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An Open Letter to President-Elect Clinton

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Despite significant progress in recent years, a number of important financial reforms remain unfinished. With the change of administration, the Shadow Financial Regulatory Committee finds this an opportune moment to identify key areas where early action by the new administration would be highly advisable.

Clean Up Past Deposit-Insurance Losses

The Clinton Administration will inherit a legacy of deposit-insurance losses that are not yet fully recognized nor adequately funded. Several actions should be taken to resolve these losses promptly and to prevent them from hindering future budget initiatives.

° Sufficient funds must be appropriated and used to clean up book-insolvent S&Ls already under the control of the Resolution Trust Corporation (RTC). For several months lack of funding has brought the case-resolution efforts of the RTC to a standstill. The longer these insolvencies remain unresolved, the greater the probable cost to taxpayers and the higher the odds that taxpayers will hold the new administration responsible for that cost.

° The Clinton Administration should promptly reserve for the threat of deposit insurance losses posed by weak banks and thrifts that at the moment barely pass book-value accounting tests of capital adequacy. Reserves currently posted by the Bank Insurance Fund (BIF) do not adequately recognize BIF's loss exposure in these crippled institutions and the Savings Association Insurance Fund has yet to post any reserves at all.

° It would be a mistake to attempt to fund these inherited losses solely from future deposit-insurance premium income. The required premiums would be so high that they would prove self-defeating; they would increase BIF's future loss exposure and shrink the role of U.S. deposit institutions in the domestic and world economy.

<u>Put Deposit Insurance on a Sound Footing</u>

The Administration should put the nation's deposit insurance system on a sound long-term footing. The FDIC Improvement Act of 1991 has made real contributions to correcting critical defects in the insurance system that proved so costly during the wave of S&L and bank failures of the last decade. The Act endeavors to minimize losses to the insurance fund and taxpayers by introducing a series of key reforms. These reforms emphasize the role of maintaining adequate bank capital and more timely and extensive agency intervention as capital declines, and reduce the discretion of bank supervisors to delay appropriate corrective actions.

The 1991 Act has already encouraged banks to raise a record amount of capital in the past year. Despite this fine beginning, more remains to be done. Important issues recognized by the law have not yet been satisfactorily addressed by the banking agencies.

° Bank reporting and insurance fund accounting must be changed to reflect or disclose market values of assets, liabilities and net worth rather than values founded on acquisition costs. Failure to do so makes capital ratios into unreliable indicators of economic condition or performance.

° Interest rate risk and asset concentration risk must be fully taken into account in setting capital requirements, which at present relate only to rough measures of credit risk. The failure to control interest rate risk played a large role in the S&L debacle of the last decade. The interest rate risk regulations proposed earlier this year are far from adequate for this purpose.

° The Act also appropriately requires scaling deposit insurance premiums to the riskiness of the individual bank. But the Committee believes that the range of premiums adopted is too narrow to discourage poorly capitalized banks from assuming excessive risk at the expense of well capitalized banks.

- Lastly, the Act still permits regulators to cover uninsured depositors at insolvent large banks, considered too big to fail, at the expense of healthy banks and potentially the taxpayer as well.

Resist Pressures to Address Credit Availability Problems

The Administration will be subject to pressures to change bank supervision and regulation to increase the supply of bank lending and to target bank lending to certain sectors of the economy. Both pressures should be resisted.

Available survey evidence does not demonstrate that the recent aggregate decline in bank business lending is the result of a contraction in the supply of credit, rather than the result of a decline in demand for loans. To the extent that some banks have reduced their lending, these appear to have largely been capital-deficient institutions attempting, appropriately, to address their capital inadequacy problems. This is a transitory phenomenon. In the Committee's view, recent changes in bank supervisory attitudes have not caused an aggregate credit crunch.

- The Administration should not be tempted to "jump start" the economy by weakening prudential standards. In the long run, such a policy will undermine the health of the U.S. banking system and potentially expose taxpayers to large losses.

- For the same reason, the new administration should not attempt to remedy economic or credit availability problems in favored sectors of the economy by manipulating the weights in the risk-based capital structure.

Promote a More Competitive Financial System

Changes in technology and the integration of world financial markets have made institutional and geographic restrictions sources of serious competitive distortions. These restrictions should be eliminated and regulatory reforms should be initiated that will enhance competition among providers of financial services.

- The new administration should promote competitiveness and increase the efficiency of financial markets by eliminating all geographic restrictions on financial activities, such as the prohibition on interstate branching.

- The Administration should move to eliminate restrictions on the services that financial institutions provide, once deposit insurance reform has been adequately implemented. All financial institutions should be permitted to compete in underwriting securities, providing insurance, distributing mutual funds, offering deposits, and making loans.

- The Administration should carefully review regulatory burdens that disadvantage some categories of institutions vis-a-vis their domestic and foreign competitors. These include unnecessary disclosure requirements, intrusive operating stipulations, and programs to force institutions to provide services or credit below cost. In the highly integrated financial markets of today, failure to lighten unnecessary burdens threatens the loss of market share to foreign and domestic competitors.