

# Introduction: Purpose and Operation of the Shadow Financial Regulatory Committee

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Many economists would like to put their ideas into action to affect public policy, and some even attempt to do so. This is not exceptionally difficult to do if one is an insider working for policy makers, for example, the government or regulatory agencies; a major corporation; a trade association; or affected player. But it is more difficult if one is an outsider working as an independent without an automatic power base. The Shadow Financial Regulatory Committee (SFRC) is an example of an attempt by a group of outsiders to affect national public policy in the public interest. This introduction describes the Committee, analyzes the conditions generally identified as prerequisites for success in this area, reviews the history and operations of the Committee, and evaluates its success to date.

The SFRC is a self-appointed group of 13 experts in financial institutions and markets (“banking”) organized to:

1. identify and analyze developing trends and ongoing events that are likely to affect the efficiency or safety of all or sectors of the financial services industry;
2. explore the spectrum of short- and long-term implications of emerging problems and policy changes;
3. help develop appropriate private, regulatory, and legislative responses to such problems; that promote efficiency and safety and further the public interest; and
4. assess and respond to proposed public and private policy initiatives with respect to their impact on the public interest.

The members of the Committee are identified in the appendix to this introduction. The SFRC was organized in late 1985 and had its first meeting in February 1986. The Committee operates on a relatively small budget financed by nonindustry sources to guarantee the independence and objectivity necessary to achieve credibility—the Committee’s major product. The major source of funding has been foundations and research institutes, including the Sarah Scaife Foundation and the Mid America Institute. Lesser amounts have been provided by the University of North Carolina, the Bank Administration Institute, and Loyola University of Chicago.

George G. Kaufman is co-chair of the SFRC. This introduction is a slightly revised and updated version of a chapter published in *Restructuring the American Financial System* (Kluwer, 1990).

We perceived a need for a Committee such as the SFRC because banking is generally viewed as a technical area that does not enter the public spotlight until a major crisis occurs and then, because of its perceived complexity, the public and policy makers alike tend to rely on experts for assistance. But most experts have vested interests and are associated with important market participants. As a result, banking legislation frequently becomes a playground for lobbyists and the public interest is a forgotten party (Macey, 1989). The Committee was organized to provide an ongoing informed spokesperson for the public interest and to raise the level of public debate on financial issues.

### **How to organize for effectiveness**

There are not many previous examples of a group of outside economists organized for the purpose of affecting public policy on an ongoing basis in the public interest for more than a single issue and operating on a small budget without a professional staff. One example of such a group is the Shadow Open Market Committee, but its scope is more limited. Thus there were few guidelines available to the Committee on how to organize for maximum effectiveness.

In an article on “The Economics Profession and the Making of Public Policy,” Robert Nelson (1987) identified a number of factors he believed were necessary for outside economists to be effective in influencing public policy. Economists need to

1. be entrepreneurial and advocates of particular policies rather than neutral technicians;
2. have a good writing skills;
3. have a good command of institutional details, including the political process; and
4. have a big picture framework and ability to tell a simple and organized story to busy policy makers and the public of how the recommendations fit in.

The SFRC has satisfied most of these conditions. The group members

1. are entrepreneurial and are strong advocators from a broad base encompassing
  - a. academics and practitioners, economists, and lawyers;
  - b. currently outside experts who were previously, in most instances, inside experts, including former general counsels of the Board of Governors of the Federal Reserve System and the Federal Home Loan Bank Board, chairperson of the National Credit Union Administration, assistant secretary of the U.S. Treasury, and assistant to the chairman of the FDIC;
  - c. a wide range of sectors of the financial services industry from banking to securities dealers to futures and options markets; and
  - d. a broad political and economic spectrum, unified only by a preference (of different strengths) for market solutions;
2. have a track record of writing clearly for consumption by policy makers and the general public;
3. have a good working knowledge of institutional details and the political process; and

4. have experience in influencing public policy directly through testimony before Congress, regulatory agencies, and others, and as being recognized by policy makers as credible experts who can see the big picture.

### **Operation and history of the committee**

The SFRC meets quarterly, generally in Washington, D.C., for one and one-half days starting on Sunday morning and ending with a press conference at noon on Monday. A preliminary agenda is circulated to Committee members by one of the co-chairpersons about four weeks before the meeting for review and suggestions, and a final agenda is prepared about ten days before the meeting. The agendas identify issues that are considered sufficiently important and/or current so that the Committee may wish to comment on them in a policy statement. Discussion leaders are preassigned for each issue. They prepare background materials and, if they believe one is desirable, a draft policy statement. Sunday is devoted to discussing these issues.

If, after the discussion, the Committee believes that a policy statement is warranted, one or more members, including the discussion leader, are asked to draft a statement. The proposed statement is reviewed by the Committee as a whole, word-by-word for precision. Often this involves numerous go-arounds and drafts.

All decisions are by majority vote. On occasion, one or more members of the Committee have a direct professional financial involvement in the issue. Such members are expected to announce their potential conflict and are excused from the discussion, except for answering factual questions. They also do not vote on the policy statement, if one is to be issued, and their abstention is noted on the statement. Near-final drafts of the policy statements are typed Sunday evening for final review on Monday morning.

In addition to the final review of the statements on Monday, the Committee meets with one or two visitors. The visitors are generally policy makers or high-ranking staff members from the regulatory agencies, Congress, the administration, or financial trade associations. The visits are closed-door, off-the-record, free-flowing, two-way discussions on current developments in the guests' areas of expertise and/or responsibility. These visits have worked well and have become an important part of the meetings. The Committee is able to obtain both additional factual information on issues to supplement the information available otherwise and on-the-spot feedback on its positions from involved and informed individuals. The guest, in turn, is able to obtain considered and objective feedback on issues of concern to him or her from a group of independent experts, a pleasant and unique experience for many Washington policy makers. To date, Committee guests have included (with their affiliation at the time) William Siedman, Chairman of the Federal Deposit Insurance Corporation; Manual Johnson, Vice Chairman of the Board of Governors of the Federal Reserve System; Robert Clarke, Comptroller of the Currency; George Gould, Under-Secretary of the Treasury; Robert Glauber, Under-Secretary of the Treasury; Wendy Gramm, Chairperson of the Commodity Futures Trading Corporation; Lawrence White, Member of the Federal Home Loan Bank Board; Joseph Grundfest, Member of the Securities and Exchange Commission; Timothy Ryan,

Director of the Office of Thrift Supervision; and Robert Litan, Brookings Institution. Although guests are aware that the Committee may disagree with some of their positions, only rarely have invitations by the Committee been rejected for reasons of policy differences.

The policy statements issued by the Committee are released at a midday press conference at which the reasons for each statement are discussed. The statements are circulated widely and the mailing list has expanded rapidly to more than 500 addressees. Press coverage has been particularly good in financial trade publications, such as the *American Banker* and *Washington Banking Report*, and articles have appeared periodically in national publications, such as the *Wall Street Journal*, *Washington Post*, and *U.S. News and World Report*, as well as in many local newspapers. In addition, the press conferences are periodically covered by television, including C-SPAN, PBS, CNN, and CNBC.

The first 69 policy statements issued by the Committee through February 1991, an average of 3½ per meeting, are reprinted in this special issue. Later policy statements are published in the quarterly issues of the *Journal of Financial Services Research* on a current basis, starting with the October 1991 issue. The statements range from one page to many pages; from relatively small matters, such as disclosure by regulatory agencies and bank audits, to large matters, such as the FSLIC crisis and financial and regulatory restructuring; and from issues concerning commercial banks to issues concerning financial exchanges and ethics. The statements contain the analyses underlying the conclusions and recommendations. The Committee's track record has been rather good. It provided early warnings of a number of serious problems and offered solutions that would further the public interest.

The Committee is proudest of its record on the FSLIC crisis, the depletion of the FDIC/BIF fund, and reform of deposit insurance. In the S&L debacle, the Committee provided some of the earliest accurate warnings both of the large magnitude and of the underlying causes of the problem as well as solutions for both resolving the crisis financially and preventing reruns. The Committee issued in its first warning at its second meeting, on June 9, 1986 (Statement No. 8), when the seriousness of the problem was not yet recognized by most policy makers, the press, academics, or other independent parties. The policy statement issued highlighted the large SLA losses and the dangers of granting forbearance to decapitalized associations and permitting these zombie institutions to continue to operate and recommended timely closure of insolvent associations and quick and complete recapitalization of an insolvent FSLIC. At its February 9, 1987, meeting, the Committee adopted a statement (No. 16) that put FSLIC's deficit at twice the official estimates that were being offered by policy makers and debated in Congress at the time, and concluded that this amount was larger than could be financed by either the SLA industry alone or even by all depository institutions. Thus general revenue funding was required. This was one of the first, if not the first, public call for the need to use taxpayer funds. In addition, the statement called for fundamental reform of the federal deposit insurance structure.

In February 1989, only one week after the Bush Administration's proposed SLA legislation was introduced, the Committee criticized the proposal for inadequate funding, unnecessarily raising the cost of the funding by doing it "off-budget," and failing to deal with the fundamental problems that caused the crisis by not changing the perverse

incentives for either bank managers or regulators (Statement No. 39). At its next meeting in May, the SFRC reiterated its call for on-budget financing and issued a detailed analysis of the pending legislation (Statement Nos. 42 and 43). The statement concluded that the provisions of the pending bill, other than the financing, were sufficiently counter-productive to warrant stripping the legislation of everything except the financing. Indeed, even the toughest capital standards proposed were lower than the standards that had been recently proposed by the regulatory agencies.

In December 1988 the Committee warned that if market value accounting were applied to the FDIC as it should be for accuracy and “if the FDIC were to experience losses that would not be unreasonable to anticipate in view of recent loss experience and problem bank estimates, the FDIC’s reserve balances would be virtually exhausted at present” (Statement No. 36). At the time, the FDIC reported its reserves to be near \$15 billion. This warning was reported in the *Washington Post* of December 5. Four days later, the same paper published a story headlined, “FDIC Cries Foul on Fund Analysis.” The lead paragraph reads:

No one makes Federal Deposit Insurance Corp. Chairman L. William Seidman madder than critics who say the fund that insures deposits at banks is weaker than he lets on. “If this agency were in trouble, I’d be screaming it from the rooftops,” Seidman said in a recent interview. [*Washington Post*, 1988]

Less than three years later, it became evident to everyone, including the FDIC, that its reserves were exhausted and that it had to request Congress for permission to borrow additional funds. In a statement issued in December 1991 (No. 77), the Committee noted that even with the recent and likely future increases in insurance premiums, the FDIC appeared to be economically insolvent.

At year-end 1991, Congress passed and President Bush signed the Federal Deposit Insurance Corporation Improvement Act of 1991. Although the act did not expand the product or geographic powers of banks, as recommended by the Administration and the SFRC, it did provide for a potential major reform of federal deposit insurance through early regulatory intervention and recapitalization or resolution before a bank’s capital was fully depleted. In addition, the ability of regulators to pursue “too big to fail policies” was restricted. This program was, as was the Administration’s proposal, to a significant extent based on the Committee’s earlier proposal entitled, “An Outline of a Program for Deposit Insurance and Regulatory Reform” (No. 41), issued on February 13, 1989. (A preliminary version of this proposal had been published on December 5, 1988 as Statement No. 38.) The similarities between the Committee’s proposal and the act were clear. Both require progressively stronger and more mandatory sanctions on banks as their financial condition, characterized primarily by their capital ratio, declines through a series of zones, or tranches. The act specifies five capital zones; the SFRC proposal specified four zones. Both require timely recapitalization or liquidation when the bank slips into the bottom zone. Both require the FDIC to resolve failures at the least cost to itself and to make depositors whole only up to the \$100,000 insurance ceiling. Both mandate the use of more accurate market or current value reporting for both the banks and the FDIC in its resolution procedures.

Although the SFRC applauded Congress for the act, it was disappointed that the provisions adopted were not as strong and mandatory as the Committee believes are necessary. As it noted in December 1991 (No. 76), the act delegates to the regulatory agencies the specification of many of the provisions and their implementation, including the abolishing of too big to fail. Thus the agencies are in a position to substantially weaken the intent of the act, and effective congressional oversight of their actions is required. The Committee regretted that the act did not expand bank product and geographic powers.

## Evaluation

To date, the SFRC has done as least as well as was to be expected when it was organized. The Committee was aided considerably by the rapid increase in both the magnitude and public awareness of first the SLA and then the banking crises. This served to increase the current significance of its policy statements and the interest of the media in the Committee. The Committee has achieved significant credibility in its short period of existence, judging from (1) the number of requests for its policy statements and for information, (2) the availability of Monday morning guests, and (3) the increasing press coverage. Its policy statements are read by a large number of involved parties and taken seriously, if not always accepted. Since 1989, Committee members have been invited to testify more than a dozen times before either House or Senate committees. The Committee has also worked closely with the staffs of these committees, particularly with respect to the provisions of the FDIC Improvement Act. By providing independent and rigorous analysis, the Committee has educated both involved parties and the public on the issues and has helped to raise the level of debate.

A number of years ago, Milton Friedman (1986), in his presidential address to the Western Economic Association entitled "Economists and Economic Policy," concluded that "maybe tariffs are 10 percent lower than they otherwise would be because of our [economists] long-term advocacy of free trade; if so, that 10 percent would pay the salaries of the economics profession many times over." This probably holds equally true for the SLA and banking crises. It appears fair to conclude that the SFRC is well on the way to showing that outside economists can affect public policy in the public interest on an ongoing basis.

## References

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- Macey, J. R. "The Political Science of Regulating Bank Risk." *Ohio State Law Journal* 48 (1989), 1277-1298.
- Nelson, R. H. "The Economics Profession and the Making of Public Policy." *Journal of Economic Literature* (March 1987) 49-91.

**Appendix: Members of the Shadow Financial Regulatory Committee, 1986-1992**

Lawrence Connell (Co-Chair), Prather, Seeger, Doolittle & Farmer  
George G. Kaufman (Co-Chair), Loyola University of Chicago  
Richard C. Aspinwall, Chase Manhattan Bank  
George J. Benston, Emory University  
Franklin R. Edwards, Columbia University  
Robert A. Eisenbeis, University of North Carolina  
John D. Hawke, Jr., Arnold & Porter  
Richard J. Herring, University of Pennsylvania (1990- )  
Paul M. Horvitz, University of Houston  
Edward J. Kane, Boston College  
Roger W. Mehle, Attorney-At-Law  
Alan H. Meltzer, Carnegie-Mellon University (1986-1990)  
Franco Modigliani, Massachusetts Institute of Technology (1992- )  
Kenneth E. Scott, Stanford Law School

# Statement No. 1

## The Baker Plan and LDC Lending

February 15, 1986

Treasury Secretary Baker's recent proposal calls upon banks in the United States to lend an additional \$29 billion to debtors in 15 countries with recent debt-servicing problems. This proposal interposes the government as a party in the negotiations and a proponent of additional bank lending.

We oppose the Baker Plan. The plan shows a lack of political discipline. The international debt problem is one for the banks to work out with the principal debtors. The Baker plan shifts onto the taxpayer, in an indirect and roundabout way, costs arising from prospective losses that should be borne by bank owners and managers.



## Statement No. 2 Aid to Failing Banks

February 14, 1986

The Comptroller of the Currency has recently proposed that failing agricultural banks be kept in operation by a combination of deferral of losses and direct financial assistance from the FDIC. We oppose unrealistic deferral of losses, but FDIC assistance may be an appropriate alternative to liquidating a bank or merging it into a healthy institution. Such an approach has merit when a turnaround of the institution appears possible and provided that it imposes appropriate penalties on stockholders, management, and uninsured depositors and other creditors. The FDIC should obtain an equity position in the bank that will allow it to recapture its outlay through sale of that equity if the bank becomes a viable entity.

## Statement No. 3

# The Federal Reserve Ruling on Junk Bonds

February 14, 1986

In the view of the Shadow Financial Regulatory Committee, the interpretive ruling issued by the Federal Reserve Board on January 10, 1986, dealing with financing takeovers through debt issued by shell corporations was not justified in empirical, theoretical, or legal terms.

On an empirical and theoretical level, the Fed made no case to justify the proposition that current leverage ratios should be a matter for concern. The risk of a business enterprise is determined by the nature of its assets and activities; that risk is then distributed among debt and equity holders in proportion to the size and priority of their claims. The Fed made no effort at all to demonstrate that the present structure should be a matter of special concern at this time.

Legally, the Fed made use of a source of regulatory authority—its control over margin requirements in the trading markets—to reach an end only tangentially related to its statutory power. Indeed, the Fed has itself suggested that that very statutory power serves no necessary or essential purpose and should be repealed. Its use in this context suggests an attempt to serve an entirely different objective: a politically expedient response to congressional pressures generated by the desire of the managements of large corporations to be protected from the possibility of takeover by the managements of smaller corporations. This limitation upon the operation of the market for corporate control is not justified by any evidence of reasoned discussion offered by the Fed in issuing its ruling.

The shortcomings of the justifications for the Fed's action were no doubt exacerbated by its refusal to follow the procedures of the Administrative Procedure Act for notice and adequate opportunity for public comment on regulations. Had the Fed not chosen to follow the shortcut procedure for an interpretive rule, its action might have been better considered.

## Statement No. 4 Disclosure of Supervisory Actions and Examiner's Ratings

June 9, 1986

The Federal Deposit Insurance Corporation (FDIC) has proposed disclosing its filings of final supervisory enforcement actions (such as cease-and-desist orders). Such actions have increased in frequency and are released sporadically. A general policy is overdue. We favor this type of disclosure. Moreover, we agree with the FDIC's decision not to publicize its notices of charges, because such rare revelation does not give the bank charged adequate opportunity to explain its side of the issue and is subject to abuse.

We suggest that all supervisory agencies reveal their examiners' ratings to all bank directors. In addition, we urge supervisors to develop a uniform and objective rating system and allow (but not require) banks to publicize these ratings. All banks should be allowed to tell the public about their performance. Those with bad ratings can be silent, but their silence provides information to those with incentive to use this information.

## Statement No. 5

# Disclosure by Regulated Financial Institutions

June 9, 1986

The Office of the Comptroller of the Currency (OCC) has proposed regulations that would significantly increase the disclosure requirements to which all national banks are subject. We oppose these regulations for several reasons.

First, there is no reason to require banks to report to their shareholders differently from other corporations. The OCC's regulations would apply to banks that have relatively few shareholders and therefore, like any corporation, are not subject to the securities acts' requirements. The OCC would impose excessive costs on these institutions.

Second, the regulations would not benefit customers with \$100,000 or less in a deposit account because they already are protected by deposit insurance. Uninsured depositors and other bank creditors might benefit from increased disclosure if they believed that their funds were at risk. In this case, however, banks themselves would have a greater incentive to disclose more information voluntarily. Thus additional disclosure regulations will impose costs on banks in excess of benefits.

Consumers also would not benefit from banks being required to report their charges for services in their annual reports. The ordinary bank customer does not receive such reports. There are more effective and less costly ways of improving disclosure of bank service prices. Competition among banks and other providers of financial services assures that consumers are informed about prices and services. Furthermore, the required reporting would not be current and would impose costs on banks that consumers eventually would have to pay.

## Statement No. 6

# Proposals for Risk-Related Capital Guidelines

June 9, 1986

The Federal Reserve, the FDIC, and the Comptroller of the Currency have proposed risk-based capital adequacy guidelines for bank holding companies and for member and nonmember banks. Concern with this issue is welcome.

First, any risk-related capital or insurance premium system must be based on an effective system for monitoring capital. The proper measure of capital is the market value of assets less the market value of nonequity liabilities. The proposed capital guidelines are based on historical values of assets and capital and are therefore deficient. Reporting of current market values should be the first step in the development of capital guidelines.

Second, the proposals assign arbitrary weights to risk classes instead of weights reflecting the market valuation of risk. The more that market valuations are used, the more objective and reliable risk-based capital standards become. The use of market values also inhibits the tendency for asset weights to become the basis for nonmarket credit allocation.

Third, the proposal should require the quantification of interest rate risk and should use these measures to develop capital guidelines. Maturity or duration-based systems for quantifying interest rate risk exposure are now in use in many institutions and should be adopted by regulators.

Fourth, the proposed weighting scheme does not adequately recognize diversification, a fundamental principle of finance. The risk borne by a financial institution can be changed by diversification as well as by the choice of individual projects, and by leverage. The proposed weighting system concentrates on interaction between leverage and the risk of individual projects but neglects the role of diversification within and among asset groups.

Fifth, the proposals make a useful first step toward recognizing some important risks that do not appear on current balance sheets. Such risks are equivalent to risks on the balance sheet and should be treated symmetrically.

## Statement No. 7

# Proposals for Capital Forbearance Policy for Agricultural and Energy Banks

June 9, 1986

In response to the financial difficulties in the agricultural and energy sectors of the economy, the Federal Reserve Board, Federal Deposit Insurance Corporation, and Comptroller of the Currency have recently announced a joint program of capital forbearance for agricultural and energy banks in which the agencies will not enforce the 5½ percent minimum primary capital-to-asset requirement for qualifying banks for up to seven years if the ratio does not decline below 4 percent. This program permits lowering capital requirements precisely when they are most needed. Because bank capital is already low by historical and regulatory standards, we believe that this program is unwise and will prove counterproductive in the long run.

Bank capital represents funds that shareholders have at risk and that they attempt to protect by exerting discipline on bank management. Such discipline is particularly important at smaller banks whose deposits fall almost entirely within the FDIC's \$100,000 insurance limit and thus are not subject to market discipline by uninsured depositors. As recent experience from the thrift industry clearly indicates, when capital declines to the point where owners have very little to lose, institutions are encouraged to "go for broke" in an attempt to replenish equity quickly. Few such gambles pay off, and losses to the federal deposit insurance agencies, and eventually the taxpayer, will be larger than otherwise.

A requirement for eligibility in the program is that a bank be both well managed and experiencing temporary losses. Such banks, however, should have little difficulty in raising additional capital, particularly if shareholders and management are provided with the incentive to do so by fear of losing control of the bank. Raising additional capital may take some time, and during this time it is appropriate for a bank to be permitted to operate with lower capital. But the time permitted to replenish capital should be closer to seven weeks than to seven years as permitted under the program. Longer-term capital forbearance is a program of forbearance for bank management and owners. It is of little benefit for bank customers.

We also see little value in Statement of Financial Accounting Standards No. 15 (FAS 15), which forestalls recognition of losses on restructured troubled loans as long as the total of future payments, as rescheduled, is not less than the recorded principal value of the loan. This primarily substitutes future income losses for current capital losses. We favor prompt recognition of losses by banks even if this results in lowering recorded net worth, and we support actions by the bank regulatory agencies to this end.

## Statement No. 8

### Recapitalizing FSLIC and Zombie S&Ls

June 9, 1986

According to estimates reported by the U.S. General Accounting Office, as of mid-1985 461 S&Ls with \$113 billion of assets were operating with negative net worth, as defined by generally accepted accounting principles (GAAP). For the industry as a whole, the deficit aggregated \$3½ billion. The number of economically or market-value insolvent S&L associations is underestimated by GAAP, since GAAP includes as assets goodwill and other intangibles carried at “book” value. In essence, economically insolvent S&Ls are de facto nationalized; in practice, they are appropriately described as “zombies”.

The zombie development has reached its present stage for several reasons. Supervisory, monitoring, and information development systems for S&Ls have been inadequate. The Federal Home Loan Bank System chose to defer oversight problems; operating and valuation losses were concealed by novel and irregular regulatory accounting principles (RAP) and the use of a liquidity criterion to differentiate between the viable and zombie institutions. The availability to insolvent institutions of FSLIC guarantees of deposits has enabled most of these institutions to pass the liquidity test and continue in operation.

The presence of S&L zombies raises three issues of public policy. First, S&L zombies must be kept from absorbing additional FSLIC resources by the contamination of healthy institutions and through future operating losses. This suggests the need for expeditious recapitalization, public conservatorship, interindustry takeover, or closure of these entities, since existing regulations have been ineffective in curbing the zombie practice of bidding up deposit rates. Healthy institutions are also weakened by agency-imposed, across-the-board increases in deposit insurance premiums.

The second problem is to distribute the economic losses already imposed on the FSLIC. A 1982 resolution expressed the sense of Congress that the full faith and credit of the United States might be available to potential claimants against FSLIC reserves. If these potential claims were now to come due, the FSLIC would be unable to meet them from its present resources. An injection of substantial new capital into the FSLIC would be required. Although the largest possible part of this capital injection should come in some way from the thrift industry, recent proposals for new infusions to FSLIC from advances by the Federal Home Loan Banks do not fully resolve the problem.

The third policy requirement is to prevent a repetition of this development in the future. A central element of reform must be an early elimination of well-known weaknesses. This applies to banks as well as to S&Ls. A threshold for the “windup” of an institution’s position should be established at some level of net worth above zero. Ideally, such net worth should be defined in market terms—that is, balance sheet and off-balance sheet positions should be marked to market at frequent intervals to provide an estimate of economic net worth. Recent proposals by the Federal Home Loan Bank Board to increase capital and liquidity requirements, to move away from RAP accounting, and to strengthen oversight of credit quality represent steps in the right direction.

## Statement No. 9

# Proposals to Facilitate the Interstate Takeover of Failing Depository Institutions

June 9, 1986

Hearings have been held recently by the Senate Banking Committee on legislation being sought by the federal banking agencies to modify the provisions of the Garn-St. Germain Act of 1982 that provide under certain circumstances for the interstate takeover of failed banks and thrifts. The principal changes being proposed include permitting the takeover by bank holding companies of failing but not yet closed commercial banks in other states and lowering the minimum size of failed and failing banks that would be eligible for interstate takeovers from \$500 to \$250 million in assets.

The proposed legislation is designed to facilitate the bidding process for institutions that are likely to fail by allowing the takeover of firms that have not been closed and to enlarge the pool of potential bidders for failing institutions. The broadening of the definition of takeover candidates to include failing institutions is particularly important because it recognizes the relevance of market value as opposed to the accounting value of the institution's capital. Both of these provisions should facilitate the resolution of bank insolvencies and reduce potential losses to the insurance funds.

In addition the proposal would provide greater flexibility by permitting the acquisition of bank holding companies owning troubled banks. However, the retention of limitations on the acquiring institution's ability to expand further in the state of the acquired bank is undesirable. An acquiring institution should be treated the same as other institutions in the acquired bank's state.

We believe that such legislation has great merit and urge its prompt consideration and passage by the Congress. Existing provisions of the Garn-St. Germain bill are unduly restrictive, reduce the likelihood of speedy resolution of failures, and result in unnecessarily high costs to the insurance funds in resolving the failure of many institutions. Objections to these proposals are raised by those fearing that more liberal takeover rules will lead to full interstate banking and will reduce the role of the states vis-à-vis the federal government in regulating and shaping the structure of banking in individual states. The interstate banking concerns are fast becoming moot as regional interstate compact laws, with and without national triggers, are passed. Currently, some three fourths of the states already permit some type of out-of-state entry by bank holding companies. Moreover, restricting the FDIC and FSLIC from seeking the lowest-cost way of resolving failures by selling failed and failing institutions to the highest bidder, regardless of the location, forces the insurance funds, and ultimately the federal taxpayers, to subsidize in-state institutions by protecting them from competition by out-of-state firms.



Statement No. 10  
Federal Home Loan Bank Board  
(FHLBB) Proposed Rules on Regulatory Capital and  
Nationwide Lending by Insured Savings and  
Loan Associations

August 5, 1986

The FHLBB has proposed rules that would (1) change the way insured savings and loan associations' (SLAs') capital is measured, (2) increase the equity capital required of SLAs to 6 percent over six years, (3) impose additional capital requirements on certain activities, and (4) regulate and restrict their lending to 100 miles from their office location. We share the FHLBB's concern that some SLAs take risks that impose potentially large losses on the already inadequate Federal Savings and Loan Insurance Corporation (FSLIC) fund. Ultimately these losses may be borne by the taxpayers. But we disagree with some important portions of the proposed rules.

We applaud the FHLBB's move toward measuring capital with generally accepted accounting principles (GAAP). We urge, though, that this change be accompanied by recourse to more realistic and useful market-value accounting. We also applaud the FHLBB's program to increase significantly the level of capital for SLAs. SLA managers and owners who have substantial amounts of their own capital invested tend to be relatively more prudent in the activities they undertake. Consequently, there is less need to regulate them closely. We urge that the FHLBB also give greater consideration to developing deposit insurance premiums that reflect the risks taken by SLAs, as discussed in our June 8, 1986, "Proposals for Risk-Related Capital Guidelines".

Unfortunately, the FHLBB seems unwilling to rely primarily on the higher capital requirements it has proposed. Instead it would impose additional regulations that arbitrarily restrict direct investments (DI) and nonresidential construction and land loans (NRCLL). The proposed rule would impose an additional 10 percent capital requirement on DIs (for a total of 16 percent) and 4 percent on NRCLLs (for a total of 10 percent), while continuing a previously enacted regulation that limits DIs to 10 percent assets or twice equity absent the specific approval by the agency. The implicit risk rating inherent in these percentages is arbitrary and is unsupported by empirical research or practical experience. While restrictions on those SLAs without adequate real capital may be warranted, adequately capitalized and managed SLAs should be allowed to function without special constraints; it is sufficient that such firms merely be subject to oversight by state and federal regulators and supervisors. Imposition of restrictions on specific assets is counterproductive because it (1) inhibits well-capitalized and well-managed SLAs' pursuit of profitable and potentially risk-reducing activities; (2) is insufficient to control the other SLAs whose managers have incentives to "bet the bank," for which purpose they can use a wide range of unconstrained activities; and (3) interferes with the efficient

allocation of resources. On the other hand, insolvent institutions should be closed and near-insolvent SLAs should be specially monitored.

The proposal to restrict nationwide lending suffers from the same defects. We acknowledge that some loan participations and sales can present serious problems. But the proposed rule overly constrains well-capitalized and well-managed SLAs and importantly limits potentially risk-reducing geographical diversification, while inadequately controlling SLAs predisposed to take excessive risks. It also would impose costs on the free and effective movement of capital, which would hurt both borrowers and depositors. We suggest that the Bank Board can deal with the problem by adopting a policy statement requiring adequate documentation and monitoring for all loan participations, similar to that adopted by the Office of the Comptroller of the Currency.

Indeed, we urge that the Bank Board not attempt to adopt rules that restrict the activities of all associations. Rather, general policies should also be adopted that provide associations with incentives and opportunities to increase their capital and reduce potential costs to the FSLIC.

# Statement No. 11

## Federal Regulation of Activities of State-Chartered Financial Institutions

November 17, 1986

A basic premise of the dual banking system is that the powers of state-chartered financial institutions are to be defined in the first instance by the states. Recently, however, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Federal Savings and Loan Insurance Corporation have asserted broad authority to limit and condition the activities of state-chartered institutions. These initiatives have been prompted by laws in an increasing number of states that have given state banks broader powers than national banks and, in some cases, broader powers than nonbanking subsidiaries of bank holding companies, principally in the areas of real estate, securities, and insurance.

While we recognize that there is a legitimate federal interest in the scope of the activities permitted to state-chartered institutions—the interests of the FDIC and FSLIC as insurer of deposits—we believe the states should have maximum freedom to define the powers of the institutions they create. Ideally, the question of state bank and thrift powers should be addressed in the context of a risk-related deposit insurance system. Absent such a system, however, if federal authority is to intervene at all with respect to banks, we believe the FDIC, rather than the Federal Reserve, is the appropriate agency to protect the federal interest. The Bank Holding Company Act was not intended to give the Federal Reserve the responsibility of regulating the activities of banks, and it is inappropriate for the Federal Reserve to create disparities among state-chartered banks by using the Bank Holding Company Act to regulate the activities of state banks that happen to be in holding companies, whether such activities are carried on directly in the bank or through a bank subsidiary.

There should, we believe, be a strong presumption that state-chartered financial institutions may properly exercise any powers conferred upon them by state law, and the FDIC and FSLIC should not intercede to curtail such powers except in the most compelling circumstances, where a substantial, well-defined, and clearly documented threat to the insurance interest is presented.

## Statement No. 12

# Conversion of S&Ls from FSLIC to FDIC Insurance Coverage

November 17, 1986

Over the last several months a number of FSLIC-insured savings and loan associations have proposed to convert to commercial banks or savings banks with FDIC insurance. The Federal Home Loan Bank Board has expressed concern about this development, noting that a loss of future deposit insurance premiums from healthy savings and loans could adversely affect the ability to sell the bonds to be issued in connection with an FSLIC recapitalization plan. Thus the Bank Board has adopted regulations and procedures designed to impede or prevent conversions of healthy institutions.

The ability of financial institutions to convert from one charter to another is one of the strengths of the American financial system. It is the best means of preventing excessive or overzealous regulation by a single regulatory agency. Indeed, in the absence of the ability to change from one type of charter to another—state to federal, bank to thrift, savings and loan to savings bank, or vice versa—there would be little justification for our existing complex, multilayered regulatory structure. We oppose, therefore, actions by the regulatory agencies that would eliminate or weaken this traditional safeguard of the regulatory system.

We recognize, of course, that the FSLIC is in critical financial condition. The Bank Board has imposed a special insurance assessment of  $\frac{1}{8}$  of 1 percent of deposits in addition to the normal  $\frac{1}{12}$  of 1 percent. This represents an additional cost to FSLIC-insured institutions that is not faced by their commercial bank competitors. It is unlikely that the Bank Board will eliminate this special assessment in the near future. This provides an incentive for some institutions to seek to change insurance systems in order to avoid that special assessment.

Such a conversion is not easy, as the S&L converting to commercial bank status would have to meet the higher capital requirements imposed by the banking regulatory agencies, as well as face some restrictions on its allowable activities. We do not believe that the number of institutions that would find conversion attractive simply to avoid the  $\frac{1}{8}$  of 1 percent additional insurance cost is large enough to pose a serious threat to the FSLIC. Institutions reasonably close to meeting the FDIC requirements account for less than 10 percent of the industry's assets.

Existing law provides for a final insurance payment, or "exit fee," when an institution leaves the deposit insurance system, though that provision was not aimed at institutions moving from FSLIC to FDIC coverage. The FSLIC has recently begun to impose a fee on institutions planning such a conversion. The Committee is uncomfortable with such a charge because its objectives are not clear: Exit fees cannot represent a significant source of funds to the FSLIC, and exit fees cannot hold unwilling members in the FSLIC system. We also find it difficult to see how an appropriate fee can be determined. Before any such

fee is imposed, it must be demonstrated that a fee is essential to a congressionally enacted recapitalization plan, and provision for the fee should be explicit in the legislation. Any charge should not be so large as to prevent conversions by those institutions that have a legitimate business reason for conversion.

It is the Committee's policy that members abstain from voting on policy statements in instances in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, John D. Hawke, Jr. abstained from voting on this statement.

## Statement No. 13

# Current Bank Holding Company Applications for Increased Securities Activities

November 17, 1986

The Federal Reserve Board presently has before it applications by four bank holding companies—Chase, Chemical, Citicorp, and Morgan Guaranty—that, if approved, would expand the securities activities permissible for bank holding companies. If approved, bank holding companies would, for the first time, be permitted through a wholly owned subsidiary to engage domestically in underwriting and dealing in municipal revenue bonds, mortgage-related securities, and consumer receivable-related securities, as well as commercial paper.

The Committee believes that these applications should be approved. The proposed activities are closely related to banking and a proper incident of banking, do not pose an unacceptable risk to the soundness of bank holding companies, do not compromise the interest of either the company's subsidiary bank customers or its affiliates' customers, and would promote competition in the relevant securities markets.

More broadly, the pending applications are part of a general trend toward expanding the securities activities permissible for bank holding companies under both the Glass-Steagall Act and the Bank Holding Company Act. The Committee believes that this trend is a constructive development that promises to improve the quality of financial services and to provide greater economic stability for financial institutions and markets.

With respect to the specific applications, the Committee would go further than the Federal Reserve Board would if it were to approve the applications as submitted. Section 20 of the Glass-Steagall Act requires that the proposed securities affiliates not “engage *principally*” (emphasis added) in the underwriting and/or dealing in the new securities activities that are proposed in the application. To adhere to this standard, the applicants have agreed to restrict their new activities in two ways. First, they would impose on their new activities an internal limit of 10 percent of the gross sales of both their presently permissible activities and their newly proposed activities. In addition, the applicants have agreed to limit their proposed activities to specified percentages of the total market value of all underwriting and/or dealing in the market for the securities activities in question.

The Committee believes that, although there is no authoritative judicial interpretation of the Section 20 “engage *principally*” test, the Federal Reserve Board should give maximum reasonable latitude to this limitation. In addition, the Committee sees no constructive purpose in the specified limits on total market value. These limits are not necessary to meet the “engaged *principally*” test and would needlessly restrict competition. The Committee believes that no such restriction should be imposed on the applicants.

Finally, the Committee recognizes that the legislative barrier between banking and securities activities erected by the Glass-Steagall Act is being eroded in a piecemeal and haphazard fashion and that the applications at issue are part of this larger drama being

played out. The Committee, therefore, strongly believes that new legislation should be enacted that is more consistent with both current market forces and present economic theory and fact. Until that is done, however, the Federal Reserve Board, by approving the proposed applications, has the opportunity to move us forward toward the desired goal.

It is the Committee's policy that members abstain from voting on policy statements in instances in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Richard C. Aspinwall, George G. Kaufman, and Kenneth E. Scott abstained from voting on this statement.

## Statement No. 14

# Policies Toward Troubled Depository Institutions

November 17, 1986

While asset valuation problems have received particular attention where institutions have had energy, LDC, and agricultural concentrations, exposure to losses from real estate lending is probably the chief vulnerability at present. When finally recorded, loan write-downs are often a significant percentage of the “book” valuation of such loans. Unrecognized losses now affect—or soon will—a broad range of banks and S&Ls having assets totaling hundreds of billions of dollars. These losses pose a substantial threat to the solvency of the FDIC and the FSLIC.

Because of these losses, a substantial amount of additional funding is urgently needed for the FSLIC. Based on reasonable economic estimates, the \$15 billion recapitalization recently considered for the FSLIC is significantly less than the amount of funds required by that agency.

The problem of insolvency now facing the FSLIC could also confront the FDIC. In the long run, capital forbearance and open-bank assistance can easily amplify unrealized losses in the banking system. If this occurs, the FDIC may need recapitalization too.

In the current political and economic environment, “open assistance” may be the most appealing way of dealing with the inadequate capitalization of the insurance system. Open assistance should have as its sole objective the reduction of the ultimate total cost of resolving the insolvencies we now face. It may do this by “buying time,” if there is a reasonable expectation that the cost of doing so is warranted by specific measures that will alleviate the problem.

When giving such assistance, either through equity or debt infusions, the Committee believes that the FSLIC and the FDIC should have to demonstrate clearly the reasonableness of individual assistance decisions. Criteria governing eligibility for open assistance, and regulatory guidelines covering decisions on such assistance versus closure, should be explicit.

The Committee proposes that, at a minimum, the following criteria for assistance be met:

1. The agency should make timely and accurate disclosure of the economic value of the direct and indirect assistance given and the estimated costs of the alternative of liquidating the insolvent institution. The bases for these calculations also should be disclosed.
2. An institution’s losses should be imposed on its shareholders and uninsured claimants to the maximum extent possible.
3. The program should contain a clear schedule for the reprivatization of the institution or its assets.
4. The agency should not give the assisted institution sustained and material competitive advantage over stronger entities.



## Statement No. 15

# Proper Financing of Private Party Securities Fully Guaranteed by the Federal Government

December 1, 1986

Federally guaranteed securities proliferated in the early 1970s when a number of federal agencies (e.g., Department of Agriculture, Defense, Housing and Urban Development, General Services Administration, Small Business Administration), to escape budget constraints on their lending programs to private parties, began to guarantee the loan obligations of such parties, rather than lend them money directly.<sup>1</sup>

Typically, these private party obligations, which carried the full faith and credit of the United States, were sold in cooperation with the agencies by underwriters in the public market at interest rates considerably higher than ordinary Treasury obligations, their credit equivalent.

In response to a mounting flood of this costly form of federal financing, the Congress in 1973 created the Federal Bank (FFB) with the U.S. Treasury Department. In general,<sup>2</sup> all private party securities fully guaranteed by the federal government were thereafter required to be sold to the FFB, which, in turn, would fund the securities through ordinary Treasury financing, thereby passing the benefit of the Treasury's low-cost borrowing to the private parties. For years, the FFB thus efficiently financed federal credit programs. The disbursements made by the FFB, however, were not recorded as budget outlays. This budget treatment was agreed to because it was effectively the same as had existed before the FFB, when such government-guaranteed obligations were sold in the open market; the political tradeoff for creation of the efficient FFB financing mechanism was its off-budget status. Thus through their private party loan guarantee programs federal agencies were still able to channel substantial resources to their constituencies without increasing stated government expenditures.

In 1986, after thirteen years of off-budget treatment, the Gramm-Rudman Act mandated that the disbursements of the FFB be recorded as budget outlays and charged to the agencies that fully guaranteed the private party securities funded by the FFB. Accordingly, federal government expenditures now include the very sizable aggregated disbursements formerly made "invisible" through FFB off-budget treatment.

Unfortunately, this change in accounting treatment has led recently to a return to pre-FFB open-market financing by federal agencies. Under the pressures of Gramm-Rudman, Congress, having put the FFB outlays on budget, is now ordering that the fully government-guaranteed loans of certain private parties be financed once again in the open market to keep them off-budget. Examples of measures along these lines enacted by the last Congress include legislation that requires the following

Two billion dollars of fully government-guaranteed rural electric cooperative loans to be sold in the open market, rather than to the FFB.

Several hundred million dollars of fully government-guaranteed small business investment company debentures to be sold in the open market, rather than to the FFB. Approximately two billion dollars of fully government-guaranteed agricultural loans to be sold in the open market, rather than to the FFB.

Thus, to reduce the apparent deficit, sound federal financing policy is being sacrificed. (Ironically, the inefficiencies and increased costs of these financing programs will cause the true value of the deficit to become even greater.) When the Congress returns, it seems likely that there will be a renewal of these misguided efforts.

The Committee urges that all federal credit programs be funded through Treasury financing rather than through the inefficient method of open-market sales, as separate and distinct securities, of fully federal-guaranteed private party loans (or their inventive functional equivalents, such as pledgeable federal financing leases with private parties, federal agreements to buy back defaulted private party securities or to make up deficient private party debt service, and so forth).

In this spirit, we encourage Congress and the Administration to contest vigorously any future efforts to undermine this principle. In particular, the Committee objects to legislation of the kind passed in 1986 that mandates sale of fully federally-guaranteed private party obligations in the public market rather than to the FFB. The FFB, or its equivalent, should be preserved in essentially its present character, with its use required for private party fully guaranteed obligations. Legislative "quick fix" attacks on the FFB concept under Gramm-Rudman pressures for deficit reduction will only add to the true cost of financing government programs.

1. Federal government budget conventions require recording the entire amount of a government loan as a cash expenditure, or "outlay," of the current period. When loan repayments are made to the government in the future, they are recorded as "negative outlays" of that period. By contrast, loans *guaranteed* by the federal government do not give rise to "outlays" at all unless a payment is made under the guarantee. The Committee believes that the recording of the entire amount of a federal loan as an "outlay" is misleading and that *only* the present value of the subsidy inherent in the loan, together with reserves from any losses expected, should be recorded as current expenditures. (The Committee recognizes that such a convention leads logically to the use of the type of structure for the federal budget sometimes referred to as a "capital budget." Thereunder, the principal amount of a loan would be recorded as an asset acquisition rather than a current expenditure.)
2. Notably excepted, among others, were the fully government-guaranteed mortgage pool securities of the Government National Mortgage Association (Ginnie Mae).

## Statement No. 16 FSLIC Recapitalization

February 9, 1987

Congress is considering proposals to recapitalize the FSLIC. The FSLIC's net reserves have declined to about \$2 billion, while the present value of its expected losses has been estimated at \$30 billion or more.

The current Administration proposal, however, entails raising only \$10-15 billion, through issuance of long-term debt. This debt would be serviced by contributions from the Federal Home Loan Banks, a pledging of the FSLIC's future income, and a continuation for many years of the special assessment on FSLIC-insured institutions.

The Shadow Committee believes that the problem of insolvency of the FSLIC is critical, demanding prompt governmental decisions. Delays in resolving this insolvency have already added substantially to the ultimate bill that must be paid. Moreover, the FSLIC reports that currently insolvent institutions are incurring losses of over \$6 million per day.

Congress now must decide who will pay for these mounting losses. There are four broad alternatives:

1. The FSLIC could be allowed to fail when it runs out of cash. Losses would be suffered by insured depositors in failed institutions. This policy assigns the loss to depositors and raises the problem of runs on other institutions.
  - Deposit insurance was established with limited resources and without an explicit U.S. government guarantee. However, the public has been led to believe that the federal government stands behind the deposit insurance system. A March 1982 resolution stated the United States Treasury stands behind the FSLIC. While this resolution would not seem to have legal force, savings and loans have used this statement widely in their advertising, with no objection from the federal government. We do not believe that substantial losses should be imposed on depositors who have relied on this implicit guarantee.
2. The funds needed to restore the FSLIC to health could be drawn mainly from the savings and loan industry, as the Administration's proposed legislation would do.
  - This approach assumes implicitly that it is most equitable that the savings and loan industry bear the largest part of the burden of recapitalizing the FSLIC. These institutions have benefited over the years from the operation of the federal deposit insurance system. While the Committee agrees with assessing savings and loan associations, it believes that the funding contemplated by the Administration's proposed legislation is inadequate. Moreover, funding at an adequate level (i.e., \$30 billion) would exhaust the industry's present net worth.
3. Commercial banks could be tapped, in addition to savings and loan associations, to make up the FSLIC losses.
  - Since commercial banks have also benefited from the existence of federal deposit

insurance, it has been argued that they should share in the burden of recapitalizing the FSLIC. On the other hand, commercial banks have not caused the FSLIC problems. One way of indirectly assessing commercial banks would be by merging the FSLIC with the FDIC. However, the combined insurance funds cannot cover the present expected losses of all banks and savings and loans.

4. We think it inevitable, therefore, that the general taxpayer will have to bear some of the cost.

—The current Administration proposal provided significant resources to be financed by the industry to deal with the immediate problem, and we support that approach. We believe, however, that the FSLIC needs more funds—which must come from the taxpayer.

—Although recognizing and distributing FSLIC losses is necessary, that is only the most obvious part of the solution to the problems insolvent institutions pose. An explicit commitment must be made to the taxpayers to assure them that their money will be used efficiently. A system that uses market values must be established for making FSLIC officials more accountable to Congress and the taxpayers. Economic principles for selecting institutions for reorganization need to be enunciated explicitly. While forbearance may be useful in some cases, opportunities for corrupt or wasteful management of the assets of weak institutions must be curtailed.

—Fundamental redesign of federal deposit insurance, to the end that current problems will not again be encountered, remains a project of the highest priority.

Statement No. 17  
The Federal Reserve Board's "Source-of-Strength"  
Policy  
May 18, 1987

On April 24, 1987, the Federal Reserve Board issued a policy statement declaring that it would generally consider it to be an unsafe or unsound banking practice for a bank holding company to fail to act as a "source of strength" by assisting a troubled or failing bank subsidiary when the holding company is in a position to provide financial support. The statement is an outgrowth of concerns that some federal bank regulators have had where a multibank holding company having available financial resources has permitted or threatened to permit a subsidiary bank to fail. The Board's policy would be implemented in particular cases through the institution of cease-and-desist proceedings aimed at forcing financial support.

The Board's "source-of-strength" policy appears to be intended to force bank holding companies to be guarantors of the capital adequacy of their subsidiary banks. Viewed as such, this policy is tantamount to a rule making bank stock assessable. The Shadow Committee believes that the Board's policy statement is defective in several respects:

1. The policy runs counter to what the Committee believes to be sound bank closure policy. Bank owners should not be required to inject financial resources into insolvent banks; nor should they be deprived of the right to place solvent institutions into voluntary liquidation in order to prevent further erosion of their investment. The interests of depositors and the FDIC could be better protected by an improved closure policy that permits and encourages the closing of troubled banks prior to real insolvency. The threat of early closure would present owners with the choice of infusing additional resources to protect their investment or leaving the salvage of their investment to the regulators. A rule that would deprive owners of the ability to close troubled institutions serves only to promote socially inefficient investment.
2. In its present form the policy statement is exceptionally vague. It does not define specific circumstances under which financial support will be demanded from holding companies; it does not specify in what amounts it will require support; and it does not specify how it will determine whether a holding company "is in a position to provide the support." Because of this vagueness, and because the policy can be enforced only through case-by-case litigation, it creates the potential for an overly broad and arbitrary application of the policy, which could have an adverse impact on the value of bank holding company stocks and on the willingness of holding companies to acquire banks—particularly troubled banks.
3. The policy discriminates among different types of owners of banks, imposing liabilities on corporate owners that would not be imposed upon individual owners or upon chain banking organizations that do not operate in a holding company format. The Committee believes that if bank owners are to be assessable, the need for assessment should

be addressed by the regulators responsible for determining the adequacy of bank capital, rather than by the regulator of bank holding companies.

4. The Board's legal authority to enforce the policy is open to question. Congress has not given the Board power to issue capital directives to bank holding companies, whereas it has given such power to the regulators of banks, and it is far from clear that the Board can use its cease-and-desist authority over holding companies to compel capital contributions to subsidiary banks.

# Statement No. 18

## Regulatory Proposals for Risk-Related Capital Standards

February 9, 1987  
(Revised May 18, 1987)

The Federal Reserve Board, the FDIC, the Office of the Comptroller of the Currency, and the Bank of England have published proposals for public comment to establish risk-based capital adequacy standards to be applied to consolidated bank holding companies and to banks. In commenting on a similar proposal in June 1986, the Shadow Financial Regulatory Committee applauded the agencies' concern with this issue.

The new proposal makes an important additional advance by including the Bank of England as a participant in the program. The move to standardize the definition of primary capital and international supervisory policies is an important one, reflecting the increased internationalization of the world financial system. Moreover, the proposals make a further advance in addressing risk posed by off-balance-sheet items. In addressing these risks, the agencies correctly recognize that such risks are equivalent to risks on the balance sheet and treat them symmetrically.

In commenting on the previous proposal, the Committee noted several weaknesses and problems. The regulators have addressed some, others remain, and a few new issues have arisen.

### **1. Market value reporting**

Any risk-related capital or insurance premium system must be based on an effective system for monitoring capital. The proper measure of capital for regulatory purposes should be the market value of assets less the market value of nonsubordinated liabilities. The proposed capital guidelines are based on historical values of assets and capital and are therefore deficient.

### **2. Market-determined risk weights**

The proposal assigns weights to risk classes that do not necessarily reflect risk premiums determined in financial markets. The more that market-determined risk premiums are used, the more objective and reliable risk-based capital standards become. Their use also inhibits the tendency for asset weights to become the basis for nonmarket credit allocation, a tendency that would be fostered by the present proposal.

### **3. Interest rate risk**

The proposal should include procedures for quantifying interest rate risk. While the agencies indicate that such a program is under development, the Committee supports the Comptroller of the Currency and the FDIC in opposing the categorical assignment of specific assets to a risk class because of interest rate risk characteristics rather than credit risk concerns. The degree of an institution's exposure to interest rate risk does not depend upon having particular assets in its portfolio. Rather, it is determined by the relative interest sensitivity of the institution's assets and liabilities considered together.

### **4. Portfolio diversification**

The proposed scheme does not yet adequately recognize the value of diversification, which is a function of the combination of assets and liabilities in a bank's portfolio. The weights to be given to individual assets and liabilities must take into account their marginal contributions to overall portfolio risk.



Statement No. 19  
Supplementary Statement:  
Regulatory Proposals for Risk-Related  
Capital Standards

May 18, 1987

On March 31, 1987, the FDIC published for public comment a proposal jointly sponsored with the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Bank of England to establish risk-based capital adequacy standards to be applied to banks and consolidated bank holding companies. The Shadow Financial Regulatory Committee commented previously on these proposals, and a modified version of the previous statement appears as Statement No. 18. There are two additional points that should be considered before the proposals are adopted.

**5. Risk-taking incentives**

To control excessive risk-taking incentives inherent in the present flat-rate deposit insurance system, regulators need to rely upon regulation and capital policy. To the extent that the proposed risk weights do not reflect market-determined risk pressure or the risks are too broad, incentives are created to avoid the proposed capital constraints and increase risk exposure.

In the present proposal, all loans are treated the same, regardless of whether the borrower is a AAA or BBB. Thus an AAA credit would bear the same capital requirement as a BBB credit. To avoid inducing institutions to decrease their holdings of lower-risk relative to higher-risk loans, there needs to be more explicit considerations that some loans, by virtue of their terms, maturity, and credit quality, have different exposures to risk than others, and hence, should bear different capital requirements.

The proposal may also discourage securitization of assets, since partial guarantees would have the same capital requirement as if the loan had been retained on the books, regardless of the extent of the guarantee. However, some of the loss guarantees on securitized transactions cover losses up to a fixed proportion of assets. Under normal circumstances, these percentages may exceed historic loss rates on such assets, and in such instances we feel that treating such guarantees as equivalent to loans is entirely appropriate.

**6. Bank holding company capital policy**

The proposals pose an interesting set of problems in view of a recent policy of the Federal Reserve announced on April 24, 1987, concerning bank holding company responsibility for maintaining the financial strength of bank subsidiaries. The policy of drawing on the parent company and its nonbank subsidiaries to prop up ailing bank subsidiaries makes

bank capital adequacy determination a function not only of the risks within subsidiary banks but also of the capital strength of the rest of the organization as well. In addition, such a policy means that the agencies must monitor not only the condition of bank subsidiaries but the rest of the company to determine capital adequacy of bank subsidiaries.

# Statement No. 20

## Unnecessary Costs of FSLIC Recapitalization Program

September 14, 1987

The first issue of bonds to be sold by the newly established Financing Corporation to recapitalize the insolvent federal savings and loan insurance system will soon be coming to market. Analysts estimate that these bonds will carry interest rates as much as 1 percent over Treasury securities. This spread compensates bondholders for perceived risks that could be avoided if the Treasury were to finance the Federal Savings and Loan Insurance Corporation deficit directly. Based on the planned sale of \$10 billion of these bonds at a 1 percent spread, the additional cost of this indirect financing scheme would amount to \$100 million per year.

While we believe that the federal government would not allow a default on these securities, the legislation establishing this program states that the bonds are not a full faith and credit obligation of the United States. Instead, investors are led to believe that they must rely on limited sources of repayment specified in the legislation.

Withholding an explicit federal guarantee has two apparent effects. First, it keeps the flow of funds to the FSLIC out of the federal budget. Second, it places the formal burden for financing the FSLIC wholly within the thrift industry.

However, as this Committee has stated in the past, the financial resources of the industry are not sufficient to cover the estimated losses in the savings and loan system, which are now estimated to exceed \$40 billion. Thus much of this burden will eventually be borne by the taxpayer, and the extra \$100 million of annual interest on the bonds will increase the taxpayer's share.

We believe that \$100 million per year is an excessive cost to pay for deferring recognition of the government's responsibility for meeting the losses incurred in the thrift industry. As such, it represents an inefficient use of the public's funds.

## Statement No. 21 International Debt

November 13, 1987

United States loans to Latin American debtors are, on average, now worth about fifty cents on the dollar. As a result, additional loans to these countries represent a transfer of United States wealth to foreigners.

Since the international debt problem first came to public attention in the summer of 1982, the principal debtor countries have continued to increase their debt absolutely and relative to exports. The problem of servicing the debt has increased.

Additional lending by the U.S. government, international agencies, or financial institutions to permit countries to service outstanding debt is at best a stopgap measure. A long-term solution to the international problem requires more than additional loans. Policies should be designed to bring the debtor countries to a position at which they can service their debt and borrow in the market without intervention by governments or international agencies. This cannot occur until the debt/export ratios and debt service as a percentage of exports fall substantially. In recent years, these ratios have increased.

The debtor countries have three options. First, they can default. Wealth would be transferred from creditors to debtors. Equivalently, creditors can forgive or write off part of the debt. Second, the debtor countries can further reduce their domestic spending by lowering living standards, thereby increasing exports and their ability to service the outstanding debt. This would require a new round of austerity. Third, debtor countries can sell assets. A sale of domestic assets transforms debt into equity but does not necessarily reduce the long-term servicing costs of the debtor countries.

The Shadow Financial Regulatory Committee offers a four-part program to move toward a long-term solution. First, the U.S. government and international agencies should reduce their lending and their involvement in the debt rescheduling process. Debtors and creditors should be encouraged to develop a long-term program through negotiation without participation of the U.S. government or international agencies.

Second, a main source of capital for debtor countries, particularly Mexico and Argentina, should be the capital that nationals of these countries invested abroad during the 1970s and early 1980s. Debtor countries should adopt policies that would repatriate this capital through voluntary private inflows.

Third, debtor countries should increase productive efficiency and improve resource allocation. A major step in this direction can be achieved by beginning or accelerating the privatization of state industries and parastatal firms.

Finally, to encourage both repatriation and privatization, countries can exchange dollar-denominated debt for (domestically denominated) equity. Exchange of debt for equity should be made at current market prices of the debt. These would reduce foreign investment service obligations if the exchanges occur through a voluntary repatriation of capital by nationals of the debtor countries.

To reduce debt/export ratios, debt must grow more slowly than exports. For countries like Brazil and Mexico, the historic average growth of exports is sufficiently high that the debt service requirement as a share of exports and the ratio of debt to exports can be reduced substantially in five to seven years, if debt is held at present levels. Debt equity swaps of \$2 billion to \$3 billion per year to offset an equivalent capital outflow would permit the debt to remain constant. Within a decade, at the growth of exports of the past ten years, Brazil and Mexico would be close to the point at which they could return to the marketplace. For other large debtors—Argentina is an example—a longer time or more extensive program would be required. Additional lending will only impede the necessary adjustments.

It is the Committee's policy that members abstain from participating in the formulation of policy statements in instances in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, John D. Hawke, Jr. abstained from participating in or voting on this statement.

## Statement No. 22

# FSLIC Handling of Insolvent Thrift Institutions

November 13, 1987

The Shadow Financial Regulatory Committee is concerned about the continuing slow pace of the Federal Savings and Loan Insurance Corporation in resolving cases of insolvent S&Ls. The FSLIC has already received \$600 million in proceeds from the first sale of its recapitalization bonds and is in the process of acquiring additional resources to resolve a significant number of cases.

The Committee recognizes that deciding which institutions are the first to be closed or sold is difficult. Nevertheless, it is clear that the continued operation of insolvent institutions is in general costly to the FSLIC because of (1) the exceptionally high operating expenses of the insolvent institution; (2) the premium rates of interest that must be paid by these institutions to attract deposits; and (3) the possibility that the insolvent institution may take excessive risk in the hopes of returning to solvency, particularly where it is still stockholder-controlled.

We are encouraged by the recent statement of Chairman Wall that the FSLIC will resolve a case a week for the next year. We view that as a minimum goal—cases should be resolved as rapidly as funds permit.

Part of the difficulty is the cumbersome nature of FSLIC procedures for acting on bids. These procedures have discouraged many potential bidders, who incur significant costs to prepare bids on cases that drag on without a decision. While a competitive bidding process may be desirable under the Garn–St. Germain Act, we believe that substantial improvements are possible.

The Committee also notes that the FHLBB's announcement of a year's delay in implementing GAAP accounting for all S&Ls. Although this decision is not of crucial significance, since GAAP accounting itself has some unrealistic elements (such as treatment of goodwill as an asset and carrying restructured loans under FASB 15 at a value greater than fair market value), the Committee hopes that this delay in implementation of GAAP does not signal a return to regulatory attempts to paper over the extent of thrift problems by misleading accounting.

Such a policy would only work to the detriment of healthy institutions, as the market would be suspicious of all savings and loan financial statements. Rather, prompt resolution of the problems of insolvent savings and loans and accurate accounting will benefit the healthy institutions.

## Statement No. 23

# The Brady Commission and Recent Market Events

November 13, 1987

The October 19, 1987, stock market crash resulted in the appointment of a presidential commission (the Brady Commission) to determine its causes and suggest additional regulatory safeguards if necessary. The commission must present its findings to the President within sixty days. The Shadow Financial Regulatory Committee is concerned that the time and political pressures faced by the Brady Commission will result in its recommending inappropriate and ill-advised but convenient “regulatory actions.”

The Committee believes that the experience on October 19 and its aftermath show two important facts about our financial system. First, both the securities and futures markets continued to operate in the midst of the sharpest market decline in the history of the United States. Except for brief periods, both markets were open and trading was continuously conducted. Indeed, our present system of exchange and securities protection appears to have worked reasonably well.

Second, there may be some incompatibility between the trading policies in securities and futures markets. Trading in stock index futures necessarily requires simultaneous trading in both markets. The events of October 19 revealed that actions taken by one market to “protect” itself (e.g., suspension of trading) can have serious repercussions for the other market. Thus better coordination appears necessary between these two markets.

The events of October 19 provide an opportunity for experts to study the advantages and disadvantages of both trading systems and to decide whether additional institutional mechanisms can be developed to assure their smooth functioning, even during the kind of extreme turbulence experienced on October 19. However, sixty days is simply not enough time to make such meaningful analysis.

As a result, the Committee is concerned that the Brady Commission, as well as the other study groups being established, may seek to pacify critics and other concerned parties by pointing to a few scapegoats and by proposing additional unnecessary and ill-advised regulation without a thorough analysis of the potential effects of those regulations.

For example, futures markets and certain futures trading strategies, such as program trading and portfolio insurance, have already been identified as possible culprits, and restrictions on futures trading have been proposed. Thus higher governmentally imposed margin requirements, daily price limits, and position limits are being discussed as potential remedies, despite a substantial body of research suggesting that such regulations are an inappropriate response to the recent market events.

Furthermore, as presently constituted, the Brady Commission does not include sufficiently knowledgeable market makers, regulators, market users, and academics. An enhanced committee to examine the operation of both the stock and futures market systems, the linkage between them, and its timetable should be extended at least until the end of March 1988.

The Committee also is concerned that the events of October 19 will be used in an appropriate way by some private interest groups to further their goals. A case in point is the contention that these events demonstrate that we should not discard or liberalize the Glass-Steagall Act to permit greater commercial bank securities powers. Although such arguments should be subjected to a careful analysis, the Committee has found little relationship between what happened on October 19 and the issues that underlie the Glass-Steagall debate and does not believe that this even should delay meaningful reform.

It is the Committee's policy that members abstain from participating in the formulation of policy statements in instances in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, John D. Hawke, Jr. abstained from participating in or voting on this statement.



Statement No. 24  
The Federal Reserve Board's Request for Comment  
on the Acquisition of Healthy Thrift Institutions by  
Bank Holding Companies  
November 13, 1987

Since its 1977 decision in the *D. H. Baldwin* case the position of the Federal Reserve Board has been that the operation of a thrift institution is not a "proper incident" to banking and, accordingly, that bank holding companies may not acquire thrifts under section 4(c) (8) of the Bank Holding Company Act. In 1982 the Board modified that policy to permit bank holding companies to acquire failing thrifts. The Board is now seeking comment as to whether it should overrule the *D.H. Baldwin* policy in its entirety, leave that policy in effect, or modify it to permit bank holding companies to acquire healthy thrifts located in states where such holding companies are eligible to acquire banks.

The Committee strongly urges the Board to overrule *D.H. Baldwin* in its entirety. There is simply no rational basis in economic or regulatory policy for perpetuating that policy. Furthermore, the Committee urges the Board to abandon for all thrift acquisitions the "tandem operations" restrictions it has imposed in those cases in which it has permitted the acquisition of failing thrifts.

The *D.H. Baldwin* rule was born out of the politics of the thrift industry as that industry existed in the mid-1970s. At a time when the industry, then predominantly mutual in form, was in relatively healthy condition, when Regulation Q afforded thrifts an interest rate advantage to compensate for their inability to offer demand deposits, and when the interstate banking movement had not yet started, the prospect that bank holding companies might acquire stock thrift institutions at locations at which they could not acquire banks raised the potential for embroiling the Board in extended political controversy. Today, however, circumstances have changed markedly. The condition of the thrift industry has worsened to the point at which a substantial segment of the industry—not to mention the Federal Savings and Loan Deposit Insurance Corporation itself—is insolvent. Deposit interest rate controls have been repealed and most thrifts can now offer all forms of transaction accounts. Interstate banking has progressed to the point at which almost every state has sanctioned some form of interstate expansion. Finally, mutual-to-stock conversions have been widely authorized and a vast number of thrifts, having abandoned mutual form, are now able to be acquired.

Sound policy today should favor regulatory actions that are likely to result in the attraction of new capital to the thrift industry, and many bank holding companies are likely to be interested in acquiring thrifts as a means of expanding interstate. Because Congress has excluded FSLIC-insured and FHLBB-chartered thrifts from the definition of a "bank" in the Bank Holding Company Act, and thus from the reach of the Douglas Amendment, the Board could, by permitting the acquisition of healthy thrifts nationwide, provide a strong incentive for banking institutions to bring their resources to the ailing thrift industry.

While some regulators have expressed concern that a repeal of the *D.H. Baldwin* rule will result only in acquisition of the healthiest thrifts, and will not provide any incentive for banking organizations to bid for takeover of problem institutions, the Committee believes this concern is not well founded. Because the ownership of multiple thrifts on an interstate basis is subject to limits similar to those in the Douglas Amendment, and because more liberal rules apply to the interstate expansion of thrift organizations through the acquisition of problem institutions, a bank holding company that has invested in a healthy thrift, and thus obtained a sound base in the thrift industry, is more likely to be willing to bid on problem institutions in other states than it would under present policy. Indeed, the Board's present policy, which permits a bank holding company to acquire only problem thrifts, and then only subject to operating limits that deprive the holding company of the ability to integrate the troubled institution effectively into the holding company structure, may well have had the perverse effect of discouraging bank holding companies from entering the bidding for such institutions.

The Committee recognizes that there is a significant issue as to the powers that thrifts acquired by bank holding companies should be permitted to exercise. That issue need not be addressed in the pending rule-making proceeding and may be reserved for consideration on a case-by-case basis.

## Statement No. 25

# The Moratorium on Bank Securities Activities

February 8, 1988

The moratorium on expansion of the securities activities of banks and bank affiliates, imposed by the Competitive Equality Banking Act of 1987 (CEBA), is due to expire on March 1, 1988. Meanwhile, a number of applications by banking institutions to engage in new securities activities, approved by the Federal Reserve Board early in 1987, have been challenged in court and today were upheld by the United States Court of Appeals for the Second Circuit.

The Committee has previously noted that the public will benefit from enhanced competition between commercial banks and securities firms. Court decisions on the extent to which competition may be permitted under the present Glass-Steagall Act should be allowed to proceed to final decision, and the act amended when Congress does reach the merits of this issue.

The moratorium was enacted on the representation that it would not be extended if Congress did not address or alter the current law in the interim. Moratoria are not adequate substitutes for congressional decisions on policy issues and should not be used to escape the burdens of taking a position. The Shadow Financial Regulatory Committee believes that the CEBA moratorium should not be extended, either explicitly by legislation or indirectly by efforts of congressional committee chairmen, to pressure the independent banking regulatory agencies into a continuation of inaction.

It is the Committee's policy that members abstain from voting on policy statements in instances in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Richard C. Aspinwall, Lawrence Connell, John D. Hawke, Jr., and Kenneth E. Scott abstained from participating in or voting on this statement.

## Statement No. 26

### Studies of the Stock Market Crash

February 8, 1988

It is now a little more than three months since the October 19 stock market crash, but already we have had at least six studies of what happened. A common feature of all these studies is their confirmation that fundamental economic factors played an important role in the market crash. None suggest that the fall in stock prices was primarily the result of some breakdown in market making or institutional factors.

Nevertheless, many of the studies identify “problems” and propose provocative policy responses. In reviewing these studies, the Committee is struck by the failure to establish a relationship between the facts reviewed and discussed and the policy recommendations in the studies. None of the studies suggest that what happened on October 19 would have been any different had any of their policy proposals been in effect in October. The Committee doubts that the adoption of these proposals would have made a difference. We are concerned that the studies have become vehicles for everybody’s favorite recommendations. In our view, all the studies fail to show how their policy proposals are responsive to the problems or failures that they purport to identify, how their recommendations would have eliminated those problems identified, and, had the problems not occurred on October 19, whether the precipitous drop in stock prices would have been effected. Until these issues are addressed, little, if any, credence should be given to the recommendations.

The widespread recommendation to impose higher margin requirements on futures transactions illustrates these points well. Were there defaults in October that would not have occurred had there been higher margins? Did stock prices prior to October 13 rise to higher levels than would have occurred with higher margins? Did the stock market fall faster and further than it would have had with higher futures margins? Would price volatility in either the stock or futures market have been lower with higher margins? The Committee believes that none of these questions can be answered in the affirmative. In addition, we know of no research, theory, or evidence that suggests that higher margins would have been helpful in October.

While the studies of the crash have served us well in identifying and pulling together information about events surrounding the crash, they are not serving us well if they are used to rush to judgment about what, if anything, needs to be done. We urge that no action be taken until more thought is given to the connection between the policy proposals advanced and what happened in October.

It is the Committee’s policy that members abstain from voting on policy statements in instances in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, John D. Hawke, Jr. abstained from participating in or voting on this statement.

Statement No. 27  
Disposal of FDIC Equity Interests in Assisted Banks  
February 8, 1988

Confronted with a number of cases in which large banks have been threatened with failure, the Federal Deposit Insurance Corporation has, when providing open-bank assistance, increasingly used the technique of making an equity investment in the troubled institution. The principal motivations for using this technique are to effect a significant dilution of the interest of existing shareholders, so as to approach the impact that shareholders would feel in an insolvency proceeding, and to recoup some of its outlay if the institution regains profitability.

A significant consequence of this technique is that such institutions are effectively nationalized, although for political reasons the FDIC has been reluctant to assume day-to-day control of these institutions. Although such a procedure is desirable for brief periods during which potential private buyers for the institution can be found without confronting fire-sale prices, the Shadow Financial Regulatory Committee believes that the operation of a government-owned banking institution beyond this brief period is not a proper function for the FDIC and undermines the efficiency and competitive equity of the banking system.

The Committee urges the FDIC to adopt an explicit policy that calls for it to dispose of any such equity interest as soon as practicable after assistance is provided. Furthermore, the practicability of a disposition should be determined only with respect to the tasks necessary to effectuate a sale. It should not be the FDIC's policy to hold such interests for extended periods in the hope of realizing a gain on sale. Losses are equally likely.

In this respect the Committee notes that in July 1984, when the FDIC acquired an equity interest in Continental Illinois Corporation in connection with the provision of assistance to that institution, it announced its intention to dispose of that interest "as soon as practicable." More than 3½ years have expired since that intention was expressed, and Continental has had a substantial period of operation under new management. There is no apparent justification for the FDIC to continue Continental as a government-owned institution.

## Statement No. 28

# The Southwest Plan for Ailing Thrift Institutions

February 8, 1988

The development of the Southwest Plan by the Federal Home Loan Bank Board (FHLBB) is an important step toward a comprehensive, coherent approach to dealing with problem savings and loan associations in Texas. There are clear benefits to setting and announcing criteria for decisions on troubled institutions, and this plan should help the Federal Savings and Loan Insurance Corporation (FSLIC) use its limited resources more effectively.

Unfortunately, FSLIC resources appear woefully inadequate for a full solution to the problem. While we applaud the FHLBB's efforts to make creative use of the FSLIC's limited resources, we believe it is equally important that sufficient resources be devoted to the problem now. Experience indicates that delay in case resolution is costly to the FSLIC and ultimately to the taxpayer. As we have indicated in previous statements, it seems inevitable that the taxpayer will end up bearing the burden of S&L failures.

The Southwest Plan contemplates merging insolvent institutions into existing well-managed (though not necessarily solvent) institutions. This move will facilitate the closing of branches without a loss of convenience to customers.

While reduction of noninterest operating expenses would constitute an important saving to the industry and to the FSLIC, interest costs are much more important. The FHLBB's statement on the Southwest Plan contemplates a reduction of interest costs through an expected reduction in the "Texas premium" (the higher rates paid by Texas S&Ls). We fail to see the basis for this hope. If a number of institutions, each seeking funds from the market, are replaced by one large S&L needing the same level of funding to finance its asset holdings, there is no reason to expect interest rates to decline. The demand for funds will decline only if assets are liquidated, and it is not clear whether such shrinkage is contemplated by the Southwest Plan. The Texas premium reflects a market risk assessment that will not disappear without an improvement in the market's confidence in the FSLIC. We question whether the plan will inspire that confidence.

In view of the limited resources provided by last year's recapitalization legislation, the FSLIC is attempting to maximize the impact of the new funds by "leveraging" them. The FHLBB indicates that case resolution will be handled largely through the use of notes rather than cash. "Leveraging" means borrowing, and borrowing implies repayment. It is important to distinguish borrowing or issuance of notes by the FSLIC from the bonds being sold by the Financing Corporation (FICO) under the Competitive Equality Banking Act (CEBA) recapitalization legislation. Repayment of principal on the FICO bonds is assured through purchase of zero-coupon Treasury bonds, and interest on the FICO bonds is provided by a first claim on FSLIC income. Under plausible assumptions about S&L growth and continuation of membership in FSLIC, debt service is reasonably assured.

The Committee's reservations go to the ability of the FSLIC to handle its own obligations with the income it will have available after the FICO debt service is paid. The implications of any such weakness for future FSLIC case resolution are ominous. We note that the congressional resolution contained in the CEBA promised support for deposits insured by FSLIC but is silent with respect to other FSLIC liabilities. As long as the financial soundness of the FSLIC is in doubt, those institutions attracting deposits primarily on the basis of FSLIC insurance will be forced to pay higher rates than FDIC-insured institutions or sound FSLIC-insured institutions. In view of the difficulty of distinguishing sound from weak institutions, it is not irrational for depositors to demand higher rates from *all* Texas thrifts.

We support the use of a variety of means to reduce the dependence of weak institutions on high-cost funds. For example, the "As Agent" and "DalNote" programs developed by the Federal Home Loan Bank of Dallas can be helpful, as can the willingness of the Home Loan Banks to make advances on the basis of FSLIC guarantees. Nevertheless, we believe that FSLIC-assisted mergers under the Southwest Plan should generally be conditioned on a plan for asset shrinkage by the resulting institution.

The FHLBB policy of issuing notes in case of resolutions is made necessary by its lack of cash. The alternative, to handle many fewer cases, is not desirable. As we have argued previously, Congress must provide resources sufficient to solve the problem. The Administration must face up to the problem and prepare an adequate proposal. The FHLBB must make the Administration and the Congress aware of the magnitude of the problem and of the fact that delay will increase the ultimate cost.

# Statement No. 29

## Regulatory Proposal for Risk-Related Capital Standards

February 8, 1988

On January 27, 1988, the federal bank regulatory agencies released a revised proposal concerning risk-based capital adequacy standards. This new proposal, which is very similar to one put forward in February 1987, follows as a response to the December 1987 Basle Committee proposal for risk-based international capital standards. The chief differences between the present proposal and its predecessor are its focus on core capital, a relaxation of capital requirements applied to particular assets, and imposition of an additional minimum standard to be phased in by 1992.

These capital proposals have two objectives: (1) to increase the level of capital in banking organizations and (2) to reduce supposed intercountry competitive advantages created by differential regulatory capital standards.

On the first point of increasing the level of capital, which the Committee believes is the more important and pressing issue, the impact of implementing the standard is unclear. No evidence or analysis is provided on the net effects of application of the proposed standards on the existing adequacy of capital (as defined) in the banking industry or on the distribution of equity across different classes of banks.

On the issue of competitive equity, the Committee questions whether it will be achieved by the proposal, given the arbitrary way that weights are assigned on asset classes. Furthermore, individual country supervisors have substantial discretion to determine which assets belong to which particular risk classes and to define supplementary capital.

In commenting on the previous proposal, the Committee noted several other weaknesses and problems. Some of these have been addressed in this proposal, other problems remain, and some new issues have arisen.

First, a proper risk-related capital or insurance premium system must be based on an effective system for monitoring capital. The proper measure of capital for regulatory purposes should be the market value of the assets less the market value of nonsubordinated liabilities. The proposed guidelines are based on historical values of assets and capital and are therefore defective.

Second, the proposals still assign to risk classes essentially arbitrary weights that are not supported with evidence on either market valuations of risk or historical loss experience in different classes of assets. Arbitrary asset weights become the basis for nonmarket credit allocation.

Third, the proposal focuses only on credit risk. Efforts should also proceed to recognize the importance of interest rate risk. Interest rate risk has been a substantial problem in the past and remains a significant concern.



Fourth, the risk ratings of particular asset categories do not sufficiently reflect the wide dispersion of risks that may exist within a given risk class. This is particularly a problem for the treatment of the lower weights assigned to municipal obligations.

Finally, the proposed weighting scheme does not recognize the value of diversification. The risk borne by a financial institution can be changed by diversification as well as by the choice of individual projects and leverage.

# Statement No. 30

## Disclosures by Financial Institutions of Financial Assets and Liabilities

February 8, 1988

The Financial Accounting Standards Board (FASB) has taken a giant step in the right direction in its proposed “Disclosures About Financial Instruments” (Financial Accounting Service Exposure Draft 054, dated November 30, 1987). If the proposal were implemented, companies would have to estimate annually market values and cash flow information on financial assets and liabilities that presently are reported only in terms of their historical costs.

This information is particularly useful for oversight of federally insured depository institutions (banks, savings and loans, and credit unions). In the absence of knowledge about when an institution is close to or actually economically insolvent, the agencies are less able to monitor and control the risks an insolvent institution might take. As a result, costs of insolvencies to the insurance agencies are likely to be higher. For example, the size of the current \$50 billion deficit at the Federal Savings and Loan Insurance Corporation (FSLIC) could have been held to a greatly smaller amount had the FSLIC acted sooner to recognize and reorganize insolvent savings and loans. These costs are inflicted on well-run, adequately capitalized thrifts and banks and, in the case of inadequate insurance resources, inevitably on the taxpayers.

We are concerned, however, that the FASB’s proposal in its current form might be so ambitious as to entail excessive cost. At least with respect to financial institutions, the reporting requirements ought to be directed solely to provide the banking regulatory and insurance agencies and the public with information about the state of insured depository institutions’ economic net worth. Consequently, at this time we would suggest requiring financial institutions to report only the market value of their on- and off-balance-sheet financial assets and liabilities. However, the reporting should be quarterly rather than annually.

## Statement No. 31

# The FDIC's New Policy on "Whole Bank" Takeovers

May 16, 1988

On April 18, 1988, the FDIC announced that potential bidders for acquisitions of failed or failing banks will be invited to submit competitive bids on a "whole bank" basis. Under this approach the successful bidder would assume all deposit liabilities and take over all the assets of the failed or failing bank—not simply "clean" assets, as under past practice—in exchange for a payment from the FDIC. Bidders would be given as much as four weeks to analyze the troubled institution before submitting bids.

The Committee believes that this new approach is a useful step in the direction of bringing market forces to bear on the valuation of insolvent banks. While the past practice of dealing with failures through "clean bank" purchase-and-assumption transactions, in which an FDIC receivership retains all problem assets, may have facilitated the submission of bids on short notice, it resulted in the FDIC's assuming the costs and risks involved in liquidating such assets—a task for which it is not necessarily well suited.

Under the new approach, bidders will have an opportunity to assess all aspects of the failing bank, and the bid process should approximate a market valuation of the institution. The successful bidder will have maximum incentive to administer problem assets efficiently, and the administration of such assets by an ongoing financial institution, as opposed to a receivership, should result in the realization of greater values.

The Committee notes that in one respect, the new policy may have the potential for adding to the FDIC's costs of dealing with insolvencies. It is possible that the additional lead time allowed for the formulation of bids could increase the incidence of leaks concerning an imminent failure, and thus cause uninsured depositors to withdraw their deposits prior to the declaration of an insolvency. To the extent that this occurs, the new approach could result in an increase in the FDIC's costs when the bid process does not result in an increase in an acceptable proposal and the FDIC is forced to liquidate the bank.

On balance, however, the new policy is a desirable move toward extricating the FDIC from the task of asset salvage and increasing the role of the market in the process of insolvency resolution.

Statement No. 32  
Proposed FDIC Policy Statements Encouraging  
Independent Outside Audits of Banks

May 16, 1988

The FDIC's recently announced policy of encouraging nonmember banks to obtain independent external audits should help reduce bank failures due to fraud, insider abuse, and gross mismanagement. The Committee supports the policy and offers two suggestions to enhance its effectiveness. We suggest that the auditors report to a committee of independent (nonmanagement) bank directors and to the FDIC. The FDIC also should make its examiners' reports available to the external auditors.

## Statement No. 33

# Policy Responses to the Stock Market Crash

May 16, 1988

The Committee continues to be concerned about the direction and the quality of the debate generated by last October's stock market collapse. During the past few weeks several prominent business representatives have called for a ban on either stock index arbitrage or all stock index futures trading. Intense pressure has been put on large broker-dealers to cease index arbitrage for their own account; as a consequence, some firms have acceded to these demands and have voluntarily stopped their index arbitrage activities. Both stock and futures exchanges also have instituted various "circuit breaker" mechanisms to halt trading and close their markets whenever prices move by more than a certain amount in either direction.

Recent discussion appears to be driven by a concern about current stock market volatility and the reluctance of investors, especially smaller investors, to trade stocks as actively as they did prior to the stock market crash. Those concerns confuse and cloud the events of last October 19 and have resulted in remedies being proposed that are not responsive to the events of last October.

None of the extensive reports and analyses of the crash, including the Brady Commission report, provide persuasive evidence that stock index futures trading in general, and stock index arbitrage in particular, caused the crash. None of the studies even claim, let alone show, that the continued volatility in the stock market is the result of futures trading. Without any substantive analysis, a widespread belief seems to have emerged that stock index arbitrage and program trading are responsible for the current volatility and for frightening small investors into leaving the market.

The Committee believes that regulatory and legislative action is premature. It is clear that neither we nor others know which factors were responsible for the crash. Similarly, no one understands the causes of the stock market volatility and the reluctance of small investors to trade stocks. Remedies designed to curb activities that are not clearly linked to the purported ills are more likely to be harmful than beneficial.

Much of the discussion about proposed solutions fails to recognize a few key facts. First, the stock market collapse was not unique to the United States. Stock markets collapsed throughout the world, many by more than in the United States. Second, several foreign stock markets began to fall prior to the opening of our markets on October 19. Thus, since the crash, volatility has been higher and trading volume lower in many stock markets throughout the world. Finally, trading in stock index futures is significant only in the United States. Such trading does not even take place in most foreign markets. It is difficult for the Committee to accept, therefore, the notion that stock index trading is the culprit.

Despite these facts, it appears that regulatory proposals to institute circuit mechanisms may be forthcoming. If we must have such mechanisms, the Committee urges that they not be in the form of "price limit" trading halts. We believe that price limits will cause investors to try to exit the market when such limits are being approached, for fear that a

halt in trading will result in increased uncertainty about whether and at what prices it will be resumed. More rather than less chaotic markets and greater investor uncertainty are likely to result.

To the extent that circuit breakers are used, they should be designed to cope with order imbalances, preferably before large price changes occur. They should be designed to resolve order imbalances by disseminating information about the nature of the order imbalance to a wide variety of market participants so that greater market liquidity can be generated.

Finally, the Committee continues to believe that we must examine all of our market-making systems to determine whether we can either improve these systems or find superior ones. The growth of institutional and large “basket” trading requires that we consider market-making systems that can accommodate them. The recent discussion and debate, unfortunately, has not focused on these long-run issues but instead has sought to advance band-aid solutions that either are responses to certain private interests or are “political” circuit breakers intended to head off even more harmful legislative remedies.

It is the Committee’s policy that members abstain from participation on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, John D. Hawke, Jr. abstained from participation in this statement.

## Statement No. 34

# The FSLIC's Handling of Failed Thrifts

May 16, 1988

In previous Statements the Committee noted that the resources available to the Federal Savings and Loan Insurance Corporation (FSLIC) are inadequate to meet its insurance responsibilities for insolvent savings and loan associations. The shortfall was estimated to be less than \$15 billion in 1985, less than \$30 billion in 1987, and now it appears that \$50 to \$60 billion would be required to protect depositors at insolvent institutions. We are concerned that this shortage of funds has led the FSLIC to in specific cases prefer solutions that minimize immediate outlays but are likely to have great long-run costs that will have to be paid by the taxpayers or depositors. This problem is particularly acute as the FSLIC attempts to deal with the large number of insolvent institutions in the economically troubled Southwest.

The Committee recommends that priority be given to case resolutions that bring new private capital into the S&L industry. Well-capitalized parties are willing to invest in thrifts, but they usually want to earn returns commensurate with their alternatives. Therefore they will not take over an insolvent institution unless the value of its assets at least equals the amount of its liabilities, which requires the FSLIC to provide the shortfall. Rather than deal with these investors and put up the required resources, the FSLIC prefers to buy time and impose higher costs on taxpayers in the future by selling failed institutions to weak or insolvent S&Ls. Unlike well-capitalized investors, these S&Ls are willing to take over the failed institutions so that they can buy time and expand risk taking. Most of the risk taking results in higher future losses to the FSLIC, which will add to the FSLIC shortfall.

Dealing with economically (market value) insolvent or weak S&Ls allows the FSLIC to maintain the charade that it is not massively insolvent. These S&Ls often are willing to acquire a failed institution with a smaller amount of financial assistance than is needed to restore economic solvency. They often ask only that the book value negative net worth hole be filled, and they are willing to accept notes from the FSLIC that are worth less than face value. Since the book value of their net worth often depends on including overvalued assets on their balance sheets, they cannot argue that the assets on the acquired institution are misstated. Since these potential buyers often operate with inadequate net worth themselves, they put considerable value on FSLIC forbearance, which gives them the time either to take gambles that might pay off or to wait for a favorable change in economic conditions.

If auctions are conducted under the FSLIC's current procedures, successful bidders for failing institutions will tend to be relatively weak themselves. Well-capitalized investors have learned the FSLIC's preferences and are becoming less willing to go through the costly, time-consuming bidding process when they believe they have little chance of winning.

The Shadow Financial Regulatory Committee and others have regularly provided rough estimates of the recognized capital losses buried in the FSLIC's potential caseload. For the FSLIC, outside estimates now fall in the range of \$75 billion to \$100 billion. The order of magnitude of the FDIC's unrecognized losses can and should be analyzed in parallel fashion. As of year end 1987, we conservatively estimate that allowing for expected losses of troubled banks would reduce the FDIC's gross reserves by half.



## Statement No. 35

# The Need to Make FSLIC and FDIC Assistance Deals Accountable

September 25, 1988

As the number of economically insolvent and near-insolvent depository institutions has surged in recent years, the creativity that FDIC and FSLIC personnel have shown in dealing with such problems has grown too. Deposit-insurance officials have developed a series of imaginative ways to proffer financial assistance both to firms that acquire the institutions whose insolvencies the agencies decide to resolve and to individuals they permit to operate quasi-failed firms. While we applaud the initiative and administrative flexibility that deposit-insurance officials have shown, we are disturbed by the incomplete way in which they have chosen to lay out the salient economic facts of many of these deals.

FDIC and FSLIC officials typically fail to provide—even as background—the precise financial information that an outside analyst would need to monitor the economic reasonableness of the individual assistance transactions the agencies decide upon. Frequently, the most significant element in large or complicated assistance transactions is the expected drain on agency reserves from various contingent agreements. Yet reproducible estimates of the agency's expected losses or recoveries from such agreements are seldom supplied.

To build up public confidence in the capacity of the FDIC and the FSLIC to manage the many problem cases that need to be resolved over the next few years, the agencies should not ask the public to settle merely for an assurance that they habitually strive to cut the best deal possible. To establish confidence in the honesty and efficiency of their decision making, it is critical that agency staffs prove in each instance how and why the deal they made was a good one. Taxpayers deserve to learn of the expected benefits and costs of each transaction and a reproducible description of the procedures by which these estimates were developed. Weaknesses in agency accountability increase the probability that, in moving a troublesome case off their immediate agenda, FDIC and FSLIC officials may choose to act myopically or self-interestedly. By not giving the press and outside financial analysts the information needed to evaluate these transactions as they develop, officials insulate themselves from the discipline of informed criticism. Open debate between agency personnel and informed critics is needed if taxpayers and politicians are to approve or reject in timely fashion the effects of agency policies and priorities that unfold slowly over time.

More generally, incentives to manage the risk exposure of both the FDIC and FSLIC would be improved if each agency were regularly required both to report its best estimate of its expected future losses and to set up a reserve to cover these losses. The two major components of this expected-loss reserve would consist of (1) allowances for the contingent liabilities in assistance likely to be delivered to presently identified troubled insured institutions, and (2) assistance apt to be given to institutions not yet so identified.

The Shadow Financial Regulatory Committee and others have regularly provided rough estimates of the recognized capital losses buried in the FSLIC's potential caseload. For the FSLIC, outside estimates now fall in the range of \$75 billion to \$100 billion. The order of magnitude of the FDIC's unrecognized losses can and should be analyzed in parallel fashion. As of year end 1987, we conservatively estimate that allowing for expected losses of troubled banks would reduce the FDIC's gross reserves by half.

## Statement No. 36 The Need to Estimate the True Economic Condition of the FDIC

December 5, 1988

Based on information now available from the FDIC, a crude appraisal of the condition of the Federal Deposit Insurance Corporation can be made that takes account of the agency's unbooked losses. Using these data and simple assumptions, the Committee infers that, if the FDIC were to experience losses that would not be unreasonable to anticipate in view of its recent loss experience and problem bank estimates, the FDIC's reserve balance would be virtually exhausted at present.

The Committee's calculation makes use only of inadequate information publicly disclosed by the FDIC. Table 1 estimates unbooked losses from three critical assumptions: the percentage of assets allocated to problem banks, projected bank failure rates, and a failure-resolution cost rate.

In light of the Committee's calculation, proposals to reduce the cost of recapitalizing the Federal Savings and Loan Insurance Corporation (FSLIC) by combining it with FDIC seem futile. Indeed, in a November 1988 report entitled *The Financial Services Industry*, the General Accounting Office reaches a similar conclusion:

While merging FSLIC with the healthier Federal Deposit Insurance Corporation (FDIC) has been suggested as a possibility, it would not solve the financial problems. The FDIC's reserves cannot cover the FSLIC losses. Moreover, problems in the commercial banks, especially those related to energy, real estate, agriculture, and third world lending, may require all of FDIC's present \$18 billion of reserves. [P. 6]

It is impossible for us to determine the accuracy of our crude estimate of the FDIC's net reserve position. To develop a more refined estimate, we urge the FDIC to release detailed information on the asset-size distribution of both problem-bank assets and failure-resolution cost rates.

*Table 1. Estimate of FDIC's net reserve position on December 31, 1988***1. 1987 Year-end data: FDIC-insured commercial banks**

	<i>Number</i>	<i>Percentage</i>	<i>Projected assets (in \$billions)<sup>1</sup></i>
Problem banks	1,575	11.5	345.1
Nonproblem banks	12,124	88.5	2,655.8
	13,699	100.0	3,000.9

**2. Crude calculation of amount of losses through December 31, 1988**

	<i>Problem Banks</i>	<i>Nonproblem Banks</i>
Allocated assets	\$ 345.1 billion	\$2,655.8 billion
Failure rate <sup>2</sup>	.125	.01
Failure-resolution cost rate <sup>3</sup>	.30	.30
Estimated booked and unbooked losses	\$ 12.9 billion	\$ 8.0 billion

**3. Calculation of net FDIC reserves on December 31, 1983**

Deposit insurance fund on December 31, 1987	\$ 18.3 billion
Income for 1988 (estimate)	3.0
Estimated reserve before booked and unbooked losses as of December 31, 1988	21.3
Estimated total FDIC booked and unbooked losses	\$ 20.9 billion
Net reserve balance	0.4

<sup>1</sup>The FDIC does not provide data on the size distribution of banks on its problem list. This analysis assumes that the size distribution of problem banks is similar to that of all banks. Since we know that several very large institutions have well-publicized weaknesses, we do not expect that this assumption leads to an overstatement of the FDIC's potential losses.

<sup>2</sup>Over 1982-1987, the number of failures per year has averaged 14.1 percent of the number of problem banks identified going into the year. The median ratio is 13.6 percent, which our procedure rounds downward to 13.5. Because some "surprise" failures develop entirely within a calendar year, we treat roughly 7.5 percent of projected failures as developing outside of the population of banks identified as problems at the end of the previous year.

<sup>3</sup>The 30 percent loss figure was developed by J. Bovenzi and A. Murton in the *FDIC Banking Review* (Fall 1988), for a sample of relatively small banks that failed in 1985 and 1986. Evidence exists that FDIC's loss experience in handling large bank problems is substantially better. Thus, in resolving the First City (Texas), Continental Illinois, and First Republic Bank (Texas) cases, the FDIC's losses are expected to be less than 10 percent.

## Statement No. 37

# Assessing FDIC Premiums Against U.S. Banks' Unsubordinated Debt and Deposits in Foreign Branch Offices

December 5, 1988

Currently, unsubordinated debt issued by U.S. banks and deposits held in their foreign branch offices are not part of the base against which explicit FDIC deposit-insurance premiums are assessed. Requiring insured banks to pay insurance premiums on these liabilities would serve two purposes. It would both shore up the revenue base from which the FDIC will eventually have to cover unbooked losses in failing banks and close an inequitable loophole in its existing premium structure.

Although unsubordinated debt and deposits in foreign branch offices are not formally covered by FDIC guarantees, neither are deposit balances in excess of \$100,000, which are part of the FDIC's assessment base. All three categories enjoy substantial de facto federal credit support. The importance of unsubordinated debt and deposits at foreign branch offices is greater for very large U.S. banks. In the past authorities have confirmed their reluctance to allow such institutions to fail and to impose losses on holders of formally uninsured instruments when these banks become economically insolvent. Failing to price implicit federal guarantees of these liabilities constitutes a subsidy to the use of unsubordinated debt and of deposits at foreign branch offices of U.S. banks. This subsidy promotes the growth of bank debt relative to equity finance, of U.S. banks' foreign deposits relative to their domestic deposits, and of very large U.S. banks relative to smaller financial institutions.

The Shadow Financial Regulatory Committee believes that U.S. banks should be required to pay FDIC premiums on their unsubordinated debt and foreign deposits. Eliminating the subsidy on foreign deposits and unsubordinated debt is bound to raise large banks' funding costs at the margin. However, this effect could be lessened by phasing in the new premium over time.<sup>1</sup>

The critical points are that this move would strengthen the FDIC financially and narrow a politically sensitive and economically distorting loophole in the fabric of U.S. banking regulation. Correcting this distortion promises to redistribute the burden of financing FDIC operations somewhat more in line with the agency's de facto risk exposure and to increase the flow of aggregate premium income to the FDIC's increasingly beleaguered insurance fund.

Unfortunately, this policy action promises to increase interinstitutional equity and strengthen the deposit-insurance system more in the short run than it can in the long run. The roots of the deposit-insurance problem do not lie in the existing structure of explicit FDIC premiums. They lie in federal regulators' reluctance to resolve insolvencies at very large U.S. banks and zombie S&Ls. As long as regulatory forbearances are routinely extended to stockholders and creditors (including uninsured depositors) of very large

banks, substitute loopholes can be fabricated. Until federal authorities adopt a size-neutral policy for resolving or avoiding commercial-bank insolvencies, subsidies to the operations of large U.S. banks will distort to some degree patterns of competition in U.S. and foreign banking markets.

### **Notes**

1. Industry estimates of the effect tend to overstate its impact on bank profits. For example, deposit rates offered by foreign banks in foreign markets will decline by part of the amount of the premium assessed. This will occur because changes in FDIC premiums affect all U.S. banks as a group, so that an FDIC premium increase implies a downward shift in the industry supply curve. Hence declines in the equilibrium interest rate in markets for foreign deposits and nondeposit debt would cushion the net impact on the profits U.S. banks earn in these locales. This cushioning comes from whatever portion of deposit-insurance subsidiaries are currently being shifted to bank depositors and borrowers.

It is the Committee's policy that members abstain from participation on policy statements in which they have direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Richard C. Aspinwall, Lawrence Connell, and John D. Hawke, Jr., abstained from participation in this statement.

# Statement No. 38

## An Outline a of Program for Deposit Insurance Reform

December 5, 1988

Successful deposit insurance reform requires that four policies be adopted. First, existing losses in the system need to be recognized as governmental liabilities and necessary steps taken to keep these losses from becoming larger. Second, the current regulatory and supervisory system needs to be reformed to correct the incentive problems and structural defects in the present system. Third, an acceptable phase-in period should be adopted so that institutions will have time to adjust to the new regime. Finally, a method should be devised to pay for the real but unrecorded losses in existing depository institutions.

The following proposal seeks to remedy the current flaws in the present system and to manage the transition from the present to a new system. The proposal embodies capital adequacy policies, increased monitoring of asset values, timely reorganization before a depository institution's economic capital is exhausted, increased market incentives, and rigorous supervisory enforcement as the foundations for new supervisory and regulatory policies consistent with an efficient financial system that is equitable and safe. The following are the major components of the proposal:

### Capital policy

Establish four ranges, or tranches, of capital/asset ratios with differing supervisory policies applicable to each tranche as follow:

1. **Tranche 1: Adequate Capital** (e.g., 10 percent of assets or greater). Banks with capital above this minimum amount would be subject to "normal" (i.e., minimal) regulation and supervision.
2. **Tranche 2: First Level of Supervisory Concern** (e.g., 6 percent to 9.9 percent of assets). Once a depository institution's capital ratio falls into this range it will be subject to increased regulatory supervision and more frequent monitoring of its activities. The supervisory authority will have the discretion to require the institution (a) to submit a plan to raise sufficient capital to the entry level for Tranche 1, (b) to suspend dividend payments and/or upstream or downstream payments within a holding company system, and (c) to restrict permissible asset growth.
3. **Tranche 3: Second Level of Supervisory Concern** (e.g., 3 percent to 5.9 percent of assets). When an institution's capital ratio falls into this range, it will be subject to intense regulatory supervision and monitoring. Suspension of dividends, interest payments on subordinated debt, and outflows of funds to an institution's parent or affiliates will be mandated. Prohibitions on asset growth will be used to prevent institutions

from attempting to “grow” out of their problems. Finally, an institution will be required to submit an emergency plan for its recapitalization to be implemented in the event it falls into Tranche 4.

4. **Tranche 4: MANDATORY RECAPITALIZATION AND REORGANIZATION** (less than 3 percent of assets). The federal deposit insurance agency will place the institution in a mandatory conservatorship. This conservatorship would be charged with recapitalizing the institution or liquidating it in an orderly fashion within a short period of time by merger or by sale of either the entire organization or its individual assets. Present owners will have the option of implementing the plan submitted when the institution moved into Tranche 3 or electing not to inject further funds into the institution. Following final disposition of the firm’s assets, any residual value will be returned to subordinated debt holders and shareholders, after allowing for any costs incurred.

### **Key clarifications and features of the proposed structure**

1. **Definition of capital.** Capital should be defined as the difference between the market value of assets and the market value of liabilities other than subordinated debt.
2. **Supervision costs.** Charges for supervision, regulation, examination, and monitoring would be paid for by depository institutions. Because examination and monitoring effort increases as an institution’s capital declines, these charges would increase as capital declines, so that charges function as a form of risk-adjusted insurance premium.
3. **Charter shifting.** Institutions are still permitted to change their regulatory agency within the new structure. This feature contributes an incentive for the respective agencies to balance the costs and benefits of supervision and to limit overzealous supervision.
4. **Accountability of supervisors.** Supervisors will report to Congress yearly on the institutions in each tranche and on the actions taken to restore institutions to Tranche 1. —Supervisors will be responsible for assuring that recapitalization plans are acted upon. Periodic GAO audits, annual reports, and regular congressional oversight will provide an element of discipline for the regulators.
5. **Regulatory responsibility in Tranche 4.** The appropriate insurance agency will be notified when an institution moves into Tranche 3 and will receive all supervisory reports and the like in anticipation of having to take the institution over if it moves into Tranche 4.
6. **Creation of supervisory audit trail.** Use of tranches and required consultations will document regulatory problems encountered in attempting to value firms as they moved through the tranches. This feature should simplify resolution of valuation controversies should an institution be forced into recapitalization or reorganization.
7. **Insurance premiums.** Explicit charges for insurance should be low under this system since theoretically only fraud cases and abnormal market movements would involve significant risks to the insurance funds.



8. **Holding companies and permissible activities.** Neither the wisdom of the present holding company structure nor the logic of the activity restrictions that now exist under the current regulatory structure is addressed in this proposal. Resolution of these issues, while important, is a separable issue.
9. **Insurance coverage.** Present deposit insurance coverage of \$100,000 per insured account need not be changed for the proposal to be effective.
10. **Market value accounting.** The reorganization rules should be based on market values to minimize risks to the insurance funds and to allow both the regulators and banks to take informed actions in a timely fashion.
11. **Disclosure.** The reports embodying the market values of institutions should be publicly available. This will enable the Congress and public to monitor better the financial condition of banks and the performance of the supervisory agencies.
12. **Large bank failures.** All institutions that fall into Tranche 4 should be reorganized or allowed to “fail” regardless of their size and pro rata losses charged to uninsured creditors. “Failure” means reorganization and change of ownership and does not necessarily imply a disruption of borrower or depositor relationships. Any other policy would present unacceptable incentive problems, provide inequitable treatment, and foster unfair competition.

## Transition

Except for institutions with zero (or less) GAAP net worth, there should be a transition period for the new capital tranches and regulatory policies that might be as long as five years. Unless they are recapitalized, GAAP-insolvent institutions should not be kept afloat.

## *Dealing with existing losses in the system*

Dealing effectively with existing losses in the system requires, first, that they be explicitly recognized as liabilities of the government rather than merely of the insurance funds; second, that insolvent institutions be either recapitalized and/or reorganized, merged, sold, or liquidated; third, that a method be devised to finance the costs associated with closing these institutions that entails direct use of U.S. government credit;<sup>1</sup> and fourth, that methods be devised for prompt disposal of assets acquired during reorganization of insolvent institutions.

## Notes

1. Any financing method not based upon the full faith and credit of the U.S. government will necessarily be more expensive and, given the magnitude of the existing problem, inappropriate. A straightforward approach in the context of the present system would be for the insurance agencies to turn their funds over to the Treasury and to meet deposit insurance obligations by drawing checks on the Treasury.

## Statement No. 39

# The Administration's Plan to Resolve the Thrift Crisis

February 13, 1989

The Bush Administration's proposal for resolving the thrift crisis recognizes that the problem is much larger than has previously been officially acknowledged. The proposal forthrightly admits that losses have mounted during many years of procrastination and that public funds must now be employed to support the government's deposit insurance obligations. The Administration envisions raising an additional \$50 billion over the next three years to recapitalize or liquidate insolvent thrifts. These funds will give the FSLIC/FDIC flexibility that could be used to resolve efficiently the many insolvent institutions it will have to deal with.

While the President's statement correctly notes that economic conditions, excessive risk taking, and fraud have played major roles in the development of the current problem, it does not recognize the critical role that the perverse incentive structure underpinning the existing deposit insurance system has played in bringing about this crisis. A critical part of any Administration proposal must be to restructure the deposit insurance system to correct the present adverse incentive structure facing institutions and regulators. In particular, once an institution approaches insolvency, it is unreasonable to expect that regulation and supervision can overcome the incentives that managers of failing institutions have to take excessive risk. Allowing undercapitalized and insolvent institutions to remain in business through regulatory forbearance encourages risk taking that ultimately leads to huge losses.

To improve bank managers' incentives, it is essential that the increased capital requirements recommended by the Administration be accompanied by an improved monitoring system (including market value reporting and enhanced supervision) and by an obligation on the part of the insurance agency to intervene when capital is still positive and before insolvency is a strong possibility. The Committee's view on the necessary reforms are set out in its February 13, 1989, Policy Statement No. 41, "An Outline of a Program for Deposit Insurance and Regulatory Reform."

To improve incentives for regulators, the Administration's plan should include an accountability mechanism to assure that decisions are made objectively and efficiently during the insolvency resolution process. At a minimum, this requires a coherent program for distinguishing between institutions that can and cannot survive, for acquiring the assets of insolvent thrifts, for reprivatizing the assets and institutions acquired, and for regular and comprehensive public reporting of the determinations made.

At least two other issues must be considered in evaluating the Administration's plan. First, we are concerned that the magnitude of the problem is potentially greater than the \$90 billion that the plan recognizes. There is a strong possibility that additional thrifts that are now marginally solvent will become insolvent in the near future. Increases in interest rates may also lead to financial difficulties for many more thrift institutions.

Second, whatever the size of the required government financing, it is important that the funds be raised in the lowest cost way possible. By funding off-budget (albeit with Treasury guarantees of interest) as the plan proposes, it is likely that the cost will be greater than if the Treasury financed the cash requirements directly.

## Statement No. 40

# Risk-Based Capital and Early Intervention Proposal of Federal Home Loan Bank Board

February 13, 1989

The Federal Home Loan Bank Board has proposed capital requirements for savings and loan associations that are based on the associations' risk exposure. More importantly, they would define a minimum level of capital for purposes of intervention to force reorganization of undercapitalized associations. This proposal represents a first step in the right direction.

The risk-based capital proposal follows the lead of the bank regulatory agencies, which have imposed similar requirements on commercial banks. In its past policy statements, the Committee has criticized aspects of the banking agencies' proposal, in particular, its failure to use market values in sorting institutions into risk classes. This failure leads to arbitrary incentives for institutions to direct credit to or away from particular sectors. The same problem exists with the Bank Board's proposal. Unlike the bank regulatory agencies, however, the Board explicitly recognizes interest rate risk, for which it is to be commended.

An early intervention rule is more important than risk-based capital standards and represents good public policy. Suitably modified, implementation of the Board's proposal would simplify and enhance the supervisory process and could make the risk-based capital standards unnecessary. The 1.5 percent capital/asset ratio, measured by GAAP, that may initiate regulatory intervention by the Board is too low. Because of the differences between GAAP valuation and market valuation, the institution may at the proposed intervention point actually be insolvent on a market value basis and thus impose losses on the FSLIC. In addition, because of delays and inaccuracies in monitoring, by the time that this level of capital is recognized by the Federal Home Loan Bank Board and action can be taken, the institution may have depleted its capital further. Thus the threshold capital/asset ratio should be increased substantially.

To make the intervention process more effective, it is desirable to introduce a structure of explicit capital/asset tranches, requiring progressively increased supervision and more restricted operations by the institution. This would establish predictable regulatory discipline and discourage institutions from reducing their capital to low levels. An example of such a structure is provided in the Shadow Financial Regulatory Committee's February 13, 1989, Policy Statement No. 41, "An Outline of a Program for Deposit Insurance and Regulatory Reform." It is important that the tranches be very specific, that enforcement be mandatory, and that forbearance from intervention not be granted.

# Statement No. 41

## An Outline of a Program for Deposit Insurance and Regulatory Reform

February 13, 1989  
(Revision of No. 38)

The large number of current bank and thrift problems demonstrates clearly the inadequacy of federal regulatory policies and procedures to deal with insolvencies in a timely enough fashion to avoid undue financial burdens on both the insurance funds and the public at large. In particular, policies of regulatory forbearance and prolonged deferral of resolving problem cases, made possible by government insurance guarantees, permitted economically insolvent institutions to keep operating. This has substantially increased the eventual costs of solving the problems, which ultimately will be paid by the taxpayers.

Fundamental reform is necessary and requires that (1) the current regulatory and supervisory system be restructured to correct risk-taking incentive problems and structural defects in the deposit insurance system, (2) an acceptable phase-in period be adopted so that solvent institutions would have time to adjust to the new regime, and (3) existing losses in the system be recognized as government liabilities and necessary steps taken to keep these losses from becoming larger.

The following proposal remedies major flaws in the system by minimizing incentives for insured depository institutions to take excessive risks. The proposal embodies:

capital adequacy policies,

increased monitoring of asset values,

timely reorganization before a depository institution's economic capital is exhausted, and

enhanced market incentives and rigorous supervisory enforcement,

as the foundations for new supervisory and financial regulatory policies that would ensure an efficient financial system that is equitable and safe. The suggested program would not only improve regulatory performance but also foster greater discipline in managerial decision making. Managers of federally insured institutions must understand that the economic consequences of their actions would become known and that additional funds must be invested when capital falls to insufficient levels. Finally, owners, managers, and uninsured creditors must know that the federal safety net would not support mismanaged or economically insolvent institutions. The following are the major components of the proposal.

## Capital policy

Establish four explicit, predetermined ranges or tranches of capital/asset ratios with differing supervisory policies applicable to each tranche as follows:

### 1. **Tranche 1: Adequate Capital**

(e.g., 10 percent of assets or greater). Banks with capital above this minimum amount would be subject to “normal” (i.e., minimal) regulation and supervision.

### 2. **Tranche 2: First Level of Supervisory Concern**

(e.g., 6 percent to 9.9 percent of assets). Once a depository institution’s capital ratio falls into this range it would be subject to increased regulatory supervision and more frequent monitoring of its activities. The supervisory authority would have the discretion to require the institution (a) to submit a business plan to raise sufficient capital to attain Tranche 1 within a specified period of time, (b) to suspend dividend payments or unapproved transfers of funds within a holding company system, and (c) to restrict permissible asset growth.

### 3. **Tranche 3: Second Level of Supervisory Concern**

(e.g., 3 percent to 5.9 percent of assets). When an institution’s capital ratio falls into this range, it would be subject to intense regulatory supervision and monitoring. Suspension of dividends, interest payments on subordinated debt, and unapproved outflows of funds to an institution’s parent or affiliates would be mandated. Asset growth would be prohibited to prevent institutions from attempting to “grow” out of their problems. The institution would be required to submit, in addition to the business plan to increase capital required in Tranche 2, an emergency plan for its immediate recapitalization to Tranche 1 level.

### 4. **Tranche 4: Mandatory Recapitalization and Reorganization**

(e.g., less than 3 percent of assets). The federal deposit insurance agency is mandated to place the institution in a conservatorship; delayed supervisory response has been one of the causes of the level of existing losses. This conservatorship would be charged with recapitalizing the institution or liquidating it in an orderly fashion within a short period of time by merger, sale of the entire organization, or sale of individual assets. Present owners would have the option of implementing quickly the plan submitted when the institution moved into Tranche 3 or electing not to inject further funds into the institution. If the owners elect not to recapitalize the institution, it would be sold or liquidated, and any residual value from its sale or liquidation of assets would be returned to subordinated debt holders and shareholders, after allowing for any costs incurred.

## Key clarifications and features of the proposed structure

### 1. **Definition of capital.**

Capital is defined as the difference between the market value of assets and the market

value of liabilities (including so-called off-balance-sheet items) other than indebtedness counted as capital for regulatory purposes because it is subordinated to the claims of the deposit-insurance agency and has a maturity of at least one year.

**2. Market values.**

The reorganization rules should be based on market values to minimize risks to the insurance funds and to allow both the regulators and banks to take informed actions. As a matter of implementation, it is envisioned that market valuation estimates would have three sources: (a) directly observed market prices; (b) prices derived from instruments of comparable tenor including maturity, credit quality, and rate; and (c) estimates based on generally accepted valuation principles. Parties expected to be involved in the development of valuation standards and procedures include the regulatory agencies, public accountants, market and valuation experts, and the industry itself. Once the estimation programs are in place (as they already are in many institutions), valuations should be relevant to both management and the supervisors.

**3. Supervision costs.**

Charges for supervision, regulation, examination, and monitoring would be based upon the efforts required of the supervisors and paid for by the depository institution. Because examination and monitoring efforts increase as an institution's capital declines and risks assumed increase, agency charges would function in a manner analogous to risk-adjusted insurance premiums.

**4. Charter shifting.**

Institutions would be permitted to change their primary regulatory agency within the new structure. This feature would serve as an incentive for the respective agencies to balance the costs of supervision with its benefits to the agency and to limit overzealous supervision.

**5. Accountability of supervisors.**

Federal bank supervisors must report publicly to Congress yearly on the institutions in each tranche and on the actions taken to restore institutions to Tranche 1.

Supervisors would be responsible for assuring that the business and recapitalization plans are appropriate and are acted upon. Periodic General Accounting Office audits and yearly congressional oversight would be required to provide an element of discipline on the regulators to operate in accordance with the required standards.

**6. Regulatory responsibility in Tranche 4.**

The appropriate federal deposit insurance agency would be notified when an institution moved into Tranche 3 and would receive all supervisory reports and other information in anticipation of having to assume control of the institution as it moves into Tranche 4. All institutions falling into Tranche 4 should be reorganized regardless of their size. Their losses would be charged pro rata to uninsured creditors.

**7. Creation of supervisory audit trail.**

Use of tranches and required consultations would document regulatory problems encountered in attempting to value firms as their capital declines and they move through the tranches. This should simplify resolution of controversy should an institution be forced into recapitalization or reorganization.

**8. Insurance premiums.**

Explicit charges for insurance should be low under this system since only fraud cases and unusual market movements would impose significant losses on the insurance funds.

**9. Holding companies and permissible activities.**

Neither the wisdom of the present holding company structure nor the logic of the activity restrictions that now exist under the current regulatory structure is addressed in this proposal. Resolution of these issues, while important, is a separable issue. Use of the suggested valuation scheme, however, does suggest that the primary criterion relevant for establishing the suitability of a bank activity should be the ability of the insurance agency to monitor the activity and to estimate its market value.

**10. Insurance coverage.**

Present deposit insurance coverage of \$100,000 per customer need not be changed for the proposal to be effective. Indeed, were the proposal to be adopted, it would be doubtful that any depositors would lose funds, except those involved in frauds on banks.

**11. Disclosure.**

Regular reports to the supervisors embodying the market value of banks should be publicly available. This would enable the Congress and public to monitor better the status of financial condition of banks and the performance of the supervisory agencies.

**12. Large bank failures.**

All institutions that fall into Tranche 4 should be reorganized or allowed to “fail” regardless of their size. Any losses should be charged pro rata to equity holders and uninsured creditors. “Failure” means reorganization and change of ownership and does not necessarily imply a disruption of borrower or depositor relationships. Policies that differentiate among firms based on their size (e.g., “too big to pay off”) present unacceptable incentive problems, provide inequitable treatment of creditors, and foster unfair competition.

**13. Market discipline.**

Under this proposal the supervisory authority rarely would have to close or reorganize a bank. The suspension of dividends and interest payments on subordinated debt required when a bank falls into the second level of supervisory concern (Tranche 3) should bring actions by stock and debt holders to correct poor performance and inject more capital in the bank to keep it from being taken over by the insurance agency.

**Transition**

Except for institutions with zero or negative GAAP net worth, there should be a transition period for the new capital tranches and regulatory policies that might be as long as five years. Unless they are immediately recapitalized, GAAP-insolvent institutions would not be kept in operation. Institutions that are not GAAP-insolvent would plan for a three-year phase-in of the program ending in 1992 (the final effective date of the current “risk-adjusted” capital program).



**Dealing with existing losses in the system**

Dealing effectively with existing losses in the system requires, first, that they be explicitly recognized as residual full faith and credit liabilities of the government rather than merely liabilities of the insurance funds; second, that insolvent institutions promptly be recapitalized and/or reorganized, merged, sold, or liquidated; and third, that methods be devised for prompt disposal of assets acquired during reorganization of insolvent institutions. Any financing method not based upon the full faith and credit of the U.S. government would necessarily be more expensive and, given the magnitude of the existing problem, inappropriate.

## Statement No. 42

# The On-Budget Status of Expenditures to Resolve Thrift Insolvencies

May 15, 1989

The House Ways and Means Committee recently expressed its sentiment that expenditures of the \$50 billion provided in the pending “Financial Institutions, Reform, Recovery and Enforcement Act of 1989” to bail out the Federal Savings and Loan Insurance Corporation should be scored as budget outlays. The Shadow Financial Regulatory Committee applauds this action.

The Ways and Means Committee vote represents an important break with deposit-insurance agency and federal budget gimmickry that has for years deceived the public about the size of the FSLIC bailout and who would have to pay the FSLIC’s bills. On-budget treatment of the assistance outlays makes it clear that the bailout is a taxpayer obligation. It also eliminates the unnecessarily high costs that non-Treasury borrowing would impose on the taxpayers. This higher borrowing cost would be about \$3 billion to \$5 billion over the lifetime of the proposed non-Treasury (i.e., Resolution Funding Corporation) debt instruments, far too much to pay for the alleged political benefits “off-budget” treatment would afford.

Assertions by the Secretary of the Treasury that the financial markets would be disturbed and that higher costs would be incurred for Treasury debt by on-budget treatment for thrift bailout outlays are without apparent foundation. Fifty billion dollars of government expenditures will have the same effects on financial markets whether financed by an on- or off-budget entity. Indeed, in the aftermath of the Ways and Means Committee’s action, the financial markets were essentially unaffected. The argument that on-budget treatment would undermine the fiscal discipline imposed by Gramm-Rudman restraints is also fictitious. These losses have already been incurred.

Other significant benefits flow from the Ways and Means Committee decision: The convoluted Resolution Trust Corporation (RTC)/Resolution Funding Corporation (RFC)/FDIC structure becomes unnecessary when budgetary honesty is pledged. What would undoubtedly be an unwieldy and wasteful three-way bureaucracy can be streamlined. With the elimination of the need for the off-budget fig leaf, the Federal Deposit Insurance Corporation alone can resolve thrift insolvencies. It is ironic that the Administration proposes to eliminate the discredited Federal Asset Disposition Association (FADA), but to replace it with *two* new bureaucracies—the RTC and RFC.

The public is entitled to candor and efficient performance from its elected officials. The Shadow Committee urges Congress to enact on-budget treatment of outlays to resolve troubled thrift insolvencies, as well as to eliminate altogether the RTC/RFC concept (together with the Regional Advisory Boards, which are fraught with conflict of interest and potential for scandal). The FDIC, as expanded by its merger with the FSLIC, should be charged with handling thrift resolutions directly, without muddled lines of authority and responsibility.

# Statement No. 43

## The Financial Institutions Reform, Recovery, and Enforcement Act of 1989

May 15, 1989

### General position

After years of procrastination the Administration and the Congress have finally come to grips with the insolvency of the FSLIC and have proposed spending some \$90 billion to resolve the deficit. Three years ago, the Shadow Financial Regulatory Committee called public attention to the depth of this problem and recommended an expeditious recapitalization of the FSLIC, along with merger or closing of hopelessly insolvent (“zombie”) thrifts. At the beginning of 1987 we estimated that the cost of resolving the thrift problem was at least \$30 billion, and we stressed the need for Treasury funding and for early takeover of deteriorating and insolvent institutions (see Statement No. 16, February 9, 1987). Recent actions by the Administration and Congress make it clear that the full faith and credit of the United States stands behind the deposit insurance system, even if the cost turns out to exceed today’s estimate.

Unfortunately, the commitment to raise the necessary funds is one of the few constructive provisions contained in the lengthy bills now before the Congress. In the past, the Shadow Financial Regulatory Committee has expressed the need for fundamental reform of the deposit insurance system and articulated the key issues that such reform should address. The Committee urged that such reform would be coupled with any bailout of FSLIC. None of the pending bills effectively deals with the incentive and other structural defects of the present system. Instead, they contain a number of provisions that could worsen the situation.

The Committee has concluded, reluctantly, that given the need for prompt action, *the best action would be legislation restricted to raising the funds needed to take over insolvent and hopelessly deteriorating thrift institutions.* While the Committee is disappointed that significant regulatory reform does not seem politically feasible at this time, we urge the Administration and the Congress to consider carefully serious structural reform.

This statement lists a number of issues on which we believe that the legislation does mischief or represents a facile “solution” to a complicated problem. This listing is not exhaustive.

### Financing

We strongly oppose the complex financing scheme provided for in the bills that passed the Senate and the House Banking Committee. There seems to be no purpose to this arrangement other than the desire to keep the cost off-budget. All agree that this will increase the ultimate cost of resolving the problem, and there is no public benefit from the money wasted in this manner. Keeping the funding off-budget necessitates the creation of

the Resolution Funding Corporation and the Resolution Trust Corporation, with resulting additional inefficiencies and costs. We commend the House Ways and Means Committee for its tentative vote that all spending be handled on-budget, with all borrowing being done by the U.S. Treasury. The Shadow Financial Regulatory Committee has issued a separate Policy Statement (No. 42) dealing with this issue.

### **Capital standards**

The aspect of the legislation that has generated the most controversy is the level and structure of the capital requirement to be imposed on S&Ls. This Committee has been a strong supporter of high and rigorous capital requirements, but specification of capital requirements requires careful action. We do not believe that Congress can develop an effective system on the short time schedule necessary for this legislation. If Congress is to include provisions on capital in this legislation, we believe that it should be to express (1) a general objective—that no depository institution should be allowed to continue to operate without capital that is positive when calculated in accordance with generally accepted accounting principles (and eventually on a market value basis); (2) a definition of capital as all claims junior to the claims of depositors and other general creditors—obviously this includes subordinated debt; and (3) an implementing principle—that thrifts should be required to meet commercial bank capital standards by a date certain.

Related to the capital controversy is the debate over accounting treatment of goodwill and other intangibles. Congress is not the place to debate technical accounting matters, such as which intangibles have more economic value than others, or whether purchased rights to mortgage servicing deserve more favorable treatment than purchase accounting goodwill, or whether goodwill acquired as a result of supervisory mergers is better than goodwill acquired in other ways.

### **Qualified thrift lender test**

Portfolio diversification is fundamental for the prudent management of interest rate and credit risk. Tightening of the “qualified thrift lender” (QTL) test, as the legislation provides, will produce perverse results. It also is not a reasoned response to irresponsible risk taking by some thrift managers.

### **Deposit insurance funds**

The legislation perpetuates the idea that it is necessary to maintain two separately reserved deposit insurance funds, even though explicitly recognizing that deposit insurance is backed by the full faith and credit of the United States. The funds would serve as accounting devices rather than as a constraint on spending for deposit insurance purposes. With the funds under common management (the FDIC), separate accounting may focus attention on differences in risk exposure to thrift and commercial bank operations.

It is important that Congress not allow the implication that one fund is stronger or safer than the other. Clearly, both are backed by the U.S. government. As a result, there is no logic to separate deposit insurance names or logos. If any artificial distinction in the quality of deposit insurance is perceived by depositors, thrifts will be forced to pay higher rates on deposits. Much of this increased cost will be borne by taxpayers, through the operation of existing conservatorships and yield maintenance agreements. Both House and Senate versions of the bill provide for different insurance names and logos.

### **Organizational structure**

The legislation makes a number of changes in the organization structure of thrift regulation that address the perceived regulatory failures of the FHLBB. The thrift industry, with the aid of the Congress, historically exerted undue influence over its regulator. But we find it hard to believe that thrift regulation can be more effective as part of the Treasury Department than as an independent agency. Nor is it clear that such a structure would keep this function freer of congressional pressure. The legislation does provide for exemption from the appropriation process for the thrift regulator, and that may indeed be helpful.

### **Enforcement powers**

There are a number of provisions in the legislation that increase the regulatory agencies' enforcement powers. The agencies were granted substantial enforcement powers in 1966, which were significantly enhanced in 1978. We have seen no evidence that lack of the powers included in the proposed legislation was responsible for the losses incurred. It is clear that there was a lack of will to use existing powers effectively. Far worse, some of these additional powers raise substantial issues of regulatory overkill. We find it hard to justify, for example, the power to levy fines as high as \$1 million per day. If any such additional powers are granted, there should be clear provisions for accountability by the agencies and an attempt to see that rights to procedural fairness are protected.

### **Cross guarantees**

The legislation provides that bank subsidiaries of a multibank holding company be required to indemnify the FDIC against losses due to failure of their affiliated banks. The FDIC has a valid concern that its potential exposure is now affected arbitrarily by the way in which a bank holding company chooses to organize its operations. On the other hand, the proposed change would have far-reaching implications for the position of creditors and minority stockholders of the subsidiary banks. If any such change is made, it should become effective only after a substantial phase-in period. In addition, affected institutions should have the option to operate their banking operations as branches, rather than subsidiaries, regardless of state or federal restrictions on branching.

**Acquisition of healthy thrifts**

The Senate bill delays for two years the authority of commercial banks or bank holding companies to acquire healthy thrifts. There should be no delay, and this authority should be granted immediately, as the House bill provides.

**CPA audits**

We support the provision in the legislation that requires independent CPA audits of all commercial banks. Savings and loans are already subject to such a requirement. The Committee endorsed this concept earlier in our Policy Statement No. 32, May 16, 1988.

## Statement No. 44

# The Comptroller of the Currency's Proposal for a Minimum Bank Leverage Ratio

September 18, 1989

The Comptroller of the Currency (OCC) recently issued a proposed regulation to set a 3 percent minimum leverage ratio that national banks would be required to meet in addition to the 8 percent risk-based capital standard that will be fully implemented by 1992. The Shadow Financial Regulatory Committee agrees with the thrust of the Comptroller's conclusion that the risk-based capital system is inadequate to protect the deposit insurance system, but we have serious reservations about the specifics of the Comptroller's proposal. Our criticisms of the risk-based requirements are spelled out in Statement Nos. 18 and 29, issued May 18, 1987, and February 8, 1988, respectively.

We have urged, instead, the adoption of a structure of capital requirements that would call for increasingly strong supervisory actions as properly measured capital falls. The Committee's proposal was set forth in Statement No. 41, issued on February 13, 1989.

Our criticisms of the OCC proposal relate to:

1. the definition of capital,
  2. the appropriate ratio requirement, and
  3. the action to be taken if the requirement is not met.
- 
1. The appropriate definition of capital in terms of protection to bank creditors and the deposit insurance system is the difference between the market value of assets (including intangibles) and the market value of those liabilities (including off-balance-sheet items) that are not subordinated to the claims of the insurance agency. We reject as artificial the distinctions between first- and second-tier capital, as well as the concept of core capital.  
If one prefers to think in terms of historical costs, or "book values," our view implies that subordinated debt and preferred stock and that part of the loan loss reserve, if any, that exceeds the expected loss in the loan portfolio should not be excluded from capital. Similarly, it is inappropriate to deduct goodwill from the computation of capital if the goodwill represents a market estimate of the franchise value of the institution, although it is appropriate to ignore goodwill that does not reflect economic values.
  2. We believe that the required ratio, with capital defined as above, should be significantly *higher* than the existing 6 percent standard (see Statement No. 41).
  3. A meaningful capital standard must include clear rules that specify actions to be taken when requirements are not met. These actions are not spelled out in the OCC proposal. We could support the proposal if it were intended as the "trigger" for a mandatory recapitalization and reorganization rule, such as that described in our Statement No. 41.

We recognize that the OCC proposal may be intended to resolve the confusion over the applicability of the national bank capital standards to savings and loans as required by FIRREA. We might note that this confusion is an unfortunate result of an attempt at *legislating* detailed capital requirements and accounting definitions that are more appropriately left to the regulatory agencies. We warned about this danger in our Statement No. 43 on FIRREA, issued May 15, 1989.



# Statement No. 45

## Federal Reserve Proposals to Modify the Payments System Risk Reduction Program

September 18, 1989

In mid-June the Federal Reserve Board issued for public comment proposals to change its large-dollar payment system risk policy. According to the Federal Reserve, the primary objective is to reduce risk to the payments system and to the Federal Reserve due to large overdrafts on its Fedwire system. Such risk occurs because the Federal Reserve guarantees all Fedwire payments as “final.”

The Federal Reserve proposes levying a fee of 25 basis points (annual rate) on average overdrafts on the Fedwire system that exceed a specified minimum.

The Committee believes this fee is not high enough to alter significantly the payments risk the Federal Reserve now faces. The proposed fee does not accurately reflect relevant credit costs and is not responsive to differences in insolvency risk. A preferable role for the Federal Reserve is to act as a “switch” in providing payment services, providing real-time clearing against “collected” funds only. An important goal of a fee schedule imposed on the Fedwire system by the Federal Reserve should be to avoid deterring the private sector from creating an alternative clearing and payments system.

This statement concentrates on pricing issues contained in the Federal Reserve proposal and concludes that problems of Fedwire mispricing are far from resolved. In addition, it reflects the Committee’s doubt that significant risk reduction will be achieved.

### **Background**

Fedwire is a large-dollar funds transfer clearing mechanism through which final settlement takes the form of credits and debits to reserve accounts held by banks at Federal Reserve Banks. During the course of a business day, considerable mismatching occurs in the timing of funds transfers and securities transactions, which often results in the extension of substantial intraday credit by the Federal Reserve. In recent years the Federal Reserve has undertaken to reduce the amount of intraday credit it extends by placing caps on the amounts of intraday credit available to individual banks. In turn, observance of cap constraints has prompted banks to monitor more closely intraday positions and undertake adjustments as needed.

The Federal Reserve now proposes to augment its program by levying a fee of 25 basis points (annual rate), phased in over three years in steps of 10, 10, and 5 basis points, for average intraday overdrafts on the Fedwire that exceed a deductible of 10 percent of capital as calculated under the new risk-adjusted method. The price and overdraft program affects primarily the largest Fedwire participants. According to the Federal Reserve, the 15 largest bank sources of overdrafts would pay almost 90 percent of the total proposed charges.

## Analysis

In effect, the Federal Reserve's current operation of Fedwire provides, at public expense, interest-free credit plus (because payments are final) guarantees against insolvency. We calculate, using data furnished by the Federal Reserve and assuming an 8 percent federal funds rate, that the subsidization implied on the credit on funds transfers alone is on the order of \$750 million annually.<sup>1</sup> To be complete, provision also should be made for the counterpart payment of interest on intraday credit balances. Indeed, it would not be inappropriate under the circumstances to consider the broader issue of payment of interest on Federal Reserve credit balances generally.

Under the Monetary Control Act of 1980, Federal Reserve payments services, including interest on items credited prior to collection, must fully reflect relevant costs. The current pricing proposal does not respond adequately to this requirement. Indeed, the Federal Reserve proposal does not provide information on how it concluded that a charge of 25 basis points is reasonable.

The 25 basis-point charge (to say nothing of the smaller phase-in increments) appears small when compared with existing pricing arrangements. One is the 100 basis-point fee now assessed by banks to brokers for intraday loans. Another is the overnight penalty rate on Federal Reserve overdrafts of the greater of 10 percent or the federal funds rate plus 2 percentage points. The subsidy will remain. At a minimum, pricing should reflect the overnight federal funds rates.

Moreover, no provision is made in the Federal Reserve proposal for differences in insolvency risk: One price fits all. Under the proposed cap program, it is unlikely that the Federal Reserve (and taxpayers) will be adequately compensated for bearing insolvency risk. This suggests at the very least the need for lower caps and for substantially improved risk evaluation programs, combined with early closure of insolvent institutions (see this Committee's Statement No. 41).

A preferable role for the Federal Reserve in payments services—one resolving the subsidization questions posed here—is to act as a “switch,” providing real-time clearing only against collected funds. This would entail additional private sector investment in technological capacity (including payments queueing facilities) and risk monitoring. Such a switching role would not foreclose discount window access.

Alternatively, if the Federal Reserve's current role in the payments system is to continue, it should more closely mimic market behavior. Subsidization of credit and insolvency risk will remain large if the proposed pricing is adopted.

## Notes

1. Calculated as  $251/365$  (average in number of days)  $\times$   $9/24$  (hours per day)  $\times$   $8/100$  (the federal funds rate)  $\times$  \$37.3 billion (measured overdrafts).

Statement No. 46  
Proposals to Modify Loan Loss Reserves  
for Third World Debt

September 18, 1989

Concern about the willingness of domestic banks to continue participating in official efforts to deal with the Third World debt problem is reflected in recently introduced legislation by Representatives Fauntroy and LaFalce that would provide inappropriate incentives for banks to engage in the debt rescheduling contemplated in the Brady Plan. Under this legislation, institutions would be required to increase substantially their reserves against loans to financially troubled countries unless they participated in the extension of additional credit.

The implication of this legislation is that U.S. banks currently are significantly under-reserved for these loans. To the extent this is correct, the increase in reserves is desirable.

However, the responsible bank regulatory agency simultaneously would be directed to treat any new loans made as part of a debt restructuring or financing program as reducing the exposure on existing loans. This introduces a new form of congressional loan loss accounting that intentionally overvalues loans and hence artificially inflates the stated regulatory capital of banks that cooperate with the Brady Plan, without affecting the banks' real capital.

Prudent bank supervision would require institutions to reserve against declines in credit quality of any outstanding loan. To provide congressionally mandated forbearance in the form of reductions in required additions to loan loss reserves in return for participating in rescheduling of Third World debt is unsound and corrupts the integrity of the bank supervisory process.

# Statement No. 47

## Congressionally Mandated Accounting for Junk Bond Sales

September 18, 1989

The U.S. taxpayer is faced with a cost of more than \$150 billion to pay off depositors in insolvent savings and loans associations. One reason many of these institutions were not closed by the authorities before they lost billions of dollars in excessively risky loans and other investments is that their economic insolvency was covered up by traditional and regulatory accounting systems. These practices allowed “zombie” savings and loan associations to show assets at cost, even when the assets were, in actuality, worth far less.

The Financial Institution Reform, Recovery, and Enforcement Act of 1989 (FIRREA) continues to authorize misleading reporting practices. In particular, although S&Ls are directed to dispose of their “junk” bond holdings no later than July 1, 1994, according to the Conference Report they can report these assets at cost, even when the economic value of the bonds is known to be lower. The Shadow Financial Regulatory Committee supports the Financial Accounting Standards Board (FASB) in opposing this congressional interference with prudent regulatory practice. It is contrary to generally accepted accounting principles (GAAP) because, under GAAP, securities that will not be held to maturity must be stated at the lower of cost or market. Consequently, allowing S&Ls to report at cost (if higher than market) “junk” bonds that will not mature before they must be sold is contrary to the Competitive Equality Banking Act of 1987, which requires that regulatory accounting conform to GAAP.

The Committee would require insured depository institutions to report all assets at their current market value, at least when these values are readily determinable, as is the case for marketable securities. It does not matter whether the securities will be traded or held—their relevant value is given by the market. Unless such market values are regularly reported, both the supervisory authorities and the public are likely to be misled once more, and insolvent and undercapitalized institutions might again be allowed to play the “heads we win, tails the insurance fund loses” game that has been so costly to taxpayers.

## Statement No. 48

# The Activities of the Resolution Trust Corporation

December 4, 1989

The savings and loan (S&L) disaster has been officially estimated to have a present value cost of around \$100 billion. The way that failed S&Ls' assets are disposed of could impose substantial additional costs on taxpayers. The Committee believes that the impending losses and potential scandals can be reduced by having the Resolution Trust Corporation (RTC) sell the failed S&Ls and their assets as quickly and efficiently as possible.

The Committee is disappointed by the slow pace at which the RTC is able to resolve S&L insolvencies. Nearly all case resolutions so far have involved liquidations or deposit transfers. These approaches require large amounts of cash payments to depositors or to the institutions assuming these deposits, while most assets of the failed S&Ls remain with the RTC.

If these forms of insolvency resolution remain the standard, the RTC will soon exhaust its working capital, even if the \$50 billion provided by the Federal Institution Reform, Recovery and Enforcement Act (FIRREA) were sufficient to cover the ultimate loss. We believe that the RTC should have sufficient cash resources so that it can make optimal decisions as to the type of case resolution procedure used.

It is a flaw in FIRREA that sufficient working capital is not provided for. Limiting the RTC's working capital is not a satisfactory way to establish accountability for its decisions. The lowest-cost way to raise the needed funds is through borrowings of the U.S. Treasury. Any other source of financing will be more expensive to taxpayers. Further, if lack of cash causes the RTC to delay case resolution or to choose inferior methods of case resolution, the ultimate cost to taxpayers will be even higher.

While deposit transfers and liquidations should be available options for case resolution, it should be recognized that these approaches result in S&L assets remaining in the RTC's portfolio. We believe that, in general, the value of such assets is more likely to be fully realized if they become privately owned. Case resolutions should involve the sale of the failed institutions' assets and attendant risks to private parties. The RTC's overriding concern should be to foster an effective and competitive market for these assets.

Potential buyers should be provided with extensive information in standard formats about the properties to be sold and reports of the terms of sale for those that were sold. We believe that the secrecy with which the FSLIC insisted on carrying out its Southwest Plan played a heavy role in the criticism it received and the suspicion of its actions. Full public disclosure is likely to produce the best results for taxpayers and best protect the credibility of the RTC. This means disclosure of RTC's methodology for selecting winning bids, the terms of losing bids as well as winning bids, and, at least after the sale, the bid package.

While the markets for S&L assets may not be perfect, neither are the incentives nor information available to government program managers perfect. Indeed, past experience suggests that the second set of problems is considerably greater in asset management

programs. Furthermore, the unfolding HUD scandal demonstrates clearly the potential for corruption when government officials have discretion over billions of dollars of resources. When properties are under government management for long periods, as might be the case with the RTC, the likelihood for bribery and other forms of fraud is too great to be accepted.

The RTC has expressed an interest in doing both “whole thrift” transactions, whereby all assets and the attendant risks are transferred to the acquirer, and “clean thrift” transactions whereby only the deposits and “good” assets are transferred. There may be no best way to structure all sales of insolvent thrifts. The RTC should be encouraged to experiment with different approaches. However, such experimentation should generally avoid the RTC’s keeping the risks or allowing purchasers to shift the risks back to the government should events turn out badly. Such transactions privatize only the favorable outcomes.

## Statement No. 49 Latin American Debt

December 4, 1989

The government's continuing involvement in the international debt problem is likely to cost U.S. taxpayers billions of dollars, as this Committee noted in its criticism of the Reagan Administration's Baker Plan (Statement No. 1, February 15, 1986). The Bush Administration's Brady Plan encourages the World Bank and the International Monetary Fund to make additional loans to debtor nations. Because the U.S. taxpayer puts up about 20 percent of the World Bank and International Monetary Fund capital, taxpayers will pay a substantial part of the cost of bailing the banks out of their bad loans. Furthermore, the additional loans will not resolve the international debt problem. Restructuring should be left to the debtors and creditors without government involvement.

Two major developments have changed the outlook for the international debt problem in recent months. Both suggest that creditor banks do not plan much new lending in Latin America.

First, negotiations with Mexico under the Brady Plan left creditor banks three options. They could reduce principal by exchanging outstanding loans for bonds valued at 65 percent of the face value of the loans, or reduce interest rates by exchanging loans for bonds bearing 6.25 percent interest rate, or agree to make a substantial amount of new loans. The Mexican government has announced the response from holders of 60 percent of the nearly \$53 billion of medium- and long-term debt covered by the agreement. Only 10 percent of the banks decided to offer additional loans; 50 percent chose to reduce principal and 40 percent to reduce interest rates. If all lenders choose in the same proportions, Mexico's annual debt service will fall by \$900 million, and outstanding debt will fall by \$8 billion.

Second, major banks in the United States and the United Kingdom increased their reserves against medium- and long-term loans to heavily indebted countries. On average, eleven U.S. banks with significant exposure now have a 60 percent reserve against medium- and long-term debt. Reserves at major U.K. banks run between 50 percent and 70 percent and reserves of other European banks are approximately 50 percent of their medium- and long-term loans.

The Brady Plan, like the Baker Plan before it, will fail to provide any significant increase in private lending. At a time when banks are increasing reserves against old loans, substantial new lending is unlikely. With old debt selling in the secondary market at a small fraction of its face value, new loans that are subordinated to earlier loans are not attractive investments for banks or other private lenders.

The Brady Plan anticipates a substantial increase in loans and guarantees from the World Bank, other development banks, and the International Monetary Fund (IMF). The world Bank will increase its loans, but it (and others) will also face rising demand for loans to Eastern Europe. The IMF has received net repayments of \$3 billion in recent years, but after an increase in capital it will again become a net lender to debtor countries.

Since these international agencies obtain their capital from the governments of the major industrial countries, an increasing share of the debt of troubled countries will become an indirect liability of the taxpayers in the United States and other countries.

Increasing the developing countries' debts postpones a long-term solution and delays reforms. The major problems of the debtor countries are a result of wasteful policies, large subsidies to inefficient enterprises, low prices for public services, and other inefficient uses of resources at home. Additional lending often finances capital flight from the debtor countries by providing foreign exchange that politically favored individuals can obtain. Although it is difficult to define or measure capital flight with precision, citizens of major debtor countries hold assets abroad ranging from 50 percent to more than 100 percent of the outstanding debt.

The principal problem for the debtor countries is to improve the operations of their economies. This requires reduced subsidies, lower inflation, an end to capital outflow, and new policies to attract capital held abroad by foreigners and the debtor countries' own citizens. Improvement will come only if there are major reforms, including privatization, deregulation, and tax reduction. Mexico's recent reforms and a reduced fear of devaluation have attracted a small capital reflow this year. Also, Mexico and the United States agreed on October 3 to negotiate reductions in tariff and nontariff barriers in the next few years. Removal of these barriers is the most desirable way to help Mexico. This includes barriers in the United States to Mexican imports of steel, textiles, and agricultural products and Mexico's barriers against a wide range of goods and services.

Chile has followed policies of this kind. Chile's reforms have produced high growth with relatively low inflation and a substantial reduction in outstanding international debt. The Chilean experience serves as an example for other countries. Debt has been reduced. State-owned industries have been sold, in many cases using debt-for-equity exchanges. Chile has also arranged to repurchase some of its outstanding debt at a discount from face value.

For several years, banks' new loans to debtor countries have been less than the repayments and interest due from those countries. Additional lending by creditors to cover the service of outstanding debt delays a solution. The next step in the debt problem requires reforms in the debtor countries sufficient to attract direct investment and capital repatriation. Without major reforms, the debtor countries will not be able to return to the market or fully service their debt.

Repayment of outstanding debt and arrangements for settlement of arrears should be left to debtors and creditors. It is now universally recognized that debt is worth less than its face value. Debtors and creditors should be left to negotiate settlement values without assistance from or interference by governments and international agencies. Removal of governmental involvement will increase the incentives for creditors and debtors to reach agreements.

Government regulators should require U.S. financial institutions to value debt at market prices on their books. This, too, will encourage meaningful negotiations.

It is the Committee's policy that members abstain from voting on policy statements in instances in which they have a direct or professional involvement in the matter that is the subject of the statement. Accordingly, Richard Aspinwall abstained from voting on this statement.



## Statement No. 50

# Federal Reserve Board Proposed Transition Capital Standards for Member Banks

December 4, 1989

The Federal Reserve Board's proposal for a 3 percent minimum leverage requirement, to supplement risk-based capital standards for commercial banks, provides yet another example of the banking authorities' continued resistance to raising bank capital requirements. The Committee is convinced that common adoption of the 3 percent minimum leverage requirement will foster an undesirably low level of capital in the banking system. The Committee previously noted in its proposal for restructuring the banking system (Statement No. 41, February 13, 1989) that the major problem in the banking system is inadequate capital at even the strongest banks. We have repeatedly argued that capital ratios for all institutions should be raised above their current levels.

By introducing a supplementary requirement, the banking regulators implicitly recognize that their risk-based capital system may not provide sufficient capital to secure their safety and soundness objectives. A well-conceived, risk-based standard would not require an additional leverage constraint.

The Board's proposal fails to address at least two other important issues. First, as emphasized in the Committee's policy statement on the Comptroller of the Currency's proposed minimum leverage standard (Statement No. 44, September 18, 1989), capital is still being based on historical costs rather than being measured in current market value terms. Institutions with a low positive book value of equity could even have negative economic net worth. Consequently, this mismeasurement problem would permit institutions, lightly capitalized in economic terms, to leverage themselves excessively and pose great risks to the deposit insurance fund. Second, meaningful capital standards would indicate precisely the actions regulators must take when institutions fail to meet the standard. As the S&L debacle demonstrates, unmet capital requirements must be followed immediately with effective regulatory responses such as mandatory recapitalization or reorganization. Otherwise they are equivalent to no capital standards at all.

# Statement No. 51

## Proposals to Curb Stock Market Volatility

December 4, 1989

The Committee believes that recent proposals to reduce stock market volatility are misdirected and counterproductive. Increased reliance on circuit breakers (automatic trading halts) is inadvisable, and granting additional power to the SEC to close markets will be counterproductive. The Committee also believes that criticisms of index arbitrage are misdirected and that such arbitrage should not be restricted.

Under pressure from the threat of restrictive legislation and regulation, first advanced by the Brady Commission in its report on the 1987 stock market crash, exchanges have adopted a variety of circuit breakers for the purpose of moderating market volatility. These actions were taken despite the absence of any evidence that circuit breakers will reduce market volatility.

The experience on October 13, 1987, in fact suggests that circuit breakers do not work. Twice during the afternoon of October 13 circuit breakers were triggered that resulted in the closure of the S&P 500 futures market. Despite these actions, the stock market continued its precipitous fall. Futures exchanges have responded by increasing their reliance on circuit breakers by reducing the permissible price change that can occur before circuit breakers are triggered.

Circuit breakers are not an effective solution to stock market volatility. They are unlikely to result in less volatility in most instances and will reduce the liquidity of markets. The ultimate result will be able to make U.S. markets less efficient than foreign markets and to drive business to foreign markets.

In addition, proposals have been made to give the SEC authority to close equity markets to prevent "excessive" volatility. The Committee is also opposed to granting this power to the SEC. Such authority should remain with the exchanges. Exchanges themselves are in the best position to judge whether closure is beneficial, and such exchange actions are already subject to regulatory approval.

Finally, the Committee believes that proposals to bar or curb equity index arbitrage are misdirected. There is no evidence that index arbitrage has been the cause of market volatility. Such arbitrage provides an essential link between equity futures and cash markets. Without it these markets would operate less efficiently.

## Statement No. 52

# The FDIC's Proposed Regulation on Purchased Mortgage Servicing Rights

February 26, 1990

The FDIC recently proposed a regulation that would limit the amount of purchased mortgage servicing rights that banks and savings institutions can recognize when calculating their regulatory capital. Under the regulation, the amount of servicing rights that would be recognized is limited to 25 percent of an institution's regulatory capital, with a five-year phase-in provision. The FDIC has provided no evidence to indicate that servicing rights are a particularly risky asset.

Servicing rights are contracts to service mortgages for the owner in return for a fee. Many investors, such as pension funds and individuals, are now interested in acquiring mortgage-backed securities but do not want to service the individual loans. A number of firms have developed expertise in this function, including commercial banks, savings and loans, and mortgage bankers. This appears to be a business in which economies of scale are significant, so that the efficient servicers handle a large volume of mortgages—often more than they originate. Their willingness to buy servicing rights has created a liquid market in servicing and enabled originators to earn a profit by selling servicing.

The mortgage servicing business has historically been a profitable one, though profits have been lower in recent years. Servicing is particularly attractive to thrift institutions because of the positive relationship between the value of mortgage servicing rights and the level of interest rates. As interest rates rise, mortgage prepayments decline, and so the value of mortgage servicing rights rise. Also, the escrow accounts that are part of the servicing relationship represent a low-cost source of funds to depository institutions (one that becomes more valuable if interest rates rise). As the Committee has noted earlier, the degree of an institution's exposure to interest rate risk does not depend upon having particular assets in its portfolio. Rather, it is determined by the relative interest sensitivity of the institution's assets and liabilities considered together.

Credit risk is not a significant problem in most mortgage servicing since the risk remains with the owner of the mortgage. However, some mortgage servicing, including some servicing of VA loans, is done on a recourse basis and does expose the servicer to risk of loss in case of default of the mortgage. The few institutions with a significant volume of recourse servicing, or with an undiversified VA mortgage portfolio, can be dealt with through the examination process. In any case, the accepted procedure for dealing with such risk is to calculate capital requirements as though assets involved in such risk were actually on the balance sheet. Such treatment will tend to discourage banks from taking on risky recourse servicing without limiting their ability to engage in traditional mortgage servicing.

The FDIC appears to be concerned about the operational risks inherent in mortgage servicing. A breakdown in back-office operations can lead to losses by a mortgage servicer, but this potential problem can be dealt with easily on a case-by-case basis. It is not appropriately addressed by a regulation applying to all mortgage servicers.

FIRREA imposed a severe and arbitrary restriction on purchase servicing rights by limiting the extent to which they can be included in regulatory capital to 90 percent of market value. Servicing rights do fluctuate in price, as do all bank and thrift assets. We believe that capital adequacy for all assets should be based on market values, and we support a high capital requirement. However, the proposed regulation involves an effective capital requirement on purchase servicing rights that may be many times that imposed on unsecured loans, and does so without any evidence of unusual risk associated with the mortgage servicing business.

It is the Committee's policy that members abstain from participation on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Lawrence Connell abstained from participation in this statement.

## Statement No. 53 Subsidized Federal Reserve Assistance

February 26, 1990

Several banks in New England have been experiencing financial difficulties in recent months. Deposit rates now offered in this area are among the highest in the country. The Federal Reserve Bank of Boston has been lending more than \$1 billion to New England institutions through the discount window at less than market rate of interest.

Because the Federal Reserve has a policy against loans to insolvent institutions, the Committee hopes that this subsidized credit is not being granted to banks that are insolvent in economic terms as well as on a book value basis. The Committee previously urged in its Policy Statement No. 41 that banks with capital of less than 3 percent should be required immediately to increase their capital substantially. If such institutions prove unable to raise additional equity capital, we may interpret the market to be effectively declaring them insolvent.

The Committee has previously warned about the high costs of open bank assistance to insolvent banks. In addition, if such assistance is provided because the institution is deemed "too large to fail," the Committee believes that it unfairly discriminates against smaller institutions. This doctrine was used to support lending to the Continental Illinois National Bank in 1984, Republic National Bank in 1988, and MCORP in 1989, among others. Nevertheless, all of these banks subsequently failed with large losses to the FDIC. The assistance primarily provided time for many uninsured depositors to withdraw their funds without loss. The loss, though, was borne first by the FDIC and ultimately, as the bankruptcy of the FSLIC demonstrates, may be underwritten by federal taxpayers.

It is the Committee's policy that members abstain from participation on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Richard Aspinwall and John D. Hawke, Jr., abstained from participation in this statement.

## Statement No. 54

# The Failure of the Treasury's Study of the Federal Deposit Insurance System to Focus on Identifying and Correcting Defects in Governmental Incentives

February 26, 1990

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) directs the Secretary of the Treasury to study the federal deposit insurance system for the purpose of recommending reforms. As part of this study, the Treasury has requested public comments on a wide range of subordinate issues.

Extensive comments on the most important of the Treasury's selected issues may be found in past policy statements on this Committee and in the writings of many individual Committee members. These analyses develop the guideline that deposit-insurance officials should measure, monitor, price, and police institutional risk exposures in the same ways that market discipline would lead a well-managed stockholder-owned firm to perform these tasks in a private enterprise setting. In particular, Committee Policy Statement No. 41 offers a plan based on graduated capital ratios designed to give bank stockholders and debt holders strong incentives to take self-protecting actions that would keep institutions from being operated with inadequate or negative capital.

Missing from the Treasury's topic outline is the recognition that the deposit insurance system also suffers because elected and appointed officials face strong incentives to breach the private enterprise guideline. As thrift industry insolvencies and FSLIC's cumulative capital shortage grew, authorities repeatedly sought but time. But they used this time badly with respect to their fiduciary responsibilities to well-capitalized institutions and taxpayers. They employed gimmicky accounting to paper over industry and insurance fund weaknesses and to defer fully adequate corrective action to someone else's watch. As politically attractive as this policy was in the short run, not requiring the recapitalization or closure of insured institutions when they neared insolvency imposed enormous, but not immediately accounted for, longer-run costs on taxpayers.

An institution becomes economically insolvent when explicit and implicit losses push the earning power of its assets below the level needed to service its debts. Because deposit liabilities are federally guaranteed, insolvent deposit institutions have no difficulty in funding at below-market interest rates growth-oriented, go-for-broke forms of risk taking that are inefficient for society as a whole. This ease of financing encourages risky strategies.

The FSLIC collapse demonstrates defects in political and bureaucratic accountability that, if not corrected, will undermine the FDIC as well. The Treasury study must address two core issues before deposit insurance can be properly reformed. First, why did elected and appointed officials charged with overseeing the deposit insurance agencies break faith with taxpayers by putting off needed insolvency resolutions for years on end? Second, how can the authorities' incentives be restructured to assure that they will serve taxpayers' interests scrupulously in the future?

The overriding problem is that covering up troublesome evidence and engaging in regulatory forbearance is, at least for strictly self-interested politicians and bureaucrats, a rational response to widespread industry insolvency. The current system confronts authorities with a painful tradeoff between protecting general taxpayers' economic interests and incurring the displeasure of politically strong regulatory clients and their various political allies.

To overcome this tradeoff, the incentives bearing on the exercise of judgement and discretion of bureaucratic decision makers must be reconstructed and the scope of that discretion must be greatly narrowed with respect to the information they report and the forbearance they give. To forestall cover-ups, deposit insurers and their clients must be required to estimate the long-run costs of regulatory forbearances honestly and in a timely fashion. To lessen congressional pressure for granting forbearances, estimated losses should be put into agency budgets and flowed through the federal budget in the year they occur. This would provide an informational framework in which market and political forces would push deposit insurers to enforce timely recapitalization of troubled deposit institutions. In addition, members of Congress should be required to report all efforts to win forbearance for constituent firms to their ethics and banking committees for examination and potential sanction. Finally, these committees should hold regular hearings during which outside experts are asked to assess compliance with these new requirements by regulators and politicians.

This informational framework should apply to banks as well as to thrifts. A threshold for reorganizing an insured institution's affairs should be established at a positive rather than negative level of net worth, measured in terms of market values. Although a number of transitional difficulties need to be addressed, regulators and deposit institution managers can, if higher authorities insist, develop workable procedures for marking to market on-balance sheet and off-balance sheet items often enough to provide timely appraisals of the economic net worth of every federally insured enterprise and of the net value of the deposit insurance reserves that stand behind them.

At the same time, the statutory provisions governing deposit insurance managers should be narrowed and made more precise, leaving little room for regulatory judgement and the play of political pressure.

The Committee wants to emphasize that the past operation of the deposit insurance system did not go wrong only because of incentives facing the managers of insured institutions, but also because of the incentive problems facing public officials. A study that ignores the second dimension of the 1980s' disaster cannot hope to develop an effective solution.

## Statement No. 55

### RTC Thrift Resolution Policies

May 7, 1990

The initial approach of the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) to resolving thrift insolvencies has been to sell institutions net of assets whose values are hard to determine. In these so-called “clean bank” deals, the RTC retains the deleted assets of the thrift and gives the acquiror cash (less any acquisition premium) to cover the cost of assuming the thrift’s liabilities.

Alternatively, especially in the case of large institutions, the RTC sells the whole institution but permits the new owner to “put” to the RTC (return) any asset the owner later determines it does not wish to retain. Exercise of this put provision turns the transaction into a clean bank deal in the end but subjects the RTC to the additional risk of interim declines in value. Moreover, in holding problem assets under either approach, the RTC is taking title to hundreds of thousands of individual properties, trying to account for them, manage them and ultimately dispose of them.

The Committee believes that the RTC should revise its procedures. The cost of S&L resolutions consists primarily of losses in institutions’ assets. To minimize aggregate losses (present and future), the management and ownership of the assets should be transferred to the private sector as rapidly as possible. Only a private owner who bears the costs and gains has the correct incentives to make judgements on maintenance, further investment, and terms of sale.

The principle is to privatize risks as soon and as far as possible. “Clean bank” deals and “whole bank” deals with “puts” violate this principle by leaving all the problem assets in the hands of the RTC. The institution’s liabilities and readily marketable assets are transferred to the buyer, but so are its personnel, which means their knowledge of the problem assets becomes lost to the RTC. Transactions of these types have an unfortunate attraction to the RTC, in that they avoid immediate recognition of the full extent of the losses imbedded in assets. This creates a misleading impression of the unfolding cost of the resolutions. The hidden cost is that huge asset holdings remain in the hands of the RTC and are subject to further deterioration. The taxpayers’ interest would be better served by outright sales of institutions (“final bank” deals) and assets, under terms designed to maximize the transfer of investment risk.

The Committee recognizes that the primary difficulty in effecting final sales of problem assets is uncertainty of valuation. When uncertainty is so great that “final bank” deals do not seem feasible, the RTC should use thrift and asset management agreements. The acquirors of thrifts would thus carry the properties and dispose of them (without risk of loss), with the “workout” compensation established by a widely competitive auction process.

The details of yield-maintenance and loan guarantee agreements must be structured to maintain optimal incentives for property disposition. In structuring management contracts, the RTC should examine in a more constructive manner the performance history of agreements used in the past by the FSLIC and the FDIC.



# Statement No. 56

## The Elimination of Restrictions on Bank Securities Activities and Affiliations

May 7, 1990

Issues of liberalized banking powers and affiliations between banking organizations and others are receiving increasing attention. While the range of securities services authorized for banking organizations is relatively extensive, two kinds of restrictions inhibit banks: percentage-of-revenue limitations on individual activities and the requirement that many functions be conducted in separate nonbank entities. Similarly, nonbank entities are constrained from owning banks by the restrictions on permissible powers contained in the Bank Holding Company Act.

The Shadow Financial Regulatory Committee maintains as a basic principle that safety and soundness considerations do not justify restrictions on bank powers or affiliations between banks and other entities once a rigorous economic capital program is in place. Specifically, the Committee has repeatedly called for three steps to assure strong economic capital at banks: the definition of capital in terms of current market valuations, measures to require sufficiency of such capital, and timely recapitalization and reorganization of entities facing economic insolvency. These actions would impose discipline on bank regulators and bank managers alike to sustain adequate economic capital in banks. The balance of this Statement elaborates on the applications of this position to affiliations and securities activities of banks.

### **Background**

The current attention to bank powers reflects a variety of forces, including (1) regulatory actions gradually widening the scope of banking powers, (2) reviews of the role and structure of federal insurance and guarantee programs, (3) uncertainties about the connections (if any) between the extent of powers and risk, (4) losses incurred in recent bank and thrift failures, and (5) greater recourse by nonfinancial business to unintermediated services in financial markets.

Table 1 summarizes the current status of domestic securities powers of banks and bank holding companies.

### **Securities Powers**

Current restrictions on bank securities activities curtail innovation and efficiency and impose higher costs on users of these services and therefore should be liberalized. A rigorous bank capital program of the kind proposed by the Committee should resolve concerns about broader powers. The chief prerequisite for new activities should be the ability of bank supervisors to evaluate and monitor the effects of such activity on total risk.

Table 1. Status of Major Domestic Securities for Banks and Bank Affiliates

	Banks or bank subsidiaries <sup>1</sup>		Nonbank holding company affiliates	
	Underwriting and dealing <sup>2</sup>	Investment	Underwriting and dealing	Revenue limits (if any)
1. U.S. government securities and securities of agencies guaranteed by the U.S. government	Yes	Yes	Yes	None
2. General-obligation securities issued by state and municipal entities	Yes	Yes	Yes	None
3. Other securities issued by state and municipal entities	No <sup>3</sup>	Yes <sup>4</sup>	Yes	10% of gross revenues
4. Corporate debt	No	Yes <sup>4</sup>	Yes	10% of gross revenues
a. Commercial paper				
b. Other debt				
5. Mortgage-backed securities	No <sup>5</sup>	Yes <sup>4</sup>	Yes	10% of gross revenues
a. Secured by federally insured mortgages				
b. Secured by other mortgages				
6. Securities backed by nonmortgage securities	No <sup>5</sup>	Yes <sup>4</sup>	Yes	10% of gross revenues
7. Corporate equities	No	No	Yes (subject to infrastructure review)	10% of gross revenues
	Permitted for banks or bank subsidiaries		Permitted for nonbank holding company affiliates	
9. Mutual funds	No <sup>2</sup>		No	
a. Underwriting and distribution				
b. Investment adviser	Yes		Yes	
c. Brokerage	Yes		Yes	
10. Futures, options, and swaps (brokerage and advice)	Yes		Yes	
11. Brokerage	Yes		Yes	
a. Discount				
b. Full-service	Yes		Yes	
12. Private placements	Yes		Yes	
13. Advisory services	Yes		Yes	

Source: Melanie Fein, Arnold & Porter.

<sup>1</sup>This table generally refers to the powers of national and state member banks of the Federal Reserve System. State nonmember banks may have broader powers under state law.

<sup>2</sup>Nonmember banks may engage in underwriting through a bona fide subsidiary pursuant to FDIC regulations (12 C.F.R. 337.4).

<sup>3</sup>National banks may underwrite certain state housing, hospital, and dormitory securities.

<sup>4</sup>Subject to limitation of 10 percent of the bank's capital and surplus.

<sup>5</sup>National banks may underwrite their own securitized assets.

### Institutional structures for undertaking securities activities

In recent years most newly authorized bank securities powers have had to be exercised through a holding company's nonbank affiliates. Legal stipulations (e.g., the requirement

under the Banking Act of 1933 that bank affiliates not be “principally engaged” in securities underwriting) and political expediency are responsible for this form of evolution. This separation imposes unnecessary operational inefficiencies. In addition, current regulatory limitations discriminate against smaller banking organizations because of the high costs of establishing separate securities affiliates.

### **Removal of cross-ownership constraints**

A counterpart to expanded securities powers for banks is authorization for securities firms to establish or acquire banks.

### **Avoidance of conflicts of interest and abuses**

Authorization to engage in securities activities within a bank need not increase risks of conflicts of interest and potential abuses. Furthermore, sections 23A and 23B of the Federal Reserve Act and other federal banking and securities laws already deal with these matters.

### **Functional oversight**

*Functional regulation* (the promulgation of applicable rules governing the provision of a particular kind of activity) is a term often used by agencies (and their constituents) engaged in struggles over turf. But this debate does not distinguish between the desirability of functional regulation and the enforcement of rules. Placing securities activities in separate affiliates or subsidiaries is not necessary to regulate or supervise those activities. In fact, it may be more economical to delegate supervision of particular activities to the relevant depository institution oversight agency, to be undertaken during the course of its regular supervision. Furthermore, the degree of substitutability among financial activities has risen in recent years and now appears to be relatively high. Consequently, there are unlikely to be discrete groups of services where a functional approach to supervisory oversight would lead to material supervisory efficiencies. Thus, assuming the organization of supervisory agencies will be designed to achieve regulatory objectives with maximum operating efficiency—as it should be—functional supervision will not be a useful organizational guide.

### **Bank securities powers in the absence of fundamental capital reform**

Table 1 shows that some functions (generally involving underwriting and dealing) are not permitted for banks themselves but are allowed to holding company nonbank affiliates. Even without the discipline of economic capital that is the central element of reform, however, the Committee has argued previously (see Statement No. 13, November 17, 1986) that relaxation of Glass-Steagall restrictions on securities activities is warranted.

It is the Committee’s policy that members abstain from participation on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Richard Aspinwall and Roger Mehle abstained from voting on this statement.

## Statement No. 57

# Proposals to Consolidate the SEC and CFTC

May 7, 1990

H.R. 4477 proposes the creation of a single agency, to be called the Markets and Trading Commission, that which would oversee securities and futures markets and would set margin requirements on all securities, options, and futures contracts. The proposed super-regulatory agency would replace the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) in regulating securities, futures, options, and any new products that are a hybrid of these instruments.

Other less sweeping proposals would enlarge the jurisdiction of the SEC at the expense of the CFTC by, at a minimum, transferring jurisdiction over stock index futures, and options on such futures, to the SEC

The Shadow Financial Regulatory Committee believes that proposals to consolidate regulators should be carefully scrutinized and should meet the burden of showing that such consolidation is in the public interest.

In general, the Committee believes that markets not governed by a monolithic regulatory structure display greater innovativeness and greater competitive creativity than do markets in which firms can operate under one of several regulators. This has been true for U.S. financial markets during the past two decades. U.S. financial markets have been among the most innovative in the world, and futures markets have provided us with some of the most successful innovations. Stock index futures, T-bond futures, Eurodollar futures, currency futures, and energy futures have proved to be immensely useful to all kinds of financial and nonfinancial firms. The Committee believes that, given the SEC's past record, it is highly unlikely that these products and markets would have been born had the SEC had sole jurisdiction over futures markets.

Merging the SEC and the CFTC threatens to inhibit the innovative responsiveness of U.S. securities and futures markets and ultimately, to put U.S. financial markets at a competitive disadvantage internationally. It is important, therefore, that those who support merger proposals demonstrate that there are significant benefits to consolidation. The Committee wants to emphasize that this has not been done.

Supporters of the proposed change in regulatory jurisdiction have not made clear exactly what problems would be alleviated by the shift in jurisdiction. Allegations include the following:

Stock index futures and related trading strategies, such as stock index arbitrage, have caused excess volatility in the stock market and have driven small investors from the stock market.

Low margins on stock index futures have caused stock market volatility and are a source of potential instability.

Separate and independent regulators cannot effectively monitor and police "intermarket frontrunning" involving both securities and futures markets.

The present fragmented regulatory structure in the United States puts the country at a competitive disadvantage in international negotiations with regulators from other countries.

The present fragmented regulatory structure is stifling competition and innovation.

The Committee rejects these allegations. Moreover, a shift of jurisdiction to the SEC would not address the alleged problems.

There is little evidence to support the contention that the trading of stock index futures is responsible for increased stock market volatility. Studies of stock market volatility have found that such trading is not the responsible factor. Similarly, there is no evidence to suggest that small investors have been "driven" from the market by stock index futures trading. There is also no evidence that stock index arbitrage has increased stock market volatility.

The view that low margins on stock index futures are the cause of increased volatility and of greater instability is without merit. Almost all studies, including a study by the Federal Reserve Board's own staff, have concluded that low margins have no relationship to volatility or market instability. The Committee is amazed that some regulators and government officials continue to make this argument in the face of overwhelming evidence to the contrary.

The Committee wishes to note that in a previous statement on the Brady Commission report (Statement No. 33, May 16, 1988) it expresses similar conclusions about margins and stock index futures trading. At that time criticisms of stock index futures trading and low futures margins were propounded by the Brady Commission. The same views are now being advanced by the U.S. Treasury under Secretary Brady. Since the Brady Commission report, there have been additional studies that confirm the Committee's views and not those of Secretary Brady.

On the issue of intermarket frontrunning involving futures markets, there is no evidence that this is indeed a significant problem, or that it is any more of a problem than is frontrunning between the stock and options markets, which are already under the single jurisdiction of the SEC. In addition, recent regulations and regulatory arrangements among exchanges and the SEC and the CFTC have been instituted to police and control this practice. If these provisions are not adequate, we need to know in what ways they are deficient so that a remedy can be fashioned. Regardless, it is not obvious how a merger of the SEC and CFTC would be responsive to this issue.

It is unclear how the present regulatory structure prevents the United States from successfully negotiating with foreign regulators. Both the SEC and CFTC have recently concluded agreements with foreign regulators. The charge that the CFTC now stands in the way of competition and innovation is, at best, ironic. Not too long ago critics of the CFTC contended that the agency was fostering "excessive" innovation and competition: There were, allegedly, too many new products and too much competition.

To conclude, the Committee cannot identify any serious problems that will be remedied by a shift in regulatory jurisdiction to the SEC. The current regulatory framework has fostered a competitive and innovative financial system. While some regulatory inefficiencies may exist, these are a small price to pay for the innovative markets we have developed. Before doing major surgery on a seemingly healthy patient, it is important to be sure that the surgery promises to accomplish something beneficial.

## Statement No. 58

### Provision of Seller Financing by RTC in Asset Sales

September, 24, 1990

Chairman William Seidman has proposed to the Resolution Trust Corporation Oversight Board that the RTC adopt a new policy of being prepared to provide financing to purchasers of assets that the RTC has acquired from failed thrift institutions. The stated reason is that, under current economic conditions, buyers cannot finance such purchases from normal commercial sources.

The Shadow Financial Regulatory Committee believes that there are grounds for skepticism about the proposition that real estate purchase finance has become unavailable. Substantial funds continue to flow through normal channels for mortgage originations and in the secondary market for real estate mortgages and mortgage-backed securities. It is possible nonetheless that buyers for some kinds of properties are having difficulty in obtaining financing in amounts and on terms that they find attractive.

The RTC is currently experiencing a shortage of funds, which can create pressure to avoid recognizing losses. If the RTC should undertake to provide more attractive financing, there is a danger that the transaction would evolve in substance into a sale at a nominally higher price but with the buyer having the right to put the asset back to RTC. If, for example, RTC offers loans with concessional terms, such as artificially low interest rates (which in effect offset any small down payment), on a nonrecourse basis or to buyers with little or no net worth at stake, the buyer is really acquiring an option—to keep the asset if market prices go up or to let the RTC foreclose if the market goes down. In such a transaction, the RTC would retain most if not all of the downside risk, while forgoing any upside gains.

The Committee recommends, therefore, that in any financing program designed to speed resolutions, the RTC should offer interest rate and down payment terms that correspond to prevailing market levels, and let potential purchasers compete on the basis of the purchase price they bid. Otherwise, the financing program could create the illusion of progress by the RTC in disposing of its troubled assets, whereas in reality it had not reduced the risks entailed in asset ownership.

## Statement No. 59

# Condition of the Bank Insurance Fund

September 24, 1990

Emerging problems in the banking industry are now recognized as posing a serious threat to the Bank Insurance Fund (BIF). Both the General Accounting Office (GAO) and Congressional Budget Office (CBO) have recently stated that actual and contingent liabilities may exhaust the BIF. The Committee is concerned that declines in the health of FDIC-insured savings banks, which were not considered in the GAO and CBO analyses, threaten an additional drain.

Legislation has now been introduced to increase deposit insurance premiums and the borrowing authority of the FDIC. The Committee believes that raising deposit insurance premiums is not an adequate response to this problem. Raising premiums is one way to charge banks and thrifts for past and possible future losses, but this response does not address the fundamental flaws in the deposit insurance system and may be counterproductive for several reasons.

First, higher premiums will not restrain banks from taking excessive risks. Risky banks will still have incentives to play the game, "heads we win, tails the FDIC and then other banks and the taxpayers lose." Second, higher deposit insurance premiums tax healthy, well-run, and well-capitalized depository institutions to pay for those that are poorly capitalized and risk-prone. FDIC premiums, although a small percentage of deposits, are a large fraction of many banks' net profits. This cost will make it more difficult for weak banks to survive and for U.S. banks to compete in the world market. Third, increased premiums will encourage people to bypass the banking system, thereby reducing the amount of deposits on which insurance premiums can be levied. Finally, although raising deposit insurance premiums will increase the FDIC's funds, the amount that might be raised is unlikely to be sufficient to prevent taxpayers from having to pay some of the costs of bank failures.

The Committee strongly believes that Congress and the Administration should act to increase banks' and thrifts' capital requirements substantially and to institute policies similar to those described in our Statement No. 41 (February 13, 1989). In particular, when an insured depository's capital declines to below a predetermined level of adequacy, the depository institution should be prohibited from growing and from paying dividends to stockholders and interest on subordinated debt, and should be required to raise additional capital. Indeed, because losses to the FDIC would be lower, adoption of this plan should result in lower, not higher, premiums for future operations. Unless a fundamental change in capital requirements is adopted, the threat to the BIF will accelerate.

In 1988 the Committee estimated that the FDIC reserves were nearly exhausted. Our Statement No. 36 (December 5, 1988) and underlying methodology were criticized by the FDIC as being unduly "alarmist." Subsequent events, however, have confirmed the necessity for the public to monitor the true economic condition of the FDIC's insurance funds.

## Statement No. 60

### RTC Property Disposition Policies

September 24, 1990

The Resolution Trust Corporation (RTC) continues to be unable to dispose of the properties it has acquired from scores of closed thrifts. The recent cancellation of the RTC's widely publicized property auction illustrates its continuing difficulties in disposing of properties, even while its inventory mounts by hundreds of millions of dollars monthly. The Committee feels compelled, given the prospect of the FDIC's rapidly growing property acquisitions from the weakening commercial banking industry, to restate its concerns on property disposition policies set forth in Statement No. 55 of May 7, 1990. The statement concluded:

The taxpayers' interest would be better served by outright sales of institutions ("final bank" deals) and assets, under terms designed to maximize the transfer of investment risk.

The Committee recognizes that the primary difficulty in effecting final sales of problem assets is uncertainty of valuation. When uncertainty is so great that "final bank" deals do not seem feasible, the RTC should use thrift and asset management agreements. The acquirors of thrifts would thus carry the properties and dispose of them (without risk or loss), with the "workout" compensation established by a widely competitive auction process.

The details of yield-maintenance and loan guarantee agreements must be structured to maintain optimal incentives for property disposition. In structuring management contracts, the RTC should examine in a more constructive manner the performance history of agreements used in the past by the FSLIC and the FDIC.

If the RTC does not immediately accelerate its efforts to dispose of property, the losses to taxpayers will continue to increase.



## Statement No. 61

# Limiting Taxpayer Loss Exposure in Government-Sponsored Credit Enterprises

September 24, 1990

Government-sponsored credit enterprises (GSEs) are financial intermediaries chartered by the federal government to increase the flow of credit to designated types of private borrowers. GSEs operate principally in the areas of housing, agricultural, and educational finance. Five major GSEs are: the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal Home Loan Bank System, the Federal Agricultural Mortgage Corporation, and the Student Loan Marketing Association.

Although most of these enterprises are now owned by private stockholders, they nevertheless retain many characteristics of a federal agency. The hybrid private-federal nature of GSEs means that, much as was the case for the Federal Savings and Loan Insurance Corporation, any difficulties these firms encounter in covering their borrowing and guarantee obligations expose federal taxpayers to loss.

Because each GSE has a federal origin and retains many governmental responsibilities, its obligations receive the benefit of an informal federal guarantee. This means that its credit standing is enhanced in quality beyond that which it would deserve strictly on the basis of its accumulated net worth and risky prospects for future profits. The guarantee extracts a credit subsidy from general taxpayers, in that being able to count on taxpayer backup lowers the interest rate on the GSE debt below the level that each entity would have to pay if it were strictly a private corporation.

Assisted (indeed encouraged) by the federal credit subsidy, GSE obligations have grown rapidly in recent years and now aggregate more than \$800 billion in amount. In the absence of its perceived guarantee, a GSE's funding cost would move inversely to the market value of its net worth. Hence, when a GSE's capital is low, taxpayer exposure to loss in its obligations can be substantial. For example, although Fannie Mae has since strengthened its balance sheet, research indicates that at year-end 1981 interest-rate-related capital losses on FNMA's mortgage holdings had driven its net worth to a negative value that equaled almost 15 percent of its debt. This negative net worth corresponds to the taxpayer's loss exposure in FNMA.

In May 1990 the Secretary of the Treasury recommended legislation to limit the credit subsidy created by taxpayer loss exposure in GSEs. The principal provision of the Treasury plan is to require that each GSE obtain from at least two nationally recognized credit rating services a triple-A rating that expressly excludes any presumption of federal credit support. The Treasury also recommended the creation of a new "financial safety and soundness regulator" to monitor and enforce GSE compliance with this requirement and to negotiate and oversee a business plan to correct any deficiencies that emerge. A final Treasury recommendation proposed that the value of any credit subsidy that still accrues

to each GSE from ongoing federal credit enhancements be disclosed annually as part of the President's budget.

The Shadow Financial Regulatory Committee applauds the Treasury's proposals as a sensible plan for starting the important task of bringing credit subsidies to GSEs under appropriate administrative control. The central feature of the plan is to enlist the analysis of market-driven private credit-rating services to supplement and override the judgments of politically sensitive entities. Credit rating services would have incentives to do this job. To preserve the good reputation on which the rest of its business vitally depends, a credit service could not afford to give a "bailout-inflated" triple-A rating to a GSE that was not well-capitalized for the business and portfolio risks inherent in its operations.

Top officials of the GSEs prefer to have their debt rated with the benefit of the guarantee and to negotiate standards for assuring the strength of its balance sheet with politically sensitive government officials. Fannie Mae and Freddie Mac executives have argued against the Treasury plan by labeling the proposal an extreme measure whose adoption would disrupt housing and mortgage markets and sharply raise the cost of the ongoing FSLIC bailout. These claims are misleading. They greatly exaggerate both the importance to housing markets of the credit subsidy these firms receive and the extent to which the subsidy passes through to the average homeowner.

Moody's Investors Service has also attacked the practicality of the Treasury plan, claiming that a rating that ignored the relationship between GSEs and the government would be a "spurious product" based on "hypothetical and unrealistic assumptions." The Committee finds this an unconvincing objection. All credit ratings are based on assumptions that are by their nature hypothetical and undertake to analyze a multiplicity of possible events. In contrast, the Standard & Poor's Ratings Group has said that it could in fact perform the necessary analysis. The relevant concern for the rating agencies, which has been clearly noted by Standard & Poor's, is developing safeguards by which to assure that political efforts to influence the ratings GSEs receive do not ultimately corrupt the rating process.

## Statement No. 62

# Congressional Intercession with the Financial Regulatory Agencies

December 10, 1990

Controversies in recent years concerning intercessions by individual members of Congress in the process of federal thrift supervision have raised serious questions about the propriety of such conduct. Particularly difficult is the question of when such intercession crosses the line between legitimate constituent service and impermissible attempts to affect the process of agency decision making. This is the principal issue raised by the current “Keating Five” hearings before the Senate Ethics Committee. It also played an important role in the Wright proceedings before the House Ethics Committee.

In certain situations Congress itself has provided guidance that answers this question. Where Congress has by statute prescribed a procedure designed to ensure due process to parties dealing with a financial regulatory agency, there is a clear implication that members of Congress should allow that process to go forward without interference. In supervisory enforcement proceedings, where the governing law affords an aggrieved party an opportunity for a hearing before a disinterested trier-of-fact, subject to ultimate court review, intercession by individual members of Congress is inappropriate. Similarly, in application proceedings, where judicial review based on the agency record is also possible, *ex parte* intercession should be viewed as inappropriate.

Where an agency is exercising rule-making powers conferred upon it by Congress, it must follow procedures for the formulation of rules set forth in the Administrative Procedure Act. Efforts to influence the rule-making process outside the scope of those procedures may also be viewed as inconsistent with the scheme Congress itself established.

Issues arising out of the process of bank examination may be viewed as especially inappropriate for congressional intercession. If bank examiners are to do their job properly, they cannot be subject to challenge by individual members of Congress acting on behalf of the institution being examined, while the examination process is going on. The procedure affords due process protections to the institutions involved, and the responsible committees of Congress have ample oversight jurisdiction to assess the quality of supervision after the fact. To tolerate *ex parte* interference in the process by members of Congress and their staffs would ultimately weaken not only the process itself but, more importantly, public confidence in the examination and oversight process.

There are, to be sure, occasions on which representations from members of Congress to the financial regulatory agencies may be perfectly appropriate. Routine “status” inquiries, when not intended to communicate a coercive intent, are certainly within the realm of acceptable conduct, as are formal comments on proposed rule-making actions.

In all such cases, however, the agencies should make such communications a matter of public record—indeed, Congress itself should insist on such a procedure. Such a disclosure rule not only would inhibit improper communication but would bolster public confidence in the integrity of the regulatory process.

## Statement No. 63 National Branching

December 10, 1990

The United States has perhaps one of the most inefficient banking structures among developed countries. In particular, we do not permit our banking institutions to branch nationwide. Our atomistic banking system is prone to excessive failures when local economies deteriorate. Because of inadequate geographical diversification, bank failures were unnecessarily high in Texas when oil and real estate prices declined and in the Midwest when agricultural incomes went down. Similar problems threaten banks in the Northeast because of the collapse in the real estate market. This condition is hardly new. In the 1920s over 600 small banks a year failed, and in the 1930s over 9,000 small banks failed. Almost all of these failures were independent unit banks. The effect of such local problems could have been mitigated had banks been permitted to branch nationally.

Some geographical diversification has developed as states have permitted entry by out-of-state bank holding companies. This move, while desirable, has generally been limited regionally. Furthermore, the holding company structure restricts the free flow of resources within a banking organization and makes the costs of diversification high. Nationwide branching would allow banks to capture the full benefits of diversification and increase operational efficiencies. It also would permit mergers that would help the banking system return to financial health.

The Committee urges that legislation to reform the deposit insurance and banking system include provisions permitting banks to branch nationwide without restriction.

## Statement No. 64

# FDIC Ownership of Continental Illinois Stock

December 10, 1990

As a result of its rescue of Continental Illinois Bank in 1984, the FDIC now controls 26 percent of the company's stock. The Shadow Financial Regulatory Committee believes that it is appropriate in some cases for the FDIC to take an equity stake in failed bank transactions. However, sound public policy calls for the FDIC to sell that stake as soon as possible.

The Committee recommended such action on February 8, 1988 (Policy Statement No. 27), supporting the FDIC's intention to dispose of its interest in Continental Illinois "as soon as practicable." It is inappropriate for the FDIC to hold the stock in the hope that its price would rise. Once the market has a sufficient information to value the stock of a recapitalized company, holding the stock is simply an attempt to outguess the market and bet on future price gains. As we noted in 1988, "losses are equally likely."

In the last year the FDIC turned down three bids for its remaining holdings of Continental Illinois stock. In the fall of 1989, it received a bid of \$22 a share. In the spring of 1990, it received a bid of \$15 a share, and recently it refused a bid of \$7.875 a share. While the Committee is not passing judgment on the FDIC's rejection of these bids, these decisions demonstrate both a reluctance to sell assets and the risk inherent in holding assets for long periods of time.

The FDIC apparently fears that it will be criticized if it sells at "too low" a price or that prices will rise subsequent to its selling the assets. The FDIC was stung by criticism of its deal involving the sale of Bowery Savings Bank. The acquirors later resold Bowery at a substantial profit. We urge the FDIC to ignore second-guessing of deals that happen to result in profit to the other buyers.

Our concern transcends the FDIC's handling of Continental. An unwillingness to expose itself to second-guessing also underlies the reluctance of the RTC to sell assets at prevailing prices.

# Statement No. 65

## Treasury's Deposit Insurance Reform Recommendations

February 11, 1991

Last week the Treasury Department released its study of deposit insurance, as mandated by FIRREA in 1989. The report covers many important issues, such as deposit insurance reform, expanded product powers and other regulatory preferences for banks whose capital position is in the highest zone, nationwide branch banking, and the reorganization of the regulatory agency structure.

The report contains a number of proposals that are similar to positions espoused by this Committee in past statements, including a regulatory definition of capital that better incorporates subordinated debt and reflects interest-rate risk and procedures for the regulatory agencies to intervene promptly in dealing with capital-deficient banks. Like the Treasury Report, the Committee has emphasized:

That regulatory intervention should be mandated according to specific measures of the extent to which a bank's condition has deteriorated;<sup>1</sup> and the desirability of nationwide branching,<sup>2</sup> greater product powers, and affiliation between banks and nonbanking organizations.<sup>3</sup>

We are pleased by the parallels between our views and the Treasury's proposals. We are disturbed, however that the Treasury plan fails to take the critical step required to make early intervention and regulatory discipline fully predictable and effective. This step is needed to prevent large losses from being incurred by banks and S&Ls, which pass through to the supporting insurance funds. The missing step is the adoption of an objective and prespecified criterion that requires regulatory intervention and mandates the recapitalization of all troubled institutions before their economic net worth becomes negative. It is inappropriate to provide any exceptions to this requirement, regardless of a bank's size, location, or political influence.

Under the Treasury's plan, escalating regulatory discipline is presumptive but not mandatory. Specific sanctions and zones of discipline remain to be specified, but the authorities would retain the right on their own authority to tailor specific discretionary responses to a given situation. Worse yet, the FDIC and an institution's primary regulator would jointly have the right to exempt capital-deficient bank from demands for recapitalization. Moreover, although the proposal makes a point of limiting deposit insurance to \$100,000 per individual account holder per bank, for the taxpayers this is an inconsequential change. The FDIC retains the authority to extend unlimited coverage when it unilaterally determines that such action would provide the least-cost manner of insolvency resolution. The Committee remains critical of the way in which the FDIC conceives these calculations for two reasons. First, the estimates are susceptible to easy manipulation. Second, the FDIC's calculations ignore longer-run incentives for the industry as a whole.

The proposal also confers a right to the Treasury and the Federal Reserve to provide unlimited coverage, even if this is not the least-cost method of resolution, if they jointly determine that the failure to protect a bank's uninsured deposits would endanger financial stability. The Committee sees this provision as weakening rather than strengthening discipline.

The Committee also believes the incremental contribution to market discipline that would result from the Treasury's proposed reductions in deposit insurance coverage is inconsequential as compared with that which would result if the present de jure limits were strictly enforced.

No bank is so special that uninsured creditors should not share in losses brought about by its insolvency. No bank can safely be permitted to operate for long periods without adequate capital. Undercapitalized banks should be allowed to persist only for the period of time during which regulators are resolving an institution's insolvency by sale or merger. Without immediate mandatory recapitalization of insolvent institutions, political pressures on the regulatory agencies will encourage top officials, as in the past, to delay and forbear with disastrous consequences for taxpayers.

Discretionary regulation has a poor record. Market discipline, imposed on banks by uninsured claimants, will help to maintain safe levels of capital and contain portfolio risk, and is a necessary supplement to the discipline imposed by regulators.

Without required regulatory discipline, the Treasury's proposals would be far less effective in protecting the insurance fund and the taxpayers than the mandatory resolution procedures contained in the bills introduced by House Banking Committee Chairman Gonzalez (H.R. 6) and by Senate Banking Committee Chairman Riegle (S. 3103) in 1990. Under mandatory resolution, the amount of deposit insurance coverage becomes of secondary importance as fewer losses should accrue to depositors of the insurance fund.

History demonstrates that banks without capital take greater risks and generate larger losses than well-capitalized banks. Experience prior to the introduction of federal deposit insurance shows the wisdom of charging large depositors for their fair share of losses at insolvent banks and of promptly removing undercapitalized banks from the control of their managers and shareholders. These actions need not cause serious reductions in the provision of banking services to the community. Nor need they have adverse spillover effects on well-capitalized banks or the money supply and macroeconomy. Effective federal deposit insurance and intelligent Federal Reserve action can be relied upon to prevent these effects.

The Treasury study would also strip the FDIC of its present ability to examine banks and fails to extend to the FDIC the authority to close insolvent banks. Since the FDIC is the agency charged with primary responsibility for administering the insurance fund, it ought to have the greatest incentive to provide diligent oversight. Removing the FDIC from responsibility for regulating and examining insured banks threatens to be counterproductive.

## Notes

1. Statement No. 41, February 13, 1989.
2. Statement No. 63, December 10, 1990.
3. Statement No. 56, May 7, 1990.

## Statement No. 66

# Proposals to Inject Additional Funds into the Bank Insurance Fund

February 11, 1991

In December 1988, the Shadow Financial Regulatory Committee issued a statement warning that the Federal Deposit Insurance Fund—now the Bank Insurance Fund (BIF)—was nearing economic insolvency (Statement No. 36, December 5, 1988). The Committee's statement was strongly denied at that time by regulatory authorities. Recently, the Congressional Budget Office, the U.S. General Accounting Office, and the Chairman of the Federal Deposit Insurance Corporation have confirmed that the BIF now lacks the resources to meet its expected obligations over the next few years. Estimates of the additional funds needed range from \$10 billion to as high as \$40 billion. The FDIC and banking industry responses to this crisis are reminiscent of the events that preceded the insolvency of the Federal Savings and Loan Insurance Corporation: initial denial of the existence of a problem, continual underestimation of the potential costs to the taxpayer, and attempts to cover the resource shortage from industry sources that are essentially "smoke and mirrors" accounting mechanisms.

The Committee believes that the BIF's need for funds is critical, and may even be greater than currently admitted by agency officials. If this is true, then any deficiencies will ultimately be born by the taxpayer, which makes the Treasury's decision to postpone addressing this need an important omission in its recently released deposit insurance reform package.

In evaluating alternative ways to fill the hole in the BIF, it is important to recognize that there are only two sources of capital to cover losses in weak and insolvent institutions: enterprise-contributed capital and public capital in the form of tax dollars or government guarantees. Unfortunately, many recent proposals to recapitalize the BIF primarily shuffle capital from the industry to the BIF without providing much in the way of new funds to protect the taxpayer. This is the case for the proposals currently being discussed by representatives of the banking industry in which banks would provide funds to the BIF in the form of debt or equity purchase.

Alternatively, some have called for the resurrection of net worth certificates, which would count as capital for receiving institutions. This is an accounting shell game in which claims on an economically insolvent institution (BIF) would be injected into insolvent, or nearly insolvent banks. No net new funds would flow into the industry or the BIF, and this claim structure lends itself to adverse distortions to risk-taking incentives within the industry. Another proposal is for the Federal Reserve to pay interest on bank balances at Reserve Banks and to pass this directly to the FDIC to augment resources of the BIF. This proposal uses what are currently taxpayer funds to support the BIF. Donating Federal Reserve interest payments to the BIF would reduce by an equal amount the Federal Reserve's yearly payment of its net earnings to the Treasury and would, absent other actions, increase the government's budget deficit. To make up the difference, taxes or



borrowing would have to be increased or expenditures cut. Variants of the above proposal that transfer member bank reserves directly to the BIF would have essentially the same consequences for the taxpayer.

Sufficient funds to cover the government's guarantee to insured depositors can only come out of the wealth of taxpayers and shareholders of well-capitalized banks. It is the appropriate function of the Congress to determine the equitable sharing of that burden between these parties. The Committee strongly urges that the BIF refinancing burden be addressed directly and immediately. Given that the banking industry bears a significant portion of the blame for the existing problem, the Committee feels that it is entirely appropriate that it bear a large portion of the cost. It would be preferable that Congress levy a one-time tax on banks rather than resort to an ongoing series of taxes on loans, deposits, or assets. We must abandon the long-standing pattern of adopting patchwork proposals that attempt either to hide the true costs to the taxpayer or, worse yet, to defer dealing with fund losses while continuing to let the costs to the taxpayer escalate.

It is the Committee's policy that members abstain from participation on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Richard Aspinwall abstained from voting on this statement.

## Statement No. 67

# Concerns About the Availability of Bank Credit

February 11, 1991

Concerns about credit availability have led some in Congress and the Administration to question the standards being applied by the banking supervisory agencies to determinations of loan quality and capital requirements and to urge more leniency as to both. In view of the Shadow Financial Regulatory Committee, this reasoning confounds issues that should be analyzed separately.

Complaints about a “credit crunch” sometimes seem to mean no more than that borrowers do not now find loan financing—especially for real estate development projects—available on terms as liberal as in the recent past. Given the excesses and waste in real estate development in the 1980s, driven by the subsidy to risky lending embodied in the operation of the deposit insurance system and by lax supervision during that period, the Committee believes it very much in the interest of taxpayers that more stringent standards now be followed.

Other references to a credit crunch assert the existence of a major reduction in the supply of lendable funds as banks faced with increased loan losses “downsize” their asset bases as a means of achieving compliance with regulatory capital requirements. In these terms, there are questions about the factual underpinnings for such an assertion. In any event, this argument identifies a change in the amount of bank credit as a change in the amount of aggregate credit from all sources. Higher capital requirements and numerous other factors, such as regulatory impediments to bank efficiency and profitability, may lead to a loss of market share by intermediaries or by directly issued and held financial instruments such as commercial paper or asset-backed securities. Likewise, there may be a shift in lending from weakly capitalized banks to more strongly capitalized banks. Such shifts may create temporary transition problems and costs, but in the long run should not be seen as a worrisome credit crunch—except from the perspective of weak banks and weak borrowers.

The Committee fears that prudential standards are being compromised to deal with the problems of a recession that can better and more appropriately be addressed through fiscal and monetary policy measures. Such reductions in prudential standards threaten to intensify future economic downturns.

## Statement No. 68

# OTS Proposal for Capital Requirement for Interest Rate Risk

February 11, 1991

The Office of Thrift Supervision (OTS) has recently proposed changing its risk-based capital regulation to require thrift institutions to hold capital against the risk of loss from changes in interest rates. The OTS proposal would require thrift institutions to hold capital equal to 50 percent of the estimated decline in the market value of the firm's equity that would result from a 200 basis point adverse change in interest rates. The OTS requests comments on whether such a requirement should be in addition to, or should replace, components of the existing credit-risk based system.

In the view of the Shadow Financial Regulatory Committee, the lack of such a requirement has been a major shortcoming of the risk-based capital standards promulgated by the regulatory agencies. The thrift industry suffered huge losses from the extremely sharp interest rate increases of the early 1980. We attribute much of the movement of thrift institutions into high-risk real estate investment as a direct response to their weakened financial condition brought about by the losses from adverse interest rate movements.

The Committee welcomes the proposal as a serious attempt to deal with the very difficult problem of capital adequacy in the presence of interest rate risk and urges the banking agencies to accelerate their efforts at developing such a requirement for commercial banks. The recent Treasury Report on "Modernizing the Financial System" also endorses adoption of such a requirement by OTS and the banking agencies.

Besides its concern about the lack of an interest rate risk component, the Committee has two significant reservations about the existing system of capital requirements. First, the Committee believes that capital requirements should be higher than they are now (Statement No. 41, February 13, 1989). Second, the Committee believes that capital requirements should be based on market values (Statement No. 18, May 18, 1987). We support the use of market values as the base for the OTS capital calculation, and we urge that this requirement be framed as an addition to existing risk-based capital requirements.

Reservations expressed about the proposed regulation relate to the details of implementation rather than the concept of requiring capital against interest rate risk. The OTS proposal tempers conceptual aptness with considerations of practicability. One limiting factor is the availability of data with which to make the market value calculations that are essential to the proposal. It may be appropriate to increase the level of detail on the Maturity and Rate section of the Thrift Financial Report and to experiment with other types of interest rate change.

Other criticisms of the OTS proposal have focused on the complexity of the methodology. The approach taken in the proposal makes the OTS responsible for calculating the capital requirement for each institution, using a standardized approach. While the Committee is aware of implementation problems, we urge that the proposal be adopted. Practical difficulties can be resolved over time.

Statement No. 69  
Financial Accounting Standards Board's Proposed  
Statement of Financial Accounting Standards  
Concerning "Disclosures About Market Value of  
Financial Instruments"

February 11, 1991

The Financial Accounting Standards Board (FASB) has proposed requiring disclosure in financial statements of the market value of financial assets and liabilities. The FASB proposal would also permit an entity to disclose separately, in the body of the statements or in footnotes, the estimated market values of its nonfinancial tangible and intangible assets and liabilities, including the core deposit intangible.

Under the FASB proposal, managements would be permitted to report their best estimates of market values where these are not available from quoted prices. Present values of estimated cash flows, option pricing models, or matrix pricing models could be used to make these estimates. Where such procedures were not practical, information about the financial instruments (such as interest rates and maturities) would have to be disclosed. Thus reporting entities would not be required to incur excessively high costs to make the required disclosures.

The Shadow Financial Regulatory Committee fully supports this proposal improvement and urges its adoption by the FASB.<sup>1</sup> Market value accounting is particularly important for institutions with government-guaranteed liabilities. Because the role of capital is to absorb losses before the funds of the Federal Deposit Insurance Corporation and taxpayers are called upon, it is important to provide regulators, legislators, and the public with a more meaningful measure of capital than historical cost.

Going beyond FASB, we recommend that financial institutions with federal government-guaranteed liabilities be required to include assets and liabilities at market values in the body of their financial statements, rather than in footnotes. So that the public can more easily monitor the extent of potential taxpayer loss exposure, we also urge that the FDIC and government-sponsored entities (such as the Federal Home Mortgage Corporation and the Federal National Mortgage Association) be required to adopt market value accounting.

## Notes

1. See also our Statement No. 30, February 8, 1988, on the FASB's previous proposal on this subject.