:	155	105
Aggregate Amount of Deposits Insured:	\$320.58 million 6/30/82	\$2.455 billion
Total Assets-Corporation:	\$7.3 million 6/30/82	\$83.851 million
Reinsurance:	None	None as such. However Corporation has available a guaranteed line of credit of \$98 million with large commercial banks to provide immediate liquidity
Gross Claims Paid in 1981 or Most Recent Year:	In fiscal year ended 6/30/82, one bank was placed in liquidation by Colorado Bank Commissioner. IBSGC advanced \$1,249,000 to cover guaranteed deposit liabilities. Maximum corporate liabilities estimated at \$3 million, with 60% expected recovery	1980 - Paid \$350,000 to facilitate a merger of two members 1981 - paid a final payment of \$2,537,000 to further facilitate same merger.
Supervised By:	Bank Commissioner of State of Colorado	Division of Savings and Loan Associations
Ratio: Insurance Fund/Deposits:	2.28% 6/30/82	3.42% 12/31/81

TABLE G7

Comparison of Deposit Insurance Programs\*  
(continued)

	Mutual Savings Central Fund Inc. Liquidity and Deposit Insurance Fund	Cooperative Central Fund
Type of Covered Institution:	Savings Banks in Massachusetts (Membership Mandatory)	Savings and Loan Associations (called Cooperative Banks in Massachusetts) (Membership Mandatory)
Incorporated:	1932	1932
Membership Deposit:	<u>Liquidity Fund:</u> May require special assessments as necessary. Last one was in 1957 for 1/20% of member deposits. Power for assessment was eliminated by statute in 1981	<u>Reserve Fund:</u> Similar to Mutual Savings Central Fund
Annual Premium:	<u>Insurance Fund Only:</u> Basic rate of 1/16% of insured deposits. Rate may be charged for any particular year upon approval of Commissioner of Banks	<u>Share Insurance Fund:</u> Similar to Mutual Savings Central Fund
Maximum Coverage:	All deposits	All deposits
Number of Insured Institutions:	159	111
Aggregate Amount of Deposits Insured:	\$11.393 billion	\$4.302 billion
Total Assets-Corporation:	\$11.39 million - Liquidity Fund \$291.18 million - Deposit insurance fund	\$151.58 million: \$47.91 million in reserve fund \$103.67 million in share insurance fund
Reinsurance:	For FDIC members-first "\$100,000 for each depositor" insured by FDIC	None as such -- however, CCF has reserved \$53 million in lines of credit from commercial banks, for liquidity purposes
Gross Claims Paid in 1982 or Most Recent Year:	Last closing was in 1972, which resulted in the DIF acquiring approximate book value of \$24 million in assets. Liquidation continuing	In 1982: (1) Performed assisted merger; granted a \$450,000 distribution to facilitate it. (2) Advanced \$1,250,000 as interest-free loan to facilitate merger of two members. (3) Two transactions involving one acquiring member bank and four consolidating members. Interest free loans could total \$4.4 million by 1988.
Supervised By:	Independent State Chartered Corporation. Some functions performed together with Massachusetts Commissioner of Banks	Independent Corporation. Some function performed together with Commissioner of Banks.
Ratio: Insurance Fund/Deposits:	2.556% 12/31/81	3.52% 8/31/82



TABLE G7

Comparison of Deposit Insurance Programs\*  
(continued)

	North Carolina Savings Guaranty Corporation	Ohio Deposit Guarantee Fund
Type of Covered Institution:	Savings and Loan Associations and Credit Unions	Building and Loan Companies (Savings and Loan Associations)
Incorporated:	1967	1956
Membership Deposit:	1/12% of total savings deposits. However, fee assessed is effectively \$1500-2500. Board usually varies the 1/12 fee	Deposit is maintained at 2% of savings balances
Annual Premium:	Each member bank must maintain a deposit of 1.25% of savings deposits - annual assessments made to maintain this level	Membership deposit above is adjusted semi-annually by assessment to maintain membership deposit above
Maximum Coverage:	Up to \$100,000 each separate account. (Up to \$250,000 each separate IRA account)	All deposits
Number of Insured Institutions:	S&Ls - 45 Credit Unions - 24	80
Aggregate Amount of Deposits Insured:	\$2.067 billion	\$2.505 billion
Total Assets-Corporations:	\$27.17 million	\$68.055 million
Reinsurance:	Coverage of \$14 million, with \$8 million deductible. Also a \$50 million line of credit with 2 major commercial banks is kept for liquidity	None
Gross Claims Paid in 1982 or Most Recent Year:	None	Merger of two members in default negotiated in 1982. Fund took back notes in approximate amount of \$9.3 million at rates ranging from 9-12%, to facilitate merger.
Supervised By:	Department of Commerce, S&L Division	Ohio Building and Loan Commissioner
Ratio: Insurance Fund/Deposits:	1.31% as of 12/31/81	2.72% as of 6/30/82

TABLE G7

Comparison of Deposit Insurance Programs\*  
(continued)

	Pennsylvania Savings Association Insurance Corporation	Pennsylvania Deposit Insurance Corporation
Type of Covered Institution:	Savings and Loan Associations	Commercial Banks otherwise uninsured
Incorporated:	1979	1980
Membership Deposit:	2% of savings accounts	
Annual Premium:		1/6% of average deposits, semi-annually
Maximum Coverage:	\$100,000 each separate account	\$100,000 each separate account
Number of Insured Institutions:	82	4
Aggregate Amount of Deposits Insured:	\$97.541 million	\$95.0 million
Total Assets- Corporations:	\$2.354 million	\$306.8 thousand
Reinsurance:	None	None
Gr. Claims Paid in 1982 or Most Recent Year:	None	None
Supervised By:	Pennsylvania Commissioner of Banking	Pennsylvania Commissioner of Banking
Ratio: Insurance Fund/Deposits:	2.41% as of 10/31/82	0.32% as of 12/31/82

TABLE G7

Comparison of Deposit Insurance Programs\*  
(continued)

	California Thrift Guaranty Corporation	Thrift Guaranty Corporation of Hawaii
Type of Covered Institution:	Licensed industrial loan companies which issue thrift obligations. Membership is compulsory.	Industrial loan companies that issue thrift accounts.
Incorporated:	1971	1977
Membership Deposit:	Initial fee equal to 1.5% of outstanding deposits.	Initiation fee of \$15,000 may be applied as a credit to any assessment.
Annual Premium:	0.15%	Annual premium equal to 0.50% until the fund equals or exceeds 2% of the total thrift account obligations of all members of the Guaranty Corporation.
Maximum Coverage:	\$50,000 per account	\$10,000 per account
Number of Insured Institutions:	70	18
Aggregate Amount of Deposits Insured:	\$92.5 million	Less than \$550 million
Total Assets-Corporations:	\$10 million as of 9/30/81	\$27.52 million
Reinsurance:	None	Corporation may borrow from the State of Hawaii
Gross Claims Paid in 1982 or Most Recent Year:	Approximately \$7 million in 1977	\$4.85 million
Supervised By:	State Chartered Corporation supervised by Commissioner of Corporations	State Bank Examiner
Ratio: Insurance Fund/Deposits:	1.08% as of 9/30/81	2.0% as of 12/31/81

Table G6

Maximum Number of Banks Participating in  
Deposit Insurance, Eight States, 1908-1930

State	Year or years during which number of participating banks was at a maximum	Participating banks		Deposits of participating banks at or near time of maximum participation 1/	
		Number	Percent of all banks <sup>2/</sup>	Amount (in thousands)	Percent of all deposits in all banks
Oklahoma .....	1911	695	75.2%	\$ 61,509	50.7%
Kansas .....	1922	714	52.0	185,989	43.3
Nebraska .....	1921	1,011	84.3	272,256	57.8
Texas .....	1921	1,014	58.1	319,346	32.6
Mississippi ..	1921	309	90.9	144,528	77.8
South Dakota .	1921	566	80.6	174,231	67.0
North Dakota .	1920	720	80.6	151,531	66.4
Washington ...	1921	116	29.1	74,859	19.5

<sup>1</sup>For dates nearest beginning of indicated years.

<sup>2</sup>All banks include national, State, and private banks, regardless of eligibility for insurance under the various laws. Excludes trust companies not regularly engaged in deposit banking except for Oklahoma. Dates of data for various categories of uninsured banks used in computing percentages are not identical in some instances with dates of insured bank data.

Source: Annual Report of the Federal Deposit Insurance Corporation for 1952.

Table G7

## Comparison of Deposit Insurance Programs\*

	FDIC	FSLIC
Type of Covered Institution:	Commercial Banks, Mutual Savings Banks	Savings and Loan Associations
Incorporated:	1933	1934
Membership Deposit:	None	None
Annual Premium:	1/12% of deposits, with rebate credit, based upon FDIC net earnings	1/12% of deposits, with rebates which assure a reserve to total insured deposits ratio of at least 1.25%. No rebate credit.
Maximum Coverage:	\$100,000 per depositor per bank	\$100,000 per depositor per S&L
Number of Insured Institutions:	14,487 Commercial Banks 315 Mutual Savings Banks as of 12/31/82	3,311 as of 1/31/83
Aggregate Amount of Deposits Insured:	\$1,104,019 million est. as of 12/31/82	\$571,017 million as of 1/31/83
Total Assets- poration:	\$13.8 billion in deposit insurance as of 12/31/82	\$6.40 billion (insurance fund) as of 12/31/82
Reinsurance:	Treasury lines of credit, plus March 1982 Congressional resolution concerning backing of insurance funds by full faith and credit of US Government	Treasury lines of credit, plus March 1982 Congressional resolution concerning backing of insurance funds by full faith and credit of US Government
Gross Claims Paid in 1982 or Most Recent Year:	1982 - \$750 million spent in year to facilitate merger or closure of 42 institutions	1982 - assisted 47 mergers, for a present value expense of \$1.1 billion
Supervised By:	Independent agency within US Executive Branch	FHLBB
Ratio: Insurance Fund/Deposits:	1.25% - Insured deposits as of 12/31/82	1.12% - Insured deposits as of 12/31/82

\*1982 data unless otherwise indicated.

Table G7

Comparison of Deposit Insurance Programs\*  
(continued)

	Industrial Bank Savings Guaranty Corporation of Colorado	Maryland Savings Share Insurance Corporation
Type of Covered Institution:	Industrial Banks (Coverage Mandatory for all institutions)	Savings and Loan Associations
Incorporated:	1973	1962
Membership Deposit:	None	Assessed individually on new members, and are refundable upon termination of membership. Individual institutions may be required to increase their deposit.
Annual Premium:	If fund falls below the greater of \$3 million or 3% of total membership deposits, assessment will be 1/4% of savings deposits	
Maximum Coverage:	\$100,000 per depositor entity	\$100,000 "for each separate account"
Number of Insured Institutions:	155	105
Aggregate Amount of Deposits Insured:	\$320.58 million 6/30/82	\$2.455 billion
Total Assets-Corporation:	\$7.3 million 6/30/82	\$83.851 million
Reinsurance:	None	None as such. However Corporation has available a guaranteed line of credit of \$98 million with large commercial banks to provide immediate liquidity
Gross Claims Paid in 1981 or Most Recent Year:	In fiscal year ended 6/30/82, one bank was placed in liquidation by Colorado Bank Commissioner. IBSGC advanced \$1,249,000 to cover guaranteed deposit liabilities. Maximum corporate liabilities estimated at \$3 million, with 60% expected recovery	1980 - Paid \$350,000 to facilitate a merger of two members 1981 - paid a final payment of \$2,537,000 to further facilitate same merger.
Supervised By:	Bank Commissioner of State of Colorado	Division of Savings and Loan Associations
Ratio: Insurance Fund/Deposits:	2.28% 6/30/82	3.42% 12/31/81

TABLE G7

Comparison of Deposit Insurance Programs\*  
(continued)

	Mutual Savings Central Fund Inc. Liquidity and Deposit Insurance Fund	Cooperative Central Fund
Type of Covered Institution:	Savings Banks in Massachusetts (Membership Mandatory)	Savings and Loan Associations (called Cooperative Banks in Massachusetts) (Membership Mandatory)
Incorporated:	1932	1932
Membership Deposit:	<u>Liquidity Fund:</u> May require special assessments as necessary. Last one was in 1957 for 1/20% of member deposits. Power for assessment was eliminated by statute in 1981	<u>Reserve Fund:</u> Similar to Mutual Savings Central Fund
Annual Premium:	<u>Insurance Fund Only:</u> Basic rate of 1/16% of insured deposits. Rate may be charged for any particular year upon approval of Commissioner of Banks	<u>Share Insurance Fund:</u> Similar to Mutual Savings Central Fund
Maximum Coverage:	All deposits	All deposits
Number of Insured Institutions:	159	111
Aggregate Amount of Deposits Insured:	\$11,393 billion	\$4,302 billion
Total Assets-Corporation:	\$11.39 million - Liquidity Fund \$291.18 million - Deposit insurance fund	\$151.58 million: \$47.91 million in reserve fund \$103.67 million in share insurance fund
Reinsurance:	For FDIC members-first "\$100,000 for each depositor" insured by FDIC	None as such -- however, CCF has reserved \$53 million in lines of credit from commercial banks, for liquidity purposes
Gross Claims Paid in 1982 or Most Recent Year:	Last closing was in 1972, which resulted in the DIF acquiring approximate book value of \$24 million in assets. Liquidation continuing	In 1982: (1) Performed assisted merger; granted a \$450,000 distribution to facilitate it. (2) Advanced \$1,250,000 as interest-free loan to facilitate merger of two members. (3) Two transactions involving one acquiring member bank and four consolidating members. Interest free loans could total \$4.4 million by 1988.
Supervised By:	Independent State Chartered Corporation. Some functions performed together with Massachusetts Commissioner of Banks	Independent Corporation. Some function performed together with Commissioner of Banks.
Ratio: Insurance Fund/Deposits:	2.556% 12/31/81	3.52% 8/31/82

TABLE G7

Comparison of Deposit Insurance Programs\*  
(continued)

	North Carolina Savings Guaranty Corporation	Ohio Deposit Guarantee Fund
Type of Covered Institution:	Savings and Loan Associations and Credit Unions	Building and Loan Companies (Savings and Loan Associations)
Incorporated:	1967	1956
Membership Deposit:	1/12% of total savings deposits. However, fee assessed is effectively \$1500-2500. Board usually varies the 1/12 fee	Deposit is maintained at 2% of savings balances
Annual Premium:	Each member bank must maintain a deposit of 1.25% of savings deposits - annual assessments made to maintain this level	Membership deposit above is adjusted semi-annually by assessment to maintain membership deposit above
Maximum Coverage:	Up to \$100,000 each separate account. (Up to \$250,000 each separate IRA account)	All deposits
Number of Insured Institutions:	S&Ls - 45 Credit Unions - 24	80
Aggregate amount of Deposits Insured:	\$2.067 billion	\$2.505 billion
Total Assets-Corporations:	\$27.17 million	\$68.055 million
Reinsurance:	Coverage of \$14 million, with \$8 million deductible. Also a \$50 million line of credit with 2 major commercial banks is kept for liquidity	None
Gross Claims Paid in 1982 or Most Recent Year:	None	Merger of two members in default negotiated in 1982. Fund took back notes in approximate amount of \$9.3 million at rates ranging from 9-12%, to facilitate merger.
Supervised By:	Department of Commerce, S&L Division	Ohio Building and Loan Commissioner
Ratio: Insurance Fund/Deposits:	1.31% as of 12/31/81	2.72% as of 6/30/82



TABLE G7

Comparison of Deposit Insurance Programs\*  
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Membership Deposit:	2% of savings accounts	
Annual Premium:		1/6% of average deposits, semi-annually
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Aggregate Amount of Deposits Insured:	\$97.541 million	\$95.0 million
Total Assets- Corporations:	\$2.354 million	\$306.8 thousand
Reinsurance:	None	None
Gr. Claims Paid in 1982 or Most Recent Year:	None	None
Supervised By:	Pennsylvania Commissioner of Banking	Pennsylvania Commissioner of Banking
Ratio: Insurance Fund/Deposits:	2.41% as of 10/31/82	0.32% as of 12/31/82

TABLE G7

Comparison of Deposit Insurance Programs\*  
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	California Thrift Guaranty Corporation	Thrift Guaranty Corporation of Hawaii
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Reinsurance:	None	Corporation may borrow from the State of Hawaii
Gross Claims Paid in 1982 or Most Recent Year:	Approximately \$7 million in 1977	\$4.85 million
Supervised By:	State Chartered Corporation supervised by Commissioner of Corporations	State Bank Examiner
Ratio: Insurance Fund/Deposits:	1.08% as of 9/30/81	2.0% as of 12/31/81