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Statement No. 41

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

February 13, 1989.

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

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

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

* capital adequacy policies
* increased monitoring of asset values
* timely reorganization before a depository institution's economic capital is exhausted, and
* enhanced market incentives and rigorous supervisory enforcement

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

CAPITAL POLICY

Establish four explicit, predetermined ranges or tranches of capital-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 would be subject to increased regulatory supervision and more frequent monitoring of its activities. The supervisory authority would have the discretion to require the institution: a) to submit a business plan to raise sufficient capital to attain Tranche 1 within a specified period of time, b) to suspend dividend payments or unapproved transfers of funds within a holding company system, and c) to restrict permissible asset growth.

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

4. Tranche 4 - MANDATORY RECAPITALIZATION AND REORGANIZATION (e.g., less than 3% of assets) - The federal deposit insurance agency is mandated to place the institution in a conservatorship; delayed supervisory response has been one of the causes of the level of existing losses. This conservator-

ship would be charged with recapitalizing the institution or liquidating it in an orderly fashion within a short period of time by merger, sale of the entire organization or sale of individual assets. Present owners would have the option of implementing quickly the plan submitted when the institution moved into Tranche 3, or electing not to inject further funds into the institution. If the owners elect not to recapitalize the institution, it would be sold or liquidated, and any residual value from its sale or liquidation of assets would be returned to subordinated debt holders and shareholders, after allowing for any costs incurred.

KEY CLARIFICATIONS AND FEATURES OF THE PROPOSED STRUCTURE

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

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

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

4. CHARTER SHIFTING - Institutions would be permitted to change their primary regulatory agency within the new structure. This serves as an incentive for the respective agencies to balance the costs of supervision with its benefits to the agency and to limit over zealous supervision.

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

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

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

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

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

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

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

11. DISCLOSURE - Regular reports to the supervisors embodying the market value of banks should be publicly available. This

would enable the Congress and public to monitor better the status and financial condition of banks and the performance of the supervisory agencies.

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

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

TRANSITION

Except for institutions with zero or negative GAAP net worth, there should be a transition period for the new capital tranches and regulatory policies that might be as long as 5 years. Unless they are immediately recapitalized, GAAP-insolvent institutions would not be kept in operation. Institutions that are not GAAP-insolvent would plan for a three-year phase-in of the program ending in 1992 (the final effective date of the current "risk-adjusted" capital program).

DEALING WITH EXISTING LOSSES IN THE SYSTEM

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