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EXPOSURE DRAFT

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Statement of the Shadow Financial Regulatory Committee on An Outline of A Program for Deposit Insurance Reform

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Successful deposit insurance reform requires that: (1) existing losses in the system need to be recognized as governmental liabilities and necessary steps taken to keep these losses from becoming larger, (2) the current regulatory and supervisory system needs to be reformed to correct the incentive problems and structural defects in the present system, (3) an acceptable phase-in period be adopted so that institutions will have time to adjust to the new regime, and (4) a method be devised to pay for the real but unrecorded losses in existing depository institutions.

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

CAPITAL POLICY

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

1. Tranche 1 - ADEQUATE CAPITAL (e.g., 10% of assets or greater) -- banks with capital above this minimum amount would be subject to "normal" (i.e., minimal) regulation and supervision.

2. Tranche 2 - FIRST LEVEL OF SUPERVISORY CONCERN (e.g., 6-9.9% of assets) -- once a depository institution's capital ratio falls into this range it

will be subject to increased regulatory supervision and more frequent monitoring of its activities. The supervisory authority will have the discretion to require the institution: (a) to submit a plan to raise sufficient capital to the entry level for Tranche 1, (b) to suspend dividend payments and/or up or downstream payments within a holding company system, and (c) to restrict permissible asset growth.

3. Tranche 3 - SECOND LEVEL OF SUPERVISORY CONCERN (e.g., 3-5.9% of assets) -- when an institution's capital ratio falls into this range, it will be subject to intense regulatory supervision and monitoring. Suspension of dividends, interest payments on subordinated debt and outflows of funds to an institution's parent or affiliates will be mandated. Prohibitions on asset growth will be used to prevent institutions from attempting to "grow" out of their problems. Finally, an institution will be required to submit an emergency plan for its recapitalization to be implemented in the event it falls into Tranche 4.

4. Tranche 4 - MANDATORY RECAPITALIZATION AND REORGANIZATION (less than 3% of assets) -- The federal deposit insurance agency will place the institution in a mandatory conservatorship. This conservatorship would

be charged with recapitalizing the institution or liquidating it in an orderly fashion within a short period of time by merger, or by sale of either the entire organization or its individual assets. Present owners will have the option of implementing the plan submitted when the institution moved into Tranche 3, or electing not to inject further funds into the institution. Following final disposition of the firm's assets, any residual value will be returned to subordinated debtholders and shareholders, after allowing for any costs incurred.

KEY CLARIFICATIONS AND FEATURES OF THE PROPOSED STRUCTURE

1. DEFINITION OF CAPITAL -- Capital should be defined as the difference between the market value of assets and the market value of liabilities other than subordinated debt.

2. SUPERVISION COSTS -- Charges for supervision, regulation, examination and monitoring would be paid for by depository institutions. Because examination and monitoring effort increases as an institution's capital declines, these charges would increase as capital

declines, so that charges function as form of risk-adjusted insurance premium.

3. CHARTER SHIFTING -- Institutions are still permitted to change their regulatory agency within the new structure. This contributes an incentive for the respective agencies to balance the costs and benefits of supervision and to limit overzealous supervision.

4. ACCOUNTABILITY OF SUPERVISORS -- Supervisors will report to Congress yearly on the institutions in each tranche and on the actions taken to restore institutions to Tranche 1.

Supervisors will be responsible for assuring that the recapitalization plans are acted upon. Periodic GAO audits, annual reports and regular congressional oversight will provide an element of discipline for the regulators.

5. REGULATORY RESPONSIBILITY IN TRANCHE 4 -- The appropriate insurance agency will be notified when an institution moves into Tranche 3 and will receive all supervisory reports, etc. in anticipation of having to take the institution over if it moves into Tranche 4.

6. CREATION OF SUPERVISORY AUDIT TRAIL -- Use of tranches and required consultations will document regulatory problems encountered in attempting to value firms as they moved through the tranches. This should simplify resolution of valuation controversies should an institution be forced into recapitalization or reorganization.

7. INSURANCE PREMIUMS -- Explicit charges for insurance should be low under this system since theoretically only fraud cases and abnormal market movements would involve significant risks to the insurance funds.

8. HOLDING COMPANIES AND PERMISSIBLE ACTIVITIES -- Neither the wisdom of the present holding company structure nor the logic of the activity restrictions that now exist under the current regulatory structure is addressed in this proposal. Resolution of these issues, while important, is a separable issue.

9. INSURANCE COVERAGE -- Present deposit insurance coverage of $ 100,000 per insured account need not be changed for the proposal to be effective.

10. MARKET VALUE ACCOUNTING -- The reorganization rules should be based on market values to minimize risks to the insurance funds and to allow both the regulators and banks to take informed actions in a timely fashion.

11. DISCLOSURE -- The reports embodying the market values of institutions should be publicly available. This will enable the Congress and public to monitor better the financial condition of banks and the performance of the supervisory agencies.

12. LARGE BANK FAILURES - All institutions that fall into Tranche 4 should be reorganized or allowed to "fail" regardless of their size and pro-rata losses charged to uninsured creditors. "Failure" means reorganization and change of ownership and does not necessarily imply a disruption of borrower or depositor relationships. Any other policy would present unacceptable incentive problems, provide inequitable treatment and foster unfair competition.

TRANSITION

Except for institutions with zero (or less) GAAP net worth, there should be a transition period for the new capital tranches and regulatory policies that might be as long as 5 years. Unless they are recapitalized, GAAP-insolvent institutions should not be kept afloat.

DEALING WITH EXISTING LOSSES IN THE SYSTEM

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

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