

Panel 3

Lessons of the Eighties: What Does the Evidence Show?

The World Financial System: Lessons Learned and Challenges Ahead

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It is an honor to come to the land of the world's major banks to talk with you about international finance. At last count, four of the five largest banks in the world, and 15 of the largest 30 were based in your country. Japan and its international banking relationships are key players in a system where every major international bank can influence, or perhaps even threaten, the entire world of finance.

Coming from the United States, I suspect I am invited here primarily for two reasons. First, my country has experienced, and now recovered from, a banking and savings and loan and credit union problem of major proportions—clearly the worst difficulties since the Great Depression. About 2,000 institutions failed and two of the three deposit insurance funds had to be recapitalized. The S&L fund became a liability of the government at a cost of over \$100 billion. Notably, the other two insurance funds were able to meet their obligations without cost to the taxpayer. These two funds were refinanced and recapitalized by the premiums of the institutions they served.

Second, I'm here because my government service covered this traumatic period of disaster and recovery. Thus, I can report from first-hand experience what happened to the U.S. financial system.

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I will use my experience to give you thoughts on a few of the major lessons we learned in the United States and also the lesson the U.S. learned in its relations to the world financial community. Given the extent of the problems, we in the U.S. are “long” on experience and if we don’t learn a lot from these experiences, we will surely repeat our problems.

After reviewing lessons learned, my views on the major challenges ahead will conclude this statement. Obviously, this is an ambitious undertaking so please understand I will only highlight what seem to me to be the most important issues.

Lessons Learned

First, every major developed nation learned that it is possible to have serious banking problems despite a great variety of regulatory structures, deposit insurance systems and banking organizations. Nations like the United States with thousands of banks had problems. But so did countries with only a few major institutions such as Canada, England, Sweden, Norway and others. Nations with relatively small insurance funds like Japan and the United Kingdom had problems, as did the United States with a very large and comprehensive funding. It seems evident that government subsidies like deposit insurance cannot be determined to be the basic cause of the problem, though subsidies may affect its magnitude. Equally, countries with a large, hands-on regulatory system like the United States and those with much smaller ones like Japan and England had similar types and dimensions of system upset.

No developed country system escaped banking problems, though it must be noted that the rigid German regulatory system probably fared better than most. This rigid system, however, seems to create competitive problems of its own. No magic formula for supervision or financed system can be identified from the difficulties of the last decade.

In the United States, states have different types of regulatory structures. In Massachusetts, regulation was strict and in Texas, less rigid, but both states’ banks had severe financial problems.

Thus, lesson one then must be that there is no “magic bullet” system that will ensure banking safety and soundness.

Second, when world-wide financial problems occurred, every country called upon the government to move in and deal with the situation. No country said let

the market work without any government intervention. Moreover, with respect to large institutions, uniformly, the government adhered to what we label in the United States as the “too big to fail doctrine.” All governments moved to protect the system from economic trauma that could result from large bank failures. The unwritten international banking code provides that governments will rescue large international banks from failure through guaranteeing their liabilities. Here in Japan, I believe you have recently given a blanket guarantee to stabilize the system.

When I was chairman of the FDIC, we held a world conference on “too big to fail.” This meeting was something of a *failure* because a conference is in trouble when no one wants to talk about its major subject, the reason for the gathering taking place. But that was the situation at our conference in 1990. Uniformly, regulators hesitated to talk about rescuing failing institutions because even to speak about rescuing institutions might affect the way their management behaved. Thus, I labeled the “too big to fail” doctrine as an “unwritten code of international conduct.” In the United States, we now have made government rescue more difficult to achieve but it is still available when necessary. The bank regulator is yet to be born that won’t find a duty to “save the system” when the chips are down. Nor is a supervisor to be found that won’t seek to increase supervision. As the result of its experience, the U.S. regulation system is more restrictive and regulatory than it was.

As Adam Smith recognized, banking is different. Thus, lesson number two must be that financial systems are not and probably never will be totally free market systems.

Third, the banking problems of the 80s and 90s came primarily, but not exclusively, from unsound real estate lending. It is instructive to note that the real estate boom and lending fiasco appears to have started in the United States. U.S. banks had been prevented from following their customers’ desires to borrow with money-market instruments because of the U.S.’s Glass-Steagall prohibitions. This law allowed investment bankers to dominate the field. Our U.S. banks were losing the business of the larger borrowing companies.

As a result, in looking around for other kinds of loans to make, and seeking ways to maintain growth, the larger U.S. banks tried leveraged buyouts (LBOs) and Latin American loans. But the largest growth in lending was in new loans for commercial real estate. Previously, banks had done only short-term lending

on commercial real estate construction. For example, by law, they could lend on a new office building solely for the construction period and were required to have a follow-on “take out” by a long-term lender, primarily insurance companies, as a part of the required package. When this requirement was repealed, many banks, large and small, began to make loans without “take outs” and real estate lending became the fastest-growing area in the banking business.

The change was sudden and dramatic. Prior to the 80s, U.S. banks’ real estate loans were less than 10 percent of the portfolio. By the mid-80s, some banks had 50 to 60 percent of their loans in real estate. Real estate was “where the action was.” Of course, this change and increase in availability in and of itself provided fuel for funding a new commercial building boom. “A builder will build if a financier will finance.” Prices soared, construction skyrocketed and banks seemed prosperous. Inflation in the 70s had made real estate a very attractive option as it enhanced nominal value. The generous bank lending and inflationary pricing set off the real estate construction mania. Soon this same disease was affecting most of the developed world.

Excess real estate lending, powered by rapidly rising rents and prices, rapidly occurred worldwide. But more than anything else, real estate lending became the fashion, the “new” banking idea of the times.

Everywhere from Finland to Sweden to England to the United States to Japan to Australia, excessive real estate loans created the core of the banking problem. Some have maintained that government subsidies such as deposit insurance created a moral hazard, which caused institutions to behave in a non-market manner and therefore to take risks that they would not have taken without government subsidy. However, in looking around the world, the risks were taken without regard to whether the deposit insurance system was comprehensive as in the United States, minimal as in the UK, moderate as in Japan, or essentially non-existent as in New Zealand.

The critical catalyst causing the institutional disruption around the world can be almost uniformly described by three words: real estate loans. In the U.S., the problem was made even worse by allowing S&Ls to make commercial real estate loans in areas they knew little about. They were already in trouble because they borrowed “short” and lent “long” in financing the housing market.

Thus, our third lesson is that the biggest danger for financial institutions is lending based on excessive optimism generated about certain kinds of lending that are the fashion of the day.

Fourth, with bank failures and near failures occurring around the world, governments adopted different approaches to dealing with troubled financial institutions. In the situation where a few large institutions essentially were at the heart of the banking system, government used the approach that the United States had utilized in the Great Depression with the Reconstruction Finance Corporation (RFC). This approach required the government to take a direct financial position in the banks and to provide financial support until they could recover. Support might include buying out “bad assets” or providing investment to recapitalize the bank. Their continued existence was dependent on government support.

In contrast, in the United States during the 1980s, where thousands of institutions big and small were in trouble, a different approach was taken by the FDIC and the Resolution Trust Corporation (RTC).

The FDIC and the RTC “took over” failed institutions and protected their depositors, generally by selling deposits to another institution with accompanying funds to meet the obligations and then by disposing of their assets as rapidly as possible. In the United States, large institutions came to be handled through a new institution—a “bridge bank”—with the government creating a new bank and operating it as an owner until the institution could be disposed of privately. This system allowed the government to eliminate all liabilities and equity claims (except deposits) and start the bridge bank with a solvent balance sheet. Several insights can be gleaned from these experiences.

(a) First, each country’s solution to its failing financial institutions requires a separate plan designed to meet the particular institutional structures of that country. And within the country, each institution may require different treatment based on individual situations. Size, condition, location, etc. will affect the method used.

(b) Second, in the U.S. every plan that succeeded sought to put the institutions back into the private sector with as little government support as could be used and still be effective. In the plans that did the best the government kept its involvement to the minimum activity required to return the institution to the private sector.

(c) Third, based on U.S. experience, the quicker the action taken to deal with insolvent institutions, the lower the cost and the faster the recovery of the finan-

cial system. The biggest mistake my administration made, in its early days, was to take over a failed institution, liquidate it, take out the assets and manage them till they could be sold. Later we learned it is much more efficient and quicker to maintain the failed institution, manage it, and sell the assets from there.

Bureaucratic attempts to delay action so that the problems will not become a political issue on their watch, as happened with the U.S. S&Ls, can only lead to increasing the cost of the solution.

(d) Fourth, where commercial real estate was involved, recovery requires re-establishing an active real estate marketplace so that troubled loans and nonperforming assets could be sold. This means selling to “venture buyers” at the start of the process. But as I often said, “The RTC never saw a buyer acting out of a sense of patriotic duty.” Only with this action can the system become stabilized and the true condition of the institution be determined.

Thus, based on these insights, our fourth lesson can be that insolvent banks require government action, tailored to fit the individual situation, and the longer the corrective action is delayed the more costly and destabilized the problem will be. Of course, there were many other lessons to be noted; for example, the use of monetary policy to keep interest rates low and aid wounded banks to recover.

My final observation leads us to into the challenges of the years ahead. What encouraging things have we learned about our systems and its regulators when they were subjected to the great pressures of the last decade? We have seen remarkable resilience in the free market financial system of the developed countries in the world. In the face of the excesses of the real estate market and defaults on foreign debt, many systems were threatened but no system failed. The world system was jeopardized but it continued to function. Essentially, the marketplace did its job of self-correction, aided by large doses of government support at crucial times. In the U.S., every large bank that failed did so when the marketplace acted to force government assistance.

Thus, the fifth lesson can be that our faith in our international system, despite its flaws, actually was enhanced, perhaps to our surprise. Not only was the world financial system able to survive, but during this period international regulation was improved and the supervision of the system was changed in a fundamental way.

The Basle Committee of the IMF put into effect the first effective capital standards and procedures for the international banking community. These new

rules were designed to ensure that undercapitalized banking by nations or individual banks did not jeopardize international banking. I have attended many world conferences during my government service. The Basle (Cooke) Committee's work and accomplishments stand out as the most successful effort in international cooperation I have ever seen. These lessons of the last decade hopefully can be used to help the banks and regulators as they meet the potential large challenges to the international financial system in the decade ahead.

Challenges Ahead

How can this wealth of experience be used to give us a transformation strategy for core competence in the financial system of the next decade? What are the key challenges ahead?

The *first challenge* is to deal with the problems left in the system by the last decade of excesses. The financial system is a bit like a chain—only as strong as its weakest link. The continuing problems in Japan are now well known and action appears to be underway to restore the health of the system. But clearly more decisive steps need to be taken to deal with the problem—and the sooner the better. The Japanese real estate market must be restarted by “biting the bullet” and taking the losses that sales will require. Other developed countries also have some clean-up work to do to restore their systems.

Little has been said about the banking problems of the newly developing countries or of those that were formerly part of the communist or socialist bloc market economies. Their financial system problems are just coming to light. The World Bank tells me of the 180 countries they cover, 130 are undergoing or recovering from a crisis in their banking systems. From Venezuela to India, from Lithuania to Kenya, and from Poland to China, banking systems suffer from bad loans made largely at the direction of controlling governments for political purposes or personal favoritism. A large international effort by all of the international agencies is underway to help bring those systems to an appropriate level of safety and soundness. This can only be done when the systems are fully privatized and needed legal infrastructures are put in place. This will not be easy, but correction of these problems from the past must be a part of the new core competence of the system of the future.

The *second challenge* is to move worldwide toward *full disclosure* in a free market. As the experience of the less-developed countries particularly underscores, the best banks operate with the deregulated *free market as the primary*

regulator. Markets are self-correcting, though often late and drastic in their work. But to operate effectively, the marketplace needs *full disclosure and total transparency*. In the United States, the disclosure required by the SEC and bank regulators helped to keep most of the system's banks safe; and it helped regulators to close those that weren't. Much greater disclosure of all significant financial information worldwide is a real challenge to those who supervise the system. Only with full transparency can the free market work its wonders. Full disclosure, worldwide, will require some basic changes in philosophy in many countries. That is a real challenge, but it is essential for core competence in the years ahead.

The third challenge is to create effective international supervision of the world financial system. Supervisors, to work best, must concentrate on disclosure standards that are understandable and comparable around the globe. More is being done at the securities regulation level than at the banking level in this regard. Some sort of penalty must be developed for those countries and institutions that will not conform. Perhaps, restriction in use of the market system could be proposed. This was suggested for governments based on the recent exchange problems that came to light in Mexico. Such problems might have been less severe with more openness by the Mexican government.

In addition to supervision of disclosure, the regulators must and will continue to enhance capital standards and encompass new risks. In this regard, the evaluation of an institution's own system to measure risk is certainly the most effective supervisory method. This brings me to the next challenge.

The fourth challenge is for the banking system to operate successfully in the new technological environment. Banking was really the first business to be on an Internet-type system. Technology can create soundness or hinder it. Many have identified the globalization created by new technology as a threat to the world financial system. Its speed does create the potential for panic. Another danger is that technology also gives institutions the ability to create infinitely complex financial instruments. These new contracts are a two-edged sword, giving the banks and regulators the ability to hedge risk and also to misjudge it. The *challenge* is to *use* technology to develop systems that will aid safety and soundness, knowing all the while that it also has the potential to destroy.

I believe that technology has brought the possibility of doing a much better job of managing risk. Operating a financial institution has always been *about*

managing risk, but technology with its modeling brings a powerful new tool of management. The new approach, which requires financial institutions to build their own models, holds great promise for a more effective and timely self-correcting system. Full disclosure of the risk profiles developed by institutions can provide the information for the core competence needed in a stable system.

Thus, new technology is essential in judging the risks of derivatives and other new financial instruments. New early-warning systems can also be developed. Any unusual activity in the world's market can be monitored. This is the way personal credit is monitored in the U.S. by some institutions. *Any unusual activity and the warning alarms begin to sound.*

Using new technology to aid market discipline, full disclosure, risk management and early-warning systems gives promise that a more core competent system can be developed in the future.

But there is a *final challenge* and that challenge is common to all areas of our wonderful new interrelated world. That challenge is the threat of organized or even isolated acts of terrorism. The terrorists of the world of finance are not bombers but are the rogue traders and rogue institutions, like BCCI, Sumitomo's copper trader and his lenders, Baring's Leeson and others who can operate to undermine the system, often with cover that escapes surveillance. Today's interrelationships are such that such rogues could seriously jeopardize an institution or even threaten the financial system in a country or parts of the world. Experience here tells us that most of the rogue traders were successful in their operations because their institutions or their regulators were inadequate in their policing of the individuals involved, or worse, were seduced by the profits the rogue produced to look the other way.

The ability of these defrauders to do great harm and bring down institutions has never been greater nor more difficult to control. Like the terrorists who kill, the subway gas bomber and the perpetrators of the Pan Am 107 bombing, financial terrorists are tough to catch and even harder to protect against. Yet in the modern internationally interdependent world system, they are ever more dangerous and destructive. And financial systems could be the target of the terrorists with bombs as well as false entries. Terrorism has no easy answer. That mundane word of accountants *internal control* will be the most important requirement of the day. Constant vigilance and the development of even more sophisticated systems will be the challenge to both the financial institutions and their regulators. The

search for the most effective backup systems of internal control will be the never-ending duty of those in charge.

In conclusion, let me say there is little evidence that the future will change human nature and its weakness for over-enthusiasm and excessive pursuit of gain and a tendency of mankind to be *secretive*. Yet this aspect of human behavior lies beneath many of the challenges the financial system has faced in the last decade. I don't challenge those reasonable to change human nature. But perhaps it is fair to challenge the next generation to use technology, disclosure, supervision, cooperation and vigilance to successfully manage the "uncontrollable."

Comments on Lessons of the Eighties: What Does the Evidence Show?

Robert E. Litan*

I join the other commenters in applauding George on a thorough and well-researched paper. It will make a valuable addition to the literature. At the same time, I have several concerns about the paper and its analysis that I wish to highlight.

What Went Wrong in the 1980s?

George accurately describes the decade as one in which Murphy's law proved accurate—about everything that could have gone wrong did go wrong: banks lost their bread and butter business (commercial loans) to the commercial paper market, so they chased higher-risk LDC, real estate and LBO loans—many of which went sour; deep regional recessions in the Southwest in the early 80s and in New England at the end of the decade caused many otherwise healthy banks to topple; and many new banks entered the business and these failed at a higher rate than preexisting institutions. The paper strongly implies, if not explicitly states, however, that the one thing that went right during the 1980s was regulatory forbearance, initiated both by Congress and the regulators, which George argues gave many weak banks time to recover (although some banks took the opportunity offered by regulatory laxity to take deeper plunges).

While I agree with parts of this story line, I also have a couple of dissents or qualifications. First, it is important to note that the 1980s was not the first decade in which this country experienced deep regional recessions. I am old enough to remember the first oil shock of 1973–74, which sent many parts of the country that didn't produce oil—notably, states on the East Coast and in the Midwest—into a tailspin. Yet we had very few bank failures in the 1970s: Franklin National was one of the largest and its problems were due primarily to losses suffered in foreign exchange. Why, then, were there so many bank failures in the 1980s?

Part of the answer is that in the 1970s banks still hadn't lost much of their commercial lending franchise to the commercial paper market, as they did during the 1980s. But this is an incomplete answer because most of the bank failures in the 1980s—at least measured by the numbers—involved banks too small to have

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been involved in much lending to companies who chose to issue commercial paper instead. More important, the loss of prime quality borrowers needn't have led banks to take *improperly priced* risks, as many of them did; after all, finance companies generally make riskier loans than banks do, but charge for it through higher lending rates, and so relatively few such companies have failed.

A good portion of the answer for why so many banks experienced troubles in the 1980s, therefore, must lie in the pernicious effects of moral hazard created by deposit insurance, compounded, of course, by the litany of factors that George cites in his paper. In fact, the 1980s proved to be the decade in which Congress and federal regulators collectively extended the safety net to virtually all banks in the system. While the insurance ceiling was formally raised in 1980 (from \$40,000 to \$100,000 per account), it was, as a practical matter, increased to much higher levels—indeed to uninsured deposits of any size—in the case of the many failed banks that were merged with healthier institutions, a process that de facto protected all depositors. Moreover, regulators *explicitly* protected uninsured depositors of several large banks that failed, including Continental Illinois, Bank of New England and the MCorp banks.¹

It is not my purpose here today to question the wisdom of these actions; even with the luxury of 20–20 hindsight I can certainly sympathize with the desire of policymakers who had to wrestle with the Continental crisis to avoid a potentially damaging run on many major banks if the uninsured depositors of Continental had not been protected (the bank failed, after all, during a time of great anxiety about the health of money-center banks generally). But the blanket extension of protection to virtually all bank depositors during the 1980s had its price in undermining the incentives of managers of banks, especially large banks, to avoid taking excessive risks—a price which showed up in record deposit insurance losses during the decade and into the early 1990s.

Yet even with these perverse incentives, many bank failures could still have been avoided had full interstate banking (and branching) been in effect throughout the 1980s. It is well known, for example, that during the 1980s nine of the top ten banking organizations in Texas failed. It is not a coincidence that Texas also

¹ Indeed, in the case of Continental, policymakers even guaranteed uninsured creditors of the *holding company*, not just the bank.

severely restricted branch banking and for a time, prohibited out-of-state bank holding companies from coming into the state. While Texas suffered a deep recession during the decade, it is unlikely that all of the state's top banking organizations would have toppled had they been integrated into larger, nationwide institutions that would have spread their lending risks across different geographic regions. In this regard, it is unfortunate that apparently Texas has chosen to opt out of the nationwide branching law that is to become effective later this year.

Regulatory Forbearance

While George concedes that regulatory forbearance for thrifts in the 1980s proved to be a major mistake, he takes a more sanguine view of the practice for banks, which represents an implicit, if not explicit criticism of the “Prompt Corrective Action” (PCA) provisions of FDICIA (requiring regulators to take early actions as bank capital weakens, such as constraining bank growth unless they raise more capital, and taking over banks even before they are insolvent on a book value basis).

To be sure, George cites some data suggesting forbearance was costly: if PCA had been applied during the 1980s, then 340 banks that failed would have been closed or recapitalized earlier, saving an estimated 6 percent of their resolution cost, or about \$600 million.² At the same time, however, George also seems to suggest that this cost was a small price to pay for the following “successes”:

(1) that most of the banks classified as problem banks during the 1980–94 period did not fail, which suggests that allowing troubled banks breathing space—and not prematurely closing them or forcing their recapitalization or sale—was a good idea;

(2) that most banks granted forbearance because of their heavy concentrations of agricultural and energy loans that turned sour actually survived; and

(3) that losses of the banks that failed were not materially greater than the losses of other failed banks, suggesting that forbearance didn't make things worse.

² Readers should note that these figures were taken from a draft paper and so differ from those presented in Chapter 1 in volume 1 of this study (FDIC's note).

Furthermore, George argues that by focusing only on capital, as a way of avoiding forbearance in the future, FDICIA looks at a lagging indicator of weakness, suggesting that Congress has forced regulators to pay attention to the wrong measure.

These are interesting observations, but they overlook several other compelling considerations. First, and perhaps most important, the paper does not discuss what was probably the largest bank forbearance program of all during the 1980s—the fact that the regulators did not force the large banks that had big LDC debt exposures to mark their loans to market, and thus to replenish their depleted capital positions or to shrink. In fact, as already noted, regulators bailed out Continental’s uninsured depositors in large part out of fear that otherwise depositors would run on other money-center banks that were then in trouble over LDC loans.

Defenders of “big bank forbearance” will no doubt argue that the policy “worked”: other than Continental no money-center bank failed. But this version of history overlooks the fact that by not constraining the growth of weakened banks, regulators allowed them to gamble for recovery—in much the same way that many truly insolvent thrifts gambled for “resurrection”—by pouring tens of billions of dollars into commercial real estate and other high-risk loans on which the banks later had to take big writedowns. By looking only at the FDIC’s losses from forbearance and neglecting the larger economy-wide resources that were wasted by banks that faced insufficient incentives to be prudent, the paper fails to properly measure the true total costs of forbearance.

Second, what I read to be an implicit criticism in the paper of the PCA requirements of FDICIA ignores the valuable *deterrent* effect of PCA, which has encouraged banks to push capital ratios above the regulatory minimum, as an insurance device, if you will, against suffering the costs or indignities of automatic regulatory intervention if at some point they are forced to weather unusually large losses again. This extra layer of capital that is now found in many banks has largely removed the danger of the country repeating the sorry episode of the 1980s, a valuable benefit of FDICIA.

Third, the paper argues that regulators were taking a tough line on weak banks in the 80s—even before FDICIA. This claim is inconsistent with some of the evidence Jim Barth, Dan Brumbaugh, and I looked at in 1990 when we studied the Bank Insurance Fund for the House Banking Committee. We found that in

1987 and 1989, two years when large banks took big hits on their loan portfolios, there were significant numbers of large banks (those having at least \$1 billion in assets) that lost money yet nevertheless were allowed to pay dividends. This was true even for banks with capital ratios less than 6 percent, then considered to be a benchmark of health (39 in 1987 and 29 in 1989).

Fourth, while the paper is correct in arguing that capital, as measured by *book value*, is a lagging indicator of health, it should be pointed out that capital measured at *market value* almost by definition would provide a more current indication of a bank's true health. Yet it must also be recognized that for many of the nation's largest banks, with their increasingly sophisticated derivatives operations, even current market values may not provide a good signal of the bank's true risk exposure. This is because changes in the values of derivatives, as well as loan instruments themselves, can cause the market value of a bank's capital to move by significant margins from day to day, even by substantial amounts within the day. One of the challenges for regulators and market participants alike in the future is to harness the tremendous advances in information technology and communications to move in the direction of real time monitoring of banks, indeed of all financial institutions, so that these fluctuations in value can be more precisely determined and monitored.

In the meantime, I want to close with a suggestion for making the job of regulators easier—while also ensuring that they are not able again to be tempted to resort to forbearance strategies in the future, which I believe, on balance, are dangerous to pursue. The idea is not novel, but all the same, it's about time it should be implemented.

In brief, I believe that large banking organizations—say, those with assets of \$10 billion or more—should be required to back some small portion of their assets (such as 1 percent) with long-term subordinated (and thus uninsured) debt. The debt should be staggered in maturity so that, even if a bank didn't grow, it would have to regularly (quarterly) go to the market to sell its debt. And just to be clear, I would impose the requirement on *banks*, and not their holding companies (which do not rely on insured deposits).

Why subordinated debt? One important reason is that it is a stable source of funds: unlike holders of uninsured deposits who can run on a moment's notice, holders of subordinated debt are stuck with their investments until maturity (or until they can persuade someone else to take the securities off their hands). As a

result, investors in uninsured subordinated debt have very strong incentives to encourage banks to avoid imprudent risks, as well as to disclose a maximum amount of information (yes, even balance sheets marked-to-market) that would be useful to investors.

Subordinated debt is also better than capital at disciplining a bank because holders of the debt do not share in the upside of a bank's gains, and thus have no incentives to encourage gambling. At the same time, the amount of subordinated debt cannot be manipulated, unlike equity, which consists in part of retained earnings (which can be manipulated through various devices—lenient loss reserving being just one example).

Finally, subordinated debt also disciplines regulators. Weak banks that cannot sell their debt in the market at reasonable terms will not be able to grow and take more risks. As a result, regulators cannot engage in forbearance even if they want to. And that is one lesson from the 1980s that should not be forgotten.

The Lessons of the 1980s for Bank Regulation: An Overview of the Overview

Lawrence J. White*

The 1980s and early 1990s were an extraordinary era for depository institutions and for their regulators. Failures of commercial banks and of savings institutions occurred in numbers that had not been seen since the early 1930s—indeed, in numbers that the regulatory reforms of the 1930s were supposed to have precluded.

The Federal Deposit Insurance Corporation (FDIC) should be warmly commended for its decision to commission a set of studies (“History of the Eighties—Lessons for the Future”) that is intended to assess this experience for commercial banks (and their regulators) and to distill the lessons for future regulation. Having read three of the papers, I am eager to see the remainder of the papers from this Project; I believe that they will add significantly to our understanding of that turbulent period.

In these comments I will first briefly discuss George Hanc’s overview paper, “A Summary of the Project Findings.” I will then expand on a number of themes that arose at the January 16, 1997, Symposium at which three of the Project’s papers (“A Summary of the Project Findings,” “Bank Examination and Enforcement, 1980–1994,” and “Off-Site Surveillance Systems in the 1980s and Early 1990s”) were presented.

A. Hanc’s Paper

George Hanc’s “Summary. . .” is a clear statement of the findings of the other papers and of many of the problems that arose in commercial banking in the 1980s. It is well written and will improve most readers’ understanding of what went wrong during that decade.

But, alas, at the end Hanc is too restrained. We don’t learn what Hanc, with the benefit of “20–20 hindsight,” would recommend that the FDIC should have done differently. And, given that hindsight, what are the “Lessons for the Future” that should be learned?

Though the Symposium was not about the S&L debacle of roughly the same period, I know what the benefit of 20–20 hindsight would cause me to recom-

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mend that my predecessors at the Federal Home Loan Bank Board should have done differently (or should have recommended strongly that the Congress do differently):

- S&Ls should have been deregulated in 1960 and 1962, not 1980 and 1982, in terms of their ability to have wider asset powers and to originate adjustable-rate mortgages (ARMs).
- Regulation Q (which placed ceilings on the interest rates that could be paid on deposits) ought not to have been extended to S&Ls in 1966 or should have been repealed in 1970, not 1980.
- The headquarters of the Ninth District of the Federal Home Loan Bank System should have been moved from Little Rock to Dallas in 1973, not 1983.

Even if none of these actions had occurred, my 20–20 hindsight would cause me still to recommend that the deregulatory actions of the 1980–1982 period should have proceeded; but they should have been accompanied by:

- More examiners and supervisors, not fewer.
- Tougher capital standards, not weaker.
- A better accounting system (market value accounting), not one that allowed goodwill assets to be freely created when there were no underlying values.
- An assignment of examiners and supervisors from other districts to the Dallas (Ninth District) office in 1983–1985, to help cover the personnel shortages that arose in that office after the move from Little Rock.
- Tighter limits on annual growth by any individual S&L.
- A strong memo to all FHLBB personnel that George Bailey (as portrayed by Jimmy Stewart in “It’s a Wonderful Life”) was no longer the CEO of any S&L in their jurisdiction.

Though these are the specific actions that should have been applied to the actual historical experience, they carry clear implications for future policy.¹ I hope that Hanc—either as part of this Project or in another forum—will distill clearly from the studies the “should have been done” and “therefore should be done” implications for commercial banks and their regulation.

Let me now turn to some recurrent themes of the Symposium.

¹ I have previously outlined my beliefs about the implications for regulation. See Lawrence J. White, *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation*. New York: Oxford University Press (1991).

B. Rules versus Discretion

It is the natural inclination of regulators to want discretion. I know that this is so; I've been there. Rigid rules never have enough flexibility to allow the "right" outcomes under all circumstances. Hence, we need discretion.

But discretion can be abused. In the early 1980s discretion toward S&Ls became "forbearance," and the eventual costs were quite high.

In reality, the choice is never between "only discretion" and "no discretion;" instead, we are always on a slippery slope somewhere in between, with the necessity of making tradeoffs. But in the process of considering those tradeoffs, we need to shed at least one important piece of mythology that still mistakenly guides too much policy in the bank regulation area.

That mythology is exemplified by the giant-sized photographs that adorn the walls of the auditorium where the Symposium was held. They show worried men and women in lines outside failed or failing banks, hoping that their deposits have not evaporated. These are marvelous photographs and an important reminder of why deposit insurance is a vital part of today's banking world.

But a second look at the photographs shows that they are all vintage shots of the 1930s. There are good reasons why this is so. Equivalent photos could not have been taken during the past 60 years.² This phenomenon doesn't happen any more. Even when the FDIC has to close an insolvent bank, the agency almost always does so after the close of business on a Friday, and the bank typically re-opens with new owners (and often a new name) on Monday. But virtually all depositors are unaffected. Even in the rare instance when the FDIC actually closes a bank permanently and liquidates the assets, the insured deposits are moved to a neighboring bank, or the checks are ready for the insured depositors by that Monday.

Nevertheless, the mythology of shuttered banks and forlorn depositors queuing in the street to get the bad news about their deposits still dominates too much of regulatory policy.

Specifically, consider bank closures and the tradeoffs between mistakenly delaying closure (excessive discretion) and mistakenly closing a bank prema-

² Perhaps there were somewhat similar photos that were taken in the mid-1980s when state-chartered thrifts in Maryland and Ohio failed and their state-sponsored deposit insurance funds also failed; but such photos would not be available in the cases of failures of federally insured institutions.

turely (insufficient discretion).³ The costs of inadequate monitoring and delayed closure can be quite high, as the S&L debacle illustrated. The costs of premature closure also are not trivial. As Stephen Steinbrink reminded the Symposium, closure removes the owners and (usually) the top managers and affects their reputations; the FDIC should not do this casually or without sufficient cause. But the notion that bank closures are catastrophic events for communities (as illustrated by the photographs on the wall), and therefore should be avoided at almost any cost, is simply a relic from another era that (thankfully) the FDIC has buried in practice and that (hopefully) the agency soon will put to rest in thought as well.

In sum, the tradeoffs between discretion and strict rules, and thus between delayed and early closures, should be considered on the basis of the real costs and benefits of each route and not by the outdated mythology of bank closures as catastrophic community events.

C. The Dangers of Narrow “Back-Casting” or Extrapolation

As an illustration of the potential costs of rigid rules, the Project conducted a statistical exercise to “back-cast” the application of the “prompt corrective action” (PCA) rules imposed by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 to the experience of the 1980s. The studies found that the imposition of the rules would have caused the “unnecessary” closure of 143 thinly capitalized banks. (Their closure would have been “unnecessary” in the sense that these 143 banks actually survived and did not require eventual closure). But, as Hanc points out in a footnote, the actual numbers of banks that would have been so closed would have been different from 143, because the presence of PCA would have changed some (or, perhaps, many) bank owners’ and managers’ behaviors; specifically, they likely would have avoided some activities and/or raised capital earlier if they had believed that the PCA rules would apply to them, so the number of prematurely closed institutions would have been less. Steinbrink made the same point in his oral remarks at the symposium.

This point is too important to be relegated to a footnote. To be sure, the complete modeling of the likely behavior of banks in the 1980s with the counterfactual presence of PCA is an extremely complex task; I do not wish to belittle the necessary effort nor claim that I could easily do it myself. And, yes, the simple

³ Another dimension of regulatory policy that is driven by the “shuttered-banks-and-queuing-depositors” mythology is the insistence that banks’ examination reports be kept confidential and not released to the public—presumably, so as to avoid depositors’ runs on banks in response to unfavorable examination reports.

back-casting does give us a useful benchmark. But that benchmark should be seen as just the upper bound, with the likely number of prematurely closed banks being smaller, probably considerably so (and the consequences of the premature closure would not be catastrophic, for the reasons discussed above).

The same point applies to the prospective application of market value accounting (MVA) to banks. Opponents of its application frequently cite the volatility of banks' earnings that would thereby be revealed—an implicit statement about the results of back-casting MVA onto historical bank financial results. But the actual consequences of the imposition of MVA would surely be that banks would change their investment behavior (including the acquisition of hedges, the shortening of maturities of debt securities held, and other smoothing devices) so as to reduce the volatility reported under MVA.⁴ Such changes would not be costless. But the debate ought to be focused on the benefit-cost tradeoffs of the induced reduction in that volatility⁵ and not on the past levels of volatility that generally accepted accounting principles (GAAP) have masked and that MVA would have revealed.

D. Where Was the Risk?

Reidhill and O'Keefe's paper presents a careful analysis of all of the potential elements that might have led to banks' downfalls. Their conclusion, which is also found in Hanc's paper, is that high loans/assets ratios were the best leading indicator of a bank's likelihood of subsequently failing.

Though I do not question the substance of Reidhill and O'Keefe's methods, I wonder if high loans/assets ratios themselves really were the culprit⁶—or whether these high ratios were really indicators of some underlying elements of riskiness that the data are not capturing.⁷ After all, modern finance theory has come to understand that an important comparative advantage of banks is as infor-

⁴ Similarly, if bank owners and managers know that examination reports will be made public and that such revelation might sometimes be embarrassing, they are likely to change their behaviors so that the underlying conditions that give rise to embarrassment are less likely to occur.

⁵ As is clear from the discussion below, I believe that the benefits would exceed the costs.

⁶ Also, the identification of high loans/assets ratios as the risky element has the flavor of the 1960s, when loans were considered risky and debt securities were considered safe for a bank.

⁷ Reidhill and O'Keefe also find that rapid growth rates in assets and in loans are significantly associated with subsequent failure rates. This finding has considerably more appeal, since rapid growth is likely to place stress on any organization—leading to errors and possibly losses. Reidhill and O'Keefe do not present any correlation coefficients between loans/assets ratios and growth rates; if they are positive and high (as I would guess they are), the high loans/assets ratios may well be a proxy for rapid growth and other risky strategies.

mation processors and monitors of loans that are made to firms and individuals who are too small and/or too informationally opaque to be able to access securities markets. Equivalently, banks' comparative advantage is generally not in investing in publicly traded debt securities but rather in making loans.

Consequently, I urge extreme caution in interpreting these results as indicating that high loans/assets ratios for banks are automatically a suspicious characteristic worthy of regulatory scrutiny. And in any event, as the papers suggest (and, indeed, they ought to emphasize), any reliance on static ratio tests for discerning risk must be supplemented by forward-looking stress tests.

E. The Quality of the Information

The accounting system used by banks is the crucial determinant of the quarterly Call Report data, the determination of a bank's profitability, the calculation of the bank's capital, and ultimately (as Steinbrink reminded the Symposium) the basis for the regulators' being able to take legal actions vis-à-vis an errant bank. Reported insolvency is always a comforting piece of evidentiary support for nervous agency lawyers when a receivership for a bank is being contemplated.

But, unlike a system of weights and measures, the GAAP accounting system that is the standard today has no physical reality; a bank's capital (or net worth) cannot be measured in the same physical way that tons of grain or barrels of oil can be measured. Instead, GAAP provides a set of definitions and rules that guide the arithmetic of balance-sheet and profit-and-loss statement calculations. The GAAP definitions and rules are generally oriented toward backward-looking, cost-based valuations—which are more appropriate for a “stewardship” notion of accounting than for using the accounting information as an indicator of whether a bank may be sliding toward (or may have already reached) true (market value) insolvency that will be costly to the deposit insurance fund (and possibly to uninsured depositors).

In this context, then, it is clear that GAAP has not served bank regulators well. This inadequacy of GAAP arose a number of times in the papers and in the discussions at the Symposium, explicitly and implicitly:

- In the “Examination and Enforcement” paper, the FDIC found that regulatory supervisors were reluctant or unable to bring sufficient pressure on the managements of banks that the supervisors knew were sliding downward, so long as their GAAP accounts continued to show profitability. It was stated that bank capital can be a “lagging” indicator.

- Joe Peek’s oral comments reminded the audience that, when a bank is starting to experience financial problems, it often sells its strongest assets—those with market values above their book values, so as to recognize the gains—while retaining its “underwater” assets (with market values below book values) on its balance sheet at book value. With systematic behavior of this kind, the bank’s balance sheet would soon represent a significant overstatement of the value of the bank’s assets and thus an overstatement of the bank’s capital.
- Steinbrink lamented that too often the closure of a bank was delayed beyond when it should have happened, because of the delays in GAAP accounting to register asset losses.
- Reidhill and O’Keefe’s findings indicated that the Call Report data of a bank’s condition (essentially, GAAP accounting data) were not very useful in predicting bank failure five years into the future (but did provide useful predictions three years in advance); and high return-on-assets (ROA) ratios in 1984 and after were associated with bank failures after 1984 (again indicating a serious drawback to relying on GAAP).
- Finally, Mark Flannery reminded the Symposium that if the regulators insist on expressing their rules in terms of GAAP book value, they “deserve everything [too many costly bank failures] that they get.”

There is a cure for these problems: moving to a current-looking market value accounting (MVA) system. If MVA were combined with on-site examinations (so that examiners can assess directly the quality of management) and forward-looking stress tests, bank regulators then would truly have the proper tools to do their jobs.

There is a conundrum here, however. My call for MVA is not new; I and others have been making this plea for over a decade. Despite slow movement in this direction by the Financial Accounting Standards Board (FASB), the basic backward-looking structure of GAAP (and the accompanying mindset of bank executives and their accountants) has remained largely unchanged. Indeed, bank regulators have resisted efforts to strengthen their own hands in this respect.

Why? The banking industry has resisted⁸ for obvious reasons, since GAAP accounting gives them a free option that they can use to gain time for themselves:

⁸ Also, the industry’s accountants have resisted—perhaps because MVA would require them to “tool up” for a different system, and perhaps because it would require them to become value estimators, a role that they are probably reluctant to adopt.

sell “above-water” assets to show gains, while keeping “underwater” assets on their balance sheets at book value and hoping that the latter’s market value will rise again. But why have the regulators resisted? Perhaps they all have been “captured” by the industry on this point; I don’t think so, but it’s a possibility. Alternatively, harking back to my earlier point concerning rules versus discretion, I think that an MVA system gives regulators less discretion (in the sense that they will have less room to forbear from forcing writedowns when their judgment is that the bank can be turned around). Or perhaps the sheer newness of an MVA system and the difficult questions that would arise in the transition from the “known” existing GAAP to a new MVA system are too daunting.

In any event, I find it to be a political-economy puzzle that regulators have been so opposed to considering MVA.⁹

F. Conclusion

There is much to be learned from the experience of the 1980s. The FDIC has made a good start in compiling and analyzing the data from that era. I look forward to reading more of the reports of the Project as they become available.

⁹ Indeed, today—and probably the next few years—would be an ideal time for the adoption of MVA: The overwhelming majority of banks are profitable and would not be seriously (adversely) affected by MVA. They wouldn’t like it (for the reasons mentioned in the text), but they could live with it today. That same statement could not have been made six or seven years ago; the industry would have fought MVA with all of its political might (because of how adversely it would have affected many of the industry’s members). In this political-economy sense, then, the stars are aligned favorably; but I fear that no one will find it worthwhile to take any initiative in this respect.

Lessons of the 1980s: Some Comments

Stanley C. Silverberg*

George Hanc has written a very comprehensive and well-balanced paper on the 1980s, and I find little to disagree within the principal thrust of his paper. In the brief time I have been given, I would like to make a few selective points on (1) the causes of the bank problems and failures in the 1980s; (2) the impact of early resolution and forbearance; (3) the role played by deposit insurance; and (4) the future role for deposit insurance and bank supervision.

1. Why Did So Many Banks Fail in the 1980s?

George Hanc is correct in emphasizing the wide swings in economic activity, in commodity prices, in prices generally, and in interest rates. Another important consideration was the fact that we had gone so many years with so few commercial bank failures—the bankers who had been around during the 1930s had all died or retired. Of the various “causes” cited, I would be inclined to place greater stress on commercial real estate than George Hanc and other speakers have done. There were several special factors in the commercial real estate market:

- Savings and loans (S&Ls) were given expanded lending authority in 1982 federal legislation and through state legislation in California, Texas and elsewhere. Many S&Ls combined incompetence with a desperate need to increase income.
- The 1986 tax legislation made investment in commercial real estate less attractive and made it much harder to sell troubled real estate.
- Bank regulators had little experience in evaluating commercial real estate loans, and prevailing accounting practices that permitted capitalizing interest for several years on such loans did not provide the appropriate flags to alert bank supervisors of existing problems. Some have suggested that earlier recognition and action by bank examiners would not have mattered. Perhaps not.
- There was also the fact that somebody else’s bad loan (whether or not an S&L made it) could adversely affect the performance of what otherwise would have been a good bank loan. The impact of others’ mistakes was significant, whether that was S&Ls in Texas, savings banks in Massachusetts or Japanese commercial banks in California.

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Commercial real estate problems in the 1980s contributed to bank problems and failures, and, I believe, poor credit judgment by banks and thrifts exacerbated the commercial real estate problem and its impact on the overall economy. Hindsight also suggests that some of the strong economic performance in the second Reagan term came at the expense of the economic performance during the Bush presidency.

High nominal and real interest rates during much of the 1980s also contributed to bank failures. During the late 1980s when nonperforming loans rose dramatically, very high carrying costs placed a heavy burden on weak banks. While there was much discussion a few years back about how the Fed saved the banking system by reducing interest rates, a careful review of rates in the late 80s and early 90s suggests that the Fed was very slow to ease monetary policy during that period—for example, the federal funds rate averaged over 8 percent in 1990 even though real GDP was declining.

2. *Forbearance and Early Resolution*

We are all familiar with the many reasons why forbearance is bad: operating losses continue; if the bank is going to fail, then the franchise value is likely to shrink; bank management focuses on what can boost short-term performance, allowing longer-term values to deteriorate; there are apt to be fire sales on those pieces of the bank that have value; and, worst of all, management has an incentive to roll the dice on risky activity. Like so many *obvious truths*, we can point out situations where forbearance allowed banks that were probably insolvent to survive or to merge without any Government assistance. And we can cite a few cases where relatively large banks would have survived or merged if the regulators had moved more slowly (Southeast, First City, and PSFS). George Hanc points out that the farm bank program and, to some degree, the mutual savings bank net worth assistance program allowed a lot of institutions to survive and probably saved money for the FDIC. These programs generally included oversight and restraint on risk taking that served to restrain the potential cost of forbearance.

The worst forbearance in the 1980s occurred among the S&Ls where capital standards and accounting rules were relaxed, where growth by marginally solvent or insolvent S&Ls was encouraged, and where weak institutions were permitted to or encouraged to acquire still weaker institutions. In these situations, continued

operation and rapid growth generally led to increased insolvency.¹ In addition, banks and stronger S&Ls were exposed to aggressive competition for deposits, loans, and services from undercapitalized institutions² and may have suffered the effects of bad commercial real estate lending as discussed above. Rigorous enforcement of capital requirements is a clear remedy for this problem.

The concept of *early resolution* was not invented in FDICIA. In principle, I believe, it had been part of the supervisory armory for many years. However, enforcement was uneven, and regulators were sometimes overly concerned about potential legal challenges to *early* closings. When a bank got into difficulty, it was pressed to write off bad loans and recapitalize (“stop being insolvent”). If it wasn’t able to raise capital it would look for a buyer, and many failures were forestalled through such transactions, whether or not bank regulators played an active role. However, there were many situations where bank management underestimated its problems or overestimated the bank’s value. Deposit insurance, slow action by regulators and limited disclosure helped keep stock prices of troubled banks at unrealistically high values. As a result, bank-saving private-sector mergers sometimes did not come off even though the raw material was there for such mergers. The failure of Franklin National in 1974 was a notable example of this.

While early resolution may save some money for the FDIC in bank failures that cannot be forestalled, I believe the principal case for an early resolution policy is that it affords a more credible threat for bank regulators, and pushes troubled banks to seek solutions while they still have value: while they still can raise capital or merge without Government assistance. In some cases the awareness of early resolution practice may be sufficient to get banks to act without pressure from the regulators. Early resolution also removes some discretion from bank regulators,³ and while that’s probably good, we should not get carried away about the value of hard and fast rules. In any case, departures from the practice will presumably require some conscious, thought-out policy.

FDICIA was enacted in December 1991, and became effective a few months later. Bank stock prices began to move up from very depressed levels in early

¹ The FDIC’s track record here was less than perfect (e.g., Seamen’s Bank for Savings, FSB where the FDIC shared supervision with the Federal Home Loan Bank System).

² This used to be referred to as the “airline problem.”

³ It is my impression that the FDIC has, in fact, tolerated some exception from early resolution, and I can think of one New York savings bank where that has apparently worked.

1991 for reasons wholly unrelated to FDICIA. The common thread was that the bank failure problem had passed its peak. The stock market apparently recognized this. Congress (and the FDIC) did not. Early resolution works very well when the market places reasonable or high valuations on bank franchises. However, in, say, 1990, the stock prices of several of the most conservatively run banks were well below book value. Investors and other banks were reluctant to pay positive prices for troubled banks without FDIC assistance. That has changed considerably during the past several years. Stock prices of thrifts came back somewhat later, and that too has led to unassisted acquisitions of troubled institutions.

An interesting question is: did the exaggeration of bank problems by many pundits, academicians, OMB, the FDIC, etc. have any impact on the market for bank stocks, and, if so, did this affect bank failures in 1990–91?

3. Deposit Insurance Coverage

For a while it was fashionable to blame deposit insurance for the bank failure problem of the 1980s, and apparently there are many today who blame deposit insurance for restrictions on bank activities⁴ and intrusions on bank practices in many areas. I believe that the high level of insurance coverage was a very important factor in contributing to the S&L failures—when combined with the absence of meaningful capital requirements, forbearance, etc. However, I believe that deposit insurance and the very high level of nominal and *de facto* coverage were only marginal contributors to bank failures.

In his paper George discusses the Continental transaction. Continental was never a realistic candidate for a payoff. Not because of correspondent banks whose resulting problems could have been addressed with receivership certificates. The three federal bank regulators were all concerned, rightly or not, with the impact of the Continental payoff for Manufacturers Hanover and other large troubled commercial banks. And there was also the fact that the FDIC did not have the system and capability to pay off Continental's depositors in a reasonable time period and without looking incompetent.

A better payoff prospect was the First National Bank of Midland, Texas, which was closed in October 1983, several months after it was apparent that the

⁴ Deposit insurance exists in Canada and the EU countries, and that has not gotten in the way of allowing banks to perform most financial services through subsidiaries or directly within the bank.

bank was insolvent. When it was closed it had assets of about \$1.4 billion and deposits of only \$575 million. Federal Reserve advances replaced large deposits and that made a cost test finding for a P&A possible. The bank had a modest number of deposit accounts (about 60,000), and, a few months earlier, a large percentage of uninsured deposits. The ultimate loss on the bank was \$400–500 million. This was a potential payoff that the FDIC could have handled. It is interesting to speculate whether paying off Midland a year or so after the Penn Square payoff would have slowed bank loan growth in Texas and elsewhere and moderated some of the banking problems during the next several years.

It is very difficult to simulate a U.S. banking system in the 1980s with much lower *de facto* insurance coverage—presumably banks would have been more vulnerable to deposit flights and this would have affected their portfolio policies. Would the Fed have necessarily been a more willing lender? Would the cost of lower coverage have been much higher interest margins to compensate for reduced leverage or reduced risk in general? FDIC practice has generally been to focus on the immediate transaction and its impact on the next transaction rather than the longer-term considerations. On the other hand, however, many of the critics of FDIC practices have not always examined the immediate or longer-run implications of their proposed alternatives.

Overall, I think the deposit insurance system performed reasonably well in handling bank failures. George Hanc provides data on the number of bank failures and deposit insurance losses. Between 1982 and 1992, cumulative failures among FDIC-insured banks amounted to about 10 percent of banks with about 10 percent of domestic deposits. Cumulative insurance losses amounted to about 1.5 percent of average outstanding domestic deposits, so that these *unusually* large losses could have been covered by an average deposit insurance assessment rate of less than 0.15 percent of deposits—a cost that could be easily borne by the banking system, and, in fact, was.

FDICIA has made it harder to avoid imposing losses on larger depositors in bank failures, and it has made it more difficult for the Fed to fund deposit outflows in insolvent banks—my preference would have been not to allow the Fed to take collateral on its advances. It might be desirable if the level of deposit insurance coverage were reduced—but that’s not going to happen. It wasn’t even possible to reduce coverage modestly by simplifying the various separate capacities associated with insurance coverage. And what member of Congress would vote to reduce the \$100,000 figure when everything is going well just because a bunch of

economists are concerned about something called *moral hazard*? As for eliminating the Government guarantee, I doubt that it would be possible to convince anyone that the guarantee won't be there, if needed. I have no problem with privatizing the FDIC if it is possible to separate insurance from supervision. However, I believe that the case for reducing various forms of Government intrusion can stand on its own, and, in any case, has little to do with deposit insurance.

4. Future Role for Deposit Insurance and Bank Regulation

During the past several years most everything has gone well for banks and thrifts. There have been few failures, and earnings have achieved record levels, not only in absolute terms, but measured as a percentage of assets and capital. Bank performance has benefited from the combination of a growing economy, relatively stable prices and relatively stable interest rates. Apart from economic factors, which are extremely important, institutional factors are also contributing to an environment where there are likely to be fewer failures. These factors include:

- The experience of the 1980s probably has made bankers more cautious about lending, concentrations and internal controls.
- Disclosure has improved. Bank analysts and large customers use output from bank reports, and the quality of data in those reports has improved for several reasons, including more cautious behavior by accounting firms.
- Capital requirements are now uniformly monitored and enforced so that banks are pushed to rectify shortfalls early. In addition, banks no longer have to compete with banks and thrifts whose pricing reflects excessive leverage.
- Early intervention is also likely to force troubled banks to look for help while they still have positive value. High valuations of bank stock have made it much easier to find help.
- The failures and/or absorptions of so many banks and thrifts have lessened some excessive competition, although geographic expansion through branching and computer-based services may more than offset this reduction in competition.
- Most banks have had an opportunity to eliminate or write off longer-term, low interest-rate loans and investments.
- Banks appear to have become more “bottom line” oriented. Why? Capital requirements; experience with high deposit insurance premiums?

Despite the factors cited above, it is hard to explain why banks are performing so well, and not just compared with the 1980s.

In this improved environment, what should be the role of bank supervision? I believe that supervision should focus on overall policies of banks, particularly on their controls in key areas. In addition, it is important to verify that bank reports are accurate. That does not mean looking at all loans or even a high percentage of loans for good banks whose reporting is accurate, based on sampling. I suspect that better coordination of on-site and off-site supervision can provide good results in a less intrusive manner. Annual examination requirements should be handled flexibly. I also believe there are opportunities for greater coordination between bank supervision and audits by accounting firms, and it may be helpful to study practices in Canada and elsewhere.