Confidence for the Future: An FDIC Symposium January 25, 1998

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Introduction

The rapid pace of change in the banking industry and the prospect of new permissible activities for banking organizations raise issues regarding the appropriate scope of deposit insurance and the risk exposure of the insurance funds. Indeed, in the current debate over financial modernization in the United States, some industry observers have called for reform of the deposit insurance system.

On January 29, 1998, the FDIC sponsored a symposium to promote a deliberate discussion of the role and nature of deposit insurance. The audience of over one hundred included bankers, regulators, consumer and trade group representatives, academics, and congressional staff members. Many of the complex issues associated with maintaining an effective deposit insurance system were explored in four panel discussions.

This volume of proceedings includes written versions of participants' remarks, where available, and edited transcriptions of the remarks delivered by the other panelists. The luncheon address delivered by James A. Leach is also included. These materials are organized according to the symposium's agenda.

Confidence for the Future

An FDIC Symposium

L. William Seidman Center, Arlington, VA
January 29, 1998

8:00 to 8:45 a.m. **Registration and Continental Breakfast**

8:45 to 9:00 a.m. **Opening Remarks**

9:00 to 10:30 a.m. **Deposit Insurance and Financial Modernization**

The rapid pace of change in the banking industry and the prospect of new permissible activities for banking organizations raise issues regarding the appropriate scope of deposit insurance and the risk exposure of the insurance funds. This panel will discuss the role of deposit insurance in the financial system of the future.

Moderator: Joseph H. Neely, Director, FDIC

Panel Members:
John D. Hawke, Jr., Under Secretary of Treasury for Domestic Finance
Thomas M. Hoenig, President and Chief Executive Officer, Federal Reserve Bank of Kansas City
Lawrence Connell, Attorney at Law
Carter H. Golembe, CHG Consulting, Inc.

10:30 to 10:45 a.m. **Coffee Break**

10:45 to 12:30 p.m. **Reform Proposals: Examining the Role of the Federal Government**

Some industry observers have proposed deposit insurance reforms that would curtail the role of the federal government in protecting depositors. This panel will consider the merits of these proposals in light of the goals of a deposit insurance system, the realities of "too big to fail," and the significance of the reforms enacted in response to the events of the 1980s.

Moderator: William R. Watson, Director, Division of Research and Statistics, FDIC

Panel Members:
Richard M. Kovacevich, Chairman and Chief Executive Officer, Norwest Corporation
Bert Ely, Ely and Company, Inc.
Helen Boosalis, Chair, Board of Directors, American Association of Retired Persons
Thomas E. Hales, Chairman, Chief Executive Officer, Union State Bank, Orangeburg, New York
George J. Benston, Emory University

12:30 to 2:00 p.m.	**Luncheon Address**

Honorable James A. Leach
Chairman, Committee on Banking and Financial Services
U.S. House of Representatives

2:00 to 3:30 p.m.	**Striking a Balance Within the Current Framework**

Bank safety-and-soundness regulation and the current deposit insurance system represent an attempt to strike the right balance among the potentially competing objectives of providing stability in the financial system, controlling moral hazard, and minimizing undue regulatory burden. This panel will consider whether the deposit insurance system currently balances these objectives appropriately, and whether adjustments are needed to ensure a proper balance going forward.

Moderator: Arthur J. Murton, Director, Division of Insurance, FDIC

Panel Members:
- Gary H. Stern, President, Federal Reserve Bank of Minneapolis
- Hjalma E. Johnson, Chairman and Chief Executive Officer, East Coast Bancorp
- David E. A. Carson, Chairman and Chief Executive Officer, People's Bank, Bridgeport, Connecticut
- Mark J. Flannery, University of Florida

3:30 to 3:45 p.m.	**Coffee Break**
3:45 to 5:15 p.m.	**Roundtable Discussion**

Moderator: Andrew C. "Skip" Hove, Jr., Chairman, FDIC

Panel Members:
- Ernest Ginsberg, Vice Chairman of the Board, Republic National Bank of New York
- Jonathan L. Fiechter, Director, Financial Sector Development, the World Bank
- Charles E. Waterman, Chairman and Chief Executive Officer, South Holland Trust and Savings Bank, South Holland, Illinois
- Catherine A. Ghiglieri, Texas Banking Commissioner

5:15 p.m.	**Reception**

Opening Remarks

Opening Remarks

Andrew C. "Skip" Hove, Jr., Chairman, FDIC

It is my pleasure to welcome you this morning to this FDIC Symposium on Federal Deposit Insurance and Financial Modernization. It has been said that experience is the best teacher, and growing up in America's agricultural heartland as I did was certainly an education. As a child, I recall I once overheard a farmer in a feed store explaining a new method he had discovered for cutting his costs. He said, "One day I happened to spill some sawdust into my mule's feed, and to my amazement, the animal ate it. That gave me an idea." He swept a little more sawdust into the feed every day, increasing the amount every time, and without fail, the mule ate the mixture. The man said, "I thought I had discovered a sure way to cut my feed bill, but it didn't work out." The feed store manager said, "Well, what happened?" The farmer answered, "About the time I had the mule up to about 100 percent sawdust, it died."

I draw several lessons from this experience, and number one is that there are certain basic costs of doing business. And two, trial and error can be awfully expensive. Three, if you think you've got a good idea, try it out on other people because maybe they will see the holes in your reasoning that you don't see, or maybe they'll know important facts that you don't know.

I think a good idea certainly will withstand scrutiny and criticism. In that spirit, we have asked panelists with a wide range of opinions and views to come here today to discuss federal deposit insurance, particularly within the context of the changes that we're seeing in the financial system.

We have bankers and academics, current and former government officials, and representatives of the public. Needless to say, they all have different perspectives. The collective experience that we call history tells us that Congress created the federal deposit insurance system in 1933 in response to more than 9,000 bank failures and a severe contraction of economic activity that followed the stock market crash of 1929. Deposit insurance was intended to maintain stability in the financial system, and thereby promote growth, protect small depositors from the losses associated with bank failures, and insure the viability of small banks. In good times like those that we enjoy today, it is easy to forget that stability is a goal and not a given. Events overseas certainly remind us of that. Even then, however, people were aware and policy makers were concerned about the potential for deposit insurance to create a moral hazard, which is the tendency for people to take more risk when they are insured.

In the case of banking, the moral hazard refers to the fact that deposit insurance reduces a depositor's incentive to monitor and discipline banks for the excessive risk taking that they might otherwise take. Some

people say that the banks do not bear the cost of carrying additional risk when depositors are insured and may take on too much risk.

In the beginning, lawmakers who created the FDIC capped the insurance coverage and increased supervisory authority over insured institutions to address this potential moral hazard. The potential, however, still exists. There also exists the possibility that in our eagerness to curb excessive risk taking, we may burden banking with regulation that inhibits the industry's ability to compete and to evolve. This overburdening, in turn, can create market distortions. Our symposium here today is part of a continuing effort to strike a balance between the problem of moral hazard and the problem of regulatory burden; a balance between the appropriate scope of deposit insurance and the risk exposure of insurance funds; a balance between market forces, and the significant economic and social benefits that deposit insurance has created.

We suspect that we don't have all the answers, nor even all the questions. We believe that other people may have ideas or facts that will be useful in our searching for this balance, and we think this symposium may bring new answers and questions, new ideas and facts to light. Experience is a great teacher. The terrible experience of the 1930s taught us the principle that deposit insurance provides stability. Our experience since then has shown that deposit insurance continues to have an enduring value for the American people.

On the other hand, more recent experience with the Federal Savings and Loan Insurance Corporation taught us that a system of deposit insurance can be costly if it is not managed correctly. Moreover, financial markets and depository institutions have changed dramatically since federal deposit insurance was established in 1933, and especially in recent years as the technological advances have enabled financial innovation and globalization to occur. In our effort to ever refine deposit insurance in light of these changes, our symposium asks all the panelists and participants—where do we go from here?

Introductory Remarks by Joe Neely, Director, FDIC

This is a red letter day, I think, for the agency. Today we have a situation where the audience and attendees are equally impressive as our panelists. We are very honored by your presence.

In advance of this symposium, over the past several months, we have been going out around the country and holding outreach meetings with various industry representatives from all portions and factions of the insured depository institutions industry—national banks, state banks, members, nonmembers, thrifts, older institutions, de novo institutions, urban money center institutions, community banks. We have gathered a great deal of industry input and comment as it pertains to issues we tend to take for granted, until times like these when we have an opportunity to revisit fundamental issues such as deposit insurance.

This symposium today is certainly held against a very favorable industry backdrop. We are here today with a very healthy industry, arguably the healthiest the industry has ever been. We are here today against the backdrop of two fully capitalized deposit insurance funds. We are here today against the backdrop of very healthy, positive, and upbeat projections for continued industry health and prosperity. This symposium, I think, is very appropriate in times such as these. These times give us an opportunity to revisit issues, fundamental issues such as

deposit insurance. I'm proud that the agency has taken the opportunity to bring various people and various perspectives together today and provide a forum for a very positive and substantive discussion on these fundamental issues.

Our first panel today will focus on financial modernization, and financial modernization as it pertains to, and its effect on, the deposit insurance system. Financial modernization—that is a term that means a lot of different things to a lot of different people. However, it is a term that has been at the forefront of legislative, regulatory, and policy discussions regarding the financial institutions industry for quite some time. It is safe to say that financial modernization will dominate as an industry issue for the foreseeable future.

Practically everyone associated with this industry acknowledges the reduced role that traditional financial institutions now play in the financial services marketplace. Most will also agree that the current statutory and regulatory framework prohibits banks and thrifts from competing on an equitable basis with the nonbanking firms and other financial intermediaries. However, there is a wide diversity of opinion and agreement as to the proper way to address this situation, to promote a safe, efficient, competitive, and equitable evolution of our financial markets, along with a strengthening of our banking industry.

No modernization or substantive reform proposals can ignore the related consequence for the deposit insurance system. It has been suggested that the current deposit insurance system actually serves as a barrier to modernization. Some feel that the current federal safety net serves as a convenient excuse for policymakers not to extend powers and services to those afforded deposit insurance protection. Some also feel that the industry is subjected to substantial regulatory and compliance burden as a result of a federally administered deposit insurance system. Some also feel that an expansion of product or service offerings by insured depository institutions will increase moral hazard and reduce prudence and discipline. However, many institutions look to the current deposit insurance system as an essential, intrinsic component of their franchise value, which over time, in both good times and bad, provides the stability and confidence that differentiates their institution from others. The first panel will focus on the role of deposit insurance in the financial system of the future.

Panel 1: Deposit Insurance and Financial Modernization

John D. Hawke, Jr.
Thomas M. Hoenig
Lawrence Connell
Carter H. Golembe

Panel 1: Deposit Insurance and Financial Modernization

Issues and Background

The rapid pace of change in the banking industry and the prospect of new permissible activities for banking organizations raise issues regarding the appropriate scope of deposit insurance and the risk exposure of the insurance funds. This panel will discuss the role of deposit insurance in the financial system of the future.

Issues for Discussion:

- *The financial markets and depository institutions have changed dramatically since federal deposit insurance was established in the 1930s. Has the fundamental role of deposit insurance changed?*
- *Expanding the activities that banking organizations can conduct potentially extends the federal safety net—and related problems such as moral hazard and regulatory burden—beyond banks. How does one decide what activities should or should not be conducted within insured institutions? How does this question bear on the desirability of merging the insurance funds?*
- *A number of reform proposals attempt to address the potential for moral hazard, deposit insurance subsidies, and regulatory burden by reducing or freezing in place the scope of activities that may be conducted within an insured institution. What are the potential benefits and limitations of these proposals?*
- *What safeguards or firewalls are necessary to protect the insurance funds from undue risk and minimize potential market distortions associated with federal involvement in deposit insurance? Would a subsidiary or affiliate structure be more effective for implementing and maintaining such safeguards?*

The FDIC was created when President Franklin D. Roosevelt signed the Banking Act of 1933 to help restore stability to a financial system that had seen over 9,000 bank failures and a severe contraction in economic activity in the four years following the stock market crash of 1929. In passing this legislation, President Roosevelt and the Congress were concerned about the potential for deposit insurance to create

"moral hazard," which is the tendency of people to take on more risk when insured. As applied to banking, moral hazard refers to the fact that insurance for depositors reduces their incentive to monitor and discipline banks for excessive risk taking. Consequently, it is argued that banks do not bear the cost of carrying additional risk and may take on too much of it. In order to address this effect, and thus limit the potential loss to the government, the legislation limited the amount of insurance—to $2,500 in 1934, $5,000 in 1935—and increased the amount of federal supervisory authority over insured institutions (FDIC 1984).

For the next 50 years, public confidence in the banking system was maintained even through serious recessions and other major economic shocks. In the 1980s, however, a crisis in the thrift industry culminated in the insolvency of the Federal Savings and Loan Insurance Corporation. The banking industry also experienced significant problems, raising serious concerns about the FDIC's insurance fund. As a result, many observers began to question the structure of the deposit insurance system. Indeed, the Federal Deposit Insurance Corporation Improvement Act of 1991 contained numerous provisions that were intended to address weaknesses in the system highlighted during this crisis period. While banks and thrifts have experienced an extraordinary resurgence during the last several years, the dramatic changes under way in the industry—and in financial markets generally—call for a continuous evaluation of both the structure of banking organizations and the role of deposit insurance.

Innovations in technology and information services have allowed financial service providers to offer a full range of products, blurring the distinctions between banking and nonbanking organizations. It is generally agreed that eliminating some of the current artificial restrictions on the financial activities of banking organizations could strengthen these organizations and promote a more efficient, competitive evolution of financial markets in the United States. The challenge, however, is to provide a statutory and regulatory framework that allows this evolution to occur while maintaining the safety and soundness of individual institutions and the stability of the financial system without causing significant market distortions.

The FDIC has testified to Congress that banking organizations should be permitted to engage in any type of financial activity, unless the activity poses significant safety-and-soundness concerns, and that organizations should have the flexibility to choose the corporate or organizational structure that best suits their needs, provided adequate safeguards exist to protect the insurance funds and the taxpayer. The FDIC also has testified that merger of the two insurance funds—the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF)—should be an element of any financial modernization legislation (Hove 1997). While financial modernization should allow banking organizations to achieve greater diversification of income sources and deliver more and better services to customers, it raises fundamental questions with respect to the structure of banks and the role of deposit insurance.

The Role of Deposit Insurance

The most commonly cited purposes for federal deposit insurance are to maintain stability in the financial system and thereby promote economic growth, to protect small depositors from the losses associated with bank failures, and to ensure the viability of small banks. Some industry observers sug-

gest that a narrower role for deposit insurance is more appropriate.[1] Others argue that the original role of deposit insurance has diminished over time. For example, since the creation of the FDIC, a number of factors have led to a significant erosion in banks' one-time dominance of many activities. Innovative competitors have developed products that are the economic equivalent of traditional bank products. In addition, large corporations now frequently meet their funding needs by issuing commercial paper, debt securities, and equity, rather than by borrowing from banks. The decline in bank assets as a percentage of total financial assets over time is often pointed to as evidence of the declining relative importance of banks (BAI 1996).

Alternatively, it can be argued that banks continue to play a vital role in the economy as special financial intermediaries. It is this role that makes them susceptible to bank runs, which can threaten the stability of the financial system, and for which federal deposit insurance was seen as the remedy (Murton 1989). Today, banks continue to be an important source of business financing, particularly for small and new businesses, which may be key sources of new job creation and innovation in the U.S. economy. In addition, many banks are leaders in the development of complex new products, such as financial derivatives that allow credit risk to be unbundled and transferred to market participants. It also should be noted that in some communities, smaller local banks are the most important source of credit for households and businesses. These institutions, which are generally more reliant on deposits as a primary source of funds than larger institutions, might be unable to compete for funds without federal deposit insurance. Finally, banks are critical providers of certain payment services; the bulk of individual payments continues to be processed through the banking system.

The fact that the net income of banks as a percentage of Gross Domestic Product has been increasing is another argument against the notion that banks are now less important to the economy (Kaufman and Mote 1994). As recently as the early 1990s, a nationwide lull in commercial real estate markets was attributed to the lending decisions of insured depository institutions.

Taken together, these observations suggest that the original, closely related purposes of deposit insurance—ensuring the stability of the financial system, protecting depositors from losses, and maintaining the viability of small institutions—remain important in the current banking environment.

Financial Modernization

The goal of financial modernization—to allow financial institutions to evolve in response to a dynamic marketplace and to provide a level playing field for competition—must be balanced by the need to ensure the safety and soundness of insured institutions and the stability of the financial system. A related goal, minimizing any unwarranted expansion of the federal safety net, of which deposit insurance is a prominent component, raises questions about where banking organizations should conduct nonbanking activities, as well as what should constitute a banking activity for deposit insurance purposes. Indeed, in the Deposit Insurance Funds Act of 1996, merger

[1] They have suggested that the primary purpose of deposit insurance was to protect small savers, and that the current $100,000 coverage amount should be reduced to be more in keeping with this original purpose; it should be noted, however, that the amount of insurance coverage was over 10 times per capita personal income in 1935, while $100,000 was about 4 times per capita income in 1996.

of the two insurance funds is delayed subject to agreement on a unified charter for depository institutions. These issues are considered in turn.

Corporate separation. There seems to be general agreement in financial modernization discussions that banking and nonbanking activities should be carried out in separate organizations. A commonly cited reason for requiring such a separation is the fear that a nonbanking operation could expose a bank to greater risk of failure. Although some nonbank activities may be less risky than traditional banking activities, certain risks may be difficult to detect or monitor without some degree of corporate separation. A related reason for requiring separation of nonbanking activities is to prevent banks from using federally insured deposits to fund these activities. The concern here is that, to the extent that banks enjoy a funding advantage from access to the federal safety net, which includes deposit insurance, this funding advantage—or "subsidy"—will be passed on in their nonbanking activities and give banks an unfair advantage over nonbank competitors (Kwast and Passmore 1997). While one can debate whether or not there is a net subsidy, after taking into account the additional regulatory and other costs that are unique to banks, an important purpose is still served by minimizing unnecessary government involvement in the economy. Market distortions that diminish productive capacity can occur if, for example, banks make investment and lending decisions based upon regulatory considerations.

Corporate separateness can be accomplished either by requiring nonbanking activities to be conducted in subsidiaries of insured institutions, or in nonbanking affiliates that share a common parent holding company with the insured institution. One advantage to the subsidiary model is that the residual value of these activities accrues directly to the insured entity, rather than to the parent holding company, and thus provides greater protection for the insurance funds. Indeed, in the case of a troubled bank, the parent holding company has incentives, and perhaps a fiduciary responsibility, to keep value in the nonbanking affiliate and away from the insured institution to reduce the parent's total losses. One also could argue that as banking organizations increasingly manage risk on a consolidated basis, the holding company structure can increase the riskiness of the bank. For example, if the holding company is diversified with respect to a certain risk, the bank may represent only one side of a hedge, thereby creating additional risk exposure to the insurance funds.

An advantage to the holding company model is that it may maintain a more meaningful corporate separation between insured and uninsured affiliates, insulating the insured bank from losses associated with the nonbanking activities. In addition, the holding company structure may provide a better framework for monitoring transactions between insured and uninsured affiliates for potential transfers of value that could threaten the insured institution.

Another issue that has received considerable attention is the extent to which restrictions on affiliations between banking and commercial firms should be eased. An argument can be made that allowing such affiliations would diversify income in the same way as expanding allowable financial activities. However, opponents of relaxing these restrictions are concerned with the banking industry's ability to manage new and unfamiliar risks. They also cite concerns about possible concentrations of power. Finally, they argue that in times of economic stress, the elimination of barriers between banking and commerce could create opportunities for large commercial organizations to divert value from an insured entity to commercial

operations, increasing risks to the financial system.

Permissible Activities and Fund Merger

The recent experience with different assessment rates for BIF- and SAIF-insured institutions provides an example of the kind of market distortion that can occur when a regulatory structure imposes artificial distinctions on banking organizations. The existence of the two funds is tied historically to the existence of separate charters for banks and thrifts. While there may continue to be substantial disagreement with respect to the permissible activities of banks and thrifts, it is difficult to argue that the two funds should continue to be separate for insurance purposes. A combined BIF and SAIF would have a larger membership and a broader distribution of geographic and product risks, and would thus be stronger than either individually. With the recent capitalization of the SAIF, the two funds are now on comparable financial footing; their reserve ratios are so close that a merger would not result in a material dilution of either fund. Given the clear advantages of merging, from an insurance perspective, the question is whether a merger should continue to be delayed for the purpose of reaching agreement on charter unification.

Alternative Bank Structures

As discussed previously, expanding the activities that banking organizations can conduct potentially extends the federal safety net, and the related problem of moral hazard, beyond banks. Several proposals attempt to address this issue by separating deposit-taking from virtually all other activities in banking organizations (Litan 1987, Pierce 1991). These "narrow bank" proposals generally require deposit-taking "banks" to invest only in Treasury securities, highly rated commercial paper, and similar low-risk instruments, and require lending activities to be conducted in separately capitalized affiliates funded by uninsured liabilities. Proponents argue that this approach significantly decreases risks to the deposit insurance funds, minimizes market distortions by allowing banking organizations to provide financial services free of unnecessary regulatory restrictions, and virtually eliminates the potential for systemic instability caused by bank runs.

A potential practical problem with the "narrow bank" approach is that it would require many banks, even small institutions involved primarily in traditional lending, to create more complex, potentially expensive corporate structures. In addition, this approach may destroy the special intermediary role of banks. If this function remains important in some sectors to ensure an adequate supply of funds for productive investment, it is likely to be performed outside the safety net, exposing the financial system to increased instability.

Given the expanding array of complex activities available to banking organizations, as well as the difficulty and cost of regulating these activities, another set of reform proposals would limit the activities banks can engage in to a set of "core" banking activities, which are essentially activities traditionally performed by banks (Bryan 1991, Carns 1995, Hoenig 1996). Institutions that wish to engage in other activities would be required to do so outside of the federal safety net. One problem with this "core bank" approach is the difficulty of determining whether the benefits of imposing a new structure will outweigh the transition costs. If the new structure requires insured institutions to change the menu of products avail-

able to their customers, such costs could be significant. A related difficulty is that of defining a permissible set of products or activities as financial innovation continues to blur the distinctions between new and traditional bank products. It can be argued that the reform proposals would simply replace the current government-imposed structure with a newer, equally artificial government-imposed structure. As a result, it is not clear that these proposals would be more flexible or conducive to market-oriented change in the industry.

A number of financial modernization legislative proposals contain yet another approach to curtailing federal involvement in banking activities. These proposals would create Wholesale Financial Institutions (WFIs), which are financial institutions that are authorized to conduct banking activities and to have access to the payments system, but are not permitted to take insured deposits. Under these proposals, WFIs would continue to be subject to safety-and-soundness supervision and to the Community Reinvestment Act, even in the absence of deposit insurance. These requirements serve as a practical reminder that deposit insurance is only one part of the federal safety net, which also includes access to the Federal Reserve's discount window and to overdraft protections on Fedwire, the payments system operated by the Federal Reserve District Banks.

Safeguards

A major challenge for the current deposit insurance system will continue to be its ability to allow for rational financial evolution without sacrificing control of moral hazard. Simply requiring all nonbanking activities to be conducted either in a bank subsidiary or affiliate will not, by itself, address all concerns associated with expanding the activities that banking organizations can conduct. Without limitations on their exposure, banks could suffer significant losses if the nonbanking activities conducted in a related entity are highly risky. If a nonbanking subsidiary or affiliate were to suffer losses, the health of the insured entity could be threatened if, in the absence of adequate safeguards or clear disclosure, value was diverted from a bank to support the troubled organization, or depositors withdrew their funds out of concern for the effect the losses might have on the bank. To the extent that a deposit insurance subsidy exists, it could be transferred to nonbanking activities if insured deposits are used to fund a subsidiary or affiliate. In addition, if moral hazard affects the risk-taking decisions of a bank's managers, significant management overlap also could corrupt the decisions of the nonbanking organization.

Most proponents of expanded activities look to the current system as a guide for establishing safeguards to minimize such problems. For example, Sections 23A and 23B of the Federal Reserve Act were designed to safeguard the resources of federally insured banks against misuse for the benefit of affiliates. Section 23A places limits on the dollar amount of loans a bank may make to, or investments it may make in, affiliates. Section 23A also imposes collateral standards on loans or extensions of credit, and generally prevents banks from purchasing low quality assets from affiliates. Section 23B requires certain transactions between a bank and its affiliate to be carried out at arm's length, under terms and conditions comparable to those between unaffiliated entities.

The FDIC and the OCC have applied the principles of Sections 23A and 23B to the oversight of activities engaged in by subsidiaries that are not permissible for national

banks. Other safeguards to strengthen the corporate separation of banks and their subsidiaries include requirements that the entities have different names, as well as separate physical facilities, boards, employees, and books and records. Banks and their subsidiaries also are required to make clear disclosures to their customers with respect to the legal and financial relationships of the entities.

The FDIC and the OCC also require a bank to deduct its investment in a subsidiary from capital for purposes of meeting regulatory capital standards, and require the subsidiary to be adequately capitalized by appropriate industry standards (FDIC 1997, OCC 1996). Another safeguard contained in most financial modernization legislation proposals would limit authorization of expanded activities to those banking organizations with insured institutions that are well-capitalized and well-managed.

One problem associated with requiring banking organizations to conduct all nonbanking activities in separate entities is that it could thwart efficient, market-oriented developments if the resulting organizations are less flexible or customer-oriented. In addition, sophisticated financial organizations increasingly measure and manage risk on a consolidated basis, not just by department or entity. Given that the activities, practices, and transactions in one part of an organization can affect the distribution of risk across the entire organization, it can be argued that some amount of federal regulatory oversight of the entire organization is needed to assess its financial condition and to coordinate the supervision of individual affiliates and transactions among affiliates. A concern with this approach is the potential for excessive regulatory burden, which itself can be a cause of market distortions.

In summary, preparing the deposit insurance system for the 21st century requires careful balancing of issues such as the appropriate scope of deposit insurance and the risk exposure of the insurance funds. The challenge is to accommodate market forces without sacrificing the significant economic and social benefits associated with federal insurance of bank deposits.

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Comments on Deposit Insurance and Financial Modernization

John D. Hawke, Jr.

The charge to this panel is to discuss the role of deposit insurance in the financial system of the future. Let me start the discussion with what might be considered a provocative assertion: If we want a truly modern and competitive financial services industry, we cannot continue to use protection of the deposit insurance fund as the excuse

- for dividing markets among competing segments of that industry,
- for limiting the ability of providers to offer a full range of financial services or to make efficient use of their resources, or
- for imposing constraints on form and structure that are intended to advance other interests.

This is not by any means to say that protection of the fund is not an important objective; it clearly is one—but by no means the only—reason we regulate banks in the first place. It is simply to say that protection of the federal interest in the fund can be achieved without sacrificing the objective of a more competitive, more efficient system of financial institutions. Indeed, when the Treasury Department transmitted its proposed financial modernization legislation to the Congress last year, we believed we had struck a reasonable balance between these objectives. Let me summarize our approach.

First, we proposed that the limitations that prevent common ownership of banks and entities involved in other nonbanking financial activities be repealed. Thus, we would allow banking organizations to engage in insurance and securities activities—both through operating subsidiaries and holding company affiliates—free from the artificial constraints they now labor under, and we would allow insurance and securities firms to become bank holding companies.

Second, we proposed a precondition for an organization owning a bank to engage in an expanded range of financial activities. Namely, all of the affiliate banks in the organization would have to be—and stay—well capitalized and well managed, and the holding company would have to supply a written undertaking to maintain the bank's capital at that level. Failure to meet this requirement would be a ground for significant curtailment of the organization's activities or for a forced divestiture of the bank.

Third, we would require that if the organization elected to engage in the expanded

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range of activities through an operating subsidiary of the bank, the bank's satisfaction of the well-capitalized standard would have to be achieved after deducting the amount of its investment in the subsidiary. With this capital haircut, a failure of the subsidiary would not in itself cause the bank to fall below the highest level of capital required by the supervisors.

Fourth, we proposed that the affiliate transaction limits of sections 23A and 23B be applied to dealings between a bank and its operating subsidiaries engaged in nonbanking financial activities. In light of the capital haircut for equity investments, however, we would not apply 23A in that respect.

Finally, we proposed to protect insured banks from being held accountable under the "piercing the corporate veil" doctrine for liabilities of subsidiaries or affiliates for which they would not otherwise be obligated. As an adjunct to this, we would require bank supervisors to take steps to assure that institutions observe principles of corporate separateness, and we would make it a crime for a bank employee to represent that the bank would stand liable for any obligation of a subsidiary or affiliate that it had not expressly and lawfully assumed.

These proposed requirements, which we believe provide solid protection for the insurance fund, must be viewed against the backdrop of FDICIA's capital requirements and "promptcorrectiveaction" regime. While I know that some on this panel (and elsewhere) may disagree with me, I believe that FDICIA's basic concepts—set strong capital requirements, strive to measure the real economic value of capital accurately, and move promptly to force corrective action before real capital disappears—should be viewed as liberating regulation from many of the old concerns about the threats posed by expanded activities. With these protections, there should be a heavy burden placed on those who would encumber the system with restrictive regulation to justify their need.

You may have noted that I have spoken about an expanded range of *financial* activities, and have not addressed the subject of nonfinancial activities—the dreaded banking and commerce issue. This is an issue that has broad philosophical and theological dimensions, but to the extent that it has any relationship to safety and soundness, we believe that the panoply of protections I have just described would provide strong safeguards for the bank. Under one of the alternatives we formulated on this subject, bank holding companies would have been permitted to have a modest "basket" of nonfinancial activity, and if the Congress were to elect this alternative, as the House Banking Committee did, we would expand the section 23A and 23B firewalls to prohibit *any* transactions between an insured bank and an affiliate engaged in nonfinancial activities.

Consistent with the approach we have taken to the protection of bank soundness, we have not proposed to expand the range of financial activities that banks may conduct as principal in the bank itself. We saw no need to do so, given the range of activities we would permit in affiliates and subsidiaries. The issues about bank activities that were so hotly debated in the last session were, in my view, overinflated. The question should only be one of appropriate grandfathering: Because banks have been permitted for ages to engage in some securities and insurance activities in the bank itself, how do we draw a line that avoids disruption of traditional bank activities?

Let me now turn to another argument grounded in deposit insurance that is being advanced as a rationale for imposing constraints on the way in which providers of financial services should be permitted to operate—the safety net subsidy argument.

Banks enjoy such a subsidy, the argument goes, and if banking organizations are permitted to expand into other financial activities, sound public policy should require that steps be taken to ensure that the advantage of this subsidy is not spread. Because it is easier for a bank to spread the benefit of the subsidy to a subsidiary than to a holding company affiliate, new financial activities should be permitted only in affiliates, and not in subsidiaries.

I do not propose to take on here the debate over whether a subsidy, gross or net, actually exists. Many believe that when the costs of regulation are taken into account, banks do not enjoy any net subsidy, and therefore do not have any resulting competitive advantage. Others argue that the relevant question is not whether there is a net subsidy, but whether there is a gross subsidy. I will only say that if a subsidy exists, it suggests that deposit insurance is underpriced, and the appropriate response from government should be to price deposit insurance in such a way as to eliminate the subsidy, rather than to impose organizational constraints on banking organizations.

Even assuming the existence of some subsidy, the fatal defect in the argument is its assumption that the value of the subsidy can be more easily transmitted to subsidiaries than to affiliates. This is simply wrong.

In the first place, if a bank does benefit from a subsidy, the value of the subsidy inevitably inures to the benefit of the consolidated enterprise. It can be used to the advantage of affiliates, whether or not funds are actually transferred from the bank to another component of the enterprise. For example, if a holding company owned both a bank and a securities underwriting firm, the value of subsidized earnings retained in the bank could theoretically be used by the affiliated securities firm to achieve a competitive advantage by shaving its margins. On a consolidated basis, the economic result would be the same as if the bank had conveyed equivalent value to the affiliate through the payment of a dividend.

More important, even if the value of the supposed subsidy were spread through a transfer of funds, there is no practical distinction between a downstream transfer to an operating subsidiary and the payment of a dividend to a parent holding company. This is particularly so if the bank must take a capital haircut for regulatory purposes in the amount of any equity investment it makes in a subsidiary. In such a case, the effect on the bank's regulatory capital is exactly the same as if it had paid a dividend.

To be sure, there are legal limits on a bank's ability to pay dividends without regulatory approval. There is, however, an enormous excess dividend capacity in the banking system. In 1996, for example, 25 of the 30 largest national banks could, in the aggregate, have increased their dividends by more than 50 percent, from $14.7 billion to $22.3 billion, both within the limits on paying dividends without supervisory approval, and without falling short of the well-capitalized standard. If there were any concern at all that banks might have greater freedom to dedicate resources to subsidiaries than they might have to fund affiliates through the payment of dividends, that concern was fully addressed in the House Banking Committee's reported version of H.R. 10. The Banking Committee bill provides not only for a capital haircut, as we had proposed, but limits the amount that a bank can invest in a subsidiary without prior supervisory approval to the amount the bank could pay as a dividend without prior supervisory approval. This formulation, which we supported, would create a virtually perfect parity between upstream and downstream investments, and should eliminate completely any basis for arguing that

the assumed subsidy can somehow be more easily transmitted downstream than upstream.

It is only when one steps back from this argument and looks at it with some real-world perspective that its fundamental misdirection becomes clear. Keep in mind that the affiliate-only argument is not—and could not be—based on safety and soundness considerations. It is based on supposed policy considerations relating to the spread of the subsidy. But the implication of the argument that new activities should be conducted only in holding companies is that banking organizations may be able to take advantage of such new authority only *by weakening their banks*—that is, by upstreaming funds from the bank to capitalize a new affiliate or by committing a portion of the bank's earnings stream to the servicing of holding company debt used for that purpose. Given a choice between forcing banks to deplete their resources to support new activities in affiliates, where the earnings will not benefit the bank, or to capitalize bank subsidiaries for the same purpose, one would think, safety and soundness factors otherwise being equal, that sensible policy would not *prohibit*, but would in fact *encourage*, the latter. After all, even if the bank cannot count its investment in the subsidiary toward its regulatory capital requirements, the bank still retains its equity interest in the subsidiary and stands to gain the economic benefits from the subsidiary. In either case, affiliate or subsidiary, if the new activity fails, the bank's economic loss is limited to the amount of the dividend payment or the downstream investment.

To the extent the subsidy argument really reflects concerns about the impact that broadened authority for operating subsidiaries may have on the vitality of holding company regulation, those concerns, if warranted, should be addressed directly. We will never achieve true modernization of our financial services system, however, until we embrace the principle that the system should not be burdened with governmental restrictions except where a less burdensome approach would not provide reasonable protection for clearly demonstrated governmental interest.

Comments on Deposit Insurance and Financial Modernization

Thomas M. Hoenig

Financial Modernization: Implications for the Safety Net

It's a pleasure to be here today as part of this panel on deposit insurance and financial modernization. Over the past 20 years, the world of finance has changed dramatically. During this period, we have seen phenomenal growth in new types of securities and derivatives markets, the globalization of finance and capital flows, and a blurring of the distinction between banks and other financial intermediaries.

These changes in financial markets have led to public debate among Congress, financial regulators, and financial industry participants about the appropriate role for banks, the so-called "financial modernization" debate. Much of this discussion has centered on the question, Should we expand bank powers? I believe, however, that this question is not very useful to us as policymakers. Modernization and expanded powers are clearly necessary to allow banks to adapt to the changing financial world. In my view, a more relevant question is, How does the expansion of bank powers affect the exposure of the deposit insurance system and the other components of the safety net?

The main point I want to make is that the path that banks are allowed to take in expanding their powers has important implications for the exposure of the safety net. In my remarks this morning, I would like to address four questions. First, why do we need a safety net? Second, why should we be concerned about extending the safety net? Third, in light of concerns about the size of the safety net, is it feasible to roll back the safety net? Finally, how does the approach to financial modernization affect the exposure of the safety net?

Why do we need a safety net?

Let me begin by defining what I mean by the safety net. The component of the safety net that receives the most attention is, of course, deposit insurance. The safety net, however, also includes the Federal Reserve's lender of last resort function and guaranteed final settlement on Fedwire, the Federal Reserve's large-dollar interbank settlement system. As we think about the impact of new activities on the exposure of the safety net, I think it is important that we keep all three components in mind.

The safety net for the banking system has been put in place because of the unique role

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that banks play in the financial system—that is, because banks are, and will continue to be thought of as, "special." Banking is special because, unlike other industries, disruptions in certain banking activities have negative external effects that extend beyond banking and into other sectors of the economy. Indeed, banking problems can have a wide-ranging impact on overall economic activity. To limit the negative externalities associated with banking problems, most countries have chosen not to leave the fate of the banking industry solely in the hands of the market and to establish some form of a safety net for banks.

While banks have lost market share in business lending in recent years, one reason they are special is that they still play a vital role in satisfying the credit needs of many sectors of the economy. Even when banks do not directly make the loans themselves, they often provide letters of credit and other guarantees that ultimately stand behind nonbank forms of credit. While the health of any single bank may have little impact on overall economic activity, broader problems in the banking sector can lead to a credit crunch and reduce economic activity at the regional, national, and even international levels. One need look no farther than the current banking crises in Southeast Asia to see how disruptions in bank credit flows can threaten not only the health of domestic economies, but also the health of economies in other parts of the world. Closer to home, we all saw how the banking problems in Texas and the Midwest in the 1980s, and New England and California in the early 1990s, reduced credit availability and slowed economic activity.

A second reason banks are special is their role in the payments system. A well-functioning payments system is essential to the workings of a modern economy because serious disruptions in the payments system impair the ability to complete transactions and adversely affect economic activity. The payments system has always revolved around banks since bank demand deposits serve as the principal noncash means of payment. In addition, banks perform the function of clearing and settling almost all noncash payments. The potential for systemic problems arising from payments failures, particularly payments failures in large-dollar payments systems, suggests that participants involved in clearing and settlement operations must be subject to greater scrutiny than other institutions. Thus, due to the crucial role of banks in credit markets and the payments system, some form of safety net seems important and necessary.

Why should we be concerned about extending the safety net?

Given the presence and significance of the safety net, my second question is, Why should we care if the safety net is expanded when new bank activities are permitted? The answer is that while the safety net helps protect the economy from the externalities associated with banking problems, it has its own unique side effects that are costly to the economy.

The most often mentioned problem is the moral hazard that banks will take excessive risks to the extent that explicit or implicit government guarantees remove the incentive for depositors and other creditors to monitor banks. In particular, the guarantees and reduced private sector monitoring mean that the cost of risk-taking is lower for banks than for other financial institutions. To the extent they are allowed to do so, some banks will fund investment projects that might not otherwise be viable in the sense that the expected returns on the projects are too low. As a result, the moral hazard problem leads to a misallocation of credit, which is costly

for the economy as a whole because it reduces economic efficiency.

The increase in risk-taking combined with the reduction in private monitoring leads to an obvious reaction—namely, greater reliance must be placed on regulatory discipline. Regulatory discipline has its own cost for banks as it increases regulatory burden. Beyond banks, however, it is also costly for regulators, who must keep up with the increasing complexity of ever-changing bank activities, and for the economy to the extent that regulatory rules and decisions lead banks to operate less efficiently.

As banks expand their activities, it is at least possible that the exposure of the safety net will rise. The concern for policymakers is that the additional costs associated with an expansion of the safety net will be greater than the additional benefits. Indeed, some believe the costs of the safety net as it is currently structured are already greater than the benefits.

Can we roll back the safety net?

Given the concern about the costs of the safety net, it is natural to ask whether it is possible to reduce the exposure of the safety net by either scaling it back or reforming its structure. Proposals for changing the safety net have tended to focus on deposit insurance reform. Some of the options that have received the most attention include scaling back deposit insurance coverage, using subordinated debt to reduce the moral hazard problems associated with the safety net, relying on private insurance systems, and creating narrow banks.

Conceptually, I have considerable sympathy for rolling back and reforming the safety net. The difficulty with changing the safety net, of course, is that it increases the potential for the systemic problems that the safety net was designed to prevent. I have argued elsewhere that safety net reform would be more feasible if we shift our regulatory focus from protecting individual banks to preventing problems at one or a few banks from spreading throughout system. Protecting the banking system in this way would allow individual institutions to fail without necessarily threatening the financial system. To the extent that systemic risk does decline, we could reduce the scale of the safety net and place greater reliance on market discipline, because individual failures would be less threatening to the economy.

From a practical standpoint, however, I wonder whether we can realistically reform or scale back the safety net in the near term for two reasons. First, I do not see a public mandate for reducing safety net coverage. Second, even apart from whether an attempt to scale back the safety net would be politically feasible, it is unlikely that a reduced safety net would be credible. Recent experience in the U.S. and other industrialized and developing countries suggests that governments are inclined to bail out both depositors and other creditors to preserve stability in times of financial crisis even when there are no explicit guarantees. Again, the current events in Southeast Asia illustrate just how intense the pressure is to contain a crisis, even when it means some depositors and creditors might be protected. With the globalization of financial markets, few countries are willing to allow banking problems to jeopardize their reputation and access to international capital markets. At the same time, other countries have an incentive to lend assistance to prevent significant disruptions in trade and capital flows. Thus, while fundamental safety net reform should remain our long-term goal, the realities of the economic environment make such reform difficult to achieve.

How does the approach to financial modernization affect the exposure of the safety net?

If we assume, then, that the safety net will remain basically as we know it today, how will financial modernization affect the exposure of the safety net? The answer depends on the approach banks are allowed to take in adopting new powers. One approach is to permit new activities to be conducted within the bank itself. The key policy issue raised by this approach is that it necessarily increases the exposure of the safety net to the new activities. As a result, the new activities would have to be regulated and supervised the same way as other bank activities.

Whether this is the best approach to financial modernization depends on the relative benefits and costs of allowing the bank to conduct directly the new activities. On the benefit side, allowing banks to engage in new activities that have synergies with existing activities may be efficient for the economy as a whole. In addition, while new activities may be risky, modern portfolio theory suggests that what matters is not the risk of individual activities but the risk of the overall portfolio of activities. Thus, it is possible that allowing banks to engage directly in new activities will reduce their overall risk through greater diversification.

On the cost side, allowing banks to conduct new activities directly expands the costs associated with safety nets that I noted earlier. To the extent that banks do not bear the full social costs of their activities, they may make loans or engage in other activities that might not otherwise be viable. In addition, this increase in moral hazard makes it necessary to extend regulation and prudential supervision to new activities. For example, new activities would have to be regulated under a safety and soundness criterion rather than the less extensive fraud and disclosure requirements for market-based activities. Thus, as activities are expanded within the bank, there is a greater regulatory burden for banks, greater costs for bank regulators, and perhaps less efficient decisions by banks.

The alternative to conducting new activities directly in the bank is to conduct them in affiliates or subsidiaries that are separated and insulated from the bank with firewalls. The advantage of isolating new activities in this way is that it would limit the exposure of the safety net to new risks, thereby better controlling the costs associated with extending the safety net. In particular, while some oversight would still be required, the degree of regulation necessary to control moral hazard would be substantially less than if the activities are conducted in the bank itself. In general, supervision and regulation could be designed to focus on transactions and other relationships between the bank and the affiliate. More specifically, the role of supervision would be to make sure that affiliates operate as separate entities, do not expose banks to additional risks, and do not gain an advantage over nonbank firms by exploiting the safety net.

The disadvantage of this approach is that, although some of the synergies remain, there would be reduced direct benefits of new activities for the bank. In addition, some additional regulation and supervision would be necessary, although as I just mentioned, it would be less than if new activities were conducted directly by the bank.

Conclusion

In conclusion, I am convinced that financial modernization and expanded powers are inevitable, as banks must adapt to a changing financial world. For me, a key issue is the impact of modernization on the

safety net. While the safety net serves an important role in helping to preserve financial stability, it also increases moral hazard. As a result, it is necessary to regulate banks differently than financial and nonfinancial firms that are not protected by a safety net. While I am in favor of safety net reform, it will require a sea change in attitude by the public, and this strikes me as unlikely as I view the past and current environment. Thus, as we proceed with financial modernization, we must first be aware of its impact on the safety net. Then, we should proceed only after carefully balancing the private and social costs and benefits of new activities and, to the extent possible, in a way that limits further inadvertent extension of the safety net to new activities and firms.

Comments on Deposit Insurance and Financial Modernization

Lawrence Connell

Today I will focus on financial modernization from the state bank charter perspective. Until the savings and loan debacle of the late 1980s, the dual banking system was healthy and dynamic. For many generations, state-chartered savings banks successfully invested in common stocks and corporate debt securities that were denied to national banks. As we all know, the NOW account phenomenon under state law that permitted payment of interest on transaction accounts originated in the mid-1960s to avoid the federal and state prohibition on payment of interest on demand deposits. During this period, the FDIC and state regulatory authorities were able to deal with the risks associated with these powers, especially the broader investment powers permitted under state law.

Unfortunately, the uncontrolled, unsupervised explosion of expanded savings and loan activities under federal law following the enactment of the Garn-St Germain Bill and expansion of state-chartered savings and loan powers in such states as Texas and California resulted in severe losses in that industry. Eventually, FIRREA limited activities of state-chartered institutions to those permitted to national banks, unless authorized by the FDIC.

In the early days of exercising that supervisory responsibility, the FDIC was very cautious, limiting and discouraging investment by savings banks in common stock, even when it had been successfully done for many generations.

For some years now, the Congress has struggled with financial industry modernization legislation with no real success. Indeed, the progress that has been made over the past five years has almost all been accomplished through interpretations by the various regulatory agencies, specifically, the Office of the Comptroller of the Currency in its rulings on insurance and subsidiary operations and the Board of Governors of the Federal Reserve System with respect to securities activities by banks through Section 20 subsidiaries. This has prompted my colleagues on the Shadow Financial Regulatory Committee to recommend continued change by regulatory agency interpretive decision over congressional action.

The legislative process is simply incapable of repealing obsolete laws. Instead of simply enacting a repealer clause or two, a several-hundred-page statutory monster is created, resulting in not just an ineffective response to market change, but a whole new immensely burdensome regulatory structure.

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With this as background, I would propose that the FDIC actively join in the regulatory process of financial modernization through its FIRREA authority. This could be done by a means similar to the OCC in its Part 5 regulatory amendments. As an example, the FDIC could invite requests for opinions on state operating powers that differ from national bank authority even though a particular bank had not made such a request. This would encourage state legislatures and banking departments to reexamine their laws for efficiency in today's economy. It would offer an opportunity for experimentation with new powers on a limited basis.

Maine is an example. Some 20 years ago, Maine changed its banking laws to permit interstate banking well ahead of other states and federal law. In 1997, it did the same with respect to the operating powers of its state financial institutions. Under the leadership of the Superintendent of Banks, Don DeMatties, the state banking code was completely overhauled. Four basic concepts were employed in the effort:

1. Operating powers of commercial banks, savings banks, and savings and loan associations were combined into one universal banking charter. Essentially, this was done by taking the best powers of each type of institution—investment in stock by savings banks, unlimited commercial and consumer lending in the commercial bank charters, and real estate development in the savings and loan charter—and making them available to all. The distinction among institutions was then only according to corporate governance, stock, and mutual or cooperative status.

2. The incidental powers clause was expanded to include activities that were "convenient and useful" in addition to activities closely related. This would help facilitate a break with past federal and state interpretations.

3. To help ensure that modernization would be prudently implemented, Maine adopted the "eligible bank" concept contained in Part 5 of the OCC regulations, a concept which permits banks to engage in a nontraditional activity. An eligible bank was one that was well capitalized, in sound financial condition, with good management. This is in contrast to Garn St Germain, which did not have a transition supervisory mechanism.

4. Restrictions on ownership of banks, other than the character test, were eliminated. After observing the legislative deadlock in Washington over ownership of a bank versus a unitary savings and loan holding company, it became clear to the country bankers and country lawyers in Maine that the whole argument was not about the substance of impositions of bank ownership, but rather a turf fight about which agency is to gain or lose regulatory power.

In addition to these four basic concepts, the Maine state law revision repealed or revised such obsolete provisions as the prohibition on payments of interest on demand deposits and branching laws.

The concern about moral hazard and the extension of the benefit of deposit insurance beyond insured institutions can and has been dealt with by the OCC in its structure of Part 5. The establishment of a bona fide operating subsidiary along with the deduction of the investment in that subsidiary from the bank's regulatory capital and the concept of the eligible bank would appear to effectively insulate the insured institution with respect to downstream activities. Section 23 and Section 24 constraints would further buttress that protection as well as pro-

vide similar protection from activities of horizontal affiliates.

I want to make clear that expansion and modernization of bank powers must be accompanied by alert, strong, and vigorous supervisory oversight. The OCC is doing this today, which the Federal Home Loan Bank system did not. The FDIC has an opportunity to join this process of bank modernization and contribute in a special way. With its long history of concern for prudent bank operations, it could uniquely facilitate change and offer yet another regulatory alternative to the failed effort, legislative modernization of the bank charter. I hope this conference will be the beginning of that effort.

Comments on Deposit Insurance and Financial Modernization

Carter H. Golembe

This is the second meeting within about one year to consider the future of deposit insurance. Last year we looked back at the banking problems of the 1980s for lessons to be applied in the future. On this occasion the focus is on the changing financial environment and proposals for reform of the deposit insurance program. The chairman, members of the FDIC Board, and the FDIC staff are to be congratulated for posing, once again, some tough but important questions for consideration and debate.

This panel was asked to "discuss the role of deposit insurance in the financial system of the future." The reasons for this assignment were described as the rapidity of change in the banking industry, and the prospect of new permissible activities for banking organizations, which in turn raise questions as to the scope of deposit insurance and the risk exposure of the deposit insurance funds. I will focus my comments on just the first of six or seven questions suggested for discussion: "Has the fundamental role of deposit insurance changed" since 1933?

To the question as posed, my answer is "No, it is the same as in 1933." But if asked whether the role played by the FDIC has changed in a fundamental way since 1933, I would respond, "Yes, totally." I am not sure how to reconcile these two responses, assuming they are correct, but I intend to try during the next ten minutes by taking a close but necessarily hurried look at the way the FDIC has changed, and then offer suggestions as to what this may mean.

If you have any doubt that there has been a remarkable change in the FDIC between January 1, 1934, and January 29, 1998, consider the ways the Corporation defines its mission. The FDIC's annual report 50 years ago (1947) put it clearly, with acceptable accuracy and admirable brevity: "The Corporation was created to protect bank depositors from losses arising from bank failures." Though not further discussed in 1947, it was always understood that good results were expected to flow from carrying out this mission successfully, such as making old-time "bank runs" things of the past, thereby contributing to banking stability and enhancing the confidence of the public in the banking system. Also paramount in the minds of a great many people was the expectation that deposit insurance would check any tendency toward the consolidation of the banking industry. The prevention of undue concentrations of banking power was an

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extremely important public policy objective in the U.S. almost from the founding of the republic, and was the major political reason for passage of the deposit insurance legislation in 1933.

Since I only have ten minutes, there is not time to read the most recent statement of the Corporation's mission, which appears in each of the last three annual reports. It consists of four paragraphs, and has all of the familiar words—"stability," "public confidence," "safety of the deposit insurance fund," etcetera. But nowhere does the word "depositor" appear, nor is there any mention of restoring funds to such an individual after a bank failure. This is an interesting omission, on which I will comment later. (I must mention here that I was saved a great deal of research time by David Holland of the FDIC's Office of Policy Development, who, in an excellent but yet unpublished article, has collected in an appendix the statements of the FDIC's mission as they appeared in its annual reports since 1934.)

Now for a hasty recap of how the FDIC itself has changed. As you will see, it was largely because of accident, good intentions, an absence of congressional attention except at certain times, and a tendency to adopt quick solutions to problems, without taking time to consider their long-run implications.

The first significant change occurred in 1935 with the establishment of an assessment rate and the introduction of what, 30 years later, evolved into the "too big to fail" policy. Prior to 1935 the FDIC was simply the paying agent for the federal government's guarantee of deposits up to, first, $2,500 (the old maximum in the postal saving system), and then $5,000. The Corporation had no broad powers of bank supervision, nor was it in the bank merger business. But in 1935 the Congress had to come up with an assessment rate, and the choice was between one-eighth of 1 percent or one-twelfth of 1 percent of all deposits. FDIC officials argued, based on extensive historical analysis, that one-eighth of 1 percent was needed, and that even this would not be sufficient in periods of deep depression, such as 1930-33. However, there was strong support in Congress for a lower assessment rate, to which the FDIC eventually agreed but only with the provision that it be given expanded bank examination powers. This made the FDIC a bank regulatory agency as well as a deposit guaranty agency, thereby introducing the conflict of interest problem that I discussed at last year's conference.

At the same time, the FDIC was given power to facilitate mergers between solvent banks. The amount of capital required for admission to the deposit insurance system at the time was, to my mind at least, quite reasonable—one dollar. By 1935 there were still a good many banks happily participating in deposit insurance with just about that amount of capital, and the Corporation began to fear that even a slight breeze might topple a few. Accordingly, it obtained from Congress authority to facilitate mergers of weak banks with stronger banks by purchasing assets from or making loans to the weaker institutions, contingent on merger. Note these were not failed banks. At the time, the FDIC counted as "failed" only those banks placed in receivership, and none of the banks involved in this program had failed. The new program was slow to get under way, but it then picked up for several years, until World War II began, and it came to an end.

The next key year was 1945. The war had ended, and the U.S. was about to face a serious postwar depression, or so almost all economists predicted. What to do with those millions of veterans who would return? Some good things happened, such as passage of the GI Bill of Rights. But the FDIC also did its bit. It decided it would use its

merger powers to put an end to bank failures, thus raising public confidence because of the public's association of bank failures with depression. From 1945 through 1954 there was not a single bank receivership; failing banks were merged with sound banks, and the FDIC could announce with each passing year—you can even find this in some of the annual reports—that the U.S. had entered its umpteenth year without a single bank failure. This new policy upset some in Congress, Senator Fulbright for example, but it reportedly ranked high in the affections of Mr. Truman.

The FDIC did something else in that postwar period: It began to agitate for permission to make loans to operating banks without requiring that they merge. Most of those running the FDIC had been in the banking business, particularly bank regulation, since the early 1930s, and they were acutely aware of the failure of the Federal Reserve to fulfill its "lender of last resort" role in 1932-33, which had resulted in a great many unnecessary bank failures. The FDIC argued that if this were to happen again, which it thought might be the case given the unanimity with which a massive depression was predicted and the fact that much of the Federal Reserve staff was still in place, the FDIC would be unable to pay depositors. The Federal Reserve hit the ceiling, to put it mildly, arguing that it was absolutely impossible to believe that the nation needed two "lenders of last resort." The argument was intense and was not settled until 1950, by which time most people had begun to believe that maybe the great postwar depression was never going to show up. In any event, the Corporation got its law, allowing it to make loans or purchase assets from banks in order to keep them in business (as distinct from having to merge them), but it sort of promised unofficially never to use this power except in rare, unusual situations, such as where the distressed bank was the only bank in the community. Nothing in the law said that this was what the FDIC had to do; it was kind of an unwritten, gentleman's agreement. So for 20 years the law remained unused.

The next key year was 1956. The FDIC had been happily arranging for 100 percent insurance coverage for almost all failing banks by merging them with other banks; all were very small institutions. Then in December 1956, the Comptroller of the Currency, probably lacking a sense of humor, found a bank distressingly insolvent, placed it in receivership, and handed it over to the FDIC for liquidation. The problem was that the bank was located in a small town about 80 miles from New York, it was the Christmas season, and the New York newspapers were making FDIC the Grinch that ruined Christmas, particularly because a major depositor—scheduled to receive only the deposit insurance guarantee of $10,000—was a local factory that employed a good many people in the village.

What to do? An unknown hero at the FDIC must have said something like, "Wait a minute, as receiver we have all the assets; why don't we sell them to an operating bank, and if we can't find one we'll have another bank started, so long as the other bank assumes all of the deposit liability." This was done, the factory was saved, Christmas joy was preserved, and when FDIC officials looked around they decided it was a lot neater to handle mergers involving failed banks by first having the bank placed in receivership, thereby cutting off a lot of nettlesome claims. This new policy required a name, and I guess another unknown hero came up with "purchase and assumption," which I think survives to this day. (I might note that I, too, had to come up quickly with some new terminology because at that time I was in charge of putting out the FDIC

annual report, and we clearly had to change all of the tables at the back of the report, since we now had a receivership of a bank that had not "failed," in the old meaning of the term. In desperation I came up with "deposit payoff" to replace the word "receivership" at the head of all columns where there had been an actual payoff. I have often wished that I had dreamed up a more elegant term.)

Years went by with few if any deposit payoffs; most failed banks continued to be handled by merger. Such cases were now lumped with deposit payoffs to give the total of bank failures, but however handled, no really large banks failed. Then came 1972 and the imminent failure of the Bank of the Commonwealth in Detroit—the first billion-dollar bank to fail. What to do? The FDIC was under tremendous pressure to make certain that there was no deposit payoff. There was also great pressure to avoid having an FDIC-assisted merger since by now this was recognized as being the same as a failure. Nineteen seventy-two was an election year, and Michigan was a key state. Moreover, Commonwealth was a state-chartered bank, a member of the Federal Reserve, and it was virtually holy writ at the Fed that the large banks it supervised never failed; only large national banks failed! Someone pointed out to the new FDIC Chairman, Frank Wille, that there was an old statute hanging around from 1950, under which the FDIC could make a loan to the Bank of the Commonwealth and keep it in operation. That was what the FDIC did.

Breaking the old agreement had to be justified, of course, because Commonwealth was not the only bank in Detroit. The FDIC handled this in two ways, according to the 1972 Annual Report. First, the bank was treated as the only bank in the inner city, the only bank available for minority groups. Second, the avoidance of failure was justified by the effect that "closing might have had on the nation's banking system."

This was the real beginning of what we now call the "too big to fail" policy. "Too big to fail" became virtually a household word, particularly after the Continental Bank case, in 1984, when the FDIC had to deal with the then eighth largest bank in the U.S. Few people remembered that the practice of ignoring insurance coverage limits had begun in the immediate post-World War II period, and that it was almost always small banks in small communities that were the beneficiaries of this policy for at least 20 years.

Finally, there came the banking troubles of the late 1980s and, particularly, 1990-91. Instead of the FDIC routinely returning to the government the special taxes (also called assessments) paid by banks, the FDIC became a drag on the federal budget, with more money going out than coming in. The end result was passage of FDICIA, which can be characterized in many ways. My view of that measure—particularly its early closure provisions—is that it was not only unnecessary and potentially dangerous, but also that it was one of the most insulting pieces of legislation ever adopted by the U.S. Congress. In effect, it was Congress saying to professionals who had spent their lives in bank regulation that they didn't know how to supervise banks. This is not surprising since it was a number of academicians who claimed, and still claim, credit for this remarkable piece of legislation.

Regardless of what one thinks about it, however, it does mark a significant milestone in the evolution of the deposit insurance system. For embodied in the statute itself is the explanation that many of the additional powers (actually, instructions) given to the FDIC were needed to protect the deposit insurance fund, that is, to protect the federal government against any loss it might incur in fulfilling its deposit insurance com-

mitment. It was not unusual therefore—indeed was quite reasonable—for someone to write, as did one of the FDIC officials who submitted a paper to our conference last year, that the "primary goal of bank supervision is to prevent losses to the deposit insurance fund." The world had turned upside down, and the FDIC was now in the business of protecting itself.

Clearly, the FDIC, once the agency in charge of implementing a wise and necessary government deposit guarantee program, has since gotten itself involved in a host of matters that, originally at least, were never dreamed of as having relevance to its basic mission. For if the present role of deposit insurance is, as best I understand it from current mission statements, to be the nation's major force for financial stability, the FDIC must indeed be concerned, in addition to safety and soundness, with the kinds of activities in which banks might engage, whether banks are good citizens in terms of CRA and other notable pieces of social legislation or the antitrust laws, how large individual banks might get and how to deal with them, etcetera. None of this had been of the slightest relevance in 1934 because the FDIC was not a banking agency; it was simply in charge of restoring the rent and grocery money to depositors, the large majority of whom had been unsophisticated victims of bank failures, generated by a banking system that had, and still has, a great many desirable features but at the same time is one that produces occasional bank failures.

What does all of this suggest about the role of the FDIC—the Corporation's mission—and the role of deposit insurance? I conclude that the FDIC had an important, well-defined mission from the day it began business in 1934 to the present day—to restore deposits up to a specified amount for each depositor when there is a bank failure—but this mission is too narrow to justify the size of the organization and cluster of powers that have grown up around it. This suggests for the future either that drastic retrenchment is called for or, alternatively, that a new, much expanded, mission must be identified.

This, I assume, is what this conference is all about. The future of the FDIC depends on defining accurately its new mission. There may be great need for a major financial stabilization agency at the federal level, kept quite separate from deposit insurance. Certainly the Hunt Commission in 1971 seemed to have something like this in mind. Currently, and more to the point perhaps, much may be learned from what is happening in Britain, which is in the midst of bringing together in one newly created agency oversight of all financial institutions (banks, investment banks, insurance companies, etcetera). At the same time, Britain is cutting the old ties that hindered such a development, most obviously by stripping the central bank (Bank of England) of its bank supervisory powers. It is not hard to see the present FDIC serving as the centerpiece of a new regulatory system for financial institutions.

But this depends on cutting the link with deposit insurance. So long as the FDIC ties itself to the deposit insurance function, I suspect it is headed for trouble. It is likely to confuse serving as one of the nation's most important bank supervisory agencies with its long-ago responsibility for providing limited protection to unsophisticated depositors of failed banks. For example, it is likely to be seduced into thinking that the purpose of bank supervision and financial stabilization is protection of the deposit insurance fund. This would be a fatal error.

Panel 1: Deposit Insurance and Financial Modernization

Discussion

Question—I'm Burt Ely. This question is for Tom Hoenig. This has to do with where the risk really lies in the federal safety net. Isn't it true, Tom, that because the Fed makes loans from the discount window only on a very well secured, collateralized basis, and also because of the protections it is putting in the payment system, specifically, to deal with the daylight overdraft problem—as a practical matter, isn't all of the federal safety net risk concentrated in federal deposit insurance, and in effect, all that is borne by the FDIC and none by the Fed?

Hoenig—No. I think certainly when you talk about the lender of last resort and the fact that those are collateralized, the risk is less and controlled. In terms of the safety net and terms of settlement, those risks are real. We still spend a lot of time on the issue of daylight overdrafts. And as you think about part of the role of lender of last resort in systemic situations, you are in the position of having to lend large amounts of money very quickly—that still requires a great deal of analysis in terms of collateral. So, all those risks are there and the collateral, like any lending business, is there to offset that. It takes time and energy to assure yourselves of that collateral. With the payment system itself, the role that you play, I think, in terms of assuring finality and in terms of these daylight overdrafts, involves fairly substantial risks that you are very conscious of at all times. So, yes, I think there is risk there and I think it does not fall, necessarily, on the deposit insurance system, although that is very real because we don't limit deposit insurance in reality to $100,000—it goes beyond that. So, to that extent, there is greater risk there.

Neely—Let me ask one then. It seems to have become obvious that larger institutions have a different perspective and arguably place a different value on deposit insurance. Most of this difference of opinion tends to focus on the different funding mechanisms that large institutions rely upon versus the traditional funding mechanisms, deposit liabilities, that smaller institutions rely upon. This has almost evolved into a large bank/community bank issue. In a financial modernization framework, how do we address, or do we address—if you even suggest modifying the existing deposit insurance system—the different perspective in value that larger banks, which have very sophisticated funding sources, and community banks that rely heavily on traditional funding sources, place on deposit insurance?

Hawke—It is an interesting question, Joe. I think Carter was pointing to one answer to that question, and that is looking back at the original purpose of deposit insurance—to

provide essentially unlimited deposit insurance coverage to anybody who wants to take the trouble to get it. We've got a system that is something quite different from the system that Carter described that allows households to protect their rent and grocery money.

I think small banks undoubtedly use deposit insurance far more for those purposes than for funding purposes. There are a lot of small bank/large bank differences in this whole issue of financial modernization and they don't all relate to deposit insurance. But, I think the implication of your question is certainly right—that there are different values attached to deposit insurance, depending on the size of the bank.

Comment—It is just not a new issue. In other words, it has been there from the beginning. It was the small banks that made sure that the legislation went through in 1933 and the large banks tried to stop it.

Comment—You mentioned, Carter, that you have this issue of concentration of banking resources and so forth. That is still a concern because you will find it very difficult to convince people today, I think, that the too big to fail doctrine is no longer in place. As long as that perception remains, then that means as a depositor you view your funds as safe. If you are smaller and you don't have that concept of too big to fail, you are thought to be at a disadvantage. Therefore, you will very much oppose any type of reform. If you get into a reform mechanism, then it has to be one that assures you that you have addressed the issue of too big to fail, or I don't think you're going to see much progress on reform.

Comment—No, I agree with that.

Question—George Benston. Carter Golembe, you mentioned, with a bit of derision, that the FDIC was now looking to protect its funds instead of depositors. But of course, it is the same thing because with the FDIC now protecting depositors, the question is, as would be true of any insurance company, how can it make sure that, in fact, the costs of the insurance are not borne by the U.S. taxpayer. So, perhaps you could explain a little better why it would be wrong for the insurance company to try to protect itself, or for a government agency to try to make sure that the costs aren't borne by the taxpayers?

Golembe—George, I guess my major problem—or maybe I'm missing the point here. If you give some of the authority to insure—and we don't really have insurance, but authority to run this system where we restore funds to depositors after a bank failure—my problem is asking the same agency to supervise the banks. That, I think, is a serious conflict of interest. That is why I was derisive of it. It seems to me what the FDIC, in making that statement, is saying is, "We're going to pay more attention in protecting ourselves," while a good supervisor should say, "Look, I want the institution to be safe and sound, but I want it to be competitive, I want it to be entrepreneurial," and so forth. There is a mixture of functions there that should not be combined. I am far from the first one to make that point. The Hunt Commission made it very, very strongly. It keeps coming up all the time.

Question—Isn't the problem that you have a single insurance company and there is no competition among deposit insurers? Would you have multiple deposit insurers then?

Golembe—I don't think that is insurance. It is a government guarantee, for one thing. I really have trouble mouthing the words—deposit insurance fund—which I think is a

pure fiction. But, it is something we like to talk about, and it keeps a lot of economists in business, and it doesn't exist, for God's sake, and we all know it.

Comment—Kind of like the Social Security fund.

Question—Carter, you mentioned that the insurer having supervision powers weakens it or creates problems. Isn't that what happened with FSLIC—they had no supervision authority; they had no real powers over the institutions they were insuring, and that contributed to some of the problems that happened there?

Golembe—I didn't realize that I had said—or if I did, I certainly didn't intend to say—that the FDIC had no bank supervision powers that were significant. I think what I was saying is that when Bill Isaac, a former chairman of the FDIC, was here last year, his major argument was that the writ wasn't broad enough. In the case I gave, which was the one he cited, the FDIC shouldn't have walked for the first time in the doors of the eighth largest bank in the country, when it was about to go under. It should have been on top of that from the beginning, but it couldn't because of these restrictions. It was, I don't know who supervised that thing—the Comptroller.

Comment—I just wanted to supplement that—the FSLIC was a constituent, subordinate agency of the Federal Home Loan Bank Board, which had very significant supervisory powers. So, I think it is wrong to say that the thrift problem was caused by the FSLIC not having supervisory powers. If anything, the problem was caused by combining, in a single agency, the task of promoting an industry at the same time as you're examining and insuring it.

Comment—I would agree on that too because the president of the Local Federal Home Loan Bank was also the supervisory agent in that capacity. To me, in working with our situation in Texas, the problem was that, first of all, they didn't have the capacity professionally to deal with a change in the business. They had a regulatory system that was command control rather than prudential. For instance, they didn't have a system where the examiner and the supervisory agent could say this is imprudent. They had to find a violation of a regulation, and then the whole thing fell apart.

Question—Hi, I'm speaking for Richard Mead from the Federal Reserve Bank of New York. I have a question for Mr. Hoenig. The FDIC Improvement Act sought to restrain the too big to fail doctrine. There is more red tape in implementing it now. Other than that, has anything really changed?

Hoenig—Well, I think some things have changed with that legislation. Certainly, you are required to take action sooner and you have the authority to do that. So, you're not waiting for the capital to go to zero. I think beyond that, though, when you have an environment, not just an individual institution, but when you have an environment of uncertainty within the banking industry, and that is one of, say, several banks that may be under question, that is when the pressure becomes enormous to, in fact, bail out these institutions to ensure that we do not have effects on the real economy. In that sense, we find ourselves still in the environment of too big to fail under those circumstances. So, in that sense, I think it has changed marginally. There has been a cost to that: additional, like you said, red tape and more oversight. But, at the same time, in times of crisis, I don't think things have changed much—no.

Question—Carter, I thought I was agreeing with you until you said that you agreed with Isaac's view that it wasn't a surprise that the FDIC, for the first time, went into Continental, the eighth largest bank, and should have been there all along. I thought your view was there was a conflict between insurance, supervision and . . .

Golembe—Good point. I was simply trying to report Bill's comment as one of a number of attempts to sort of redefine the role and mission of the FDIC. I wondered about that myself and I went back and looked at the published version last night to see what he had said about deposit insurance, and there is no mention of it. He is just talking about the role of supervision. But, you're right—I was simply trying to give an illustration of one person's view as to how the mission, if he were rewriting it—I think he said the FDIC should not pass—on bank mergers. It shouldn't have anything to do with CRA. It should have no regulatory power whatsoever, but broader supervisory power. That is just a new mission statement, but not one with which I necessarily agree.

Question—Mr. Secretary, Tom Hales, Union State Bank—your comments and your previous comments seem to indicate, or at least I'm interpreting it that way—that the modernization or the expansion of powers in the banking industry really do not require changes in the present form of FDIC insurance. Would you comment on that, or have I misinterpreted you?

Hawke—No, I think that is correct. We have not proposed any changes in the form of FDIC insurance. What we have proposed in our legislation are additional protections for the federal deposit insurance interest.

Hales—The expansion of powers and keeping the FDIC insurance as it is, is certainly acceptable to you?

Hawke—That is what we propose.

Hales—I'm not disagreeing. I just wanted to make it very clear. I wanted to be sure that is what you were saying.

Hawke—As we were formulating our legislative proposal, we gave some thought to whether we ought to include provisions addressed to federal deposit insurance reform. I think probably everybody in this room would have some idea about how the federal deposit insurance system might be reformed. We concluded that it was not an essential part of financial modernization and would tend to divert attention from those broad issues.

Joe, I wanted to just take a second to address the question about what has changed since 1991, because I think there are some other things that have changed since 1991, in addition to FDICIA and the provisions relating to lender of last resort.

In the early years of this decade, the FDIC became much more enamored of the modified payoff, in the case of bank failures, and uninsured depositors have taken some losses in payoffs. It leads one to think that maybe what we need for credibility purposes is to have a large bank failure every few years to give the FDIC an opportunity to do a modified payoff and reiterate the message that uninsured depositors will not be protected 100 percent in solvency proceedings.

Comment—Jerry, you remember that program, the modified payoff, was going full blast until Continental, when the FDIC had an opportunity to use it there and they should have, in my opinion, and they didn't.

Question—Ken Ryder from OTS. Two-part question—one to Tom Hoenig and then the second one to Jerry Hawke. Tom, you mentioned there were three elements in the safety net—deposit insurance, the payment system, and the lender of last resort. I'm wondering whether those latter two perhaps are as relevant to banks as they need to be to a broader audience, given the extensions of technology, the change in the way payments are being made, and the integration of capital markets. Then with regard to deposit insurance, Jerry, you raised a good point about whether in fact, if we had priced deposit insurance correctly, we might not be debating the issue of subsidy. But, my question to you, if we were to price deposit insurance accurately, according to the risk, would we be so concerned about the form and structure of the various kinds of activities that the banking agencies would engage in?

Hoenig—To your first question: As new players come into the payment system, one of the issues will be access to the payment system through the Federal Reserve System. To the extent that those transactions are large dollar transactions and they flow through, over time there will be a natural question, especially if we have a financial disruption, as to whether these players shouldn't also have access to the discount window and the lender of last resort. That question has come up from time to time when you've had a financial disruption, and I think it will become a very real point. That is part of the issue of how you allow the expansion, not only of bank activities, but of new players coming in. I think it is a very serious question that will have to be addressed because the safety net will, in time, cover them, and then the reaction will be for these institutions because you have this issue of, well, what about the market. That means they will have to come under additional supervision; some kind of oversight to ensure that you are not taking a new risk or the settlement system is not at risk, and I think that is the process that will evolve if they, in fact, come in and have access.

Hawke—Ken, your question was, if deposit insurance were priced correctly, would we be so concerned about diversification of activities—that is exactly my point. The moral hazard issue, it seems to me, is dealt with if you have correctly priced deposit insurance. It takes into account what the risk is. I would make the same point with respect to payment system risk. If the cost of daylight overdrafts were properly priced, or if we had a different kind of settlement system that didn't require the Fed to take on the risk of finality, the subsidy that is implicit in the payment system would be eliminated as well. You could then approach questions of diversification of activities from a different perspective.

Comment—Can I make one other comment on that? I think, of course, the issue of price is discovering the appropriate price, and that is one of the most difficult issues. The second is with the payment system—I have argued if you get into reforming the safety net—not just deposit insurance, but the safety net—around somehow isolating the shocks that go through the payment system, then you would be able to focus more on the individual bank and its difficulty without having the immediate concern of how many other banks it affects and so forth. That would be, I think, a very good approach toward allowing more participants in the payment system. The difficulty is finding the design that works and discovering the price that works when you take it outside of the market. So, what you get is a reaction, then having to administer the price and having to administer the discipline, rather

than having the market discipline. That is where the rub is in many of these cases.

Question—Neil Milner. Going to the issue of the FDIC's role in the area of supervision, does it clarify the issue if we divide it between examination on behalf of the insurance fund as to the exposure, regardless of where the charter comes from, and the area of implementing from a safety and soundness standpoint, expanded activities in regard to state chartered institutions that are approved under the new authority under Section 24? Larry, do you want to comment on that?

Connell—Carter mentioned that this conflict of role is there and my remarks were to deal with the statute as it now exists. We are all talking about ideal structures to deal with deposit insurance and risk and cost to the public. But, it would have been nicer if that statute was written in a veto manner and, if it were there at all, written in a veto rather than affirmative approval. But, it is there and you kind of have to live with it until something happens down the road. But right now, the way I see it is the FDIC has statutory authority and responsibility to carry out certain functions. How do you deal with it in the context of modern banking services and the dual charter? Right now we don't have a dual banking system. We have a dual bank examination system, for all intents and purposes. But, I think there is opportunity to turn that around. It is certainly different culturally to have the FDIC involved in operating powers of banks. But, it is getting very significant, statutory authority that has had a depressing effect on innovation at a state level. In fact, it has almost eliminated it.

I think the most important thing as you look at what is happening today is the system is really working and probably the best indication of it, to me anyway—last night we were discussing this matter and I learned that there was a recent receivership where it appears there are going to be some proceeds back to shareholders. That means the bank was closed before the net worth went to zero on a real market basis. So, the system is working and maybe it is time to begin an experiment and have a third alternative to the OCC and the Federal Reserve on banking powers, to essentially the states around the country.

Question—Several people have argued against the timing for deposit insurance reform in today's setting. FDICIA, of course, brought about quite a few requirements that we are all bound by going forward—but arguably they have not been properly tested, given the state of the industry and the health of the industry and the failure scenario—such as prompt corrective action, least cost test, formalized too big to fail mechanism. In thinking about that and thinking about the consequences of deposit insurance reform in this environment, some people argue that we just went through the most stressful time in the industry's history since the depression, and came through that period of time of massive bank and thrift failures where the deposit insurance system was under great stress, yet there has been no identifiable or documented loss of consumer confidence in the system. Would anyone like to address the appropriateness of the timing of deposit insurance reform in this environment post-FDICIA?

Golembe—I don't know whether I can address it—just say I think this is the time when we are not facing serious problems. When you have tough decisions to make, banks are failing like there's no tomorrow, you may not necessarily get the right kinds of precedents established. This is the time to do it, I think.

Something I wanted to say, but since we were limited to ten minutes, I couldn't. I did want to congratulate Larry on a point that he made that I think doesn't get enough emphasis. The fact that we can get substantial modernization without paying any attention at all to Congress—we'll just let the agencies, some of them, do what they want to do or could do—that was an excellent point Larry made.

Connell—I made it this summer. One of our Senators lives in the town of Rye, where I live, and I went up to him and I said, "Senator, this has been the best legislative year that I can remember in 30 years in Congress." And he said, "Oh, is that right—what did we do?" I said, "Nothing."

Question—Rick Carnell from the Treasury. I have a question for Tom Hoenig. Tom, you've mentioned in your remarks and in your response to questions the issue of too big to fail, and the perception that large banks may still be such that it would be necessary to protect all depositors in a failure. This is certainly a very significant question in its relationship to financial modernization and to all the other issues we're dealing with here. If too big to fail continues in a meaningful form, then formal limits on deposit insurance coverage mean little. You've spoken specifically of the pressure on decisionmakers during a crisis to protect all depositors at a large bank. Now, this could happen in a couple of ways. One circumstance would be if you have an indiscriminate collapse of confidence in the financial system, an irrational contagion. But, I think there is a good case that we haven't had that in this country since 1933. So, if it didn't happen that way, it would operate through linkages in the financial system—through the payment system, through other ways in which financial institutions connect to each other. Isn't there an opportunity here for the Federal Reserve to make a significant contribution through a further effort to reform the payment system, to reduce the possibility of transmitting problems through these linkages? And, wouldn't it make sense to set a goal of sufficient reform of payment, clearance, and settlement such that the failure of a large depository institution would not bring down other institutions?

Hoenig—Well, to your question of whether it behooves the Federal Reserve to continue to improve the payment system so that you don't have a single institution bring you down, I agree. I think that is partly why so much time and effort has been placed on trying to control daylight overdraft issues as they come forward. I've argued in past comments that we should focus on the linkages—and some steps have already been made—to ensure that there is less ability to transfer the problem at one large institution, through the payments and settlements mechanism, to other institutions, which bring up the crisis of confidence. So, yes, I think we should continue to work on that. We have, and I think we need to continue to move forward, to give us the greatest insulation without freezing the payment system at the same time.

I think when you say we haven't had a substantial crisis in terms of an institution, I think that is correct, but that is partly because of the pressure that was brought to bear on the policymakers in the 1980s to step in and ensure that these institutions don't fail. So, what you want to do is, as you're suggesting, continue to move to ensure that we don't have systemic transmissions and that people are confident, perceive themselves as not being at risk through systemic transmission, so that a bank can fail without it creating a crisis. But, we have a ways to go before that is in the public's mind, certainly

especially when you have large, multi-billion-dollar organizations that might be perceived, or might actually be in difficulty, and what that may mean to the economy and to other institutions. As long as that risk is there in the moment of the crisis, then the pressure comes down to bail out that institution or some of the creditors in that institution. You have to bring that confidence forward through these improvements. It is your suggestion and I agree with it.

Question—A brief rebuttal and then a question. With regard to Tom Hoenig's comment about the Fed's risk, I would just like to point out that to the best of my knowledge, the Fed took no losses in the problems of the 1980s and 1990s, and the deposit insurers, both the FDIC and the old FSLIC, took about $200 billion in losses. So, I think that gives you some idea of the relative degree of risk. My question again comes back to too big to fail. We now have interstate branching going on and as a result, we are getting a tremendous amount of consolidation within the bank holding company. We are not only getting consolidation at the holding company level, but also within the holding companies, we are getting some very large banks in this country, and increasingly, community banks have offices across the street from a bank that is, let's say, over $100 billion or more in assets. Isn't too big to fail creating actually more of a competitive problem for the community banks, particularly as inflation steadily reduces the real value of the $100,000 insurance limit?

Hawke—Can I address that? I don't know whether that is so or not, but it does strike me that we ought to start trying to be a little more careful in how we talk about too big to fail. Too big to fail is a term that emerged from an era in which, as Carter described, the FDIC was doing assisted takeovers so that no uninsured depositors suffered any loss at all, and to a great extent even the shareholders survived. We ought to be thinking about a system in which big banks can fail and uninsured depositors will take some haircut on their uninsured deposits. We are not talking about a doomsday scenario where uninsured depositors are necessarily going to lose everything. It doesn't take much of a haircut on uninsured deposits to create the kind of discipline that we need in the system.

One other point I just wanted to add so that it is on the table for these discussions. There are other things that have happened since 1991 that bear on the risk of the deposit insurance fund. Cross-guarantees and depositor preference are important additions to the law that cushion the exposure of the FDIC to stresses in banking organizations. We can't lose sight of that when we consider the relevance of deposit insurance in the context of financial modernization.

Question—Gene Shahinian—I have a question on the current Far East banking experience and the proposed mixing of banking and commerce. In some Far East countries such as Korea, there are close relationships and affiliations between banks and commercial firms. These appear to have contributed to the current financial crisis there. I was wondering if the panelists might share observations on whether and how the experience of the Far East banks is relevant to assessing the risks of mixing banking and commerce in our own country.

Hawke—I knew that question was going to come up at least once today, and I was going to put it on the table myself for that purpose. That is a spurious comparison. First of all, the tradition, the background, the context, the structure of banking in Korea and Japan is vastly different from what we

have here. We not only have a system in which the tradition is a very substantial mixing of nonfinancial and financial activities, but you also have not only government sanction, but near compulsion from government for the financial institutions to stand behind the liabilities of their nonfinancial family members. We have an enormously different situation, and this is one of the things that is so frustrating about the banking and commerce debate in our environment. Nobody is seriously proposing that we have a system that mixes banking and commerce to the extent that we see in Japan, for example. That is simply not on the table. Complete mixing of banking and commerce was a possibility in the banking business up to 1970, and we never saw it. We saw very little interest in nonfinancial firms owning banks. It has been possible in the savings and loan industry up to this very day, and the extent to which nonfinancial firms have become involved in the ownership of insured thrift institutions is minuscule. To be sure, there are some nonfinancial firms that have interests in thrifts, but for the most part they are small, we haven't seen any movement toward the affiliation of nonfinancial firms and insured depository institutions.

In the context of the present financial modernization legislation, what the House Banking Committee's bill provided for was some modest authority for organizations that own banks to have some limited amount of nonfinancial activity. Essentially, that was done for three reasons: It was done because, as part of the effort to bring insurance and securities firms under a common umbrella with banking organizations, account had to be taken of the fact that some of these companies had some degree of nonfinancial activity. Legislation that forced them to give up, as a cost of buying a bank, the ability to have some diversified, nonfinancial activity—which, for the most part, was extremely modest—simply was not going to get off the ground. Second, it was important to have some modest leeway of that sort to provide a structure for combining the thrift charter and the banking charter and for dealing with the fact that the unitary thrift charter today has unlimited ability to engage in any activity it wants. And third, another reason for providing that kind of basket was to allow for the fact that it is becoming increasingly difficult to define where the line is between financial and nonfinancial activities. Organizations should not be subject to artificial constraints on their ability to use their financial technology and experience in nonfinancial applications, and they shouldn't have to get into great theological debates each time they want to make such use, whether the activity is financial or nonfinancial. So, we have a vastly different setting, a vastly different tradition, and a completely different rationale for addressing the banking and commerce issue in the context of today's financial modernization.

Panel 2: Reform Proposals: Examining the Role of the Federal Government

Richard M. Kovacevich
Bert Ely
Helen Boosalis
Thomas E. Hales
George J. Benston

Panel 2: Reform Proposals: Examining the Role of the Federal Government

Issues and Background

Some industry observers have proposed deposit insurance reforms that would curtail the role of the federal government in protecting depositors. This panel will consider the merits of these proposals in light of the goals of a deposit insurance system, the realities of "too big to fail," and the significance of the reforms enacted in response to the events of the 1980s.

Issues for Discussion:

- *Several proposals would reform deposit insurance by privatizing many of the functions performed by the FDIC. Can these plans credibly guarantee the availability of resources sufficient to maintain stability in times of severe financial stress? Further, is it likely that depositors would maintain confidence in a private system during a period in which many banks were failing? Is it plausible to expect the public to accept something less than a full federal guarantee of insured deposits?*

- *A primary motivation behind the various privatization proposals is to reduce regulatory burden on insured institutions. Given that the government would retain an interest in various aspects of banking activity, such as the safety and soundness of banking institutions, the potential for systemic instability, and the provision of equal access to credit, is it reasonable to expect that the elimination of the federal role in the deposit insurance system would significantly reduce regulatory burden?*

- *To address the problem of moral hazard, several reform proposals would eliminate the systemic risk exception from the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). If the systemic risk exception were eliminated, is it plausible that the government would relinquish the right to intervene in the resolution of a large bank to ensure systemic stability? Is the deposit insurance system the appropriate vehicle for implementing "too big to fail" determinations?*

- *In response to the events of the 1980s, deposit insurance was debated at length and reformed significantly. Among the reform statutes were the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, FDICIA, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, and the Deposit Insurance Funds Act of 1996. In light of the healthy banking environment that has prevailed for much of the period since the provisions of these laws were implemented, should additional major reforms be initiated before the effectiveness of the last set of reforms has been tested?*

A number of industry observers have called for reforms that would reduce dramatically the federal government's role in protecting depositors, effectively privatizing the deposit insurance system. Some advocates of privatization contend that the current system fails to address adequately the moral hazard problem associated with deposit insurance. Others argue that it reduces banks' ability to compete with other financial intermediaries by burdening institutions with intrusive regulations and imposing severe restrictions on the products they can offer.

One set of privatization proposals would retain the FDIC's basic structural form, but transfer its ownership to insured institutions and appoint a new Board of Directors that would include bankers. In addition, the government's full faith and credit guarantee of insured deposits and the so-called "too big to fail" doctrine would be abolished in order to introduce more market discipline. Member institutions would be required to replenish the insurance fund if it fell below 1.25 percent of insured deposits (Kovacevich 1995, BAI 1996).

Another approach to deposit insurance privatization, involving more extensive changes, would require every bank to enter into a contract with a syndicate of voluntary guarantors—largely other banks and thrifts—that would guarantee the original contractual terms of all deposits and most other liabilities of the guaranteed institution (Petri and Ely 1994, H.R. 4318, 104th Congress). The guarantee contracts would be written by a syndicate with the authority to seize system members whose contracts expired or had been cancelled. A "stop-loss" rule would pass all of a guarantor's loss above a certain limit to its own guarantors, in order to spread the burden widely and eliminate the need for the federal government's full faith and credit guarantee. The cross-guarantee proposal would eliminate bank and thrift regulation by the FDIC, the Federal Reserve, the Office of the Comptroller of the Currency, and the OTS, though it would maintain a government backup fund and would repeal many regulations, including examination and reporting requirements.

Capacity and Credibility

A major concern with respect to these proposals is that private systems may not have the capacity to survive a sustained period of catastrophic bank failures (Gorton 1994). Compared to the federal government, private plans have a more limited pool of resources upon which they can draw. This is an important weakness because bank failures tend to occur in waves, closely tied to the performance of the economy. A private insurance system, facing depletion of its fund during a crisis, would need to be replenished by the banking industry at the very time when the industry could least afford it. Bank panics would be more likely if an insurer were not able to honor its obligations immediately. Moreover, in the event of a private insurer's failure, congressional action to restore public confidence might occur only after significant damage had been done to the banking system.

Closely related to the problem of capacity is the question of credibility. For deposit insurance to be effective in ensuring systemic stability, depositors must have confidence that the insurance plan can remain viable in times of severe stress. It is generally agreed that federal deposit insurance was successful in maintaining stability in the financial system throughout the banking crisis of the 1980s, at least in part because insured depositors knew that ample capac-

ity existed and was available to make full payment on their claims.

Confidence in a deposit insurance system also is more likely if its basic operations are generally understood by the insured. It can be argued that proposals involving extensive networks of guarantors may simply be too complicated to inspire confidence. To the extent that, operationally, these systems would be opaque to the public, depositor confidence could be undermined, especially in periods of crisis. Another concern—particularly with respect to a cross-guarantee system—is the potential for conflicts of interest and collusion when participants are responsible for insuring and monitoring their competitors. This situation could be especially problematic in connection with the resolution of failing institutions, when decisions affecting the failure or survival of a bank might be made by direct competitors of that institution.

Any assessment of the feasibility of a privatization plan should consider the experience of state deposit insurance systems in the banking crisis of the 1980s and early 1990s. While 32 deposit insurance funds were in operation as recently as 1982, only six operate today. Most of the funds were state sponsored, although the state did not usually provide any financial guarantees to the fund, and were typically mutual funds with boards of directors drawn from the insured institutions. Almost all of these funds collapsed because of the failure of one or more insured institutions. Although the extent to which private deposit systems of the past resemble current proposals should not be exaggerated, the experience of the 1980s—particularly in Ohio and Maryland—seems to support the argument that private plans have difficulty handling waves of failures. This experience is generally consistent with early evidence from state-sponsored and private schemes, dating back to the 1800s, although some have argued that there were isolated successes (Calomiris 1989).

Regulatory Burden

Proponents of privatization argue that government regulations interfere with the ability of institutions to function as financial intermediaries and make it more difficult for banks and thrifts to respond quickly to changes in the financial services marketplace (BAI 1996). Although the various proposals to privatize deposit insurance differ from one another with respect to some details, all are intended to reduce the burden associated with federal scrutiny.

It is important to note, however, that government supervision—by the OCC, the Federal Reserve, and the states—predates the federal deposit insurance system. Systemic problems in the banking system can have far-reaching consequences for the economy as a whole: They can have a contractionary effect on the money supply, disrupt the payments system, and interfere with the financial intermediary role of banks. These concerns suggest that, even without a direct role in deposit insurance, the government would likely have a strong interest in ensuring that the safety and soundness of banking institutions and a comprehensive system of regulation and supervision were maintained.

In addition, the problem of moral hazard exists in any situation—including private sector insurance schemes—in which insured parties do not bear the full costs of adverse outcomes. The federal government uses capital standards, examinations, and safety-and-soundness regulations to reduce risk arising from moral hazard. In the absence of government involvement, private insurers would almost certainly impose financial standards, require adherence to best practices, and insist on access to management

and any information necessary to evaluate the condition of the institution.

"Too Big to Fail"

In resolving failed institutions prior to 1991, the FDIC operated under a statutory cost test that generally permitted the FDIC to select any resolution method that was expected to be less costly to the insurance fund than a liquidation of the failed institution.[1] In practice, this test often gave the FDIC latitude to resolve failures without imposing losses on uninsured depositors. Moreover, if the FDIC determined that a bank's services were essential to the community in which the institution was located or if the failure of the bank posed a risk to the banking system, the FDIC had the authority to set aside the cost test and resolve the institution without imposing losses on uninsured depositors and general creditors. While in most pre-1991 cases institutions were resolved with no loss to any depositors, those resolutions that resulted in losses for uninsured depositors tended to involve small institutions. As a result, the practice of protecting uninsured depositors and general creditors of large banks from loss in the event of failure became known as "too big to fail," and was criticized for undermining market discipline and being unfair to small banks and their customers.

The least-cost provision of FDICIA, designed to minimize the exposure of the deposit insurance funds to losses from failing institutions, reduces the flexibility of the FDIC by requiring failing banks to be resolved at the lowest cost to the insurance funds. This provision reduces the likelihood that uninsured depositors will be protected in a resolution because it requires the acquirer to compensate the FDIC for the additional cost of covering uninsured depositors. Transactions that would protect uninsured depositors are thus at a considerable cost disadvantage. However, FDICIA provides an exception to the least-cost rule in cases that pose systemic risks. This exception allows the FDIC to select a resolution method that would not impose losses on uninsured depositors and general creditors, even if the estimated cost for such a resolution is greater than that of alternative resolution structures.

The inclusion in FDICIA of the systemic risk exception has fueled criticism that the legislation failed to strengthen adequately the incentive for large depositors and other creditors to exercise market discipline, and preserved the apparent disparity in the regulatory treatment of large and small institutions. Critics argue that as long as the exception can be invoked there will be a temptation to follow the "too big to fail" doctrine when resolving large institutions.

It can be argued, however, that FDICIA made it less likely that a "too big to fail" determination would be made in any cases other than the clearly exceptional. First, the language found in FDICIA is restrictive; the Secretary of the Treasury—in consultation with the President—must determine that there would be "serious adverse effects on economic conditions or financial stability." Such a decision could be undertaken only after favorable written recommendations from both the FDIC Board of Directors and the Board of Governors of the Federal Reserve System, with at least two-thirds of the members of each body voting in favor of the recommendation. FDICIA also requires the FDIC to impose a special assessment on

[1] In a liquidation, insured depositors are paid off, the bank's assets are sold by the FDIC, and uninsured depositors and general creditors share some of the loss associated with the institution's failure, along with the FDIC.

the industry to pay for any losses in excess of the amount it would have cost using the least-cost resolution structure. Taken together, these measures pose a high standard, especially considering the scrutiny that a "too big to fail" resolution would likely receive.

In addition, some have argued that the increased use of certain resolution techniques mitigates some of the adverse consequences associated with bank failures and thereby reduces pressures that may lead to systemic risk exceptions under FDICIA. These techniques, which include the use of bridge banks and "advance dividend" payments to uninsured claimants (based on the estimated present value of proceeds from the disposition of a failed bank's assets), are intended to maintain systemic stability without increasing losses to the insurance funds.

While these changes have not been tested in adverse economic conditions, and most failure resolutions in recent years have involved small institutions, some evidence does suggest that resolution practices are increasingly guided by an approach that promotes market discipline. In 1992—the year following FDICIA's enactment—66 out of the total of 120 bank resolutions resulted in uninsured depositors receiving less than 100 cents on each dollar above $100,000. That was a substantially higher portion than in 1991, when fewer than 20 percent of the failures involved a loss for uninsured depositors. Uninsured depositors at relatively large banks such as First City Bancorporation of Houston, Texas and American Savings Bank of White Plains, New York were left unprotected in 1992. The trend continued in 1993, as uninsured depositors in 85 percent of the 41 resolved institutions were left unprotected. Between 1994 and 1996, 17 out of the 24 resolutions resulted in losses sustained by uninsured depositors.

Some argue that, even without the statutory exception to the least-cost provision, the government would be unlikely to refrain from extending protection to uninsured depositors and other creditors if the Federal Reserve, the FDIC, and the President determined that systemic stability would be otherwise imperiled. This suggests that the issue of government intervention to prevent systemic problems transcends the deposit insurance structure. If the failure of a private firm were to threaten the stability of the U.S. financial system—whether that firm was a bank, a financial services company, or a commercial entity—the decision to intervene would likely be made at the highest levels of the government. While FDICIA currently ensures that such a decision cannot be made independently by the FDIC Board, it can be argued that "too big to fail" is not a deposit insurance issue at all, but rather an economic issue that can only be evaluated in the broader context of public policy. An important question is whether the deposit insurance system is the appropriate vehicle for implementing "too big to fail" determinations.

Recent Reforms

A number of reform measures were enacted following the 1980s banking crisis in an attempt to increase the federal deposit insurance system's effectiveness in controlling moral hazard. While these measures retained the essence of the system conceived to protect small depositors and promote systemic stability, they generally moved in the direction of stronger regulatory and market discipline on bank risk taking.

In addition to requiring the least-cost resolution for resolving failed institutions, FDICIA required prompt corrective action (PCA) for troubled institutions and also

authorized the FDIC to implement a risk-based premium system. Under PCA, the appropriate regulator is required to take increasingly severe corrective action as a bank's equity-to-capital ratio declines. The sanctions begin with restrictions on deposit gathering for institutions that are not well capitalized and culminate in the closing of institutions that are critically undercapitalized for a prescribed period. PCA was designed to reduce moral hazard and to enhance the ability of the insurance funds to withstand the effects of severe stresses in the banking industry.

In addition, the national depositor preference provision in the Omnibus Reconciliation Act of 1993 was enacted to establish a uniform priority of claims on the assets of failed institutions. In the absence of depositor preference, proceeds from the sale of a failed bank's assets would be distributed among the FDIC (as subrogee for the insured depositors it had already paid), uninsured depositors, and other creditors. Under depositor preference, all of a failed bank's depositors—both insured and uninsured—have priority over nondepositors' unsecured claims. Liquidation proceeds thus are used to satisfy FDIC and uninsured depositor claims before other unsecured claimants receive any payments.

Despite these deposit insurance reform measures, proponents of more significant change argue that the recently enacted federal reforms fail to address adequately the effects of moral hazard. For example, some criticize the PCA provision for not narrowing sufficiently the FDIC's discretion in handling failing institutions; that, in fact, PCA fails to require a significant change from the practices already followed by federal regulators (Gilbert 1992). In the view of these observers, FDICIA does not increase adequately the incentives for greater market discipline.

Others have argued that moral hazard in the deposit insurance system has indeed been addressed to some extent by the reform measures already enacted (Benston and Kaufman 1997). Due to the robust condition of the industry since these reforms were implemented, however, their effectiveness has not yet been tested. Banks have built capital levels higher than at almost any time in the past 60 years. Overall asset quality of commercial banks is stronger than it has been since 1982, when asset quality measures were added to bank financial reports. Perhaps most importantly, bank failures recently have been almost nonexistent—no institutions failed between August 1996 and November 1997, a period of 15 months, and only one bank failure was recorded in 1997. In short, the recent history of the banking industry has been characterized by a complete absence of the kind of stresses the reform measures were designed to address. In light of these conditions, it can be argued that calls for major new reform measures may be premature.

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Comments on Reform Proposals: Examining the Role of the Federal Government

Richard M. Kovacevich

Some people incorrectly believe that my idea of deposit insurance reform is to abolish deposit insurance. Let me make my position perfectly clear. I am a strong supporter of a deposit insurance system that protects the unsophisticated depositor, those with $100,000 or less in deposits, in case of their bank's failure. The FDIC insurance fund should be capitalized adequately, invested prudently, and banks assessed appropriately to ensure that such depositors, and only such depositors, are fully, 100 percent, protected. This is, indeed, the founding principle of FDIC insurance. The banking industry is fully capable of creating and maintaining such a fund without government assistance or backing. I very strongly support such a system. What I do want to see abolished is the use of deposit insurance funds to protect all comers under the concept of too big to fail.

I commend the Federal Deposit Insurance Corporation for hosting this forum today. The subject is timely, and it is important. In my opinion, deposit insurance reform is essential if banks are to remain viable participants in the new world of financial services. In this new world banking is necessary. Banks are not.

For the first time in our history, regulation is not the factor that will determine the structure of the financial services marketplace. Financial services modernization is being driven by technology and by consumers' passion for choice; information; advice; and outstanding, efficient service when, where, and how *they* want it. Financial modernization will occur with or without deposit insurance reform. Markets are too powerful and money is too important to let a little thing like deposit insurance stand in the way. If the cost of the deposit insurance system is more than its perceived benefit, people will transact their financial business through less costly channels and, over time, insured banks simply will become irrelevant. The $1.2 trillion in uninsured money market accounts certainly has proved that.

The financial services delivery channel that has resulted from the current deposit insurance system cannot survive because it costs too much. It costs too much because of too big to fail. Too big to fail is at the root of the problem with the current deposit insurance system. The cost of too big to fail is unpredictable and potentially huge. The draconian potential of too big to fail deposit insurance has led the government to seek to

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manage this exposure in the only way it knows how—by regulation.

As a result, banks are subject to intense and expensive safety and soundness regulation. They are limited in the products they may offer and in the affiliations they may have. Regulation limits choices and opportunities. Regulation slows things down, and it is expensive. A recent McKinsey study found that regulatory costs for the 100 largest bank holding companies were $123 billion, 14 percent of their noninterest expense. Without these costs, the average efficiency ratio of these companies would improve from 62.9 percent to 54.5 percent.

This kind of cost might be worth it if the system it paid for worked, but it does not. The savings and loan crisis proved that regulation cannot manage too big to fail risk. Indeed, deposit insurance exacerbated the problem by eliminating market discipline as a safety and soundness regulator. The public fed the frenzy by providing funds at high rates to S&L speculators, knowing that depositors would suffer no loss if the speculations failed. S&L managers knew that they did not have to concern themselves with imprudent risk-taking because their depositors would continue to provide funds that would be protected no matter what. Too big to fail deposit insurance put the incentives in all the wrong places. Managers made high-risk bets with other people's money. The other people's money was not at risk because of deposit insurance. The bettors lost the bets and deposit insurance paid the bill. Regulation watched from the sidelines, proving itself unable to manage the risk.

The best protectors of safety and soundness are market discipline and risk diversification. A well-informed market will react to excessive risk-taking much faster than a government bureaucracy ever can. Historically, the safety and soundness of the banking industry have been compromised by concentration of risks: geographic concentration, industry lending concentration, interest rate concentration, and product concentration. Diversity of income streams and diversity of risk-taking are fundamental to safety and soundness, particularly in today's financial services marketplace. It is the value of diversification that convinces me that many companies will be moving from narrowly based banking to broadly based financial services. In today's environment, a regulatory paradigm that attempts to ensure safety and soundness by limiting marketplace choices will not work. Whether the market or regulation is the more effective safety and soundness regulator is the issue at the heart of the deposit insurance reform debate.

The too big to fail deposit insurance system doesn't work for another reason. Proponents of too big to fail deposit insurance claim that it is necessary to protect the financial system from cataclysmic shock. The problem with this view is that deposit insurance does not cover the financial system. It covers only a small part of the financial system. If the cost of running the part of the system deposit insurance covers is greater than the cost of running the part of the system it does not cover, business will continue to move away from insured institutions to their more efficient uninsured competitors. This movement has been going on for some time. In 1980, money market mutual funds were 23.28 percent of checkable deposits. At the end of the first quarter of 1997, they were more than 150 percent of checkable deposits. Today, 80 percent of the financial system is controlled by uninsured companies. In my opinion, the pattern of movement of financial assets from banks to uninsured institutions alone belies the claim that banks receive a net subsidy from the safety net.

An insurance program that applies to just one part of a system cannot protect the whole system. Unless the cost of deposit-

insurance-driven regulation decreases, financial transactions will simply continue their move to greener pastures outside the insured system and deposit insurance will be left without a system to insure.

The correct model for dealing with systemic risk is not the current deposit insurance model. If a systemic risk problem should occur in spite of a disciplined, diversified market, the government's response should be tailored to the particular crisis at hand, and determined in the full light of public debate. Witness, for example, the Chrysler bailout and the Lockheed, Equity Funding, and Drexel Burnham failures. These are the models that should be used to determine the public response to any systemic risk problem. That each of these situations led to debate about a publicly funded solution illustrates my point: The sources of systemic failure that may require a public response are not confined to banks. That the system absorbed the shock of Drexel without public assistance illustrates the further point that the system can deal with the failure of a huge financial services company without the help of too big to fail deposit insurance.

An existing deposit insurance fund on standby to bail out too big to fail institutions is likely to be used simply because it is there, whether or not it is really needed. Using a preexisting fund to solve a potential problem is too easy. An existing fund creates the illusion that the solution is free and the temptation to spend the money without questioning the wisdom of the expenditure becomes irresistible.

On the other hand, linking the decision to spend with the decision to appropriate the money will lead to more disciplined decision making and less costly decisions. In my opinion, there has not been a bank failure where sophisticated $100,000-and-over depositors should not have taken a loss just as they do every day on their stocks, bonds, and other investments. Let me repeat that. In my opinion, there has not been a bank failure where sophisticated $100,000-and-over depositors should not have taken a loss just as they do every day on their stocks, bonds, and other investments.

The most recent and most nefarious purpose of the deposit insurance system is to help balance the federal budget. Putting deposit insurance on the federal budget is like putting a four-year-old in charge of the cookie jar; at the end of the day, it is unlikely that there will be any cookies. Early in the Clinton administration, there was talk of using FDIC funds to capitalize community investment banks and other social programs. Recently, FDIC funds have been used to pay the S&L FICO bonds. By this June, the FDIC says Bank Insurance Fund reserves could exceed required reserves by $4 billion. Are the banks that supplied the money going to get a refund? Not likely. As OTS director Ellen Seidman said, "When they build up and don't get used, they begin to look like honey pots. There are a lot of Pooh bears out there."

The unfortunate thing about having deposit insurance on budget is that it makes meaningful reform less likely. Instead of focusing on the best way to promote efficient and safe financial markets, the focus becomes how to raise revenue and manage the deficit. Discussion of these issues has no place in the deposit insurance reform debate.

Three questions raised by the deposit insurance reform debate require special comment. The first is, Didn't FDICIA do enough? The second is, Will the public have confidence in anything less than government-sponsored too big to fail deposit insurance? The third is, Government being government, would regulatory burden lessen even if we did abolish too big to fail deposit insurance?

First, didn't FDICIA do enough? FDICIA made important improvements. It established prompt corrective action requiring regulators to deal with failing institutions more quickly, and it required regulators to use least cost resolution in liquidating failed banks. These FDICIA reforms took their cue from the marketplace. In a disciplined market, prompt corrective action and least cost resolution just happen—automatically and without regulatory intervention. In my opinion, the market will always do a better job than regulation that tries to emulate the market. Further, FDICIA did not eliminate too big to fail. The ability to use deposit insurance funds to save too big to fail institutions is the great weakness of the deposit insurance system, and FDICIA continues this weakness.

The second question is, Will the public have confidence in anything less than government-sponsored too big to fail deposit insurance? Proponents of the current system point out that we are living in good times, and ask how will people feel if we encounter a period of bank failures? Evidence suggests that even highly liquid financial assets do not rush to government protected too big to fail banks in times of crisis. The 5-year period with the largest number of bank failures during the last 20 years was the period 1986 through 1990, when there were 945 bank failures. This compares with 67 commercial bank failures during the last 5 years. During all but one of the 1986 to 1990 years uninsured money market mutual funds for the personal sector grew at a faster rate than checkable deposits. People did not rush to insured banks.

It is my opinion that in times of crisis liquid financial assets will move to higher quality institutions. Without too big to fail deposit insurance, this movement will be more efficient than it would be today because a market without too big to fail deposit insurance will be more vigilant in identifying weak institutions.

The third question is, Would regulatory burden lessen for banks even if deposit insurance is reformed to eliminate too big to fail? This is a tough question to answer in a country where more paper probably has been used in complying with the Paperwork Reduction Act than has been saved because of it. I offer an observation and, being an optimist, a suggestion. The observation is that financial services companies not covered by too big to fail deposit insurance are subject to less intrusive and less costly regulation than those that are. The suggestion is that we should try it. If we don't, the marketplace will continue to do its work, and an important segment of the financial services industry will be smothered—ironically, under the weight of the shield that is intended to protect it.

We should not ask too much of the deposit insurance system because it can't deliver. It cannot deliver protection against systemic risk because systemic risk will simply move to less regulated sectors. Supervision intended to protect the deposit insurance system by imposing safety and soundness regulation on insured institutions cannot deliver safety and soundness, because supervision creates a level of moral hazard risk that has the opposite of its intended effect and encourages imprudent risk taking. Recent history has shown that regulation alone cannot manage risk. Market discipline is a more effective safety and soundness regulator than rules can ever be.

Deposit insurance should serve the limited and achievable goal of protecting small savers against loss. Today, that is defined as protecting depositors with $100,000 or less in deposits. That's it. It should give consumers a storage place for liquid assets that is as risk free as a Treasury bill. This should be its only purpose. In my opinion, this level of protec-

tion can be provided by the banking industry itself without government support. It can be provided without the cost of expensive regulation. Indeed, it can be provided by proper investment of today's $28-billion fund such that banks will never have to pay another cent into the fund. It can be provided without banks being forced to march to the heavy drumbeat of special regulatory burden and public service CRA obligations, while their money market and mutual fund competitors dance to the music of the marketplace.

I strongly believe that the allocation of financial transactions among providers should be left to the marketplace. An efficient market will champion safety and soundness. True systemic breakdowns cannot be prevented by micromanaging the activities of selected financial services companies. If a systemic breakdown occurs in any industry, it should be dealt with by the government on the basis of its particular facts.

Comments on Reform Proposals: Examining the Role of the Federal Government

Bert Ely

I want to thank Chairman Hove and the FDIC for the opportunity to speak today on privatizing banking regulation and its attendant deposit insurance and systemic risks. Privatization would be accomplished by statutorily delegating to a new private-sector marketplace the full responsibility for ensuring the prudent operation of individual depository institutions. Legislation to privatize today's cross-guarantee system has been introduced by Representative Tom Petri (R-WI).[1]

A fundamental aspect of privatized cross-guarantees is that they will be optional for individual banks and thrifts. That is, enactment of the Petri legislation will not trigger a forced, mass shift of FDIC-insured banks and thrifts into the cross-guarantee system. Instead, once the system launches under the circumstances discussed below, participation in the system will be entirely voluntary.

The heart of this regulatory delegation is the cross-guarantee contract. Figure 1 illustrates the four parties to each such contract: the guaranteed institution; its direct guarantors, called the cross-guarantee syndicate; an independent firm, called a syndicate agent, which monitors the guaranteed institution's compliance with its cross-guarantee contract; and a government agency charged with enforcing certain risk-dispersion rules applicable to each contract.

Each bank and thrift that elects to become a guaranteed depository institution will have its own cross-guarantee contract, which will be the product of a negotiation between it and those direct guarantors (largely other banks and thrifts) who *voluntarily* agree to guarantee the specified liabilities of that institution under the terms of the negotiated contract. This volunteerism, an essential feature of any marketplace, is absent in today's cross-guarantee system since every bank and thrift, through deposit insurance assessments, effectively guarantees every other bank and thrift. In effect, privatizing cross-guarantees is comparable to a country shifting from an army of sullen conscripts to a professional army of gung-ho volunteers.

A key provision in each cross-guarantee contract will be the negotiated, risk-sensitive formula for calculating the cross-guarantee premium that the guaranteed institution will pay to its direct guarantors.

[1]Mr. Petri introduced H.R. 4318 on September 28, 1996. He will introduce a slightly revised version of this bill in 1998. This bill can be accessed at http://thomas.loc.gov/cgi-bin/query/z?c104:H.R.4318: A synopsis of the 1998 version of the Petri bill is attached.

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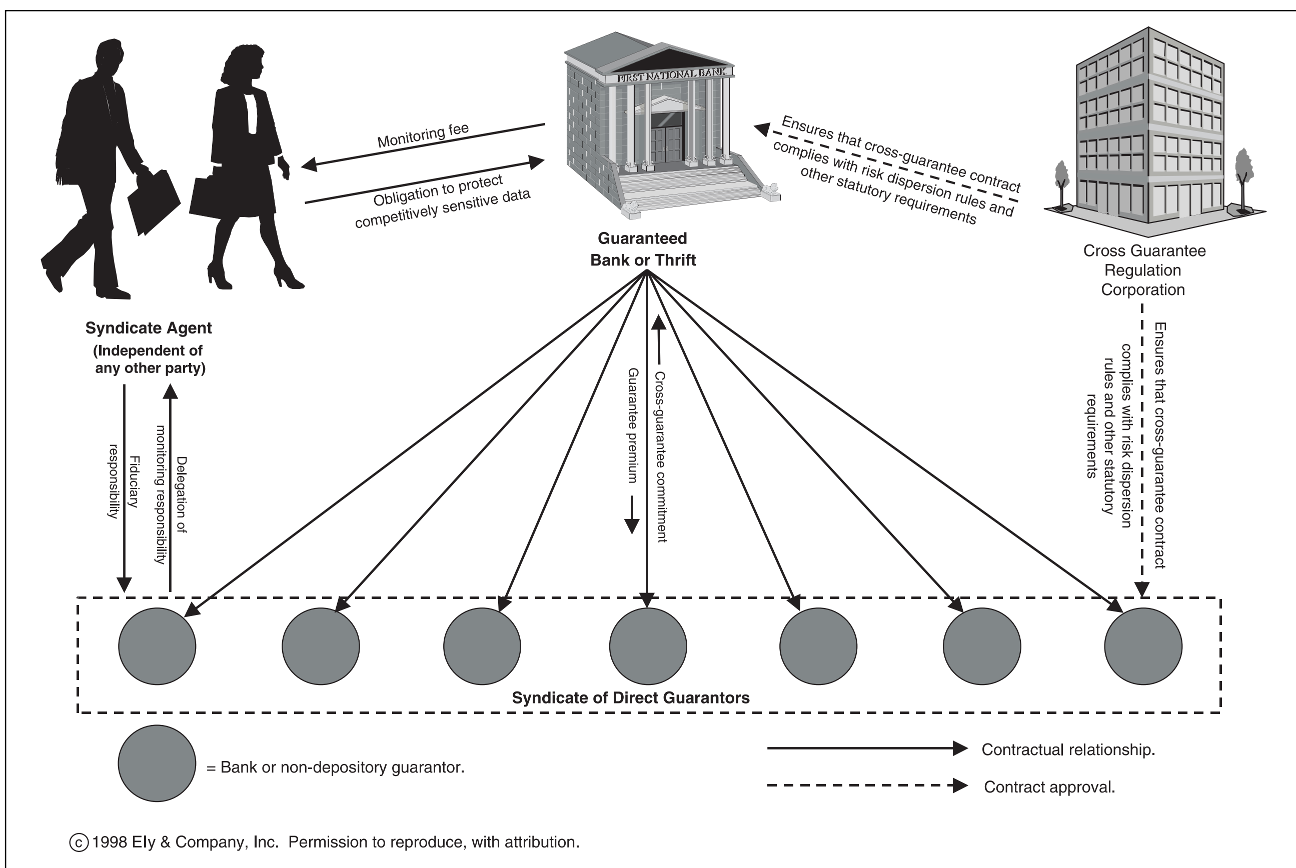
Figure 1. The Parties to a 100% Cross-Guarantee Contract



Premium formulas developed within the cross-guarantee marketplace undoubtedly will be based on *leading* indicators of banking risk, specifically internal risks, such as risk mismatches, rapid growth, and poor internal controls, as well as external risks, notably excessive credit exposure to emerging speculative bubbles. Basing premiums on leading indicators of risk also will compensate guarantors in advance of any losses they may incur, thus undermining any rationale for using taxpayer funds to protect guarantors facing large losses.

Because banking risk changes constantly, cross-guarantee premium rates will be recalculated frequently. A bank's capital effectively serves as an insurance deductible, so a bank's premium rate will increase as its riskiness rises, unless the bank's capital rises sufficiently to offset the higher risk to guarantors. The reverse also will be true.

While cross-guarantee premiums will be the primary deterrent to unwise risk taking by banks, cross-guarantee contracts will contain other provisions designed to ensure the guaranteed bank's sound operation. These provisions, and not statutes or one-size-must-fit-all regulations, will define what a bank can and cannot do. Through the negotiation process, an individual bank or thrift will be able to effectively tailor its regulatory strictures to the business strategy it has selected; today, regulation drives business strategy, which leads to herd effects within banking and to periodic financial crises. Cross-guarantee contracts also will specify the conditions under which a syndicate can step in and take action if the institution that it

has guaranteed is sliding into serious trouble, further lessening herd effects. Therefore, in addition to reducing systemic risk, contractually tailored regulation will lead to a much more efficient banking industry.

The parties to a cross-guarantee contract will designate a syndicate agent firm to ensure compliance with the contract, which it will do through direct, ongoing access to nonpublic data about the institution. In effect, syndicate agent personnel will replace government safety-and-soundness regulators. There will be numerous syndicate agents, which will introduce competition into the regulatory business without creating the competition in laxity sometimes found in government regulation. Whereas government regulators tend to favor their regulatees, the designated syndicate agent under a cross-guarantee contract will carefully balance the interests of both the guaranteed institution and its guarantors since it can be fired by either side. For competitive reasons, syndicate agents will have to diligently protect the competitive secrets of guaranteed institutions, something government regulators apparently do not fear, according to a recent news report.[2] If syndicate agent firms do not perform satisfactorily, they will go out of business and their personnel will be unemployed; this is not a concern of government regulators.

In order to ensure systemic stability by eliminating the incentive to run, each cross-guarantee contract will explicitly protect all depositors as well as all other funding-type creditors, except stockholders and subordinated debt, from any loss for any reason. Therefore, as Figure 2 illustrates, all insolvency risk now borne by depositors and other unsecured general creditors, except nonfunding obligations,[3] will be shifted to the direct guarantors of the guaranteed institution. In effect, the concept of guarantor discipline is substituted for the notion of depositor discipline, which is of dubious efficacy for too big to fail banks. As a bonus, this shift to guarantor discipline will bring all guaranteed institutions an AAA credit rating, which will greatly enhance their competitiveness.

The federal government's role in a privatized cross-guarantee system is limited to enforcing four risk dispersion rules designed not to prevent the failure of individual institutions—that is a private-sector responsibility—but solely to ensure that losses from individual failures are contained entirely within the universe of private-sector guarantors, thereby not falling upon depositors or taxpayers. These rules have been designed to handle banking problems far worse than those experienced during the Great Depression. Table 1 summarizes these risk-dispersion rules; I will not discuss them further.

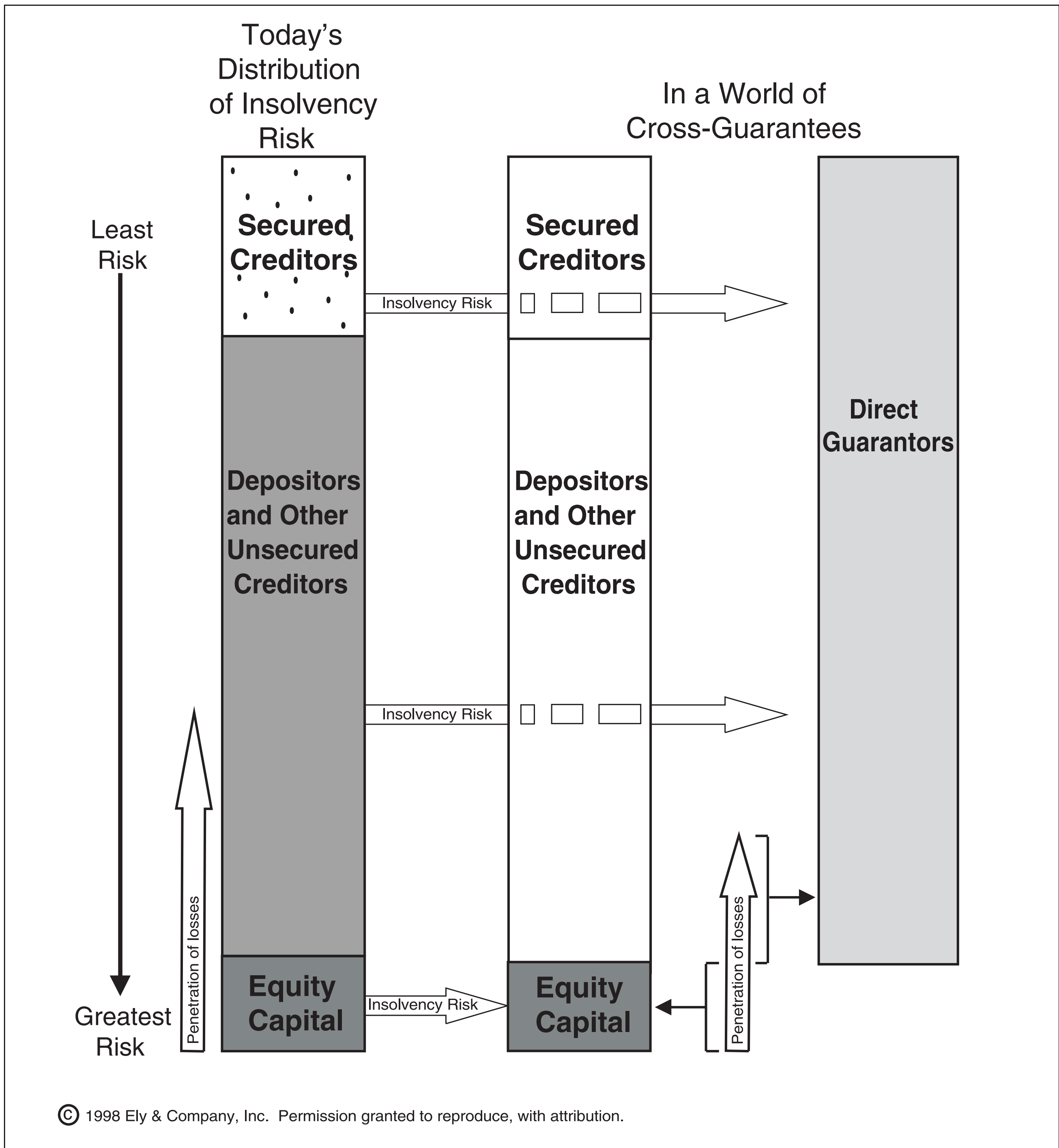
Four other features of privatized cross-guarantees are worth noting. First, in order to broaden the cross-guarantee system's capital base, the Petri bill authorizes "nondepository" guarantors, or NDGs. NDGs can be any person or entity with a net worth of at least $100 million which has first obtained a "stop-loss" contract that guarantees the NDG's cross-guarantee obligations.

Second, the bill keeps FDIC insurance in place so that banks and thrifts can continue displaying the FDIC sticker. Further, this insurance will be backstopped by a new FDIC-administered fund, called the Back-Up Fund, or BUF, which will be funded by shift-

[2]Timothy L. O'Brien, "Bank Regulators Circulating Secret Data: Some Lenders Worry About How Korean Records Will Be Used." *The New York Times*, January 14, 1998.

[3]Nonfunding obligations include trade accounts payable, leases and employment contracts, tort claims, and other liabilities not unique to banking organizations.

Figure 2. The Cross-Guarantee System Shifts All Creditors' Insolvency Risk in a Bank or Thrift to an Independent Set of Guarantors



ing monies to it from the BIF and SAIF as banks and thrifts obtain cross-guarantee contracts. However, because the entire cross-guarantee system will stand behind every guaranteed obligation, including deposits also insured by the BUF, the BUF will never

pay a loss unless the entire cross-guarantee system collapses after a disaster far worse than the Great Depression. In that event, though, it will be highly problematic if the federal government could meet its deposit insurance obligations. Since the BUF will suffer no losses, it will collect no premiums.

Guaranteed banks and thrifts will display a second sticker which will state that all deposits are fully guaranteed under an approved cross-guarantee contract. Eventually, the new sticker will gain the public trust now attributed to the FDIC sticker, thereby eliminating the need for the FDIC sticker and the BUF.

The third feature is the market-driven transition to privatized cross-guarantees. Briefly, the privatization process will be subject to two market tests. First, privatization will not launch until at least 250 banks and thrifts with at least $500 billion of assets have voluntarily obtained approved cross-guarantee contracts. Thereafter, individual banks and thrifts will have the option of deciding whether to switch. Switching, though, is strictly a one-way street; once a bank or thrift becomes a guaranteed institution, it cannot, for obvious moral hazard reasons, revert to a federally regulated institution.

The switching option will exist as long as government regulation and the FDIC can pass a second market test—at least 10 percent of the nation's banks and thrifts or institutions holding at least 10 percent of all U.S. banking assets elect to remain in the present system. However, if the government's market share drops below 10 percent, then the remaining institutions will have two years to obtain a cross-guarantee contract or be deemed failed institutions.

Fourth, the Petri cross-guarantee legislation, as introduced, authorizes the cross-guarantee concept only for FDIC-insured banks and thrifts. However, with just a few definitional changes, the cross-guarantee concept can be expanded to encompass any type of financial services provider, specifically securities firms, insurance companies, and managers of financial assets. Further, the Petri bill gives cross-guarantee contracts global applicability. Hence, the cross-guarantee concept provides a way, and perhaps the only way, to satisfactorily address the safety net concerns arising from an increasingly integrated and globalized financial services industry.

Table 2 illustrates something that should be quite evident by now—the many similarities between the present regulatory/deposit insurance system and a privatized system of cross-guarantees. However, as the bullet points note, there are some important differences, too. Time does not permit further discussion of this table—please review it at your convenience.

Five specific factors that make a privatized cross-guarantee system much more attractive than the present regulatory system warrant some discussion. First, privatization will eliminate "regulatory moral hazard,"[4] which arises when regulators do not utilize in a timely manner their unique access to nonpublic information about their regulatees to discipline them or close a failing bank *before* it becomes insolvent. The S&L debacle of the 1980s and the more recent Asian banking crisis amply demonstrate the dangers of regulatory moral hazard.

Second, the Petri legislation incorporates even stronger taxpayer protection than

[4]The concept of regulatory moral hazard is explained in a paper titled "Regulatory Moral Hazard: The Real Moral Hazard in Federal Deposit Insurance" which the author presented at the 1997 meeting of the Southern Finance Association, November 22, 1997. This paper can be accessed at http://www.cais.com/ely/sfa1197.pdf.

FIRREA[5] and FDICIA[6] currently provide, for two reasons. One, the inclusion of NDGs in a privatized cross-guarantee system will broaden the capital base over which insolvency losses can be spread. Two, because guarantors will not be a source of funding for guaranteed institutions, politicians will not fear a bank liquidity crisis if they do not bail out the guarantors.

Third, the Petri cross-guarantee bill enthusiastically embraces for *all* banks the underlying concept of too big to fail, which is that depositors should not suffer when a bank fails even if the institution disappears, its stockholders are wiped out, and its employees lose their jobs. Too big to fail is a political reality of the industrialized world—as we have seen time and again, most recently in Asia—and properly so, because no matter how fast regulators act to close an insolvent or possibly insolvent institution, the smartest, most savvy, and best-connected depositors will flee soon enough and far enough to avoid any loss. That reality ensures systemic instability if a large institution is shut down or if only its protected liabilities are transferred to another institution. Politicians therefore recognize that too big to fail is a very wise policy, not only to ensure systemic stability, but also because the underlying cause of banking failures has been *government* regulatory failure.

Fourth, the opportunity to switch to the privatized cross-guarantee system should be very attractive to banks and thrifts for many reasons, including those cited above. Privatization should be especially attractive to community banks, in part because cross-guarantee contracts will end the too big to fail discrimination that community banks now face. However, as I noted above, privatizing cross-guarantees will not occur unless a sufficient number of banks and thrifts voluntarily obtain cross-guarantee contracts. Hence, if privatization does not have the appeal that I believe it does, it will never occur, despite enactment of the Petri bill.

Fifth, the private competitive marketplace for cross-guarantees created by the Petri legislation will outperform a government monopoly or even competing government regulators. Specifically, markets can differentiate much better in tailoring a product or service to a customer's needs than can government agencies, which must operate under one-size-must-fit-all rules. Also, markets can much more effectively use the pricing mechanism to deter unwise risk taking by banks.

In closing, just ask yourself who, as a taxpayer, would you rather have protecting your desire for a sound banking system—government regulators with their incentives or private parties who have put their own capital at risk and therefore have a powerful financial incentive to do a good job?

A recent Treasury Department report, "American Finance for the 21st Century," observed quite accurately why banking regulation must rely much more on market mechanisms: "Markets tend to be less forgiving than regulators, who may be more willing to give a troubled institution time to work through its problems."[7] Privatizing the existing cross-guarantee system will provide the banking system with that much needed market-driven regulation.

[4]The concept of regulatory moral hazard is explained in a paper titled "Regulatory Moral Hazard: The Real Moral Hazard in Federal Deposit Insurance" which the author presented at the 1997 meeting of the Southern Finance Association, November 22, 1997. This paper can be accessed at http://www.cais.com/ely/sfa1197.pdf.

[5]Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

[6]Federal Deposit Insurance Corporation Improvement Act of 1991.

[7]Robert E. Litan, with Jonathan Rauch, "American Finance for the 21st Century." The United States Department of the Treasury, November 17, 1997, p. 118. This report (inexplicably minus page numbering) can be accessed at http://www.treas.gov/whatsnew/amfin.pdf.

Table 1. The Four Principal Risk-Dispersion Rules of a Privatized Cross-Guarantee System

Rule No. 1 (The Cardinal Rule)

Every guarantor must itself be guaranteed at all times by other guarantors with regard to all of its cross-guarantee obligations.

Rule No. 2

Every cross-guarantee contract (for guaranteed depository institutions) and stop-loss contract (for nondepository guarantors) must have a minimum number of direct and second-tier guarantors, with no direct guarantor assuming more than a specified share of the risk under the contract. For example, a bank with more than $10 billion of assets must have at least 100 direct guarantors, no one of which can assume more than 1 percent of the bank's cross-guarantee risk. Further, the direct guarantors of the bank must themselves have at least 250 unique guarantors (second-tier guarantors of the guaranteed bank), some of whom also can be direct guarantors of the bank.

Rule No. 3

Each guarantor is subject to two cross-guarantee premium limitations:

- In the aggregate, a guarantor cannot earn in any 12-month period cross-guarantee and stop-loss premium income exceeding percent of its net worth. For a guarantor which is a guaranteed depository institution, net worth is defined in its cross-guarantee contract. For a nondepository guarantor, net worth is defined under generally accepted accounting principles.
- For any one contract, a guarantor cannot earn in any 12-month period cross-guarantee or stop-loss premium income exceeding 3 percent of its aggregate premium limit for that period.

Rule No. 4

Each guarantor is subject to a uniform, mandatory stop-loss rule which provides that a guarantor will pass through to its own direct guarantors all cross-guarantee and stop-loss losses that it accrues in any 12-month period that exceed five times the amount of cross-guarantee and stop-loss premium income that it accrued in that 12-month period. Since, therefore, losses in any 12-month period cannot exceed 15 percent of a guarantor's net worth—less than one year's earnings—no guarantor should ever fail by virtue of being a guarantor.

Table 2. Parallels Between the Present Regulatory/Deposit Insurance System and Privatized Cross-Guarantees

Present Regulatory/Deposit Insurance System	Cross-Guarantee (C-G) Concept
Regulatory philosophy Government regulates individual institutions, with backup marketplace discipline to ensure systemic stability	*Regulatory philosophy* Regulation of individual institutions delegated to C-G system; government enforces risk-dispersion rules
Regulatory framework Statutes, regulations govern bank activities Competition in laxity Regulation shapes business strategy	*Regulatory framework* C-G contracts govern bank activities Competition in excellence Business strategy shapes regulation
Regulatory personnel Government employees Regulators do not suffer personally if high losses occur	*Regulatory personnel* Private-sector syndicate agents (SAs) SAs go bankrupt; SA personnel lose jobs if high losses occur
Risk-sensitive premiums Based on *lagging* indicators of risk Premium spread is too narrow	*Risk-sensitive premiums* Based on *leading* indicators of risk Market-determined premium spread
Market discipline Uninsured depositors expected to run from troubled banks if regulators fail to act	*Market discipline* Risk-sensitive premiums; monitoring by SAs; financial interest of guarantors
Banks, thrifts insure deposits Every bank must guarantee every other bank Deposits insured to $100,000	*Banks, thrifts guarantee deposits* Voluntary guarantee bank-by-bank All deposits fully guaranteed
Too big to fail For big banks only *Ex post* TBTF assessments under systemic risk exception provision of FDICIA Unfair to "too small to save" banks	*Too big to fail* For all banks and thrifts *Ex ante* C-G premiums buy protection for all deposits, which effectively provides TBTF protection for all banks and thrifts, eliminating need for depositor discipline
FDIC sticker on the door No additional guarantees	*FDIC sticker on the door* Second sticker on the door notes existence of C-G contract that protects all deposits
Deposit insurance funds BIF and SAIF	*Deposit insurance fund* BUF (Back-Up Fund)
Taxpayer risk Banking capital only protection	*Taxpayer risk* Capital of all guarantors

Comments on Reform Proposals: Examining the Role of the Federal Government

Helen Boosalis

I would like to thank my old friend and colleague Skip Hove for inviting me to participate in today's conference on deposit insurance. We regard the issues being addressed here as very important to AARP members. According to the Federal Reserve's most recent Survey of Consumer Finances, households with heads aged 50 and over are more likely to have federally insured accounts than younger households—and the median value of their accounts is higher.

We at AARP are examining carefully all legislative proposals relating to financial modernization, and we will work vigorously to ensure the interests of consumers are fully addressed in any and all efforts to modernize our finance industry.

We appreciate the potential that a modernized financial services industry may offer in the way of new and useful products, as well as in additional cost savings to the consumer. As the industry changes, however, we believe it is critical that measures be taken to ensure the fundamental safety and soundness of traditional banking activities. Among these measures are preserving the federal responsibilities for deposit insurance and regulatory oversight.

Social Security is considered by many the most important and most enduring legacy of President Franklin Delano Roosevelt. Perhaps as important to the peace of mind and financial security of the American people has been another of FDR's legacies—the Federal Deposit Insurance Corporation.

We would do well to recall what we faced—in my living memory and in the living memories of many AARP members—when there was no FDIC. Between the stock market crash of October 1929, and March 1933 when President Roosevelt took office, more than 9,000 banks failed. The life savings of untold thousands of families were lost forever. Our nation's financial system was near collapse.

Since the FDIC guarantee of bank deposits took effect on January 1, 1934—64 years ago—not one depositor has lost a cent of insured funds. We cannot afford to underestimate the strength of that record of success, nor the enormous reservoir of trust and confidence it has inspired. As Roosevelt said in his very first "fireside chat," "There is an element in … our financial system more important than currency, more important than gold, and that is the confidence of the people."

We recognize the importance of assessing the effectiveness and strength of our deposit

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insurance system, along with that of our financial system as a whole. But we cannot support reform proposals that do not adhere to what we view as basic and fundamental principles of consumer protection such as safety, information disclosure, and access.

Consumers should be able to purchase goods and services that are safe and carry appropriate warnings if they put the consumer at risk. Safety of deposits—and equally important, public perception of the safety of deposits—are clearly the most vital components of public confidence in our financial system. Available survey data, as well as common sense, suggest strongly that in today's rapidly changing, complex, and intimidating financial services environment, anything other than deposit insurance backed by "the full faith and credit" of the United States government would not be accepted favorably by the American people and might seriously erode public confidence.

We believe Congress should reexamine the impact of the "too big to fail" policy. Depositors in both large and small institutions must be provided with comparable deposit insurance protection. Consumer accounts should not be subjected to severe restrictions on federal deposit insurance. A fair deposit insurance ceiling must take into account the fact that many older consumers rely upon current deposit insurance levels to protect their savings. A fair insurance ceiling must also consider individual needs such as a reasonable number of accounts, and major events such as life insurance payments; sale of a home, farm, or business; and lump-sum pension payments.

Depositors' funds must be protected from risk. Congress must not allow banks to engage in high-risk activities such as underwriting insurance and securities with federally insured assets. Even for less risky activities—and before any elimination or easing of current restrictions is approved—Congress must first require regulatory mechanisms that, *to repeat*, ensure the fundamental safety and soundness of traditional banking practices. Insured activities must be clearly separated from uninsured activities, and the difference must be made clear to the consumer.

A second basic principle for consumer protection is information disclosure. The marketplace must make available to consumers complete and accurate information regarding the goods and services they purchase. The deposit insurance status of all products sold by financial service providers should be clearly and conspicuously identified.

By offering investment vehicles such as mutual funds and annuities on their premises, banks have provided greater convenience to many consumers and easier access for such products. But such arrangements also contribute to greater confusion and allow greater potential for abuse. According to a survey of bank customers by AARP and the North American Securities Administrators Association, fewer than one in five surveyed understood that government bonds, mutual funds, and annuities are *not* insured by the FDIC. Over three-fourths of these customers did not realize that stocks sold in banks are uninsured.

Consumers should be provided with disclosures about a financial institution's health as well as with information detailing consumer rights in the event an institution fails and is taken over by regulators. The financial services industry's blanket exemption from the Freedom of Information Act should be abolished—although consumer privacy regarding their accounts must not be compromised.

A third principle is access. We will make every effort to ensure that, under any modernization plan, all financial providers who avail themselves of new authority must ensure access to basic deposit and credit services. Financial institutions should be

required to provide a minimum level of banking services to individuals such as basic savings or checking accounts.

These institutions should be required to offer small minimum balances for opening and maintaining an account; and a set number of free transactions, including checking and automatic teller activities. In addition, they should be required to offer reasonable charges beyond the number of allowable free transactions, charges for other services that meet reasonable standards, and an easy-to-understand monthly statement detailing account activity.

In closing, let me say that the FDIC represents precisely what a government program should be—one that not only has accomplished what it was designed to do, but has become for many a symbol of the very strength and safety of our nation. The current role of the federal government in protecting depositors must be preserved and strengthened.

Thank you.

Comments on Reform Proposals: Examining the Role of the Federal Government

Thomas E. Hales

I would like to thank the FDIC for inviting me to participate in this conference on deposit insurance. The issues for this panel are the following:

1. Whether a private deposit insurance system can maintain financial stability and depositor confidence during periods of financial stress, and whether the public will accept less than a full federal guarantee of insured deposits.

2. Whether elimination of a federal role in deposit insurance would significantly reduce regulatory burden.

3. Whether "too big to fail" can be eliminated.

4. Whether additional major reforms to the current system should be initiated before the reforms of FIRREA and FDICIA have been tested.

Based on history, government responsibility, fairness, and plain old common sense, my answer to each of these questions is, "No." Let's look at each issue in turn.

Privatizing Deposit Insurance

The full faith and credit of the federal government are essential to an effective deposit insurance system, both to bring long-term stability to the banking system and to ensure depositor confidence in the system. Just look at the dismal history of private and state-sponsored deposit insurance funds. Remember the Rhode Island, Maryland and Ohio crises? When there were runs on banks in those states, the funds collapsed and depositors were left in the lurch.

To prevent a banking panic, depositors must have confidence in the insurance plan. As former FDIC chairman Ricki Helfer often pointed out, the public relies on the guarantee of the federal deposit insurance system. There is no evidence that depositors would accept anything less.

Contrary to the views of others on this panel, my view is that federal deposit insurance remains important to the American public. In a 1989 *American Banker* survey, 95 percent of respondents said federal deposit insurance was important. In 1989, banks were experiencing hard times. But even when conditions vastly improved, the statistics stayed the same. In 1994, 94 percent of

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respondents to a Gallup survey reported federal deposit insurance is important to them.

The limited resources of private plans cannot compare to the unlimited resources and credibility of the federal government. Private plans may be able to handle isolated failures, but they cannot handle a crisis or a catastrophe. Remember: bank failures come in waves. The system is effective only if it can stem panic in a crisis, thereby assuring stability. Private systems cannot do this.

All we need to do is to look at the thrift crisis to recognize how important the guarantee is to the American public. We relearned the lesson during the thrift crisis, as Japan is learning the lesson today. Clearly, there is no FDIC fund without a government guarantee. The American consumer will not stand for it and should not be expected to give up federal protection for no reason.

Federal Supervision Would Continue Even Without Deposit Insurance

The argument that eliminating the federal role in deposit insurance will reduce regulatory burden is a red herring. When Bill Taylor—a career regulator and an extremely straightforward, honest, and intelligent man—was FDIC chairman, he spoke to the New York Bankers Association at the Waldorf Astoria in front of 100 to 150 bankers. I asked him then if regulation would disappear when FDIC insurance (or the government guarantee) disappeared. His reaction was classic—he smiled as if to say "Don't be silly," and he responded with a very firm "No."

Deposit insurance is not solely responsible for bank regulation and supervision. Even without deposit insurance, the federal government would have a vital interest in bank safety and soundness, to ensure the viability of the financial system and economy. Nonsafety and soundness regulation—the many consumer compliance regulations—would continue. Moreover, the banking system's key role as the primary provider of payment services, including clearing and settling, ensures that the industry will always be regulated.

A major debate will soon begin in the Congress over the U. S. contribution to IMF funding to stabilize Asia. In order to benefit us all, the plan would also rescue loans made by multinational banks, including large U.S. banks, from default. There are U.S. taxpayer funds at play like there have never been U. S. taxpayer funds in play with the FDIC. This directly leads to the regulation—and perhaps more intensive regulation—of our largest banks.

A system of private insurance wouldn't reduce regulatory burden. With private insurance, you just have a new regulator, because private insurers would want supervision and examination rights. This regulation would come on top of any from already existing federal and state bank regulators with chartering authority.

Finally, I note that under some reform proposals, large institutions with complex activities would give up deposit insurance in return for enhanced powers and reduced regulation, while traditional banks would remain subject to regulation. This is contrary to the lesson we should have learned from the S&L crisis: that new powers must be accompanied by enhanced regulation, otherwise new risks to safety and soundness are created. These concerns are spelled out in the FDIC's just-released study on the history of the eighties. The banks that would be out from under the regulatory burden would be the very institutions likely to be too big to fail. They would have de facto coverage without attendant regulation. Meanwhile, ironically, small, noncomplex community banks that pose no systemic risk and must

compete with these large complex entities would be subject to regulation.

Too Big to Fail Cannot Be Eliminated

The contention that too big to fail can be eliminated is a fallacy and a self-serving delusion of large banks. Governments will always intervene when faced with the prospect of systemic risk. Look at Asia today. Our best information is that all large depositors at large Japanese banks will be made whole even if this requires a taxpayer bailout. In Indonesia this week, the decision was made to protect all bank depositors. No developed industrial nation in modern history has allowed its large banks to fail and the U.S. will be no exception.

A mandatory haircut for uninsured depositors in large banks, as proposed by Gary Stern of the Minneapolis Fed, is unworkable. Although it injects more market discipline, it also increases the potential for systemic risk and undermines the FDIC's ability to act quickly and decisively to maintain stability and prevent panic. The Bank of New England experience in 1991 is a case in point. Frantic depositors pulled nearly $1 billion out of the bank in two days. Yet, as soon as the FDIC stepped in, the panic subsided. Because of federal deposit insurance, the panic did not spread to other banks. If uninsured depositors at too big to fail banks can expect to lose only 20 percent of their money, they will still flee, increasing the potential for systemic risk and increasing the potential loss to the FDIC fund.

Saying that Congress should have to vote to bail out a too big to fail bank, à la Chrysler, is not the answer. You cannot have a run on Chrysler as you can on a bank where depositors have an immediate right to withdraw their money. When a bank is involved, Congress cannot act quickly enough to be effective.

Market Discipline in the System and Additional Major Reforms

We have heard already and will hear much more today about the need for more market discipline in the banking system to reduce moral hazard. The FIRREA and FDICIA reforms have already imposed more market discipline on those best able to make sophisticated judgments about the health and strength of a bank—large depositors, creditors and shareholders. Risk-based capital, higher capital standards, risk-related premiums and prompt corrective action give shareholders greater incentive to curb excessive risk taking. And uninsured depositors are no longer routinely made whole when a bank fails. The least cost resolution test ensures that large depositors and creditors are at risk for losses and imposes market discipline. And under the current systemic risk exception in FDICIA, too big to fail cannot be invoked lightly, nor at the sole discretion of the FDIC.

The challenge is to balance reducing moral hazard with the need to provide stability to the banking system. But stability must come before market discipline.

These FIRREA and FDICIA reforms have yet to be tested in troubled times or on a sizable failing bank. The systemic risk mechanism has yet to be invoked. Additional major reforms are premature. Let's give the existing reforms a chance to work before we make irresponsible changes.

The reform proposals on the table are anti-consumer and anti-community bank. Remember that deposit insurance has more than one purpose. It is not designed just to protect small depositors. It also promotes stability in the banking system generally. And it ensures deposit flows to community banks so that Main Street America will have access to credit. The reform proposals are not

justified in terms of the ability of the FDIC to deal with a serious banking crisis.

It's hard for me to believe that anyone in the banking industry would consider further reform of a system that has been so successful, has repaired itself so quickly, and provides so much protection to its customers. If anything, the only reform we should be considering is increasing deposit insurance levels to keep up with inflation. Why are we trying to fix a system that has served us so well?

Comments on Reform Proposals: Examining the Role of the Federal Government

George J. Benston

Well, my academic colleagues actually know me in some respects as Dr. Frankenstein. As you recall, Dr. Frankenstein created a monster. Well, about 15 years ago I was at a meeting similar to this and I met somebody who was working in insurance, and I got him interested in the banking system, and that was Bert Ely. So, he is my monster. I apologize. He has been very good. In fact, Bert's system, which many of us have read multiple times and heard more times than we care to, is basically not that bad. The basic problem it has is the things that in fact Tom and Helen just mentioned—that is, is it even feasible in this environment or the environment of the world that something which indeed almost everyone feels is something we must have, like Social Security, can be substituted with something better or is ever going to go away? I doubt very much that is the case. I completely agree with Tom.

If we look at the history of the world and at depositors in modern times, with the exception of Argentina at one point in the 1980s, and England with BCCI, I can't think of another instance in which depositors have not been made whole in any country in any place. In terms of the issue we are involved in with this current session—what role should the government have—I would like to turn it around slightly and say, why should the federal government have any role? The role basically is that, in fact; it is one we now have. It is incorrect to say, as the handout you may have read says, that the reason that we have deposit insurance is to protect the financial system. In fact, financial collapse and crisis can occur, does occur, and need not occur—it is a function of what the central bank, the Federal Reserve, does or does not do. Deposit insurance won't stop that—never has and never will—because if there is a run to currency, the Federal Reserve can repair that. If there is just a run from one bank to another, then it is a local problem, not a national problem. That doesn't mean that we're not going to have deposit insurance. It doesn't matter whether economists like myself say that is foolish—we have it.

The basic problem is that it is also not necessary for the money supply to be maintained because again that is a central banking function. Going back in the history of government involvement in financial services, indeed it did have a lot to do with the money supply and currency, but that is when banks were, in fact, the major producers of currency. Until 1913, our currency was bank currency—it was hand to hand—and there

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was very good reason for federal involvement and state involvement in the banking system. That's gone. That isn't the case anymore. One question one should raise, and I hope we would think about in a broader context, is why should financial services be regulated at all. Other than the fact that the taxpayer is going to have to pay for deposit insurance and be given the deposit insurance, we do have moral hazard.

The moral hazard is of two types. One is—will individual bankers deliberately take risks knowing heads I win, tails the taxpayer or the prudently run banks who contribute to deposit insurance pay? The evidence on that, frankly, isn't very strong—that bankers deliberately, opportunistically take risks. Even in the savings and loan crisis, there is evidence of individuals doing that—individual banks—but most, 75 percent, of the losses of the savings and loans were because of the fact that if you have any set of institutions that have their money in long-term, fixed-interest-rate obligations and fund them with short-term liabilities, and interest rates rise as they did from 1979 to 1981, we have an enormous insolvency. That is deposit insurance, because no one would have put their money in such institutions if he knew that someone else wouldn't pick up the tab. So, deposit insurance does have a moral hazard, but it is the moral hazard that there will be inadequate capital in insured institutions because the depositors are no longer going to be concerned and the bankers, who were not necessarily opportunistic people who would deliberately take risks, will realize that—just as people build houses in California and in flood plains or the East Coast of the United States before a hurricane—if someone else will pick up the tab, it probably won't happen. So, they will tend to take risks that they might not otherwise take that they didn't have to pay for.

Even more important than that is even if they perceive it reasonably, the question is in a capital assistant, why should anyone other than stockholders or people who know their money is at risk be the ones who absorb that risk?

Even if there are mistakes made or even if someone has a reasonable error in judgment, the question is who shall pay for it because the other side of not having to pay for it is that somebody, like the government, has to come along and say, you can't do these things, because otherwise we'll pay for it. I disagreed with Carter Golembe this morning in the sense that the deposit insurance is insurance. Like any insurance, if something happens, somebody pays the price, and who is going to pay for it?

We have a procedure that was put in FDICIA, and it has several strands which can be improved very considerably, and I agree with Tom very much in that we have a system that is working and can work much better and that will, in fact, obviate the necessity of the government being involved—any government agency—in much banking regulation at all, so that banks, like other financial service firms who compete for the public's dollar and for their business, put together things in the most efficient and effective ways—insurance, securities, whatever you like—as firms do worldwide. We are the only country virtually in the world that has our crazy system where we don't permit the financial services to be put together in the ways that are most efficient for the institutions involved and that are beneficial to their customers.

The major thing is capital. It may be true that depositors are not going to absorb the loss of the deposit bank failing, and here again I would agree with you, Tom, and actually something that Bert said, namely that if there is a problem with the bank, the sophisticated people run and they can run instantly. They needn't monitor the bank. All

they have to do is have another bank account somewhere else, which everyone who has a large deposit has, and simply wire the money out instantly before the bank fails. At that point, it may be that the government agency will not step in, but evidence indicates that it will. Maybe it shouldn't, but it does.

So, what can we do about it? The answer basically is what we now have in FDICIA, but it is not as strong as it ought to be. Basically, we need a higher capital requirement and structured early intervention and resolution, so that the regulatory agencies first may take discretionary action at a point when the bank's capital has eroded, and then must take regulatory action, that is, take over the bank and insist that more capital be put in, or require that the bank be sold, merged, liquidated, whatever, while its capital is still positive. That is real economic capital—not necessarily accounting capital.

Now, there is one very important aspect of it that hasn't been mentioned that I would like to emphasize, and that is the role of subordinated debt in the capital structure of banks. Say you required—let us pick a number that might outrage everybody—a 15 percent or 20 percent ratio of capital to assets. That is outrageous. We couldn't possibly do business at that level. The costs would be way too high. Well, what are the costs of higher capital? The major cost is, under our tax system, that if you have payments to equity holders, that is not a deductible expense because we have corporate income taxes, but if you have payments to debt holders, that is a deductible expense. If you allowed subordinated debt to be calculated fully as capital, then you wouldn't have that tax problem. What is the other problem with having a higher level, say, 15 percent capital that included debt? The bank could make any mixture of debt and equity that it wanted. Now, what is the difference between a bank and any other company? Other companies sell their debt to the public. Other debt isn't insured by anybody, unless they want to buy some private insurance on it. What is the problem? The major problem is that bank debt is very short term and can run very quickly, leaving the bag to be held by somebody else. That is why subordinated debt, if it were to be counted as capital, would have to have a remaining maturity of at least two years to give the authorities time to step in and say, if you don't repair the damage that may have been done, then we are going to take you over. The bright lines, as FDICIA now does, are drawn so that the bankers can't go as they did in the past to Congress and so on and say, look, you really can't close us down—we are serving farm communities, we are serving consumers, we are too big. Too big to fail, by the way, doesn't mean, as we all know, that a bank fails. It means that the depositors are protected—that's all. It doesn't mean that the stockholders are protected, nor would it mean that subordinated debt holders are protected. The question is, can the government step in and take action, saying first, you have to repair this damage if there were losses, and second, if you don't, then we must take you over—you can't go to some congressman and try to stop us because the law requires it. We have that, but we have it at too low a level at this point.

Now, in terms of the other aspects of it, there is another advantage of subordinated debt. One advantage is that because when this is traded in the marketplace, the interest rate that is being charged on it, that it is being traded for, is your early warning that there is a problem. It is the market determination of the risks the bank is taking, as it is for any other corporation—there is no difference. But one might say, what about small banks—they can't sell sub debt. First, they could put up the equity if that were the case.

But, they can sell it. They can sell to the pension funds. They can do what Bert has suggested—they could have cross-guarantees but through the debt by any other major holder who wants to hold it. And, by the way, I should make clear that we're talking about debt sold in large enough denominations, like $50,000, so that we don't have a Keating kind of situation where people said, gee, I didn't know—I thought this was really certificates of deposit. This is large denomination stuff. We know that privately placed paper is done all the time for small corporations with pension funds, with insurance companies, with a whole range of people.

If, in fact, a bank cannot sell a sufficient amount of its debt to a private placement holder or to the public in large denominations, then I think the question is, why should those people get deposit insurance? That is, if the market isn't willing to take the risk, then why should anybody else? That is, it is not an inherent and necessary right that everyone be a banker who cares to be, and in fact we do restrict people from being bankers right now.

So, I don't think the argument that sub debt would be difficult to sell or difficult to hold bears any water. The advantage again is if there are risks that are being taken by the bank, then they will be borne by the people who are supposed to bear risks in our economy, namely stockholders or uninsured debt holders. What happens to depositors? Well, you now have effectively 100 percent deposit insurance for people who want deposits. If people want to take risks, they buy obligations where there are risks, assume they get paid for it, and that is the end of it.

What government regulation would you need at that point? The answer is very little. You would have to find out that in fact this debt was real—that it wasn't a fraud. You'd have to be sure that, in fact, the records are being reported, and there are occasional rogue bankers who might go out and do really wild and crazy things. Therefore, there would be reporting and analysis, and there would be some field recognition. Maybe because I'm a CPA I would say CPAs should audit financial statements. In fact, I know there have been very few instances of CPAs suborning themselves in a sense of not doing something right. They have done it sloppily sometimes and paid the price.

If we had simply strengthened the FDICIA system and the structured early intervention and resolution system that we now have, and made it so that it would be very unlikely for any losses to be borne, then the question of whether the bank should be involved in securities, investments, in anything, is really not an issue, and indeed I would raise the larger question—and I'll leave it at that—why should there be any regulation of financial services at all? We talk about the question that people should have various kinds of services provided for them. Well, that is true for food. That is true for the risks of buying a car and the risks of buying a house. If you look at all of the products that people buy, they are much more difficult to assess than financial products. Why do we regulate those things? I think it is because of the historical accident of money that banks once produced that they don't produce anymore. So, maybe we can go into a new era.

Thank you.

Panel 2: Reform Proposals: Examining the Role of the Federal Government

Discussion

Question—Ken Guenther. I've been in Washington for 37 years now and this is my first visit to the Seidman Center. It is a magnificent facility. I don't think most of us went in the front door, but when you go to the front door there is this hidden writing underneath the Federal Deposit Insurance Center, and this writing is the immortal words of Bill Seidman: "The regulator has not been born that is going to fail a big bank." If you look very carefully under this, they are transcribing this into Japanese.

I would like to thank Helen Boosalis and Tom Hales for their absolutely brilliant statement. I do have a question for Dr. Kovacevich and Dr. Benston. You're making this linkage between doing away with deposit insurance and dangling before banks—that if you do this, you don't have any regulation. My contention would be that if we have moral hazard, when very large American banks make loans to Mexico, Korea, Indonesia, and Thailand, and since I expect large American banks to continue to make loans to developing countries and I expect there will continue to be an IMF, since I expect and hope that the U.S. government will continue to fund the IMF, the fact that there is a backstop now—a stop loss, so to speak, for the large loans American banks make to the developing world—this will always bring regulation in its wake. I don't know if you people saw President Clinton on MacNeil/Lehrer before the State of the Union message. The President, surprisingly enough, talked to Lehrer for about three minutes about the importance of CRA, and I think again CRA ties directly into consumer compliance. Mr. Kovacevich did say that—you do away with deposit insurance, you do away with CRA. I think there is a fiction being dangled before the bankers of this country and the S&Ls of this country. I would just like to ask Mr. Kovacevich and then Dr. Benson, how do you justify, Mr. Kovacevich, your optimism that regulation would go away, and Dr. Benston, that if you did away with deposit insurance, there would be no need for regulation at all? Thank you.

Kovacevich—As I think I said, it is not obvious that is the answer, except if you look at what is happening in the marketplace. The facts are uninsured providers of financial services today represent about 80 percent of the market share, are not regulated, and do not have CRA and other obligations, even though they take funds from the community, from retirees, etc. The linkage that

has this differentiation in my opinion is the government-backed deposit insurance. What Congress does to justify putting burdens on banks that do not apply to other financial providers is to say that because I am backing you, I'm going to require certain things from you. I think that is the linkage. In fact, I think CRA is such a wonderful process that out of fairness, my competitor should have it. That is the distinction—all of this for people who do not want to give us powers that allow us to compete. Again, the excuse—and it's not rational—but it is still the excuse that they link, is safety and soundness reasons and therefore the protection of the taxpayer.

I think both Tom and Helen absolutely made the case for why we need to abolish deposit insurance. Because of that, there should be free services. You shouldn't be able to sell products and services in the same way in your facilities that you do in other facilities. All of these restrictions are because we have a deposit insurance system. It is the excuses, the reasons—I'd also correct Helen—the one person in the 1930s who said this was a mistake is the very person that you quoted: Franklin Delano Roosevelt. It is like saying that the reason we have . . . . . . today was because of the problems of the 1930s. Correct historians would say that actually it wasn't true at all. Banks' performance in that time frame was actually better than the investment banks'. So, there are a lot of redefinitions of history that are factually untrue. You get into this very emotional thing of deposit insurance.

I want to repeat—I am for a system that protects the unsophisticated depositor who has up to $100,000 in deposits. That system should be funded just like it is done in the insurance industry, just like it is done in the securities industry—by the participants. It should be actuarially sound. There should be no set of circumstances that would cause that fund not to deliver to that clientele. Those who have over $100,000 have investments in noninsured funds. They know how to determine what the risks and rewards are, and they should be subject to the same conditions on those activities. I would also take issue that no large banks that failed—Barings was allowed to fail; BCCI was allowed to fail—I didn't see where the problems occurred. There has not yet been a bank that has been rescued in the United States that shouldn't have been allowed to fail. Those who have been involved in it—Bill Isaac, I think, is the classic example—he made a mistake. He will tell you he made a mistake by rescuing Continental. It is this perception that everyone is going to be protected no matter what.

People use the argument of the S&Ls to say that we should have deposit insurance. The S&L crisis, ladies and gentlemen, could not have happened without deposit insurance. People say it is free. I don't know—who paid the $150 billion? It was your associates who paid the $150 billion so that speculators could make a lot of money, and investors who fed those speculators could make a lot of money. As long as we have the moral hazard that exists today, we will have crises, like what is happening in Asia, and like what happened in the S&L crisis here. Again, the very arguments you are using to say we need deposit insurance are the same arguments I use to say why you shouldn't have it. You could not have the crisis that occurred in Asia if there wasn't a perception that you don't have to pay any attention when you are investing with banks.

I just want to conclude again—you can't protect 100 percent of the system by restricting 20 percentof the participants. It can't work.

Hales—I guess this is what makes a ball game. But CRA and consumer protection is

something that we will have because Congress, in its wisdom and by doing the right thing, will make sure this is something we do. We do have charters. So, I think to say that regulation is going to disappear, maybe our competitors in the other industries should have the same responsibilities that we have. We would have it whether we were federally guaranteed or we were not guaranteed.

Kovacevich—Why do we have it and they don't? Just answer that question.

Hales—Because maybe they have lobbied better. We've given up a lot of our market because we don't market too well. That is another discussion. But, let me get back to a point that George made that really, and I know everybody in this room understood what he said—but it was a very big point and it is something that deserves repeating and I think it ends a lot of this discussion—under our present system, if a bank goes down to 3 percent capital, I believe 2 percent capital, the regulators must move. Now, the regulators come in and they examine a bank and its capital. The 2 percent is determined after they have looked at interest rate risk, after they have looked at all of the risks of the bank, and they make that adjustment. George made the point that if that were higher, if that were something like 5 percent, there would be no risk. We would eliminate risk. The risk would belong with the stockholders who can look at what is going on in a bank, and are obliged to look at what is going on in a bank because their money is at risk, and they knew that risk when they did that.

So, I think that if we look at the system we have in place with just a minor tweaking, we can protect everybody in the system. All we really need to do is to raise this thing to 4 percent or 5 percent, and the losses would be borne by the stockholders, and the regulators must do it. Every bank that failed had an equity to capital ratio at the time of failure of well over 5 percent.

Comment—But it was not under the present system of regulation and it was not as adjusted by the regulators.

Benston—And it was structured early so that you have it moving in earlier when the capital ratio—if it were 15 percent and it starts to deteriorate, there is first a discretionary action and then a mandatory action to repair the capital before the takeover.

One of the advantages of being a tenured professor, and why I'm going to continue to be a tenured professor, is that I run the damn class—not anyone else. I have never appreciated it so much as today. Let me, if I may, respond, to Ken Guenther. Ken, who used to be a professor, maybe suffers from what some of us do suffer from, and that is he doesn't listen terribly well. Basically, I did not say that we should do away with deposit insurance. In fact, I said quite the opposite—that we can't do away with deposit insurance. It is just not possible. It doesn't matter whether I would like to or wouldn't like to, depositors will be protected.

Now the question is, and again Tom took my statement so I don't have to repeat it—let the people bear the risk who know they are bearing the risk, and who can't claim we're depositors who can't run, and that was the situation. I am going to add one other thing now that I have a moment, because I won't get it again, I'm sure. But, Ken reminded me of something that I throw out to you as an observation I think you all ought to think about. Why is it that we have not been able to get change? The thing that we heard this morning with Jerry Hawke. The whole CRA business—I wrote an article about a month or so ago for the Journal of Retail Banking

Services that reviews all the literature and evidence on CRA. I would be happy to send a copy to any one of you. I think your estimates of what CRA has done, why it was necessary, why it was passed, and what it is doing now are totally wrong. In fact, it was passed as an antiblack measure, and in fact, it has had that effect. It has not been effective and useful for the people it presumably was supposed to help.

But, aside from that, I suggest that the reason that Jerry Hawke in the Treasury and others before him are finding it very difficult to get change is that if we did away with regulation other than capital regulation, what would happen to the trade associations? What would they have to do? The trade associations are like lawyers—one lawyer can't make a living; two can do quite well. I think they need each other. None of them want to do away with it because basically they have nice jobs. They can come to lovely meetings like this without having to write articles. They can do all sorts of things, and I think as long as we have trade associations and trade association executives, we will never reform banking.

Comment—Let me interject myself here for a moment. I think, at least from what Bill Isaac has told me, that if he were faced with a Continental today, if he knew what he knew at the time Continental failed, he would have done the same thing. If he knew what he knew today, he thought it was a mistake. He bases that on the subsequent failure of a portion of the S&L industry and on some of the larger banks that have done business with Continental or Penn Square.

But, let me ask a question, not of the panel, but of Dr. Ettin, who is representative of the Federal Reserve System. I would like to pose a question: How would the Fed view regulation if there were no deposit insurance, but banks still had access to the discount window and the large dollar Fed wire?

Edward Ettin—That is not why I raised my hand. I'm pretty much going to sidestep that question, other than to observe that when we view the safety net, we view deposit insurance as one component of the safety net. We also include the discount window in the payments system. I'd like to avoid getting into the argument about whether regulation would remain or not remain if deposit insurance was removed, and just make three observations that I think are apropos to this discussion.

One, in the last year or so, when financial modernization has been discussed so avidly on the Hill and other places, and where there are relatively large constituencies that have been convinced by the argument that the market has made financial modernization a necessity, I have not heard any significant player on the Hill be concerned about the safety and soundness of banking as a result of the new financial activities that are being discussed—not one. So, I think the issue that federal deposit insurance is keeping you from getting new financial activities is, I think, not correct. I think you're fighting an earlier battle in the 1980s. There may be some people who have said that, but no staff member has raised an issue, and I don't think any significant congressional players have raised the issue.

The second observation I would like to make is that I think you are absolutely correct that the S&L debacle was caused by deposit insurance, but it was caused by deposit insurance up to $100,000. When the S&L industry was in its significant throes of difficulties and was taking all of its risks, every depositor limited himself to $100,000 in deposits. They had multiple deposit accounts and multiple shares, but they did not have deposits over $1.0 million. When all

the big S&Ls were having problems, there wasn't a dime in deposits over $100,000 to hit.

Finally, on observations about capital and closing banks early or depository institutions early, somebody is going to have to get into these nontransparent assets and see whether the loan loss reserve is correct in order to get the correct capital number. Someone noted that all big banks that failed had large capital just before they failed. That is absolutely right, and that is because the loan loss reserves weren't adjusted correctly, even sometimes by the examiner, or the quality of the assets had changed so dramatically since the last examination that they weren't captured correctly. Capital regulation only works if the loan loss reserves are kept up to date.

Ely—Roger, I would like to respond to one of his observations, if I may, and that has to do with the influence of federal deposit insurance on the financial services modernization debate. My observation has been, from having attended many hearings, the markups, and so forth, that it is a pervasive concern on the part of the members of the U.S. Congress, and particularly the more senior members who were there during the S&L crisis. I remember very well in one session Marge Roukema, who is chairman of the Financial Institution Subcommittee, third or fourth ranking on the full committee, practically lecturing the younger members or the newer members of the banking committee to remember the S&L crisis. She has done that on several occasions. It totally pervades the debate, and in my opinion, represents the single biggest barrier to financial modernization that exists today.

Question—I'm Ned Molnar, Harleysville Savings Bank, Harleysville, PA. I can tell you every time Bert Ely appeared on ABC TV at 6:30 in our community, I had to haul out more "guaranteed by the full faith and credit of the United States government" signs into our banking lobbies. So, I guess Tom and Helen, I would just like to support your comments and reiterate the value not only of the FDIC insurance, but of the resolution that was passed by the United States Congress in either 1981 or 1982—I don't remember, Ken, when it was—when they passed a resolution reemphasizing that the full faith and credit of the United States government is behind the FDIC, and at that time, the FSLIC, which was our insurer. So, we can stand here and say that the FDIC has no value, but I lived through it and I can attest to the fact that we need it.

Ely—Roger, if I can just respond quickly on that, since my comments during the 1980s were referenced. My concern at that time was not the depositors—because I knew they were going to be protected, in part because Congress passed that resolution back in 1982. The concern then and the concern today, particularly in the U.S. Congress, is with taxpayers. That is where the real risk today is—with the taxpayer, not depositors. That is why in the Petri cross-guarantee legislation, we refer to it as a taxpayer protection bill. That is something that we don't want to lose sight of. No one is suggesting at all that depositors are somehow going to be put to risk. I agree with George—it just isn't going to happen in this day and age.

Question—Joe Flader—I'm Congressman Petri's administrative assistant. I would like to make two brief points responding to a couple of the main charges that we would do away with the full faith and credit of the United States government. This was true of an earlier version of the idea earlier in its history, but it is no longer true. The bill keeps

the full faith and credit of the United States government behind the deposits as it does today. All the bill does is interpose some additional protection. The key issue is whether you can depend upon some private parties who have their own money at risk to do a better job of overseeing and regulating banks and other financial institutions than federal regulators do. We make the judgment that yes, if you have proper risk dispersion rules and the proper system set up by the federal government, overseen by the federal government, you can depend on those private parties, with their financial incentives, to do a better job of regulating. That is, I would submit, really what the bill is about.

Question—Hi—I'm speaking for Richard Mead of the Federal Reserve Bank of New York. This is a question for Ms. Boosalis. One of the things we're discussing is how to best protect depositors. If it were possible to devise an effective protection system that does not involve explicit federal government guarantees, would the AARP be taking a position, or would that be viewed as just a technical question?

Boosalis—Well, we are first and foremost against total privatization. We don't think the public would have confidence, to begin with, in that kind of a system. It would do away with protections that now exist. How you could ensure and insure the kind of protections that now exist with the FDIC in a privatization system is not readily understood by me or many others.

Luncheon Address

Introduction by Chairman Hove

Chairman Hove: We are privileged and honored today to have as our guest speaker the chairman of the House Banking and Financial Services Committee, Jim Leach. By education and temperament, Chairman Leach is accustomed to thinking in the long term and taking a global view. Chairman Leach has a distinguished educational background in political science and international studies. In addition to his duties on the Banking Committee, Chairman Leach is a member of the Committee on International Relations and the Subcommittee on Asia and Pacific Affairs. He is also vice chairman of the 20th Century Fund and sits on the Advisory Council of the Woodrow Wilson School of Public and International Affairs at Princeton University. Chairman Leach worked through the farm bank crisis, the savings and loan crisis, and the high number of failures in the late 1980s and the early 1990s. Chairman Leach is uniquely qualified to speak to this group today on our nation's deposit insurance system. Most recently, Chairman Leach persevered in a solution to the disparity between the Bank Insurance Fund and the Savings Association Insurance Fund. Clearly, without his contributions over the past decade, it is very possible we would not have the healthy insurance funds that we have today. Chairman Leach has just returned this week from a fact-finding mission in Asia, and I'm sure that these nations gained as much from his visit as he learned from Asia. Chairman Leach, I'm most grateful to you for your leadership and for your taking time from your schedule today to join our symposium. Please join me in welcoming a good friend, Jim Leach.

Address by James A. Leach

We are in a world in which the negative receives disproportionate attention. Let me suggest that sometimes it is appropriate to accentuate the positive. From that perspective, two aspects of the current deposit insurance system demand attention:

1. The American banking system has never been stronger. Capital to asset ratios are solid and, most important, new techniques for diminishing risk are being developed every day.

2. The deposit insurance system has never been stronger. The FDIC Bank Insurance Fund (BIF), as of the third quarter of last year, has assets of $27.9 billion, which amounts to 1.38 percent of insured banking deposits. And, the Savings Association Insurance Fund (SAIF) has assets of $9.2 billion, which amounts to 1.35 percent of insured S&L deposits.

Because the two funds are above the statutorily mandated 1.25 percent of insured deposits level, no premiums are currently being charged healthy banks for deposit insurance. A modest premium is exacted to pay interest on the FICO bonds, which were issued in the wake of the massive S&L losses of the 1980s. The current situation means that the U.S. banking industry is the first industry of any kind in the history of the world to have prepaid insurance, potentially ad infinitum, unless a banking crisis is precipitated. While the history of banking indicates that substantial mistakes are made every generation or so, the regulatory model currently in place requires prompt corrective action on an institution-by-institution basis.

Here it is important to note that problem institutions are an exceedingly short list today. For the foreseeable future, interest on the deposit insurance funds is likely to accumulate, and calls on these funds are likely to be negligible. Indeed, the meaning of the current market valuation of banking assets is that if regulators close an institution because of inadequate or negative capital today, it is likely to be sold at a premium, rather than a discount, tomorrow.

When bank insurance premiums were high, it was understandable that banks would chafe at their cost. But when they are non-existent, the cost case disappears. Indeed, it defies logic to think a banker would want to walk away from the $37 billion in FDIC assets. The only case for doing so relates to a conjectural assumption that all

The Honorable James A. Leach is Chairman of the Committee on Banking and Financial Services, U.S. House of Representatives.

regulation or constraints on banking behavior would be removed if deposit insurance was removed.

Because there is a cost to regulation, this assumption demands review. It is based on the notion that public policymakers should and would abandon concern for prudential banking practices if deposit insurance were eliminated. This is highly unlikely. Whereas an eager banker might believe that policymakers would abandon all current regulations if deposit insurance were eliminated, the fact is that anyone in public life would have to be concerned with implicit public guarantee problems.

The well-being of the economy and the public depend on prudential and fair credit practices. Policymakers, whether right or wrong, believe banking is too important to be left simply to bankers because, among other things, public treasuries inevitably would be tapped if the banking system collapsed. Here, the Japanese model is instructive. Despite the inherent unpopularity of the initiative, the Diet is this month considering a $300 billion bailout of the Japanese banking system. And ten years ago, Congress set in motion what amounted to a $130 billion (and still counting) bailout of America's S&Ls.

Because a sound economy requires a safe and sound banking system, public liabilities exist even if public funds are not placed in jeopardy by statute. Even if one finds attractive the radical models such as Bert Ely's, one should understand that interbank rules would quickly develop before any institution would accept cross-guarantees related to another. Constraints on banking behavior simply don't go away with the end of deposit insurance.

It is thus my view that while it is better to review long-term issues in good times than in times of emergency, and while systemic changes, preferably modest, should never be ruled out, it is my view that the case for significantly changing deposit insurance rules at this time is totally uncompelling. The current system is strong, it is working well, and it is tampered with at significant risk.

The better way to address problems in banking today, which are a function of constrained powers, not deposit insurance costs, is to advance financial modernization approaches such as those contained in H.R. 10.

I cannot stress enough the overwhelming need for reforming a banking system that is operating under outdated and arbitrary statutory restrictions. The financial services industry is evolving at a rapid pace. Legislation is needed to reflect marketplace changes and to set the ground rules for the next generation of change. New products and innovative approaches that were unimaginable in the 1930s are regularly being introduced, and the financial services industry is chafing at decades-old restrictions on its ability to serve its customers.

Indeed, while virtually all statistics in banking are solid, one is not. Banks are playing a smaller and smaller role in America's savings and credit system. In less than two generations the banking industry's share of the savings pie has declined from two-thirds to one quarter.

Thus, the case for increasing competition within the financial services sector appears to be compelling. There are true benefits to consumers—particularly smaller businesses—as well as individuals. These include more choices for accessing credit and a broader range of financial products, as well as potentially greater convenience from consolidated operations. Economies of scale can be obtained along with expanded markets with fuller integration of financial services.

Homogenization within the financial services sector—banking, securities, insurance—makes sense. But, I would caution again about mixing commerce and banking. There

are few proposals that would jeopardize our deposit insurance and economic systems more than this one. A restructuring of the business world that permits the mixing of banking and commerce would completely abandon the traditional role of banking as an impartial provider of credit and could spread the deposit insurance safety net to commercial investments.

A review of regional economies indicates that those countries with prudential and transparent banking regulation have done well, and those without have found public treasuries jeopardized. Likewise, a review of countries that have experimented with banking and commerce indicates that there are enormous public liabilities associated with such empowerment. The chaebols of Korea, the keiretzus of Japan, and cartels of Indonesia have lessons for the United States. Those in the United States Congress today who advocate financial modernization legislation that mixes commerce and banking might want to take a hard look at the kinds of conflicts of interest endemic to systems that have allowed such mixing.

Unfortunately, the Asian financial contagion is not the kind of event from which an economy as large as ours is totally immune. Economists now suggest that between one-half and one-and-a-half percent of the U.S. GDP growth will be erased this year because of events in Asia. The number could rise if Asian economies and currencies are not stabilized. Virtually all critiques I have read about a policy reliant on institutions like the IMF have a degree of credibility. The problem is that alternatives may be worse. The challenge is to establish a policy that neither ignores the problem, nor Americanizes the solution.

Ignoring the problem will produce an economic cratering of Asia that could be devastating to our export sector and place U.S. manufacturers at a profound currency-related disadvantage. The other alternative—exclusive reliance on the U.S. in a region of strategic significance where we have fought three wars in the past 60 years—would be much more costly to the American taxpayer. The two greatest advantages of the IMF are that it involves burden-sharing, with the U.S. role being 18 percent, and that it has the authority of the international community to insist on modern fiscal, monetary, and banking reform.

The irony of current IMF bashing deserves review. In Latin America, the IMF—which was a decade ago pilloried by the left and right for advancing anti-inflation policies—appears to be increasingly vindicated. Fiscal and monetary polices that have radically reduced inflation have lifted all boats. As for Asia, it is possible that IMF conditionality should include greater concerns for human rights, environmental, and labor concerns. There are few economists, however, who don't support the IMF's efforts to advance greater market competition with less corruption-feeding governmental intervention in various societies. If the IMF didn't exist, analogous institutional efforts would be recreated for each crisis. Whatever mistakes in judgment are ascribed to it, the IMF stands as a coherent alternative to chaos. In times of disorder, institutions that help reestablish order take on enhanced significance, psychologically and substantively.

This type of crisis may be more a result of structural rather than currency problems; imprudent banking practices appear to have been disproportionately responsible for a sudden loss of confidence in several economies. The key at this time is to ensure that the IMF's role is not expanded from being a last resort stabilizer of currencies and economies to a last resort lender to banking systems. The IMF can responsibly undergird economies to protect the public, but it is not the IMF's role to bail out banks.

Capitalists should not be shielded from mistakes of capital allocation.

Hence, it is appropriate for banks to take hits on their banking misjudgments as J.P. Morgan did recently to the tune of a half a billion dollars in reserving against potential losses in Asia. Long-standing international banking covenants dictate that the countries in which banks are chartered and operate are responsible for regulating individual financial institutions and for dealing with problems as they occur. Not only do moral hazard problems come into play with regard to any IMF policy that might be designed to bail out banks, but the wrong publics would be asked to take responsibility.

Let me also state that many people use the term "bailout" in discussing IMF-led programs. Bailout indicates that someone is getting something for nothing. This is wrong on two fronts. First, the IMF is a lending institution, not an aid-granting one, and every year of its existence it has made a profit. Funds transferred by nation-state treasuries to it are the equivalent of bank account movements of resources, not the giving up of assets. Second, no one government or international institution has the capacity to resolve this crisis in Asia. Grand sweeping solutions don't exist. It will take cooperation of governments, banks, commercial businesses, and most of all ordinary citizens to solve this problem.

From a political perspective, the difficulty is that anything that smacks of foreign aid is always controversial, but anything that leads to global recession is even more explosive.

Finally, a note about opportunity. Just as America's manufacturers are disadvantaged with strengthening of the dollar relative to various Asian currencies, America's financial companies are advantaged. A stronger dollar means a greater capacity for America's banks, insurance, and securities companies to lead. Hence, the case for financial modernization increases as opportunity does. For all the world's problems, and perhaps because of some of them, this is a time of opportunity. It is important to put our most competitive foot forward.

Panel 3: Striking a Balance Within the Current Framework

Gary H. Stern
Hjalma E. Johnson
David E. A. Carson
Mark J. Flannery

Panel 3: Striking a Balance Within the Current Framework

Issues and Background

Bank safety-and-soundness regulation and the current deposit insurance system represent an attempt to strike the right balance among the potentially competing objectives of providing stability in the financial system, controlling moral hazard, and minimizing undue regulatory burden. This panel will consider whether the current operational features of the deposit insurance system achieve an appropriate balance among those objectives and whether adjustments are needed to ensure such a balance going forward.

Issues for Discussion:

- *Under the existing statutory framework, the FDIC has limited flexibility with respect to assessment rates if the fund is below the target reserve ratio of 1.25 percent of insured deposits. Legislative changes have recently been considered that would limit the FDIC's discretion even further by requiring all amounts in the fund above a certain level to be rebated back to the banks. What are the appropriate operational rules to ensure an adequate fund without unduly limiting the insurer's ability to smooth losses across institutions and over time?*

- *One criticism of the FDIC's risk-based premium system, which assesses different rates on insured institutions depending upon their capital levels and CAMELS ratings, is that it does not price risk effectively because it is not forward-looking. Is this a fair criticism? If so, what other factors could be incorporated for more timely and accurate pricing of risks to the insurance funds? Can market information be used to improve the risk-based premium system?*

- *The Federal Deposit Insurance Corporation Improvement Act of 1991 allows the FDIC to establish separate risk-based assessment systems for large and small institutions. As industry consolidation proceeds, would such an approach provide advantages over the existing system?*

- *Some have advocated coinsurance or similar measures in order to increase depositor discipline. How likely is it that individual depositors will be able to monitor effectively the financial condition of insured institutions? Would the extra depositor discipline be worth the increased risk of systemic instability? Does simplifying insurance coverage rules have potential benefits, separate from its effect on the amount of coverage?*

The current deposit insurance system attempts to strike a balance among the potentially competing objectives of providing stability in the financial system, controlling moral hazard, and minimizing undue regulatory burden. Striking such a balance presents complex and difficult decisions, in part because there exists no competitive marketplace for providing deposit insurance. It is questionable whether the marketplace alone is capable of establishing a deposit insurance system that maintains stability without dramatically altering the products provided by insured institutions. However, a virtue of market competition is that many critical decisions are guided by the collective knowledge and judgment of numerous market participants. A number of the potential enhancements to the current framework that will be considered below represent attempts to capture the benefit of market participation in the deposit insurance system without generating instability or changing the nature of activities conducted by insured institutions. These potential enhancements relate primarily to the adequacy of the insurance funds, the effectiveness of the risk-based premium system, and deposit insurance coverage levels.

Insurance Fund Adequacy and Operations

The current statutory framework governing insurance fund adequacy provides that, for both the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF), the FDIC must maintain the fund reserve ratio—the ratio of the fund balance to estimated insured deposits—at 1.25 percent. In raising revenue for the insurance funds, the FDIC also must establish a premium schedule that reflects the risk posed to the fund by the paying institution. The current premium schedule consists of nine risk categories based primarily on capital ratios and examination ratings.

In order to maintain the target "designated reserve ratio" (DRR) of 1.25 percent, the FDIC must, as directed in the 1996 legislation that capitalized the SAIF, charge a premium of zero to institutions in the lowest risk category of the premium schedule whenever the reserve ratio is expected to remain above the target DRR. When the reserve ratio is expected to be below the target DRR, the FDIC must either raise premiums sufficiently to achieve the target within one year or establish a recapitalization schedule, not to exceed 15 years, under which the average annual premium charged must be at least 23 basis points of assessable deposits. The FDIC may not lower the DRR for either fund but may raise it above 1.25 percent for a particular year if it finds a "significant risk of substantial future losses" to an insurance fund.

To further facilitate maintaining the DRR, the FDIC has statutory authority to provide refunds to BIF-insured institutions whenever the reserve ratio exceeds the DRR. However, the refund to any institution is limited by the amount of the assessment paid by that institution for the current semiannual assessment period, and is available only to institutions in the lowest risk category of the premium schedule. There is no similar refund authority with respect to SAIF premiums.

The appropriateness of the 1.25 target and the accompanying rules governing deposit insurance pricing depend upon the objectives established for the deposit insurance system. Some have argued that the history of the 1980s shows that a 1.25 percent target should be adequate to maintain solvency and, therefore, the law should be amended to require the FDIC to refund all amounts in the insurance fund exceeding 1.25 percent, (i.e., refunds should not be limited to current

premium income) (*American Banker* November 17, 1997). The 1.25 target was established following the banking and thrift crises of the 1980s, and was adapted from the Depository Institution Deregulation and Monetary Control Act of 1980, which specified a 30-basis point range for the reserve ratio with 1.25 as the midpoint. This midpoint was selected because 1.25 represented the approximate historical average reserve ratio for the FDIC fund prior to 1980. As it happened, the reserve ratio of the bank fund also stood near 1.25 percent as of year-end 1981, just prior to the onset of severe banking problems. Despite the fact that statutory restrictions prevented premiums from rising in a timely manner in response to insurance losses throughout the 1980s, the fund proved to be sufficient to finance all actual losses. The BIF became insolvent in an accounting sense in 1991 only because the FDIC reserved for future losses that never materialized.

Compared with the pre-1980s crisis period, the banking and thrift industries today are better capitalized and more broadly diversified, and operate under significantly different rules established by statutory reform measures such as prompt corrective action, least-cost resolution, risk-based premiums, and depositor preference. As a result, some argue that the possibility of future deposit insurance losses approaching the magnitude of the 1980s is remote. Given that a reserve ratio of 1.25 percent was sufficient to fund the realized losses of the 1980s even without the favorable features of the system in place today, this has been offered as a basis for proposed statutory reforms to require refunds of all amounts in the insurance funds above 1.25 percent of insured deposits.

While this view appears reasonable, the fact remains that the current strength of the industry and the effectiveness of the reforms enacted in response to the last crisis have yet to be tested in a downturn. Faced with intense competition for business, some banks may be compromising their underwriting standards and pricing in ways that will rebound unfavorably. While industry capital ratios are high, so are off-balance-sheet activities, and many of these pose risks to the insurance funds that are difficult to quantify. Similarly, while banks and thrifts are better diversified than in the past, industry consolidation may mean that the funds face increased exposure to the failure of individual institutions. With respect to the numerous reforms undertaken in the past decade, it remains to be seen whether these will perform as intended, and whether they will survive the inevitable pressures to ease the plight of troubled institutions during times of severe stress.

Moreover, it is unclear whether the loss experience of the 1980s represents the appropriate "extreme event" to be used for gauging the necessary size of the insurance fund (or its reserve ratio) to maintain solvency in the future. Some would argue, and the consensus failure predictions of the time would corroborate, that the bank losses stemming from the 1980s crisis could have been significantly larger than the actual experience. A combination of factors, such as macroeconomic policy decisions, regulatory actions, strategic decisions by insured institutions, and economic developments, intervened to reverse the course of numerous FDIC-insured institutions that were troubled and deteriorating. Similar decisions and events cannot necessarily be relied upon to limit losses in the event of a future crisis. From this perspective, the adequacy of the 1.25 reserve ratio for the banking problems of the 1980s does not by itself assure that this is the appropriate target going forward.

An additional consideration relates to the advisability of a single, "hard" target for the

reserve ratio. A potential function of a deposit insurance system is to spread risk over time as well as across insured parties. Combined with the current rules for returning to the DRR when the fund is undercapitalized, a refund policy that provides little cushion above the DRR would effectively establish a "pay-as-you-go" basis for deposit insurance. Such a policy is pro-cyclical, in that it raises the likelihood that mandatory premium increases (to 23 basis points or more, on average) will take effect during downturns, curtailing lending in the economy and exacerbating the problems of already troubled institutions.

This "pay-as-you-go" feature of the system also could significantly increase the overall volatility of net income for insured depositories, given historical experience, and volatility itself may generate additional economic costs. Financial markets typically require higher returns on debt and equity instruments for absorbing the risk associated with greater earnings volatility (Shaffer 1997). To the extent that premium stability and risk-spreading over time are important objectives for the deposit insurance system, consideration should be given to combining any refund policy with greater flexibility in premium-setting when the fund becomes undercapitalized.

To summarize, fund "adequacy" ultimately depends upon the goals established for the deposit insurance system. If maintaining solvency in the face of extreme outcomes were the only consideration, then, conceptually, the choice of a reserve ratio would be reduced to identifying the process that generates insurance losses and selecting the level of protection desired from the appropriate statistical loss distribution (e.g., selecting some number of standard deviations above normal, or expected, losses). In practice, the latter tasks are difficult, involving judgments on the basis of imperfect information about the loss-generating process, as the previous discussion suggests. The issue is complicated further by considering other relevant factors, such as economic costs associated with the premium volatility that may be required to maintain a given reserve ratio continuously. These considerations raise the possibility that greater flexibility in choosing a target reserve ratio, as well as determining the appropriate steps to achieve it, may provide better balance among the relevant objectives.

The Risk-Based Premium System

The current risk-based premium system for deposit insurance involves nine risk categories. Institutions are classified into one of three possible risk-based capital categories and one of three supervisory categories. The supervisory categories are based primarily on examination ratings (i.e., CAMELS ratings). Premiums currently range from zero basis points of assessable deposits per year for the lowest-risk institutions to 27 basis points per year for those in the highest-risk category. Given the favorable conditions in the banking and thrift industries, approximately 95 percent of all insured institutions currently pay nothing for deposit insurance.

The risk-based premium system is one of the post-1980s reforms intended to prevent excessive risk-taking by insured institutions. Charging institutions appropriately for the risk they pose to their insurance fund was viewed as a fundamental step toward controlling the moral hazard problem in deposit insurance. Viewed in terms of the discussion in the previous section, an effective risk-based pricing system would, other things equal, reduce the potential magnitude of insurance losses and, therefore, reduce the size of the fund balance needed for adequate protection. The question is whether the cur-

rent system is likely to be effective in this regard and, if not, whether there are potentially attractive adjustments to this system that should be explored. Two separate, but related, components of effective deposit insurance pricing are the determination of solvency risk (probability of failure) posed by institutions and the determination of insurer exposure (expected loss). These are considered in turn.

Solvency risk. The current risk-based premium system focuses primarily on solvency risk, given that institutions are classified into risk categories based upon their capital and CAMELS ratings. Reflecting the favorable conditions in the industry, more than 9,000 institutions currently are classified into the lowest risk category and pay nothing for deposit insurance. One question is whether this is desirable. Finer distinctions can be achieved by expanding the number of risk categories in the premium matrix, using factors additional to capital and CAMELS ratings for classifying institutions, or both.

The reported capital measures used in the current system tend to be lagging indicators of an institution's financial condition. The examination ratings have been designed to assess the safety and soundness of an institution as of a given date, and thereby identify any institution in a weakened condition that may pose a risk of insolvency. The ratings have proven to be effective in this regard, as demonstrated by their performance in models designed to predict near-term failures (Hanweck, Fissel and O'Keefe 1995). Recent refinements to the examination rating system, including the addition of an explicit market-sensitivity factor (the "S" in CAMELS) and the stronger overall focus on processes to control risk within the institution, contribute a forward-looking dimension that will add further value to these ratings for purposes of assigning risk-based premiums.

Nonetheless, it is reasonable to ask how forward-looking the current premium system can become, given that it is based upon capital and CAMELS ratings. This raises the possibility of looking to additional factors, supplemental to capital and CAMELS, to provide a more prospective assessment of risks and, perhaps, a stronger basis for differentiating among institutions according to their risk profiles.

One suggestion has been to include in the premium system an explicit rating for compliance with "best practices" or similar standards for establishing effective internal controls. This may serve to deter some imprudent practices before their effects become apparent in the financial condition of an institution. Such an approach has been proposed by the Canada Deposit Insurance Corporation (CDIC). As part of the examination process, institutions would be rated on their efforts to adhere to certain "standards of sound business practice," established by the CDIC in 1993, and these ratings would be used as one component of the premium determination (CDIC 1997). The standards cover areas such as credit risk management, capital management, internal control, real estate appraisal, interest rate and foreign exchange risk management, and liquidity management.

It also may be possible to use financial ratios currently reported by insured institutions to identify differences in risk profiles. Certain indicators of asset concentrations, asset growth, and related measures have been used successfully to identify high-risk institutions using historical data (Reidhill and O'Keefe 1997).

Another possibility may be to incorporate reported market information or its surrogates into the premium determination. For example, measures of stock price volatility have been shown to improve the performance of failure-prediction models that

include both capital and CAMELS ratings. Yields on certain debt instruments also appear to be sensitive to the same information that moves bank stock prices (Flannery 1997), and debt ratings provide a possible additional source of information regarding risk exposure. For institutions without publicly traded debt or equity, measures of net income volatility have been shown to contribute to improved failure prediction (Hanweck, Fissel and O'Keefe 1995). In short, given that the market differentiates among institutions on the basis of risk, it may be possible to incorporate some of this information into the deposit insurance pricing system.

A potential difficulty in using reported market prices to influence premiums that are determined by formula involves the interpretation of market price movements. Analytically, the risk component must somehow be distinguished from the other components that may account for price changes, and this may not always be straightforward. One option that avoids any need to decipher market signals is to subject institutions directly to greater market discipline. Recent proposals to increase the loss exposure of large depositors (Stern 1997) or to require institutions periodically to issue puttable subordinated debt (Litan 1997, U.S. Department of the Treasury 1997) are among the possibilities. In the past, lower coverage limits for deposit insurance and various coinsurance schemes also have been proposed as means of expanding depositor discipline. While such approaches may supply the desired market signals, they introduce additional complications, either by posing the possibility of greater instability, altering the deposit products that insured institutions may offer their customers, or imposing a particular funding strategy on insured institutions.

An alternative is to allow direct market participation in the pricing of FDIC insurance risks. For example, private reinsurance might provide an effective mechanism for obtaining direct market prices of the different types of risks facing the insurance funds. This possibility was explored initially in a 1993 FDIC study that described a potential pilot program (FDIC 1993a). Another, potentially complementary approach would be to enlist the market's capabilities to devise contracts that transfer portions of the FDIC's risk exposures at prices determined in a competitive market. The rapid pace of innovation in financial engineering, as witnessed by the emergence of over-the-counter markets in credit derivatives and insurance derivatives, suggests the potential feasibility of such a "market-guided" approach to deposit insurance pricing.

While there are clearly a number of questions and potential obstacles to market participation in deposit insurance pricing, there also are potential advantages. A key part of the FDIC's mission involves the assessment of risk. A similar task is performed by the marketplace. As has been learned from the failure-resolution experience over the past decade, substantial benefits may result from well-designed public-private partnerships under such circumstances. Second, market participation in deposit insurance pricing guards against the possibility of a growing divergence between the market and regulatory approaches to risk assessment as financial innovation proceeds. Such a divergence poses a risk of increasingly severe distortions in investment and lending decisions over time. Finally, this approach has the potential to reduce regulatory burden by effectively comparing the regulatory and market approaches to risk assessment on a continuous basis. Market participation may reveal that certain regulatory practices have become inessential, providing a basis for additional relief.

Insurer exposure. The second component of effective deposit insurance pricing—the

determination of expected loss to the insurer—requires consideration of the liability structure of institutions. For example, a potentially important determinant of losses to the insurance fund in the event of a failure is the proportion represented by deposits in the liability structure of the failed institution. Given the national depositor preference law now in place, an institution with a small percentage of deposit liabilities may pose little risk to the deposit insurance fund, even if it is highly likely to become insolvent. In contrast, an institution with a high percentage of liabilities that are secured may represent a high risk of loss to the FDIC, because secured creditors stand ahead of all others in the receivership. Explicit consideration of liability structure is missing from the existing premium system.

Incorporating liability considerations into the premium determination may pose challenges. It is not clear, for example, that an institution with relatively few insured deposits or secured obligations will inevitably present a small risk of loss to the insurance fund, because uninsured depositors may become insured and unsecured creditors may become secured prior to the institution's demise. There has been scant experience with bank failures under the set of regulatory rules now in place, so that predicting the magnitude of such effects would be difficult.

Large *versus* Small Institutions

In the 1991 law that provided for risk-based deposit insurance premiums, the Congress included explicit authority for the FDIC to establish separate risk-based systems for large and small institutions. The prospect of continued consolidation within the industry suggests that it may be useful to explore this possibility in further detail. Greater consolidation may widen the already substantial differences between small and large institutions in terms of activities, financial structures, geographic presence, and other characteristics. For purposes of risk assessment, community banks and global institutions might usefully be treated as different businesses.

For example, large institutions are subject to closer scrutiny by the market than are small institutions. Their equity shares and numerous debt instruments are publicly traded in competitive markets, and they are monitored and evaluated by large investors, equity analysts, debt-rating agencies, and interested parties around the globe. This may suggest different requirements in designing an appropriate system of risk-based premiums. A possible parallel may be seen currently in the evolution of risk-based capital requirements. Capital regulation is incorporating market practices with regard to internal risk modeling, for those institutions with significant trading operations. Standard risk-based capital requirements continue to apply for all other institutions. Moreover, recent discussions among bank regulators have focused on possible extensions of such a "bifurcated approach" to capital regulation for large and small institutions (FFIEC, 1997).

Similarly, different mechanisms may be appropriate for insuring a group of relatively few, large institutions as opposed to a group of numerous, small institutions. The diverse structures and recent developments in the insurance industry, covering the full range of insurable risks, may suggest future directions for the deposit insurance system. Finally, some may argue that the potential for a "too big to fail" decision should be reflected explicitly in the premiums paid by large institutions. All of these factors suggest that the notion of separate premium systems

for large and small institutions may be worth exploring.

Coverage Limits

Various issues related to deposit insurance coverage limits may be considered in the context of "striking a proper balance." Lowering the current coverage limit has been suggested as a means of providing more depositor discipline on bank risk-taking.[1] As indicated earlier, this approach may effectively change the deposit products that institutions currently offer their customers and carries the potential for greater instability. There may be alternative approaches that provide additional market discipline without introducing these complications.

Some consideration also could be given to the opposite question, whether the coverage limit might usefully be raised. Specifically, it could be argued that the coverage limit should be indexed to reflect increases in prices, income, or wealth. The real value of deposit insurance coverage has declined substantially since the $100,000 limit was established in 1980. Given price inflation, in order to maintain the real level of protection provided by $100,000 in 1980, the coverage limit would need to exceed $195,000 as of 1997.

Another possible reason to consider raising the coverage limit might be suggested by the different nature of the businesses conducted by large and small institutions. Small retail-oriented institutions might be subject to a higher coverage limit than large institutions that are less reliant on deposits. However, some would argue that these considerations must be balanced against the view that the current coverage limit exceeds the amount of insured deposits a small saver is likely to maintain.

A related issue is whether deposit insurance coverage should be voluntary for bank customers. For example, many businesses maintain deposit balances well in excess of $100,000 for payroll and transactions purposes. Banks typically pass along deposit insurance premiums to such customers, and these premiums are based on total domestic deposits. Therefore, some corporate treasurers maintain that they are paying for coverage not received (Logan 1997). In addition, some smaller institutions have indicated that customers in their communities would be better served if the institutions could offer optional, excess federal deposit insurance coverage.

A final consideration involves the complexity of the current rules governing deposit insurance coverage. With eligibility based on numerous separate "rights and capacities," confusion often arises regarding the insured status of deposit accounts. Any simplification of the eligibility rules likely would result in a change in the total amount of deposit insurance coverage available. The issue is whether the potential benefits of simplification are significant and, if so, whether simplification can be achieved with a resulting coverage level that is consistent with the policy objectives related to deposit insurance, such as maintaining stability and controlling moral hazard.

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Comments on Striking a Balance Within the Current Framework

Gary H. Stern

Last summer, in the wake of conversations with a representative of the community bankers, we hosted two meetings at our bank to see if we could reach consensus about deposit insurance reform. The meetings included representatives of Ninth District banking institutions of various sizes and geographic locations, as well as a representative of the FDIC. Needless to say, we did not reach consensus, but the meetings stimulated us to consider the issue of deposit insurance reform once again.

Out of this reconsideration came our current proposal, namely to enhance market discipline by revising the Federal Deposit Insurance Corporation Improvement Act (FDICIA) to explicitly put uninsured depositors at risk in situations where FDICIA's too big to fail (TBTF) provisions are invoked. (Recall that under FDICIA, uninsured depositors at banks deemed too big to fail can be fully protected.) In our proposal, the exposure of such depositors would be limited to, say, 20 percent of their account, to contain spillover effects and the potential for contagion and systemic risk. Nevertheless, the clear intent of the proposal is to put large depositors on notice; to make them more sensitive to the condition of the banks with which they are doing business. If this reform is adopted, we would expect to see differential market pricing of bank liabilities. That would be salutary in its own right, and also could prove valuable in establishing deposit insurance premiums.

Clearly, this proposal is a variation of the coinsurance plan we suggested about ten years ago. The idea is to get before-the-event market discipline from large, uninsured depositors and not to "punish" them after the fact.

Perhaps the most surprising thing that came out of our meetings with Ninth District bankers last summer was their relative lack of concern about the issue of deposit insurance reform. Many of the bankers were not bothered by the perverse incentives of the current system, even though the costs of moral hazard to taxpayers and to economic efficiency have been striking, both domestically and internationally.

Upon reflection, perhaps we should not have been so surprised, because the United States banking system today appears to be sound and stable. That is exactly why this is the appropriate time to seriously consider deposit insurance reform. Because our banking system is healthy, reform can be assessed deliberately and objectively. It also can be phased in over time, to give both bankers

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and depositors ample opportunity to adjust, and to hold disruptions to a minimum. Further, it is not as if bank supervision is a free good; it requires considerable real resources from bankers as well as regulators, and it has not been foolproof. Thus, there appears to be a case for enhanced market discipline as a complement to supervision.

Both the presidential commission that examined the causes of the savings and loan fiasco in this country and the U.S. Treasury in formulating its financial services restructuring proposal in 1991 concluded unequivocally that the moral hazard of deposit insurance had been fundamental in the savings and loan debacle and the exposure of taxpayers. Similarly, examination of the banking crises of the 1980s, and earlier this decade in Asia and other parts of the world by the World Bank, the International Monetary Fund, and the Bank for International Settlements, among others, singled out the moral hazard of government depositor protection as a major culprit.

To be sure, introduction of additional market discipline raises the risk of instability, and some may consider this unacceptable. But as I have argued previously (see "Government Safety Nets, Banking System Stability, and Economic Development," remarks prepared for a conference on "Money and Financial Markets in Asia: A Challenge to Asian Industrialization"), the challenge to policymakers in this arena is to balance two competing objectives; namely, banking system stability and elimination of the costs of moral hazard. There is clearly a trade-off here: stability can be achieved at the expense of high moral hazard costs, or moral hazard can be eliminated at the cost of instability. We think our revised coinsurance proposal strikes a reasonable balance between these objectives.

Let me emphasize that striking this balance is a critical issue. About a year ago, the FDIC hosted a symposium on the banking history of the 1980s and its lessons for the future. Many of you were probably in attendance. Near the end of that symposium, Paul Volcker commented on the repercussions of the TBTF decision to fully protect the creditors of Continental Illinois in 1984. He said: "Even when you had headlines about the weakness of an institution, no depositors moved their money because they had been convinced that the government was going to take care of everything—so you had no market discipline.... How do you get some balance between the rescue and retaining some discipline?"

In conclusion, I would offer four additional observations. (1) In our proposal, the burden of increased market discipline falls on large, presumably sophisticated depositors. More important, if our proposal is in place, we would expect the market for information about the financial condition of banks to broaden and deepen over time. We also would expect depositors to diversify more than formerly. (2) Community banks should welcome our proposal because it goes some distance to leveling the playing field. It does so because, as matters now stand, uninsured depositors have an incentive to bank with TBTF institutions, an advantage that is diminished by our scheme. (3) If our proposal is successful in enhancing market discipline, it should permit over time a reduction in the regulatory burden on banks. (4) History has shown that damage to a country's banks may well damage its growth prospects. If we are committed to attaining over time maximum sustainable economic growth, and I believe we are, then we should take the steps available to improve incentives in the banking system.

Thank you.

Comments on Striking a Balance Within the Current Framework

Hjalma E. Johnson

I would like to thank you, Mr. Chairman, for putting this conference together. It is a great way for regulators and bankers to exchange ideas on a subject of considerable importance to both groups.

I would also like to thank the FDIC staff for preparing background papers to help get us focused. As I read through the materials, I was struck by two things. First, it is clear that bankers and the FDIC have the same goals—a safe and sound banking system that protects depositors with minimal regulatory intrusion. Second, it is also clear that the industry and the FDIC tend to look at things differently. At first, this difference in approach surprised me a bit. But the more I thought about it, it seemed natural that there would be a healthy tension between the industry and the insurer on some key issues. Regulators, after all, are paid to worry.

For example,

- FDIC worries that the insurance fund isn't big enough;
- We think the fund is too big.
- FDIC worries about not having enough flexibility;
- We think it has plenty of flexibility.
- FDIC worries that too many banks are in the lowest risk category;
- We think the goal should be to have *all* banks in the lowest category.

I would like to spend a few minutes on some of these differences.

- First, is 1.25 percent enough? Absolutely.

Consider how FDICIA changed the world: First, it lowered the probability of bank failures; second, it reduced the cost of resolving those institutions that do fail; and third, it made fundamental changes in the way FDIC is funded.

Under the old system, banks paid flat rate premiums set by statute. Maintaining a big fund balance was very important because the regulators had no way to quickly raise premium income to cover losses.

Today, the situation is very different. We have risk-based premiums, flexibility to adjust the premium schedule, and a $30 billion line of credit from the Treasury—which, by the way, must be fully repaid by the banking industry if it is ever tapped. FDIC can

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also raise the 1.25 percent designated reserve ratio if conditions warrant. On the cost-containment side, we have prompt corrective action, conservatorship at 2 percent capital, least-cost resolution, and depositor preference.

Suppose BIF could not grow beyond the required 1.25 percent. Does this constrain the FDIC at all? The answer is no. In fact, the FDIC has a very powerful set of tools to deal with any problems that may develop. At the first sign of trouble, FDIC would increase reserves for losses within the BIF—which do not count in calculating the 1.25 percent. Risk-based premium income would automatically rise as troubled banks move into higher risk categories. If more income were needed to keep the BIF at 1.25 percent, the premium rate schedule itself could be increased. This is the way the system was designed to work. The bottom line is that FDICIA requires the industry to maintain the fund at the 1.25 percent level, and gave the FDIC the flexibility necessary to make that happen.

In my view, it is hard to explain why the FDIC is worried about either the size of the BIF or the flexibility to cope with any reasonable scenario. In fact, as your staff paper pointed out, 1.25 percent was large enough to deal with the crisis of the late 1980s to the early 1990s, *even without the ability to increase premiums and without all the cost containment procedures of the current system.* Our research shows that the BIF could weather such a crisis even if it began with a balance of only 0.25 percent of insured deposits.

In good times, such as now, the current system generates a lot more money for BIF than is needed to pay resolution costs and FDIC operating expenses. With no mechanism for rebating excess income, the BIF has grown to $28 billion—1.38 percent of insured deposits. The BIF is likely to continue to grow rapidly for the foreseeable future. I have to admit that having a big fund—way in excess of the 1.25 percent—means that we bankers don't have to think much about paying premiums anymore. I'm not sure this situation provides the proper incentives for us.

It seems reasonable to me that excess funds should be rebated back to the banking industry—I believe we can find a better use for those funds in our communities than can be found here in Washington.

- Second, should we tinker with the risk-based premium system?

Specifically, should we fine-tune the current system either by adding additional criteria or by creating additional risk categories? My feeling is that we should not. We all knew going in that we could not design a perfect system—one that includes all the factors affecting the condition of every insured institution *and* one that would be forward-looking enough to predict trouble before it got out of hand.

However, the existing nine-grid system has some desirable characteristics. First among these is simplicity. Another is objectivity. The capital ratio categories are straightforward, objective criteria; and the supervisory concern categories, while certainly more subjective, represent the examiner's view of an institution's condition. Bankers can take specific actions—like raise capital—to move up the grid to pay lower premiums. There are significant financial incentives to moving toward the lowest risk category. The fact that 95 percent of the industry is in the top category is clear evidence of that.

Surprisingly, the FDIC seems concerned by the fact that the vast majority of banks are in this top category. The goal should be for *all* institutions to be in this category. Are more boxes better? I don't think so. I espe-

cially don't think we should create a "super-well-capitalized" category. There are two reasons for this. First, it would place unnecessary emphasis on increasing capital at healthy banks; and second, it would send a misleading message to the market that banks not in the super-well-capitalized category don't have enough capital. The regulators should focus on institutions that currently present the greatest risk of loss to the FDIC, not on the best rated institutions.

Should we add more criteria to the grid to make it more forward-looking? At the risk of sounding like a broken record, I don't think so. Complicating the grid by adding more factors and making it more subjective just does not make sense.

Let me make one more point on risk-based premiums. I do not think it is a good idea to have separate systems for large and small banks. While it may be appealing to make such an arbitrary distinction, the fact is the business of banking is fundamentally the same for all institutions—managing risk. While examinations for large and small institutions may vary in scope and sophistication, the criteria for judging the financial condition of all institutions come down to the elements included in CAMELS.

- Finally, should we lower insurance coverage limits?

Absolutely not. The real value of the current coverage limit has already been significantly eroded by inflation. In fact, coverage would have to be *raised* to $195,000 to remain equivalent to $100,000 set in 1980.

The bigger issue with respect to deposit insurance coverage is ensuring that no uninsured depositor is fully protected in a bank failure, regardless of the size of the bank. Coverage limits are meaningless unless those above that limit are subject to loss. Imposing losses on uninsured depositors would provide market discipline to help to contain excessive risk taking. Without the potential for loss, there will be little market discipline.

This means we must get rid of the too big to fail policies once and for all. While FDICIA addressed this to some degree, there is still the perception that policymakers will invoke the systemic risk exception too readily—and when they do, it is the banking industry that bears the cost. We believe a way can be found so that all bank failures can be resolved without resorting to this exception.

In 1990, the ABA proposed the "final settlement payment" as a way to impose losses on uninsured depositors and creditors and provide the necessary liquidity to prevent systemic instability. Whether this method is used, or some other system is adopted, the point is, we need to have policies and procedures in place to resolve a large bank failure if one should ever occur. Now is the time to work on this while the industry is healthy and profitable.

Thank you for the opportunity to present my views. I look forward to the discussion of these issues. Thank you.

Comments on Striking a Balance Within the Current Framework

David E. A. Carson

Thank you, Skip Hove, for the opportunity to be here today and talk about my favorite subject, which is merging BIF and SAIF. All those who are opposed to that are opposed to good public policy, and that is already established. The real question is when will they wake up to the fact that when you propose bad public policy, you continue to get bad public policy.

It occurred to me that I would like to write Skip Hove's next speech—perhaps before a joint meeting of the House and Senate Banking Committees, and Skip Hove would get up and say, "Ladies and gentlemen, in view of the crisis in Asia, I think it is important that I come here and talk to you about the American banking system and the proposals that will ensure that the American public understands that what's happening in Asia will not affect their deposits. What we have determined is that we can have, within the current FDIC system, a very nice, simple system. What we will promise to the American people is that we will do away with all the acronyms that are understood within the Beltway. BIF and SAIF will be consigned to their graves. We will never again refer to FDICIA or FIRREA when we talk to the American consumer. What we will talk about is that the full faith and credit of the United States, and the work of this great agency, have ensured that depositors of banking institutions and thrift institutions in this country have their deposits guaranteed to $100,000, unequivocally, and that our work will be involved in making sure that happens. We will simplify all of the rules. We will make it very clear on one page exactly what that deposit guarantee is to every individual in the country."

I think it is a wonderful speech. I think there are only 20 people in the combined houses of Congress who even care about all those acronyms. The other 90 percent of all legislators understand what their customers want—they want a nice, simple guarantee that the American banking system is the best in the world, and that it will continue to do that and that this great agency will continue to help us all make that happen.

I think given that as a goal, we must establish clear goals. The clear goal is, and you heard it from a variety of people today, you simply have to continue the guarantees to the American public. That is what they have grown up with. In the midst of the biggest economic changes and turmoil going on in this country short of a period of war or economic disaster, don't change that basic promise. Reinforce it. Make it simpler. You

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do that and you ensure, I believe, good public policy.

Now, what should the FDIC then step back and do? They should step back and say, yes, we are the ultimate guarantor. Financial guarantees are not insurance, my friends. One of the questions I was asked to address is, How do you get better risk-based premiums for financial guarantees? The answer is, you don't. I understand there are at least two schools of thought on financial guarantees. There is the very strong, soundly based belief that no premium for a financial guarantee is an insurance premium because no one writes a financial guarantee expecting to ever perform on it. I repeat that—nobody writes a financial guarantee expecting to perform on it. What they expect to do is to guarantee the performance of the person they are guaranteeing.

The best example is suretyship. Suretyship is an ultimate financial guarantee in the simple form; a surety company guarantees performance of a construction contract. The biggest potential surety loss in this country, fully insured, never had a dime of reserve put up against it because the insurance company that was involved maintained that it would complete the project that it had guaranteed. And it did. There was never a dime paid. That is the ultimate guarantee—the ultimate performance of someone in the guarantee business is to ensure that no loss is ever paid. That is what the goal of the FDIC should be. It should be that it will never perform. It will make those requests of guarantee to whomever requests the coverage to perform. That becomes the essence of the system.

There is no risk-based premium that works. As soon as guarantors see risk, they see the potential for failure of performance. What they have to do is move—and have the power to move—to ensure performance. Now, this can involve costs to the person who is getting the guarantee. But it does not involve a prospective premium that will change the relationship. That is the simple way—you've got somebody going down the tubes, you say, "OK, I'm going to run up your premium," and he says, "I don't have any money to pay last year's premium, I might as well gamble even further as long as you're letting me stay in business." I think that happened about 1989-1990.

Financial guarantors ensure performance. They do not pay losses. Basic insurance, basic suretyship—go back to the textbooks—it is written there. There are lots of people who have thought they could make money in the financial guarantee business by taking risk and treating it as insurance. There are lots of companies that are no longer in business that thought that. The ones that have operated in the financial guarantee business and have stayed alive have ensured performance.

One other thing—intercooperative guarantors—the insurance business in this country in the 1960s put together in virtually every state a financial guarantee system to ensure the performance of its companies. In all but one state, all of those were postassessment guarantee funds, again on the same basis. There was no premium up front that would provide a fund large enough for payment of all losses that would come about through failure of the largest companies. So, there was no way to assess a premium. The one thing you could do was to guarantee that if the guarantee corporation ever had to step in on behalf of a failed institution, it could then assess everybody in order to pay off those guarantees. That is the way an interindustry guarantee fund can work. The states, New York being the most notable one, that had a preassessment guarantee were constantly in the throes of a political fight that it was a slush fund for the state government, and it was. There is absolutely no doubt about it. In

other words, you incur risk when you put together funds that do not have a clear and dedicated purpose.

That is instructive. In other words, when you try to meddle with the system we have now, when you step away and say that it is other than a guarantee system and a guarantee of performance by the banking industry, you're in deep trouble because you're trying to say that somehow or another through an insurance mechanism you can raise enough premium to pay for the default of the whole system. That becomes the moral risk. You do away with that risk, you ensure that the enforcers of the guarantee can ensure that the guarantee never pays a loss, and you have a much better system.

So, two things to take away. One is simplify the system. Make it really understandable to the American consumer. That is who is going to vote. That is who our customers are. That is who we ought to care about. The second thing is, stop talking about insurance and stop talking about risk-based premiums. If you're going to insure performance and you know there are risks, you ought to get out of the business or you ought to ensure that those people can perform, which is what other guarantors do when they give us guarantees. We guarantee our asset-backed securities. We get AAA ratings from rating agencies. What we do is we structure them in such a way as to guarantee the performance to the AAA tranche. That is what it's all about. That is guaranteeing performance. That is the guarantee that people want.

If we do that, then I think we can talk about a really viable, simple system that will take care of all of the changes that are going to take place and should take place. We should have diversification. We should have knowledge of it. But we should have an agency that requires reporting, that looks at what is happening, and then has the authority that if there is risk to the guarantee, to act. I think if we do that, we will continue to be able to proclaim to the world that this is the best system in the world and we don't need to replicate the disasters that have happened in other countries and other segments of the financial industry.

Thank you.

Comments on Striking a Balance Within the Current Framework

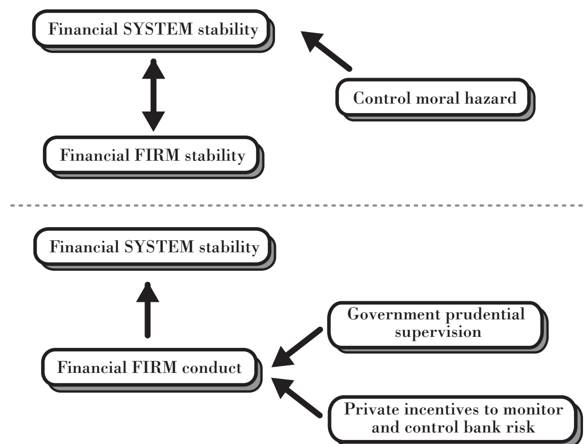
Mark J. Flannery

Thank you. It is a pleasure to be here, and I would like to add my voice of thanks to Chairman Hove and the FDIC staff who have organized this session.

The organizers' suggested discussion points for this session concern ways to "strike a balance within the current framework." As an academic (and therefore an adolescent), the first thing I tried to do was figure out how they might have misstated the relevant questions here. I couldn't find very much to complain about. The organizers' main emphasis is on the top line in Figure 1, which represents our current regulatory system's tension between moral hazard and financial system stability. The tension really comes from the notion that we must ensure financial *firms'* stability in order to have financial *system* stability. Moral hazard arises because the system seeks failure-proof individual firms. Managers and shareholders, expecting to be protected from untoward outcomes, tend to take excessive risks.

My suggestion today is that we should refocus the regulatory system. Rather than basing systemic stability on financial firms' stability, we should induce firm behavior that is consistent with systemic stability. We can concentrate on the largest players in the system, and we should employ a combination of government prudential supervision and private incentives to monitor and control their risk exposures. The major change I would offer to the organizers' basic questions is illustrated in the lower portion of Figure 1: How can we ensure that financial firms' conduct cannot threaten the financial system's stability?

Figure 1.



Today, I would like to make two main points about the lower half of Figure 1. The first point concerns the distinction between *firm* and *systemic* stability. I think that is a very important distinction to make. Second,

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I would like to talk about the extent to which government and private governance mechanisms presently *duplicate* one another, but could be made to *complement* one another.

My first point is based on a simple but very far-reaching assertion: that *the potential for systemic risk reflects poor diversification by individual firms in the system*. Tom Hoenig's discussion this morning about the ex post pressures to which regulators become exposed was right on the point—extremely telling. Regulators come under ex post pressure because everybody knows there are large instances of bilateral credit exposures among important firms. Regulators and the public alike fear potentially crippling bilateral credit exposures. But this is the core of our moral hazard problem! If market participants conjecture that the regulators will step in if a large firm fails, they have scant ex ante incentive to avoid bilateral exposures. Given the bilateral exposures, regulators rationally intervene to protect investors. A vicious circle.

We need to ask whether large bilateral credit exposures constitute an intrinsic part of the financial system. Poor diversification can come from three places: "old-fashioned" credit risk, payment system interconnections, and derivative counterparty risks. The "old-fashioned" kind of credit risk entails the potential default by a bank's loan customers. Continental Illinois provides the most famous example of bilateral credit risk influencing government regulatory policy, and we all know that story. (My question is this: Why did Continental's counterparties accept such a large credit exposure to start with?) Credit risk exposures have become more troubling, and more confusing, as we have become aware of the credit components of our payments and derivatives trading systems. These risks reflect very subtle technical issues, which relatively few people understand fully. Regulators around the world are pondering these issues, as are many industry participants.

Traditional forms of prudential regulation—safety-and-soundness inspections—are pretty good at dealing with old-fashioned credit risk exposures. What is more, the largest number of firms, all of the banking firms in the economy, have the potential to be exposed to these credit risks. By contrast, the big-dollar risks are much more concentrated. The number of financial firms which have substantial amounts of payment system or counterparty derivatives risk probably number no more than 100 in the U.S. Importantly, this leaves about 9,900 banks for which big-dollar counterparty risks are not a problem.

What can we do about these risks? I suggest that we don't view them as exogenously fixed and unavoidable. Large-dollar settlements *need not* involve substantial amounts of credit. Alternative settlement mechanisms can avoid counterparty risks on the payment system and in derivatives transactions: collateralization, real-time gross settlement, various kinds of netting arrangements. Some of these arrangements are even operating at the present time! Although it might be costly to change from our present, credit-based system of settlement, it is not impossible to switch. For example, when the Federal Reserve began to price daylight overdrafts (at what I thought was a rather small premium), those overdrafts fell quite substantially. The institutional arrangements that generate large bilateral credit risks are, in many situations, arrangements of convenience. Nothing fundamental about the economic system requires these exposures.

The legitimate social concern for financial system stability should be the avoidance of large bilateral credit exposures. Private incentives to accept large exposures, when individuals are secure in the knowledge that regulators cannot stand by when large firms

fail, constitute the real externality that needs correcting in our financial system. If we can credibly avoid these bilateral credit exposures, the government can withdraw to its de jure insurance limits. (Whether that insurance limit should be $100,000 or $30,000 or $200, the point is that it is going to be a very different system from what we have today.) When the government withdraws credibly to its de jure guarantee levels, market investors—stocks, bonds, debentures, and who knows what other forms of guarantors—will come forward and design systems that control the risks to which individual firms find themselves exposed.

What do I mean by "credible" avoidance of bilateral exposures? Regulators must be able to convince counterparties and the general public that other firms are adequately diversified against their exposure to a large, troubled firm. Perhaps more to the point, economists must assure the regulators who implement FDICIA that one firm's failure will not generate important systemic effects, because financial firms generally avoid large bilateral credit exposures.

Undoubtedly, some people will be discomfited by the suggestion that we should let large firms fail, despite the fact that it is not a new suggestion. In order to provide a salient point of comparison, I have compared large banks' potential failures to stock market fluctuations in Figure 2. In October 1997, uninsured commercial bank liabilities in the United States were about $1.4 trillion. One of the symposium discussion papers reports that the typical loss to a failed bank's depositors has been about 10 percent. (You will recognize, of course, that I am ignoring the distinction between depositors and other uninsured liability holders.) If this is a reasonably accurate loss estimate, we should expect credit losses of $140 billion *if every bank in the country failed*.

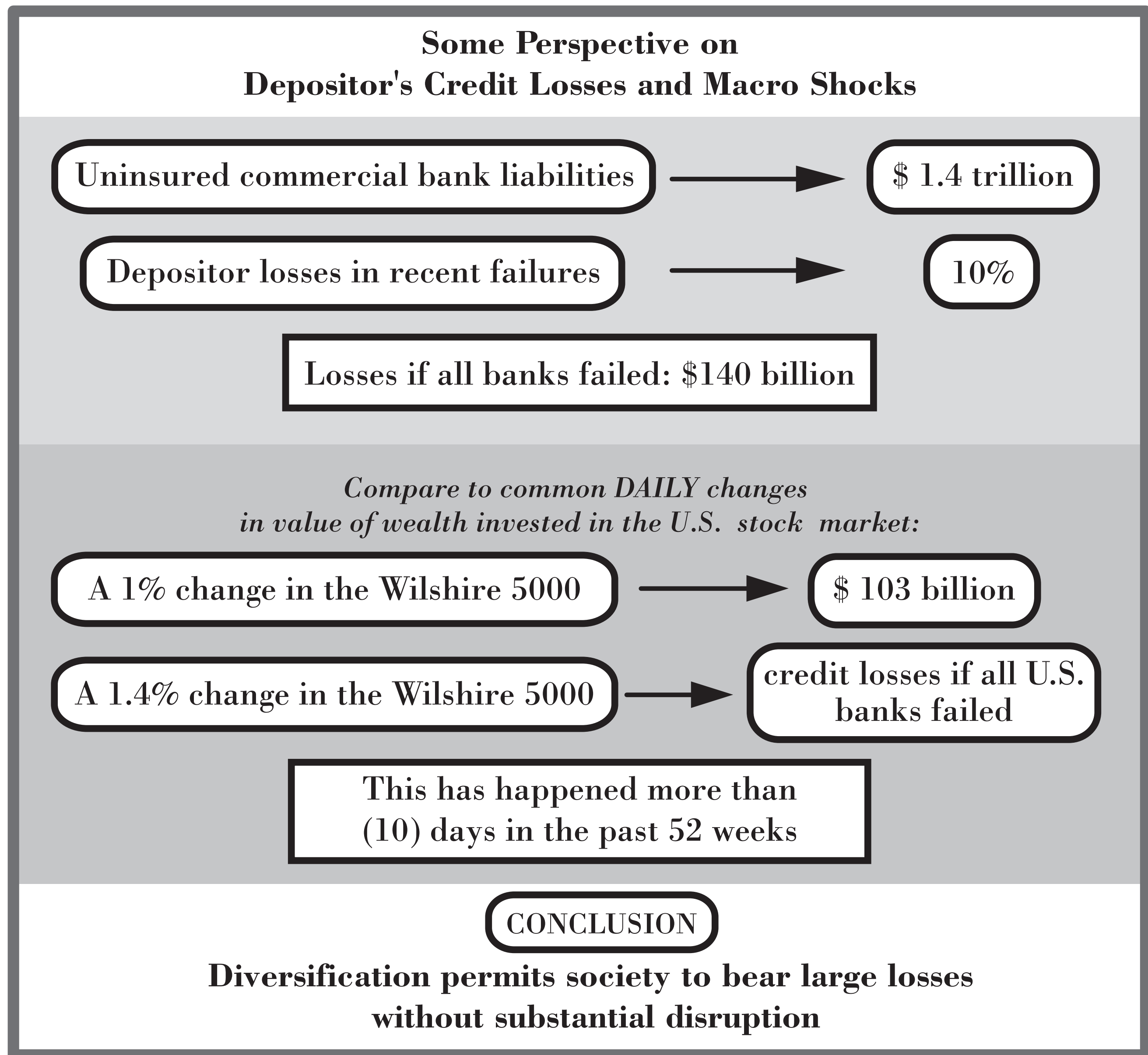
Is this a large loss for the economy to absorb? Consider the stock market, as measured by the Wilshire 5000 index—which is a pretty good estimate of U.S. stocks' total market capitalization. Currently, the Wilshire 5000 is worth in the neighborhood of $10 trillion. A 1 percent decline in stock prices therefore implies a $100 billion loss. A 1.4 percent loss in the stock market is roughly the scale of uninsured losses we would observe if all U.S. banks collapsed. Without trying to minimize the effects of a $140 billion decline in wealth, let me point out that this daily loss actually occurred ten times during 1997. That's about once per month! Why don't losses of this magnitude threaten financial stability? Because they are diversified, and diversification permits society to absorb large losses without intrinsic and substantial disruptions.

Are creditor losses potentially large if a big bank fails? Yes, of course they are. Will the world end as a consequence of diversified absorption of those losses? I think not, and someone wishing to raise our concerns about such a possibility has, I think, a very difficult task ahead of him.

To summarize thus far, I suggest that regulators should withdraw from rescuing large firms. Enforce diversification and let the market take over supervision. My second point follows directly from the first: One size of regulation or prudential supervision certainly should not fit all. It doesn't make any sense. Why?

Large banking firms around the world are already scrutinized by dual supervisory systems. In addition to government regulators, a set of private analysts and investors seek the same type of information and impose similar "corporate governance" restrictions. In the United States, a substantial dual supervisory system applies to a small number of large firms. But these firms (roughly 100 of them) control about 65 percent of the

Figure 2.



industry's assets. By contrast, the larger number of smaller banks have limited—in most cases, totally absent—market supervision. These smaller firms are subject to only one supervisory system under current institutional arrangements, and that supervision is provided by the government.

I have recently completed a review paper of the empirical evidence about market discipline. The main question, it seems to me, is whether investors do a better or worse job (than government supervisors) of identifying changes in banking firms' conditions. I argue in that paper that the market supervisory system really does quite a nice job. It is not obviously better, but neither is it much worse than the government supervisory system. Both of these systems are trying to get at the

same things. They tend to identify problems at approximately the same time. What's more, the empirical literature clearly indicates that the behavior of rational investors and analysts absolutely reflects what they think the government is going to do. The government's actions displace private behavior in bank oversight, just as surely as they do in matters of national defense, police protection, etc. For financial firms, private governance arrangements that might arise under a system of less government oversight will not occur if government is thought likely to protect investors from potential "systemic risks" when a large firm fails.

My suggestion for "striking a balance within the current framework" is therefore to divide the banking system into two parts. Leave the prudential apparatus effectively unchanged for 9,900 small banking firms. This suggestion may strike some observers as cavalier. Surely some regulatory changes would improve the system! Should we change the statutory insurance limit? Should we merge BIF and SAIF? I am unwilling to get bogged down debating these and all the other questions that affect primarily the smallest 9,900 firms, *because these issues are not first-order important*. The regulatory system's main problems in recent years have been with the large and complex companies—and that is where the important problems will continue to arise. This is the set of firms that innovates. This is where risk monitoring and measurement are most difficult. This is where the asymmetry between public and private capabilities are most stark.

The primary role of supervisors vis-à-vis the largest financial firms would be to require and enforce diversified credit exposures. Having thus eliminated the potential for systemic effects if a firm fails, we could withdraw conjectural or systemic guarantees. Market investors would understand their new risk exposures, and market forces would provide appropriate governance arrangements. The FDIC, which will still insure up to $100,000 (or whatever), should assure itself that market investors have somehow taken the first risk exposures, but it should be very flexible about *how* those risks are distributed among uninsured claimants. Some firms will use subordinated debentures (as suggested by George Benston and Bob Litan in his recent Treasury report). Others may seek private guarantees. Still others may establish narrow banks. However, *all banks will not utilize the same techniques for ensuring safety*. The power of the market lies in its ability to fit a proper tool to each firm's specific situation. Provided that safety and soundness are valuable components of a bank's business—as I am certain they are—we will have safe financial firms. However, banks will provide credible safety in differing ways after we remove conjectural government guarantees.

For the 100 largest firms, we can also use market information much more aggressively than regulators presently do. Market information can help supervisors do two things. First, they should *systematically* use stock and bond price changes, deposit rates, and deposit flows to help identify changes in bank condition. While these variables have long formed part of the regulator's information set, there has been little systematic use of that information to supplement examination conclusions and quarterly condition reports. Second, market investors' actions when a firm gets into trouble can be used to justify a prompt supervisory response. Market behavior can instill a sense of urgency at times when regulators might be inclined to "wait just a little bit longer" before acting.

In short, we have underutilized market information heretofore. While I do not have a detailed, implementable procedure to suggest at this time, my reading of the empirical evidence indicates that investors' assess-

ments can help supervisors identify changes in condition, and also improve the speed with which discipline is imposed or disciplinary restrictions are removed.

I conclude with four summary points:

I think we all agree that the social interest involves a stable financial *system*, as opposed to failure-proof financial *institutions*.

The government must have a reliable way to ensure that diversification is an important part of each institution's credit exposures. Enforcing adequate diversification might well be the primary correction that government needs to make to private incentives or to private allocations.

Large banks should be subject to separate regulatory treatment from small banks, because they are qualitatively different. Our bank supervisors have long worried about "fairness" and "equal treatment." While such concerns are laudable and necessary, they have made regulatory change difficult to achieve. "One-size-fits-all" supervisory procedures make it unnecessarily difficult to protect the financial system from the main (potential) sources of systemic risk.

Finally, it would be very useful, and in fact, very feasible, to complement government supervisory activities with the systematic use of market information, for a small number of very important financial firms.

Panel 3: Striking a Balance Within the Current Framework

Discussion

Question—I'm Steve Hailer from North Akron Savings Bank, and I'm a member of the SAIFIAC Committee. The question I would have is that there seems to be a lot of resistance from the trade organizations, the banking organizations to be specific, regarding the unitary thrift charter. I would like to know what specific problems the unitary thrift charter causes for the banking industry, whereas there don't seem to be any problems with the FDIC with that charter. I just wanted to echo Dave's comment that it was nice for the FDIC to give them time to talk about merger of the funds. It is good public policy, and it is the way it should be. But I would like to know what specific problems the unitary thrift charter would cause and why wouldn't somebody else want additional powers?

Johnson—We have no problems with it. We would love to have it; we can't get it. Essentially, when the FICO bond paydown proposal was put, we felt that the Congress entered into a firm and binding agreement that we would not put out $11 billion over 25 years and have no improvement in our charter. We want an upgraded charter. We want ability to offer a wide range of products and services, much wider than we have now. We are not saying every one of our 8,000 banks out there wants to do everything, but we are saying every one of them should have the right to do those things. So, it is a matter of a compact that we went to our members and said, let's back this, let's go for it. The thrifts said, we're still around, that wasn't our obligation. We say, it certainly wasn't our dog in that hunt. If it wasn't yours, it wasn't ours, but we are going to help, and we want a better charter. The first amendment said, give us some certain guarantee that we would receive that better charter before there was a merger of the funds. You have to deal with the Congress on the basis of what you can do. There was no way to merge the funds and get the charter then. We felt like before our money crosses the line, we should have an improved charter, and that is still where we are. We are working hard with ACB, the thrifts, to try to work through that situation and get that moved.

Question—My name is Al Byrne. I was taken by the comment by Mr. Carson, and I hope I wrote it down accurately—"make those who request the guarantee, the protection of the guarantee, to perform." The title of this topic is striking a balance within the current framework, and let me pose a question that I hope links those two thoughts. Implicit in any free-market economy is the notion of choice. Consumers, depositors in this context, are entitled to make choices, and the producers of goods and services, banks and other financial institutions, can

make choices as well. I wonder if a choice for us to make here in the current framework is to allow institutions to request deposit insurance and pay for it and all the costs, not just the premium that goes along with that, or not.

Carson—I think the implications of my statement are exactly that. I would argue that if you look at American savings right now, we have already mentioned that deposits now represent a very small fraction of the American savings. The customer has already opted for uninsured deposits. In other words, the people who want to be in the deposit-taking business know how to be in it without being in the insured-deposit business. They run things called mutual funds, which happen to be structured almost identical to 1820s savings banks in that you have the impartial trustee who makes sure that the money is safe and then you run it so tightly that you don't lose money and the customer is happy.

So, we have, if you will, a dual system today of deposit taking. We don't call it that, and by not calling it that, we give the fiction that somehow the bank deposits are more important than other deposit instruments, obviously the largest one being the money market funds.

I think that becomes the core of how you can restructure for the 21st century. But you can't do it unless you overcome the complexity of what should be a simple guarantee for people who have lived with that. For the millions of Americans who are opting out of that system in terms of putting their money somewhere else, they have already made that decision. So, I think now is the time to do a nice, simple system to recognize that when we get into the payment system and other indicia of banking, there are implicit guarantees that are important, and people who opt to be part of the payment system, in a sense, opt to be party to being guaranteed by a federal agency. I don't think we're going to change the fact that the monetary structure of a country is going to be totally privatized. There is a clear role for government in managing the monetary system. That does not include all savings, all deposit instruments, but it includes very specific ones.

I think when we look to real modernization, we need to look through the titles that we give things. So, I very deliberately used that word, and I'm glad you picked up on it. I do think we are constrained from really modernizing the system because we won't bury the past. The ABA's failure to bury the BIF/SAIF past, to bury their antagonism to thrifts that no longer exist or have been out of business now for years, the failure to move the public policy agenda toward a discussion of what the financial system is today, is the great curse that the ABA has brought on all of us. It is time they got off their ass and did something about it.

Johnson—My momma told me if you can't say something nice about somebody, don't say anything.

Question—Gary, let me ask you a question about your proposal. If I understand it right, when the too big to fail exemption would be used, essentially there would be some kind of announcement that we are taking action in a crisis situation that would have the effect of limiting losses of uninsured depositors or other creditors to 20 percent. Is that . . . .

Stern—The 20 percent is an arbitrary number, but essentially.

Question—I guess the question is, and I think one of the earlier panelists got at this point—in what sense or how would that

restore the stability to the situation that you're being asked to address?

Stern—Let me just make two observations about that. One of the objections in the past has been to the idea of simply interpreting uninsured depositor literally, the size of potential spillover effects and contagion effects and so forth. So, clearly what I have in mind in saying the exposure is going to be at most 20 percent, or pick your number, and clearly our plan when we spell out all the details, is to phase this in over a series of years. I don't know if the number needs to go that high. Jerry Hawke sort of suggested this morning that we might improve market discipline without a very large haircut, but I don't know what he had in mind specifically.

The idea is to assure the uninsured that while they are going to lose something, they are not going to lose so much that their economic viability is threatened, and therefore the risks of major contagion, major systemic effects, are limited. That is the idea behind that.

I think it is just a different version of Mark Flannery's proposal. He says, let's limit bilateral credit exposures. All I'm saying is, let's limit the size of the haircut. So, you are limiting the potential spillover effects, and therefore if you can do that, then you don't have to be as concerned as you are today about the size of the institution that is failing.

Comment—George Benston. Gary, let me pursue that just a bit. Clearly, I think most people would agree that having market discipline is preferable to any other alternative. I just wonder in terms of how it would work. Let's take an example—let's assume that Chase is in trouble. We know that Chase can't fail. It has tried every way there is, and it still can't manage it. So, we'll use it as an example. Let's say the capital requirement that it has is low—Mark may be able to talk to this later—and Chase might decide to have a low capital because, what the heck. It does take a large loss. It somehow has an undiversified portfolio, or one doesn't realize its portfolio was as undiversified as it turned out to be, because it thought it was diversifying but it really wasn't—as happened earlier, as we know, when people put their money in various underdeveloped countries without thinking that they might all go down at the same time. So, it takes a large loss. Now, under FDICIA, we have the structures, but under the current procedures, they are very tight. The problem basically isn't that everyone is a good bank, but that everyone seems to be a good bank when they really aren't because the levels are so low.

Now, you are the controller of a large company and you've got several million dollars at Chase. And you say I'm going to get a 20 percent haircut, and I've got a better idea—I'm going to move my money over to Citibank or Norwest, or somewhere else. How are you going to stop them? They can get it out within five seconds. Or, they just watch and wait until it looks as if you're going to do something. It is sort of like people who study the exchange rate controls, who know when they are going to change the exchange rate, when we used to have fixed exchange rates, is when there are continuing government announcements that the rate will never change, and when the last one comes on Friday, they know they are going to do it that weekend.

Stern—Again, let me just say a couple things in response to that. I think, in a way, I'm not troubled if large depositors recognize or believe, correctly or incorrectly, that they are not getting compensated for the risks they are taking at Chase or maybe your institution, and move their money. I presume in that environment, Chase is going to

have to replace that funding. The only way they are going to succeed in replacing that funding is paying up for it, and that is precisely one of the things I want to have happen. So, I'm not too troubled about the scenario you are describing.

Now, I must say, we're still in the throes of trying to iron out some of these details. You put your finger on what I think is a thorny issue—and that is, to some people this is a sensible idea, but how do you implement it in practice? We are in the process, to be honest, of trying to work out some of those details on how you do that. But, I'll reiterate, the kind of reaction I think you're going to get, if you get that kind of movement of funds, isn't all bad. It is the kind of market reaction you would like to see more of. You started off by saying Chase can't fail. If they really believe Chase can't fail, they wouldn't bother to move their money. What you want to do is get them to believe that Chase can fail and therefore they better pay attention to what they're doing.

Question—The problem isn't what the depositors might do; it is what the regulators might do, whether they would, in fact, forbear from stepping in and not taking the risk. That is the big problem.

Comment—Would you compare what you're suggesting to the alternative of what one might call a delegated monitor, which is to say the subordinated debt holder who knows that he is at risk and who can't run, who can't just zap the money out, but has to effectively charge an interest rate that is sufficient or take the loss?

Stern—Let me say that is why we have put our proposal in the form of an amendment, if you will, to FDICIA. Because, what we want to do is put the depositors and other creditors on notice, in advance, that there is the potential for a loss even if the regulators do invoke too big to fail—that is the whole point. So, I think we have addressed that issue. I think subordinated debt is fundamentally another way of addressing the same kind of concern. I'm not opposed to going down that path. I have a couple of reservations about regulating the capital structure of the institutions, and there may be some questions about the maturity structure of the subordinated debt, and so on and so forth, but I think that is another way to go, certainly.

Question—Would you give the depositors a haircut or the uninsured liability holders a haircut?

Answer—Well, uninsured liability, including uninsured depositors.

Question—Pat Montgomery with the Treasury Management Association. I have at least one and perhaps two questions for Mr. Johnson, and the second question will depend on the answer to the first one. Do you see, in your view, the rebuilding of FDIC reserves over the years? Does the banking industry play an intermediary role whereby the costs are passed on to retail and corporate customers?

Johnson—No. If you step back and look at our—I don't have the figures right in front of me—but our earnings or our return on equity, return on assets once we began to get that behind us, and even as we were paying it, began to move up. I'm not prepared to say analytically that it was all passed on, but by and large, there is no free lunch, and we are all looking at how can we continue to create shareholder value and still meet all our costs, build our capital. I wouldn't sit here and say that none of it was passed on. I think eventually all of it is passed on.

Montgomery—I know from a corporate perspective, corporate America played a major role in terms of assuming some of the costs of the FDIC's rebuilding of its reserves. My second question would be—if there were a rebate, say from 1.38 percent to 1.25 percent, do you believe the banking industry would have a responsibility to pass on that rebate to the people who paid it initially?

Johnson—We have a responsibility to be sure that our capital formation rate meets our growth needs, covers our risk that we're trying to minimize and we're trying to understand as you are, and at the same time, makes a return to our shareholders that will allow us to raise capital when needed. So, to step back and say would there be a direct pass-through of that—I don't think that is the right of the government when it was our money that was sent. It was our shareholder's money that was sent. To tax a provision that says we're going to send it back to you, but we want it allocated to this or that, is a system that I think has just resoundingly failed throughout the world.

So, I think we tried to manage the money we have to build our communities. We were, in fact, community reinvestors 100 years before the Community Reinvestment Act. If we don't get it done, if we don't help build our communities, satisfy the credit needs, we lose market share. We go out of business. So, certainly, that would be a nice pass-through back to us. I think it would be used wisely. I think we would use it to build with. But I wouldn't attempt to say where every bank would go with it.

Johnson *(responding to a question regarding the proposed payment of interest on demand deposits)*—Chairman Leach has recently indicated that he and his staff are preparing a bill that would permit us to make up to 24 transfers on commercial accounts to any type of instrument. The ABA has gone on record—after a lot of discussion where we get our policy from small banks, medium banks, large banks—in favor of that. We are losing market share as we sit here, every moment. The consensus built over about a year of discussing this reached about 82 percent to 83 percent at the last meeting of our body that gets ideas from all sizes—our Government Relations Council. The bottom line is we are in support of the ability to pay on corporate. It was not a unanimous decision inside our industry, and it was not a small bank/large bank decision. There were large banks that took a position absolutely against it. They are now supporting us because of the consensus, and there were small banks that were absolutely opposed. But, over 80 percent of our membership agreed, and we will support payment of interest on commercial deposits.

Comment—Removal of all restrictions—is that what you're saying?

Johnson—That is not a removal of all restrictions. That is "you can do these things if you want to, bank"—if you're feeling a funding problem, if you're losing market share and you can offer this to your commercial customers. It wouldn't be a mandate. We went to the Fed and asked to do that. We thought, in our looking at it, that the Fed had the authority to grant that. They advised us that they did not. Chairman Greenspan himself sent that letter back. We sent another letter back saying would you reconsider. That was three or four months ago, and we haven't heard from that one. They advise us that it needs congressional action, and we are supporting that.

Jim, did I tell that pretty much like it is? Jim Chessen is our Senior Economist here.

Chessen—I would just add one piece of clarification. We're supporting the 24 transfers on the MMD account, which is what Leach just said he would introduce. That is distinct from explicitly paying interest. I think the bankers view it as an intermediate step that gives them choices to do that.

Comment—But what other justification is there?

Answer—Last time I looked there were some 9,000 banks that were separately owned and operated, and that is not the definition I learned, but again you know I'm not an economist.

Comment—But that is the Banking Act of 1933, which basically imposes, at the behest of the banking industry, a cartel zero rate of interest on commercial bank deposits. As I think you all know, most corporations don't pay it because they simply move their funds out or have them in sweep accounts or a variety of other things. The only reason any banker would still want it is because they still think some of their customers are stuck. Otherwise, it is foolish.

Comment—Well, when you're working with a large number of members in a diverse industry, it sometimes takes a while to get to nirvana, but we are trying our best to move forward. Seriously, at this discussion, there were people radically opposed to this little, tiny, baby step, and we listened to everybody in there. But we do have a consensus. We weren't exactly out front on the NOW accounts. But we're there now. We weren't the first to make consumer loans, but we're there now. But as we look at the 21st century, we are asking Congress to give us a chance to amend some of our past sins and let us go forward with a broader charter. But it is basically working through your own membership to try to get these steps done.

Chessen—Can I just add to that? I think it is easy to make this black and white and to laugh about it. I think from a lot of the bankers' standpoints, they feel there are some things that they've done to meet that market—they are doing sweep accounts, they have compensating balances, they offer other kinds of services to business to make up for that. I think one of the things that makes it more complicated is if you would move to explicit pricing, I think many feel they would have to begin to unwind the contracts that they have with their commercial customers, revisit all those, reprice everything, and all the complications of doing that. So, I think the practical steps are a little more imposing than to say, of course, you must just be stupid, you just don't realize this.

So, I think that is part of the intermediate stage to be able to say, banks are offering sweeps more and more. They are sweeping it out of their institutions. This is an ability to keep it within the institution to continue to meet the loan demand and to continue to offer the kinds of market price services they can for customers. Maybe we move to a full system at some point, but again, you've got to realize the practical implications, what contracts already exist, and how you would unwind those.

Comment—And, in fact, if I can just make one last point to close that out. In our recommendation back to the House Banking Committee, there is a phase-in period for exactly that reason. It is not because we're trying to drag it. It is because we have given breaks for demand deposits that are lying free except for the reserve requirement. So, that will be in there, and that is the reason.

Question—A question related to this: Isn't it true that the Federal Reserve has categorically opposed the 24 sweep approach for monetary control reasons?

Answer—I'm not aware they have taken a position—someone from the Fed. I'm not aware of that.

Comment—The only thing I would say is that they have denied the request—for regulatory reasons—on the 24 transfer; they have suggested that it go to legislation. I think if you ask the Fed really about reserves, they would say we would like to be able to manage reserves because we think maybe sometime, for monetary reasons, we would want to. I think people are moving away from the thinking that you need reserves to manage that. But I think that is leading the Fed to conclude you ought to pay interest on those reserves, which we would, of course, fully support. We don't think it is a budget problem, as the Fed seems to think. We figure they can price it in such a way that it wouldn't be, and they could manage reserves if they felt it appropriate. I think the Fed would very much support interest on reserves. I think they would probably go as far to say that they want some kind of corporate checking account interest and ability to pay. I think they are looking as an offset for budgetary reasons, but those are separate issues.

Question—This is actually a question for you, Art Murton. People have mentioned several times today that during the 1983–84 period, the intention of the FDIC was to impose losses on uninsured depositors, and the intent was to have that program start off with 13 banks. The intention was to have it apply to all banks. What would it take for the FDIC to have that again be their principal way they would like to treat uninsured depositors?

Murton—If you're asking what would it take for us to impose losses on uninsured depositors . . .

Question—No, I guess what I'm asking is, right now the FDIC is supportive of the current FDICIA framework—it is law, but they are also supportive of it. In that period, it seems like the main goal was to impose losses on uninsured depositors regardless of the size of the institution. I'm wondering what would it take to move back to that framework, which is more similar to what Gary was talking about?

Murton—If you're talking about the FDIC operating under a framework where we follow the statutes that we are asked to work under, I think we have been. Since the passage of FDICIA, we have followed the least cost test. As far as I know, there have not been any situations where we have encountered a too big to fail determination. I want to be responsive to your question . . . .

Question—I think I phrased it improperly. The modified bailout payoff was the manner in which the FDIC was heading when it was allowed to and given that freedom. Would that be the preference of the FDIC?

Murton—We use advance dividends.

Question—But for all institutions, regardless of the size of the institution.

Murton—I don't think there is evidence that is not our policy now.

Bovenzi—Art, if I can try to answer that. Really, now, when a bank fails, it is offered in a variety of ways, and you take the least cost

and the traditional purchase and assumption transactions where historically the FDIC would protect all depositors. It is offered that way, but it is also offered where you only protect insured depositors, and more often than not, that is likely to turn out to be the least costly bid. So, we have seen far more situations now where the uninsured are not protected, since FDICIA and the bidding process just allow the market to choose which option, and then go to a payoff if they don't choose any kind of merger option.

On the modified payoffs in 1983 and 1984, the distinction that was being made there, I think, was when there was a payoff, the FDIC would give a cash advance to the uninsured depositors to minimize some of the problems associated with not getting 100 percent. You would at least get some amount up front—some conservative estimate of what you ultimately would collect. I don't think it was done in every situation. It was still the case that the institution would be put up for bid, and there would be a merger where all depositors were protected. If they weren't, then in the payoff, there would be some cash advance to the uninsured.

Question—Joe Neely. This is for Gary Stern just to follow a thought. There was a notion this morning that I think was quickly passed by and I wanted you to follow up on because it falls right into your proposal. Someone this morning alluded to the fact that instilling the 80 percent haircut on the uninsured, particularly in a too big to fail situation, and the intent to instill depositor discipline, possibly could cause a lessening of market discipline in a crisis situation. As John was just alluding to, under least cost, we would have the resolution of a smaller institution where the uninsured could certainly be at risk, where if there were some knowledge or disciplined knowledge, if you transferred to a too big to fail institution, you would at least have an 80 percent recovery. I don't recall when that was mentioned this morning, but I picked up on it and thought it was a very interesting observation. What is your comment as to going 100 percent recovery for uninsured in too big to fail situations, 80 percent recovery in a crisis situation—would there actually be a flow from smaller institutions subject to least cost to too big to fail institutions?

Stern—Well, I guess that is conceivable, although I must admit that is not the issue that principally concerns me. I think what you're getting at is something that we have thought about. Right now, with regard to a large institution, it is ambiguous as to what is going to happen. Too big to fail may or may not be invoked. If it is, I think the presumption, at least under the current version of FDICIA, is the depositors and other creditors will be fully protected. I think as George Benston and some others have suggested, there is the concern that that is the way the regulators are going to prefer to go in situations where there is at least the looming possibility of systemic risk. So, that is the concern that my proposal is designed to address.

Could you get a run, which is I guess what you're suggesting, from small institutions to too big to fail institutions to take advantage of whatever that haircut protection is? I guess in theory yes, but in practice I'm not so sure. The reason I say I'm not so sure is that I think with regard to at least the vast majority of the smaller institutions with which I'm familiar, there tends to be a good deal less uncertainty about their condition. In other words, I don't think you're going to get simply random runs. You might get them only in situations where they are justified.

Hales—Gary, could I just make a comment as a guy whose name is Tom Hales, as

a guy who has to deal with customers. Your 20 percent haircut—because it is fascinating to watch our customers move money over $100,000 into the money market funds that are collateralized—would be perceived by our customers as a 20 percent loss. Think about that. My customers that have $5 million in the bank—and we have lots of them, even in a bank my size, which is only a billion dollars, my customers sometimes have $5 million in the bank—their reaction to me would be, you know, Tom, I'm worried about that because after all, I could get a 20 percent haircut.

Stern—I want them to be worried about that.

Hales—But you're not hearing me. He'll find another way to deal. That could be a thing that could hurt us from a marketing standpoint, no matter how safe we are. You have to understand how the customer perceives that. We have customers that move money out of our banks, over $100,000, into collateralized money market funds and ignore the fact that we have capital that supports their deposit. So, you seem to indicate that you are not locked into the 20 percent, and I think we do have things in place right now that would make a 20 percent haircut a fantastically big haircut. That means the things we think would work just aren't working. I think if you could rethink, first off, the percentage, and then I think if you would never say it, that would be a very good thing. That is something that needs to be not said.

Stern—Let me respond briefly to that. First of all, yes, there is nothing magic about that 20 percent, and in fact, in the current version of our full fledged proposal, what we talk about is starting with a 5 percent haircut and adding five percentage points each year until you get to 20 percent. You may decide somewhere along the way that you don't need to go much beyond 5 percent. I don't have a conviction one way or the other about that. But I do think, the heart of our proposal, in a way, is exactly for your customers with $5 million in that account to want to be assured by you that the bank is safe and sound, or if they believe they are not getting compensated adequately for the risks, to demand that they do—that is, to get a higher return on that deposit, or to diversify more. After all, one solution to having $5 million in one institution is to have $1 million in five institutions. Then, if you get in trouble, your exposure is x percent of $1 million, rather than x percent of $5 million.

Hales—Theoretically that sounds very good. But what happens is he closes on a deal, he is a builder, and he's got $5 million, and that is in the account for a very short period of time. But he has exposure for that period of time. Just think through what I am saying to you a little bit. It is not like the guy is going to leave $5 million in for two years or a year. He is not buying a CD for $5 million. He is running through his demand deposit account, and his first thought is, wow, insurance agents, people who use trust money, that is just perceived wrong—it is just a perception. I would just like you to think about the perception.

Can I make another point? Mr. Johnson, you mentioned, and I think you're absolutely correct, that under FDICIA, the level of FDIC, the $36 or $38 billion that we have there, is extremely high. Would you entertain any possibility instead of rebates and instead of reducing premiums, or I guess not having a premium? How about just being very practical and reasonable and maybe raising the FDIC limits to the $195,000 that you were talking about? Let's leave the money in the fund, adjust this

thing, and maybe it would be done over 10 years so that we have maybe 1 percent in the fund, based on FDICIA, and we would raise this level to $200,000. Would you entertain that—would you consider that?

Johnson—I'm not sure that we would take that on. We certainly are looking for ways to increase our market share, but I'm not sure long term that would do it for us. Certainly we will consider and look. But I don't think with the limited amount of political capital we have, we would be able to push much that way.

Roundtable

Ernest Ginsberg
Jonathan L. Fiechter
Charles E. Waterman
Catherine A. Ghiglieri

Remarks by Ernest Ginsberg

I want to commend the FDIC, you, Skip Hove, and your board members, for conducting this all-day seminar. It was one of the objectives of our report (*Deposit Insurance Reform in the Public Interest,* The Bankers Roundtable, May 1997) that this kind of discussion should take place. For too long, the subject of FDIC insurance reform was pretty much taboo, and if you have a subject that is taboo, then you can't think about the various ways in which that subject can be addressed. This is a good beginning for opening up the issue and getting the various points of view involved, and I hope it leads to further discussions in various forms so we can really get these issues out on the table and thoroughly ventilate them.

When I was invited to participate on the panel, I was told I could have approximately ten minutes to make some comments. I went through various drafts, all of which I discarded. I didn't want to repeat what other people said, and yet I wanted to say something that was meaningful in my opening remarks. I guess I am going to begin by saying the deposit insurance system we have today is about 65 years old, and except for the changes that were made by FDICIA in early intervention and depositor preference, it remains pretty much the same.

But, in that 65 years, the world has changed. In 1930, all banks, both big and small, were very much alike. Smaller banks held a larger share of the banking assets of the country. I don't have the numbers in front of me, but I believe that to be an accurate statement.

Today, I would like to go through a few numbers with you because they are important in connection with a discussion we are going to have later and Mark Flannery's presentation.

More or less, there are about 9,000 banks in this country, of which maybe 8,000 to 8,500 of $500 million or less have only about 25 percent or less of the banking assets. This means that about 800 banks, more or less, have about 75 percent of the banking assets of the country. Those numbers are rapidly changing as a result of the consolidation process that is going into effect. The banks that are left today have, as we have been told by Chairman Leach, about 25 percent of the financial assets, down from something on the order of 75 percent or 60 percent a few years ago. Despite deposit insurance, many of those larger banks are relying less and less on insured deposits as their source of funding. And, despite deposit insurance, smaller banks are finding that they cannot attract

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enough funds and they have to think about alternative means such as becoming members of the Federal Home Loan Banking System, another way of accessing the government guarantee in order to obtain their funding.

I'm sort of reminded here of the prizefight story about the two fighters who are in the middle of a prize fight and one comes back to his corner and he is all bloody and his trainer says to him, "Don't worry about it, things are going great." His response was, "You better watch the referee because somebody is hitting me."

With all that in mind, it strikes me that with those changes, it is appropriate to review the deposit insurance system as we know it today. Chairman Leach said today at lunch—"It ain't broke, don't fix it," and I think you're crazy for taking it on. Well, maybe he was concerned about the impact it might have on the legislations moving. But if now is not the time, when things are great in the banking industry, are we going to wait until there are problems and then start scrambling for ideas and scrambling for solutions and move under the pressure of crisis? It strikes me that the time to deal with the problem is when you can handle it at your leisure and think very, very carefully about it.

Also, I would remark that at the time deposit insurance was installed, everyone knows one of its major purposes was to preserve the unit banking system. One of the policy choices before the Congress at that time was whether or not to move to branching and thereby enable larger banks to move out. Today, we have nationwide branching. So, that is another circumstance that changed.

Then, finally, as I mentioned, the consolidation wave. So, for all of those reasons, the deposit insurance study that was put out by the Bankers Roundtable, which I was pleased to chair the working group on, I think is a good piece of work. We don't think we invented the wheel in terms of how to deal with the issues. We wanted to provoke discussion and put ideas forward as part of the discussion.

I just want to make a couple more observations. We heard a lot about protecting the small depositor. The lady who was the Chairman of the Board of the American Association of Retired Persons talked about it, etcetera. But what has always puzzled me is that if that was our primary purpose, why didn't we provide a consumer-friendly type of program where people who needed that kind of protection could buy direct government obligations. Today, it is so hard for somebody. You go to buy savings bonds, and the rates of them are really not competitive. If you want to buy treasury bills, you have to go through a broker. The fact of the matter is if you made those kind of products available, there would be an alternative for people whose only concern is safety, and I have to tell you that I believe that those people and bank depositors who are insured couldn't care less where the bank places their money.

So, it strikes me that the real purpose of deposit insurance was to provide funding for smaller banks in order to enable them to participate in the purpose of banks, one of the purposes being the ability to intermediate funds. So, the question I'm asking myself is, shouldn't deposit insurance be linked in some way to the intermediation process? I don't think we want to allow banks to sell government risk, which essentially they do, which may be priced more or less than the price of government risk if you bought it directly, in order to create a portfolio of securities or other activities which are not part of the intermediation process.

The next question I have often asked myself is obviously banks perform a role in

the payment system. But why is it that we protect investor depositors so carefully when we allow them to be at risk in other forms of investment? If the principle of the unsophisticated investor is valid, that principle is equally valid across the board. Yet, somehow or another, it is only in banks that we see that principle being applied. These are questions that have occurred to me as I tried to think about these issues.

I guess at this point those are all the remarks I put together. I am now going to run down a list of the comments made, but maybe we should do that at a later time because I think I pretty much used up my time limit.

Remarks by Jonathan L. Fiechter

Let me say up front that I'm a lot more ambivalent than I would have been 15-18 months ago, based on what I've seen. I had hoped to come and spend the morning here and listen to the various panels and pick up the ideas and the disagreements, but unfortunately, I was unable to come. I had to brief the Board of Directors at the World Bank on what was going on in Indonesia, and in particular on the financial restructuring program that was announced earlier this week which, among other things, had as its hallmark a 100 percent guarantee of all creditors and depositors and all banks in Indonesia. The reason that the Bank, the Fund, and the government chose to take this route was that in Indonesia they were experiencing massive runs on all institutions following the closure of a very small number of banks (16) last fall. The runs were requiring massive liquidity support, and we're talking tens of billions of dollars every week to keep these institutions afloat. Indonesia, as well as Thailand and Korea, is suffering from major liquidity problems because as the banks try to collect their breath, and try to build their capital in line with part of the agreements that require that they have stronger systems, in areas where it is very difficult to get capital, where you don't have asset securitization, the banks just stop lending and they try to pull whatever loans back that they can so that they shrink the denominator and that helps their ratio.

It's fascinating to contrast the U.S. experience that we had over the last 15 years—dealing with the energy banks, the agricultural banks, the thrifts—with what has gone on in Asia and how they have approached and dealt with their problems. It is a great context, I think, in which to discuss changes in the U.S. system. Mr. Ginsberg and I have known each other for a number of years, and I think I've probably agreed with 95 percent of everything he has said. But I must admit that after spending a lot of time in Asia over the last few months, our present system looks pretty good and sensible. As we saw in the early '90s, whenever 700 thrifts were closed, the system of deposit insurance—and at that time it wasn't even clear it was a fully funded deposit insurance system, but the system the government backstops, etc.—allowed a very orderly disposition and resolution of a whole slew of institutions. It is quite a contrast from what is going on in Asia right now.

When I served with Skip and Joe and others at the FDIC, I asked a lot of the same questions that were being asked today. I

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think when you have the luxury of a system that is working well, when you have few if any failures, and it is fully funded, you can, if you will, tinker with the system. I agree with the notion that if we're going to change, perhaps this is a better time to change than in the middle of a crisis. I also fully accept that no system is perfect. Certainly, the share of financial assets held by insured institutions has been declining for a number of years, and maybe that is something that is caused by government action as opposed to just a natural change in the way people conduct their business. So, I don't want to suggest that today's system is perfect.

But, in countries that don't have a workable deposit insurance system and don't have any type of rating system that allows the public to differentiate, to distinguish, between healthy institutions and weak institutions, what you run into is the kinds of runs that we had in the 1930s where no bank is safe. In that kind of market, even if you had what would have been a decent capital base two months before, there is no liquidity such that you could sell assets. You run into situations where, as it's been said in Indonesia, every corporation with any amount of foreign debt is now insolvent. Therefore, every bank with any exposure to any corporation in Indonesia is now insolvent. So, you have a system where literally you have a form of meltdown.

What I found surprising, and I'm a believer in market discipline, is this: I always found the idea of sub debt a good one, that every bank had to issue a couple of percentage points, and you could look at the rates and get some sense of what the market thought of the institution. What surprised me in Asia is the number of sophisticated depositors, the big names in international banking, that exercised what would appear to be virtually no market discipline on these institutions. You had the Deutsche Banks and the J.P. Morgans providing short-term dollars to institutions that were taking it on an unhedged basis and putting it into commercial real estate. When the market began to fall apart, obviously the first step was to start pulling all this money out, and some institutions have been fairly successful. But as everyone starts to pull his money out, you have obviously lots of difficulty and you get into the kinds of situations that are now occurring in Korea where you have committees being set up.

I think that kind of discipline is good. I think those kinds of losses, at least to liquidity, were good. But I would have thought, with the benefit of hindsight at least, that in a system where you have very sophisticated investors, there would have been far more signs, far more people backing out, that the spread over Libor that these countries were paying would have been going up a year and a half ago rather than going up when CNN reported that the exchange rate had changed and the crisis occurred.

I can recall looking at the agricultural bank numbers where you had land prices projected to go up forever, and with the benefit of hindsight we regulators all looked like idiots because it was so clear that we all missed it. So, maybe we're all just doomed to learn from experience.

In any event, these systems in all three countries did not have deposit insurance, so that arguably the money going in was, in some respects, what we're talking about, which is a free market. Money was going in, and none of the banks was promised that there was a guarantee, although it might have been implicit. The consequence was what appears to have been, in all three Asian countries and maybe others, real-life bubbles of the type that we saw in the Midwest with land prices. Once it collapsed, once all these loans that the domestic banks had made with collateral turned out to be worthless,

you had real meltdowns. The systems in these countries just aren't working. Very, very healthy companies—some of the major corporations—are finding they can get virtually no money. The market isn't working because it isn't that you pay up for it—there is just no money. It is not coming in, or at least not coming in at rates that the companies can ever borrow and hope to have any type of repayment.

Mark Flannery put up a chart that talked about the dilemma between maintaining financial stability while controlling moral hazard. That is talked a lot about at the Bank and the Fund as we, the staff, propose boards and adopt 100 percent guarantees for everything. When you're in the midst of the crisis, when you're applying tourniquets to stop the bleeding, talking about whether or not you should have a 5 percent haircut or a 10 percent haircut becomes sort of irrelevant. What you want to do is try to maintain, get back to some type of stability. In all these countries, the only losses that are now being posed are on the shareholders and on the sub debt holders. Everybody else is being covered because, frankly, we haven't figured out a system that includes a little market discipline and a little bit of moral hazard. It obviously is not a great solution. We are hoping that we can tap into the FDIC's expertise to help these countries move from a 100 percent guarantee to the kind of system that we have right now. In that respect, I would echo what Chairman Leach said, which is, it is amusing to have discussions of changing this system—and again, I don't want to suggest that improvements can't be made—but the rest of the world, including the EU, is adopting a system that is very close to this.

In any event, it isn't just deposit insurance. These countries have lots of problems with banks in terms of insider lending and directive lending, and the supervisory systems aren't great. So, it isn't simply the absence of deposit insurance that has caused the problems. I guess the bottom line is that I wonder whether it is deposit insurance per se that is causing the difficulties, the loss of market share of the banks, to the extent that there are lots of restrictions imposed on institutions because of deposit insurance. Maybe it is the restrictions; maybe it is expanded activities that are necessary. But, as someone was saying today,—it takes 5 seconds to move money around right now. We are in a very different system in terms of being able to go on your PC, and the incentives, if you create market discipline, make it not worth waiting. If I'm a corporate treasurer, it is a lot easier for me to pull my money out, wait and see if anything happens, and if nothing happens, put it back in again. I would pull my money out instantly because otherwise how would I ever explain to a corporation when an article appears in the *New York Times* that this bank is in trouble? I think if there is a perception of risk, everyone will pull out, and maybe the Minneapolis Fed can provide lots of lending through the discount window. I'm serious. You can do the temporary, but I think the bottom line is that we've got a pretty good system here.

Remarks by Charles E. Waterman

Thank you, Skip, for your kind introduction. I am struck by a couple of different themes that I've heard today. The number one theme is that no one has referenced the pictures of people standing in line in front of their bank during the Depression on the walls of this room. Now, as a community banker from a small town, I don't get a warm, cozy feeling sitting all day long looking at people pulling their money out of the community bank. The second thing I was struck by is that no one has told a President Clinton story so far. Before you have a heart attack, Skip, let me just say—emphasizing that I am from Illinois—if you're going to run Air Force One off a runway and get it stuck in the mud, better to do it in Champaign, Illinois, where you have lots of John Deere tractors that can pull it out. So, that is the good news—maybe that is the only good news the President has had in the last few days.

I would like, in the few minutes that I have, to present my observations of the issues presented throughout today's meeting. The one common theme that I think has stood out more than anything else to me today, relates to Carter Golembe's earlier reference to the "rent and grocery money" of the unsophisticated depositor. I haven't heard anyone here today say that isn't an important aspect of everything we're talking about. It doesn't matter whether it is Bert Ely's program with the parties to a 100 percent cross-guarantee contract; or Dick Kovacevich's proposal from Norwest to move the $28 billion in reserves in the Federal Deposit Insurance Corporation to the banking industry to manage and guarantee; or even the AARP's position or Tom Hales's—don't change it, just leave everything like it is.

Everyone feels there is a need to protect that unsophisticated depositor. I certainly agree with that for the short-term. I'm not sure what we will gravitate to 20 years from now, or what will be necessary, but I would suggest that there will always be an unsophisticated depositor. Not everyone is going to be like my son at age 24, doing all of his banking transactions on a PC. He works in our bank. One of the first things I had him do when he graduated from Northwestern was take all of our senior officers down and set up some accounts at different banking entities and demonstrate to them why our customers never needed to visit bricks and mortar again. That will evolve. But, there will always be unsophisticated customers because, as you are well aware, there are

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folks from this society that are not going to have access to computers, that are not going to be that sophisticated in terms of investments and watching markets. So, protecting the unsophisticated depositor is a must.

If we have a system that works right now, as has been suggested by Jonathan Feichter, maybe we shouldn't tweak it too much; that has been suggested by a couple of people here this morning. I think we should. Let me explain why. What Skip didn't relate to you is that in an earlier life I drove a nuclear submarine for a living. I had an engineer that came on board one time when we were doing some test depth dives and he was remarking how this one particular control valve only failed every 10,000 hours. I said, which way does it fail? He said it fails in the down position and we go to full dive. I said, let's see: At flank speed and operating at test depth, by the time we recover, the hull will be crushed and we will die. He said, yeah, but it is only once every 10,000 hours. I said, you're not seeing my point on this. Maybe as a preventive maintenance routine we ought to change it while things are nice and controlled and stable. Every once in a while you do some preventive maintenance. I think it is time—in the nice, stable environment that we are in right now—to do some preventive maintenance on our deposit insurance system.

Why? People have alluded to the 80/20 split where banks' market share of assets held is now only about 20 percent or so. I think that gets overemphasized. But, the reality is if you have 80 percent of the regulation applying to 20 percent of the deposits, or 20 percent of the financial services sector supporting all the regulation and 80 percent being virtually unscathed by it, you can't have a system that is going to be viable in the long term.

Everyone has talked about the too big to fail issue, and I think that is a very real issue that we need to address. David Carson hopes that we can structure systems so we will not have to repeat some of the mistakes of other countries. Just because no big bank has been allowed to fail in another country doesn't necessarily mean that you have to have a too big to fail policy in the United States. We have a unique and very different banking system in this country. As everybody at this meeting knows, as educated people in the field, our system doesn't resemble anything else in the world. Why should we follow the same dictates that exist elsewhere?

The moral hazard issue has been raised today, and I think that issue applies to both the FDIC and to the bankers. I'll come back to that toward the end.

We know we are in a changing world and Ernie Ginsberg has referred to it, as did Hjalma Johnson by telling his story about Johnny going to sue the teacher. Well, Hjalma didn't tell you that he is an attorney and he is now representing Johnny before the Florida Supreme Court in that case.

Chairman Leach concluded his remarks with a question: "Why do we want to take on FDIC reform?" That was early on in his presentation, before he answered questions. If you were listening, in his last comments at lunch he said that there are a lot of banks out there that will be put in severe jeopardy if they cannot offer securities and they cannot offer insurance and they cannot offer the plethora of products and services that our customers are going to demand.

Those two comments seemed in direct contradiction. I didn't have a chance to talk to the chairman about it, but I certainly agree with the comment about the need for financial modernization. If we can't compete in all aspects of financial services, we are going to have a big problem. My own bank is an example. We have about a billion dollars in assets under management. If you look at our

balance sheet, it will say $560 million in assets. How can I make the statement of a billion dollars? We have a trust department. We have a product called Investors Choice where we sell annuities, we sell stocks, we sell bonds, and we're about to do some joint venturing getting into insurance because it is allowed in Illinois. We're not growing our traditional bank deposits. Those are staying pretty solid. What is growing are those trust assets and all of those other assets that we are managing.

My premise is that now is a good time to do some preventive maintenance on the FDIC system. Carter Golembe, with his history lesson, pointed out that a lot of what we know today as deposit insurance evolved out of either crisis management or turf wars between regulators. When you think about it, everything we have talked about today—every new power and every change—has come out of crisis management. The only two entities that manage this way are committees at country clubs and the federal government. It is crisis management and it is turf. There is very little in between.

I think we have a chance to do some fixing in that area.

Will changes of any nature be a tough political fight? Absolutely, they will. But, in the words of Mr. Kovacevich from Norwest, if you don't try, you're never going to accomplish anything. I would propose that there are some steps we can take short of totally overhauling the system. We must also recognize that anything we do has to have a transition period, because you have to make people feel comfortable with change. There are about $400 million in traditional bank deposits, and $100 million of those are in passbook savings—real passbooks, with people who come in to the bank to have their passbooks posted. Every time our operations people tell me how much cheaper we could do it if we just force all those people into statement savings accounts, I say, fine, you explain it to that person who comes in here and wants to see his interest posted. We are in a very ethnic area, and that is going to exist for a long time to come. So, you've got to have a transition as you move into new ways of doing things.

Let me throw out a few ideas.

First, I would eliminate the FDIC's $30 billion line of credit at the Treasury. This line of credit creates a perception of dependence, and I would make the observation that perception normally counts for 90 percent and reality counts for 10 percent. My customers don't know about or care about this line of credit. What does it matter whether or not there is a $30 billion drawing right? If someone wants to beat the industry over the head with that, let's just get it off the board.

Second, I would get the FDIC off budget. With the work that I've done both in Illinois and in Washington, the budget issue just keeps coming back to haunt you in virtually every legislative initiative.

Third, I would pick a reserve ratio for the deposit insurance fund and stick to it. I don't know that the 1.25 in current law is the right number. But I do know that it is not good to say let's just have the fund keep building, building, building—like the ad for Pontiac, wider is better. Okay, bigger is better. I don't agree with that because you get fat and you get sloppy when you get too comfortable. I think that applies to the banking industry in terms of self-policing. I would suggest, with all due deference to the savings and loan people that are here today, that there could have been a lot more self-policing by the industry of what was going on during the S&L crisis. If I've got a comfort level that the deposit insurance fund is so large that somebody can really screw up without affecting my premiums—that does not create a healthy attitude.

I don't think it is healthy for the FDIC either, because I think the agency has a public trust to determine the right balance of regulation—so that banks and financial institutions are not overly regulated, and so that bank products and services can be reasonably priced on both sides of the balance sheet for the consumers of this country. That is part of the fiduciary responsibility of the FDIC.

Another one of the key issues is the systemic guarantee process put in place by FDICIA. As several people have said, it just makes it too easy to not allow a large institution to fail. The systemic bailout should be on budget and on the American taxpayer—not on the FDIC fund and not an industry assessment. I realize the political realities of what we're talking about, but you've got to set the stage for where we want to be 10 years from now. The President, the Secretary of the Treasury, and all the folks that have to be consulted in the systemic emergency process are going to be very reluctant to use it if the congressmen and senators have to go back to their districts and explain why they bailed out a certain institution. The point is that the systemic risk provision is going to be used very, very judiciously. I think in order to have that moral discipline on the subset of folks that make the decision on systemic risk, you have to have it on budget and on the American taxpayer, not on either one of the two deposit insurance funds.

Those are my observations, Mr. Chairman.

Remarks by Catherine A. Ghiglieri

Well, first of all, this has been a very interesting day, and I realize I'm the last speaker. When I looked over the agenda and saw the names on here, I said, golly, I wonder if this is our consolation prize for not getting the chairman job. But I am very honored to be on this panel and to participate today.

In preparation for today, I just reflected back on the connection that my family and I have had with the FDIC insurance fund. I'm from a family that has been in banking for three generations. My grandfather, before we had deposit insurance, actually prevented a run at our family bank when there was, during the Depression, a run on the bank. We were one of the few banks that did not close during the Depression. I think it would be interesting to see what he might have to say about some of the changes that are being proposed here today.

I did spend a long time at the OCC, and one of the things I did was close failing banks. I saw firsthand the grief that people went through when they did lose money. As Commissioner, I've closed banks, and I've closed First City, along with the OCC, for the second time. I've stood by while the FDIC treated our state banks differently than the national banks because of our state depositor preference statute, and I saw the grief that caused in our state. I actually had to go to our legislature and get a bill passed so that never again would the state banks be treated differently than the national banks.

We also have independent trust companies in Texas. When I close a trust company, I have to liquidate it. There is no FDIC to turn to. It is amazing how many of the beneficiaries of these trusts call us up, crying and saying, we thought this was insured by the FDIC.

We also have just passed a new statute in Texas regarding trust companies, and we have given them limited deposit-taking powers. They either have to be insured by the FDIC, which the FDIC is not doing right now but may in the future, or these deposits have to be fully secured. The reason why I give you this litany of things is just to tell you that in my experience, over almost 25 years of being a bank regulator, I realize that in the public's view, deposit insurance is very important. It is something that I think I would fight very vigorously to not give up.

Now, is that the right thing or the wrong thing? I don't know. I just put it on the table, but I think it is very important for the general public.

The author is the Texas Banking Commissioner.

I think a lot of the proposals today have been very interesting, and at the time they are being put forward, I get wrapped up and say, golly, this is a good idea. But if you take a step back and think about what happens during a banking crisis, and I've been through several, it is almost unreasonable to think that the government is not going to be asking to step up to the plate.

I want to talk about one issue because of the Congress' persuasion to not reform banking laws. I think the year 2000 is going to create a problem for the FDIC fund and maybe not the way that you think. I testified on Monday before the Texas Legislature, and I actually had one of the members ask me what I was doing to guarantee that Texas would not have a meltdown in the banking system. I went through the litany of things, and he said, that is all fine and good, but what are we going to do if we have a meltdown—if the testing doesn't work. I think that just demonstrates how people do look to government to fix things. It is just what happens.

They are also saying—some of the experts are saying—that Asia and Europe are six months or longer behind the U.S. in dealing with the year 2000, which could exacerbate some of their economies, and that might have a ripple effect on the banking system here and the attendant effect on the FDIC fund.

I think any changes that are made ultimately will have to balance the interests of the big banks that want to participate in the global economy, and the small community banks who view deposit insurance as something very important because their customers view this as very important. I think that while a lot of the things that have been thrown out here today are very interesting, balance has got to be sought before changes are actually made.

One of the things that I'm very troubled by, besides the fact that we don't have interstate branching and NationsBank wants us to, is that I wonder—since we have always given the public trust to two financial institutions that are insured by the FDIC, whether it be thrifts or banks—what is happening with Bates Casket Company getting a unitary thrift charter and having the casket salesman go out and take deposits, or the State Farm agents go out and take deposits? I sat in a presentation last week where an insurance agent came and made a presentation to the Department of Banking on a new employee benefit for the State of Texas. We were going to be able to obtain whole life insurance. He starts on his presentation and was not even able to answer the most basic questions, such as, how long do I have to sign up for this. As I was sitting there, I became more panic-stricken by the minute thinking, oh my God, somebody like this is going to be taking deposits.

I wonder if we have really thought through this issue on the unitary thrift charter and the ultimate impact that it's going to have on the FDIC insurance fund—whether the funds are merged eventually or not. I think eventually there is going to be an impact to providing this public trust to people who have traditionally not had it. There has been no debate. The OTS is granting these charters. I don't have enough time to go into what some of my funeral stories are. I do regulate a portion of the funeral industry in Texas, and I can tell you I am fearful about Bates Casket Company getting thrift charters.

So, I think there are some issues because Congress may not act, and there may be no tweaking of the insurance fund issues. And maybe we need to look at some of the other issues that may impact the FDIC. I think the unitary thrift charter is one that needs to be

thought through, and maybe it is a great idea, but at least for me standing on the sidelines, I'm concerned as a regulator and as someone who has been connected to the deposit insurance fund for a long time.

I would just say that I think today has been really an interesting debate. I really applaud Skip, you and your staff, for having the nerve to let people come and say all these interesting things. It is not easy to tinker with something that has been held in such regard by members and citizens of the United States.

So, I thank you very much for having me on the panel, and I've really enjoyed today.

Discussion

Question—Thank you very much. I'm Mark Flannery. I wanted to follow up on something that John Fiechter said about how badly the market predicted Southeast Asia. I think it is an incredibly important thing to recognize that the market makes mistakes sometimes. I think it is also an important thing to recognize that supervisory agencies where the employees are government employees make mistakes sometimes. I don't think I was reading too much into your comment, John, but I would be happy to give you an opportunity to say I was. I think that a comment such as yours that the market made a bad mistake in this case and there wasn't enough increase in risk margins in a gradual enough way before things actually hit the fan, I think that can leave the impression that therefore the market can't be trusted with important stuff. I don't know if you meant to say that, but certainly I've heard regulators who did mean to imply that, upon identifying a market mistake. I wanted to just make the observation that mistakes are going to happen with any supervisory system that we design. What we need to do is think about which system is likely to make better mistakes for us—not which one is going to be perfect, because the answer is neither will be.

Fiechter—I think your point is good, Mark. I don't know that the supervisors around the world who were supervising the banks making the loans caught it either, so I guess the market was slow to respond.

Ginsberg—You don't disagree. The market was right on. Do you know why the market was right on? Because they said the government will bail out the banks. If the local government doesn't do it, Uncle Sam and the monetary fund will come marching down. The market knew the risks, and the risks were pretty low. So, the upside for the banks was very rich interest rates, and the downside is that they are going to make out all right anyway because we can't really solve a problem without bailing them out. You see it in the newspapers. You see the articles now that we're being set up for it. So, the market was right on.

Comment—So, are you suggesting that maybe—it is both of you—that if the World Bank, the Fund, or whatever, didn't go in a couple of times, then the rates would start going up, that there would be the incentive for the bankers to spend the extra amount of time visiting and seeing. So, right now, the large banks don't feel it is worth, from a strictly cost—benefit analysis, the cost to do the analysis.

Comment—They think they are making a sovereign—risk loan. That is what they decided.

Comment—And maybe even better the sovereign was gone because you've got other sovereigns now stepping up to take care of it for political reasons.

Ginsberg—I've got to reiterate. The markets sent a lot of signals in most of these countries. Their domestic stock markets, in some cases, were going down for a year. Now, each of these countries differs as a nation, and there are many ways in which they differ from our country, not just that they don't have deposit insurance. They don't have developed financial systems. If you've changed your risk assessment in these relatively unsophisticated financial systems, and you want to extract your money from the markets, you really have to extract it from the whole economy. They don't have the kind of developed short-term safe investments that we have in this country. So, they had sell-offs in their domestic stock markets and pegged exchange rates.

We have lots of experience with that. It is very hard to predict when that kind of system cracks. But when you have pegged exchange rates, it is kind of like a deposit insurance system. You are guaranteeing to foreign investors they can pull their money out. So, they say we'll just go along and we'll be pulling it out and then all of a sudden, the system then collapses when the reserve position gets to a certain point. That is what happened in each of those countries. But it is really the lack of sophistication of the financial markets and the fact that you ran a peg exchange rate with monitoring fiscal policies that were inconsistent with the peg. Yet, the market signals have been going on for a year. You could have read the pages of the *Economist* magazine. Every week they were screaming about these countries and saying this is going to collapse. So, that wasn't a market failure. The market was sending a signal for a long time. It was—I really think—a public policy failure.

Comment—Bill Seidman. I really wanted to just thank you for your kind remarks, but since I just got back from out there in the Far East, I would like to make a couple of comments. Starting with the one that we all remember our problems in the 1980s, and as the chairman, I remember many people blaming them on deposit insurance. As I travel around the world, I find out that all the world's economies were having the same problems we were, and none of them had deposit insurance. So, it was a little hard to say that deposit insurance caused the problems in Sweden and England and Australia and France and Japan and everywhere else where they had them. And the problems were, I think, human and, if we can say anything, the result of overenthusiasm. If the deposit insurance system could invent a pill which they would give to all bankers and other investors so they wouldn't become overly enthusiastic about the loan of the moment, we wouldn't have to worry about all of this.

But in talking about what happened out there, they are just following, of course, what happened in Japan. Japan, incidentally, has also guaranteed all of their banks' obligations, which simply says that when government sees their system about to collapse, they are going to put their credit behind it, no matter what happens, no matter what the Roundtable says. There isn't a regulator yet born or a government official yet born that isn't going to put the government's credit behind the system if they think the whole system is going down, and we see that time and time again. No matter how you do 80 percent or this or that, it is really kind of an exercise in futility I would say. We've seen it out there, I think, very clearly. So, the attempt to legislate in the end a too big to fail, as we have in this country, I mean today in this country to use too big to fail, you have to have the President and the Fed and the FDIC and the good Lord certify that we need

help. But believe me, they will do it if the whole system is going down. So, there is no way I would say that we could get out of that.

I would just conclude by saying that it is really fun for me to go around the world now because for years I took quite a pasting in Texas; it required calling out the National Guard to protect me. Today, you go around the world and if you were part of the RTC or the FDIC, you're a hero, and every country wants to be like us. You can all be proud of, I think, the reputation that our system has established in the world, which sort of goes to say, let's be very careful of how we tinker with it.

Ginsberg—I agree with you. The Roundtable's recommendation on the subject of too big to fail is not to abolish it. We are realistic enough to recognize it has to exist. The question is, who funds it? The fact of the matter is today, taxpayers are funding it. They really are, even though it seems to be run through the insurance system, because in the long run, we pass the cost on to our customers. Our customers are taxpayers. It is so much easier to deal with that on a political basis than it is to have a situation where the government steps up, the politicians step up, and say, there is a systemic risk to our country in this situation. In order to keep our economy going, in order to make sure our payment system keeps working, to keep credit flowing, we have to use taxpayer funds. But on that point, that issue, in terms of how it affects legislation for bank modernization, I suspect that some people are really a Cheshire cat when they talk about too big to fail, because they love to keep it captive to their own position, when the fact of the matter is it is no different than paying money for the Army or the Navy when your political purposes are to defend your country and take care of your country's political position in the world. You use taxpayer funds for that, and you should use taxpayer funds directly for too big to fail situations.

My only point going back to the numbers I gave to you is that the number of institutions who represent the potential risk is not every bank in the system. It is, as Mark Flannery pointed out, a finite number of banks. I would disagree that it is 100, but that is not the important point. The important point is that those banks which do represent a potential for systemic risk are the ones that should have the dual supervision of the marketplace and the government, with the government receding into the background as the marketplace performs a greater and greater role. For those banks who don't present a systemic risk, which are by far, in number, the largest part of our banking system, those banks should be relieved, and I would even turn supervision and regulation of those banks away from the federal government, because to the extent that they represent any risk, it is basically a localized risk. I would give them a lot more freedom. As a matter of fact, personally, and I'm not speaking for the Roundtable now, I would be willing, Tom Hales, to let you have any amount of insurance you wanted as long as you were a bank that didn't represent a systemic risk.

Comment—Chuck Waterman. Based on my vast experience from South Holland, Illinois, I would like to go back to the Southeast Asian region. We talked about the market discipline and whether it was measured or it wasn't. Ernie Ginsberg made the observation that people didn't have to worry about it because they just felt it was guaranteed by the government. I was in Malaysia and I was in Thailand and several other countries over there within the last 60 days, and I saw—actually, it was about 120 days ago—the markets had already crashed to a great degree, but we hadn't had the current round

of the crisis that we have right now. I likened what I saw to what I saw in Texas before the real estate crisis and the crash down there. I went down with one of my customers in Dallas, looking at this great tax-shelter investment that he was planning on putting a lot of money in. I said, Bob, it is a great looking building that is going up right here. What about the one next to it that is the same size that has 3 percent occupancy? And there is a building over there, and I don't know what the occupancy is, but I see this huge parking garage, and in the middle of the week, on a Wednesday, there are no cars in it. I said, something is not right here. It is not going to work. I saw that all over Southeast Asia. You go to Kuala Lumpur, in Bangkok, you sit there on the river at the Shangri-La Hotel, and there is about a 5,000-room hotel being built right across the river. And you look right next to it, and there is a Sofitel with about 1,000 rooms that was built within the last five years, standing empty. There is another national chain hotel another mile down the river that has been built within the last five years, standing empty. This is not rocket science, folks. The markets can figure out this is not going to work. So, there has to be some implicit reason why the markets ignored the obvious warning signals, especially in terms of the collapse. There are people in here much more alert on that subject than I am. But I'm an old-fashioned banker—if you make a loan on a piece of real estate, it is nice to be able to walk down the street or drive by to look at it once in a while. Obviously, that was not happening in this case.

Question—Gary Gilbert, America's Community Bankers. I'm struck by the fact that there is considerable discussion among this panel and earlier panels on the need for greater market discipline. What I haven't heard much about is what kind of public disclosure is needed? What kind of information does a marketplace need to work effectively to distinguish between well—performing and less well performing institutions, and to effectively distinguish among institutions so as not to permit systemic risk to be very pervasive?

Ginsberg—I don't want to hog the microphone, but if you will look at the deposit insurance report that the Roundtable put out—and by the way, a lot of people have made comments about it who haven't read it—one of the recommendations is that the industry undertake an effort to try to identify in what ways it could make disclosures of information so as to make itself more transparent to the marketplace and try to eliminate the opaqueness which is put forward as the justification for government regulation. That recommendation has been acted upon. There is, in place today under the Roundtable auspices, a task force working on that. As a matter of fact, I attended a meeting of it yesterday. We are at the stage where we are trying to develop specifics.

Now, when we come out with that recommendation, and I don't want to give you previews of it, we are going to make that recommendation as a standards of best practice, assuming we move it all the way up through the process of the Board of Directors for approval, which is a big assumption because we don't know where we are yet. No one says it has to apply to every bank in this situation in the system. It has to apply to those banks which are important to the system in terms of their participation in the payment system, and other banks which don't really represent a threat. I don't want to deprecate your importance—those banks are important to the local economies. I have to tell you that if I were a shareholder in Republic, a listed company, and I were a shareholder (Tom, I don't want to pick on

you) in your bank, and I see Republic making those kind of disclosures, I think I would come in and say, Tom, how come you don't do the same thing?

Question—Bert Ely. This is a comment really on some of Chuck's very excellent comments. First of all, in terms of getting rid of the $30 billion line of credit at the Treasury, I think that is something that is very feasible because even the larger line of credit could be secured from the banking industry. There are two other things I wanted to comment on. First of all, in terms of taking the FDIC or taking the BIF off budget, the problem with that is you have to leave all the money behind and, in effect, start all over again because the money has been spent, and for the Congress to give the banking industry back, or to privatize the BIF, if you will, there effectively is going to be an outlay. It will reduce the surplus or add to the budget deficit, whichever position you're in, by the amount of that money. I think politically that is not possible.

I would argue you don't need a fund at all, and you could do that. Then the question is being able to convince the Congress that a pay-as-you-go system, which is what we have today, would work equally well on an off-budget basis. So, I think that is a practical problem.

The other thing is on the question of shifting the costs of the systemic risk exception that is in FDICIA over to the general taxpayer. Let me put a caution on that for the banking industry, and that is, do you really want the general taxpayer to directly be at risk? Thinking back to the pain that Congress extracted or imposed on the banking system in the aftermath of the S&L crisis, I think it is much better to keep that cost in the banking industry from a political perspective and particularly in terms of modernization. Plus, I don't think Congress is going to let the banks off the hook on it. Politically that is possible, but I'm not sure that is a desirable thing to push for either.

Waterman—Hey Bert, I didn't pick on you today. I didn't pick on you. But, in responding, when you talk about the $30 billion and taking that off—in terms of the $20 billion and coming up, I realize if you take that off budget, there are tremendous economic problems, and I wish Dick Kovacevich were still here. The question I wanted to ask is what is the transfer mechanism? What is that interim period? How do you accomplish that? I realize there are horrendous problems that are out there on the political front. As far as the systemic risk is concerned, yes, there is risk in doing that, but I would suggest that the American banking industry or financial services sectors are in the business of taking risks. I know Chairman Leach has said you don't want to take on reform of the FDIC, and other people have said bankers—you don't want to do it. Well, if the banking industry wants to accept the risk, then let us accept the risk for taking those actions. I don't know if that would be a saleable concept among Bankers Roundtable, ABA, IBAA, and Consumer Bankers—all of the different entities that are out there. But if it is and if there could be a unanimous consensus that it is worth the risk, then let us proceed and do it. There is risk in everything that we're doing. That is what we're talking about—risk in the fund. Risk in everything.

Question—Charles, I would like to just be sure that I understand what you're saying. You're saying that we should give up the government guarantee? Is that what you're saying with the $30 billion line of credit?

Waterman—No. I'm saying that is an interim step in my preventive maintenance argument. There is an implied additional

overbearing attitude, if you will, by the Hill that not only do you have full faith and credit, which is an accurate statement—but that perception is out there—but you also can draw $30 billion from the federal government if you need it.

Benston—So the guarantee would stay in place? All we're talking about is the mechanism to raise $30 billion? That is incidental as a change. I wouldn't go too far with that. As far as putting the FDIC insurance in the budget, isn't that up to the General Accounting Office—that is not up to us. We all know that is poor accounting, but isn't it the General Accounting Office's responsibility to do that, or does that become something that we do?

Comment—If you go back to the Lyndon Johnson administration when this came in effect, along with the Department of Transportation and the Highway Fund, a lot of other things were put on the budget to finance the war in Vietnam. That was done by legislative fiat in the mid—'60s, and that is not up to the General Accounting Office—I totally agree with you—smoke and mirrors and everything else. . .

Benston—It is lousy accounting—it shouldn't happen.

Comment—But I don't think it is up to them to say, no, we aren't going to handle it that way. I don't believe they have that right.

Hales—I have difficulty with somebody saying that if you've got a lot of money in the bank, you're going to spend it. I think it is really unfair to say that the FDIC, because the ratio is up to 1.38 percent, will do something foolish. I just have problems with that, and I think we can rely on somebody sitting back and saying, maybe I think one of the previous speakers made such a great comment with FDICIA, maybe it should be 1.00. Of course, I asked him, why don't we just raise it to $200,000 and not worry about it. I'm concerned that we're talking about change, and the only thing that I've heard so far that seems to give any justification for this is that some people feel we have lost market share. Of course, I'm not sure that is even true. When you think about it, back when I was a kid, if somebody had $5,000, they put the money in the bank because $5,000 was $5,000, and they were actually rich because they had $5,000. Now, we have people that are not rich and they may have $200,000. So, they may now take 5 percent of their assets to put in the bank to cover, and the other 95 percent goes out into another marketplace. I'm not sure we're talking about the same markets. And I'm not sure that we've lost the amount of market share that everybody wants to say we've lost. I think if you look at the hierarchy of investing people go through, they put money away for a rainy day and then they buy insurance and then they buy mutual funds, and then they go out and get into more risky investments until they get at the peak of the investment hierarchy and they go to Texas and buy a building. It is all a matter of going up that hierarchy. I'm saying to you this is not our market. When we keep quoting that the reason we're down to 25 percent of the market share is FDIC insurance—I have difficulty with that. I don't think we've lost that much of the market. I think we have given up a lot of the market. But I think we have not lost that much in the market. This is not our market. People do not put all of their money in the bank.

I'm telling you, when I was a kid, five people that had $5,000, that was a lot of money. Today, everybody's got $5,000. With the money out there, people have a half-million dollars in cash. They don't put it all in

the bank. So, when you start to talk about market share, you've got to realize that there is a hierarchy of investing.

Comment—Tom, I'm afraid that if we don't have additional financial services that we can offer and go forward—you say that is not our market to be in annuities and securities and insurance and things like that—

Hales—No, no, I agree with you on that. I'm just saying that it is not a bank market. I think it is great—why not get into the other fields. I'm saying it's not a bank market, and when you guys quote 25 percent market share, you're talking about a bank market.

Comment—I'm talking about total financial services on investment in the . . .

Hales—You're talking all of the financial money that is out there, and you're saying that the banks in the past had 75 percent, and now they've only got 25 percent. What I'm saying is that is just a misstatement. The 75 percent that we had in the past was because people had lower amounts of money and they put it in banks. Now, they have large amounts of money, so they have different kinds of investments. I don't think that is hard to follow. Actually, it happens to be true. When I was a kid if you had a couple thousand bucks, you were rich. But you put it all in the bank. Now, people have a lot more money and they put it in banks that cover this, and then they put it in mutual funds. I think that when we get all finished with this thing, what we're really talking about is people feel that the FDIC insurance fund is preventing us from getting into other markets. I think that is not true. I think that is not true at all. I think we have to sit down. I think Hawke started the whole conversation off beautifully today. He talked about how we could get into the other markets. He talked about serious penalties and serious firewalls. Once we impose those firewalls, I don't think there is a problem with getting into the other markets.

Comment—Gerald O'Driscoll. Ed Ettin, on behalf of the Fed made the statement earlier today that he didn't think deposit insurance was part of the banking modernization discussion. But all you have to do is look at the proposal for corporate structure to realize that Congress, at least the House Committee, bought into the idea that in order to protect deposit insurance, it is better to do it through the holding company affiliate structure rather than through the bank subsidiary structure. So, it is in there. We know it is in there. We heard a discussion about the subsidy. So, I don't know how one could say that it is not part of the discussion. It is in there in a very subtle, subdued way.

Hales—If you do the firewalls, I think you can convince people. This is the first time in all the discussions that I heard somebody say, if you were to violate the rules, you would now be out of the business. You would immediately have to divest yourself. That makes me feel comfortable. Prior to this, Ernie, you know full well that I wasn't in favor of you guys being in anything that would interfere with my FDIC insurance. But with his comment today, I am absolutely convinced this could work.

Question—I thought I was done. George Benston. This firewalls business, let's mention that just a moment. As Chairman Leach said in response to my question at lunch, all of the empirical evidence that has been done that all of us in academia have done and many others indicates that in fact the bank is safer without firewalls. In fact, doing the insurance, doing the investments within the bank allows a greater diversification of activ-

ities, allows, in fact, risks to be lower and returns higher, and the customers to be better served. The firewalls are essentially a fiction. The Glass—Steagall Act, as it was passed, is a fiction. There is no evidence to support the conflict of interest questions or the risks. In fact, the banks that were involved in securities had much lower rates, virtually no failures among those banks. So, that is what we're talking about as turf: the Fed's turf in terms of whether the Fed or the Comptroller regulates, and turf in terms of whether the securities industry or the investment bankers can keep their turf against the bankers. Everyone recognizes technology and everything else is a road to that. The reason we are now getting branch banking is because it is not protecting anyone anymore. So, why bother.

The major thing I think that is important and where deposit insurance does affect things is it is used as an excuse. You've got this so-called subsidy, and therefore we can restrain competition in the eyes of presumably protecting somebody. What is really happening is protecting the people who don't want to compete. That is where it is being used.

One of the things I would think, especially with what Jonathan Fiechter said and others have said with what is happening overseas, is depositors are being protected. There is nothing you can do about it. No matter where you are, depositors get bailed out—every country, every place. Let's just face it. The reason I pushed the subordinated debt or higher capital is that takes away the idea that there is any subsidy. It means that the banks are like any other company—the stockholders, the people who put their money up, can't run and they take the risks and let the banks be what they are, which is one of the best vehicles we have ever seen for financial services to the public.

Question—Jerry O'Driscoll, Citibank. Sorry, I don't think I identified myself before. I really want to follow up on what George said when Ernie and the whole group that he put together, and I was part of it, got into this. Some of us had our own personal interest in this deposit insurance issue, but it was really to address the point you just made. This is the excuse that is constantly thrown up to us. I think half the time, at least, it is not seriously believed. But in many cases it is. I'm personally convinced that we will never get expanded powers without addressing this issue, even though I also firmly believe the perception is incorrect that it provides a subsidy to the industry. Somebody said perception is 90 percent of the story, and I think that is true.

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George J. Benston is the John H. Harland Professor of Finance, Accounting, and Economics in the Goizueta Business School and Professor of Economics in the College of Arts and Sciences at Emory University, Atlanta, Georgia. Mr. Benston also is Honorary Visiting Professor at City University, London. Prior to joining Emory University in 1987, he taught at the University of Rochester and the University of Chicago, visited at the London School of Economics, the London Business School, Hebrew University, and the University of California at Berkeley, and was the John M. Olin Distinguished Visiting Fellow at Oxford University. He is a member of the Shadow Financial Regulatory Committee. Mr. Benston's Ph.D. is from the University of Chicago (finance and economics), MBA from New York University (accounting), and BA from Queens College (liberal arts and accounting), and he is a CPA (North Carolina). He has published over 134 refereed articles, books, and monographs, including *Corporate Financial Disclosure in the UK and the USA* and *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered*.

Helen Boosalis

Helen Boosalis, of Lincoln, Nebraska, is a member of the American Association of Retired Persons (AARP) Board of Directors, Class of 1998. She was elected by the board to serve as Chair for the 1996-1998 biennium. As Board Chair, Mrs. Boosalis also chairs the AARP Executive Committee and serves on the National Legislative Council, the Board Finance Committee, and the Board Audit Committee, and is an ex officio member of all board committees.

Mrs. Boosalis previously served on the Membership and Member Services, Audit, and Human Resources Committees of the board. She also was the board liaison member of the National Work Opportunities Advisory Committee and a member of the Task Force on Entitlements. Prior to her election as a board member, Mrs. Boosalis was a member of the AARP/Vote Advisory Board and chair of the National Legislative Council's Housing and Consumer Committee.

Mrs. Boosalis serves on the Securities and Exchange Commission's Consumer Affairs Advisory Committee and the Continuing Care Accreditation Commission. She currently chairs the National Arbor Day Foundation Board and previously chaired the National Commission on Manufactured Housing (a congressional commission). Mrs. Boosalis served on President Reagan's Commission on Private Sector Initiatives and was a delegate to the 1995 White House Conference on Aging. Until recently, she was on the Board of the National Trust for Historic Preservation. Mrs. Boosalis also serves on a

number of other local, state, and national boards and commissions.

Mrs. Boosalis served as Director of the state's Department on Aging for two and one-half years and was the Democratic candidate for governor of Nebraska in a historic two-woman race in the 1986 election. She was the first woman elected as mayor of Lincoln and served for eight years. She previously was a member of the city council for 16 years.

Mrs. Boosalis was the first woman elected president of the U.S. Conference of Mayors and received an honorary Doctor of Laws degree from Nebraska Wesleyan University.

David E. A. Carson

David E. A. Carson is Chairman, CEO, and Director of People's Bank, Bridgeport, Connecticut, New England's largest savings bank. Between 1985 and 1997, Mr. Carson held positions of CEO, President, Director, and Trustee of People's Bank, as well as CEO, President, and Trustee of People's Mutual Holdings. He served as President and CEO of Middlesex Mutual Assurance Company from 1974 to 1982. Prior to holding these positions, Mr. Carson was Senior Vice President of ITT Hartford from 1969 to 1974.

Mr. Carson currently is Chairman of the Bridgeport Public Education Fund and the Business Advisory Committee of the Connecticut Commission on Children, and is a Trustee and former Chairman of Connecticut Public Broadcasting. Mr. Carson also is a former Chairman of America's Community Bankers, and a member of the Federal Reserve System's Thrift Institutions Advisory Council and the Senior Advisory Council of the New England Banking Institute.

Mr. Carson earned his BBA from the University of Michigan in 1955. He holds honorary Doctorates of Laws from the University of New Haven (1988) and Sacred Heart University (1996). In addition, Mr. Carson received an honorary Doctorate of Humane Letters from the University of Bridgeport in 1996. Mr. Carson is a member of the American Academy of Actuaries and is an Associate of the Casualty Actuarial Society.

Lawrence Connell

Lawrence Connell was Director, President, and CEO of Atlantic Bancorp and President and CEO of Atlantic Bank N. A. from 1994 to 1997. Prior to his experience with Atlantic, Mr. Connell was President and Chief Executive Officer of Society for Savings, a $3 billion banking institution in Hartford, Connecticut.

Mr. Connell also was a partner with Prather, Seeger, Doolittle, and Farmer, a prominent financial advisory firm in Washington, D.C. For nearly ten years he advised financial institutions on strategic planning and regulatory issues and reorganized a number of troubled savings and loan institutions in Texas and Connecticut. On numerous occasions, he has served as an expert witness on behalf of the FSLIC and the FDIC regarding the duties and liabilities of directors. Mr. Connell also held prominent positions in a number of government agencies, including Chairman of the National Credit Union Administration and National Consumer Cooperative Bank, and Vice Chairman of the Federal Financial Institutions Examination Council and Neighborhood Reinvestment Corporation. He was also a member of the Depository Institutions Deregulation Committee. From 1975 to 1977, Mr. Connell was the Bank Commissioner of the State of Connecticut. He began his career at the Office of the Comptroller of the Currency as a National Bank Examiner and rose to the position of Deputy Regional Administrator in New England and California.

Bert Ely

Bert Ely is President of Ely and Company, Inc., a financial institutions consulting firm located in Alexandria, Virginia. On an ongoing basis, he monitors conditions in the banking and thrift industries and issues involving monetary policy and the payments system. Mr. Ely has assisted in drafting legislation to enact his cross-guarantee concept for privatizing deposit insurance. He also consults on current legislative and regulatory trends in Washington, deposit insurance issues, structural change in the financial services industry, and the role of electronic technology in the financial system.

He has testified before numerous congressional committees on banking issues, appears on television regularly, and speaks frequently about deposit insurance and other trends in financial services. He also serves as an expert witness in lawsuits involving deposit insurance and regulatory negligence issues and has published numerous articles and papers on a broad range of financial service topics.

Mr. Ely was a financial consultant to a broad range of manufacturing, distribution, and service businesses from 1972 to the mid-1980s. As a specialist in corporate insolvency matters, he served as a chapter 11 bankruptcy trustee and bankruptcy examiner. Prior to 1972, Mr. Ely served as Chief Financial Officer of a public company, as a Management Consultant with Touche, Ross & Co., and as an Auditor with Ernst & Ernst. Mr. Ely received his MBA from the Harvard Business School in 1968 and his BBA in economics and accounting from Case Western Reserve University in 1964.

Jonathan Lee Fiechter

Jonathan Lee Fiechter became Director of the Financial Sector Development Department of the World Bank on October 9, 1996. The department provides policy advice and technical assistance to client countries seeking to strengthen their financial sectors. Mr. Fiechter joined the World Bank from the Office of Thrift Supervision (OTS). While at OTS, Mr. Fiechter held a series of progressively responsible positions, including serving as head of the agency since 1992.

Mr. Fiechter began his professional career at the U.S. Department of the Treasury as an International Economist in 1972. In 1978, he joined the Office of the Comptroller of the Currency, the U.S. agency responsible for supervising national banks, where he was Deputy Comptroller for Economic Research. Mr. Fiechter has also served as Director of the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, and the Neighborhood Reinvestment Corporation and as Chairman of the Federal Financial Institutions Examination Council.

Mark J. Flannery

Mark Flannery has been the Barnett Banks Eminent Scholar in Finance at the University of Florida since 1989. He previously held positions of Associate and Full Professor at the University of North Carolina and Assistant Professor at the University of Pennsylvania's Wharton School. He also has served as a Visiting Professor at the London Business School and the University of New South Wales and Research Adviser to the Federal Reserve Bank of Philadelphia (for five years). He holds degrees in economics from Princeton and Yale universities.

Mr. Flannery has published extensively in academic and practitioners' finance and economics journals. The majority of his published work concerns the management and regulation of financial institutions. He has also studied problems in information economics, capital structure, and asset market equilibrium. Early in his career, he coauthored (with Dwight Jaffee) the first scholarly economic analysis of the "cashless society."

In addition to his research activities, Mr. Flannery has consulted with private banks and government agencies, and serves on the Board of the Barnett Bank of Alachua County (a $425 million community bank). His teaching activities have included development of a PC-based bank financial management game ("Pro-Banker") which has been used in both domestic and international teaching programs. He currently serves as an Associate Editor for the *Journal of Money, Credit and Banking*, *Journal of Banking and Finance*, *Journal of Financial Intermediation*, *Journal of Financial Services Research*, *The Financial Review, The Review of Quantitative Finance and Accounting*, and the Federal Reserve Bank of New York's *Quarterly Review*.

Catherine A. Ghiglieri

Catherine A. Ghiglieri was appointed Texas Banking Commissioner on April 8, 1992, by the Texas Finance Commission. She is responsible for supervising approximately 450 state-chartered banks in Texas, which control over $51 billion in banking assets. In addition, she supervises the regulation of trust companies, foreign bank agencies, prepaid funeral contract providers, perpetual care cemeteries, sale of check licensees, and currency exchange and money transmission businesses.

Ms. Ghiglieri serves as Executive Director of the Finance Commission and Chairman of the Prepaid Funeral Guaranty Fund Advisory Council. Prior to her appointment as Commissioner, Ms. Ghiglieri spent 18 years with the Office of the Comptroller of the Currency. She began her federal bank regulatory career in 1974 as an Assistant National Bank Examiner in Joliet, Illinois, and was commissioned a National Bank Examiner in 1979. Ms. Ghiglieri held various positions of increasing responsibility, including Executive Assistant to the Senior Deputy Comptroller for Bank Supervision in Washington, D.C., and Director for Bank Supervision and Field Office Director in Atlanta, Georgia.

Ms. Ghiglieri is Chairman of the Conference of State Bank Supervisors' (CSBS's) Legislative Committee, and serves on its Performance Standards Committee, which determines which states receive CSBS accreditation. She was also a member of the State Liaison Committee for the Federal Financial Institutions Examination Council (1994 to 1996) and on the Board of Directors of CSBS (1994 to 1997).

Ms. Ghiglieri is a native of Toluca, Illinois, where her family has had a community bank for three generations. She holds a BBA in finance from the University of Notre Dame, and a JD from Georgia State University. She is a graduate of Class XV of the State of Texas Governor's Executive Development Program and is a member of the State Bar of Georgia and the District of Columbia Bar.

Ernest Ginsberg

Ernest Ginsberg is Vice Chairman of the boards of directors of Republic New York Corporation and Republic National Bank of New York, both in New York City.

Mr. Ginsberg joined Republic in April 1968 as Vice President/Legal Affairs and Secretary and has held a number of successively senior positions with Republic.

Prior to joining Republic, Mr. Ginsberg was Associate Chief Counsel to the Comptroller of the Currency from May 1965 to April 1968. He was Tax Counsel and Attorney-Advisor to the Comptroller from January 1964 to May 1965, and Attorney-Advisor in the Office of Chief Counsel to the United States Internal Revenue Service (Legislation and Regulations Division) from April 1961 until January 1964. Mr. Ginsberg was engaged in private general law practice in Syracuse, New York, from September 1957 until April 1961.

Mr. Ginsberg is a former Director of the American Bankers Association (ABA) and of the Bankers Roundtable. From 1992 through 1994, he served as Chairman of the ABA's American Bankers Council. He was President of the New York State Bankers Association during 1993-1994.

Mr. Ginsberg received a BA *cum laude* from Syracuse University, College of Liberal Arts, in June 1953. He received his JD *cum laude* from Syracuse University, College of Law, in June 1955 and his Master of Law degree from Georgetown University in June 1963. He is admitted to the New York State Bar and the United States Supreme Court Bar.

Carter H. Golembe

Carter H. Golembe is a noted writer and speaker on banking matters. He is President of CHG Consulting, Inc., Delray Beach, Florida, and is the principal author of the *Golembe Reports*, a series of interpretative reports on major policy issues.

He also is the Senior Advisor to the Board of Directors of the International Financial Conference, an educational corporation that is comprised of 50 regional banks and that he founded in 1979.

From 1989 to 1994, Mr. Golembe was Chairman of the Secura Group, a major financial services consulting firm headquartered in Washington, D.C. Prior to that, he was Chairman of the Executive Committee of Golembe Associates, Inc., also a Washington-based firm. He founded that firm in 1966 to concentrate on economic and regulatory issues related to the banking field.

Mr. Golembe served as Deputy Manager of the American Bankers Association from 1960 to 1966. From 1951 to 1960, he was a Financial Economist with the Federal Deposit Insurance Corporation.

Mr. Golembe holds the degrees of Ph.D. in economics (1952) from Columbia University, New York, and a Bachelor of Laws (1965) from George Washington University in Washington, D.C.

In addition to serving as the author of the *Golembe Reports*, Mr. Golembe authors a regular column on Washington developments affecting banking for the *Banking Policy Report*, a twice-monthly national publication of Aspen Law & Business. He is the coauthor of a college-level text—*Federal Regulation of Banking*—and the author of numerous articles on banking.

Thomas E. Hales

Thomas Hales is Chairman, President, and CEO of U.S.B. Holding Co., Inc., parent company of Union State Bank, located in Rockland and Westchester counties, New York. Mr. Hales has been with Union State Bank for 16 years. In that time, the institution has grown from $23 million to $1 billion in assets and from 2 to 20 branches.

Mr. Hales is a member of the Board of Directors of the Independent Bankers Association of America, the Board of Directors of the Independent Bankers of New York State, the Board of Trustees and Finance Committee of Nyack Hospital in Rockland County, the Board of Directors and Finance Committee of Iona College in Westchester, and the Board of Directors of the Leukemia Society of America.

John D. Hawke, Jr.

John D. Hawke, Jr., was sworn in as Under Secretary of the Treasury for Domestic Finance on June 14, 1995. In this position, Mr. Hawke oversees the development of policy and legislation in the areas of financial institutions, Treasury securities and public debt management, capital markets, government financial management services, federal lending, and government-sponsored enterprises. He serves on the Board of the Securities Investor Protection Corporation, and chairs the Advanced Counterfeit Deterrence Steer-

ing Committee, an interagency group that addresses policy questions involving counterfeiting and currency design.

Prior to joining the Treasury, Mr. Hawke was a Senior Partner at the Washington, D.C., law firm of Arnold & Porter, which he first joined as an Associate in 1962. At Arnold & Porter, he headed the Financial Institutions practice, and from 1987 to 1995 he served as Chairman of the firm. In 1975, he left the firm to serve as General Counsel to the Board of Governors of the Federal Reserve System, returning in 1978.

Mr. Hawke graduated from Yale University in 1954 with a BA in English. From 1955 to 1957 he served on active duty with the U.S. Air Force. After graduation from Columbia University School of Law in 1960, where he was Editor-in-Chief of the *Columbia Law Review*, Mr. Hawke was a law clerk for Judge E. Barrett Prettyman on the United States Court of Appeals for the District of Columbia Circuit. From 1961 to 1962 he served as counsel to the Select Subcommittee on Education in the House of Representatives.

Mr. Hawke has written extensively on matters relating to the regulation of financial institutions, and is the author of *Commentaries on Banking Regulation*, published in 1985. He was a founding member of the Shadow Financial Regulatory Committee, and served on the committee until joining the Treasury in April 1995.

Mr. Hawke serves as a Trustee of the Community Foundation for the National Capital Region, and as a member of the President's Committee on the Arts and the Humanities. He is a member of the Cosmos Club, the Economic Club of Washington, and the Exchequer Club of Washington.

Thomas M. Hoenig

Thomas M. Hoenig is President and Chief Executive Officer of the Federal Reserve Bank of Kansas City. He is a member of the Federal Open Market Committee, the key body with authority over monetary policy.

After receiving his Ph.D. in economics from Iowa State University, Mr. Hoenig joined the Federal Reserve Bank in 1973 as an Economist, and was named President on October 1, 1991. Mr. Hoenig directs Federal Reserve activities in the seven-state Tenth Federal Reserve District—an area that includes Colorado, Kansas, Nebraska, Oklahoma, Wyoming, the northern half of New Mexico, and the western third of Missouri.

Mr. Hoenig is a member of the Board of Directors of the University of Missouri-Kansas City, and serves as Chair for Benedictine College, Atchison, Kansas. He is a member of the Board of Trustees of Midwest Research Institute and is a member of banking advisory boards at the University of Missouri-Kansas City, and the University of Missouri-Columbia.

Andrew C. "Skip" Hove, Jr.

Mr. Hove was nominated by President George Bush as Vice Chairman of the FDIC, and was sworn into office on July 16, 1990. Upon the death of Chairman Bill Taylor in August 1992 he became Acting Chairman and served in that position until October 1994. He was nominated to a second term as Vice Chairman by President Bill Clinton and was confirmed by the Senate in October 1994. When Chairman Ricki Helfer resigned in June 1997, Mr. Hove again became Chairman.

Mr. Hove is a native of Minden, Nebraska, and graduated from the University of Nebraska and the Graduate School of Banking at the University of Wisconsin. Upon graduation from the University of Nebraska he was commissioned in the U.S. Navy and served as a Naval Aviator. He returned to Nebraska after his Navy service and joined the Minden Exchange Bank & Trust Co. Mr. Hove was the Chairman and CEO of the Minden bank at the time of his appointment

to the FDIC. He was very active in the community, including as Mayor of Minden, and held a variety of other public service positions. He also was actively involved with the Nebraska Bankers Association for many years, including a term as President.

Hjalma E. Johnson

Hjalma E. Johnson is the 1997-98 First Vice President of the American Bankers Association (ABA). He is Chairman and CEO of East Coast Bank Corporation, Dade City, Florida; Chairman of the Bank at Ormond-by-the-Sea, Ormond Beach, Florida; and President of Investment Advisors, Inc., Dade City, Florida.

Mr. Johnson served as ABA Treasurer from 1995 to 1997 and earlier as a member of ABA's BankPac Committee, the Government Relations Council, and the Community Bankers Council. He also served as an ABA State Vice President and Banking Leadership Conference Delegate and was Chairman of the Federal Home Loan Bank Task Force.

Mr. Johnson was very active with the Florida Bankers Association, serving as President from 1984 to 1985, on the Board of Directors, and as Chairman of the Government Relations Division.

Mr. Johnson is a member of the Board of the Florida Council on Economic Education, an Honorary Director of the World Trade Center of Tampa Bay, and a member of the Tampa Bay Business Hall of Fame. His former affiliations include serving as a member of the University of Florida College of Business Advisory Council, member of the University of South Florida Banking Advisory Committee, member of the Florida House of Representatives Speaker's Advisory Committee on the Future of Florida, Director of Enterprise Florida Capital Partners, and Chairman of the Board of Trustees of Saint Leo College.

Mr. Johnson received his Bachelor of Industrial Engineering degree with high honors from the University of Florida, Gainesville, Florida, in 1958. He received his JD from the Birmingham School of Law in 1965 and is a member of the Alabama Bar. He also graduated from ABA's Stonier Graduate School of Banking in 1968.

Richard M. Kovacevich

Richard M. Kovacevich became CEO of Norwest Corporation on January 1, 1993, and Chairman in 1995, after serving as President and Chief Operating Officer since 1989. He joined Norwest in March 1986 as Vice Chairman and Chief Operating Officer of the Corporation and Head of the Banking Group. He also was named a Director of the Corporation at that time.

Before joining Norwest Corporation, Mr. Kovacevich was Group Executive and a member of the Policy Committee of Citicorp in New York. He began his business career at General Mills, first as a planner, then moving to mergers and acquisitions, and finally, to Division Manager.

Mr. Kovacevich holds bachelor's and master's degrees in industrial engineering and an MBA, all from Stanford University.

He is a member of the boards of directors of Dayton Hudson Corporation; Northern States Power Company; PETsMART, Inc.; and ReliaStar Financial Corp. He also is a Director and Vice President of the Bankers Roundtable, Vice Chairman of the American Bankers Council, Vice Chairman of the Board of the Greater Minneapolis Metropolitan Housing Corporation, Director and Vice President of the Walker Art Center, and Director and Member of the Executive Committee of the Minnesota Business Partnership, Inc.

Congressman James A. Leach

Congressman James A. Leach, Republican Representative from the First District of Iowa, was elected to the 95th Congress and

reelected to each succeeding Congress. He is Chairman of the Committee on Banking and Financial Services, and a member of the Committee on International Relations and the Subcommittee on Asian and Pacific Affairs. Congressman Leach is also Co-Chairman of the Republican Education Caucus. In addition to these congressional memberships, he is Co-Chairman of the Constitutional Forum, Vice Chairman of the Twentieth Century Fund, and sits on the Advisory Council of the Woodrow Wilson School of Public and International Affairs at Princeton University.

In 1969 and 1970, Congressman Leach was Special Assistant to Donald Rumsfeld, Director of the Office of Economic Opportunity. He was assigned, as a Foreign Service Officer, to the Arms Control and Disarmament Agency from 1970 through 1973, and served as a delegate to the United Nations General Assembly and the Geneva Disarmament Conference in 1971 and 1972. Congressman Leach was a member of the U.S. Advisory Commission on International Education and Cultural Affairs in 1975 and 1976. Also during this period, he served as Director of the Federal Home Loan Bank Board, Midwest Region. From 1973 to 1976, Congressman Leach was Chairman of the Board of Adel Wholesalers, Inc., and President of Flamegas Companies, Inc.

From 1981 to 1988, Congressman Leach was Chairman of the Ripon Society, and in 1983 and 1984 was Chairman of the Arms Control and Foreign Policy Caucus. From 1991 to 1993, he served as President of the Parliamentarians for Global Action and was Co-Chairman of the United States Commission on Improving the Effectiveness of the United Nations. Congressman Leach was a member of the Congressional Arts Caucus from 1983 to 1994.

Congressman Leach earned a BA *cum laude* in 1964 in political science from Princeton University, and an MA in Soviet politics from the School of Advanced International Studies at Johns Hopkins University in 1966. He continued his graduate studies as a research student in economics and Soviet politics at the London School of Economics from 1966 to 1968. Congressman Leach has received an honorary Doctorate of Public Service from St. Ambrose University in Davenport, Iowa, and an honorary Ph.D. from Marycrest College, also in Davenport.

Arthur J. Murton

Arthur Murton became the Director of the Division of Insurance (DOI) shortly after it was established in 1995. DOI was created to enhance the FDIC's ability to identify, analyze, and report on current and emerging risks and to ensure that deposit insurance premiums appropriately reflect the risks posed to the insurance funds. Prior to his appointment as Director of DOI, Mr. Murton was the Deputy Director of the Division of Research and Statistics (DRS). He began his career with the FDIC in 1986 as a Financial Economist in DRS.

Mr. Murton holds a BA in economics from Duke University and a Ph.D. in economics from the University of Virginia.

Joseph H. Neely

Joseph H. Neely became a member of the Board of Directors of the Federal Deposit Insurance Corporation on January 29, 1996.

A native of Grenada, Mississippi, Joe Neely attended the University of Southern Mississippi, where he earned a BS in business administration, majoring in finance. He continued his studies as a graduate fellow of the University of Southern Mississippi and earned an MBA.

Upon graduation, Neely served for two years as an instructor of Accounting and Economics at Hinds Community College in Raymond, Mississippi. He began his bank-

ing career in 1977 with the Grenada Sunburst Banking System, serving in the lending area of the bank. In 1980, he joined the Merchants National Bank of Vicksburg, where he served as Senior Vice President. In April 1992, Governor Kirk Fordice appointed Mr. Neely Commissioner of the Department of Banking and Consumer Finance for the State of Mississippi. In July 1995, President Clinton appointed Mr. Neely to the FDIC Board of Directors. After confirmation by the United States Senate in December 1995, Mr. Neely was sworn in as Director in January 1996.

Mr. Neely is a graduate of the American Bankers Association's Stonier Graduate School of Banking, the School of Bank Marketing, and the School of Bank Management and Strategic Planning. He has lectured at the Stonier Graduate School of Banking, the Graduate School of Banking at Louisiana State University, and the Alabama and Mississippi schools of banking. In addition, Mr. Neely regularly addresses banking groups and associations throughout the country on a variety of current industry issues.

Mr. Neely has served in numerous civic leadership positions and has been active in community affairs throughout his career.

Gary H. Stern

Gary H. Stern became President and CEO of the Federal Reserve Bank of Minneapolis in March 1985. As a Federal Reserve Bank president, he serves as a member of the Federal Open Market Committee, the Federal Reserve's principal body responsible for establishing national money and credit policies.

Mr. Stern, a native of Wisconsin, joined the Federal Reserve Bank of Minneapolis in January 1982 as Senior Vice President and Director of Research. Before joining the Federal Reserve Bank of Minneapolis, Mr. Stern was a partner in a New York-based economic consulting firm. Mr. Stern's prior experience includes seven years at the Federal Reserve Bank of New York.

Mr. Stern serves on the Board of Trustees of the National Council on Economic Education and Educational Testing Service, and on the boards of directors of the Minneapolis College of Art and Design, the Northwest Area Foundation, and the Carlson School of Management at the University of Minnesota.

Mr. Stern holds an AB in economics from Washington University, St. Louis, and a Ph.D. in economics from Rice University, Houston.

Charles "Chuck" E. Waterman

Charles E. Waterman is Chairman and CEO of South Holland Trust & Savings Bank and CEO of the bank's holding company, South Holland Bancorp, Inc., positions he has held since 1986. Mr. Waterman has been employed by South Holland Bank since 1971, prior to which he served in the United States Navy's Nuclear Submarine Service for five years.

Mr. Waterman has held numerous board and committee positions in the Illinois business community, Illinois Bankers Association (IBA), and American Bankers Association. In 1986 and 1987 he served as President of the IBA, and from 1990 to 1992 was Chairman of the ABA's Government Relations Council. He subsequently served a three-year term on the ABA's Board of Directors. Mr. Waterman has been a member of the State Banking Board of Illinois since 1994. He has represented the ABA and IBA on numerous banking industry issues with testimony before both the Congress and the Illinois Legislature since 1994.

Mr. Waterman is a graduate of the United States Naval Academy, and he received an MBA from Northwestern University in 1973.

William Roger Watson

Mr. Watson, a native of Pasadena, California, joined the FDIC in 1968 as an Economist in the Division of Research and Statistics. He

was promoted to Assistant Director in 1982, and then Associate Director in 1983. He was designated the Director in 1987. He is a graduate of the University of Southern California and holds a Ph.D. in economics.