SHADOW FINANCIAL REGULATORY COMMITTEE

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, Mehle & Babyak
ALLAN H. MELTZER
Carnegie-Mellon University
KENNETH E. SCOTT
Stanford Law School

SUPPORTERS INCLUDE
AMERICAN INSTITUTE FOR PUBLIC POLICY RESEARCH
SARAH SCAIFE FOUNDATION
UNIVERSITY OF NORTH CAROLINA

Administrative Office
c/o Professor George Kaufman
Loyola University of Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
(312) 915-7075
FAX (312) 915-7003

Statement No. 59

For information contact:
George J. Benston
404-727-7831

Robert A. Eisenbeis
919-962-3203

Statement of the Shadow Financial Regulatory Committee on Condition of the Bank Insurance Fund

September 24, 1990

Emerging problems in the banking industry are now recognized as posing a serious threat to the Bank Insurance Fund (BIF). Both the General Accounting Office (GAO) and Congressional Budget Office (CBO) have recently stated that actual and contingent liabilities may exhaust the BIF. The Committee is concerned that declines in the health of FDIC-insured savings banks, which were not considered in the GAO and CBO analyses, threaten an additional drain.

Legislation has now been introduced to increase deposit insurance premiums and the borrowing authority of the FDIC. The Committee believes that raising deposit insurance premiums is not an adequate response to this problem. Raising premiums is one way to charge banks and thrifts for past and possible future losses, but this response does not address the fundamental flaws in the deposit insurance system, and may be counterproductive for several reasons.

First, higher premiums will not restrain banks from taking excessive risks. Risky banks will still have incentives to play the game, "heads we win, tails

the FDIC and then other banks and the taxpayers lose." Second, higher deposit insurance premiums tax healthy, well-run and well-capitalized depository institutions to pay for those that are poorly capitalized and risk-prone. FDIC premiums, although a small percentage of deposits, are a large fraction of many banks' net profits. This cost will make it more difficult for weak banks to survive and for U.S. banks to compete in the world market. Third, increased premiums will encourage people to bypass the banking system, thereby reducing the amount of deposits on which insurance premiums can be levied. Finally, although raising deposit insurance premiums will increase the FDIC's funds, the amount that might be raised is unlikely to be sufficient to prevent taxpayers from having to pay some of the costs of bank failures.

The Committee strongly believes that Congress and the Administration should act to increase banks' and thrifts' capital requirements substantially, and to institute policies similar to those described in our Statement No. 41 (February 1989). In particular, when an insured depository's capital declines to below a predetermined level of adequacy, the depository institution should be prohibited from growing and from paying dividends to stockholders and interest on subordinated debt, and should be required to raise additional capital. Indeed, because losses to the FDIC would be lower, adoption of this plan should result in lower, not higher, premiums for future operations. Unless a fundamental change in capital requirements is adopted, the threat to the BIF will accelerate.

In 1988 the Committee estimated that the FDIC reserves were nearly exhausted. Our Statement No. 36 (December 1988) and underlying methodology were criticized by the FDIC as being unduly "alarmist." Subsequent events, however, have confirmed the necessity for the public to monitor the true economic condition of the FDIC's insurance funds.