Shadow Financial Regulatory Committee
Administrative Office:
The Mid America Institute
[illegible]0 South Harper Street
Suite 107
Chicago, Illinois 60615
(312) 493-9800

Committee Members:
LAWRENCE CONNELL
Co-Chair
Prather, Seeger, Doolittle & Farmer
GEORGE G. KAUFMAN
Co-Chair
Loyola University of Chicago
RICHARD C. ASPINWALL
Chase Manhattan Bank
GEORGE J. BENSTON,
Emory University
FRANKLIN R. EDWARDS
Columbia University
ROBERT A. EISENBEIS
University of North Carolina at Chapel Hill
JOHN D. HAWKE, JR.
Arnold & Porter
PAUL M. HORVITZ
University of Houston
EDWARD J. KANE
Ohio State University
ROGER W. MEHLE
Royer, Shacknai & Mehle
ALLAN H. MELTZER
Carnegie-Mellon University
KENNETH E. SCOTT
Stanford Law School

Statement No. 37

For information contact:
Edward J. Kane
614-292-8708

Statement of the Shadow Financial Regulatory Committee on Assessing FDIC Premiums Against U.S. Banks' Unsubordinated Debt and Deposits in Foreign Branch Offices

December 5, 1988

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

Although unsubordinated debt and deposits in foreign branch offices are not formally covered by FDIC guarantees, neither are deposit balances in excess of $100,000, which are part of the FDIC's assessment base. All three categories enjoy substantial *de facto* federal credit support. The importance of unsubordinated debt

Sponsors:
Mid America Institute for Policy Research
[illegible]ation for Financial [illegible]ons Research
University of North Carolina

and deposits at foreign branch offices is greatest for very large U.S. banks. In the past authorities have confirmed their reluctance to allow such institutions to fail and to impose losses on holders of formally uninsured instruments when these banks become economically insolvent. Failing to price implicit federal guarantees of these liabilities constitutes a subsidy to the use of unsubordinated debt and of deposits at U.S. banks' foreign branch offices. This subsidy promotes the growth of bank debt relative to equity finance, of U.S. banks' foreign deposits relative to their domestic deposits, and of very large U.S. banks relative to smaller financial institutions.

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

---

[1] Industry estimates of the effect tend to overstate its impact on bank profits. For example, deposit rates offered by foreign banks in foreign markets will decline by part of the amount of the premium assessed. This will occur because changes in FDIC premiums affect all U.S. banks as a group, so that an FDIC premium increase implies a downward shift in the industry supply curve. Hence, declines in the equilibrium interest rate in markets for foreign deposits and nondeposit debt would

[Footnote continued on next page]

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

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

---

[Footnote continued from previous page]
cushion the net impact on the profits U.S. banks earn in these locales. This cushioning comes from whatever portion of deposit-insurance subsidiaries are currently being shifted to bank depositors and borrowers.

subsidies to the operations of large U.S. banks will distort to some degree patterns of competition in U.S. and foreign banking markets.

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