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Resolving Large Bank Failures

Statement of
Johnny C. Finch
Director of Planning and Reporting
General Government Division

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Subcommittee on Economic Stabilization
Committee on Banking, Finance and Urban
Affairs
House of Representatives



Resolving Large Bank Failures

SUMMARY OF STATEMENT BY
JOHNNY C. FINCH
Director of Planning and Reporting
General Government Division
U.S. General Accounting Office

GAO is testifying today on the issues associated with resolving large bank failures. The views presented are discussed in greater detail in GAO's recently issued reports on deposit insurance, bank supervision, and accounting reforms.¹

Perhaps more than any other aspect of banking, the problems and incentives associated with resolving large bank failures show the need for comprehensive reform of the deposit insurance and bank supervisory systems. Solutions must comprehensively deal effectively and fairly with today's incentive problems that make it easy for undercapitalized or risky banks of all sizes to obtain funding that is nearly always insured by the full faith and credit of the U.S. government. Just reducing legal or de facto coverage of deposits, as some have proposed, would no doubt increase depositor discipline and improve bank management incentives to operate more safely and soundly. But such changes to coverage may also result in an unacceptably high level of instability in our financial system.

GAO does not believe that scaling back coverage for insured deposits or eliminating de facto protection for uninsured deposits is wise, at this time. The potential for systemic instability caused by reliance on uninsured depositors to discipline risk-taking is too high. The risk of instability is especially evident at the present time because of the weak financial condition of many banks, including some of the nation's largest, and the weak condition of BIF.

GAO recommends several reforms to control the ability of banks--especially those which are large and poorly-managed--to attract deposits, while at the same time maintaining continued market stability. First, better supervision of banks is essential. Bank regulators must take prompt corrective action to stop unsafe banking activities before capital deteriorates. Accounting, auditing and financial management reforms designed to improve information on banking organizations and internal controls are also necessary to make the system of prompt corrective action effective. Second, capital requirements should be strengthened to discourage bank owners and managers from taking excessive

¹Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, March 4, 1991); Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, April 15, 1991); Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991)

risks and large banks should be required to hold subordinated debt. Third, disclosure policies that give depositors and the general public better information on the condition of banks must be adopted if uninsured depositors are to be placed at greater risk. Finally, depositors with over \$100,000 should be provided the choice of insuring those deposits at an additional cost.

In the long term it may be possible to place uninsured depositors at greater risk if GAO's recommended reforms have been implemented. Nevertheless, it may still be necessary for regulators to protect uninsured depositors in a failed large bank for stability reasons.

Mr. Chairman and Members of the Subcommittee:

We appreciate this opportunity to give you GAO's views on the complex issues associated with resolving large bank failures. The views I am providing and the reforms we are recommending are discussed in greater detail in our recently issued reports on deposit insurance, bank supervision, and accounting reform¹.

Perhaps more than any other aspect of banking, the problems and incentives associated with resolving large bank failures show the need for comprehensive reform of the deposit insurance and bank supervisory systems. Solutions must comprehensively deal effectively and fairly with today's incentive problems that make it easy for undercapitalized or risky banks of all sizes to obtain funding that is nearly always insured by the full faith and credit of the U.S. government. Just reducing legal or de facto coverage of deposits, as some have proposed, would no doubt increase depositor discipline and improve bank management incentives to operate more safely and soundly. But such changes to coverage may also result in an unacceptably high level of instability in our financial system.

The reforms that we have recommended to deal with the incentive problems in banking that give rise to the "too big to fail"

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policy are all designed to ensure industry stability through the safe and sound operation of banks instead of through deposit insurance guarantees that could result in large expenses for healthy banks and taxpayers. Any attempts to increase depositor discipline must be preceded by other reforms to improve the safety and soundness of banking organizations.

BACKGROUND

Starting with the 1984 failure and rescue of Continental Illinois, bank regulators have preferred to err on the side of guarding confidence in the banking system when large banks fail. FDIC has protected all deposits in the 14 failures of banks with assets over \$1 billion. It is important to note that while depositors in these institutions have been protected, shareholders, creditors and managers have suffered almost total losses. The cost to FDIC of resolving these banks has totalled approximately \$11.8 billion.

FDIC has protected the vast majority of deposits in all banks--both large and small. About 99.6 percent of all deposits--insured and uninsured--were fully covered in bank failures from 1985 through 1989. Nevertheless, we estimate that 32 percent of the uninsured deposits in small liquidated banks suffered losses, totalling about \$100 million.

The de facto protection provided to large banks' uninsured depositors and non-deposit liabilities--such as fed funds, repurchase agreements and demand notes--has successfully protected the stability of the banking system. Yet, it has also led to a widespread perception that some banks are "too big to fail"--or perhaps more accurately "too big to be liquidated." This perception has led to a belief that uninsured depositors can safely ignore the quality of a bank if it is large enough. This situation is troublesome for a number of reasons. Among others, large banks, whose failures pose the greatest threat to FDIC's finances, have fewer incentives to control risk. In addition, depositors have incentives that favor the placement of uninsured deposits in large banks, putting small banks at a competitive disadvantage.

STABILITY CONSIDERATIONS
ARE IMPORTANT

If legal coverage limits on insured deposits or the de facto protection afforded uninsured depositors were cut back or eliminated, as some have proposed, all banks, but especially large banks, would no doubt be operated more safely in order to win and retain depositor confidence. However, depositors who are not fully protected will also have a strong incentive to withdraw funds at the first hint of problems. The real possibility of destabilizing bank runs cannot be ignored. Stopping bank runs that stem from loss of confidence in the banking system is one of

the reasons deposit insurance was established. The reasons for being concerned about disruptive runs are as valid today as when the system was created. Uninsured deposits and nondeposit liabilities account for over 60 percent of the funding of 10 of the top 25 banks in the country. Runs on our largest banking institutions could have significant destabilizing effects, through disruptions to the settlements system, correspondent banks, or foreign and domestic confidence in the U.S. banking system, particularly if a run at one large institution becomes contagious leading to runs at others.

The potential for such contagion arises from a number of factors that must be addressed before any reduction in insurance protection--de facto or otherwise--can be contemplated. First, uninsured depositors do not currently have options--such as purchasing additional insurance--for safeguarding their deposits. Second, it is unreasonable to expect most uninsured depositors to make informed decisions about the condition of the institutions in which they place funds. Even the most sophisticated of uninsured depositors cannot be expected to accurately assess the condition of banking organizations because information on those organizations is not always available. Without such information, it is all too likely that destructive bank runs will be caused by misinformed depositors. Third, the losses that would be faced by uninsured depositors must be reduced by improving bank supervision. Losses in banking organizations closed between

1985 and 1989, averaged nearly 16 percent of the failed banks' assets. We believe this represents an unacceptably high level of loss for risk-averse depositors to accept.

For these reasons, we do not believe that scaling back coverage for insured deposits or eliminating de facto protection for uninsured deposits is wise, at this time. The potential for systemic instability caused by reliance on uninsured depositors to discipline risk-taking is too high. The risk of instability is especially evident at the present time because of the weak financial condition of many banks, including some of the nation's largest banks, and the weak condition of BIF.

A NEAR TERM APPROACH IS
NEEDED THAT DOES NOT PUT
DEPOSITORS AT GREATER RISK

I indicated at the outset that the most important problem needing attention involves dealing with a system in which undercapitalized and otherwise risky banks can easily obtain funding that is backed by the full faith and credit of the U.S. government. While we do not believe it is possible to rely more on uninsured depositors to help solve this problem at this time, it is possible, through other means, to control the ability of banks--especially those which are large and poorly-managed--to attract deposits while at the same time maintaining continued

market stability. We recommend several reforms to accomplish this objective.

First, better supervision of banks is essential. Bank regulators must take prompt corrective action to stop unsafe banking activities. As described in our recently issued reports on deposit insurance reform and bank supervision, we have found that, although bank regulators have the authority to prevent unsafe and unsound activities, they do not always use it when they discover deficiencies. They prefer to work cooperatively with bank managers rather than take swift action to discipline unsafe banks. As a result, banks may continue to engage in risky practices that can increase BIF losses. To address such problems, we have recommended that regulators be required to develop an early intervention or "tripwire" supervisory system that focuses enforcement actions on the earliest signs of unsafe behavior in all banks--large or small. An important feature of the tripwire system is that the earliest tripwires enable regulators to take forceful action to stop risky practices in seemingly healthy banks before bank capital begins to fall. Implementation of the "tripwire" system we propose should help prevent poorly managed large banks from offering above market interest rates to attract deposits, and would lower the cost to the FDIC when banks do fail.

The success of any early intervention strategy depends on good information on the value of insured banking institutions. To provide regulators with more accurate information we have recommended a strengthening of financial and management reporting requirements for banks and their external auditors, valuing problem assets based on existing market conditions, strengthening the corporate governance mechanisms for banks, and requiring annual, full scope, on-site examinations of all banks.

Second, capital requirements should be strengthened to discourage bank owners and managers from taking excessive risks and to provide a financial buffer between losses resulting from poor business decisions and the resources of the Bank Insurance Fund. We recommend that strengthened capital requirements be phased in after the risk-based Basle capital standard is fully implemented in 1992, and that they include provisions for better controlling interest rate risk. As part of the effort to strengthen capital requirements, we recommend that large banks be required to hold a minimum level of subordinated debt so that they become subject to the market discipline associated with such debt. Because subordinated debt holders are in danger of losing their investment when a bank fails, they have a strong incentive to control bank risk-taking, imposing many of the disciplinary benefits generally believed to exist if uninsured depositors were exposed to greater losses. The costs of raising subordinated debt would increase with the riskiness of the bank, and would

therefore give a clear signal to bank owners, uninsured depositors and the bank regulators of the health and perceived risk of the bank. Unacceptably high costs for such debt should force bank management to reevaluate its strategies.

Third, disclosure policies that give depositors and the general public better information on the condition of banks must be adopted. If uninsured depositors are placed at greater risk, they must have accurate and readily available information about their banks. This information could include capitalization ratios and levels, the relative performance of loan portfolios, CAMEL ratings and deficiencies noted by examiners. We have recommended that bank regulators, in consultation with industry experts, be required to develop appropriate disclosure requirements.

Fourth, a risk-based deposit insurance premium system that can be used as a supplement to risk-based capital requirements should be implemented. Such a system would provide an incentive for the owners and managers of institutions to control risk and would help regulators focus on risks incurred by the banks they are supervising.

Finally, uninsured depositors should be provided the choice of insuring their deposits at an additional cost. Options for accomplishing this result include collateralizing accounts with

lower yields to reflect their comparative safety or the purchase of additional insurance protection through the FDIC. This would allow depositors to make a more rational trade-off between risk and return than is now possible and should make the banking system less susceptible to bank runs.

IN THE LONG-TERM, IT MAY
BE POSSIBLE TO PLACE
DEPOSITORS AT GREATER RISK

In the past, decisions by uninsured depositors to withdraw funds from weak banks--like the Bank of New England--forced regulators to deal with insolvent banks that probably should have been resolved earlier. The ambiguity present in the current system generated sufficient market discipline to finally curtail the amount of regulatory forbearance shown toward these troubled banks.

If such discipline is to play an expanded role in the future, certain conditions must be met so as not to jeopardize market stability. The banking system and BIF must be in a much sounder condition than they are today and the near term reforms I have discussed relating to bank supervision accounting and auditing standards, bank capital, improved information, risk-based insurance premiums, and alternative coverage options should be substantially implemented.

When these conditions have been met, it may be appropriate to consider requiring FDIC to resolve failed banks in ways that more frequently impose losses on uninsured depositors. While such a requirement would not automatically impose losses in every instance, we believe it could significantly increase depositor discipline at large banks.

Nevertheless, even with our recommended reforms it may still be necessary for regulators to protect uninsured depositors in a failed large bank for stability reasons. Under certain conditions--a severe recession or an unstable international environment, for example--the threat of irrational runs may be so great that it would be reasonable to protect uninsured depositors. For these reasons, we believe that even in the long-run a formal policy requiring the FDIC to follow a least cost resolution method, as some have proposed, and impose losses on uninsured depositors under all circumstances would not be wise. Instead, the Federal Reserve, in conjunction with FDIC, should be given the authority to determine whether the failure of a bank would be detrimental to the stability of the U.S. financial system. If so, such a bank could be resolved in ways that protect uninsured liabilities. We are uncertain how often such intervention would be needed. However, if all of the reforms I have mentioned are implemented, such intervention should become the exception, not the rule it is today.

The Bank Insurance Fund, not the Federal Reserve or Treasury, should continue to finance such resolutions. Requiring the industry, through its BIF premiums, to pay for large bank failures will create powerful incentives for the industry to pressure FDIC to effectively deal with problems in large banks, thereby limiting losses from those that do fail.

CONCLUSIONS

Regulatory policies for resolving large bank failures have successfully protected the stability of our financial system but have reduced the incentives for owners and managers of large institutions to operate their banks in a safe and sound manner. They have also placed small banks at a competitive disadvantage.

The reforms we have recommended to resolve these problems do not require cutting back legal or defacto deposit insurance coverage. Yet they will curtail the ability of risky banks to attract uninsured deposits. These reforms also go a long way towards reducing the disparity between large and small bank regulation. Our "tripwire" system will restrict the access poorly operated large banks have to uninsured deposits, thereby reducing the advantage they have under de facto protection of uninsured depositors. In addition, our recommendation to strengthen capital standards--particularly with respect to subordinated debt--will specifically affect larger banks. Finally, other

reforms that we have recommended--such as relaxing restraints on interstate branching--not specifically designed to deal with the incentive problems of large banking organizations and depositors, might also strengthen banking organizations and reduce their probability of failure.

It would be beneficial, in the long term, to make de facto protection much less predictable for uninsured depositors. In pursuit of this goal, however, the ability of the Federal Reserve and FDIC to take whatever actions are needed to protect systemic stability should in no way be compromised.

This concludes my prepared statement. My colleagues and I will be pleased to answer any questions.

Copies of GAO reports cited in this statement are available upon request. The first five copies of any GAO report are free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

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