SHADOW FINANCIAL REGULATORY COMMITTEE

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Statement of the Shadow Financial Regulatory Committee

on

Proposals to Inject Additional Funds into the Bank Insurance Fund

February 11, 1991

In December 1988, the Shadow Financial Regulatory Committee issued a statement warning that the Federal Deposit Insurance Fund -- now the Bank Insurance Fund "BIF" -- was nearing economic insolvency (Statement No. 36, December 5, 1988). The Committee's statement was strongly denied at that time by regulatory authorities. Recently, the Congressional Budget Office, the U.S. General Accounting Office and the Chairman of the Federal Deposit Insurance Corporation have confirmed that the BIF now lacks the resources to meet its expected obligations over the next few years. Estimates of the additional funds needed range from $ 10 billion to as high as $ 40 billion. The FDIC and banking industry responses to this crisis are reminiscent of the events that preceded the insolvency of the Federal Savings and Loan Insurance Corporation: initial denial of the existence of a problem, continual underestimation of the potential costs to the taxpayer, and attempts to cover the resource shortage from industry sources that are essentially "smoke and mirrors" accounting mechanisms.

The Committee believes that the BIF's need for funds is critical, and may even be greater than currently admitted by agency officials. If this is true, then any deficiencies will ultimately be born by the taxpayer, which makes the Treasury's decision to postpone addressing this need an important omission in its recently released deposit insurance reform package.

In evaluating alternative ways to fill the hole in the BIF, it is important to recognize that there are only two sources of capital to cover losses in weak and insolvent institutions: enterprise-contributed capital, and public capital in the form of tax dollars or government guarantees. Unfortunately, many recent proposals to recapitalize the BIF primarily shuffle capital from the industry to the BIF without providing much in the way of new funds to protect the taxpayer. This is the case for the proposals currently being discussed by representatives of the banking industry in which banks would provide funds to the BIF in the form of debt or equity purchase.

Alternatively, some have called for the resurrection of net worth certificates which would count as capital for receiving institutions. This is an accounting shell game in which claims on an economically insolvent institution (BIF) would be injected into insolvent, or nearly insolvent banks. No net new funds would flow into the industry or the BIF, and this claim structure lends itself to adverse distortions to risk taking incentives within the industry. Another proposal is for the Federal Reserve to pay interest on bank balances at Reserve Banks and to pass this directly to the FDIC to augment resources of the BIF. This proposal uses what are currently taxpayer funds to support the BIF. Donating Federal Reserve interest payments to the BIF would reduce by an equal amount the Federal Reserve's yearly payment of its net earnings to the Treasury and would, absent other actions, increase the government's budget deficit. To make up the difference, taxes or borrowing would have to be increased or expenditures cut. Variants of the above proposal that transfer member bank reserves directly to the BIF and would have essentially the same consequences for the taxpayer.

Sufficient funds to cover the government's guarantee to insured depositors can only come out of the wealth of taxpayers and shareholders of well-capitalized banks. It is the appropriate function of the Congress to determine the equitable sharing of that burden between these parties. The Committee strongly urges that the BIF refinancing burden be addressed directly and immediately. Given that the banking industry bears a significant portion of the blame for the existing problem, the Committee feels that it is entirely appropriate that it bear a large portion of the cost. It would be preferable that Congress levy a one-time tax on banks rather than resort to an ongoing series of taxes on loans, deposits or assets. We must abandon the long-standing the pattern of adopting patchwork proposals that attempt either to hide the true costs to the taxpayer, or worse yet, to defer dealing with fund losses while continuing to let the costs to the taxpayer escalate.

It is the Committee's policy that members abstain from participation on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Richard Aspinwall abstained from voting on this statement.