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SYMPOSIUM ON BANKING REFORM

TOWARD DEPOSIT INSURANCE REFORM

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SCOPE OF THE PROBLEM

The subjects of this article are deposit insurance reform and the safety of the deposit insurance funds. There may be no more important issues facing Congress. For this reason, I introduced comprehensive deposit insurance reform legislation¹ on January 3, 1991, the first day of the 102d Congress. My proposal would limit insurance coverage; improve capital, accounting, and examination requirements; restrict risky activities of insured depository institutions; establish a consolidated supervisory and regulatory structure within a single agency; and protect consumers and customers of bank services.

For many years I have been concerned about our deposit insurance system—one of the cornerstones of this nation's financial and economic stability. It was evident to me that the deposit insurance system was vulnerable to abuse, economic adversity, and regulatory failure.

The failure of the Federal Savings and Loan Insurance Corporation (FSLIC) began the greatest financial scandal in the history of the nation. No one knows what the cost will be; only history will determine that

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1. Deposit Insurance and Regulatory Reform Act of 1991, H.R. 6, 102d Cong., 1st Sess., 137 CONG. REC. H53 (daily ed. Jan. 3, 1991).

figure. We do know that we must solve the problems left by a decade of financial excesses, legislative errors, and unprecedented regulatory failure.

Four or five years ago no one wanted to admit what we must now confront: the entire deposit insurance system urgently needs repair. In addition to the failure of the savings and loan insurance fund, the Bank Insurance Fund (BIF) today faces a fifth consecutive year of multi-billion dollar losses; its reserve level, still decreasing, is less than a quarter of the amount designated by law for minimum safety. The Administration has proposed refinancing the Bank Insurance Fund through a complicated mechanism of borrowing and premium increases.

THE BANK INSURANCE FUND IS A PRIORITY

The problem is undoubtedly upon us. A recent study² estimates that at least \$50 to \$70 billion in assets in portfolios of insured commercial banks and mutual savings banks have lost their economic viability. Another \$300 plus billion of assets likely will need restructuring by the Federal Deposit Insurance Corporation (FDIC) by the end of 1992, depending upon the length and duration of the current recession.

The General Accounting Office (GAO) has testified³ that the FDIC is underestimating the number of institutions that are likely to fail. GAO expects BIF's reserves, at the end of 1991, to range between \$1 billion and *negative \$5 billion*. In fact, the GAO recommended that immediate action be taken to rebuild the BIF in order to prevent its insolvency.

Congress must recognize the critical need to deal with the recapitalization of the Bank Insurance Fund as soon as possible so that regulators have the necessary money and authority to deal with failing banks in a timely fashion at the least cost to the fund.

We must ensure that regulators have the proper tools for prompt intervention before a bank fails, when problems with management, asset quality, or capital are first detected. We must require annual audits and examinations and improved internal management. Any financing mechanism must be open and direct, and repaid through premium income from the industry. And it must be timely—we cannot wait for the

2. L. BRYAN, RESTORING THE HEALTH AND PROFITABILITY OF THE U.S. BANKING SYSTEM (1990).

3. *Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 102d Cong., 1st Sess. (April 26, 1991) (Statement of Charles A. Bowsher, Comptroller General of the United States).

resolution of all the other controversial items constantly on the Banking Committee's agenda.⁴

The necessary elements of BIF refinancing and reform include:

- ** Realistic accounting practices by institutions and regulators;
- ** Hard-nosed supervision and on-site annual examinations;
- ** Prompt regulatory intervention in troubled institutions;
- ** Least-cost resolution of insolvent institutions;
- ** Refinancing the insurance fund in the most straightforward and least expensive manner;
- ** Limiting coverage of deposit amounts over \$100,000; and
- ** Ending the "Too big to fail" regulatory policy.

DEPOSIT INSURANCE

Some of the elements of BIF refinancing are also important deposit insurance reforms. Deposit insurance is at the heart of our financial and economic stability; we ignore its problems and possible solutions only with the greatest peril. The failure of the FSLIC and the hundreds of billions of dollars it will cost American taxpayers are warnings we cannot ignore. Reform is imperative.

Of course, we must and will meet our commitment to current depositors in insured depository institutions. But we must do more than protect insured depositors; we must also reform the deposit insurance system so that American taxpayers will not provide a continual and constant deep pocket for a system that increasingly seems to send profits to bankers and losses to the American taxpayer.

Deposit insurance reform really began with the passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).⁵ The increased capital requirements, limitations on the permissible investments that federally insured but state chartered savings associations could make, and the enhanced enforcement powers given to the regulatory agencies are some of the most important features of de-

4. For this reason, I introduced, for myself and Mr. Annunzio, Chairman of the Subcommittee on Financial Institutions Supervision, Regulation and Insurance, The Federal Deposit Insurance Corporation Improvement Act of 1991, H.R. 2094, 102d Cong. 1st Sess., 137 CONG. REG. H2563 (daily ed. Apr. 25, 1991). This Bill provides additional resources to the Bank Insurance Fund, to require the least cost resolution of insured depository institutions, and to improve supervision and examination of such institutions.

5. On August 9, 1989, the President signed the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 188 (codified in scattered sections of the U.S. Code).

posit insurance reform in FIRREA. Many other issues have yet to be addressed.

This Article outlines my own proposals for deposit insurance reform. Reform is necessary because, over the past few years, deposit insurance coverage has been extended, primarily through regulatory actions or decisions, to almost every deposit for almost any amount. Multimillion dollar accounts are protected as if the insurance coverage "passes through" to recipients. Amounts over \$100,000 are regularly protected when insolvent institutions are resolved, in spite of the clear language of the law passed in 1980 that limits coverage to \$100,000. In fact, studies by the Banking Committee have shown that more than 99% of all deposits in failed banks, including those over \$100,000, have been covered by the FDIC. The sole exception provided for by statute, when a particular institution's deposit services are "essential to its community," has been turned on its head.⁶

THE BENEFITS OF REFORM

Reforming the deposit insurance system will benefit the American taxpayer. Limiting the scope of deposit insurance coverage reduces the exposure of the insurance funds to losses caused by insolvent institutions, but retains coverage for the vast majority of depositors for whom the system was originally designed.

Groups, sometimes well-meaning, will press for special or extended coverage. We must decide if and when such special treatment is in the best interests of our financial system and its institutions. We need to balance the benefits and costs of deposit insurance. One thing is clear: the current system may be the most costly financial problem this nation ever has faced.

Deposit insurance creates what has been described as a "moral hazard," that is, an inducement to take risks because losses are insured by the federal government. Deposit insurance also removes the need to ask why an insured institution is offering above average interest rates or whether the institution's loan policies are prudent or risky. Ordinary depositors should not be burdened with making these judgments, but

6. In response to a letter I sent to Chairman Seidman of the FDIC on January 14, 1991, Chairman Seidman replied: "Essentiality has been found in instances in which a bank is providing necessary banking services to a community that are not otherwise available or . . . when severe financial conditions exist threatening the stability of a significant number of insured banks or banks possessing significant financial resources." (emphasis supplied).

professional money managers and sophisticated brokerage houses ought to be responsible for their investment decisions.

In addition, many institutions have not been allowed to fail even when insolvent, institutions that seem "too big to fail." Further, if an institution does fail, most uninsured liabilities are transferred and protected as if they were insured. Knowledge of these circumstances allows depositors and investors alike generally to conduct business without regard for insurance limitations or the condition of the institution.

THE PRINCIPLES OF REFORM

Reform must be guided by clear principles. If we keep these principles in mind, we can overcome the complex problems that lie along the road to reform. The underlying goal of my proposal is to strengthen and protect the deposit insurance funds. We can reach that goal by adhering to four basic principles:

- First: Ensure and stringently enforce adequate capital standards.
- Second: Limit insurance coverage to the amount authorized by law.
- Third: Require regulators to take strong, certain, and prompt action when an institution begins to lose capital.
- Fourth: Make holding companies and affiliates of insured depository institutions responsible for losses incurred by their insured depository institutions.

Though these ideas are simple, they involve many complex details. I submit that if these principles are followed faithfully, the goal of a strong deposit insurance system ultimately can be reached.

Consider the lessons from the failure of the savings and loan insurance system. We learned that it is fatal to permit insured institutions to operate with little or no capital, because the money they risk is not their own, but that of depositors and, ultimately, the taxpayers who insure the safety of those deposits. We learned that temporizing or forbearance only allows embedded weaknesses to fester and grow. We learned that permitting too much regulatory discretion only leads to the postponement of the day of reckoning, tempting regulators to delay action when institutions are hopelessly insolvent.

We learned that a deposit insurance fund must be strong enough to handle problems far greater than anyone previously had imagined. Finally, we learned, most of all, that certain fundamental principles must be known clearly, well understood, and faithfully adhered to, if insured institutions are to remain safe and sound.

Our system of deposit insurance is unique. Both state and federally chartered institutions are insured, even though states may permit banks to exercise powers that federally chartered banks cannot.⁷ Because it is backed by the American taxpayer, the distortions and weaknesses of the system can be ignored no longer. Reform is inescapable. The task will neither be simple nor pleasant, but it is essential if this unique system is to be preserved.

Last year, we removed ceilings on deposit insurance premium assessments and gave the FDIC the authority to set premiums as needed and appropriate. The existence of the premium ceiling created false expectations that deposit insurance would be cheap, regardless of the underlying risks. In fact, recent studies have shown that deposit insurance is significantly underpriced, even at today's higher premium levels.

SPECIFIC PROPOSALS

We need to do more. First, we need to limit the scope of coverage by limiting the number of accounts any one person can have and by eliminating pass-through coverage for super accounts that money managers and pension funds bundle in amounts over \$100,000. We need to set up a system of risk-based assessments so that institutions with riskier portfolios and investments pay more for their insurance coverage. While I recognize that not every risk can be quantified and that risks can change over time, I also believe that risks can and should be taken into account in the premium assessment system; insured depository institutions that take greater risks should pay insurance premiums commensurate with that risk.

We need to extend assessments to foreign deposits if they are going to be treated as insured in any event. This would increase revenues to the insurance funds, and also would be fundamentally fair, since protected deposits should be assessed a premium.

Another critical reform needed is a limit on the permissible risk of investments of insured funds. In 1989, in FIRREA, we limited investments that savings and loan associations can make: no junk bonds, limits on loans to one borrower, and other restrictions. Additionally, we established risk-based capital standards. In each instance, the idea was to pro-

7. FIRREA, however, restricted state chartered savings associations to activities permissible for those that were federally chartered.

vide both limits on risks and incentives to reduce the risks taken with insured funds. Some of these restrictions already applied to banks; we need to see what, if any, additional restrictions should be imposed on banks.

The steps I have outlined are not merely prudent, they are essential to build a deposit insurance fund that has strength approaching a reasonable level.

Not only do we have to strengthen the funds, we have to protect them. No insurance system can survive unlimited risks or wanton recklessness. Therefore, reform must protect those funds, not merely to prevent payouts, but to ensure the basic safety of the financial system itself. The weakness of the fund clearly reveals the underlying weakness of the nation's banking system.

PRINCIPLES OF PROTECTION

These measures, many of them enacted for savings associations in FIRREA, should now be extended to banks in order to protect the banking system and the insurance fund standing behind deposits.

The first and most important step is to strengthen capital. Capital is the money that the owners of financial institutions have at risk. If owners have little or no capital at risk, the only money they are really risking is the money of the insurance system and of the taxpayers who back it up. Conversely, if the owners of an institution have a great deal of capital at risk, they are much more likely to be both more profitable and more prudent. Capital is the key, the indispensable element.

In FIRREA, we went a long way toward taking the necessary action: we prevented savings associations from operating without capital; we eliminated the idea that phony capital is a substitute for the real thing; and we firmly established the principle that capital should reflect the risk of the underlying assets—the greater the risk, the higher the capital.

Accounting standards that overstate asset value or understate liabilities ought to be eliminated. Whenever possible, assets ought to be computed on a market value basis; book values, which sometimes fail to reflect what an asset can be sold for, distort economic reality. Where assets are of a type that are not often traded and thus cannot readily be marked to market, independent valuations should be made on a regular basis.

Never again should there be any notion of substituting phony capital

for the real thing, or of allowing institutions to continue in operation without a safe level of capital.

Insured depository institutions need tough, independent audits. These audits should include a comprehensive review of the institution's operations and financial statements and all other reports filed with the regulators. In addition, an audit must report on the institution's financial position and determine the accuracy of the institution's call reports. Auditors also must verify management's assertions regarding internal controls and compliance with applicable laws and regulations.

An independent regulator regularly must evaluate capital requirements. In a dynamic and rapidly changing world, no one capital standard is right for all institutions at all times. Certain absolute minimums are necessary, but regulators routinely must determine appropriate levels for additional minimum capital and must assess the need to change risk weighting.

REGULATORY RESTRUCTURING

Insured depository institutions currently are supervised by one or more primary federal regulatory agency: the Office of the Comptroller of the Currency for national banks, the Office of Thrift Supervision for savings associations the Federal Reserve for state member banks, the FDIC for state nonmember banks, and the states for state-chartered banks and savings associations. The result has been a crazy-quilt pattern of overlapping interpretive and enforcement standards. A single, independent regulatory agency would provide the consistent and efficient administration of laws and regulations necessary to protect the safety of insured institutions.⁸ A single supervisory agency would eliminate the remnants of the age-old tradition of agency-constituency relationships that have sometimes led agencies to become cheerleaders for their segment of the industry, rather than objective, flinty supervisors. For example, many justifiably perceived the former Federal Home Loan Bank Board, parent of the FSLIC, as a captive of the savings and loan industry it was supposed to regulate and insure.

Regulatory and examination staffs must be large enough and suffi-

8. My plan would retain the FDIC as the federal insurance regulator. The new agency would have primary responsibility for financially healthy institutions; the FDIC would retain authority for administering the insurance funds and resolving insolvent institutions. When an institution's capital falls below minimum capital standards, the FDIC would have the authority to impose certain restrictions on the institution's activities to protect the insurance fund.

ciently trained to enable more frequent examinations of institutions. Never again should there be institutions that are not regularly examined. We must require annual on-site examinations of all large banks and known problem banks. Although on-site exams are labor-intensive and time-consuming, their value far outweighs these concerns. It should be obvious to all that better and more timely information saves us money in the long run.

We must enforce the statutory insurance limit per account. As matters stand today, more than 99 percent of all deposits are effectively insured, notwithstanding the \$100,000 limit authorized by law. The regulators effectively evade limits by allowing coverage of giant accounts to be treated as if they were "passed through" to clients of pension systems; further evasion occurs because a single individual can have multiple insured accounts in a single institution and in unlimited additional institutions.

In addition, the resolution methods commonly used by the FDIC simply pass all accounts, regardless of size, from a failed institution to an acquirer. The FDIC has covered 99.5 percent of all deposits from failed banks since 1985! To prevent such overcoverage, we need to enforce the cost test to determine which resolutions are indeed the least costly for the insurance funds. We need to require the least-cost solution in the shortest time possible.

The Resolution Trust Corporation (RTC), established by FIRREA to resolve failed savings associations, also generally has been transferring uninsured liabilities that would not be covered during an insurance action. In its legal capacity as exclusive manager of the RTC, the FDIC has provided insurance coverage to 99.97 percent of the \$62 billion in deposits in failed thrifts restructured by the RTC. Consequently, we need to examine proposals that would require a mandatory "haircut." Such proposals mandate a reduction in coverage for amounts over \$100,000 in cases in which the regulator determines that it is cheaper to provide assistance and transfer the uninsured liabilities rather than to liquidate and pay off only amounts of \$100,000 or less.

LIMITING INSURANCE COVERAGE

Forcing the regulators to adhere to the \$100,000 limit affects only a small number of depositors. According to the Office of Thrift Supervision, as of September 1989, 87.6 percent of all deposits in savings associations were under \$100,000. In fact, the average size of an account in a

savings institution was \$8,733.20. The FDIC estimates that the average size of bank accounts may be slightly higher. The overwhelming majority of depositors would be protected fully with far less insurance coverage than the law currently provides, and a prohibition on covering amounts over \$100,000 would affect only about two percent of all depositors!

The purpose of deposit insurance is not to protect all depositors—it is to protect small depositors who do not have the means to investigate the safety of a given investment. A reduction in the amount of coverage would encourage greater prudence by large investors and bank management alike. As it is, everyone feels free to take a flyer in a weak bank, knowing that Uncle Sam will pick up the pieces if the bank fails. This “hot money” phenomenon would be diminished with a lower amount of coverage, without adversely affecting the overwhelming majority of depositors.

I also propose preventing multiple insured accounts. It might be reasonable to allow each customer insurance on a personal account and a separate custodial account like an IRA. But today, not only can depositors have hundreds of thousands of dollars insured in differently styled accounts, all in a single institution, they can repeat the process in every single bank or savings and loan; this is a distortion and abuse of the insurance system.

So-called “super” accounts, like bank investment contracts (BICs), jumbo pension fund deposits, and other super accounts managed by sophisticated money managers, should not get the kind of free multimillion dollar protection that exists today. The professional fiduciaries or trustees who place these funds ought to be able to evaluate risks for their beneficiaries and certainly should not be rewarded for placing huge sums in weak institutions. Congress should study these super accounts: whether some kinds of pension plans should be able to get “pass through” insurance coverage as they do now; what kind of protection do pension plan participants need that they don’t have now; and should this protection now be provided by federally insured depository institutions, rather than established entities such as the Pension Benefit Guaranty Corporation?

REQUIRE PROMPT REGULATORY INTERVENTION

An additional and vital principle of my reform proposal, embodied in provisions of both H.R. 6 and H.R. 2094, is to limit the discretion of

regulators when an institution is in a weakened position. This is the most important way to resolve the “nobody can fail” problem.

At the heart of the FSLIC disaster was the failure of the regulators to take prompt and forceful action to close insolvent institutions. The use of “regulatory accounting” gimmicks, the hopes that time or “forbearance” from legal or regulatory standards would allow problems to resolve themselves, and the idea that real capital was not really necessary, all contributed to the growing depth and breadth of the current losses. Hearing exactly those same kinds of proposals now, from the banking regulatory agencies for banks, deeply disturbs me. If we have learned one thing, it is that forbearance, postponing the day of financial reckoning, only costs American taxpayers more money in the long run.

I propose that regulators follow clearly prescribed actions when an insured institution’s capital is impaired: the greater the impairment, the more stringent the action and the less discretion permitted. All institutions, regardless of size, would be treated in a like way whenever their capital is impaired and with certainty as weakness develops.

Regulators need to set clear standards and limits on asset growth, particularly by weaker institutions, and put the same mandatory, stringent regulatory responses into place. Finally, when management and management controls are clearly deficient, regulators need to force change in both, before the assets of the institution are dissipated and losses to the insurance funds result.

FIRREA imposed mandatory restrictions on capital impaired savings and loans. Similar mandatory actions clearly ought to be a central element in protecting the bank insurance fund. But such treatment still is neither certain nor uniform. I propose to remedy that. The 101st Congress passed legislation⁹ prohibiting an institution with capital below a minimum level from paying “golden parachutes” to failing managers. We now need to restrict an institution’s ability to pay dividends when it ought to be replenishing capital.

When an institution is weak or failing, there should be no payments to affiliates without regulatory approval. Limits on growth, payments on subordinated debt interest and the like all should be restricted in a systematic and non-discretionary way as conditions worsen, at least when capital continues to decline. Similarly, regulatory controls on highly capitalized institutions should be loosened.

9. Crime Control Act of 1990, Pub. L. No. 101-647, § 2523, 104 Stat. 4789, 4868.

In addition, and of great importance, I would require a clear capital restoration plan when a bank goes below current minimum standards (just as we did for savings associations in FIRREA); I would require a mandatory conservatorship or receivership at a lower level, perhaps at a two percent capital level; and, in no event would I permit regulators to keep open an insolvent institution. The clarity and certainty of the actions I have proposed in recently introduced legislation¹⁰ would impose a salutary discipline on the regulators and regulated alike. Similar steps have been proposed by the Treasury Department.

STRENGTHEN THE FINANCIAL SYSTEM

But there are still more actions needed to protect a strengthened deposit insurance system.

In FIRREA, we made commonly controlled insured depository institutions liable for each other's losses. Thus, when a number of insured institutions are commonly controlled, the controlling entity cannot allow one or more institutions to sink, hold on to only the healthy ones, and thereby leave the government holding the bag. This principle must be extended to all insured depository institution holding companies.

In addition, we should consider proposals that would assess certain peer institutions. We could divide institutions into categories based on size, and assess institutions with assets over a certain amount, for example \$5 billion, for failures among their peers. This would end the present problem of smaller institutions effectively subsidizing their bigger rivals. It would also induce their larger peers to do more self policing. Regulators also might be given the authority to distribute assets from a failed institution to other institutions in the class.

I do not believe that the so-called firewall concept is very effective in preventing a holding company from undertaking activities that can put insured depository institutions at risk. In fact, "when the heat is on, the firewalls burn down." I propose that instead of depending on firewalls or "activity restraints," we extend FIRREA's principle of cross guarantees and require indemnification or liability provisions running from the parent or affiliate to the insured institution. In this way, there is a strong and, I hope, compelling financial incentive to avoid actions by the parent company that can wreck the insured institution.

Similarly, the cross-guarantee concept needs clarification, so that the

10. See *supra* notes 1, 4.

regulators' authority to require a holding company to recapitalize insured affiliates is unquestioned. We should provide for cross-guarantees and clarify the authority of regulators to require a holding company to re-capitalize an insured depository institution subsidiary. All subsidiaries of the holding company ought to be separately capitalized.

The operative principle here is to provide incentives for holding companies or affiliates not to loot the bank or let it go down the drain, secure in the knowledge that the insurance fund (and ultimately the American taxpayer) will pick up the pieces. After all, those who own banks are given special privilege and status through their charters; they owe a special responsibility in exchange for that privilege and status.

We cannot continue to let the deposit insurance system underwrite the greatest risks, while all the profits go to owners and managers. Strengthening the system of cross guarantees, better than constructing elaborate but always vulnerable firewalls, is the best possible protection against moral hazard. An entity that has its own money at the greatest risk is not likely to undertake foolish or risky ventures. What regulation and proscription cannot accomplish, economic incentives can—this is the way to minimize the moral hazard that is associated with the deposit insurance structure today.

NEW POWERS FOR BANKS

Some have suggested that now is the time to grant banks new powers and increased possibilities of geographic expansion. I disagree. I do not believe that insured depository institutions should be able to engage in underwriting securities or insurance. I disagree with those who think that the restrictions concerning the mingling of commerce and banking should be lifted. It would be a mistake to propose new and risky activities for banks before supervisory and insurance reforms are in place and working. This same "cart before the horse" mentality plagued the deregulation of the savings and loan industry in the early 1980s.

Insured depository funds should not be placed at high risk. We must set limits and train the regulators before we expose insured depository institutions to the additional credit and interest rate risks involved with new powers and new affiliate relationships.

SUMMARY

My goals, to strengthen and protect the deposit insurance system, and

thus the insured depository institutions it stands behind, can be done by providing and enforcing adequate capital standards, by limiting insurance coverage and requiring realistic pricing for that coverage, by unifying the regulatory system and making it independent, by requiring regulators to act promptly and decisively when an insured institution begins to weaken, and by making holding companies or affiliates responsible for losses their insured institutions incur.

The reforms I am offering will not be easy, but they are necessary. Various groups will ask the Congress to continue special treatment or extended coverage. We must make the hard decisions and take the high road, the road that protects not only the financial system but the taxpayer. We need to consider rolling back the regulatory exceptions and extensions that have gradually expanded coverage over time. Delay will not make the task any easier, only harder and more costly. Despite all distractions, despite all pleas to avoid these necessary actions, the reforms I have outlined must be adopted. The only question is whether we will act before the next storm clouds break.