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# Introduction: Policy Statements of the Shadow Financial Regulatory Committee 1991–1996

This volume pulls together the policy statements of the Shadow Financial Regulatory Committee issued in its second five years of existence from May 1991 through May 1996 (statement nos. 70 through 134). The first 69 statements issued from 1986 through February 1991 were published in the supplement to the August 1992 issue of the *Journal of Financial Services Research* (Vol. 6, No. 2). That volume also contains a descriptive article on the “Purpose and Operation of the Shadow Financial Regulatory Committee.” The more recent statements are published in this volume to continue to provide an accessible reference and historical guide to the Committee’s activities.

As it has since its inception, the Committee met quarterly in Washington, D.C. to analyze ongoing public policy issues in financial markets and institutions and to issue policy statements when warranted. The meetings are all day Sunday and Monday morning, ending with a press conference at which the policy statements are released and discussed. As in its first five years, the statements adopted in the Committee’s second five years respond to the financial and particularly the banking environment of the period. Although not known at the time, 1991 marked a turning point for the costly thrift and banking crises of the 1980s. The resolution of this debacle may be attributed to a large number of factors. These include the enactment of the FDIC Improvement Act (FDICIA) at yearend 1991, much of which the Committee not only supported but whose provisions for prompt corrective action and least cost resolution it helped to design (e.g., statement nos. 38, 41 and 48), as well as favorable macroeconomic conditions: lower interest rates, a steeply upward-sloping yield curve, a bottoming out of real estate prices, and a prolonged period of economic expansion.

Not surprisingly, the first policy statements in this volume (e.g., statement nos. 72, 73, and 76) focus on the need both to recapitalize the banking and thrifts industries by resolving economically insolvent institutions and to enact meaningful deposit reform as quickly as possible. Subsequently, the Committee turned its attention to the implementation of the prompt corrective action and least cost resolution provisions of the Act, particularly to attempts by the regulatory agencies to undercut these provisions (e.g., statement nos. 82, 83, 84, 87, 88, 89, 91, 92, 95, 96, 97, 101, 106, 110, 112, 114, 124 and 126). At the same time, the Committee urged and developed a framework for a comprehensive approach to legislating further financial reform in an “Open Letter to President Clinton” (statement no. 90), an “Open Letter to the Senate and House Banking Committees” (statement no. 116), and its “Principles of Bank Reform” (statement no. 118). The Committee also proposed an alternative way to confront the undercapitalization of SAIF than by levying high insurance premiums on thrifts relative to commercial banks. The Committee recommended that thrifts be subject to a higher capital ratio tripwire for closure, so that the need for reserves to cover losses to SAIF would be correspondingly smaller (statement no. 123).

Also in the banking realm, the Committee urged the repeal of the Bank Holding Company Act (statement no. 115), the Bank Merger Act (statement no. 128), and the Community Reinvestment Act (CRA) (statement no. 105). The Committee believes that these acts impose undue costs on the banking industry and that their social purposes may be better served by enforcing the existing anti-trust and anti-discrimination laws that all apply to all firms. The Committee further recommended that much additional banking reform could be achieved through actions by the regulatory agencies without additional legislation, much of which is likely to be flawed as was the proposed 1995 Leach Bill for repealing Glass-Steagall (statement no. 120).

In other areas, the Committee issued statements concerning the potential dangers to the taxpayer of existing or new government sponsored entities (GSEs), (statement nos. 75, 131, and 134) and from the Pension Benefit Guaranty Corporation (statement 102). The Committee also criticized aspects of the emergency assistance package provided Mexico following its devaluation (statement no. 117). If the U.S. banking system remains healthy, it is likely that the Committee can devote greater attention in its second ten years to other sectors of the financial system.

A few changes have occurred in the membership of the Committee since 1992. In 1993, Roger Mehle resigned to become Executive Director of the Federal Retirement Thrift Investment Board. Wendy Lee Gramm, former Chair of the Commodity Futures Trading Commission, joined the Committee in 1994, but resigned shortly thereafter for personal reasons. In 1995, John Hawke resigned to become Under Secretary of the U.S. Treasury for Domestic Finance, and Peter Wallison, a partner in the law firm of Gibson, Dunn & Crutcher in Washington D. C. and former counsel to President Ronald Reagan, joined the Committee. In 1996, Robert A. Eisenbeis resigned to become Director of Research at the Federal Reserve Bank of Atlanta. The membership of the Committee since its inception is shown on page 11.

## Shadow Financial Regulatory Committee Members 1986–1996

Lawrence Connell, Co-Chair, Atlantic Bank (Portland, ME) 1986–.  
George G. Kaufman, Co-Chair, Loyola University Chicago, 1986–.  
Richard Aspinwall, Chase Manhattan Bank, 1986–.  
George J. Benston, Emory University, 1986–.  
Franklin R. Edwards, Columbia University, 1986–.  
Robert A. Eisenbeis, University of North Carolina, 1986–1996  
Wendy Lee Gramm, University of Texas at Arlington, 1994.  
John D. Hawke, Jr., Arnold and Porter (Washington, D.C.), 1986–1995.  
Richard J. Herring, University of Pennsylvania, 1990–.  
Paul M. Horvitz, University of Houston, 1986–.  
Edward J. Kane, Boston College, 1986–.  
Roger Mehle, Attorney-At-Law (Washington, D.C.), 1986–1993.  
Allan H. Meltzer, Carnegie-Mellon University, 1986–1990.  
Franco Modigliani, Massachusetts Institute of Technology, 1992–.  
Kenneth E. Scott, Stanford Law School, 1986–.  
Peter J. Wallison, Gibson, Dunn & Crutcher (Washington, D.C.), 1995–.

# Statement No. 70

## Funding of the BIF and Depository Insurance Reform Proposals in H.R. 2094

May 20, 1991

The Subcommittee on Financial Institutions of the House Banking, Finance and Urban Affairs Committee has recently reported out H.R. 2094. This bill addresses a subset of the issues raised by the Treasury's recent legislative proposal, namely the funding of the Bank Insurance Fund (BIF) and the introduction of an early regulatory intervention and closure structure to deal with troubled banks. H.R. 2094 is scheduled to be considered by the full Banking Committee in June.

The Shadow Financial Regulatory Committee believes that the other issues raised in the Administration's bill (H.R. 1505) must also be addressed if we are to have a sound and efficient financial system. These include deposit insurance premiums and coverage, expanded geographic and product powers, and reorganization of the regulatory structure. However, the most urgent needs are refunding the BIF and meaningful deposit insurance and supervisory reforms. As explained in our Statement No. 41 (February 13, 19898), this requires structured early regulatory intervention and mandatory recapitalization of failing institutions.

The BIF's need for funds is critical, and the amounts required may even be greater than currently believed by agency officials. If this is true, then any deficiencies will ultimately be borne by the taxpayer.

H.R. 2094 does not answer the question of who in the final analysis will bear the BIF's losses. If BIF's resources are exhausted, there are only two sources of additional capital to cover losses in insolvent institutions: levies on solvent institutions or on taxpayers. Given that the banking industry bears a considerable responsibility for the existing problems, the Committee feels that it is entirely appropriate that a large portion of the burden of recapitalizing the BIF be borne by the private sector. The extent of this burden will have to be determined by the Congress. In the interim, however, BIF financing should come directly from the Treasury, as H.R. 2904 provides, to minimize costs and to acknowledge them candidly, without any resort to deceptive devices such as borrowing from the Federal Reserve.

The Committee also strongly endorses the supervisory reforms contained in H.R. 2094. Requiring early structured regulatory intervention or mandatory closure for banks that fall below predefined capital ratios is fundamental to correcting existing perverse regulatory incentives and to protecting taxpayers against escalating burdens on the deposit insurance fund.

The Committee reiterates its opposition to any weakening of mandatory regulatory actions that would allow regulators to exempt certain undercapitalized institutions from required sanctions because they believe that those institutions might be too big or too special to impose losses on uninsured claimants. Prompt action under the intervention and closure provisions should eliminate both the threat of runs on individual institutions



and systemic risk. Providing exceptions for large institutions from the costs of regulatory sanctions only increases the threat of taxpayer bailouts and eliminates market discipline for these institutions.

The Committee also endorses the proposal contained in H.R. 2094 to constrain the FDIC to use the “least costly” method to resolve each failed bank and to document its calculation. We urge that this documentation be made publicly available. This proposal, together with the additional provision that prohibits the FDIC from protecting uninsured depositors and creditors from sharing the losses of a failed institution, will provide adequate protection for taxpayers.

Finally, the Shadow Financial Regulatory Committee believes that the Federal Reserve’s ability to provide liquidity to undercapitalized institutions should be restricted. Unrestricted, such lending can put taxpayers at greater risk by delaying regulatory intervention to resolve the problems of troubled institutions. The Federal Reserve should be permitted to make loans only on an uncollateralized basis to institutions that have fallen below the critical capital standard.

# Statement No. 71

## The Need to Develop a Satisfactory Data Base with which to Analyze the Economic Condition of Insurance Companies

May 20, 1991

Recent insolvencies of several large insurance companies have highlighted inadequacies in the financial information available to the public concerning such companies. The Shadow Financial Regulatory Committee suspects that the onset of these insolvencies predated their official recognition. To help insurance markets to work better to reduce exposure to insolvencies, the Committee sees an urgent need for improvements in the information content, frequency, and timeliness of the income and financial-condition reports that insurance companies file.

In the absence of a federal regulator for insurance companies, the National Association of Insurance Commissioners (NAIC) has assumed the role of coordinating and standardizing the reporting format employed by insurance companies. The current annual reports collected by the NAIC ought to be converted into a data base for insurance companies that outside analysts can use at replication cost. There is great need for up-to-date and accurate industrywide assessments of the economic solvency and profitability of the industry's roughly 4,400 members. Major problems with NAIC reports include paucity of intrayear measurements, delays in data availability, and high access charges imposed on analysts who seek to study industry data.

Federally insured deposit institutions file quarterly call reports that federal regulators now assemble into an electronic data base that analysts may acquire readily within three to four months of each filing date. In contrast, NAIC reports are only collected annually, and the data reported to the NAIC are not released until almost six months after the date for which they are filed. While some limited data are being collected on a quarterly basis, they have yet to be integrated into a comprehensive data base.

Customers look to insurance companies for help in managing risk. A risk that purchasers and beneficiaries need to evaluate is potential weakness in the insurance source itself. The absence of timely, reliable, and reasonably priced financial data on insurance companies interferes with market discipline. It makes it hard for customers and regulators to recognize and respond to developing problems. This helps weak insurance firms to prosper at the expense of strong ones.

Delays in dealing with developing insolvencies also may threaten taxpayers. Defaults on insurance obligations by large insurance companies are bound to generate political pressure to use taxpayer funds to bail out customers of failed insurance companies. To protect taxpayers and healthy insurance companies, it is desirable for markets or regulators to force the prompt recapitalization of troubled firms.

During the 1970s and early 1980s, the lack of reliable and timely data on the true economic condition of thrift institutions masked burgeoning losses. Somewhat later in the 1980s, problems with data adequacy similarly masked commercial bank problems. While much remains to be done, in recent years federal regulators of banks and thrifts have

markedly improved the availability of comparable data on individual institutions. Market-adjusted valuations derived from these data by independent financial analysts are helping regulators and depositors better to judge and to balance the risks and returns offered by competing institutions.

The expense and limited usefulness of multicompany accounting data for insurance firms have discouraged academic and financial analysts from using these data. This lack of use has, in turn, dissuaded outside researchers from participating aggressively in the evolutionary process of improving the information content and transparency of the data being collected.

Neither regulatory nor market discipline can work effectively without an adequate information base. We urge the press and the industry's stronger members, and if necessary Congress and the Administration, to insist that the NAIC develop a quarterly reporting system and transform the resulting reports into a data base that can facilitate the information flow that analysts and markets need. Should NAIC be unable to do so, responsibility for development and management of information should be placed with a federal agency.

Statement No. 72  
OMB and CBO Statements Calling for More  
Informative Accounting and Budgeting for  
Deposit Insurance  
September 16, 1991

The Shadow Financial Regulatory Committee has frequently noted that losses incurred by the defunct FSLIC, as well as losses still accumulating at the Federal Deposit Insurance Corporation's (FDIC's) Bank Insurance Fund (BIF), have been aggravated by delays in measuring and recognizing the effects of prospective losses at insured institutions. Such delays are inherent in the cash-based accounting procedures traditionally used to measure deposit-insurance revenues and expenditures. The result is a perennial understatement of the FDIC's liabilities. Because taxpayers, Congress, and the rest of the Administration are not apprised in timely fashion of developing problems, pressures for appropriate public responses are forestalled.

Traditionally, the FDIC did not establish reserves for deposit insurance losses until an insured institution was taken over by the government. Its delay in recognizing liabilities for losses from future bank failures has been a point of continuing controversy between the FDIC and its official auditor, the General Accounting Office (GAO). This issue has become increasingly important as the FDIC has become more willing to grant forbearance to insolvent and undercapitalized banks.

In principle, whenever it is possible to identify specific banks that will require future FDIC expenditures, reserves should be established to cover losses. Until recently the FDIC rejected this approach, arguing that these expenditures should be treated as unrecorded "contingent liabilities." As a result of GAO insistence, the FDIC has partially adjusted its procedures. The effect of this for yearend 1990 is to increase its allowance for expected 1991 failures by \$4.3 billion, which cut its reported fund balance in half.

However, the FDIC's financial statements still will not reflect expected losses from identifiable insurance cases that are not scheduled to be handled until after 1991. In principle, reserves for these losses should be established as soon as such cases are identified.

Further, additional failures are bound to occur that will have have been specifically anticipated. The BIF should include a provision for losses from such failures to the extent that they exceed anticipated net revenue. As a minimum, reserves should be established on a probabilistic basis for losses apt to occur in the following year. There is now no effort to reserve for such expected losses.

To remedy long-standing measurement weaknesses, the Omnibus Budget Reconciliation Act of 1990 required the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) separately to study alternatives for improving accounting and budgeting for federal deposit insurance. Both reports call for computing and publicizing estimates of the economic costs of deposit insurance on an accrual basis. The reports also indicate that accrual and cash-based information may be combined usefully to produce improved measures of the government's financial position. Using an accrual

approach, OMB estimates the BIF's yearned 1990 net reserves to lie in the vicinity of negative \$40 billion, a figure far more worrisome than FDIC's + \$4 billion estimate.

OMB goes further than CBO to illustrate the feasibility of the procedure and to establish a timetable for change. OMB recommends that, beginning in 1993, the FDIC's estimates of accrued liabilities be incorporated into the federal budget in some way. To enhance the reliability of accrual estimates, OMB envisions collecting helpful information on the scheduled maturity of assets and liabilities from commercial banks, parallel to that already collected from insured savings and loans (S&Ls).

The Committee applauds the OMB initiative. The accounting reforms it suggests are long overdue. The public has been badly served by official use of flawed accounting schemes. Cosmetic accounting procedures continue to make it hard for legislators, the press, and other citizens to evaluate and appreciate the full magnitude and true nature of the deposit insurance mess.

## Statement No. 73

# Additional Comment on Deposit Insurance Reform Legislation

September 16, 1991

On May 20, 1991, in Policy Statement No. 70, the Shadow Financial Regulatory Committee generally supported H.R. 2094, a bill that provides for funding the Bank Insurance Fund (BIF) and deposit insurance reform through structured early intervention and resolution. This legislation appears to be stalling in Congress, as various lobbying interests battle over provisions of the bill that affect bank operating powers, in particular, securities and insurance, as well as geographic expansion.

In addition, various misguided schemes that would radically restrict the activities that may be performed by an insured commercial bank confuse the process even more. One of these plans—the Schumer proposal—would even reimpose ceilings on deposit interest rates.

Since the Committee's inception over five years ago, it has urged deposit insurance reform. (Statements No. 8, June 9, 1986; No. 16, February 9, 1987; No. 22, November 13, 1987; No. 36, December 5, 1988; and Nos. 39 and 41, February 13, 1989). During the mid-1980s, bickering over the recapitalization of the FSLIC and the restructuring of the regulatory process delayed the resolution of insolvent thrifts. These delays cost taxpayers billions of dollars. Early intervention would have prevented continued speculation and unnecessary excess costs at these insolvent thrifts. Today the BIF is admitted to be economically insolvent and is predicted to run out of cash by the end of the year.

It is critical that Congress not allow deposit insurance reform to languish until next year. Deposit insurance reform should focus on early intervention and resolution, as generally provided in HR. 2094. Mere temporary funding of BIF is not a solution. The Committee believes that deposit insurance reform is an issue of the highest priority and should be enacted without further delay. The Committee also supports broad geographic and operating powers for banks as necessary for efficiency and risk diversification in financial institutions.

## Statement No. 74

### Bank of Credit and Commerce International

September 16, 1991

The central question raised by the collapse of the Bank of Credit and Commerce International (BCCI) is why it took so long for its problems to be detected and acted upon by bank regulators. A second question is how regulation and supervision of foreign banks should be changed.

BCCI allegedly committed fraud on a global scale. Fraud is notoriously difficult for regulators to detect. But it is especially difficult to discover when fraudulent transactions cross national borders and can be concealed through the use of secrecy havens. BCCI, like Banco Ambrosiano nearly a decade earlier, was cleverly structured to impede careful supervision. Indeed, its headquarters were established in countries with weak supervisory authorities, strong secrecy laws, and neither lenders of last resort nor deposit insurers who would have financial reasons to be concerned about the solvency of banks that are chartered in their jurisdiction.

Apparently banks and regulatory authorities in many countries were deeply concerned about BCCI several years before its collapse. Indeed, an international “regulatory college” was established several years ago to monitor BCCI. But in the absence of strong supervisory control over the parent, this improvised mode of cooperation among national regulators proved ineffective. Prior to the banks’s seizure, sophisticated participants in financial markets acted to protect themselves from BCCI’s weakening condition. This information was not shared by the regulators with thousands of less sophisticated depositors, many of whom sustained ruinous losses.

Institutions such as BCCI seriously challenge the U.S. tradition of permitting relatively free entry to foreign banks. When a foreign bank’s global operations are not subject to effective supervision in its home country, the bank should be permitted to enter only through a subsidiary which can be monitored by the U.S. supervisory authorities. Even though BCCI succeeded surreptitiously in obtaining a charter for a U.S. subsidiary, so far available evidence indicates little damage to American depositors. Other modes of entry—such as branches, state-chartered agencies, or representative offices—facilitate evasion of scrutiny by U.S. regulatory authorities and may increase the ease with which a rogue bank can engage in money laundering and other nefarious activities.

The BCCI collapse contains important implications for the coordination of international regulation and supervision. Clearly the Bank for International Settlement Conordat, negotiated among the banking authorities of 12 leading nations, needs to be strengthened with regard to the sharing of information. It should also be extended to all other important banking centers. Depository institutions should not be allowed to buccaneer under flags of convenience.

In addition, this scandal should cause the European Community to reconsider its allocation of responsibility between parent and host country supervisory authorities. The Second Banking Directive assigns responsibility for supervising and solvency of a bank to the chartering country, but places responsibility for providing deposit insurance with the host country. This diversion of responsibilities undermines incentives for effective supervision. The parent authority is likely to be more attentive in monitoring the solvency of an institution if it shares the risk of loss with the institution's creditors.

Note: 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 voting on this statement.



# Statement No. 75

## Protecting Taxpayers from Risks of Government-Sponsored Enterprises

September 16, 1991

The Financial Institution Reform, Recovery and Enforcement Act of 1989 required three governmental agencies to study of the risks posed by government-sponsored credit enterprises<sup>1</sup> (GSEs): the Department of the Treasury, the Congressional Budget Office, and the General Accounting Office. Following their studies, legislation (H.R. 2900) was introduced to impose federal bank-type regulation, risk-based capital requirements, and early intervention and closure policies on GSEs. This legislation acknowledges that risks to taxpayers are inherent in these institutions' operations. The Shadow Financial Regulatory Committee previously urged action to deal with this situation (see Statement No. 61, September 24, 1990).

Although GSEs have equity contributed by private shareholders, it is widely believed that the liabilities of these institutions are covered by implicit government guarantees. Consequently, taxpayer funds might be required to cover losses that exceed shareholder-contributed equity. These implicit taxpayer guarantees have contributed to the rapid growth of GSEs, which now have more than \$980 billion in outstanding liabilities. Because the guarantees are not priced, current owners and managers enjoy a subsidy.

Taxpayers loss exposure to GSEs has two roots. The first is the lack of adequate monitoring of GSE performance. The second is the absence of clear-cut governmental responsibility for ensuring that prompt corrective actions are taken before GSEs exhaust their shareholder-contributed capital and require taxpayer support. H.R. 2900 does provide for structured early intervention and resolution of troubled GSEs in the manner that the Committee has long favored for commercial banks and thrifts.

The Committee believes that early intervention and resolution would be sufficient to control taxpayer risk exposure to GSEs, provided that required private capital were sufficient to absorb expected losses, that capital were measured meaningfully, and that the intervention and closure criteria were clearly specified. These provisions would avoid the flaws and distortions in the risk-based capital requirements now applied to banks and thrifts, and that are proposed by H.R. 2900 for GSEs. (See Committee's Statement No. 18, May 18, 1987.)

Higher required capital and early intervention and resolution proposed have several desirable properties. They accommodate the evolution of new GSE activities and products, rely on market discipline to control risk taking, and keep government involvement in GSE decisions to a minimum. To protect taxpayers further, these measures should be coupled with adequate monitoring and reporting systems, which include market-value reporting of the value of assets and liabilities and improved accountability.

<sup>1</sup>The five major GSEs are the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Association (Freddie Mac), the Federal Home Loan Bank System, the Federal Agricultural Mortgage Corporation (Farmer Mac), and the Student Loan Marketing Association (Sallie Mae).

To avoid potential conflicts of interest, the Committee urges that government oversight of a GSE's activities not be lodged with an agency charged with promoting the social or private-interest goals that gave rise to that GSE. For example, the Committee is concerned that the Department of Housing and Urban Development's (HUD's) responsibilities for the housing-related GSEs create incentive conflicts between the agency and the taxpayer. Should either of the housing GSEs get into financial difficulties and threaten government-housing-support policies, the pressure for regulatory forbearance could result in de facto commitment by HUD of taxpayer funds without proper oversight and government review. Instead, we urge that oversight be lodged either with a new independent agency or with an existing one, such as the Department of the Treasury or the Office of Management and Budget.

Finally, we urge reform of GSEs to reduce to zero taxpayer subsidies to these entities. To assist such reform, we propose that the value of these subsidies be estimated and explicitly recognized in the federal budget.

## Statement No. 76

# The FDIC Improvement Act of 1991

December 16, 1991

After a yearlong struggle, Congress has passed and sent to the President S.543, the Federal Deposit Insurance Corporation Improvement Act of 1991. News coverage for most of the last half-year has focused on fights among various interest groups over the extent of bank powers and activities in such areas as securities underwriting, insurance and real estate brokerage, and interstate banking. The final bill reflects a lobbying stalemate that has largely paralyzed legislative action on these subjects for several decades. That should not obscure the fact that S.543 makes major contributions to the reform of federal deposit insurance, a matter of a greater urgency and importance. The FDIC Improvement Act of 1991 is aptly named, up to a point.

### I.

1. The new banking bill would enact into law the concept of prompt regulatory actions keyed to a bank's capital ratio. The extent of supervisory attention and restriction would increase for banks with lower capital levels (§ 131). If an institution falls below a "critical" capital ratio, even though at least nominally still solvent, the banking agency is empowered to appoint a conservator or receiver.

All of these are measures the Shadow Financial Regulatory Committee has been urging for some time (see Statements No. 38, December 5, 1988, and No. 41, February 13, 1989), and we believe they have the potential for preventing a recurrence of the deposit insurance disaster of recent years.

2. To determine more accurately the economic condition of insured institutions, the banking agencies are to require them to include off-balance-sheet assets and liabilities in their financial statements, and to disclose estimated fair market values as well as the numbers generated by generally accepted accounting principles (§ 121). The Committee supports strengthened accounting standards and indeed has since 1986 consistently recommended the use of market value accounting standards (Policy Statements No. 3, June 9, 1986, and No. 30, February 8, 1988).

3. S.543 also addresses the policy of "too big to fail", whereby in the past the banking agencies have in effect provided depositors and other creditors with unlimited deposit insurance despite the legal ceiling. As of 1995, the FDIC is not to pay uninsured claims in arranging a takeover of a failed institution unless the total cost would be less than that incurred in a straight liquidation (§ 141), and the Federal Reserve System is no longer to use advances to keep open and in operation "critically" undercapitalized institutions (§ 142). The Committee has previously expressed strong disapproval of the "too big to fail" policy (see Statement No. 37, December 5, 1988), and believes the action of Congress in S.543 is a major step forward.

In the area of deposit insurance reform, therefore, Congress has truly effected "FDIC improvements." But the story cannot end there. Each of the actions Congress has taken requires implementation by the banking agencies and relies on agency discretion to be effective in individual cases. The agencies must define the various capital categories and

the minimum ratios on which they are based. The agencies control the sanctions imposed and the promptness of intervention and the appointment of a conservator or receiver for a critically undercapitalized institution.

It is still possible for the FDIC to read the statute to permit payment of uninsured depositors in full (by generously estimating liquidation costs) or to override the limitation itself by invoking an emergency procedure for perceived "systemic risk"; the Fed could still support an insolvent institution with advances by absorbing the interest charges. In either event, "too big to fail" reappears.

Despite the good start undertaken in S.543, therefore, the actual achievement will be determined by the implementing regulations, and even more by the discretionary actions, adopted by the federal banking agencies. Much of what the banking agencies are now expressly authorized or urged to do, they previously had implied authority to bring about; the bill can be viewed as a repudiation of the course the banking agencies followed in the 1980s. Taxpayers and the Congress will be well advised to keep a close and wary eye on the agency process in the future.

## II.

The new banking bill does little to bring the scope of activities of U.S. banks into the world of the 1990s. In almost every other country, banks can offer the public a wide range of services, including insurance and securities services and underwriting. Banks in most other countries can have branches nationwide. But U.S. banks remain restricted by antiquated laws.

If and when the intent of Congress to subject banks to meaningful capital requirements is implemented by the banking agencies, banks having sufficient capital should be permitted to offer a wide range of financial products and services. In general, this change could tend to make banks less prone to failure because it would permit banks to hold more diversified assets and activities, thereby generating revenue from more diverse sources. Permitting banks to branch nationwide also would lessen the risk that a local economic downturn would result in bank failures and the absence of viable banks in the depressed area. In addition, nationwide branching would facilitate desirable consolidations.

We urge that Congress complete the job it began with the FDIC Improvement Act by repealing the restrictions on securities activities imposed by the Glass-Steagall Act, permitting national banks to branch nationwide, and allowing banks to underwrite and sell insurance products. (See Statement No. 63, December 10, 1990, and Statement No. 56, May 7, 1990.) Consumers would benefit from these changes, the banking system would be strengthened, and taxpayers would pay less if they have to bail out commercial bank depositors.

## Statement No. 77

# Accounting for Taxpayers' Stake in the FDIC's Bank Insurance Fund

December 16, 1991

Accountability for FDIC performance in managing the Bank Insurance Fund (BIF) has to begin with accurate information on the value of the BIF's net reserve position. The FDIC should not be subject to less stringent financial reporting and disclosure requirements than the institutions it regulates. For insured deposit institutions, the FDIC Improvement Act of 1991 requires that all assets and liabilities, including contingent assets and liabilities, be taken into account in preparing financial statements. It also requires that methods be developed to let financial statements disclose the estimated fair market value of assets and liabilities, "to the extent feasible and practicable."

The Shadow Financial Regulatory Committee applauds these itemization and valuation principles and urges that they be used as well to measure the condition of the BIF itself. The principal contingent obligation of the BIF is the anticipated losses to which it is exposed by the operations of the institutions it insures. The fair market value of this obligation can be identified as the charges that the FDIC would have to incur in reinsurance markets to shift its insurance obligations to another credible party.

Currently, the FDIC books at year-end a contingent liability for its exposure to losses *only* in institutions whose insolvency it expects to resolve during the subsequent calendar year. Moreover, even with respect to this limited universe, procedures for valuing the BIF's expected losses have not been tied explicitly to a market-value standard.

Using the figures now published by the FDIC, the FDIC Improvement Act of 1991 perpetuates the accounting fiction that the BIF is financed entirely out of past and future assessments paid by insured banks. Projections that the fund will experience net outflows over the next few years are presumed to be counterbalanced by the hope that the FDIC can adjust its schedule of assessment rates to generate a stream of net premium income sufficient over the next 15 years to offset the near-term outflows. Relying on this unrealistic presumption, the legislation treats the fund as if it were temporarily short of liquidity, but not economically insolvent. Presuming the fund's solvency, the law authorizes the FDIC to borrow funds to cover the cash-flow shortages it will encounter in the next few years.

Using current assessment rates, earlier this fall the Office of Management and Budget (OMB) projected substantial net BIF outlays for the years 1991 through 1996 (in billions): \$15.9, 9.7, 8.0, 6.9, 0.9, and 0.6, respectively. Discounted to present value at current interest rates, these projections establish a negative net worth for the Bank Insurance Fund. It is virtually impossible that net premium income can be driven high enough to offset the discounted present value of net outlays of the magnitude that OMB projects.

Those who maintain that BIF is economically solvent fail to recognize that banks will respond to high assessments in ways that will prevent the FDIC from realizing much of a margin of premiums over cost. Beyond an income-maximizing level, higher assessment rates entail reductions, not increases in the BIF's net premium income. Any increase in

“user charges” invokes a circumventing response. High assessment rates increase incentives for banks to reduce the base of assessable deposits and to increase the riskiness of the smaller deposit base left to be covered by the BIF. Gross revenues that can be projected from given assessment schedules are inherently limited by the opportunity costs for banks to reproduce benefits of the BIF’s insurance services in other ways: such as by expanding their recourse to liabilities secured by strong assets.

Although authorities are unwilling to admit it, the bulk of the so-called \$30 billion recapitalization of the BIF under the new banking legislation is now being underwritten by the general taxpayer and not by insured banks.

## Statement No. 78

# U.S. Listing Requirements for Foreign Companies

December 16, 1991

The New York Stock Exchange (NYSE) recently announced plans to attract foreign companies to list their stocks on the NYSE. With the increased globalization of securities markets, the NYSE and other U.S. exchanges are facing stiff competition from foreign exchanges. In the last few years the NYSE has lost its premier ranking among securities markets to the Tokyo Stock Exchange. Securities exchanges in London and Western Europe also are now formidable competitors.

A key competitive disadvantage that U.S. exchanges have in attracting listings from foreign companies are the strict U.S. rules governing corporate financial disclosure. These rules impose significant costs on issuers. For this reason, many foreign companies, even very large ones, have refused to conform to U.S. financial reporting standards, and, as a consequence, fail to meet the current NYSE listing requirements. The NYSE contends that unless U.S. standards are modified to allow the shares of more foreign companies to be traded on U.S. exchanges, the U.S. securities markets and institutions will eventually lose their preeminent position.

In raising this issue the NYSE has spotlighted the need for the SEC to review its disclosure requirements to make sure that they are not unnecessarily burdensome and do not inhibit the ability of U.S. exchanges to compete in world markets.

With respect to financial statement disclosure, U.S. standards are considerably more extensive than those of foreign countries. This may not be a competitively viable position for the United States in the long run. The Committee believes that the SEC should conduct an extensive review of its regulations with a view towards determining their competitive effects vis-a-vis foreign markets and competitors, and, where feasible, to reducing unnecessary obstacles to the listing of foreign companies on U.S. stock exchanges.

Making it more difficult to list foreign stocks on U.S. exchanges is not an effective means of protecting U.S. investors. U.S. investors can and do trade foreign stocks on foreign exchanges, especially in London, Frankfurt and Tokyo, where they incur higher trading costs and are exposed to less liquid markets. Further, with the growing institutionalization of securities markets, in the future most American investors can be expected to be indirect traders of foreign stocks—through mutual funds, pension funds, and other institutions. It would seem preferable, therefore, to permit U.S. investors, both individuals and institutions, to trade foreign stocks directly on U.S. exchanges, where superior trade surveillance and trading standards afford them better protection. That protection is extended if more foreign stocks are eligible for listing and trading in U.S. markets.

## Statement No. 79

# Interagency Policy Statement on Commercial Real Estate Loans

December 16, 1991

Bank examiners have been much criticized in recent years for excessively harsh evaluations of bank loan portfolios. Administration officials, some members of Congress, and would-be borrowers have argued that these actions have contributed to a “credit crunch.” (See the Committee’s Statement No. 67, February 11, 1991.)

These concerns have focused particularly on commercial real estate loans. Commercial real estate markets in most parts of the country are suffering severe economic problems—excessive supply and weak absorption rates—combined with heavy debt burdens based on overly optimistic past estimates of value. The result is that cash flows in many instances are inadequate to support existing loans.

The four federal banking regulatory agencies recently issued a joint statement on the review and classification of commercial real estate loans. This week, a meeting of field bank examiners is being held to address these issues in more detail. While the Administration has characterized this action as part of its efforts to promote economic growth, the regulatory agencies present their announcement as a clarification and restatement of existing policy.

Besides describing general approaches to loan markets, administrative procedures, and valuations, the statement contains language that may be construed as dictating more leniency in bank examinations.<sup>1</sup> While each of the points cited in the footnote contains qualifications or exceptions, the Committee has several concerns about the overall tone and content of the regulators’ statement. The Committee’s reservations derive as much from the fact that the statement was issued in response to political pressures as its specific language.

First and most important, we object to attempts to use bank supervisory policy as a means of influencing macroeconomic activity. This issue has arisen in the past and has usually been resisted by the agencies. It appears that the recent policy statement reflects a weakening of the agencies’ resolve to oppose such pressures. It should be emphasized that independence of examiner judgment is key to the integrity of the examination process.

Second, lenient regulatory policies cannot eliminate the substantial oversupply of commercial structures. Third, even though cash payments continue to be made on some real estate obligations, changes in the borrower’s cash flow position or the market value

<sup>1</sup>Here are four examples: First, assumptions about appraisals of real estate “should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property.” Specifically, while acknowledging that discounted cash flow is an appropriate valuation methodology, according to the regulators such procedure should take into account “the ability of real estate to generate *over time* (emphasis added) income based on reasonable and supportable assumptions.” Second, assumptions made recently by qualified appraisers “should be given a reasonable amount of deference” by examiners. Third, for a so-called performing real estate loan, increases in loan-loss allowances are not required “automatically” if the value of collateral has declined to an amount less than the loan balance. Finally, when management has maintained effective loan systems and controls dealing with quality problems and analyzed “all” significant factors affecting portfolio collectability, “considerable weight” should be accorded management’s estimates of the adequacy of loan-loss allowances.



of the collateral itself will affect the value of a lender's claim. The carrying value of a loan should reflect changes in the probability of loss, just as the values of marketable debt reflect changes in credit quality even in the absence of a default. In this connection, the Committee supports the concept of loan-splitting (reflected in general terms in the statement), but only as a step toward the current-valuation technique that the Committee has long espoused. Fourth, deference to management assumptions and valuations based on other than current conditions has in the past increased the amounts of loss ultimately born by the insurance funds or the public generally. This risk remains.

Examiners have been more critical of commercial real estate loans in recent years than many bankers believe is reasonable. While some examiners may have made mistakes, the facts are that the "unduly harsh" judgments of the examiners have proven to be more correct than the estimates made by bankers and assented to by their auditors.

## Statement No. 80 The FDIC's Program for "Hospitalizing Sick Banks"

February 17, 1992

This Shadow Financial Regulatory Committee has noted repeatedly that taxpayers are apt to lose when regulators gamble that the government can efficiently nurse an insolvent enterprise back to health. This policy affords a pretext for refusing to impose losses on uninsured depositors in failing institutions. Experience with thrift institutions insured by the FSLIC has shown that programs of capital forbearance and government management increase rather than reduce taxpayer losses.

Despite this unfavorable experience, in late January the FDIC rejected private bids for CrossLand Savings FSB, choosing instead to nationalize this firm "temporarily." FDIC Chairman William Taylor euphemistically characterized this action as the beginnings of a federal "hospitalization program" for failing depository institutions. This approach undermines the major reforms achieved by the FDIC Improvement Act that Congress passed less than three months ago.

It is possible that temporary nationalization might, in some cases, be the least-cost method for resolving an individual bank failure. But taxpayers have good reason to doubt that their interests are being well represented when "hospitalization" decisions are made. As amply demonstrated in the FSLIC fiasco, public managers are seldom as efficient as private ones, and regulatory authorities face serious conflicts of interest that can bias them against promptly reprivatizing a failed bank or thrift.

Prior to implementation, FDIC officials should have issued a public notice that fully articulated the tests and criteria by which they proposed to govern their nationalization program. The FDIC Improvement Act of 1991 favors imposing losses on uninsured creditors and undertaking a prompt privatization of risks. Given this intent of Congress, FDIC officials should have set up a reporting framework that would expose their decisions to informed outside examination. This entails releasing to the public a detailed and reproducible analysis of the costs and benefits the FDIC Board found and upon which it based its decision. General Accounting Office review of these findings as required by the 1991 Act is also essential for establishing the integrity of the Board's conclusions.

Complete accountability requires further that a timetable be established for reexamining every quarter the costs and benefits of each deposit-institution nationalization. Each nationalization should be kept to the shortest term feasible, with repeated public review. The process might usefully be modeled as an expedited bankruptcy action. This would mean establishing a receivership at the start of the process, and then, as quickly as possible, proceeding with a corporate reorganization or a liquidation. Either alternative would imply pro rata losses to uninsured creditors.

Rejecting private bids for an insolvent institution is dangerous from the standpoint of taxpayers because it has the effect of avoiding a writedown of assets to the market values that informed bidder valuations clearly imply. Taking a lesser writedown enables the agency to report a stronger balance sheet and higher operating income than it would otherwise have to reveal.

In the CrossLand case, the FDIC staff projected that the nationalization approach would cost \$763 million in present value as against an estimated \$1.3 billion cost for accepting the top private bid received. However, perhaps to insulate itself from outside criticism of the doubtful assumptions on which the staff's estimate of nationalization costs is based, the FDIC Board stopped short of endorsing its staff analysis by noting: "The Board did not adopt every detail of this analysis—finding that the overall cost of both alternatives could be greater, and the differences between the two could be smaller."

It is easy to understand why Board members might be uncomfortable with the numerical assumptions its staff employed. These assumptions are grossly disparate from the market valuation of CrossLand's balance sheet offered by the high bidder. Under these circumstances, it was incumbent on the FDIC to document a compelling supporting analysis for its projections. The Committee believes that a proper analysis would not support the decision the FDIC made. Specifically, such analysis would not:

1. Treat \$437 million as the present value of CrossLand's realizable future franchise value, based largely on an excessively optimistic 1.5 multiplier of the book value of the equity to be injected by the FDIC.
2. Assume \$440 million for the present value of an incrementally better recovery on \$4.4 billion in "difficult" assets by government agents compared to returns from liquidating these assets straightforwardly. In contrast, by declining to bid for these assets, the top private bidder treated this workout as at best a breakeven opportunity.
3. Make the deeply troubling—and totally undocumented—assumption that there is a net gain to the insurance fund from protecting a failing firm's uninsured depositors from loss. The Committee believes that this assumption is rooted in the perpetuation of deposit-insurance subsidies associated with the "too big to fail" policy. In this case, uninsured depositors were granted an estimated \$18 million in immediate relief, and protection also against short-falls in the FDIC's assumed recovery rate on troubled assets. But the cost of protecting these depositors cannot be calculated on the basis of the isolated individual insolvency, because it extends to uninsured depositors at all institutions.

The FDIC action in the CrossLand case is based on unconvincing evidence and violates the Congressional intent expressed in the FDIC Improvement Act of 1991. It is poor public policy to implement major changes in insolvency resolution in an episodic fashion, without adequate disclosure and prior comment.

# Statement No. 81

## Using Risk-Related Capital Standards to Promote Housing

February 17, 1992

In several previous statements (No. 6, June 9, 1986; No. 18, May 18, 1987; and No. 29, February 8, 1988) the Shadow Financial Regulatory Committee commented on banking agency proposals to increase bank capital requirements and to establish risk-related capital standards. We urged modifying the proposed risk-based standards because assets were assigned to risk classes by arbitrary weights based neither on reproducible market valuations nor on historical loss experience. In the absence of truly market-based risk measures, the Committee worried that the standards might result in government credit allocation and induce banks to take greater risks.

These concerns have been realized. The recently passed “Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991” (Pub. L 102-233)<sup>1</sup> attempts to stimulate housing construction by lowering bank capital requirements for several types of real estate loans. Specifically, the regulatory agencies are directed to place single-family “presold” home construction loans and loans to finance multifamily properties in the 50-percent risk category instead of the 100-percent category. The effect is to lower the required amount of capital to be held against these loans from 8 percent to 4 percent.

Proponents of this legislation offer no evidence that these loans are less risky than other loans in the 100 percent risk category. In fact, both types of loans can be very speculative investments. “Presold” home construction loans are too often made with minimal down payments and often default at the very time the commitments have to be funded. During the current recession, multifamily construction has experienced significant default rates due to speculative overbuilding.

Setting capital requirements at inappropriately low levels amounts to mandatory capital forbearance and credit allocation. We oppose congressional attempts to relax prudential standards by legislatively assigning assets to risk classes to promote macroeconomic policy objectives. Such efforts represent an undesirable intrusion into and redirection of the supervisory activities of the banking agencies.

Reduced capital requirements on certain assets can induce increased risk taking with all its undesirable consequences, including increased costs to taxpayers and a general weakening of depository institutions. Such attempts are an undesirable government intervention in credit allocation. We believe that better and more direct methods exist to stimulate housing construction—if that were desirable—that would not place the taxpayer at greater risk by perverting the supervisory objectives of the banking agencies.

<sup>1</sup>House Banking Committee Chairman Gonzalez’s recently introduced bill, the Emergency Community Development Act 1992 (H.R. 4073), contains similar language.

## Statement No. 82

### The Need to Regulate Interest Rate Risk

February 17, 1992

The Shadow Financial Regulatory Committee is concerned that current interest rate conditions are luring some banks and thrift institutions into gambling once again on the future course of interest rates. Short-term rates have declined very substantially over the past year, while long-term rates have declined only modestly. The result has been a sharply upward-sloping yield curve. Rates on 30-year Treasury bills yield less than 4 percent. This situation increases reported profits of many banks and thrift institutions whose interest costs on deposits have thus far declined much more than their earnings on loans. It also offers banks an apparent opportunity to gain by borrowing short and lending long, thereby substantially increasing their vulnerability to losses from future increases in rates.

The Committee's concern is based on sound banking principles, past experience and current developments. Many banks have been hurt by adverse interest rate movements in the past. The collapse of the thrift industry is due to the industry's long-standing exposure to interest rate risk. The high interest rates that developed in the early 1980s resulted in large operating losses as deposit interest costs soared, and in a huge decline in the value of fixed-rate mortgages. Many of these institutions, responding to the perverse incentives of the deposit insurance system, moved into high-risk lending and adopted aggressive growth policies. These strategies compounded the industry's losses when real estate markets crashed. Press reports indicate that a large number of banks are now again taking on increased interest rate risk.

The Committee deplores the failure of the federal regulatory agencies to implement a capital requirement that disciplines interest rate risks. A year ago the Office of Thrift Supervision (OTS) proposed such a regulation, and that proposal was strongly endorsed by the Committee (Statement No. 68, February 11, 1991). The OTS failed to implement its proposed regulation because of opposition from the industry.

The inaction of the regulators has not escaped notice by the Congress. The FDIC Improvement Act now requires (§ 305) that the agencies include an interest rate risk measure in the risk-based capital requirement, although this requirement does not become effective for 18 months. It is unfortunate that it takes an act of Congress to get the agencies to do what historical experience and economic logic have long demanded. The regulatory agencies must accept responsibility for the consequences of their inaction if future increases in interest rates cause bank and thrift institution failures that impose additional losses on the taxpayer.

The Committee urges the regulators to lessen the risk of another deposit insurance debacle. As the OTS proposed more than a year ago, insured depository institutions should be required to hold sufficient capital to cover the effect of interest rate risk to which they expose themselves.

## Statement No. 83

# The FDIC's Proposed Schedule of Risk-Sensitive Premiums

June 1, 1992

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) in Section 302 requires the FDIC to establish by January 1, 1994, a schedule of risk-rated premiums for the deposit insurance it provides banks and thrifts. In mid-May, the FDIC outlined a proposed four-level schedule of premiums to take effect in January 1993. Proposed premiums range from a low of 25 cents per \$100 of assessable deposits at the healthiest banks to a high of 31 cents at the weakest ones. An institution's health is to be cross-classified on two summary dimensions: (1) the extent of its accounting capitalization and (2) the degree of "supervisory concern" that emerges from agency assessments of safety and soundness.

In principle, moving to a system of risk-sensitive pricing for FDIC insurance is a salutary development, and the sooner it is put in place, the better. However, the benefits of this move depend critically on the accurate measurement and appropriate pricing of the relevant risk. The Shadow Financial Regulatory Committee believes that the FDIC's proposed premium schedule misconceives, mismeasures, and misprices risk. It neglects important dimensions of FDIC risk exposure and sets too high a price for very low-risk institutions and too low a price for very high-risk firms.

The risk that is relevant to the FDIC and to federal taxpayers is the loss exposure that insured institutions impose on FDIC insurance reserves. Premiums represent prices paid for insurance services rendered. From a public-policy point of view, the ideal situation would be for the premium each institution pays to equal the value of the services it receives. Over time, the FDIC must learn to measure its loss exposures accurately and endeavor to set prices that correspond closely to economic costs.

The appropriate price for any FDIC risk exposure is the economic cost of efficiently monitoring and financing that exposure. To assess the burden of FDIC premiums for any class of institutions, premiums must be weighed against the benefits members of the class receive from having their deposits federally guaranteed. The depth of the FDIC's current negative reserve position supports financial analysis indicating that, on average, past FDIC premiums have been too low on an ex-ante basis. By underpricing its loss exposures, the FDIC encouraged strong and weak institutions alike to take on additional risk.

The committee is skeptical of the argument that high minimum premiums are an effective way for the FDIC to repair its negative reserve position in the long run without taxpayer assistance. This could happen only if the 25-cent premiums targeted for the nation's strongest institutions would in future years produce more than enough net revenue to offset the losses that continue to reside in the riskiest end of FDIC's business. The problem is that setting premiums above cost for low-risk institutions generates pressure for such entities to take on additional risk, to shift a greater proportion of their funding activities into liabilities against which FDIC premiums are not assessed, or even to relinquish their U.S. banking charters. Whether managers who seek additional risk do so by overtly moving their institution into a recognized higher-risk category or by covertly exploiting weaknesses in FDIC's premium and risk assessment procedures, future inflows

of net revenue under the proposed schedule cannot realistically be expected to materialize in the amounts required to replenish FDIC reserves.

Industry criticism of the FDIC proposal has focused not on the rationality of the FDIC's pricing strategy, but on feared disruptive consequences. Some observers claim that making premiums conditional on agency risk-ratings may poison an institutions relations with its regulators and its standing with customers. They assert that making a bank's premium expense rise in a predictable way as its supervisory rating declines would give too much weight to the "arbitrary" opinions of examiners and their supervisors.

The economic force of this objection turns on the alleged unfairness and inaccuracy of the rating process, not on the discipline that arises from a poor rating. Unfairness and inaccuracy should be eliminated in any case.

Ratings could become public knowledge because an institution's supervisory rating might be roughly inferred from its accounting statements. Exposing controversial rating issues to public scrutiny should enhance incentives for examiners and supervisors to improve their rating skills and to work harder at eliminating unfairness in the examination process. Customer reaction to adverse changes in ratings could be expected to spur healthy shifts of business from weaker to stronger institutions. These visible effects would generate desirable pressure on chartering authorities to impose effective sanctions on low-rated institutions more promptly.

## Statement No. 84

# Brokered Deposits and Capital Requirements

June 1, 1992

The Federal Deposit Insurance Corporation (FDIC) has adopted a rule governing permissible acceptance of brokered deposits by depository institutions, as required under Section 301 of the Federal Deposit Insurance Corporation Improvement Act of 1991, to take effect on June 16th. Under the rule, an “undercapitalized” bank or thrift would be prohibited from obtaining deposits through brokers and from paying interest on directly solicited deposits exceeding 75 basis points above the interest rate in the market from which the deposits are obtained. A so-called “adequately capitalized” institution would be prohibited from using brokers, except with a waiver from the FDIC, and then would be subject to the same interest rate cap. A so-called “well-capitalized” institution could obtain deposits from brokers or directly from customers without limitations.

Although the Shadow Financial Regulatory Committee supports the FDIC’s rule in concept, we are concerned about two important aspects of its application. First, the threshold “zone” ratios defining capital strength are set substantially too low. A bank or thrift would be considered well capitalized if its total capital is 10 percent or more of its risk-adjusted assets and its Tier 1 capital (leverage ratio) is 5 percent of its total on-balance-sheet assets. Recent experience has indicated that these ratios are too low to absorb the kinds of shocks that have affected the industry. Moreover, interest-rate risk and concentration-of-default risk (both of which contributed greatly to the mass insolvency of much of the savings and loan industry) are not incorporated in the risk calculation. Furthermore, because capital is measured on an historical cost basis, which often overstates current market prices, even some well-capitalized depositories may not be adequately positioned to absorb losses of significant magnitude.

Second, there seem to be little reason to distinguish between brokered and nonbrokered deposits. The intent of the FDIC’s rules is to prevent less-than-well-capitalized depositories from paying too much for deposits, regardless of their sources. Thus, the rule could be simplified by requiring that the proposed interest rate ceilings for inadequately capitalized and undercapitalized institutions be applied to all of their deposits, whether they are brokered or nonbrokered. We believe that ceilings should not be applied to well-capitalized depositories, provided capital is properly defined, since there is less danger that their deposits would not be supported by adequate capital.

Finally, although some object to higher capital requirements as being too costly to banks, the committee believes that this concern is groundless. Most bank competitors not covered by the federal safety net operate profitably with much higher capital ratios than banks.

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 C. Aspinwall abstained from voting on this statement.



## Statement No. 85

# The TDPOB's Proposed Early Resolution/Assisted Merger Program

June 1, 1992

The Thrift Depositor Protection Oversight Board (TDPOB) published for public comment in the *Federal Register* on February 21, 1992, an early resolution/assisted merger program for troubled thrift institutions.

In commenting previously on similar proposals, the Shadow Financial Regulatory Committee noted that, while temporary government ownership of troubled institutions may on occasion achieve the least cost resolution, in general, perverse incentives are created by such a program.<sup>1</sup> It can lead institutions to take additional risks because their own capital investment is minimal. It can also lead regulators to provide continued forbearance as a way of delaying official recognition of the embedded losses and the return of the institution to the private sector.

Previous experience with government-owned or -managed programs has been mixed, and it has often resulted in throwing good money after bad. The committee has criticized the FDIC for its recent nationalization of the CrossLand Savings Bank on several grounds: failing to spell out the terms of the nationalization sufficiently, producing overly pessimistic estimates of the cost of not protecting uninsured depositors fully, and offering greatly overoptimistic and unrealistic projections of its ability to "nurse" the bank back to health and to reprivatize it profitably (Statement No. 80, February 7, 1992).

The committee is concerned that the proposed early resolution/assisted merger program will continue undesirable forbearance policies. For example, the early resolution cases provided as examples by the Oversight Board at its March 25, 1992, hearings as "weak thrifts," and potential candidates for the "program," were already clearly insolvent on either a GAAP or economic basis. Intervention, after an institution has become insolvent, is *late* rather than *early* in the supervisory process. To be effective, early intervention must be initiated before an institution becomes insolvent so as to permit resolution or recapitalization without imposing costs on the insurance fund or taxpayers.

<sup>1</sup>See Statement No. 7, June 9, 1986, "Proposals for Capital Forbearance Policy for Agricultural and Energy Banks"; No. 14, November 17, 1986, "Policies Toward Troubled Depository Institutions"; No. 22, November 13, 1987, "FSLIC Handling of Insolvent Thrift Institutions"; No. 27, February 8, 1988, "Disposal of FDIC Equity Interests in Assisted Banks"; No. 31, May 16, 1988, "FDIC's New Policy on 'Whole Bank' Takeovers"; No. 35, September 25, 1988, "Need to Make FSLIC and FDIC Assistance Deals Accountable"; and No. 80, February 17, 1992, "FDIC's Program for 'Hospitalizing Sick Banks.'"

## Statement No. 86

# SEC Listing Requirements for Foreign Firms

June 1, 1992

The New York Stock Exchange (NYSE) has recently made a proposal that would permit the trading on U.S. exchanges of a limited number of large foreign firms. The Shadow Financial Regulatory Committee endorses this proposal as a way of relaxing the burdensome Securities and Exchange Commission (SEC) restrictions on the trading of foreign securities in the United States.

SEC regulations continue to restrict the trading of foreign securities in the United States, however, putting at risk the position of the United States as a preeminent global capital market. The most onerous of these restrictive regulations is the requirement that foreign companies may not sell or list their securities on U.S. exchanges or NASDAQ unless they agree to reconcile their financial statements to U.S. generally accepted accounting principles (U.S. GAAP).

The practical impact of the SEC requirement is that very few foreign companies sell or list their securities in the United States. Although there are over 2,000 foreign companies that apparently meet NYSE listing standards, only 155 are traded on a U.S. exchange or NASDAQ. Some foreign firms trade in the United States without reconciling to U.S. GAAP, but only if their securities trade in the "pink sheets"—an illiquid segment of the over-the-counter market where there are few quotes and no last-sale reporting, and where investors face much higher costs and spreads.

The NYSE proposes that about 200 of the largest and best-known foreign companies be allowed to see and list their securities in the United States without having to reconcile their financial statements to U.S. GAAP. These companies all meet substantial revenue and market capitalization requirements and are traded actively outside the United States. The NYSE proposes that they be allowed to file in the United States their independently audited, home-country financial statements as long as they include a written explanation of the material differences between home-country accounting practices and U.S. GAAP.

The committee endorses this proposal as a reasonable first-step in reconciling U.S. disclosure standards with global competitive realities. On December 16, 1991, the Shadow Financial Regulatory Committee issued a statement (No. 78) calling for the Securities and Exchange Commission to reduce regulatory obstacles to the listing of foreign companies on U.S. stock exchanges.

The proposed step would have several benefits. It would be consistent with recent SEC proposals to lessen the regulatory burden of disclosure for emerging U.S. companies. It would also bring U.S. regulatory practices more into line with those of other major capital markets. U.S. companies may now issue stocks and list them on exchanges in Japan and in Europe without conforming to local rules of accounting, even though U.S. financial statements are not prepared in accordance with Japanese or European principles.

Nor would exempting world-class foreign companies from U.S. GAAP reconciliation undermine investor protection in the United States. There is little reason to expect that requiring foreign companies to file additional U.S. GAAP reconciliations (in most cases long after their home-country documents have been made public) will be of value to U.S.

investors. Academic studies have generally found that such filings have had no material impact on the price of a stock.

No one is protected by preventing U.S. investors from trading foreign issues on major U.S. markets. Retail customers, who trade foreign securities in the illiquid pink sheet market, are forced to pay higher spreads. Institutional investors who go overseas are forced to incur the additional cost of foreign custody and clearance and settlement arrangements.

U.S. regulatory policy should not put U.S. financial markets at a disadvantage. Competitive markets now exist in many foreign financial centers, such as London, Tokyo, Frankfurt, and Paris, and trading can quickly shift to these markets if cost differences exist. Regulations that raise trading costs but serve no valid social purpose need to be eliminated. The committee believes that U.S. GAAP reconciliation requirements exemplify this kind of harmful regulation. It is the committee's hope that the SEC will continue to examine this issue with a view toward eliminating such harmful regulations.

## Statement No. 87

# Rule Proposed by Bank Regulators to Control Interest Rate Risk

September 14, 1992

In August, the federal bank regulatory agencies each proposed rules to implement an important part of Section 305 of the FDIC Improvement Act of 1991. The proposed rule responds to the requirement that risk-based capital standards be revised to account for interest rate risk. The Shadow Financial Regulatory Committee has long argued that interest rate risk should be incorporated into risk-based capital requirements and that its longstanding omission has constituted a serious and undesirable defect (e.g., Statement Nos. 68, February 11, 1991, and 82, February 17, 1992). Thus, the Committee supports actions to correct this failing.

Unfortunately, the proposed rule fails to develop either an effective measure of bank exposure to interest rate risk or an effective framework for managing supervisory responses to limit the risk exposure of the Bank Insurance Fund. The proposed framework needs to be reworked completely before it can be said to control the exposure of the Bank Insurance Fund to interest rate risk.

The proposal notes that the “measurement system is designed to minimize reporting burdens.” In its pursuit of simplicity, the model advanced employs too little relevant information and makes insufficient use of financial theory. As a result, the model fails to fashion a truly meaningful measure of a bank’s exposure to interest rate risk. It is also inferior to the model developed by the Office of Thrift Supervision for measuring interest rate risk for savings and loan associations. Indeed, the bank regulators admit that they “do not intend for it to replace other, more sophisticated procedures that banks may use in their asset and liability management process.”

The proposed system collects data on the dollar amounts of some 20 major asset and liability categories on and off the balance sheet, classified into six maturity of repricing categories. Dollar amounts in each cell are multiplied by corresponding interest-sensitivity weights which represent measures of the time to repricing for each category. Values in each cell are summed to obtain an aggregate difference between risk-weighted assets and liabilities. This difference is divided by total assets to obtain a measure of the bank’s overall interest rate risk (IRR). A deduction, set at 1 percent, from this IRR is then used to generate a percentage of additional tier 1 capital to be required in all cases where the IRR proves greater than one (roughly 20 percent of all banks).

The model is primitive and its assumptions are arbitrary. It focuses on the hypothetical effect of a single 100 basis-point shift upward or downward in interest rates to reserve for a bank’s exposure to interest-rate risk. The single number generated as output by the bank agencies’ model provides banks with little useful information with which to evaluate their exposure to the true range of possible interest-rate changes. In contrast, the OTS model measures the present value of changes in a bank’s capital position for a 100 basis-point change in interest rates, covering a range of 400 basis-point movements in each direction.

The Committee urges that for each bank, regulators establish a reserve for interest-induced losses and gains, to absorb whatever changes in the value of bank capital result from changes in interest rates that actually take place. It is crucial for each bank’s assets

and liabilities to be properly revalued as interest rates change through time and for each bank's capital position to be recalculated to take account of interest-induced gains and losses. Accurately assessing the incremental IRR capital sensitivity to future interest rate movements is of secondary significance to calculating the effect of actual movements on the adequacy of the overall capital ratio, deficiencies in which trigger the FDIC Improvement Act's (FDICIA's) tripwire system of regulatory discipline. If the cumulative effect of actual interest rate movements is neglected, the trigger ratio for a bank will fail to reflect the interest-induced losses it has actually experienced.

The Committee believes that, as proposed, the new interest-rate risk standard would fail to trigger prompt regulatory response to interest-induced losses. By providing taxpayers and regulators a false sense of security, the proposed framework could do more harm than good. The model should be revised to capture the cumulative past effects, as well as the future incremental effects, of interest rate movements. Unless calculations of current capital are tied to market reality, the tripwire system can not provide taxpayers the protections they have been led to expect.

## Statement No. 88

# Proposed Rule on Interbank Exposure

September 14, 1992

The Shadow Financial Regulatory Committee has expressed its concern in past policy statements that the FDIC Improvement Act (FDICIA) grants the bank regulatory agencies excessive discretion with respect to when to trigger prompt corrective action and how to determine the least-cost method of insolvency resolution (Statement No. 76, December 16, 1991). Most worrisome is the discretion to declare a bank a source of systemic risk, which can be used to justify protecting all depositors, including other banks, at institutions the FDIC considers “too important to fail.” This latitude provides the rationale for regulating limits on interbank exposure. The Committee urges the regulators to foreswear the use of this discretion so that such regulations would not be necessary. Indeed, banks whose funds are at risk are, by their very nature, well suited to monitor other banks.

To implement Section 308 of FDICIA, federal bank regulatory agencies have proposed limits, effective at year-end 1992, on a bank’s credit exposure (principally interbank placements, correspondent balances and sales of federal funds) to other banks that are not classified as “well capitalized.” This classification is currently defined as risk-based capital in excess of 10 percent and tier 1 leverage in excess of 5 percent. Banks are restricted to having an exposure of no more than 50 percent of their total capital to banks that are “adequately capitalized” (currently defined as risk-based capital of 8 to 10 percent and tier 1 leverage of 4 to 5 percent) and to having no more than 25 percent of capital to “undercapitalized banks” (less than 8 percent risk-based capital and 4 percent tier 1 leverage). Adequately and undercapitalized banks account for some 10 percent of all banks, holding about 45 percent of total bank assets.

Unfortunately, the proposal specifies these lending restrictions in terms of the book value of a bank’s net worth. The Committee has repeatedly emphasized that to be effective, all restrictions related to capital need to be expressed in terms of the market value of a bank’s net worth.

In general, the proposed regulations do not appear to impose undue burdens on the banks relative to the potential cost savings to the FDIC fund. They also encourage large banks that are not well capitalized to strengthen capital positions in order to maintain their interbank business.

## Statement No. 89

# Standards for Safety and Soundness (Implementation of Section 132 of FDICIA)

September 14, 1992

The Shadow Financial Regulatory Committee endorsed the basic thrust of the FDIC Improvement Act of 1991 (FDICIA) in Statement No. 76, December 16, 1991. Among FDICIA's major components is the requirement of prompt regulatory action keyed to a bank's capital ratio. This provision attempts to limit regulatory forbearance and special treatment for large institutions ("too-big-to-fail"). FDICIA also pushes the banking supervisory process in the direction of greater emphasis on the market value of assets and liabilities, both on and off balance sheet.

FDICIA requires the banking agencies to issue regulations to implement these and other provisions of the statute. Section 132 of FDICIA requires each of the banking agencies to prescribe safety and soundness standards with respect to internal controls and audit, information systems, asset quality, loan documentation, credit underwriting, interest rate risk, asset growth, earnings, executives' and directors' compensation, the ratio of stock market to book value, and such other operational and managerial standards as the agencies determine to be appropriate. These standards must be promulgated by August 1, 1993, and they become effective by December 1, 1993.

The Committee is concerned that implementation of some parts of Section 132 could become unduly costly. Properly implemented, structured intervention and prompt corrective action should make many of the Section 132 provisions unnecessary. Rather than impose strict operating rules on banks, the Committee urges that the agencies seize the opportunity to promulgate standards of behavior that reinforce structured intervention and prompt corrective action.

For example, standards for loan documentation for well-run institutions could be put forward rather than prescribing specific rules for documentation. Violation of these standards would trigger increased supervisory scrutiny which, in turn, might result in requirements for revision in a particular institution's procedures.

Another example is the FDICIA requirement that agencies prescribe standards specifying a minimum ratio of stock market to book value for publicly traded shares. Appropriately construed as a standard that triggers closer supervisory attention, reductions in this ratio should alert the supervisory authorities to information that is not reflected in the book values of an institution's assets or liabilities.

Similar principles could be applied to most of the other components of Section 132. Such a regulatory response would enhance regulatory discretion and enforcement policy without resulting in increased forbearance.

# Statement No. 90

## An Open Letter to President Clinton

December 14, 1992

Despite significant progress in recent years, a number of important financial reforms remain unfinished. With the change of administration, the Shadow Financial Regulatory Committee finds this an opportune moment to identify key areas where early action by the new administration would be highly advisable.

### **1. Clean up past deposit-insurance losses**

The Clinton Administration will inherit a legacy of deposit-insurance losses that are not yet fully recognized or adequately funded. Several actions should be taken to resolve these losses promptly and to prevent them from hindering future budget initiatives.

Sufficient funds must be appropriated and used to clean up book-insolvent savings and loans (S&Ls) already under the control of the Resolution Trust Corporation (RTC). For several months lack of funding has brought the case-resolution efforts of the RTC to a standstill. The longer these insolvencies remain unresolved, the greater the probable cost to taxpayers and the higher the odds that taxpayers will hold the new administration responsible for that cost.

The Clinton Administration should promptly reserve for the threat of deposit insurance losses posed by weak banks and thrifts that at the moment barely pass book-value accounting tests of capital adequacy. Reserves currently posted by the Bank Insurance Fund (BIF) do not adequately recognize BIF's loss exposure in these crippled institutions, and the Savings Association Insurance Fund has yet to post any reserves at all. It would be a mistake to attempt to fund these inherited losses solely from future deposit-insurance-premium income. The required premiums would be so high that they would prove self-defeating; they would increase BIF's future loss exposure and shrink the role of U.S. deposit institutions in the domestic and world economy.

### **2. Put deposit insurance on a sound footing**

The Administration should put the nation's deposit insurance system on a sound long-term footing. The Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 has made real contributions to correcting critical defects in the insurance system that proved so costly during the wave of S&L and bank failures of the last decade. The Act endeavors to minimize losses to the insurance fund and taxpayers by introducing a series of key reforms. These reforms emphasize the role of maintaining adequate bank capital and more timely and extensive agency intervention as capital declines, and reduce the discretion of bank supervisors to delay appropriate corrective actions.



The 1991 Act has already encouraged banks to raise a record amount of capital in the past year. Despite this fine beginning, more remains to be done. Important issues recognized by the law have not yet been satisfactorily addressed by the banking agencies.

Bank reporting and insurance fund accounting must be changed to reflect or disclose market values of assets, liabilities, and net worth rather than values founded on acquisition costs. Failure to do so makes capital ratios into unreliable indicators of economic condition or performance.

Interest rate risk and asset concentration risk must be fully taken into account in setting capital requirements, which at present relate only to rough measures of credit risk. The failure to control interest rate risk played a large role in the S&L debacle of the last decade. The interest rate risk regulations proposed earlier this year are far from adequate for this purpose.

The Act also appropriately requires scaling deposit insurance premiums to the riskiness of the individual bank. But the Committee believes that the range of premiums adopted is too narrow to discourage poorly capitalized banks from assuming excessive risk at the expense of well-capitalized banks.

Last, the Act still permits regulators to cover uninsured depositors at insolvent large banks, considered too big to fail, at the expense of healthy banks and potentially the taxpayer as well.

### **3. Resist pressures to address credit availability problems**

The Administration will be subject to pressures to change bank supervision and regulation to increase the supply of bank lending and to target bank lending to certain sectors of the economy. Both pressures should be resisted.

Available survey evidence does not demonstrate that the recent aggregate decline in bank business lending is the result of a contraction in the supply of credit, rather than the results of a decline in demand for loans. To the extent that some banks have reduced their lending, these appear to have largely been capital-deficient institutions attempting, appropriately, to address their capital inadequacy problems. This is a transitory phenomenon. In the Committee's view, recent changes in bank supervisory attitudes have not caused an aggregate credit crunch.

The Administration should not be tempted to "jump start" the economy by weakening prudential standards. In the long run, such a policy will undermine the health of the U.S. banking system and potentially expose taxpayers to large losses.

For the same reason, the new Administration should not attempt to remedy economic or credit availability problems in favored sectors of the economy by manipulating the weights in the risk-based capital structure.

#### **4. Promote a more competitive financial system**

Changes in technology and the integration of world financial markets have made institutional and geographic restrictions sources of serious competitive distortions. These restrictions should be eliminated, and regulatory reforms should be initiated that will enhance competition among providers of financial services.

The new administration should promote competitiveness and increase the efficiency of financial markets by eliminating all geographic restrictions on financial activities, such as the prohibition on interstate branching.

The Administration should move to eliminate restrictions on the services that financial institutions provide, once deposit insurance reform has been adequately implemented. All financial institutions should be permitted to compete in underwriting securities, providing insurance, distributing mutual funds, offering deposits, and making loans.

The Administration should carefully review regulatory burdens that disadvantage some categories of institutions vis-a-vis their domestic and foreign competitors. These include unnecessary disclosure requirements, intrusive operating stipulations, and programs to force institutions to provide services or credit below cost. In the highly integrated financial markets of today, failure to lighten unnecessary burdens threatens the loss of market share to foreign and domestic competitors.

# Statement No. 91

## Proposed Changes in the FDIC's Risk-Related Premium System

March 1, 1993

In December 1992, the Federal Deposit Insurance Corporation (FDIC) requested comments on proposals to amend the transitional risk-related system of deposit insurance premiums put in place last year. The request raised five specific questions concerning premium structure whether and how:

- (1) to establish a new category of "minimal-risk institutions" that would be charged less than the current minimum of 23¢ per \$100 of deposits;
- (2) to widen the 8-cent spread between the highest and lowest premiums in the system;
- (3) to expand the number of risk categories beyond the nine in the current system;
- (4) the insurance premiums charged by private reinsurers in a reinsurance demonstration project should affect the FDIC's risk category assignments; and
- (5) to increase premiums assessed against lowest-rated institutions that fail to improve their condition promptly.

The Shadow Financial Regulatory Committee believes that each of these actions should be taken. The only question is how.

In principle, the FDIC's risk-measurement and pricing decisions should emulate those of a well-managed private deposit-insurance corporation operating in a competitive market. To evaluate any risk-assessment procedure requires developing and disclosing an information system that measures the loss exposure that is imposed on the Bank Insurance Fund by each risk class it insures. Absent such a system, any premium schedule inevitably will be arbitrary, with some institutions paying more than they should for the risks they pose to the insurer, and others paying less.

The object of risk-related premiums must be to reinforce and refine the risk-control incentives established by the tripwire system of capital discipline under the Federal Deposit Insurance Corporation Improvement Act of 1991. In practice, this means the insurer should seek to earn a zero net return on the business of each risk class. The FDIC should aim to remove from deposit insurance premiums both subsidies for weak entities and penalties for the strong. The number of risk categories, premium spreads across categories, and penalties levied on nonresponsive institutions should all adapt to this purpose.

The Committee urges the FDIC to put its pricing and risk-control systems on a cost basis and to disclose its supporting information and analysis.

## Statement No. 92

# FDIC Action on Critically Undercapitalized Banks

March 1, 1993

On December 19, 1992, the provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) directing the banking supervisory agencies to appoint receivers or conservators for critically undercapitalized banks became effective. Since then relatively few such actions have been reported.

This may be for entirely appropriate reasons. For example, the very favorable interest spreads that prevailed during 1992 improved reported bank earnings and reduced the number of institutions that are critically undercapitalized (with book capital below 2 percent of total assets). Moreover, the existence of a regulatory regime stressing new statutory capital standards has provided a strong spur to banks to improve their capital ratios.

However, the reasons for inaction might be less defensible. The disparities that exist across institutions in specific reserve levels for nonperforming assets could reflect inadequate identification of losses, with resultant meaningful understatement of the number of critically undercapitalized institutions.

FDICIA affords a 90-day period for regulators to take over critically undercapitalized banks. If the agencies determine to take some other action in such cases, FDICIA requires that their reasons be documented. Because the FDIC's actions since December provide the first practical test of FDICIA's requirement for mandatory receivership or conservatorship for such institutions, the public interest would be well served if the agencies were to report on their actions or determinations with respect to all institutions that met this definition at December 19, 1992.

To the extent that some banks that were critically undercapitalized at December 19, 1992, were subsequently able to meet the 2 percent standard because the decline in long-term interest rates yielded them capital gains, the regulators should be very aware that interest rate risk works both ways and poses a danger to the deposit insurance system. While some banks may have won their interest rate gambles, the longer those bets remain on the table, the longer the FDIC is at risk. Critically undercapitalized banks should not be permitted to take such risks.

# Statement No. 93

## Taxpayer Risks in the Pension Benefit Guarantee System

March 1, 1993

Weaknesses in the Pension Benefit Guarantee Corporation (PBGC) have been the subject of recent studies by the Congressional Budget Office (CBO) and the General Accounting Office (GAO) and testimony of several witnesses on February 2, 1993, before Subcommittee on Labor-Management Relations of the House Committee on Education and Labor. The evidence presented suggests that the PBGC is insolvent on a book value basis by about \$2.5 billion and is probably insolvent on a current value basis by as much as \$35 billion. Its exposure in the largest 50 underfunded plans alone amounts to nearly \$30 billion.

GAO indicates that the internal reporting, control, and monitoring systems of the PBGC are so deficient that its operations have been seriously impaired. This means that reliable estimation of taxpayers' loss exposure in the PBGC is not possible.

Many of the incentive and design defects that plagued the FSLIC and FDIC also appear to be at work in the PBGC and threaten the taxpayer with large losses. These include inadequate minimum funding rules for plans (analogous to inadequate capital requirements), low premiums not reliably related to risk, and an implicit taxpayer guarantee of PBGC liabilities. These defects have led to risk shifting behavior that threatens to undermine the system.

Shifting of risks to the PBGC has been observed in many ways and has been initiated by companies with underfunded plans, by labor unions, by creditors, and by the bankruptcy courts. Many companies view their pension funds as cheap sources of debt and have failed to accumulate a "rainy day reserve" for benefits triggered by plant closings and early retirements. Many firms experiencing financial difficulties, including some of the airlines, have successfully pressured their unions for wage concessions that have been partially offset by promised increases in pension benefits. Since many of these pension plans were underfunded, this shifted the pension obligations from the companies to the PBGC. Some companies have depleted their pension reserves while still meeting the minimum Employee Retirement Income Security Act (ERISA) funding standards. Other firms in bankruptcy have stopped making required contributions with the judge's approval. Finally, creditors rarely put pressure on financially troubled companies to fund their plans, relying on optimistic funding assumptions and the expectation that pension claims will have no priority in bankruptcy anyway. Creditors sometimes pressure distressed companies to terminate plans rather than fund them.

Clearly, the problems with the PBGC merit immediate attention by the new administration and the Congress before a significant commitment of taxpayer funds is required. The Committee has not yet developed a detailed set of reforms, but the broad dimensions of reforms necessary to protect taxpayers are clear:

- First, the defects in the structure of the insurance system must be corrected.

- Second, PBGC risk monitoring, accounting and reporting systems need to be put in place that accurately reflect the present value of its insurance liabilities. Moreover, the taxpayers' share of this liability should be recognized on the federal budget.
- Third, the priority of claims of the PBGC against companies in bankruptcy with underfunded plans needs to be modified to prevent the courts from shifting risks to the PBGC.
- Fourth, firms experiencing financial distress or in bankruptcy with underfunded plans must not be permitted to extend additional benefits to plan participants.

Going forward, consideration should be given to requiring that any additional benefits extended by insured plans be fully funded at the time the benefits are made. Finally, all companies with underfunded plans should be placed on a tight timetable to fund their plans fully.

## Statement No. 94

# The Policy of Authorizing “Minimal Documentation” Loans

May 24, 1993

On March 10, 1993, the Clinton Administration outlined a program of regulatory and supervisory changes intended to improve credit availability for small and medium-sized businesses and farms. A central purpose of the program is to boost the speed of macro-economic recovery by discouraging government examiners from penalizing deposit institutions for expanding their exposure to reasonable credit risks.

Parts of the program dealing with real estate lending and collateral, examination procedures, and appeals of examiner decisions are still unfolding. However, on March 30, federal agencies regulating banks and thrifts issued a joint policy statement aimed at streamlining credit-application procedures for designated business and farm loans at strongly capitalized banks. The interagency statement directs examiners to evaluate these loans solely on the basis of *ex post* performance. Also, the documentation of the loans that an eligible institution categorizes as qualifying for the program is virtually exempted from examiner criticism.

To be eligible for the documentation exemption, an institution must have received a CAMEL or MACRO rating of at least 2 at its most recent examination and be officially classified as “well” or “adequately” capitalized. The amount of credit for which an eligible bank claims exemption cannot exceed 20 percent of the bank’s total capital (i.e., the total of tier one and tier two capital). Individual loans are limited to the lesser of \$900,000 or 3 percent of a bank’s total capital.

The Shadow Financial Regulatory Committee has long endorsed the wisdom of subjecting the risk-taking decisions of soundly capitalized deposit institutions to less intense supervisory attention than parallel decisions made at weaker firms. This would free the agencies to assign supervisory resources to more productive uses. It would also promise a reduced supervisory burden for healthy banks to serve as a reward for managers who strengthen their bank’s balance sheet.

For this differential strategy to be pursued safely requires that longstanding weaknesses in supervisory procedures for evaluating the capital adequacy and riskiness of deposit institutions be shored up. The Committee has repeatedly warned that regulators’ current approach to measuring bank and thrift capital is unnecessarily slow to recognize important types of deterioration in an insured institution’s ability to meet its accumulated liabilities from its own resources. Examination infrequency and difficulties in assessing the adequacy of loss reserves cause CAMEL and MACRO ratings to lag behind changes in a bank’s economic strength, while standards used to define adequately capitalized institutions have been far from tight.

The Committee is also concerned that exemptive programs not to be used to subvert the objective of bank examination to uncover and remedy excessive risk-taking and weaknesses in internal controls against managerial fraud, carelessness, and incompetence before they spawn sizable losses. The worrisome aspect of this program is its potential to act as a foot in the door for reducing examiner accountability. Analysis of a business

borrower's managerial capacity, capital, collateral, and potential vulnerability to changing economic conditions is an age-old part of credit analysis. Constraining bank examiners from criticizing particular weaknesses in a designated class of loans could expand to block the flow of important information between on-site examiners and other responsible parties. To protect the federal deposit insurance funds, communication channels between federal examiners and bank officers, boards of directors, and top agency officials should be kept as open as possible.



# Statement No. 95

## “Fair Value” Reporting for Insured Depository Institutions Required Under FDICIA

May 24, 1993

The Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 provides for structured early intervention and resolution of insured depository institutions when their capital declines below specified ratios of their total assets. If effectively implemented, early intervention will result in the FDIC (and, hence, solvent institutions and taxpayers) having to take almost no losses as a result of bank and thrift failures. Implementation, in turn, depends importantly on how capital is measured. For this purpose, capital should be measured and reported in accordance with economic rather than historical-cost accounting values.

FDICIA requires that the federal bank and thrift regulatory agencies develop a method of reporting the estimated “fair value” of the assets and liabilities of insured depository institutions in a supplementary statement. The Committee believes that these estimates are equivalent to estimates of market values, and are feasible and practical.

Furthermore, estimates of economic capital should include valuation of both the liability as well as the asset side of the balance sheet. Hence, we take issue with the Federal Financial Institutions Examination Council’s (FFIEC) proposal to limit fair value reporting to financial assets (as is required by Financial Accounting Standards Board Statement No. 107). This limitation misstates a financial institution’s capital. Neglecting liabilities is particularly perverse when the institution has taken the risk-reducing step of hedging the exposure of asset values to interest-rate changes.

In response to the FFIEC request for comment on disclosure of estimated fair values, the Committee offers the following additional suggestions:

### **Reporting institutions and dates**

Section 112 of FDICIA applies to institutions with \$150 million or more in total assets. The Committee suggests that the regulatory agencies develop a supervisory mechanism to determine fair values of assets and liabilities for smaller institutions. Smaller institutions also can be weak and may fail unless their economic capital is sufficient to absorb losses from their operations. A delay in or exemption from determining fair values would continue the risk that some institutions would be permitted to continue operations despite dangerously low economic capital.

### **Reporting periods**

Fair value estimates should be disclosed with the quarterly call statements. The reporting institutions should be able to provide the required numbers without great expense, and the regulatory agencies should want to learn about changes in the institution’s economic (fair value) capital expeditiously.

**Methods of estimating fair values**

Reporting fair values is not as difficult nor as radical a change as its opponents allege.

1. Many assets, particularly securities, are regularly traded or their prices can be obtained from brokers' quotations. These assets should be valued at their current market price for the quantities that the institution holds as of the report date.
2. Similarly, liabilities that are traded, such as subordinated debentures and marketable CDs, can be valued at their current market prices.
3. Financial assets (such as loans) and liabilities (such as nontraded CDs and savings deposits) not having their own market prices can be valued at market by utilizing the current prices of comparable instruments or by determining market rates of return to discount projected cash flows. Discounting includes calculating the effect of changes in interest rates on fixed interest obligations and estimating the probability that troubled assets (e.g., loans) will not be repaid as promised.
4. The market values of off-balance sheet assets and liabilities can be similarly estimated and recorded.
5. Intangible assets can be valued in a manner similar to that used for tangible assets. For example, mortgage servicing and credit card servicing rights often are bought and sold, and hence can be assigned market values. The intangible asset that measures the value of core deposits can be estimated using well-developed statistical models and current prices.

**Format of reports**

The "fair" or economic values of assets and liabilities, and their difference, capital, should be reported as supplementary information to the institutions' quarterly balance sheets (call statements). If loans and other assets are valued at their economic values, the "reserve for loan losses" can be eliminated. (Under GAAP, this reserve is shown as a deduction against loans and under bank regulatory accounting it is partially added back as an addition to capital.)

The primary purpose of fair value accounting is to provide the supervisory authorities and the public with more meaningful measures of capital. For this reason, it is sufficient that this information be presented in a supplementary statement; the effect of changes in market values need not be reflected directly in the institutions' statements of income and expense.

## Statement No. 96

# Modifying Risk-Based Capital Standards to Account for Interest-Rate Risk

May 24, 1993

The Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 requires the banking regulatory agencies to revise their risk-based capital standards to take adequate account of exposure to interest-rate risk. Final regulations for implementing this provision are required to be published by June 19, 1993. The Act mandates a “reasonable” transition rule to facilitate bank compliance.

Last August, the agencies sought public comment on a proposed framework for including interest-rate risk. In its Statement No. 87 (September 14, 1992), the Shadow Financial Regulatory Committee found the proposal inadequate in four areas:

1. the measurement of interest-rate risk, particularly for Bank Insurance Fund (BIF) insured commercial and savings banks, was poorly constructed;
2. additional capital would be required of only a few “outlier” institutions;
3. the amount of additional capital required was insufficient for the degree of interest-rate risk exposure assumed; and
4. no provision was made for replenishing a bank’s capital depleted as a result of unfavorable interest rate changes once the initial requirement had been established.

The Committee concluded that on balance the proposed regulations would do more harm than good by giving taxpayers and regulators a false sense of security without triggering prompt corrective action on a timely basis. Unfortunately, the Federal Reserve Board’s recently adopted (but not yet published) regulations do not correct these weaknesses in risk and capital measurement.

We applaud permitting banks to use their own internal interest-rate risk models if approved by examiners. But no criteria are provided for determining the adequacy of these models. The banking agencies’ proposed model for commercial and savings banks maintains most of the weaknesses of their earlier model. Many banks would be exempt on the basis of criteria that are neither rationalized nor explained.

Most importantly, the revised proposal fails to provide for replenishing economic capital that is depleted as a result of adverse interest rate changes, but is not captured in accounting measurements. Accountants do not record declines in the market value of the bank’s accounts and equity due to interest rate changes. In addition, the assessment of capital adequacy for interest-rate risk at individual institutions is not quantified. It would be determined in some unspecified manner on a case-by-case basis either in relationship to the institution’s interest rate exposure as measured by a model or as part of a broader set of guidelines used by examiners in evaluating a bank’s overall capital adequacy.

In terms of credit, banks are required to reserve for anticipated loan losses, which reduces their recorded capital and may require replenishment to satisfy regulatory standards. Anticipated losses from interest-rate changes have no recorded effect on capital, however, until realized from the sale of the affected assets or liabilities.

The Committee continues to believe that the proposed interest-rate risk regulations are vastly inadequate to facilitate prompt corrective action and are inconsistent with the intent of FDICIA to minimize losses from bank failures both to the FDIC and to the taxpayer.

## Statement No. 97

# FDIC Pilot Reinsurance Program

May 24, 1993

The Federal Deposit Insurance Corporation (FDIC) is planning a pilot reinsurance program, as required under FDICIA. While FDICIA did not contain specifics for this program, the Congressional objective seems to have been replication in the private sector of functions historically performed by the FDIC itself.

The pricing and underwriting of risk assumed by deposit sureties are central attributes of the deposit insurance function. If done correctly, a pilot program could highlight ways to enhance the efficiency of regulatory processes.

As a first step the FDIC has sought response to a pilot project to ascertain whether premiums that would be charged by private reinsurers should be taken into account in establishing insurance premium classifications. In early 1993, the FDIC announced a pilot reinsurance program that would be a component of a broader examination of the feasibility of private deposit reinsurance. A number of important parameters of the pilot program are left at least partially unspecified.

The reinsurer would assume liability for specific institutions. Pilot reinsurance is to cover “not more than 10 percent of any loss incurred by the FDIC” with respect to an insured depository institution. That institution’s semi-annual deposit insurance assessment would be based on the cost of the private reinsurance. Private reinsurers would be invited to participate for the purpose of deriving market-based deposit reinsurance prices for those institutions the FDIC designates as eligible. Reinsurers would be required to enter into contracts with the FDIC containing terms and conditions of participation. Interested reinsurers would be required to demonstrate that they meet eligibility criteria to be established by the FDIC.

The FDIC intends to place a maximum on the acceptable reinsurance prices for institutions it designates as eligible for the reinsurance pilot program. According to the FDIC, most data necessary for determining reinsurance premiums would be generated based on the quarterly consolidated reports of condition and income and other publicly available information.

The FDIC also raised the possibility of access to examination reports. To the extent that information is withheld by the FDIC or the discovery process (e.g., due diligence) is impeded, the structure of the pilot may make premiums higher than necessary.

The FDIC proposal is deficient in at least four respects.

1. There is no indication of accountability by the FDIC itself for the prompt resolution of bank problems. That is, despite the stipulations of FDICIA, the FDIC has sufficient latitude that it could comprise the interests of a reinsurer by not undertaking prompt remedial action. A reinsurer would have little basis for assessing its exposure to this risk.
2. The proposal denies to reinsurers any right to reprice or cancel coverage prior to the expiration of the reinsurance contract for reasons of adverse disclosure, adverse developments, or (perhaps especially) actions or delays of actions by regulatory authorities contrary to the interests of sureties. Such rights constitute an important form of

discipline on the FDIC. Cancellation of reinsurance contracts by either party should follow private market practices such as consideration and notice. Repricing of reinsurance during the proposed two-year term of the contract would be a reasonable option, given the information asymmetries and uncertainty as to prompt regulatory intervention.

3. While FDICIA does not require regulatory authorities to utilize market valuations in analyzing capital sufficiency, it is unlikely private insurers would fail to do so. Current reports of condition and examination reports are highly deficient in providing these evaluation data. For the market pricing to operate effectively, reinsurers should be permitted to undertake reasonable due diligence reviews.
4. The FDIC requires consent from a surety's primary supervisory agency as to the surety's fitness to participate in the pilot. Since the FDIC is a party to the reinsurance process, however, *its* financial standards, rather than those of the primary supervisor of the reinsurer, should govern the acceptability of a reinsurance company. Such responsibility requires the development of condition measurement criteria beyond those which may be imposed on many prospective reinsurers by their own supervisors.

In summary, privatization of deposit insurance should seek to provide financial market replication of values attaching to a performance guarantee. Successful privatization requires resolution of major problems now afflicting the conduct of federal deposit insurance. Foremost of needed reforms are the valuation in economic terms of entities offering insured deposits, predictable discipline for resolution action, and accountability for results. Without these reforms, the pilot program would be an exercise in futility.

## Statement No. 98

# The New Depositor Preference Legislation

September 20, 1993

A major revision in the priority order in which uninsured claims on failed banks are paid was contained in the Omnibus Budget Reconciliation Act of August 10, 1993. The provision stipulates that claims of depositors at domestic branches of FDIC insured banks (and claims of the FDIC as subrogee after paying off insured deposits) have preference over other claims in distributions from all future receiverships. (Some 30 states have had similar provisions for state chartered banks.)

Previously, domestic depositors had the status of general creditors at failed national banks, the same status as depositors at foreign branches of U.S. banks and other creditors, including sellers of federal funds.

Depositor preference was included in the Act during the legislative process as a replacement for the Administration's proposal to raise additional revenues by charging state-chartered banks for examinations by the FDIC. The Office of Management and Budget estimated that by raising the priority ranking of the FDIC, the depositor preference provision would reduce anticipated FDIC losses by as much as \$1 billion over the next five years. Because the banking provision was a small amendment in a very large and complex nonbanking act, it received relatively little public attention.

Although in the short-run the FDIC could experience smaller losses under the new law, the longer-run dynamic implications are less clear. Because foreign depositors, federal funds sellers, and other creditors are now at greater risk, they may in time be expected to act to protect themselves to a greater extent. For example, foreign depositors and general creditors can

- require collateral, to the extent legally allowed, to secure their extensions of credit
- shorten the maturity of their deposits or obligations, or insert put options which can be exercised when a bank's credit rating is downgraded by a rating agency
- demand higher returns to compensate for higher risk, or cease dealing at all with more risky banks.

Such actions would affect the risk position of the FDIC as insurer. In response, the FDIC could

- redesign its calculation of deposit insurance premiums, to take account of the amount of senior and junior claims as newly defined
- redesign its calculation of capital and capital requirements, for the same reasons
- intervene or close banks more quickly (because of the greater likelihood of runs of federal funds or foreign deposits) or less quickly (because of the greater degree of insolvency necessary to inflict a loss on the insurance funds).

An uninsured claimants, banks, and the FDIC take reactive measures, other consequences may ensue. In banks with extensive federal funds and foreign deposits, the premiums for FDIC insurance will be higher than the risk to the insurance fund. Such

banks would seek to restructure their contractual arrangements and organizations to reduce the implicit tax. And uninsured domestic depositors might be led to shift funds from smaller banks to large money center banks that are seen as safer because they are funded with a greater proportion of subordinated foreign deposits and federal funds.

Moody's has already given formal recognition to some of the implications of the new law by creating a separate rating category for bank obligations to nondomestic depositors and other creditors than for obligations to domestic uninsured depositors. For poorly rated banks, Moody's has assigned a lower rating to these other senior obligations than to uninsured domestic deposits.

The full range of important long-run implications of the new depositor preference provision received little attention in the Congressional hearings, unlike the long and thorough hearings held throughout 1991 for the deposit insurance reform provisions of FDICIA. Although the Committee does not take a stand on the ultimate consequences of the deposit preference provision, it wishes to call attention to the dangers of enacting important legislation in haste on the basis of a consideration of static short-term effects without exploring potential longer-run implications.



## Statement No. 99

### Proposals to Permit Banks to Branch on an Interstate Basis

September 20, 1993

Under present law, interstate banking can be carried on only in a multibank holding company format. Hearings were recently held on three bills that would relax existing interstate branching restrictions. As previously stated (Statement No. 63, National Banking, December 10, 1990), the Shadow Financial Regulatory Committee believes that the prohibitions on interstate branching pose a barrier to the flow of funds within the country. Furthermore, they restrict institutions from adopting efficient forms of operation and pose unnecessary risks to the taxpayer.

Interstate branching has long been advocated on efficiency grounds. More permissive branching policies will enable banks with interstate branches to collect funds from surplus areas and direct them to deficit areas where they have the highest valued uses. Also, there is evidence that branching is often a less costly operational form than a multibank holding company.

Opponents of interstate branching believe that prohibiting this liberalization will increase the funds available in local communities and promote greater bank responsiveness to local customer needs. The validity of this view rests in part on the belief that deposit markets are essentially compartmentalized and local in character and the chief mechanism by which funds are transferred from these local areas is through lenders reallocating funds internally within their organizations.

Deposit markets are no longer compartmentalized and local, however, largely because other effective means exist for collecting customer funds and transferring them to other markets. Interstate branching restrictions can no longer be justified as a mechanism to channel funds forcibly to local borrowers. Instead, they only act to increase the costs of banking services and competitively disadvantage many banks relative to other suppliers of services.

There are also important safety and soundness reasons for preferring that institutions have the option of branching interstate. Geographically diversified institutions tend to be better able to withstand economic downturns, especially when these events are confined to local or regional areas which constitute only a portion of the markets in which they do business.

The experience with failed commercial banks suggests that the Douglas Amendment now subjects the Bank Insurance Fund to unnecessary risks. For example, the cross-guarantee provisions in FIRREA subordinate the FDIC's claims to those of depositors and other creditors when bank holding company subsidiaries experience financial difficulties. This subordination would not occur if the same losses occurred within branches of a single institution.

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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 C. Aspinwall abstained from voting on this statement.

Given the net benefits, and since 49 states have now authorized interstate banking through bank holding companies and savings and loans can branch interstate, the Committee believes there is no basis for maintaining the prohibitions on interstate branching.

## Statement No. 100

# The Proposed Federal Banking Commission

December 13, 1993

The Clinton Administration recently proposed combining the supervisory and regulatory functions of the four federal banking agencies (Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation and Office of Thrift Supervision) into a single Federal Banking Commission. Under the proposal, the Federal Reserve Board would retain responsibility for monetary policy, the payments system, and liquidity. The FDIC's role would generally be limited to insuring deposits and resolving failed and failing banks.

The objectives of the agency restructuring, according to its drafters, are consistency of regulation and implementation, improvement in efficiency, improved accountability and greater independence of regulatory and supervisory actions from political influence.

The Committee believes the proposed restructuring is a step forward in reducing the increased complexity of the depository institution regulatory structure. The current structure is fraught with duplication, imposes unnecessary costs on the industry, has resulted in inconsistent policy, and has permitted the agencies to avoid accountability by diffusing responsibility. In addition, the political independence of the supervision of federally chartered depository institutions has eroded over the past twenty-five years.

Rationalization of the regulatory process has always been frustrated by agency turf battles unrelated to substance. The most vigorous opponents of reform have been the agencies themselves. In particular, the Federal Reserve has claimed that participation in bank supervision and regulation is necessary for it to deal effectively with systemic risk and liquidity crises. The Committee disagrees.

Under the Administration's proposal, the Federal Reserve will have sufficient information, independence, and control to implement monetary policy, and will have the capacity to deal effectively with liquidity crises and systemic risk. The Federal Reserve will retain full access to other agencies' examination reports and will retain its powers with respect to open market operations, reserve requirements, the discount window and payment functions, such as daily overdraft exposure.

A potential objection to the Administration's consolidation proposal is that it may harm consumers of financial services in the long run by limiting the regulatory choice that banks have historically had. In the past this choice has often enhanced market competition and facilitated innovation. While this Committee has been receptive to this view in the past, market evolution has lessened the need for regulatory competition in the banking industry. Today, intense competition between banks and nonbank financial institutions provides ample opportunity for consumers of financial services to reap the full benefits of competition and financial innovation.

While the Committee supports the Administration's proposal as a useful first step, it recommends the following:

- (1) to enhance protection of the deposit insurance fund, the Chairman of the FDIC should be a member of the Commission;
- (2) to enhance the independence of the Commission, the Secretary of the Treasury

should not be a member, nor should the Commission be dominated by ex officio members;

- (3) that any such restructuring should be combined with an agency internal organizational structure that enhances regulatory accountability;
- (4) that supervisory restructuring is not a substitute for the substantive regulatory reform that changes in technology, markets, and social needs demand; and
- (5) that credit unions should be included.

# Statement No. 101

## Safety and Soundness Standards

December 13, 1993

The four federal banking agencies last month issued a proposed rule on safety and soundness standards for insured depository institutions, as required by Section 132 of the FDIC Improvement Act (FDICIA) of 1991. Section 132 was included in the Act largely to supplement the capital standards for prompt corrective action. The standards cover three areas: operations and management; asset quality, earnings and stock valuation; and employee compensation.

Both during consideration of FDICIA by Congress and after its enactment, the banking agencies displayed a marked lack of enthusiasm for the requirement to promulgate standards. The agencies and the banking industry deplored the possible transformation of supervisors into micro-managers of banks as unworkable and counter-productive.

The proposed rule negates that possibility by staying away from detailed or specific requirements, and prescribing the use of common sense and good judgment. Thus, internal controls must be “appropriate,” the internal audit system must be “adequate,” loan documentation should enable an “informed” lending decision, and credit underwriting practices should be “prudent.” There is a prohibition of “unreasonable” or “disproportionate” employee compensation. It is hard to disagree, but it is also hard to find much of operational value in such guidance.

Only in one area—that of asset quality, earnings and stock valuation—is there any use of quantitative standards. The standard for the maximum ratio of classified (substandard and doubtful) assets to total capital plus loan loss reserves is set at the rather generous level of 100%, while the minimum earnings standard is only that one year of losses could be followed by another of the same amount without causing the institution to fail its minimum capital requirements. As for the statutory suggestion of establishing a minimum market value to book value ratio, it is dismissed as not feasible and indeed perverse.

The proposed rule avoids the extreme on one end of micro-management by going generally to the extreme on the other end of vaporousness. Those were never the only two choices. The point is illustrated by the one area (of asset quality and earnings standards) where the rule becomes clearer and more precise. Failure to meet such a standard is not visited with any draconian sanction, but merely becomes a signal of a possible problem, requiring the institution to submit, and the agency to review, a plan that explains and addresses the problem. Similarly, the failure to meet a prescribed minimum ratio (say, 75%) of market-to-book value of stock could have been used as a signal that the agency would undertake to inquire into the reasons that the trading market seriously disagreed with the accounting values shown on the institution’s financial statements.

The point is that clearer standards, rather than confining the discretion of the bank’s management, could be used to clarify the thinking, procedures and responses of the supervisors. Indeed, in the hearings on FDICIA Congress displayed considerable concern with how the supervisory agencies had exercised (or failed to exercise) their power and discretion in the past. That is the issue that the banking agencies could have addressed in their proposed standards. Unfortunately, they have failed to take any advantage of that invitation, and issued instead a proposed rule largely devoid of meaning.

## Statement No. 102

# Deterioration in the Financial Condition of the Pension Benefit Guarantee Corporation

December 13, 1993

On March 1, 1993, the Shadow Financial Regulatory Committee expressed concern about potential taxpayer exposure to the persistent underfunding of the Pension Benefit Guarantee Corporation (PBGC) (Statement No. 93). In that Statement the Committee discussed several design defects in the structure of the PBGC and the pension insurance system that should be remedied. Figures recently released by the PBGC reveal that the PBGC's exposure to potential loss had increased sharply in 1992 to about \$38 billion, despite recent improvements in the economy.

Recent articles in the press incorrectly suggest that changes in the reported obligations of the PBGC reflect only "paper" losses due to declines in interest rates. Furthermore, there is a suggestion that concern over the growing obligations of the PBGC is unnecessary because most companies with underfunded plans will ultimately be able to meet their pension obligations. This view creates a false sense of security. Taxpayer exposure to potential PBGC obligations has clearly increased.

In September of this year, the Clinton Administration put forward proposals to address, at least partially, several of the important causes of the PBGC's problems. These include: increasing the required premiums paid to PBGC by the more severely underfunded plans, limiting the ability of companies with underfunded plans to continue to grant concessions to employees that increase the potential loss exposure of the PBGC, and accelerating company contributions to underfunded plans.

The Committee endorses these proposals and believes that they deserve prompt consideration and action by the Congress.

# Statement No. 103

## Principles of Regulatory Restructuring

February 14, 1994

A number of proposals have been made to reorganize the powers and responsibilities of federal agencies that regulate and supervise depository institutions. As an aid to evaluating these proposals, the Committee recommends that the following policy goals and institutional principles guide any agency restructuring.

### **I. General objectives of the regulatory and supervisory structure**

Restructuring proposals should be judged in terms of the following five objectives:

1. to increase the operational efficiency of financial institutions and regulatory bodies;
2. to improve the efficiency of financial markets in the allocation of resources;
3. to assure ample opportunity for innovation in financial markets;
4. to better control deposit insurance loss exposure; and
5. to make monetary policy more effective.

### **II. Implied principles of supervisory and regulatory structure**

1. Effective regulatory, supervisory, and monetary-policy performance requires that responsible authorities be held accountable for the decisions they make. Accountability is fostered by:
  - a. clarity in goals and policies;
  - b. transparency of policy decisions and the underlying decision criteria;
  - c. consistent application of policies, across institutions and over time;
  - d. insulation of policies from short-term political considerations; and
  - e. the assignment of potentially conflicting goals to separate agencies.Responsibility for monetary policy and prudential regulation should not be lodged in the same supervisory agency.  
Responsibility for approving new institutions and products should be separated from the insurer or guarantor responsibility.
2. Operational efficiency of supervisory authorities is enhanced by simplification of the regulatory and supervisory structure.

# Statement No. 104

## Mutual to Stock Conversions of Thrift Institutions

February 14, 1994

A large number of mutual savings banks and savings and loan associations have recently converted to stock ownership. In some cases, controversy has developed because of the appearance of windfall benefits. As a result, the FDIC has recently proposed new guidelines for this process.

The Shadow Financial Regulatory Committee (SFRC) believes that

- Conversions are desirable
- Windfall gains result from some conversions
- The stakeholders with a claim on these gains include management, depositors and the FDIC
- All rights to purchase the new stock should be transferable
- The FDIC should receive at least 50 percent of the rights, which it would sell in the market.

### **Public Policy Benefits of Conversion**

There are benefits from conversion, particularly for undercapitalized thrift institutions. The capital raised represents a cushion against failure, which provides additional protection for the FDIC. Conversion resolves some incentive problems that may exist when management is not accountable to shareholders. For example, mutual thrift institutions tend to spend above-average amounts on management salaries and perquisites.

### **Stakeholders**

The conversion of adequately capitalized thrifts inevitably raises questions about the distribution of the existing net worth of the institution. Such controversy intensified with the recent conversion of Green Point Savings Bank (NY), where the proposed terms were dramatically changed by order of the State Superintendent of Banking.

The Committee believes there are three plausible stakeholders in the existing net worth: managers, depositors, and the FDIC. The surplus of many institutions has been built up, at least in part, through the efforts and skill of management. It is, therefore, equitable for management to receive some rewards from the conversion. More important, if conversion is to be encouraged, it is necessary that management receive some benefit, since only management can initiate conversion. Also, after converting to stock ownership, management is more exposed to discipline from shareholders. They must be compensated for this reduction in job security.

The depositors' claim is based on the view that they, in some sense, "own" the mutual. This view is not persuasive. Most depositors have received the market rate of interest on their deposits. Moreover, to the extent that the thrift's net worth has been built up over



the years, past depositors, and not just those existing at the time of conversion, have some claim. Assigning large benefits to existing depositors will encourage a flow of speculative deposits to mutual institutions in the hope of a conversion windfall. On the other hand, in many states and under Office of Thrift Supervision guidelines, depositors must approve any conversion plan. Unless depositors are offered a benefit from the conversion, they will have no incentive to vote for conversion.

The Committee believes that the taxpayer, through the FDIC, has the strongest claim on the existing surplus from converting mutual institutions. The taxpayer has taken the risk of loss that is usually borne by the stockholder. The public that had to pay for the losses of failed thrifts should reap some of the benefits that also usually go to the stockholder.

### **Distribution of Rights**

It is difficult to determine how to allocate ownership of the existing surplus of converting institutions. The Committee believes that management should receive rights to about 20–30 percent of the stock offering, depending on the size of the transaction. This is comparable to what managements have typically received in LBO transactions. Since LBOs, by their nature, involve a higher degree of risk, mutual thrift managements should get no more out of the conversion type of reorganization.

Depositors should receive 10–20 percent of the rights. The remainder of the rights to the stock, at least 50 percent, should be allocated to the FDIC for the reasons discussed above.

This allocation of rights will encourage efficiency-promoting conversions to continue, while discouraging conversions whose only motivation is to enrich insiders.

Existing policies designed to protect the rights of depositors, and to prevent against expropriation of the surplus by management, are inadequate. The SFRC believes that the most efficient way of achieving this goal and other goals of the conversion involves the following steps:

1. Distribute rights to buy shares in proportion to the agreed division of the net worth among management, depositors (in proportion to their deposits), and the FDIC. The exercise price of the right times the number of shares to be issued will equal the amount of risk capital going to the new stock company. The appropriate amount should be decided in consultations between management and the relevant regulatory agency.

2. Provide strong incentives to assure that the rights are exercised. To this end it is *essential that the rights be transferable* and saleable in the market. In a well working market each right will command a price which is equal to the difference between the market value of a share and the exercise price. This means that those who do exercise their rights obtain a proportion of the net worth equal to what they were meant to receive.

Those who fail to exercise will lose that opportunity altogether. The value of rights that are unexercised will benefit those who do exercise, assuming that they express their willingness to oversubscribe, as is generally done. Unexercised rights are distributed among those who exercised in proportion to the rights they exercised.

It is obvious that management greatly benefits if a large number of rightholders fail to exercise. To ensure this outcome, management, in the past, has made use of the ruse of making the right *nontransferable*. Such rights are much less likely to be exercised, for many reasons (see Appendix).

## Appendix

Transferable rights can be sold for cash. By contrast, a nontransferable one can only be exercised, which means that the owner must begin by laying out cash, which he or she may not have, to exercise these rights. He or she may not be willing to exercise, since this must normally be done before the price of the stock is known, or can be estimated by a financially unsophisticated depositor, frequently unaccustomed to dealing in stocks. The only information the depositor typically has is the prospectus, which, like that in any securities offering, fully describes the risks that face the firm, and points out all the weaknesses that exist. We have seen no disclosures of the fact that the vast majority of such issues result in large price increases in the first day of trading. As a result, less than 10% of depositors typically exercise their right to purchase stock. This failure, as pointed out above, leaves more valuable rights to management and other insiders.

# Statement No. 105

## Proposed Revisions to Community Reinvestment Regulations

February 14, 1994

### **Background**

To eliminate invidious discrimination in the granting of credit, public policy follows a two-pronged approach. The Equal Credit Opportunity Act (ECOA), applies to all lenders and prohibits discrimination based on factors such as the borrower's race, gender, national origin, marital status, and age. This Act addresses permissible individual lender behavior when considering applications for loans. The Committee fully supports the intent and thrust of ECOA.

The second prong is the Community Reinvestment Act (CRA). CRA addresses presumed de facto discrimination by banks and thrift institutions against borrowers that results from failure to extend credit to residents of low- and moderate-income communities, areas often heavily populated by minorities.

Enforcement of CRA has failed to resolve satisfactorily the concerns of community activists. These critics complain that there are inconsistencies in CRA enforcement and that present regulations overemphasize process and underemphasize performance. Bankers complain that CRA is unclear, examination standards are applied inconsistently, and excessive paperwork is required, resulting in fewer loans, services, and investments. In response to criticisms of CRA, the federal banking agencies have proposed changes. For reasons given below, however, the Committee concludes that CRA should be repealed.

### **Proposed Changes**

The proposed new regulations would require banks and thrifts to report a large amount of data on the number and amount of loan applications, denials, approvals, and purchases by census tract for ten kinds of loans. These include loans to small businesses (divided into four groups by company sales volume), consumer loans, small farm loans, and four groups of residential real estate loans. Independent depository institutions with less than \$250 million in assets could choose not to report the above loan data. Instead, they would be evaluated according to their overall loan-to-deposit ratios, the degree to which they make their loans in their service area, their loan mix (across product lines and income levels of borrowers), their "fair lending" record, and community complaints. Wholesale and limited-purpose banks would be required to invest in community and economic development activities, which may include grants to organizations that promote these activities.

The proposed regulations include extensive discussions of how effective lending territories might be defined, what sort of loans or other services might count as benefiting low- and moderate-income areas and what types of investments would be counted as meeting an institution's CRA obligations (e.g., donation or sale on favorable terms of branches to minority- or women-owned institutions).

Banks and thrifts would be graded according to how well they appear to serve their effective lending territories. Each institution's market share of the ten designated loan categories in the low- and moderate-income communities it services would be compared to its share of such loans in its other service areas and to the distribution of loans by other insured depository institutions. A bank or thrift with "poor" ratios might offset this by making other types of contributions to community activities and groups. An institution's CRA evaluation would be (as it is now) an important and often controlling factor in the banking agencies' review of its applications to establish or close a branch, acquire another institution, etc. Institutions with less than satisfactory ratings would be examined more frequently and might be penalized directly.

### **Recommendation**

The Committee believes that, unlike ECOA, CRA is unnecessary. It is based on the faulty economic premise that funds raised by depository institutions should be employed first in the local communities from which they were generated, rather than where they can be most efficiently invested.

There is little evidence that CRA has had an appreciable impact on credit flows to disadvantaged communities and persons. Rather, it has evolved into a costly and ineffective credit allocation scheme that tends to benefit primarily those vocal special-interest groups capable of extracting concessions from lenders. Past experience has shown credit allocation programs to be expensive to administer, difficult to target, virtually impossible to monitor, and ineffective in helping targeted borrowers.

The complexity of the proposed regulations outlined above demonstrates the inherent difficulty of administering a program that substitutes regulatory directives for individual market decisions by lenders. In attempting to avoid imposing rigid guidelines and rules on financial institutions, federal regulatory agencies have proposed rules that are complex, often subjective, and potentially very costly for larger institutions. Lower direct costs would be imposed on smaller institutions. However, if CRA were truly an antidiscrimination statute rather than a credit-allocation scheme, there would be no justification in exempting independent banks with assets under \$250 million from the reporting requirements applicable to larger banks.

The Committee believes that the problems of inner cities are serious; they are, however, at most, only slightly due to a shortage of credit to qualified households and businesses. Programs are needed that directly target these problems, especially joblessness, crime, schooling, and inadequate economic development. These programs should be expressly funded on federal, state, and local budgets, so that taxpayers can monitor them and determine returns for effort and resources expended. For the reasons enumerated, the Committee concludes that CRA should be repealed.

At the same time, ECOA should be vigorously enforced. The regulatory agencies should foster a sympathetic environment where individuals who believe they have been unfairly discriminated against can seek agency help. The agencies should investigate all consumer complaints carefully and quickly. Lenders who discriminate invidiously should be prosecuted.

# Statement No. 106

## Proposed Lengthening of Examination Schedules and Required Independent Audits for Thrift Institutions

May 23, 1994

Two separate developments threaten the quality and quantity of information available to monitor the financial condition of insured depository institutions. First, a provision of the Community Development Bank Act would lengthen the maximum time between bank examinations from 12 to 18 months for banks with assets less than \$250 million. Second, the Office of Thrift Supervision (OTS) has published a proposed rule which would eliminate the mandatory audit requirements for thrift institutions with assets less than \$500 million.

### **Regulatory examinations**

Effective implementation of the prompt corrective action and least cost resolution provisions of FDIC Improvement Act of 1991 requires accurate measurement of institutions' net worth. Absent a well functioning market valuation system to measure net worth and to monitor its changes, the Committee is concerned about the availability of sufficient and timely information—especially on the adequacy of loan loss reserves and nonperforming (or classified) assets that are a principal focus of the examination process. This information has proved to be important in identifying emerging problems in insured depository institutions and in reducing losses to the insurance funds.

For this reason, the Committee believes that the setting of examination frequency should be based upon a comparison of the costs of gathering examination data more frequently with the expected loss to the insurance fund resulting from a rapid decline in an institution's net worth. Indeed, agency spokespersons have frequently asserted that bank asset values can change abruptly, which would argue for a shorter, rather than a longer cycle. Some evidence suggests that losses to the insurance funds are lower for institutions examined on a yearly, as opposed to a longer, cycle. The frequency of examinations should not be reduced until evidence is provided on the effects of a proposed change on expected losses to the insurance fund.

### **Independent audits**

OTS justifies its proposed elimination of an independent audit requirement for small S&Ls on the grounds that small banks are not required to have independent audits. However, in this case the Committee believes that consistency would be better achieved by requiring independent audits of all commercial banks, as the Committee recommended in 1989 (Policy Statement 83, May 15, 1989).

Independent audits by outside certified public accountants (CPAs) play an important role for smaller institutions and for those whose shares are not publicly traded. Such institutions are less likely to have a sophisticated internal audit function in place and are less likely to have a highly knowledgeable and independent board of directors' audit committee.

Independent audits supplement examinations in important ways. They provide at least a partial "second opinion" on the asset valuation techniques employed by examiners. Both examiners and CPAs do consider the adequacy of internal controls in banks they examine. But examiners have stressed that they are not conducting an audit, and they do not conduct an in-depth search for fraud. Nevertheless, outside CPAs have often uncovered fraud in the course of their audits. In view of the attention that fraud has received as a source of insurance fund losses during the 1980s, it seems inappropriate to eliminate this protection. This becomes all the more important if the interval between examinations increases. Fraud and misappropriation of resources are much more likely to cause the failure of a small institution than a large one.

The independent auditor is responsible for seeing that an institution's financial statements conform to generally accepted accounting principles (GAAP). Although GAAP practices do not report market values (in particular, the effect of interest rate changes on the value of loans is not recorded), they do provide numbers that give insight into an institution's operations and financial position.

Finally, the requirement for a mandatory audit helps to counter certain conflicts of interest within an institution. Directors, for example, may be reluctant to push management for an independent audit for fear of jeopardizing their positions on the board.

The Committee recognizes that an audit of the financial statements and internal controls imposes a cost of doing business for a bank, as it is for other corporations to which the public has entrusted its funds. However, in the absence of an independent audit, the cost would be borne by the examiners and the insurance fund.

Statement No. 107  
Federal Displacement of State Laws: Fair Credit  
Reporting and Interstate Branching

May 23, 1994

Financial services in the United States are increasingly being offered on an integrated national scale. This is a result of both technological and economic changes. This trend raises conflicts between federal and state regulation. The Shadow Financial Regulatory Committee is concerned that local regulations could impede the efficient delivery of some financial services. In some cases, state and local laws should be replaced by federal law.

Recent developments have made this a matter of current concern in two matters currently before the Congress: amendments to the Fair Credit Reporting Act, and interstate branching.

**Fair Credit Reporting Act**

The availability nationwide of accurate information about potential borrowers facilitates the availability of credit at low cost to consumers. The U.S. credit reporting industry has made considerable progress in improving the timeliness and accuracy of the information in the files of the credit bureaus. But errors do occur, and some consumers complain of difficulties in correcting errors. The consent decree recently worked out among the Federal Trade Commission and the credit bureaus, and the current legislative amendments, seem to resolve most issues in a manner acceptable both to consumer groups and the industry.

One remaining issue is the diversity of state fair credit reporting laws. Many existing and proposed state laws are inconsistent with each other and with the federal law. Most of the state laws do not reflect differences in regulatory philosophy, but represent differences in process and procedures that add to costs without significantly improving consumer protection.

The credit information business and the business of extending consumer credit are national in scope. Three credit bureaus operating on a national basis provide nearly all of the credit reports relied on by lenders. The major credit card issuers operate on an interstate or national basis. Although these businesses clearly involve interstate commerce, Congress has generally allowed the individual states to enact their own laws to define rules governing commercial transactions. In a number of cases, however, there has been a federal preemption of state laws in order to reduce the costs of duplication and inconsistency or to achieve a federal purpose.

The Committee believes that the amended Fair Credit Reporting Act now being considered by Congress should set a uniform national standard.

**Interstate branching**

It appears that Congress will soon enact legislation that will allow interstate branching. There are substantial benefits to the public from interstate branching, as discussed in the

Committee's Policy Statement 63 (December 10, 1990). The likelihood of imminent interstate branching calls for a reassessment of existing law with respect to the application of state law and regulation to the branches of out-of-state banks. Examples of such state laws relate to loan collateralization, usury ceilings, powers, community reinvestment, and taxation.



## Statement No. 108

# Proposed Increases in FHA Insurance Limits

May 23, 1994

The Federal Housing Administration (FHA) has proposed that the maximum size of the mortgage loans it can insure be increased from \$152,000 to \$173,000. The federal mortgage insurance program administered by the FHA was created to facilitate home ownership by Americans with moderate incomes, who did not have the cash available to meet the down-payment requirements on conventional loans. When FHA began operations, private mortgage insurance did not exist, lenders were generally unwilling to make loans without sizable down-payments, and secondary market institutions such as Fannie Mae and Freddie Mac did not exist.

The Shadow Financial Regulatory Committee questions the extent to which the federal government should attempt to promote home ownership. Regardless of one's views on that broad public policy issue, the economic evidence indicates that reducing the cost of mortgage credit is an inefficient means of encouraging home ownership. The benefits are hard to target and it is not clear that the supply of *housing* (as distinct from mortgage credit) has been affected significantly. However, even if government mortgage insurance has been effective in the past in making home ownership feasible for middle-income Americans, there is little justification for an increase in the size limit on FHA loans.

The proposed \$173,000 limit would be 85 percent of the maximum size of mortgage that can be sold to Fannie Mae and Freddie Mac. That maximum (now \$203,000) has been raised regularly. Future increases in that limit would result in further increases in the FHA ceiling.

Normally, borrowers who can obtain mortgages as high as \$170,000 are those with incomes of over \$70,000. There is certainly no justification for mortgage finance programs aimed at the upper 15 percent of the income distribution. The private financial markets of the U.S. are very well able to provide credit for these people. In fact, the proposal by the FHA seems aimed more at increasing FHA's market share in the mortgage insurance business, at the expense of the private mortgage insurers, than in accomplishing any relevant social goals. For similar reasons, the Committee would also oppose any further increase in the maximum loan size that can be purchased by the government-sponsored secondary market entities.

Private mortgage insurance is now widely available. The Committee sees no reason why the federal taxpayer should take on the risks of insuring mortgages that the stockholders of private mortgage insurers are willing and able to assume. Moreover, lenders now offer conventional loans with very low down payments.

# Statement No. 109

## Financial Accounting Standard 115

May 23, 1994

Some banking representatives are campaigning to keep the market value requirements of FAS 115 from affecting the determination of bank capital ratios for purposes of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

The Shadow Financial Regulatory Committee views this campaign as part of a general effort to thwart the mandatory prompt corrective action provisions of FDICIA. Banking regulatory agencies demonstrated in the 1980s a general lack of political will to face up to widespread problems, so legislation to reduce discretion and mandate agency action was deemed desirable. The Committee continues to endorse that judgment.

FAS 115 requires banks to divide their securities portfolios into three categories—trading account, available for sale, and held to maturity—and applies different accounting rules to each. Securities held in trading accounts must be marked to market, and unrealized gains and losses are recorded in the institution's income statement and then flowed through to the capital account. Securities held for sale must be marked to market with unrealized gains and losses passed through directly to the capital account. Securities held to maturity are not marked to market but are valued at amortized historical cost; unrealized market gains and losses are not recorded at all.

The stated concern of some bankers is that, under a pending regulatory proposal, loss of value from interest rate increases in securities held for trade or sale would cause a number of banks to fall to a lower Tier 1 capital ratio category. Under FDICIA, this should trigger more stringent supervisory intervention, and even supervisory takeover if equity capital fell to as little as 2 percent.

The Committee believes the FAS 115 is open to valid criticism, for example on the grounds that it ignores loss of value in securities being held to maturity and applies to only one part of one side of the balance sheet. But that is no reason to undercut what it does accomplish, which is at least partial recognition of changes in the bank's economic capital.

Federal Reserve Board Chairman Greenspan has referred to such changes in a bank's economic capital as "short-run effects." The Committee regards the assumption of quickly self-reversing interest rate changes as imprudent. Any interest rate shift may reverse, go further, or be stable for a significant period of time. A bank should have sufficient capital to deal with all these contingencies, not just the most favorable one.

The Committee supports adoption of the pending regulatory proposal to reflect FAS 115-required changes in Tier 1 bank capital for purposes of prompt corrective action. The Committee also hopes that this proves a step toward a broader use of mark-to-market valuation.

## Statement No. 110

# Final Rules on Incorporating Concentrations of Credit Risks Into Risk-Based Capital Standards

September 26, 1994

The federal banking agencies and the Office of Thrift Supervision recently promulgated a final rule implementing the requirement of Section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). This rule requires that the risks from credit concentration be incorporated into the risk-based capital standards. The method adopted relies upon examiner discretion to consider these risks subjectively rather than upon specification of numerical risk weights that would parallel the Basle approach to credit risk.

Two reasons are advanced for taking a discretionary approach.<sup>1</sup> The first is that current methods for identifying and measuring concentration risks are not sufficiently advanced to justify their use. The second is that sufficient data for estimating risk weights are not available.

Whatever the merits of these problems, the Shadow Financial Regulatory Committee believes that the proposed reliance upon examiner discretion should be, at best, an expedient and temporary solution. It should not be a permanent substitute for a more considered approach to encouraging adequate diversification—the obverse of concentration—for insured institutions.

At a certain level of abstraction, risk should be defined in terms of the expected covariances of cash flows across assets and liabilities. Unfortunately, as mentioned previously, the current lack of adequate historical data on asset returns, loss experience and liability costs make development of reliable risk weights impossible. Several alternatives could and should be explored over time, which might reduce examiner discretion and make the implementation of concentration guidelines more transparent and replicatable.

The agencies should continue to research the feasibility of measuring covariance effects using samples of assets and liabilities and their performance. At the same time, interim measures of asset risk concentrations should be explored on the basis of existing available asset and liability categories to aid in the identification of potential problems within institutions. Finally, methods for determining the vulnerability of an institution's capital to alternative adverse shocks to its loans, in particular lines of business or within specific geographic areas—so called stress tests—should be further developed as tools for examiners.

The problem of ensuring adequate diversification raises different, but important, issues for large banks than for small banks. For large banks the issues center primarily on devising methods to measure and economically monitor the effects of concentration on an institution's net worth.

For smaller banks, whose business is almost by definition concentrated, the problem is not one of measuring diversification but devising methods to encourage diversification. This need exposes fundamental conflicts between taxpayers' interests in ensuring bank

<sup>1</sup>The rule also treats the risks of new activities in the same way but provides little discussion in its accompanying statement.

safety and soundness and other public policies designed expressly to promote asset and geographic concentrations to achieve what are apparently viewed as socially desirable allocations of credit, such as the Community Reinvestment Act, the Qualified Thrift Lender test, and the remaining limitations on interstate banking. Legislated mandates to serve “local” communities can prevent diversification and impose unrecognized costs, which can extend beyond bank stockholders to the taxpayer in the event of failure. Such exposures need to be measured and managed explicitly.

# Statement No. 111

## The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994

September 26, 1994

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (IBBEA) removes two longstanding impediments to the efficient evolution of the U.S. financial system. The Act breaks a federal logjam on interstate banking and branching. After a one-year transition period, IBBEA effectively repeals the Douglas amendment to the Bank Holding Company Act, which was intended as a barrier to interstate acquisitions of banks by bank holding companies. Effective June 1997, restrictions will disappear on consolidations of affiliated or newly-acquired banks in other states into branch offices of a single bank, except in states that pass legislation specifically opting out of this provision. However, interstate operations by means of de novo bank branching must be expressly authorized by individual states.

Geographic and product-line impediments to efficiency throughout financial markets have been concerns of the Shadow Financial Regulatory Committee. While the Committee applauds the relaxation of geographic restrictions on banks, important other obstacles continue to hinder the ability of U.S. financial institutions to adapt efficiently to technological change and new competition. Prominent examples include various constraints on securities and insurance activities of banks.

The Committee continues to urge the removal of all turf-protecting restricting restrictions on the particular services that various classes of financial institutions can provide. Without these fetters, user needs and preferences would be able to shape more effectively the product lines and geographic reach of competing entities. Supervisory and regulatory resources now devoted to enforcing unnecessary restrictions would be freed to concentrate on the public-interest goals financial regulation is expected to achieve. These goals may be summarized as the enhancement of economic growth, efficiency, stability, and fairness while minimizing abuses and the bailout risks and costs that regulatory and supervisory decisions in the past have shifted to taxpayers.

IBBEA appears to acknowledge the importance to the remaining impediments. The Act directs the Secretary of the Treasury, in consultation with other financial regulatory agencies and also with a new advisory commission, to undertake and complete within 15 months a study of the strengths and weaknesses of the U.S. financial services system.

The Committee hopes this study will be treated by those involved as one of the most important parts of IBBEA. The study should cover the full range of financial institutions and markets and treat the competitiveness of these entities in a global context. In addition to assessing the rules of private financial competition, the study must address two key issues of regulatory oversight.

First, clear-cut responsibility must be established for achieving the expressed goals of regulation. Decisions made by officials must be made more responsive to broad societal goals and less responsive to pressures exerted by narrow sectoral interests.

Second, taxpayers and markets must be given information by which to assess the true quality of regulatory performance. Regulators must reveal, on a timely basis, better information about what they do and why they do it. Such disclosure requirements are needed to assure effective outside monitoring.

## Statement No. 112

# Regulatory Agency Measurement of Bank Capital for Prompt Corrective Action

December 12, 1994

The bank regulatory agencies recently ruled that banks need not include changes in the market value of their securities held-for-sale in calculating their regulatory capital position. By contrast, the Financial Accounting Standards Board (FASB) has required in its Statement 115 that securities classified as being available-for-sale be marked to market. In the absence of the agencies' ruling, therefore, banks would have been required to include unrealized gains and losses in their available-for-sale portfolios in the calculation of their regulatory (Tier 1) capital. Furthermore, Statement 115 requires companies to disclose the market value of securities that they presumably will hold to maturity. These reported changes could (and should) also enter into the calculation of regulatory capital.

The Shadow Financial Regulatory Committee believes that the accounting treatment of available-for-sale securities by the agencies is dangerous. The primary role of bank capital is to absorb losses before they endanger the par value of deposits. Losses, whether realized or not, reduce the availability of capital to protect depositors. Failure to require an accurate measure of capital for purposes of prompt corrective action weakens the effectiveness of such measures and increases the probability of bank failures, with potential attendant losses to the deposit insurance fund.

The regulators supported their ruling by arguing that most decreases in the market value of debt securities are due to increases in interest rates, which, they presume, are only temporary and likely to be reversed. Thus, they argue, the use of market value accounting introduces "significant and unnecessary" volatility in the measurement of bank capital. The Committee believes that the proposed regulatory accounting treatment of securities portfolios does nothing to eliminate the true underlying volatility in the portfolio. Rather, it represents a type of forbearance reminiscent of similar arguments that were made by the regulators in the early 1980s as justification for refusing to require a rebuilding of capital by much of the savings and loan industry, whose economic capital had been effectively wiped out by a sharp rise in interest rates. This forbearance contributed to the eventual \$150 billion loss to the former Federal Savings and Loan Insurance Corporation (FSLIC) that had to be paid by the taxpayers. It should now be obvious that regulators have no greater insights into future rate movements than other market participants.

Some regulators also argue that marking only part of one side of the balance sheet to market is inappropriate and misleading. The Committee agrees and believes that all assets and liabilities should be marked to market and that marking securities available-for-sale to market represents a useful step.

## Statement No. 113

# Proposed Community Reinvestment Act Regulations

December 12, 1994

On September 26, 1994 the federal banking regulatory agencies proposed a new Community Reinvestment Act Regulations, 12 CFR Parts 25, 228, 345, and 563e. The proposal implements a 1993 Presidential request to “replace paperwork and uncertainty with greater performance, clarity, and objectivity.” The proposed regulations introduce new reporting requirements and three tests for compliance under the Act. Reporting coverage, while supposedly streamlined, was actually expanded to include loans to small businesses owned by minorities and women. The tests consist of a lending test, an investment test, and a service test.

1. The lending test focuses on ratios of lending activity in a “geography,” particularly the ratios of loans to high-income borrowers versus low- and moderate-income borrowers, and an unspecified, unclear comparison of these ratios with those of other institutions.
2. The investment test turns on “qualified” investments in various kinds of business agencies, foundations, and institutions involved in community development, including grants to such entities that presumably would be compared with unspecified norms.
3. The service test requires the evaluation of an institution’s record of providing services through branches, ATMs, and “alternative systems” that might limit or expand service to low- and moderate-income “geographies” and persons.

What began in 1977 as a Congressional response to allegations that depository institutions were redlining neighborhoods undergoing change has grown to more detailed and extensive reporting requirements. The agencies charged with enforcing and evaluating these requirements have created bureaucratic structures involving extensive costs in agency personnel, reporting costs to regulated institutions, and even micromanagement of financial institutions. The proposed amendments are likely to increase these costs significantly, with few if any additional benefits to the communities that are supposed to be helped.

The Committee continues to question the value of the Community Reinvestment Act itself. The Act is predicated on the undemonstrated assumption that the banking and thrift industry has failed to deliver adequate credit services in certain urban neighborhoods, and the belief that significant improvement can result from supervisory pressures. No credible evidence has been published demonstrating the validity of the assumed credit failure. Financial market evolution over the past 25 years has eroded materially any market monopoly advantage that banks and thrifts once might have enjoyed. Other providers of credit, such as mortgage companies, credit unions, and finance companies, continue to increase their share of the market at the expense of banks and thrifts. In addition, recently enacted legislative changes that allow interstate banking and encourage intrastate branching should speed entry into any markets that might presently be inadequately served.

The proposed changes will not reduce the compliance burden on depository institutions, as was requested by the President. Like truth-in-lending, CRA has taken on a life of its own, resulting in ever increasing costs and regulatory micromanagement. Moreover, the Committee believes that the Equal Credit Opportunity Act and the Fair Housing Act adequately protect the public from impermissible lending discrimination.

In addition, the Committee deplores the cynical legislative strategy of the banking and thrift industries in suggesting that the Community Reinvestment Act be extended to credit unions, mutual funds and other competitors—a strategy intended only to bring in more opposition to CRA itself. Congress should reassess the Community Reinvestment Act, including its need, effectiveness, and cost, especially in view of the changes in financial markets that have occurred over the past 20 years. We believe this reassessment will lead the Congress to conclude, as did the Committee in its Statement Number 105 (February 14, 1994), that the Community Reinvestment Act should be repealed.



## Statement No. 114

# FDIC Insurance Assessments

December 12, 1994

Under current law the FDIC may reduce the rate of deposit insurance premiums when the insurance fund exceeds 1.25 percent of insured deposits. It is expected that the Bank Insurance Fund (BIF) will reach that level in 1995, while the Savings Association Insurance Fund (SAIF) will not reach the 1.25 percent target for at least several more years. Therefore, as early as next July, banks may be assessed deposit insurance premiums as much as 25 basis points lower than those paid by thrift institutions having equal risk.

Current deposit insurance premiums serve three purposes: to cover administrative expenses; to build up a reserve against predictable exposure to future deposit insurance losses; and to pay for an assigned portion of past deposit insurance losses.

With respect to prospective insurance risk, the Committee believes that premiums should be equal for all institutions that pose equal risks, regardless of their charter status. Premiums should cover all losses without the need for support from the taxpayer. The Committee believes that the reforms of FDICIA, if they were to be appropriately extended and administered so as to reduce losses to the FDIC, would permit a premium structure significantly lower than that currently in effect. Required reforms include substantial minimum capital requirements, market value reporting, and prompt corrective action. With respect to defraying past losses, Congress has already determined that the thrift industry should bear a portion of the burden it has imposed on the taxpayer and that share has been set as the cost of servicing the FICO bonds. The Committee believes it is appropriate for the industry to bear these costs; this has the desirable effect of reducing industry incentives to manipulate the regulatory process in the future.

Policy makers must recognize, however, that insistence upon enforcing loss sharing requirements may conflict with the objectives of enabling thrift institutions to reduce risk through diversification by adopting, for example, a commercial bank charter. Congress should consider lifting its moratorium on thrift charter conversions in order to promote a more efficient financial structure for thrift institutions. One way to achieve this objective while not totally abandoning its loss sharing requirement would be for Congress to impose a conversion fee for a thrift that would be less than the present value of its pro rata share of its FICO obligation.

# Statement No. 115

## Repeal of the Bank Holding Company Act and Restrictions on Product Diversification for Banking Organizations

December 12, 1994

The Office of the Comptroller of the Currency (OCC) recently proposed steps to lighten the regulatory burden on subsidiaries of national banks. Specifically, the OCC suggested that an expedited application review process be put in place and that consideration be given to expanding permissible activities for subsidiaries of national banks. The Shadow Financial Regulatory Committee applauds this initiative and sees it as bringing us closer to eliminating the need for regulating the activities of banking organizations under the Bank Holding Company Act.

Historically, the restrictions in the Bank Holding Company Act were rooted in populist fears about concentrating power in the hands of a few large conglomerate firms, as typified by the proposed combination of Transamerica Corp. and Bank of America. In 1956, legislation addressed concerns about interstate combinations of banking organizations and combinations of industrial enterprises and multibank holding companies. The 1970 amendments to the Act brought one-bank holding companies under regulation and extended the Federal Reserve Board's responsibility for deciding what activities were appropriate for corporate owners of commercial banks to undertake. In these decisions, the Fed is required both to determine that proposed activities are so closely related to banking as to be a proper incident thereto, and to consider how these activities affect bank risk exposure.

In recent decades, bank holding companies have been induced to try to expand into an increasingly wide array of previously precluded activities, including issuance of securities and insurance products. At the same time, nonfinancial and nonbank financial firms have developed subsidiaries and affiliates whose products closely substitute for bank loans and deposits. Industrial companies have been permitted to operate federally insured thrift institutions. Additionally, as a result of state actions and Congressional actions, restrictions on interstate banking have been eliminated.

Fears of inappropriate risk-taking by insured depository institutions are now addressed squarely and more appropriately by the FDIC Improvement Act (FDICIA) of 1991. FDICIA mandates risk-adjusted deposit insurance premiums and prompt corrective supervisory discipline, keyed to the adequacy of a bank's capital. These mandates have supported significant improvement in the capital positions of banking organizations and help to insulate the taxpayer from risks that either new product lines or affiliations between banking and commercial firms may entail.

Requiring supervisory intervention into the affairs of undercapitalized institutions makes risks to capital from new activities a principal focus of banking supervisors. As long as supervisors strive to force recapitalization before net worth can go to zero, the risks to taxpayers from banks affiliating with firms engaged in nontraditional banking or commercial activities are not qualitatively different from traditional activities provided they can be adequately monitored.

The Bank Holding Company Act has outlived its usefulness. Banking organizations now operate nationwide and have diverse product lines. Market power associated with this expansion is constrained by nonbank competitors. Banks now compete with securities firms, financial subsidiaries of industrial firms, communications companies, and data processors. There is no longer any substantial reason to regulate the corporate ownership of banks or the activities in which these owners can engage.

## Statement No. 116

# Open Letter on Financial Reform to the Senate and House Banking Committees

February 13, 1995

Historically, Congress has tended to approach issues of financial structure in a piecemeal fashion, usually in response to a crisis in a particular sector of the financial system or to financial innovations. As a result, a complex, confusing and, at times, contradictory code of law and regulations has evolved. Administration of this system is fragmented. Consequently, the current regulatory system is costly and occasionally has been disruptive, with sometimes unintended consequences for financial institutions and the taxpayer. The efficacy of the existing structure and the effects that an evolving market place have had on institutions need to be evaluated anew.

Legislative initiatives have been introduced by the new Congress to modernize the financial system and will be debated in the coming months. The most important and pressing of these initiatives concerns the range of permissible powers for insured depository institutions and issues of their affiliations with nonfinancial institutions. The Committee believes that most restrictions on permissible activities (such as insurance and securities) and restrictions on affiliations among banks and nonbanking firms should be removed. To prevent this from imposing additional risks on the taxpayer and bank insurance funds, prudential protections in FDICIA 1991 should be strengthened, and Congress should expand its ability to monitor the performance of the federal banking agencies to ensure enforcement of the relevant sections of FDICIA 1991.

### **A. Restrictions on affiliations and permissible banking organization activities**

The 1933 Glass-Steagall Act restricts the extent to which banking firms can engage in securities activities and limits securities firms' ability to take deposits and affiliate with banking organizations. Removing the restrictions would improve the efficiency of markets and reduce costs to customers.<sup>1</sup>

The Bank Holding Company Act of 1956, and its amendments of 1970, limit combinations of banks with financial and nonfinancial companies. Part of the rationale for these Acts was fear of concentration of economic power and concern for undue risk exposure of insured depository institutions.<sup>2</sup> These concerns have been eliminated by increased competition and the threat of new entry by foreign and domestic banking and nonbanking organizations. Moreover, any residual risks can be potentially controlled within the existing supervisory structure.

Provisions of both the National Banking Act and Bank Holding Company Act unduly restrict permissible insurance sales. Synergies and risk reducing potential have been demonstrated to exist, and there is no evidence that coercive tying in the sale of insurance is an important problem. Therefore, the restrictions on insurance activities should be removed.

<sup>1</sup>See Statement No. 56 (November 17, 1986).

<sup>2</sup>See Statement No. 115 (December 12, 1994).

## **B. Strengthening FDICIA 1991 and improving congressional monitoring of agency performance**

Fears of undue risk taking by insured depository institutions can now be addressed within the structure of the prompt corrective action and least cost resolution provisions of FDICIA. FDICIA institutes procedures that can effectively insulate the taxpayer and insurance funds from undue risk. Under FDICIA, as an institution's net worth declines, the regulatory agencies are asked to follow specific supervisory procedures and to close capital deficient institutions before capital goes to zero. If the agencies act as directed, safety and soundness concerns no longer justify maintaining restrictions on bank activities.

Additional initiatives can enhance the effectiveness of FDICIA 1991. First, reliance upon market value, instead of the book value of net worth, should be expanded and linked to FDICIA's prompt corrective action and early intervention requirements.

Second, to ensure the long-term efficiency of federal banking regulation and to prevent unwarranted expansion of the federal safety net, the Committee believes that Congress must set up an explicit and multidimensional system for monitoring regulatory agency performance. Regulators are inadequately accountable for meeting FDICIA's requirements for prompt corrective action, least-cost insolvency resolution, risk sensitive deposit insurance pricing, and expanded use of market value accounting. The need for vigilant oversight is highlighted by a recent report by the FDIC Inspector General which indicates that the prompt correction action provisions of FDICIA were not always initiated by the FDIC in a timely fashion.<sup>3</sup>

Effective Congressional and public oversight of agency performance requires unambiguous statements of agency goals and transparency of decisions and underlying decision criteria. Regulatory agency performance will be enhanced by ensuring that all decisions and the reasons for them are made publicly available promptly.

## **C. Equal Credit Opportunity Act and Community Reinvestment Act**

The Committee clearly distinguishes between two different Acts with different approaches to enforcement of civil rights laws affecting financial services. The Equal Credit Opportunity Act is designed to ensure each individual equal access to financial services on a nondiscriminatory basis. The Committee strongly supports the goal of this Act. However, the Committee also concludes that the second approach, as embodied in the Community Reinvestment Act, is based upon the faulty economic premise that funds raised by depository institutions should be employed first in the communities from which they were raised, rather than where they can be most productively invested. This Act has degenerated into a costly credit allocation scheme. No evidence suggests that CRA has appreciably improved credit flows to low and moderate income areas. For these reasons, CRA should be repealed. Better and less costly ways are available to channel funds to

<sup>3</sup>See Audit of FDIC's Implementation of the Prompt Corrective Action Provisions of FDICIA, Report of the FDIC Inspector General, Sept. 23, 1994.

socially desirable purposes. The best alternative is to transfer resources directly to address the long-term problems of inner cities. Such programs should be expressly funded in federal, state, and local budgets, so that taxpayers can monitor their costs and assess their effectiveness.<sup>4</sup>

### **Burdensome regulations**

Other proposals on the legislative agenda address regulations which impose inefficiencies and large and unnecessary costs on institutions and customers relative to their benefits. These include: the Truth-in-Lending Act, Truth-in-Savings Act, Real Estate Settlement Procedures Act, and the Home Mortgage Disclosure Act. These laws have resulted in either costly litigation and/or large compliance costs. Although lower in priority, these Acts are worthy of reevaluation and examination of their benefits relative to their costs.

Mr. Hawke did not participate in the discussion, formulation, or preparation of this statement.

<sup>4</sup>See Statements No. 105 (February 14, 1994) and No. 113 (December 12, 1994).

## Statement No. 117

# Emergency Assistance for Mexico

February 13, 1995

On January 31, 1995 nearly \$50 billion was mobilized worldwide to assist Mexico. Some observers characterized this as lender-of-last-resort assistance for a country. Indeed, striking parallels exist between Mexico's plight and that of a large illiquid bank. Mexico had primarily illiquid assets and many short-term liabilities indexed to the U.S. dollar. When the market lost confidence in Mexico's ability to redeem its liabilities when due, a run began that could have culminated in a default.

The primary case for international assistance to Mexico was the concern for the negative spillover effects which might have occurred if Mexico had not received assistance. These included the possibility of political and economic turmoil in Mexico leading to a deep, prolonged recession and the abandonment of market-oriented reforms. Other heavily indebted countries also began to experience capital outflows even though their fundamental circumstances differed sharply from those of Mexico. This heightened fears of a contagious international transmission of shocks.

The potential damage to U.S. interests was especially serious. Because of its 2,000 mile border with Mexico and the extent of integration between the two economies, a sharp decline in the Mexican economy could lead to larger inflows of illegal immigrants and a reduction in U.S. exports. More broadly, the collapse of Mexico, which had accomplished many significant economic reforms, could have led other developing countries to reject the market-based economic reforms that have been a cornerstone of U.S. foreign policy since the fall of the Berlin wall.

The problem, however, with emergency guarantees—as, indeed, with traditional lender-of-last-resort assistance and deposit insurance guarantees—is that they can create moral hazard. Investors who believe they are protected by implicit guarantees are more likely to take risks. Entities that are funded by investors who believe they will benefit from implicit guarantees will take greater risks for a longer period of time. As a consequence, crises are likely to be larger and to occur more frequently than if investors believed that they would be obliged to live with the consequences of their investments. This is our objection to the Mexican rescue package.

While we believe the case for assisting Mexico was persuasive, we have grave concerns about the bailout of short-term creditors who held dollar-indexed claims. Investors who are protected by official assistance, as they have been in the Mexican rescue, are justified in believing that they will be safe so long as they invest short term. Consequently, countries will find that they can pursue imprudent policies much longer (or delay or avoid corrective policies, such as devaluations) if they can still borrow short term. The legacy of this operation may be larger and more frequent crises around the world. This kind of official assistance undermines the capacity of markets to provide useful discipline over national macroeconomic policies.

We believe that the assistance for Mexico could and should have been structured in a way that strengthens rather than weakens market discipline. The assistance package should have drawn a distinction between old and new debt. Guarantees should have been provided only on a marginal basis, on new lending, but not extended to cover pre-existing

debt. At the same time, just as in conventional domestic workout situations, existing debt should be rescheduled with extended maturities and reduced interest rates. Until Mexico is once again able to borrow on market terms without benefit of a guarantee, Mexico policy should be monitored by the IMF, which should endeavor to function like a bankruptcy court in overseeing domestic workout situations.

This approach would have had several advantages. It would have performed the essential function of enabling Mexico to secure the financing needed to continue normal operations, but it would have required an appreciably smaller pool of guarantees which, in turn, could have been assembled in a shorter time and with less controversy.

Although this approach would have imposed losses on holders of short-term, external debt, investors who purchased Mexican equity shares have already experienced a loss in value due to the performance of the Mexican economy. We see no reason that external debtholders should be protected from the consequences of the policies which they chose to finance. This is especially true since the debtholders who are being rescued enjoyed a high return in the months preceding the crisis. More fundamentally, this is precisely what should happen to strengthen market discipline and reduce the moral hazard problem.

For these reasons, we urge the U.S. government, the IMF, and other providers of guarantees to announce promptly that future rescue operations, if any, will be provided on the "marginal" basis stated above, thus reestablishing the important principle for investors of "caveat emptor."

It is the Committee's policy that members abstain from voting 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 C. Aspinwall abstained from voting on this statement. In addition, Mr. Hawke did not participate in the discussion, formulation, or preparation of this statement.



## Statement No. 118

# Principles of Bank Reform: Guidelines for Assessing Pending Legislative Proposals

May 22, 1995

Two proposals to modernize the banking system and its associated regulatory structure are now before the Congress: H.R. 1062 (the Leach Bill) and S. 337 (the D'Amato Bill). Choosing between these proposals, which contain important differences, requires that we be clear about what we want financial reform to achieve. The Shadow Financial Regulatory Committee ("Committee") has identified five key principles that should, from the standpoint of FDIC and taxpayer-consumers, guide reform.

1. There should be no limitations on banks' permissible activities and owners so long as they demonstrably satisfy prudential regulations. Permitting banks and other financial institutions to diversify their activities can enhance economic efficiency and competitiveness. The potential risks associated with nontraditional activities will not undermine the soundness of the banking system so long as banks and their regulators meet prudential rules on adequate capital, prompt corrective action and least cost resolution.
2. If some activities are not permitted to the bank itself, because they are viewed as too difficult to monitor, it is preferable from the standpoint of maintaining the financial strength of banks to conduct them in "bank-subidiaries" (wholly-owned, separately-incorporated and separately-capitalized subsidiaries of the bank) rather than in bank-affiliates (subsidiaries of the bank's holding company). Compared to allowing banks to engage in such activities directly (through the bank itself), the bank-subidiary structure better insulates the bank from losses associated with its nonbank activities while at the same time preserving the potential benefits of a more diversified earnings structure. Compared to a bank holding company structure, the bank-subidiary approach captures the gains for the bank and avoids the costs of having to operate as a holding company. Finally, a bank-subidiary approach facilitates functional regulation of bank subsidiaries where so required.
3. There is no reason to have consolidated supervision or an "umbrella" regulator responsible for regulatory oversight of banks and all their nonbank subsidiaries. The jurisdiction of the appropriate bank regulator should be limited to the bank entity and to concerns related to the safety and soundness of the bank—including a valuation of the bank's investment in any subsidiaries. Nonbank subsidiaries should be regulated by the appropriate functional regulator, depending on their activities.
4. Reform should lower the costs and facilitate both entry into and exit from the banking industry and other financial services. As technological change occurs, it is important that the reallocation of capital both within and between industries not be impeded. In particular, as regulatory protection and subsidies to the banking industry are reduced, exit from the industry must be made easier.
5. The Committee endorses reducing regulatory restrictions when such actions will not increase the risk of taxpayer loss. Under the current regulatory system, both insured deposits and access to the discount window and to the Fedwire for payments clearance

entail implicit subsidies and guarantees to participating banks that must be constrained or bounded by regulation. So long as such subsidies and guarantees continue, the Committee believes that all banks (even those with only uninsured deposits) must continue to be subject to a degree of prudential regulation.

In the Committee's view, neither proposal before the Congress fully satisfies this set of fundamental principles of reform, although the D'Amato Bill clearly comes closer to doing so than does the Leach Bill. The D'Amato Bill provides for broader powers and facilitates both entry and exit.

Statement No. 119  
Wholesale Banking Proposal Under H.R. 1062  
May 22, 1995

On May 12, 1995, the House Banking and Financial Services Committee adopted legislation (H.R. 1062; the "Leach Bill") that includes reforms to the Glass-Steagall Act. One part of this bill provides for creation of a new kind of uninsured depository institution called a wholesale financial institution ("WFI").

A WFI as defined by H.R. 1062 is a state-chartered bank that is a member of the Federal Reserve System and thus subject to examination and regulation by the Federal Reserve Board under the Federal Reserve Act. Deposits in a WFI are not insured by the FDIC, and WFIs cannot accept initial deposits of \$100,000 or less.

The rationale for such an institution is that, since it does not pose any risk of loss to small depositors or to taxpayers, it could operate without substantial governmental regulation or restriction on its activities. As indicated in Statement 118, paragraph 5, because of the extent of subsidies and implicit guarantees we do not believe this action is currently feasible. The sponsors of the proposal appear to have recognized these problems, and the legislation includes so many restrictions on operations of the WFIs they are unlikely to be able to play a useful role in the financial system.

## Statement No. 120

### The Leach Bill

May 22, 1995

The Leach bill, approved by the House Banking Committee on May 12 (H.R. 1062), fails to meet the principles the Shadow Financial Regulatory Committee articulated in its statement 118 on May 22, 1995. Indeed, in this and other respects the Leach bill is a step back from the legislation adopted by the House Banking Committee in 1991. The Shadow Committee finds the Leach bill deficient in the following principal respects:

1. By requiring that securities activities be undertaken only through a subsidiary of a bank's holding company, the Leach bill adopts the restrictive notion that nonbanking activities cannot be conducted safely in subsidiaries of an insured bank. As long as an insured bank is otherwise meeting its capital and other prudential requirements, there is no safety and soundness issue associated with establishing nonbanking subsidiaries.
2. By restricting the activities of a financial services holding company (FSHC) so that it may only engage in activities that the Federal Reserve declares to be "financial in nature," the Leach bill adopts the idea that banks should not be affiliated with "commercial" firms. There is no evidence that affiliations between banks and commercial firms pose any special danger to banks or to the financial system, and a good deal of evidence to the contrary. Continued restrictions on the ownership of banks should be recognized for what they are: a means for the Federal Reserve to assert comprehensive control over the banking system.

By limiting FSHCs to activities the Federal Reserve Board declares are "financial in nature," the Leach bill will prevent FSHCs from substantially expanding their range of activities and restrict their ability to adapt efficiently to changes in the market. The Board's history of timidity in expanding the activities of bank holding companies over the years provides no basis for optimism that it will step up to ameliorate the failures of the Leach bill in this respect. The Leach bill will also prevent nonbanking companies from acquiring banks or FSHCs, and thus restricts entry to and exit from the banking industry.

3. By requiring higher levels of capital for banks that are affiliated through FSHCs with securities firms, the Leach bill perpetuates the false premise that securities activities in particular are riskier than banking and that affiliations between banks and securities firms create special risks for banks. In reality, many securities activities are less risky than banking and provide diversification benefits. Careful scholarship over the years has shown that the policy underpinnings of the Glass-Steagall Act were based on faulty premises. The involvement of banks in the securities business had nothing to do with the failure of banks before the enactment of Glass-Steagall.
4. Insurance services are obviously activities "of a financial nature." By failing to include insurance among the permissible activities for FSHCs, the Leach bill prevents insurance companies from acquiring banks, and prevents financial services holding companies from engaging in insurance activities without regulatory action by the Federal Reserve Board.

Statement No. 121  
Proposed Amendments to Part 5 of the Regulations  
of the Office of the Comptroller of the Currency  
May 22, 1995

In November 1994, the Office of the Comptroller of the Currency (OCC) published amendments to Part 5 of its regulation concerning policies for conducting banking activities. These amendments were proposed to reduce the regulatory burden on banks and to modernize the OCC's regulations to meet the dynamics of the nation's banking markets. This action followed the landmark VALIC case (Nations Bank of North Carolina, N.A. vs. Variable Annuity Life Insurance Company, 115S.CT.810) in which the U.S. Supreme Court ruled that the business of banking was not limited to enumerated powers in the National Bank Act and that the Comptroller of the Currency had discretion to authorize activities incidental to banking beyond those specifically enumerated in the Act. The broader interpretive authority will be implemented through banks' operating subsidiaries as governed by the proposed amendments to Part 5 of the OCC regulations.

Passage of interstate branching laws and recent court decisions on national bank incidental operating powers could allow bank management to effectively expand banks services within the bank charter and avoid use of the cumbersome and inefficient bank holding company format.

The Shadow Financial Regulatory Committee believes that the proposed regulations are consistent with the Committee's principles for banking reform (see statement 118). The regulation would expand operating powers, but with adequate prudential oversight. The OCC regulation properly limits expanded operating authority to strongly capitalized banks. In addition, the proposed regulation contains adequate supervisory oversight for approval of new activities and investment by banks in operating subsidiaries. The exercise of these activities in operating subsidiaries will facilitate the monitoring of the activity. At this time it appears that the OCC regulatory proposal offers an effective approach to accommodate market change.

## Statement No. 122

# Federal Reserve Proposal for Pricing Daylight Overdrafts

May 22, 1995

On March 2, 1995, the Federal Reserve Board announced that it was cutting in half a long-scheduled increase in the fee Reserve Banks charge for granting intraday (i.e., “daylight”) credit to banks that clear transactions through the Fed’s payment network. On an annualized basis, the Fed calculates the value of its revised fee at a mere 36 basis points. This tiny charge lies well below the current 600 basis-point interest rate on federal funds that banks lend each other overnight.

As does any private bank in clearing its own trades and in paying and receiving funds on behalf of its customers, the Fed opens temporary credit positions with other parties. Until a bank’s clearings positions with customers and other institutions are settled, these positions impose a time cost of money and a risk of noncollection.

In producing clearing and settlement services, the Fed’s transactions and communications networks compete directly with private suppliers. The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) requires the Fed to set explicit cost-based fees for eight classes of service, including daylight overdraft, that the Fed had previously performed for member banks without charge.

In contravention of DIDMCA, the Fed’s overdraft fee prices only a small fraction of the opportunity costs of intraday clearings overdrafts. The Fed’s March 2, 1995 policy statement expresses the belief that concerns about systemic risk argue for a “gradual approach to raising daylight overdraft fees.”<sup>1</sup> The Shadow Financial Regulatory Committee notes that increasing the fee by 12 basis points every 30 months would take 120 years for the Fed overdraft fee to reach the current 600 basis-point interest rate of federal funds.

To justify what amounts to a permanent pricing subsidy, Federal Reserve officials resort to scare tactics. Without quantifying the costs, benefits, or probabilities that characterize taxpayers’ stake in the fee charged, Fed spokespersons claim that the odds of a payment-system gridlock or meltdown would increase dangerously if the Fed were to set a competitive price that might divert a major portion of its still-subsidized clearing business to private networks such as CHIPS.

Principles of good government demand that the Fed face strict accountability for any decision that an outsider may reasonably construe as promoting its bureaucratic interests at taxpayer and competitor expense. The Shadow Financial Regulatory Committee urges Congress to require the Fed, except in extraordinary circumstances, to charge an intraday overdraft fee that is equivalent each day at least to the average federal funds rate. Every departure from this policy should be carefully documented and subjected to detailed Congressional review.

<sup>1</sup>Docket No R - 0806, p. 16

## Statement No. 123

# Alternatives to Recapitalizing the Savings Association Insurance Fund

May 22, 1995

Recent FDIC proposals to lower premiums for institutions insured by BIF (Bank Insurance Fund), and hearings before both the FDIC and Congress highlight the undercapitalized position of the SAIF (Savings Association Insurance Fund). FIRREA created two new insurance funds—BIF for commercial banks and SAIF for thrift institutions. In addition, the law mandated that insurance premiums be set to achieve a reserve ratio of 1.25 percent of insured deposits for both the BIF and SAIF insurance funds. BIF reserves are projected to reach the mandated 1.25 percent level by July. At that point, the FDIC is required by law to lower premiums to a level sufficient to maintain the 1.25 percent reserve ratio while maintaining a risk-related premium structure. The FDIC has proposed a structure with an average premium of between 4 and 5 basis points, with a minimum of 4 basis points and a maximum of 31 basis points.

SAIF is far from reaching the 1.25 percent reserve ratio, which presently stands at only .28 percent. To recapitalize the fund immediately would require an injection of approximately \$6.8 billion. Under reasonable, but optimistic assumptions, SAIF would not reach the required ratio of 1.25 percent by relying on annual assessments until 2002. The present concerns result from an ill-designed rescue/financing package for resolving troubled thrift institution failures and to restructure and provide for the partial recapitalization of the deposit insurance funds. Part of the reason for the delay in recapitalizing the SAIF fund has been the need to divert most of the SAIF premiums to cover FICO (Financing Corporation), REFCORP (Resolution Funding Corporation) and FRF (Federal Savings and Loan Insurance Corporation Resolution Funds) bonds issued to partially recapitalize the SAIF and to provide funds for resolving problem institutions. Of the \$9.3 billion in SAIF premiums collected between 1989 and 1994, \$7 billion has been used to cover interest payments, leaving only \$2.3 billion to replenish the fund.<sup>1</sup> About \$8.4 billion would be required to defease the FICO bonds. FICO interest payments presently account for approximately 45 percent of assessment revenues, or about 11 basis points of the 24 basis-point average assessment paid by SAIF insured institutions (this compares with the projected average premium of 4 to 5 basis points for commercial banks under the current FDIC proposal).

Several concerns exist regarding the future of the SAIF fund. First, on July 1, 1995 responsibility for resolving thrift failures will fall on the SAIF fund which has limited resources. Second, an increasing number of thrifts are being purchased by banks (so-called Oakar banks) or are converting to commercial bank charter status (Sasser banks). While these institutions remain under SAIF insurance, the FDIC has interpreted the law as prohibiting assessments from these institutions from being used to cover FICO bond

<sup>1</sup>Principal on the FICO bonds has been defeased by the purchase of zero coupon bonds and interest coverage amounts to \$779 million per year.

payments.<sup>2</sup> The present assessment base has been declining at about 8 percent per year, over the past several years. If this continues eligible assessment revenues will be insufficient to cover FICO interest payments in 5 years.

Third, concern is that with narrowing spreads and margins, the 19 basis-point premium differential will competitively disadvantage SAIF-insured institutions and that many will seek other means to avoid the premium differential, such as the formation of parallel national banks that would be commonly housed in thrift offices. This has already been proposed by Great Western Financial Corporation and several other institutions. If these tactics are successful, SAIF insured deposits would decline by approximately \$80 billion, or about half of the assessment cushion.

Part of the earnings drain on the SAIF associated with higher premiums is the statutory requirement to bring the SAIF up to the mandated 1.25 percent coverage ratio. However, this 1.25 percent ratio is no longer justified if early intervention and least cost resolution work as designed. The justification for any particular coverage ratio should rest on expectations about future risk exposure of the fund. The fund's exposure depends upon closure policies and monitoring costs. With an adequate closure policy for capital deficient institutions that resolves them before net worth becomes negative, the Committee believes the only need for a fund is to cover the costs of administration, errors in assessing solvency, and fraud, and to finance the temporary warehousing of assets of failed thrifts until they can be liquidated.

The required size of the assessment can be reduced by abandoning the 1.25 percent coverage ratio. To compensate for this reduced coverage, the Committee proposes that the higher critical level of capital that would trigger the least cost resolution provisions of FDICIA be raised from 2 percent to 4 percent, which would reduce the potential for losses to the SAIF fund even further. This would essentially substitute self-insurance and regulatory monitoring for the current system of deposit insurance for SAIF insured institutions. The proposal also relies upon an institution's own capital to protect the insurance fund and taxpayer and would not impose a burden on other institutions.

Elimination of the 1.25 percent requirement would leave thrifts with an 11 basis-point assessment to cover FICO interest payments. This assumes that Congress would stipulate that premiums from Sasser and Oakar institutions could be used to meet FICO obligations. Substituting an appropriately higher critical level of capital to trigger least cost resolution would also set the foundation for addressing the issue of the need for maintaining a separate thrift charter.

<sup>2</sup>At present, there are approximately 715 banks that have purchased \$180 billion in thrift deposits and 319 Sasser institutions with 53 billion in SAIF-insured deposits. These institutions combined account for about 33 percent of safe assessments. At current premium levels, an assessment base of \$325 billion is required to generate sufficient premium income to service the FICO bonds. If failures, conversions and acquisitions absorb an additional \$161 billion in SAIF-insured deposits, assessment revenues will be inadequate.



Properly implemented, the proposal would provide a win-win opportunity for everyone. It would strengthen the supervisory process, resolve the FICO bond burden, enhance taxpayer protection, spread the costs of clearing up the funding needs of the SAIF, and improve regulatory agency accountability and supervision. It would also reduce the financing burdens to be borne by banks and make it possible to address the issue of combining thrift and bank charters in the future. While the Committee has not reviewed in detail what a unified charter might involve in terms of permissible activities, it seems clear that any proposal to retain an artificially high commitment to housing finance is inappropriate.

**Statement No. 124**  
**The Banking Agencies' Proposed Interest Rate  
Risk Capital Standards**  
September 18, 1995

On August 2, the federal bank regulatory agencies proposed another joint policy statement on how to measure a bank's interest rate risk profile for the purpose of assessing its capital adequacy. Section 305 of the FDIC Improvement Act of 1991 (FDICIA) requires incorporating interest rate risk into a bank's capital requirements. In several past policy statements (No. 87, September 14, 1992 and No. 96, May 24, 1993), the Shadow Financial Regulatory Committee has criticized the regulatory agencies on several grounds. The Committee has deplored their failure to make the 1993 rule-making deadline specified in FDICIA, their failure to require additional capital for excessive risk exposure, their reliance on grossly inaccurate measurements of interest rate risk exposure, and their exemption of banks on the basis of size rather than risk exposure. The new proposal continues to show the low priority given by the agencies to this important assignment under FDICIA.

The Committee is disappointed that the agencies appear to have learned so little from the lessons of the past. Interest rate risk lay at the core of the S&L crisis of the 1980s that cost U.S. taxpayers some \$150 billion. Although losses from interest rate risk are not a major problem in a stable interest rate environment, evidence suggests that institutions are on average exposed to losses when interest rates are volatile. Last year many banks suffered large unrealized losses in their bond portfolios when interest rates rose sharply for a brief period of time. Indeed, many of the banks that typically assume high interest rate risk are smaller banks, which are largely exempt from the proposed regulations.

The Committee urges the agencies to move rapidly to complete the task of defining an objective capital standard for interest rate risk. Meanwhile, continuing to use the case-by-case approach leaves us in the same position as in the 1980s. The agencies should assign higher priority and devote additional resources to the developing of an appropriate interest rate risk model and an explicit capital standard, as the Office of Thrift Supervision has already done. The Committee believes that the banking agencies ought to complete this task by the end of this year.

payments.<sup>2</sup> The present assessment base has been declining at about 8 percent per year, over the past several years. If this continues eligible assessment revenues will be insufficient to cover FICO interest payments in 5 years.

Third, concern is that with narrowing spreads and margins, the 19 basis-point premium differential will competitively disadvantage SAIF-insured institutions and that many will seek other means to avoid the premium differential, such as the formation of parallel national banks that would be commonly housed in thrift offices. This has already been proposed by Great Western Financial Corporation and several other institutions. If these tactics are successful, SAIF insured deposits would decline by approximately \$80 billion, or about half of the assessment cushion.

Part of the earnings drain on the SAIF associated with higher premiums is the statutory requirement to bring the SAIF up to the mandated 1.25 percent coverage ratio. However, this 1.25 percent ratio is no longer justified if early intervention and least cost resolution work as designed. The justification for any particular coverage ratio should rest on expectations about future risk exposure of the fund. The fund's exposure depends upon closure policies and monitoring costs. With an adequate closure policy for capital deficient institutions that resolves them before net worth becomes negative, the Committee believes the only need for a fund is to cover the costs of administration, errors in assessing solvency, and fraud, and to finance the temporary warehousing of assets of failed thrifts until they can be liquidated.

The required size of the assessment can be reduced by abandoning the 1.25 percent coverage ratio. To compensate for this reduced coverage, the Committee proposes that the higher critical level of capital that would trigger the least cost resolution provisions of FDICIA be raised from 2 percent to 4 percent, which would reduce the potential for losses to the SAIF fund even further. This would essentially substitute self-insurance and regulatory monitoring for the current system of deposit insurance for SAIF insured institutions. The proposal also relies upon an institution's own capital to protect the insurance fund and taxpayer and would not impose a burden on other institutions.

Elimination of the 1.25 percent requirement would leave thrifts with an 11 basis-point assessment to cover FICO interest payments. This assumes that Congress would stipulate that premiums from Sasser and Oakar institutions could be used to meet FICO obligations. Substituting an appropriately higher critical level of capital to trigger least cost resolution would also set the foundation for addressing the issue of the need for maintaining a separate thrift charter.

<sup>2</sup>At present, there are approximately 715 banks that have purchased \$180 billion in thrift deposits and 319 Sasser institutions with 53 billion in SAIF-insured deposits. These institutions combined account for about 33 percent of safe assessments. At current premium levels, an assessment base of \$325 billion is required to generate sufficient premium income to service the FICO bonds. If failures, conversions and acquisitions absorb an additional \$161 billion in SAIF-insured deposits, assessment revenues will be inadequate.

## Statement No. 125

# Alternatives to Recapitalizing the Savings Association Insurance Fund and Defeating the FICO Bonds

September 18, 1995

Current Administration proposals to resolve the funding problems of the Savings Association Insurance Fund (SAIF) involve a two-phase plan. Phase One involves a one-time assessment of about 85 basis points on deposits of SAIF insured institutions and spreading Financing Corporation (FICO) bond payments across institutions insured by both the Bank Insurance Fund (BIF) and SAIF. Phase Two would involve merging the BIF and SAIF funds sometime in the future and creating a unified bank and thrift charter. Agreement on the program seems to be in difficulty because of doubts about the deliverability of Phase Two which effectively compensates BIF-insured institutions for bearing part of the cost of servicing the FICO bond payments.

Shadow Financial Regulatory Committee Statement No. 123 offered an alternative way of dealing with the SAIF funding problem. The Committee proposed that the critical level of institutional capital be raised that triggers the least-cost resolution provisions of FDICIA and that the FDICIA mandated 1.25 percentage reserve ratio be abandoned for SAIF.

The Committee suggests that this proposal could be modified and extended in ways that would reallocate the commitments already tentatively agreed to by banks and thrifts in a way that strengthens the Prompt Corrective Action (PCA) provisions instituted by the FDICIA. First, raise from 2 percent to 4 percent the critical level at which the least-cost resolution requirements of FDICIA would be invoked. This makes it unnecessary to recapitalize the SAIF to the mandated 1.25 percent level of insured deposits before the BIF and SAIF can be merged. The increase in the critical capital level expands the resources available to the insurance fund to draw upon should an institution experience financial difficulties. It does this by substituting available deposit institution capital for SAIF insurance funds. The Committee would also extend this two-percentage-point increase in the critical level of capital trigger to well-capitalized institutions insured by BIF. This would reduce to near zero the needed premiums for well-capitalized banks, since they would be protected more effectively by their own capital.

Second, keep the proposed 85 basis point one-time charge on SAIF-insured institutions, but reallocate its estimated \$6 billion of proceeds to defease the estimated \$8.4 billion present value cost of servicing FICO bonds. This would leave approximately \$2.4 billion in present value of FICO bond interest payments. That amount could be financed by adding less than one basis point to the premiums levied on insured institutions.

Finally, to assure that the intended resources are available to protect the taxpayer, change the method of measuring capital for purposes of the PCA provisions of FDICIA from reliance upon book values to market value measures of net worth. Many assets are already valued at market, or can easily be expressed in market values. As discussed in Statement No. 41, easily valued assets should be revalued regularly as the first step in moving to market value reporting for purposes of calculating capital.

Properly implemented, the proposal would provide a win-win opportunity for everyone. It would strengthen the supervisory process, resolve the FICO bond burden, enhance taxpayer protection, spread the costs of clearing up the funding needs of the SAIF, and improve regulatory agency accountability and supervision. It would also reduce the financing burdens to be borne by banks and make it possible to address the issue of combining thrift and bank charters in the future. While the Committee has not reviewed in detail what a unified charter might involve in terms of permissible activities, it seems clear that any proposal to retain an artificially high commitment to housing finance is inappropriate.

## Statement No. 126

# Values of Bank Capital Tripwires for Prompt Corrective Action and Least Cost Resolution

December 11, 1995

The FDIC Improvement Act (FDICIA) of 1991 emphasizes the importance of capital tripwires for federally insured banks and thrifts for purposes of prompt corrective action and least cost resolution to reduce both the frequency and cost of bank failures and to protect the deposit insurance fund. Capital provided by private shareholders serves as a layer of self-insurance and reduces the potential need for tapping public capital provided by taxpayers.

FDICIA establishes five capital categories corresponding to increasingly stringent supervisory measures. The levels for each relevant capital category are determined by the appropriate federal banking agency. In 1992, the regulatory agencies set the following capital levels:

|                                | Capital Ratios<br>(Percent) |  |  |
|--------------------------------|-----------------------------|--|--|
|                                | Total                       | Risk-based <sup>a</sup><br>Tier 1 <sup>c</sup> | Leverage <sup>b</sup><br>Tier 1 <sup>c</sup> |
| Well-capitalized               | > 10                        | > 6  | > 5  |
| Adequately capitalized         | > 8                         | > 4  | > 4  |
| Undercapitalized               | < 8                         | < 4  | < 4  |
| Significantly undercapitalized | < 6                         | < 3  | < 3  |
| Critically undercapitalized    |                             |  | < 2 <sup>d</sup>                             |

<sup>a</sup>Risk weights determined by banking agencies.

<sup>b</sup>Capital-to-assets ratio.

<sup>c</sup>Basically equity.

<sup>d</sup>Tangible equity.

In part, the values of these capital tripwires were constrained by the poor financial condition of the institutions in 1991. At that time, banks holding 25% of all commercial banking assets were classified as undercapitalized, and thrift institutions were in even poorer condition. The Shadow Financial Regulatory Committee criticized these threshold values on the grounds that they were below the levels that the market would require uninsured institutions to maintain and focuses on book (historical acquisition cost) value to measure capital rather than on the more relevant market (current) value (see Statements 84, 95, and 112). But, the financial condition of insured depository institutions has improved greatly since 1992. At mid-year 1995, a negligible percentage of both banking and thrift institution assets were held by institutions classified as undercapitalized.

The levels of accounting capital currently maintained by most institutions are considerably greater than the tripwire values for well-capitalized institutions. This provides an opportunity to raise the levels of the capital tripwires closer to those that the market would demand of noninsured institutions to prevent troubled institutions from imposing

losses on creditors. For these institutions, use of accounting leeway makes accounting capital increasingly overstated as its reported value shrinks. Accordingly, the Committee recommends that the values of the capital tripwires for each category be raised by at least one percentage point effective mid-year 1996.

The recommended increase would demote only a few institutions into the undercapitalized category, and these are the institutions that pose the greatest threat of escalating losses for the Fund. Increasing capital ratios at the nation's undercapitalized institutions will better protect the deposit insurance fund and reduce cross-subsidization of troubled institutions by financially healthy institutions.

The need to raise the values of the capital ratios for both prompt correction action and least cost resolution purposes is particularly important given the FDIC's decision to effectively eliminate insurance premiums for well-capitalized and well-managed BIF insured institutions (see Statement 127).

## Statement No. 127

# Reduction in Premiums for BIF-Insured Institutions

December 11, 1995

On November 14, the FDIC effectively eliminated premiums for well-capitalized and well-managed banks. This decision was based on its interpretation of the 1991 FDIC Improvement Act's (FDICIA) requirement to maintain a 1.25% reserve coverage ratio in the Bank Insurance Fund (BIF). Capping insurance reserves and eliminating insurance premiums is inconsistent with both a well-functioning deposit insurance system and a sound financial system. Therefore, a cap on reserves, as is contained in the pending Budget Reconciliation Bill, should be rejected. Premiums should be imposed on banks commensurate with the risks that they pose to the insurance fund in order to reserve for the loss exposure each bank imposes on the insurance fund.

The adequacy of the BIF reserves cannot be assessed without considering the risk exposure that banks pose to the insurance fund and to taxpayers. Until recently, this exposure has been dealt with by a system of risk-related premiums and capital requirements which trigger prompt corrective action and least cost resolution. As the Committee has pointed out in the past, higher capital trigger points can in principle be substituted for risk-related premiums and the maintenance of a reserve fund (see Statement 123). But, given the low capital thresholds under the current system, especially the critical level of capital that triggers least cost resolution, capping the insurance fund will shift existing risk to taxpayers.

Further, eliminating risk-related premiums will over time expose taxpayers to additional risk by inviting risk-taking on the part of insured depository institutions. The losses incurred by taxpayers in the 1980s as a result of mispriced insurance and the forbearance policies of the FSLIC (Federal Savings and Loan Insurance Corporation) should serve as an object lesson on the dangers associated with eliminating risk-related insurance premiums.



# Statement No. 128

## Bank Merger Law and Policy

December 11, 1995

By June 1997, entry via interstate branching will have become effective in most states. This can be expected to lower significantly the traditional barriers to entry and to increase competition in banking markets. Concern about preserving competition has long been the justification for subjecting bank mergers to the elaborate, costly, and cumbersome administrative process which arose from the Bank Merger Act of 1960.

The 1960 law was passed to provide a means for applying antitrust standards to bank mergers, which were thought at the time to be exempt from challenge by the U.S. Department of Justice (DOJ) under the Clayton Act. Shortly thereafter, the U.S. Supreme Court ruled that combinations among banks were indeed subject to challenges on Clayton Act grounds, just as any other business. In 1966, the Bank Merger Act of 1960 was amended, but retained DOJ authority to challenge a bank merger after it had been approved by the appropriate banking agency.

Under the Act, an applicant bank must file a complex application with the banking agencies and the DOJ. All are required to comment on the competitive aspects of the application. This requires additional staff at all the agencies and a special staff and process at the DOJ not required for other industries.

The Shadow Financial Regulatory Committee in its guidelines for bank regulatory reform has stated that such reform should facilitate and lower the costs of both entry and exit from the banking industry (Statement 118). As technological change occurs, it is important that the reallocation of capital within the industry not be impeded. In particular, as regulatory protection and subsidies to the banking industry are reduced, exit from the industry must be made easier.

The Bank Merger Act adds nothing to the process but cost, and should be repealed. Banks should continue to be subject to all antitrust laws, but banking does not need to be treated any differently than other industries.\*

\*It is the Committee's policy that members abstain from voting 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 C. Aspinwall abstained from voting on this statement.

## Statement No. 129

# Ownership of Stock by Bank Directors

December 11, 1995

Bank directors who own stock in their banks are likely to oversee their banks more effectively than if they simply collect fees for attending meetings. If the bank does well, the directors' shares will gain. If a merger were best for the stockholders, although the managers and some directors might be displaced, the directors would be more likely to act in the interest of the shareholders. Most importantly for taxpayers, who back up the deposit insurance fund, if the bank fails, the directors would take losses along with other stockholders.

The truism that directors who are substantial stockholders have greater incentives to give proper attention to their corporation's affairs is generally accepted and was recognized in the National Banking Act of 1864. This act and the current policy of the Office of the Comptroller of the Currency (OCC) require that a director of a national bank must own a stock in that bank of at least \$1,000 par value (if the bank is owned by a holding company, an equivalent interest as determined by the OCC).

The statutory directors' stock-holding requirement should be brought up to date. The Shadow Financial Regulatory Committee suggests that directors of all stockholder-owned depository institutions should be required to hold a meaningful amount of stock, say the lower of \$50,000 in market or (where stock is not regularly traded) book value, or 5% of market or book value. Directors who cannot afford to make this investment immediately should be required to receive a major part of their fees in stock until they reach the \$50,000 (or 5%) amount. This is one of many corporate governance provisions of the National Bank Act that merits modernization.

## Statement No. 130

# Expansion of Bank Powers by Regulation

February 12, 1996

During the ten years that the Shadow Financial Regulatory Committee has been in operation, there have been vast changes in technology and major innovations in financial markets and products. Banking law has evolved far more slowly. Most legislative attempts to deregulate banking have ended in failure—bogged down in disputes among various industry groups and efforts of the regulatory agencies to protect their turf.

A recent example of this is the effort over the past year to modify the Glass–Steagall Act to allow banks to offer expanded securities services. This legislation is now mired in Congress. In fact, the Leach Bill (H.R. 1062), although styled as deregulation, is now replete with an extensive array of regulatory restrictions, including a prohibition on further insurance activities by national banks (see Statement No. 120, May 22, 1995). It is clear that once again lobbying forces in Washington have frustrated legislative efforts to effect deregulation.

Experience in the U.S. with financial legislation suggests that legislation does not often lead the way to improved operations of the financial system, but rather lags changes in technology, market forces, and regulatory action. In view of these considerations, the Committee believes that the best opportunity for financial deregulation lies in the effective use of the discretionary authority of the regulatory agencies. The Committee urges the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC) to use their regulatory authority more boldly to remove needless and anticompetitive operating restrictions on banks and bank holding companies.

Three areas where such actions by the regulators can be most productive are securities activities, general operating powers of banks, and bank holding company activities.

### **Securities activities**

Section 20 of the Glass–Steagall Act (12 U.S.C. 377) prohibits a member bank from being affiliated with any company “engaged *principally*” in the underwriting of securities. The FRB has determined that a bank holding company subsidiary is “engaged *principally*” in underwriting securities if the revenue from this activity reaches 10 percent of its gross revenues (73 Fed. Res. Bulletin 473, 1987). This seems an unduly restrictive interpretation of the term.

A limit of 50 percent of gross revenue would be consistent with the common understanding of the term “engaged *principally*,” as well as other FRB regulatory interpretations, such as Regulation K. Most banking organizations interested in securities underwriting could operate more effectively within this broader definition. In addition, using the same interpretation of the “engaged *principally*” clause, the OCC should use its authority to permit national banks to engage in securities activities through subsidiaries.

Even within the FRB's 10 percent limitation, there are significant opportunities to enhance the range of activities available to bank securities affiliates. For example, the courts and the OCC have permitted national banks to underwrite and deal directly in securities that are derivatives of or represent interests in pools of residential mortgages, consumer loans, credit card loans, and the like. The FRB should recognize this authority by exempting the revenues derived from these activities from the 10 percent revenue limitation.

### **General operating powers of banks**

A recent Supreme Court decision, the VALIC case (*NationsBank of North Carolina v. Variable Annuity Life Insurance Company*, 115 S. Ct. 810), and amendments to Part 5 of the OCC Regulations have created opportunities for expanding the operating powers of national banks, directly or through operating subsidiaries. The OCC should continue this process of authorizing new operating powers for national banks (see Statement No. 121, May 22, 1995).

Under the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), the FDIC has the power to veto activities of state chartered banks if these activities are not permitted to national banks. The FDIC should not use its veto authority over state banking powers to stifle healthy innovation under state law.

### **Bank holding company activities**

Under Section 4(c)(8) of the Bank Holding Company Act, (12 U.S.C. 1843(c)(8)), the FRB may permit a bank holding company to engage directly or through subsidiaries in activities that are "so closely related to banking as to be a proper incident thereto." For more than 25 years, the FRB has interpreted this language too restrictively, hampering the ability of banking organizations to meet changing market needs.

Recently, Royal Bank of Canada was permitted to invest in a company that would engage in the development of home-banking software, dropping many of the restrictions the FRB has imposed in the past. This is a promising step. The Committee recommends that the FRB continue this approach, using its authority under the Bank Holding Company Act to enlarge the range of activities permitted to banking organizations. At a minimum, this should include the following steps:

1. The FRB should conduct a comprehensive review of the meaning of the statutory term "closely related to banking" in light of changes in the business of banking in recent years, and particularly the business of banking as it is conducted in other countries in which U.S. banks compete. The term "closely related to banking" encompasses more than banking activities alone. In addition, there is every reason to

consider banking activities outside the United States in determining what is banking and what is closely related to banking.

2. The FRB should review its orders permitting individual bank holding companies to engage in particular activities, with an eye toward adding activities to the “laundry list” of permitted activities under the FRB’s Regulation Y.

Although legislative action would be the preferable course, action by the regulators is necessary where legislative gridlock has prevented essential changes in law.

# Statement No. 131

## Extending the Credit Reform Act to GSEs

February 12, 1996

Government-sponsored enterprises (GSEs) operate principally in the areas of housing, agricultural, and educational finance. These areas receive credit subsidies in various forms. Six GSEs are officially recognized: the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), the Federal Home Loan Banks, the Farm Credit System, the Federal Agricultural Mortgage Corporation, and the Student Loan Marketing Association. The principal difference between GSEs and government agencies is that private parties own claims to the residual earnings of a GSE.

Weaknesses in the budgetary treatment of government obligations make it easier to transfer subsidies to politically favored sectors through the use of federal guarantees and GSEs than through programs that entail direct expenditures. This is because opposition to enacting or expanding any subsidy program is lessened by delays in acknowledging the costs of the services rendered. The longer the time interval over which the budgetary costs of subsidies can be spread before they become fully scored, the more difficult it is for opponents to mobilize votes against them.

The Shadow Financial Regulatory Committee recommends that the Credit Reform Act of 1990 be amended to require the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) to measure the annual cost of the credit enhancements that each GSE enjoys. This annual cost should be included in the federal budget and a reserve fund should be established sufficient to absorb the losses that might occur. This is a prerequisite to rationally evaluating the justification for continuing these enterprises.

In government, budget discipline substitutes for market discipline. But many government credit activities are not properly measured in the federal budget. Budgetary mis-measurement creates incentives that distort the size and shape of individual credit programs and shift risks to taxpayers.

It has been recognized for at least twenty-five years that improving budget discipline for federal credit programs begins with devising an accounting framework that can record the opportunity costs of government loans and guarantees in a timely fashion. Federal credit reform legislation passed in 1990 and implemented in fiscal 1992 creates a framework for measuring the present values of direct loans and statutory guarantees. However, the value of opportunities to borrow from the Treasury and the value of the inferred federal guarantees GSEs enjoy are not yet accounted for in the budgetary process. These borrowing opportunities and inferred guarantees explain why interest rates on GSE debt average at least 100 basis point below rates paid by private borrowers with similar balance sheets. They also explain how mortgage-backed securities issued by FNMA and FHLMC can sell at yields well below rates paid by private issuers with similar balance sheets.

Inferred guarantees exist because government sponsorship creates a presumption that, if a GSE were to become insolvent, political pressures would assign some of the enterprise losses to taxpayers ex post. If and when losses wipe out the market value of the

capital contributed by private stakeholders in a GSE, these stakeholders face no further downside risk. The enterprise's downside risk shifts entirely into the implied credit enhancement. Whether or not a GSE actually becomes insolvent, taxpayers need to recognize that Treasury back-up implicitly supplies risk capital that enhances the value of private stakes in the firm. The availability of the implicit finance allows enterprise managers to escape the market discipline of making other arrangements to support their creditworthiness and promises to keep alive for GSE shareholders a claim on the enterprise's future profits in difficult times. This distorted arrangement for sharing risk makes private stakeholders willing to trade upside earning potential for downside risk at terms that disadvantage taxpayers. To balance the allocation of upside and downside risk, government officials should have the duty to force GSE shareholders to subscribe additional equity funds whenever shareholder-contributed capital falls short of an appropriate leverage ratio. Indeed, such a responsibility has been assigned deposit-institution regulators by the prompt corrective action provisions of the FDIC Improvement Act of 1991.

For Congress and the Treasury to achieve adequate policy control over the federal government's expenditure and capital budgets, effects of GSE policy decisions on explicit and inferred credit enhancements must be measured and deviations from tolerable values must be corrected. Difficulty in observing the value and particularly the interest sensitivity of a GSE's credit enhancement lessens accountability in government. Perfect accountability exists when authorities are immediately and completely answerable for their actions. This requires that official decisions and their consequences be transparent enough for outsiders to monitor and discipline.

Unfortunately, the value of Treasury credit enhancements enjoyed by GSEs cannot be observed directly because they do not trade separately in capital markets. This means that no price for these instruments is established either by exchange specialists or by security dealers. Nevertheless, the value of credit enhancements is imbedded in GSE stock prices, and values can be observed for credit enhancements sold every day by comparable private financial-services firms.

For FNMA and FHLMC, recent legislation has begun the task of improving accountability. In 1992, primary responsibility for overseeing FNMA and FHLMC shifted from HUD to an independent Office of Federal Housing Enterprise Oversight (OFHEO). But the mission of this agency is limited to ensuring the "safety and soundness" of those particular GSEs. Its task is to prevent an explicit taxpayer bailout, *not* to cost out and control the value of the risk exposure the taxpayer faces from these enterprises. In addition to limitations imposed by its budget, OFHEO's ability to push its focus beyond conducting stress tests for capital adequacy is further restrained by limitations on staff size.

Although difficult, carrying out the Committee's recommendation to measure the cost of GSE credit enhancements is both important and feasible. OMB and CBO staff can appraise and account for the intangible value of a GSE's credit enhancement in two complementary ways. First, appraisers can impute a value from the annualized costs of private credit enhancements that have been issued to a sample of economically comparable private firms. Financial research methods can validate criteria by which to identify the set of comparable credit enhancements in private markets.

Alternatively, the value of each GSE's aggregate credit enhancement may be generated from a financial model. The modeling approach would interpret a GSE's aggregate credit enhancement as a government-contributed equity stake. An accurate measure of this stake should capture two components: the net cost of expected assistance payments discounted at Treasury bond rates, and an additional insurance value for underwriting the downside volatility of the risky obligations that are being supported on the GSE's balance sheet. Under current arrangements, the upside of this volatility flows asymmetrically to the private owners of the GSE's equity.

These budgetary procedures are urgently needed to recognize and value taxpayer subsidies to GSEs that flow through to shareholders, creditor, managers, and customers. Without such procedures, it is not possible to evaluate the efficiency of GSEs in achieving public policy goals relative to other uses of taxpayer funds.



## Statement No. 132

# Disclosure of Examination Reports and Ratings

May 6, 1996

Under current law, examination reports and ratings by the regulators of financial institutions are considered to be the property of the regulatory agency and are not disclosed to the public, either by the agency or financial institutions. Although it gets a copy of its examination report, the financial institution is currently told only its overall CAMEL rating and not its rating on the individual components. (C is for capital, A is for assets, M is for management, E is for earnings, L is for liquidity.)

In the Shadow Financial Regulatory Committee's view, the arguments for continuing secrecy are outweighed by those in favor of disclosure.

Regulators and many financial institutions have long opposed disclosure of examination reports. Banking agency regulations prohibit institutions from disclosing examination reports and even from complying with validly issued subpoenas requiring their disclosure. For example, the Board of Governors of the Federal Reserve System has recently warned banks and bank holding companies not to disclose their examination reports to potential acquirers of the institution.

The traditional argument for maintaining the confidentiality of examination reports is that it promotes candor in exchanges between the supervisors and the supervised. In addition, there is always the chance of examiner error, disclosure of which could seriously damage the reputation of the financial institution. Alternately, it has been argued that examiners—knowing that their reports would be made public and have to be defended—might soften their criticism of management or its policies, thus reducing the value of the examination report to the institution's board of directors.

On the other hand, transparency in this area, as in others, should enable depositors and analysts to make more informed decisions about financial institutions, and lead to greater market discipline on both banks and regulators than is currently possible. Disclosure of ratings and the information in examination reports would enable analysts and depositors to make a more informed evaluation of the institution's current condition and prospects.

In addition, permitting public disclosure of criticism of an institution's management or policies—information that is routinely included in examination reports—would provide a greater incentive for improvements by management, and supervision by its board of directors, than a confidential report.

The Committee believes that government policies should move away from treating banks and other financial institutions as special entities whose financial condition must be obscured. The argument that full disclosure of a depository institution's true condition could be a threat to stability of the financial system is without demonstrated merit and is not a justification for veiling institutions in secrecy. Recent changes in law that require the banking agencies to disclose enforcement actions against financial institution have not resulted in any exaggerated consequences for the stability of the institutions charged in these proceedings.

These factors lead the Committee to three conclusions:

bank membership has improved FHLB profitability. Moreover, converting the fixed \$300 million REFCORP obligation to a percentage-of-earnings basis as is done by the proposed legislation would be sufficient to assure viability of the System, if there is still an economic role for it to perform.

The Shadow Financial Regulatory Committee strongly opposes the proposed legislation. The only purpose of the legislation is to create a Christmas Tree of new and unjustified subsidies that taxpayers ultimately will have to pay for.

Statement No. 133  
Proposed Legislation on Enterprise Resource Banks  
(The “Baker Bill,” H.R. 3167)

May 6, 1996

Past statements of the Shadow Financial Regulatory Committee have focused on the conflict between the desire of stockholders and managers of government sponsored enterprises (GSEs) to expand their operations and the risk such operations pose to taxpayers. The current legislative proposal for a new GSE activity, in the form of the Enterprise Resource Bank Act of 1996, represents a concrete manifestation of this conflict. The legislation, like all such federal credit programs, is cast in terms of worthy objectives, but the result is likely to be a distortion of financial markets, unmeasured subsidies for some borrowers at the expense of others, hidden costs and increased risk exposure for the American taxpayer.

The Committee has spoken out several times on the risk to the taxpayer that is posed by the operations of GSEs (see Committee Statements No. 61, No. 75, and No. 131). GSEs are financial intermediaries chartered by the federal government to increase the flow of credit to designated uses, usually housing, agriculture, and education. These enterprises borrow funds in the public markets and relend to private entities. They differ from government agencies in that they are owned by private stockholders. They differ from private corporations not only in their federal origin, but also in the fact that they retain some governmental responsibilities and purportedly serve a public purpose. Importantly, the obligations of GSEs receive the benefit of an implicit federal guarantee that enhances their credit standing beyond what they would deserve strictly on the basis of their own economic strength and prospects.

The proposed Enterprise Resource Banks (ERBs) are likely to become the Godzilla of all GSEs. The ERBs are the existing Federal Home Loan Banks, but much more than a name change is involved. Federal Home Loan Banks are now oriented toward housing finance. Their loans to members must be secured by home mortgage loans. And only banks with some mortgage portfolio (10% of assets) are eligible for membership. Under the proposed legislation, only large banks would be required to meet a mortgage test in order to gain membership. Members would be able to borrow from ERBs on collateral in the form of loans to rural areas or inner cities or any loans to any small businesses. It appears that the major category of loans that would not be eligible to serve as collateral would be loans by large banks to large, suburban firms.

Part of the motivation for this legislation is to find a reason for the Federal Home Loan Banks to stay in business (see statement No. 134). Viewed as a prop for the continued existence of the FHBL System, the legislation is not needed. The FHLBs operated profitably for many years, and have incurred no credit losses in their secured lending to member institutions. However, their profitability was significantly impaired by FIRREA, which not only confiscated virtually their entire net worth, but also imposed a \$300 million per year obligation to provide a debt service on bonds issued by REFCORP in 1989 as part of the resolution of the thrift crisis (see Statement No. 42). While there was reason to question the viability of the FHLB System under this obligation, FIRREA also allowed commercial banks to become members of the System. The large commercial

bank membership has improved FHLB profitability. Moreover, converting the fixed \$300 million REFCORP obligation to a percentage-of-earnings basis as is done by the proposed legislation would be sufficient to assure viability of the System, if there is still an economic role for it to perform.

The Shadow Financial Regulatory Committee strongly opposes the proposed legislation. The only purpose of the legislation is to create a Christmas Tree of new and unjustified subsidies that taxpayers ultimately will have to pay for.

# Statement No. 134

## A Proposal for Privatization of the Federal Home Loan Bank System

May 6, 1996

The Federal Home Loan Banks (FHLBs) were established to sell long-term obligations nationally and relend the proceedings to savings and loan associations that made and held local home mortgages. Widespread securitization of home mortgages has made the role of the FHLBs obsolete. Furthermore, thrift institutions are diversifying their portfolios away from holding mortgages and the trend of legislation appears to be to abolish the specialized thrift charter.

The FHLBs presently serve only two functions. First, with their expanded membership to commercial banks and credit unions, they function as a liquidity and asset/liability-management resource for eligible depository institutions. Although FHLB loans must be secured with mortgages, the fungible proceeds are not necessarily reinvested to finance housing, but can be invested in business and consumer loans. Second, the FHLBs support payments on REFCORP bonds, which were issued as part of the savings and loan deposit insurance fund rescue.

There is no reason to believe that a government subsidy for banks and thrifts in the form of an implicit guarantee of the FHLBs' obligations is necessary or desirable to achieve either function.

Current legislative proposals try to invent new reasons for the FHLBs' existence, casting about for new areas to extend their operations. This is yet another example of an attempt to perpetuate a government agency after its mission has been accomplished. (See Statement No. 133.)

The Shadow Financial Regulatory Committee recommends that the Federal Home Loan Bank System should be phased out as a government sponsored enterprise. An alternative to liquidation would be privatization, which would require at least the following:

1. Removal of the word "Federal" in its name.
2. Removal of governmental management of the system, such as appointment of directors and oversight by the Department of Housing and Urban Development.
3. Reincorporation under regular federal or state banking laws.
4. Full taxation, which could be used to finance REFCORP obligations.
5. Removal of the obligation to finance selected social programs.

A privatized Home Loan Bank System could continue to operate to the extent the market would accept the validity of its role. An example is the corporate credit union system which provides a private source of liquidity to its individual credit union customers.

payments.<sup>2</sup> The present assessment base has been declining at about 8 percent per year, over the past several years. If this continues eligible assessment revenues will be insufficient to cover FICO interest payments in 5 years.

Third, concern is that with narrowing spreads and margins, the 19 basis-point premium differential will competitively disadvantage SAIF-insured institutions and that many will seek other means to avoid the premium differential, such as the formation of parallel national banks that would be commonly housed in thrift offices. This has already been proposed by Great Western Financial Corporation and several other institutions. If these tactics are successful, SAIF insured deposits would decline by approximately \$80 billion, or about half of the assessment cushion.

Part of the earnings drain on the SAIF associated with higher premiums is the statutory requirement to bring the SAIF up to the mandated 1.25 percent coverage ratio. However, this 1.25 percent ratio is no longer justified if early intervention and least cost resolution work as designed. The justification for any particular coverage ratio should rest on expectations about future risk exposure of the fund. The fund's exposure depends upon closure policies and monitoring costs. With an adequate closure policy for capital deficient institutions that resolves them before net worth becomes negative, the Committee believes the only need for a fund is to cover the costs of administration, errors in assessing solvency, and fraud, and to finance the temporary warehousing of assets of failed thrifts until they can be liquidated.

The required size of the assessment can be reduced by abandoning the 1.25 percent coverage ratio. To compensate for this reduced coverage, the Committee proposes that the higher critical level of capital that would trigger the least cost resolution provisions of FDICIA be raised from 2 percent to 4 percent, which would reduce the potential for losses to the SAIF fund even further. This would essentially substitute self-insurance and regulatory monitoring for the current system of deposit insurance for SAIF insured institutions. The proposal also relies upon an institution's own capital to protect the insurance fund and taxpayer and would not impose a burden on other institutions.

Elimination of the 1.25 percent requirement would leave thrifts with an 11 basis-point assessment to cover FICO interest payments. This assumes that Congress would stipulate that premiums from Sasser and Oakar institutions could be used to meet FICO obligations. Substituting an appropriately higher critical level of capital to trigger least cost resolution would also set the foundation for addressing the issue of the need for maintaining a separate thrift charter.

<sup>2</sup>At present, there are approximately 715 banks that have purchased \$180 billion in thrift deposits and 319 Sasser institutions with 53 billion in SAIF-insured deposits. These institutions combined account for about 33 percent of safe assessments. At current premium levels, an assessment base of \$325 billion is required to generate sufficient premium income to service the FICO bonds. If failures, conversions and acquisitions absorb an additional \$161 billion in SAIF-insured deposits, assessment revenues will be inadequate.