D. FILE

EXECUTIVE SECRETARIAT
ROUTING SLIP

TO:

		ACTION	INFO	DATE	INITIAL
1	DCI				
2	DDCI				
3	EXDIR				
4	D/ICS				
5	DDI				
6	DDA		X		
7	DDO				
8	DDS&T				
9	Chm/NIC				
10	GC				
11	IG				
12	Compt				
13	D/Pers		X		
14	D/OLL				
15	D/PAO				
16	SA/IA				
17	AO/DCI				
18	C/IPD/OIS				
19	NIO/ECON	✓	X		
20					
21					
22					

SUSPENSE ____________ Date

Remarks

(Received 11/20 at 1945)

cc: [redacted] OGI

[redacted]

Executive Secretary

29 Nov 84

Date

3637 (10-81)

THE WHITE HOUSE
WASHINGTON

Executive Registry
84-9935

CABINET AFFAIRS STAFFING MEMORANDUM

Date: 11/19/84 **Number:** 169092CA **Due By:**

Subject: Cabinet Council on Economic Affairs Planning Meeting - November 20, 1984 - 8:45 A.M. TOPIC: Deposit Insurance System

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☑	☐
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☑	☐
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
GSA	☐	☐
EPA	☐	☐
NASA	☐	☐
OPM	☐	☐
VA	☐	☐
SBA	☐	☐

	Action	FYI
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
	☐	☐
	☐	☐
	☐	☐
Baker	☑	☐
Deaver	☐	☑
Darman *(For WH Staffing)*	☑	☐
Mc Farlane	☐	☑
Svahn	☑	☐
Chapman	☐	☑
	☐	☐
	☐	☐
	☐	☐
	☐	☐
Executive Secretary for:		
CCCT	☐	☐
CCEA	☑	☐
CCFA	☐	☐
CCHR	☐	☐
CCLP	☐	☐
CCMA	☐	☐
CCNRE	☐	☐

REMARKS:

There will be a Cabinet Council on Economic Affaris planning meeting on Tuesday, November 20, at 8:45 A.M. in the Roosevelt Room.

The agenda and background paper are attached.

DCI EXEC REG

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2

☐ Don Clarey ☑ Tom Gibson ☐ Larry Herbolsheimer
Associate Director
Office of Cabinet Affairs

THE WHITE HOUSE

WASHINGTON

November 19, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Paper for the November 20 Meeting

The agenda and paper for the November 20 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The Council will discuss the Deposit Insurance Study which is being conducted through the CCEA Working Group on Financial Institutions. A paper, prepared by Thomas Healey, Assistant Secretary of the Treasury for Domestic Finance who chairs the Working Group, is attached.

This brief paper presents an overview of the work completed thus far. It focuses on:

1. The origins and development of the deposit insurance system;

2. The current status of the insurance funds and the industries they insure; and

3. The appropriate goals for a modern deposit insurance system.

In the coming weeks the Working Group will finish its review and present possible options for reforms.

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

November 20, 1984

8:45 a.m.

Roosevelt Room

AGENDA

1. Deposit Insurance Studies (CM # 149)

CM#149

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

November 19, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: Thomas J. Healey T

SUBJECT: Federal Deposit Insurance System Study

The purpose of this paper is to give the CCEA an overview of the status and direction of the deposit insurance system study. The final study will be organized into five chapters and an appendix.

The first chapter discusses the creation of the current system in the 1930's and highlights the major changes since then. The second chapter illustrates the current status of the underlying commercial bank and thrift industries and the insurance funds. The third chapter lays out the two primary goals of the insurance system that continue to be relevant today and describes principles to be applied in reviewing the various reform options. The fourth chapter describes all of the major reform options and analyzes them. A fifth chapter of recommendations will be added after determination by the CCEA of which options represent the best policy choices. Finally, an appendix reviews recent proposals to change the system made by the FDIC and the FHLBB.

Description of the present system

The deposit insurance funds continue to fit within a broader program of government mechanisms for ensuring the soundness of depository institutions. Three interrelated programs form the current structure supporting financial system stability. The first two -- the Federal Reserve's lender-of-last resort capability, and federal deposit insurance -- are designed to ensure the solvency and stability of the entire financial system. The third, statutes and regulations supported by periodic federal examinations and enforcement authority, acts to reduce the likelihood of failure of any individual institution. The deposit insurance system study is necessarily cognizant of the role of the other programs in providing systemic stability.

While the current insurance system has satisfied the goal of maintaining stability over the past 50 years, there is concern that the economic changes and increasing riskiness potential of large institutions may threaten the ability of the insurance funds to fulfill their goals. Moreover, the insurance system appears to treat large and small depository institutions differently, raising substantial public policy questions. These are the concerns that the CCEA Working Group was asked to examine.

Origins of the System

The first chapter discusses the creation of the insurance system in the 1930's and highlights the major changes in the economic environment since then. The immediate impetus for federal deposit insurance was the rash of bank failures during the Depression. In passing legislation to reduce the number of bank insolvencies and to prevent resulting financial instability, the Congress focused on protecting against the cause of most runs, by insuring the small depositor. Similar treatment was accorded to thrifts.

Major changes since the 1930's

There have been significant changes affecting the insurance system since the 1930's. The most significant changes affecting depository institutions were the advent of high inflation and volatile interest rates at the same time as technology permitted increased competition for funding sources from nondepository institutions. High and volatile interest rates resulted in increased consumer sophistication and institutional innovation. Substantial external competition from nondepository institutions is now occurring; today there is no significant financial service provided by a bank or thrift which is not also offered by less regulated competition. At the same time, communications technology has allowed funds to be divided into insurable amounts and transferred around the world in seconds, giving regulators little time to respond to a run. These shifts in turn cause potential severe liquidity problems at depository institutions.

Environmental changes also affected the asset side of the balance sheet. Borrower sophistication led to the development of the commercial paper market which reduces high quality lending opportunities for commercial banks. At the thrifts, new asset powers have led to the development of adjustable-rate mortgages and new types of credit risk from nonmortgage loans.

Incentive for risk-taking

The current system of flat rate premiums provides neither incentives for prudent management of risks nor for market penalties for imprudent risk managment. To the contrary, with low capital levels, the flat (and cheap) rate premium system creates incentives for managers and owners to speculate. They have everything to gain if they win their bets; the insurer (and in the extreme case, the Treasury) pays if they lose. For an institution with low or no capital, even taking modest risks might precipitate failure. But taking modest risks would also be unlikely to restore financial health quickly enough to avoid failure. Therefore, there is incentive to take large risks which could lead to either rapid recovery or rapid failure. Losses in excess of owners' meager investments are borne by the insurer, while owners reap all the rewards of winning bets.

Status of the underlying industries and the insurance funds*

The second chapter describes the current status of the underlying commercial bank and thrift industries and the insurance funds. It would be inappropriate to evaluate the deposit insurance systems without also analyzing the status of the industries they insure. Risk in their industries is clearly a cause of concern for both funds. For example there are 6 FSLIC-insured institutions and 13 FDIC-insured commercial banks that each have deposits larger than the total assets of their respective funds.

Commercial banks

The commercial bank industry is suffering from the aftermath of a long and deep worldwide recession. Banks with credit exposure to the energy and agriculture sectors and third world borrowers have suffered the most. In 1984, a modern record of 5% of banks were identified as problem cases. However, available evidence indicates a growing disparity between strong and weak banks under deregulation which implies that the better banks continue to perform well in a deregulated environment.

The biggest risk to the stability of the financial system inherently lies in the largest banks. The gradual trend toward increased concentration of assets in the largest banks makes the stability of the largest banks even more important

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*Sixteen charts illustrating the status of the bank and thrift industries are attached to this paper.

to stability of the entire financial system. The top ten banks now control 25% of the total banking assets, compared with 20% in 1958. Moreover, the largest banks tend to fund their liabilities with more volatile and hence, riskier funds on average than the industry. Banks with over $10 billion in assets fund 60% with volatile liabilities, compared with an industry average of 40%. The largest banks also seem to have invested in some of the riskier loans. The 24 largest banks accounted for 76.9% of all U.S. bank foreign loans. Yet the larger banks also have lower capital ratios than smaller banks and therefore, less of a buffer for the insurance fund.

Thrifts

Savings and loan associations and mutual savings banks face severe problems of their own. Their long-term and historically high quality mortgage assets are at interest rates on the average much below the cost of their short-term funding sources, most of which are now at market rates. Fixed-rate and inexpensive passbook accounts have dropped from 83% of total interest bearing liabilities in 1966 to less than 9% in June 1984. The effect of the rise in interest rates on earnings and capital has been dramatic and the number of problem thrifts has risen commensurately. At the end of 1983 over one-third of all thrifts were reporting losses. One of the results has been a reduction in equity capital, the buffer for the insurance fund. The industry average equity-to-assets ratio was 4.19% at year-end 1983. However, excluding the effects of regulatory accounting and goodwill, it was a meager 0.5%.

One of the results of the low or negative equity capital is that there is increased incentive to invest in high risk/high return investments. If the investment fails, the owner/manager has little to lose because there is so little invested capital, yet the insurance funds must pick up the tab. If the investment flourishes the returns will be high to managers and owners. Savings and loan associations' average growth rate rose dramatically to 18% in 1983, in part resulting from these high risk strategies which are funded quickly through offering above market interest rates. Sharp recent increases in S&L growth rates, coupled with riskier loans, exacerbate the potential problems for the FSLIC.

Goals and principles

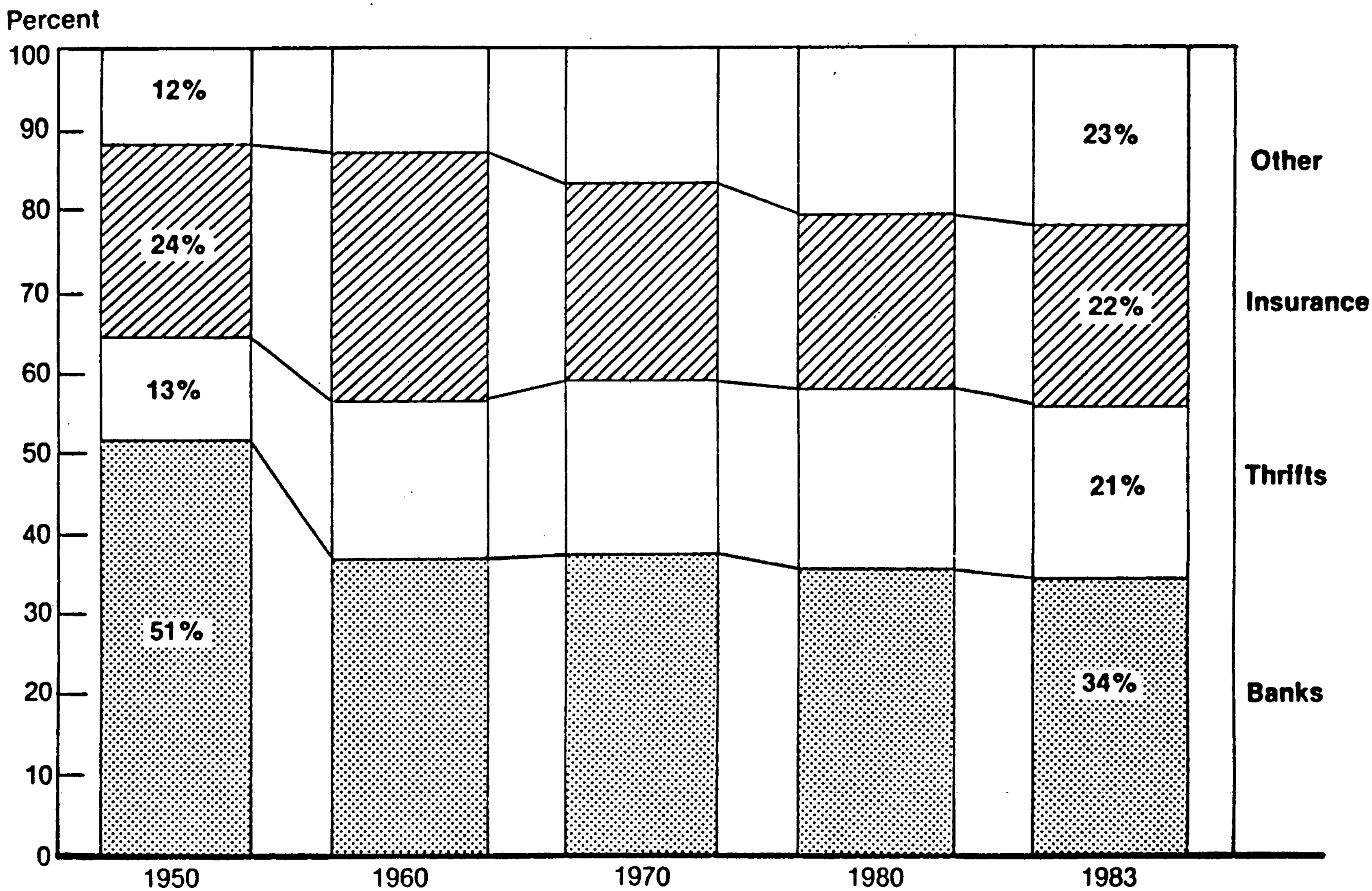
The third chapter lays out the two primary goals of a modern insurance system (the same conceptual goals as were appropriate when the FDIC was started 51 years ago). The two primary goals are: to assure the stability of the depository system, and to protect small depositors.

Seven principles have been selected by which to judge the appropriateness of changes to the present system. They are: (1) limiting distortions, (2) relying on market-oriented arrangements, (3) encouraging market monitoring of risk, (4) improving predictability, (5) promoting equity, (6) minimizing taxpayer subsidies, and (7) ensuring future flexibility.

Attachments

Chart 1

FINANCIAL INSTITUTION SHARES OF DOMESTIC FINANCIAL ASSETS



Source: Flow of Funds, Federal Reserve

Financial Assets Exclude Fixed Assets, Interbank Transactions, and Assets Booked in Foreign Offices

Chart 2

TOTAL ASSETS

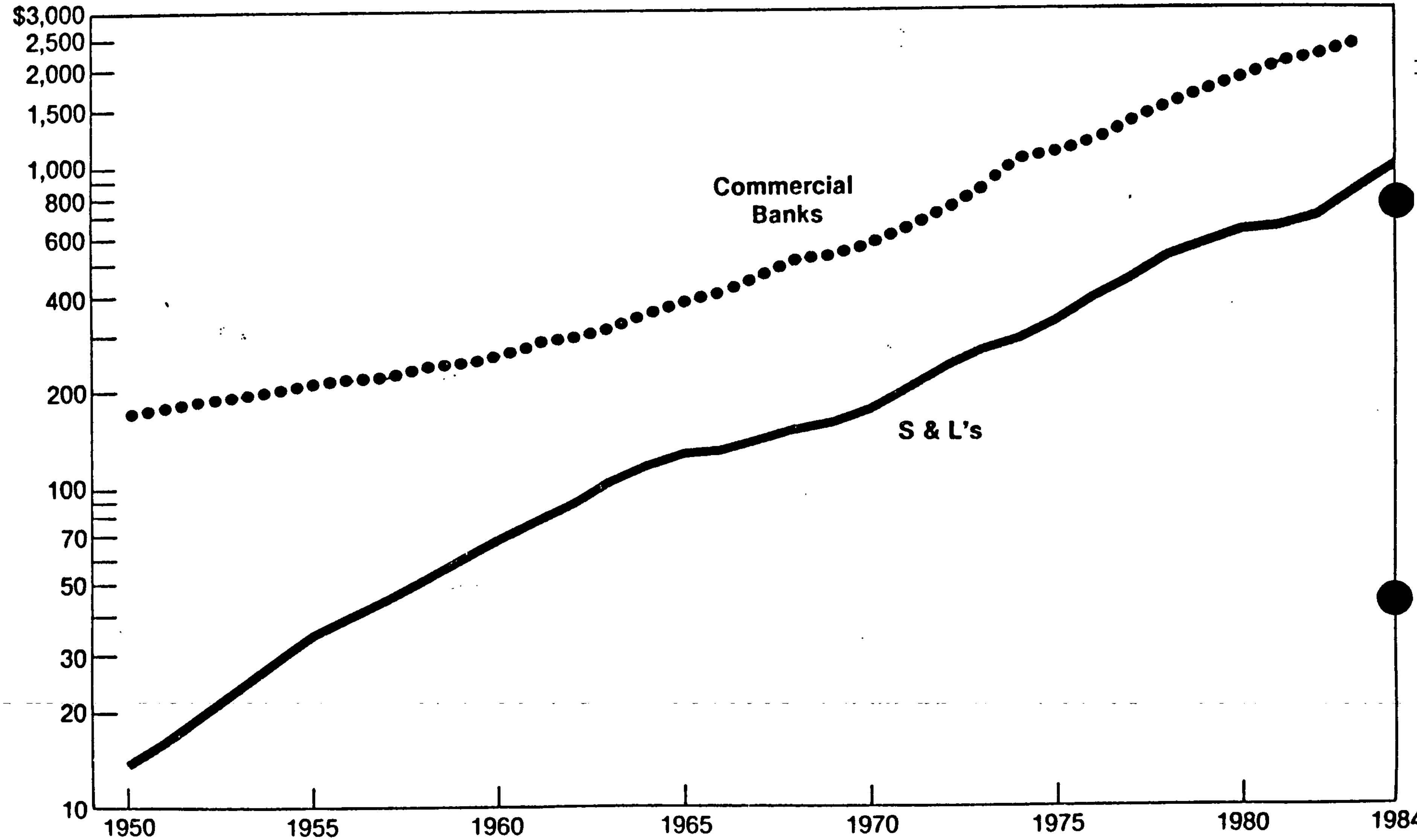


Chart 3

TOTAL ASSETS

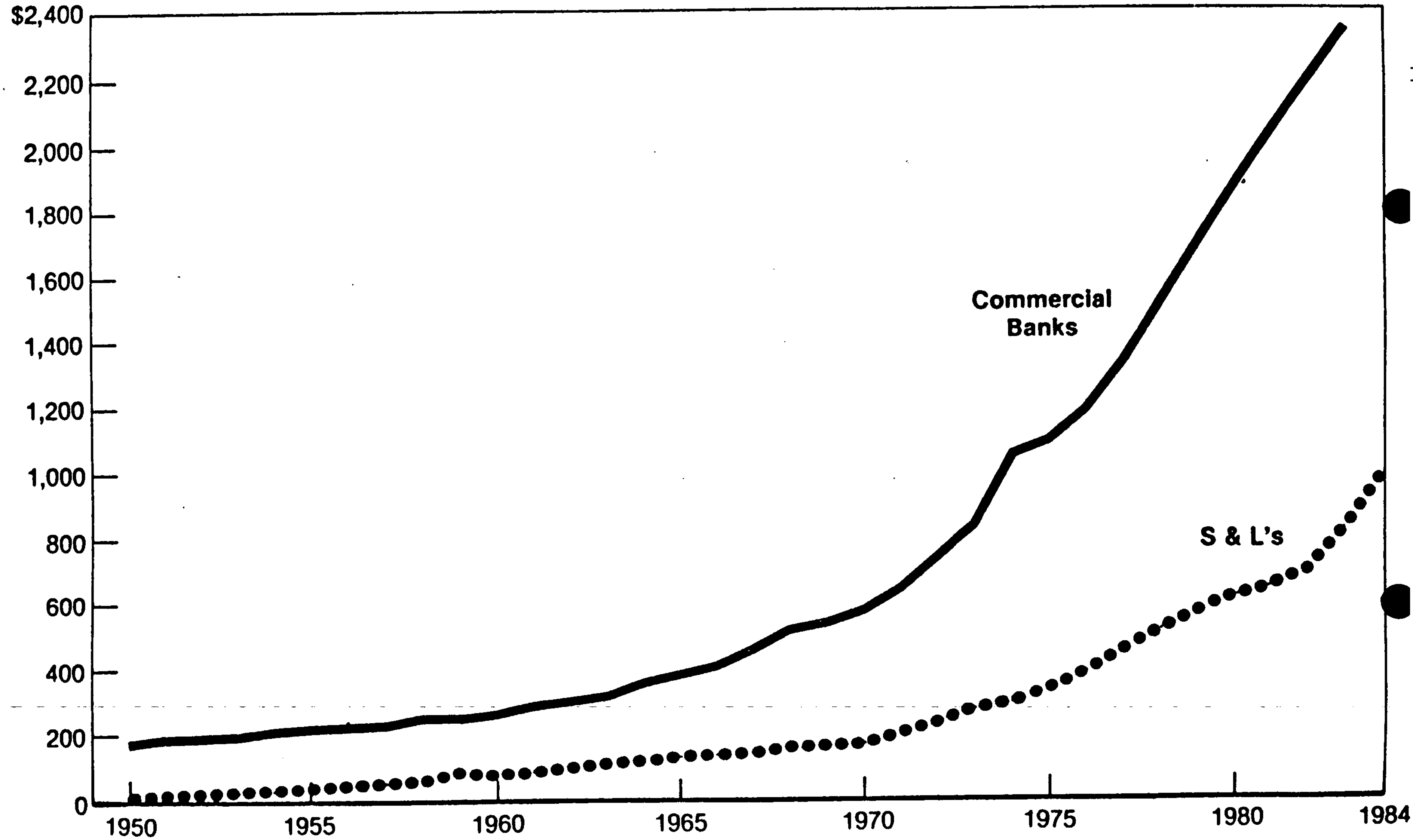
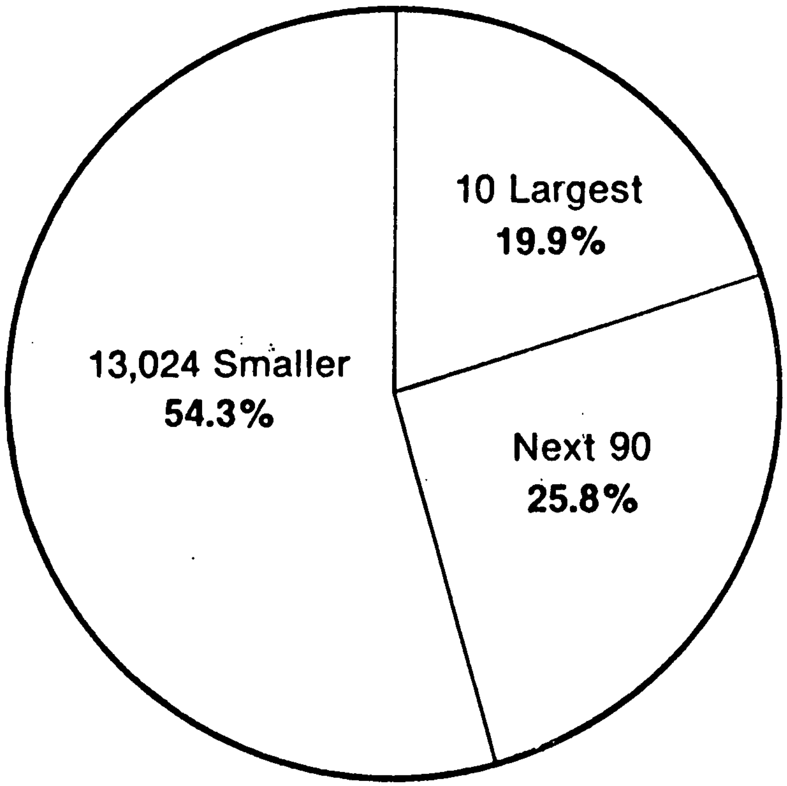
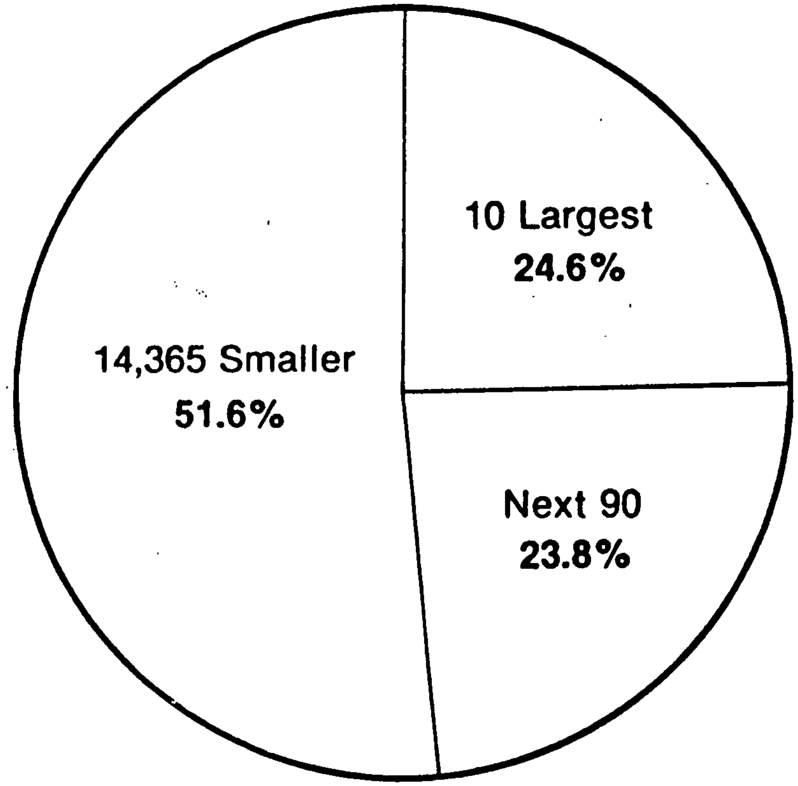


Chart 4

COMMERCIAL BANK ASSETS BY BANK SIZE



1958



1983

Chart 5

S & L's DOUBLING IN SIZE

Based on 6/83 — 6/84 Growth Rates
Industry Growth Rate = 14.3%
(Assets in $Billions)

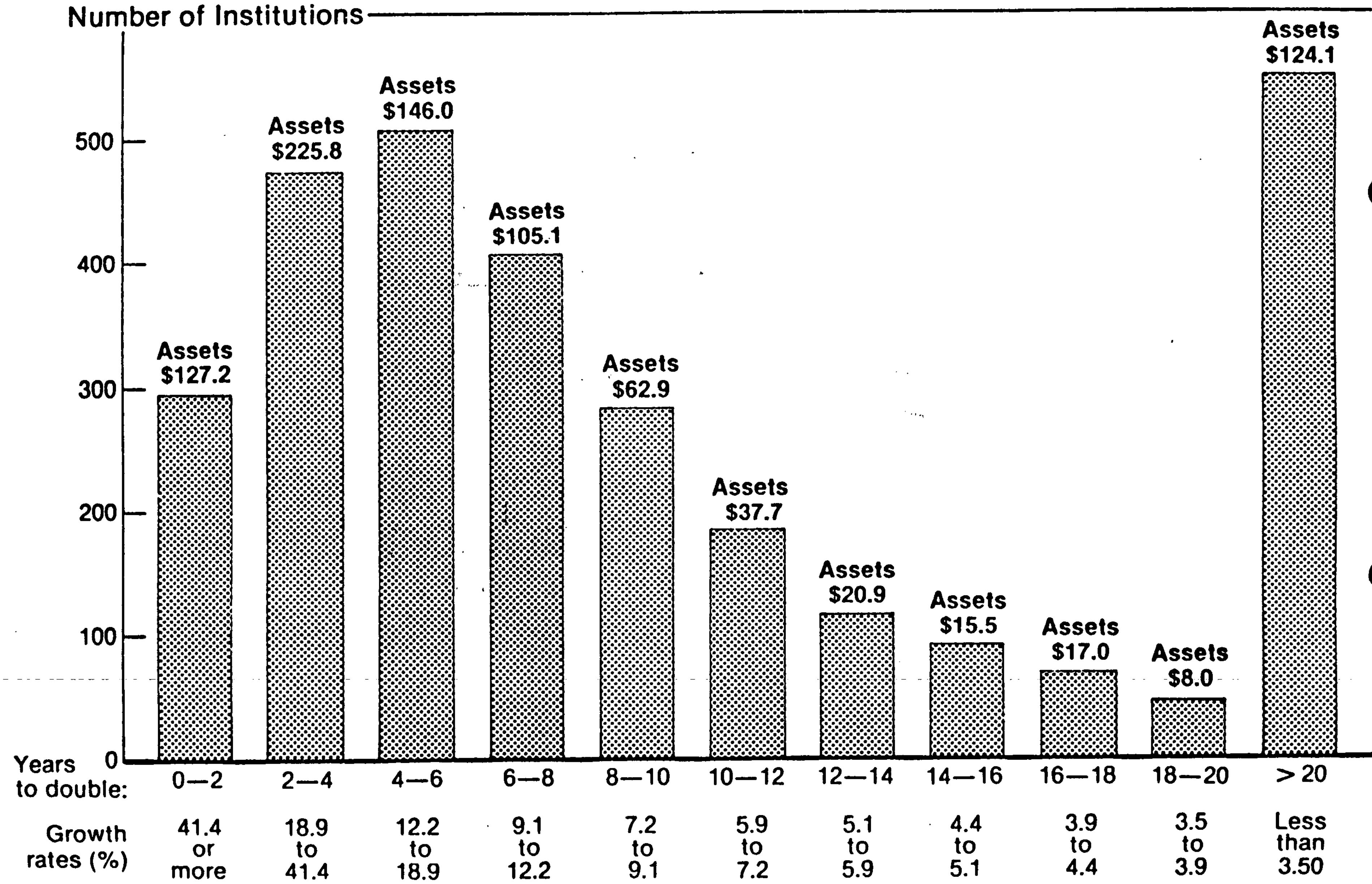


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Chart 6

DISTRIBUTION OF S & L's INTEREST-BEARING LIABILITIES

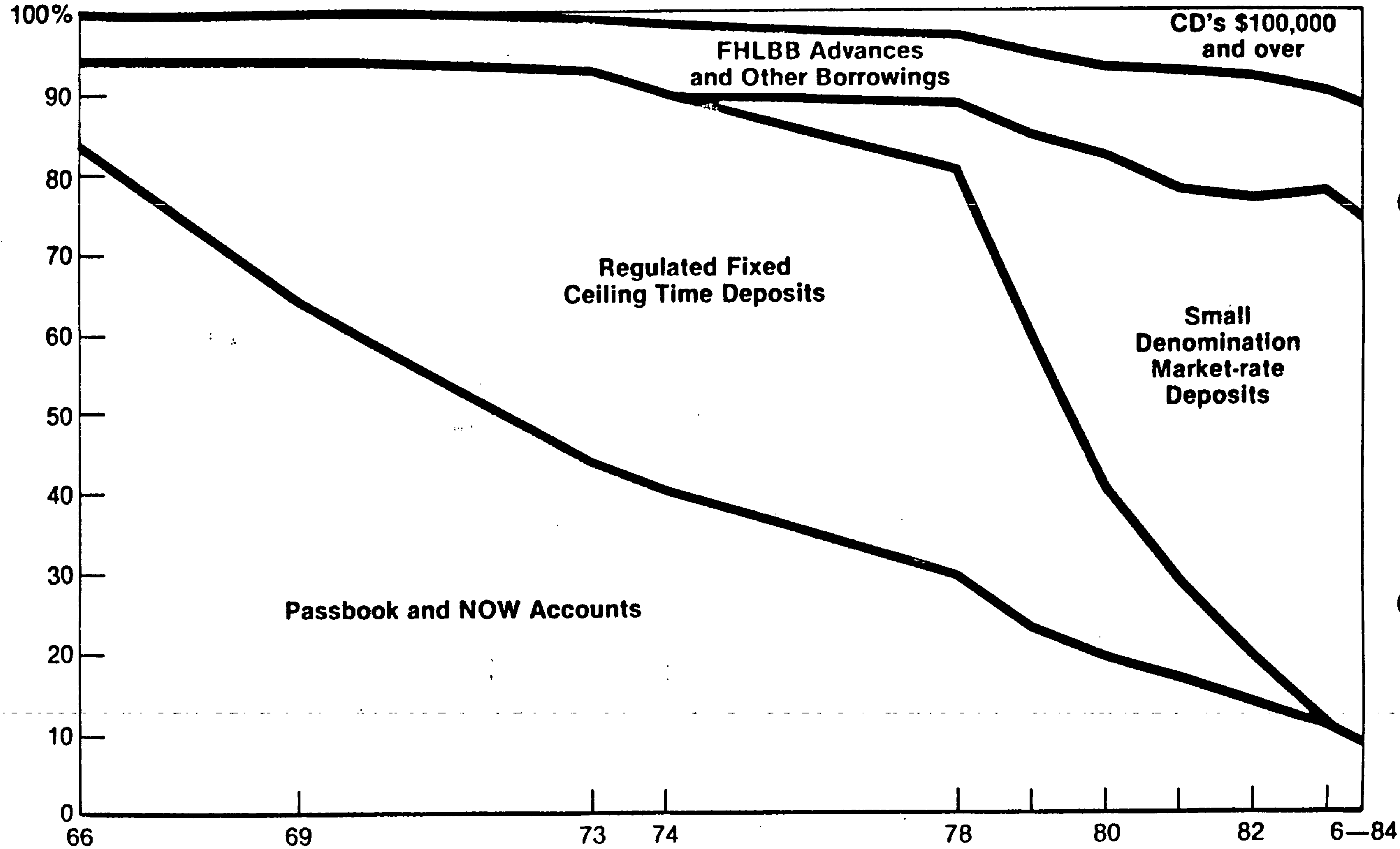

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Chart 7

EQUITY RATIOS

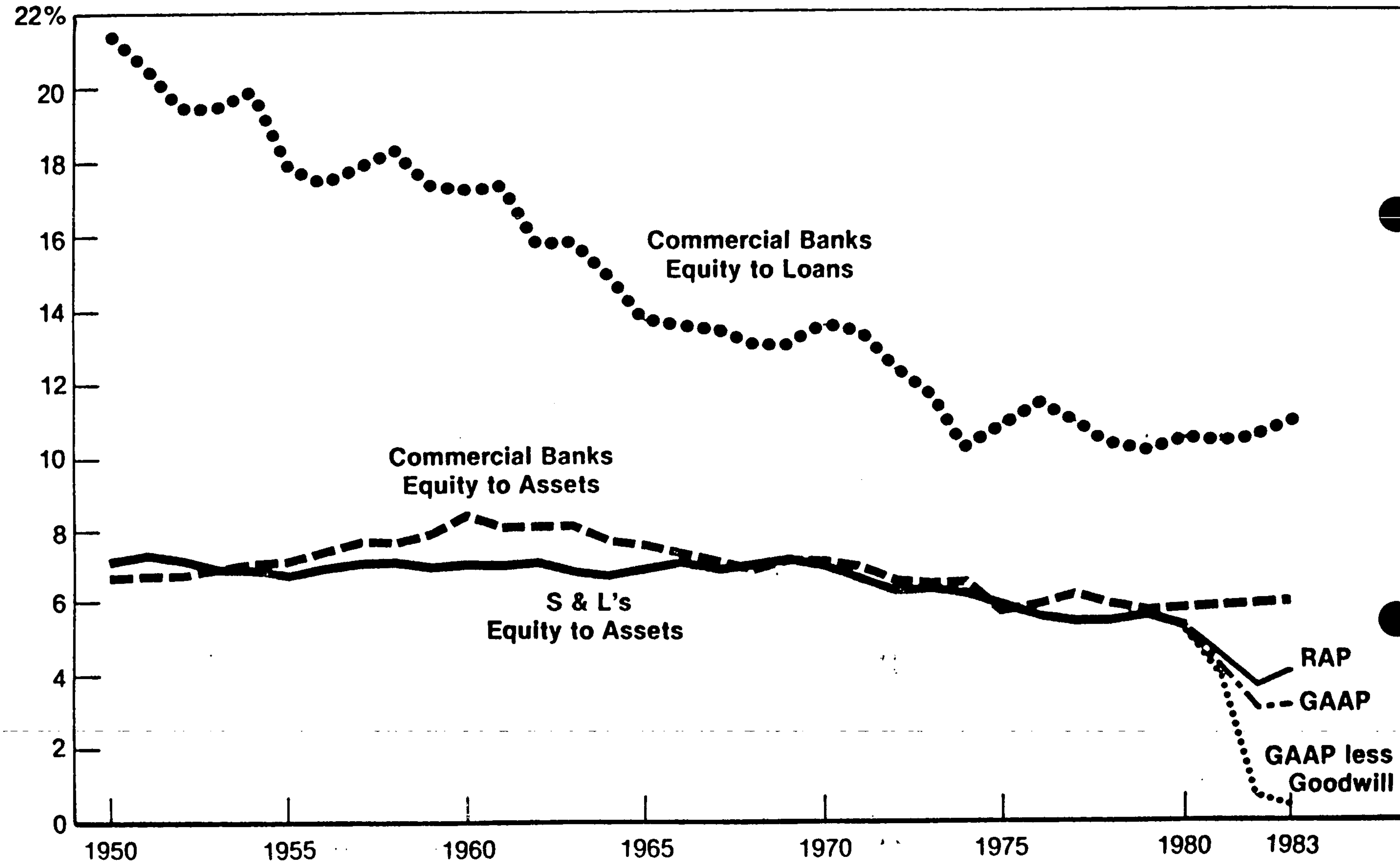

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Chart 8

RETURN ON AVERAGE ASSETS

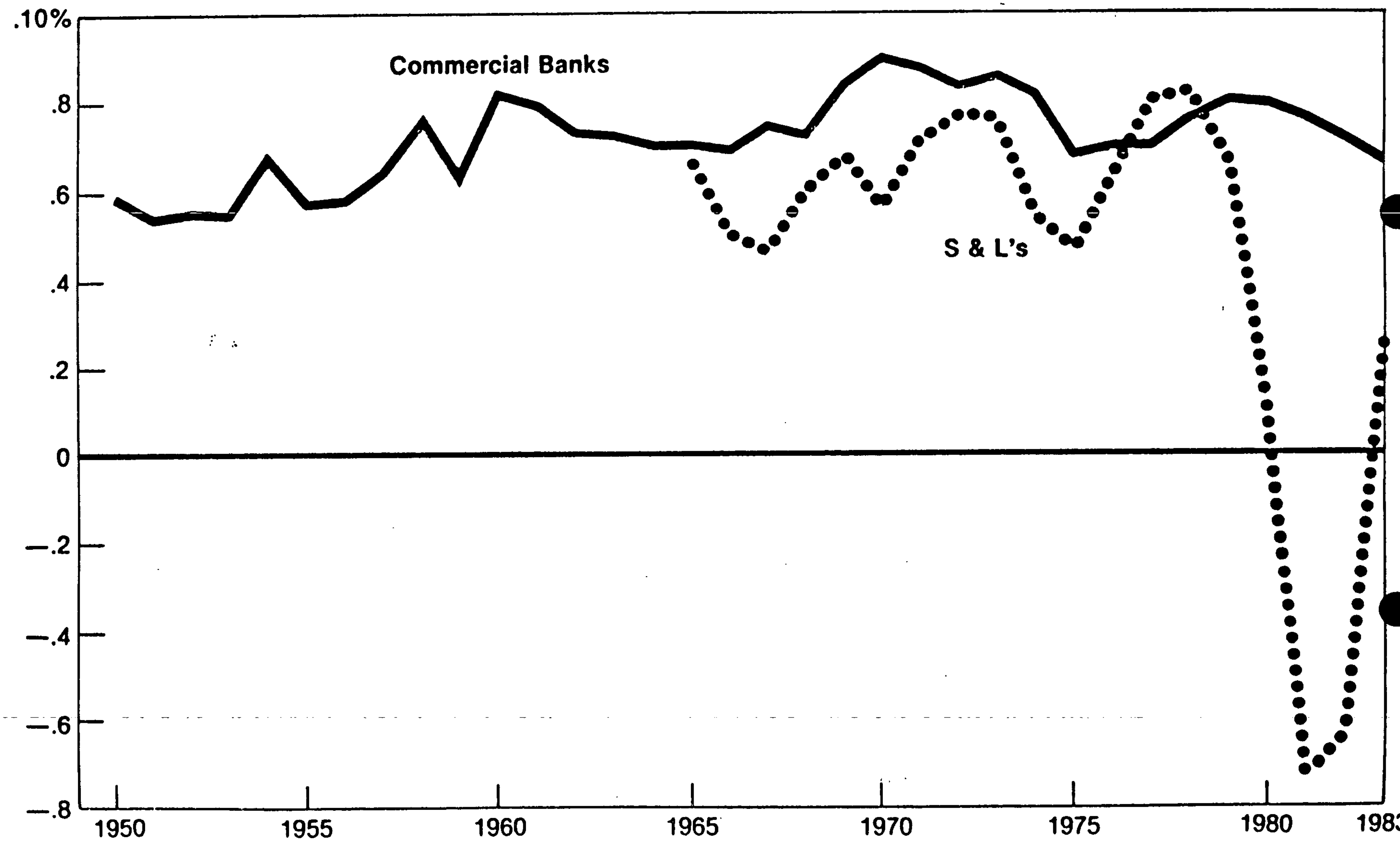

Chart 9

PROBLEM INSTITUTIONS

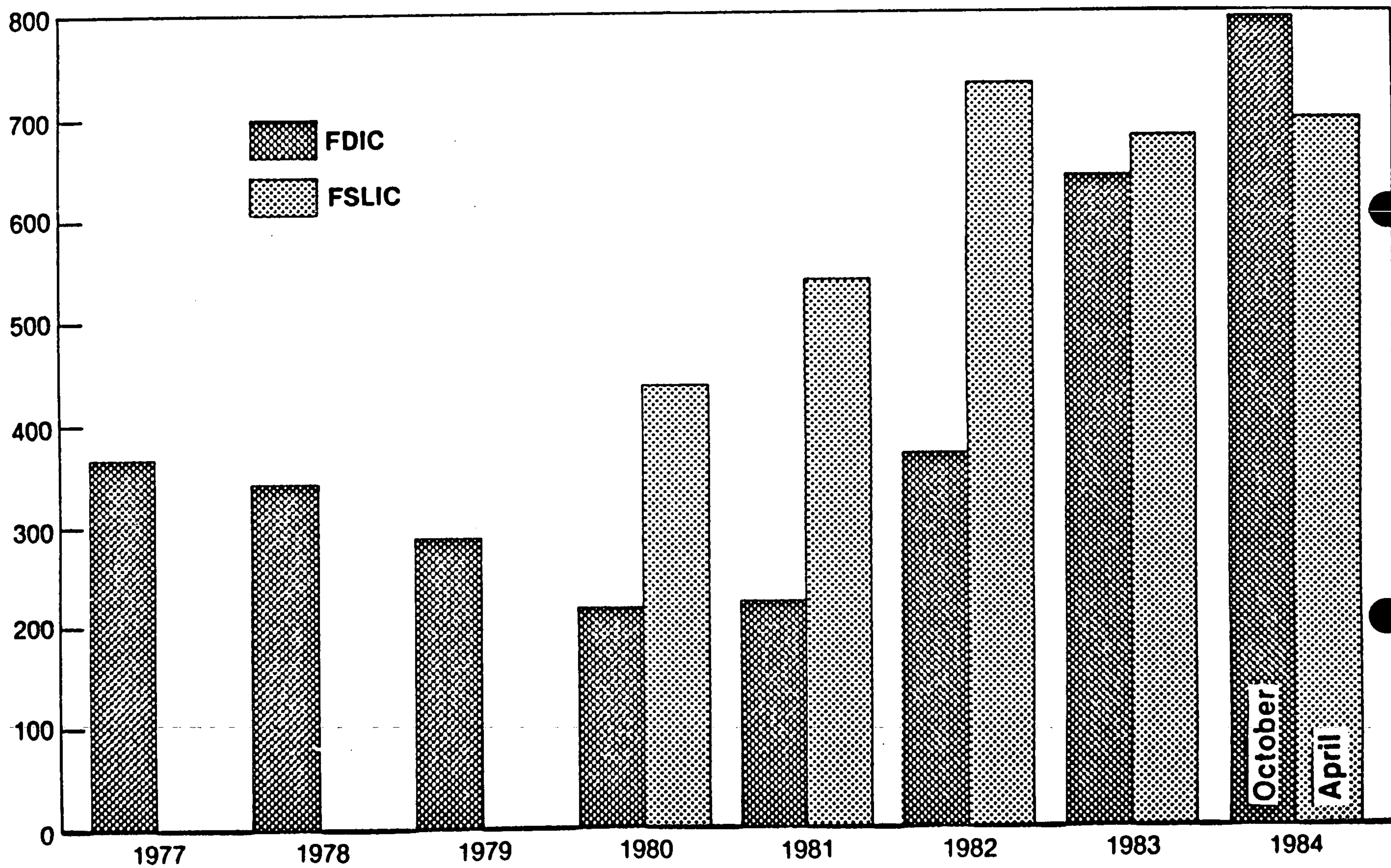

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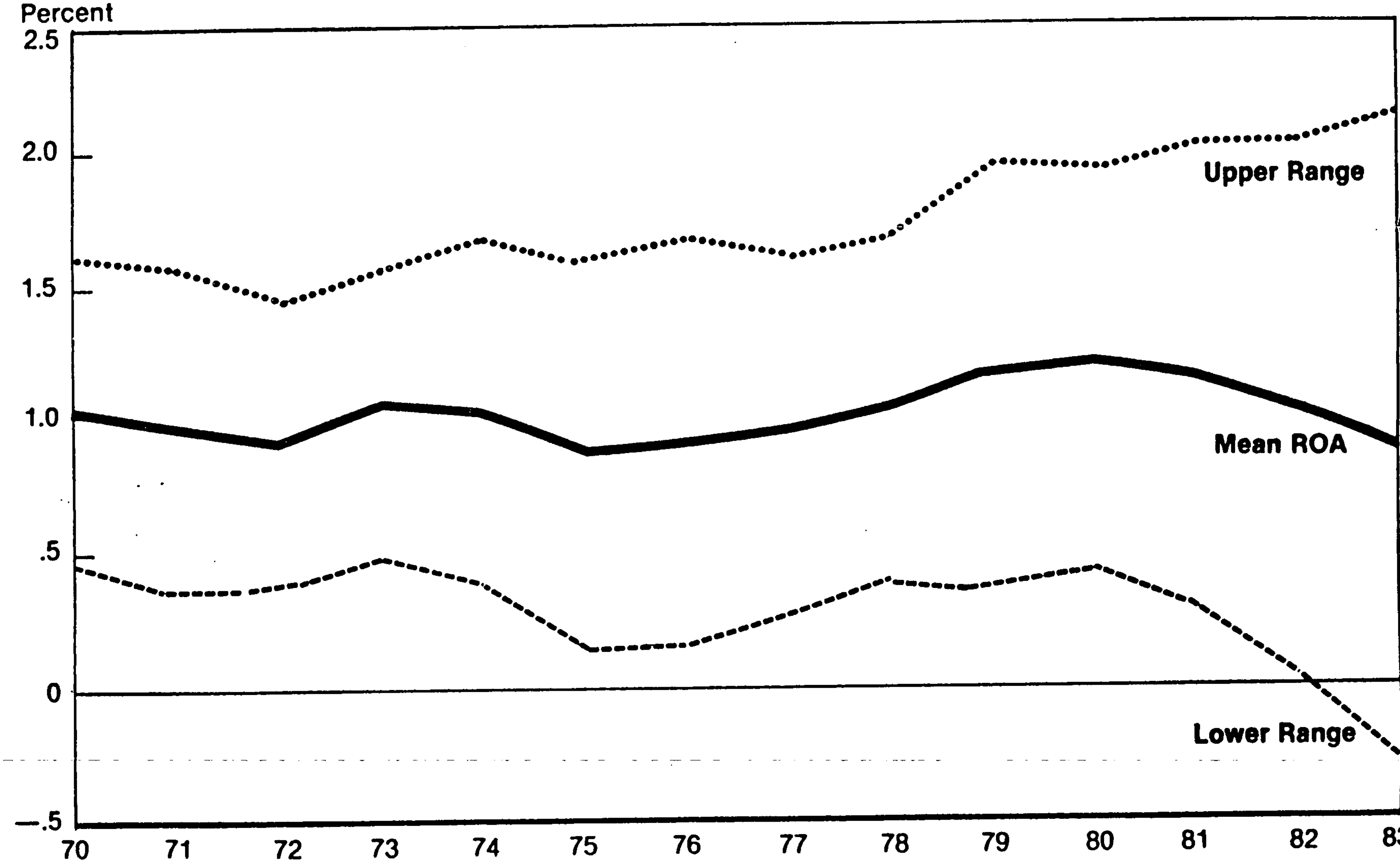
Chart 19

BANK PERFORMANCE HAS DIVERGED AS COMPETITION AND DEREGULATION SEPARATE WINNERS AND LOSERS

ALL INSURED COMMERCIAL BANKS



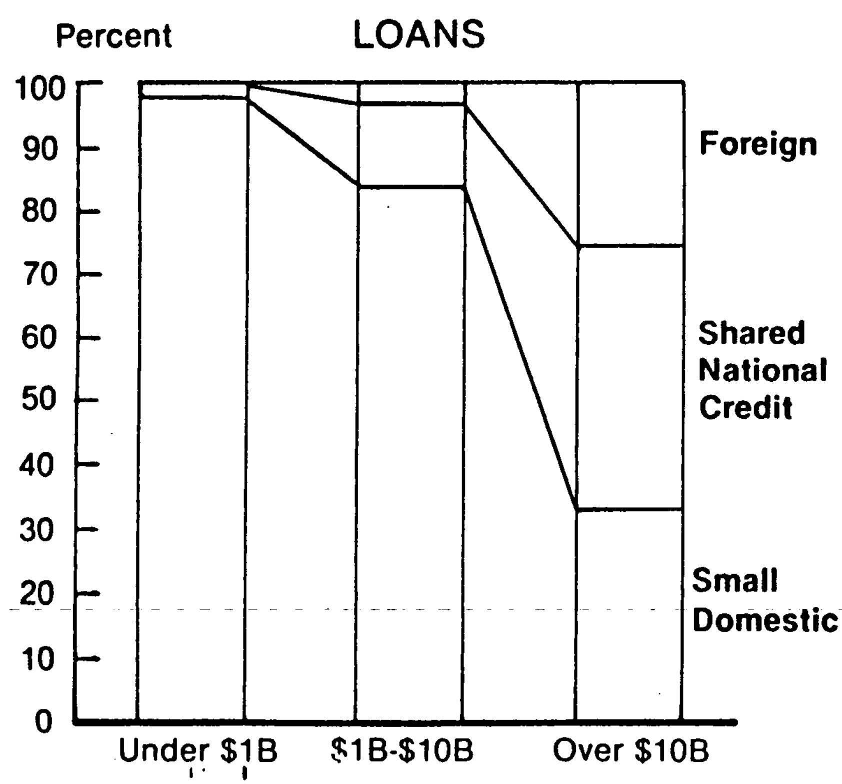
Range = Mean +/— One Standard Deviation

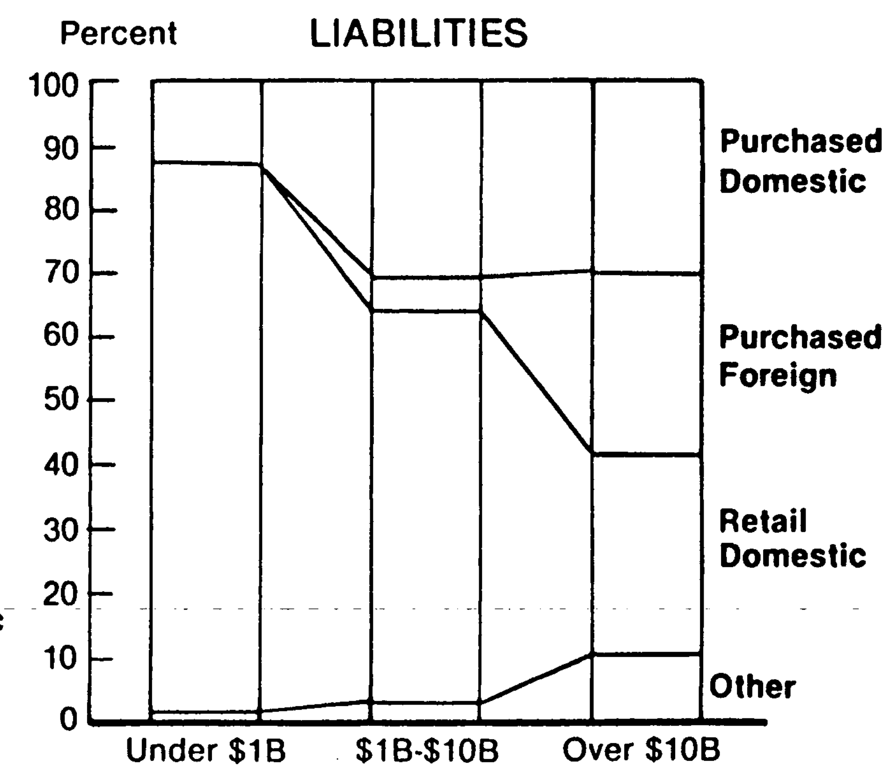
Source: OCC

Chart 11

LARGE BANK BALANCE SHEETS DIFFER FROM SMALL ONES

- Foreign Loans
- Large National Credits
- Purchased Liabilities — Foreign and Domestic





Source: OCC

Estimates for 12/83

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Chart 12

NUMBER OF INSURED INSTITUTIONS

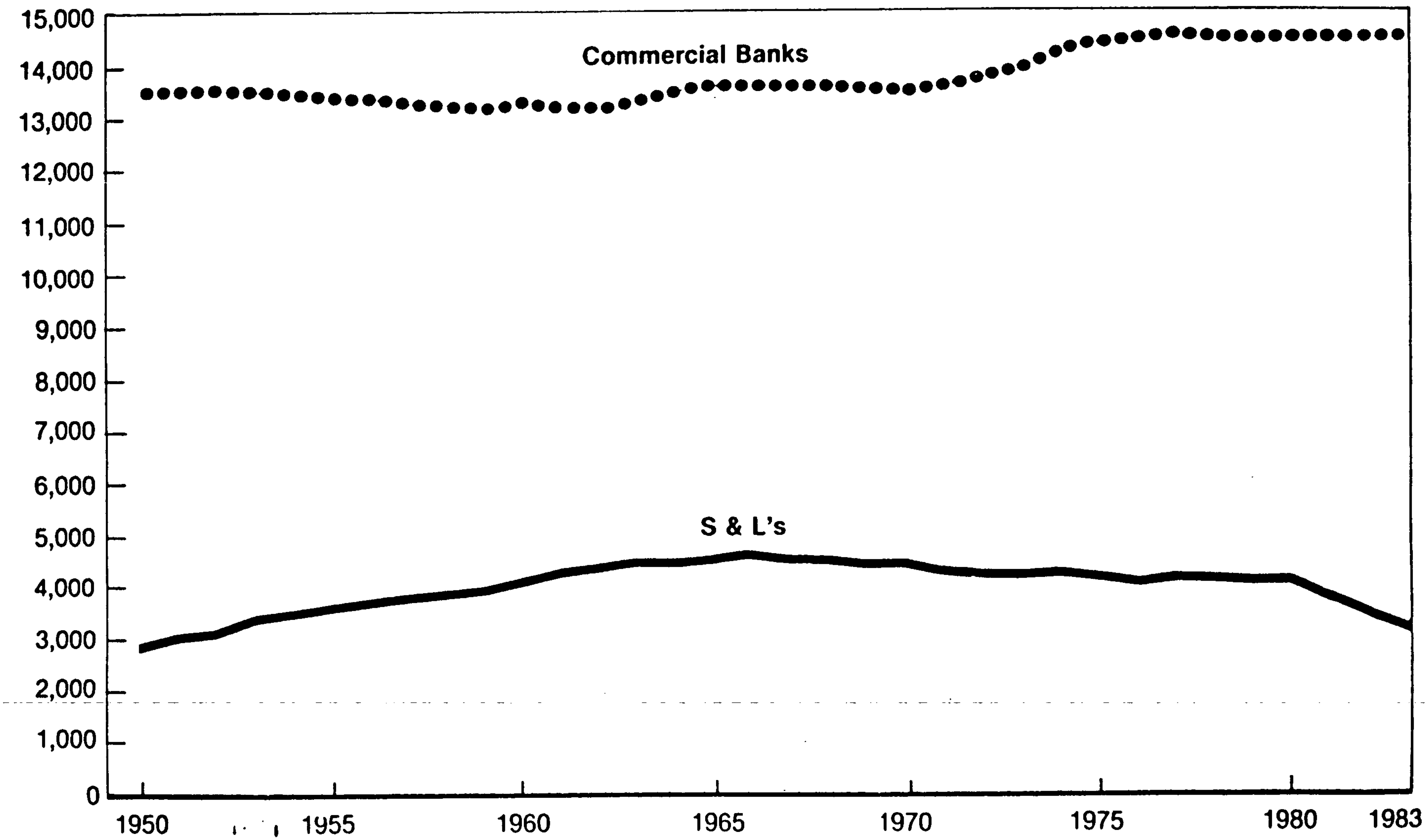

Chart 13

INSURANCE FUNDS
($ Billions)

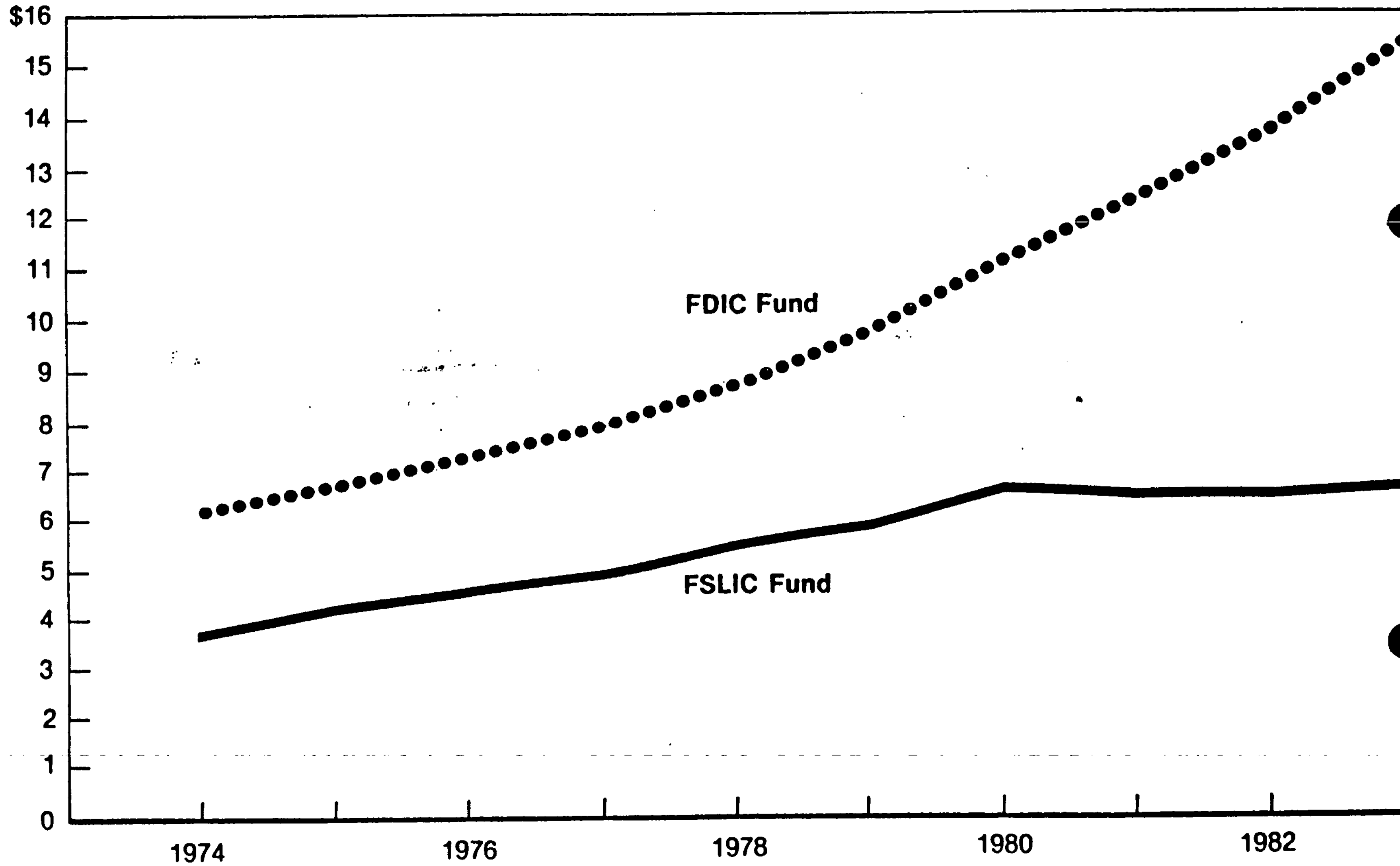

Chart 14

FUND SIZES RELATIVE TO DEPOSITS

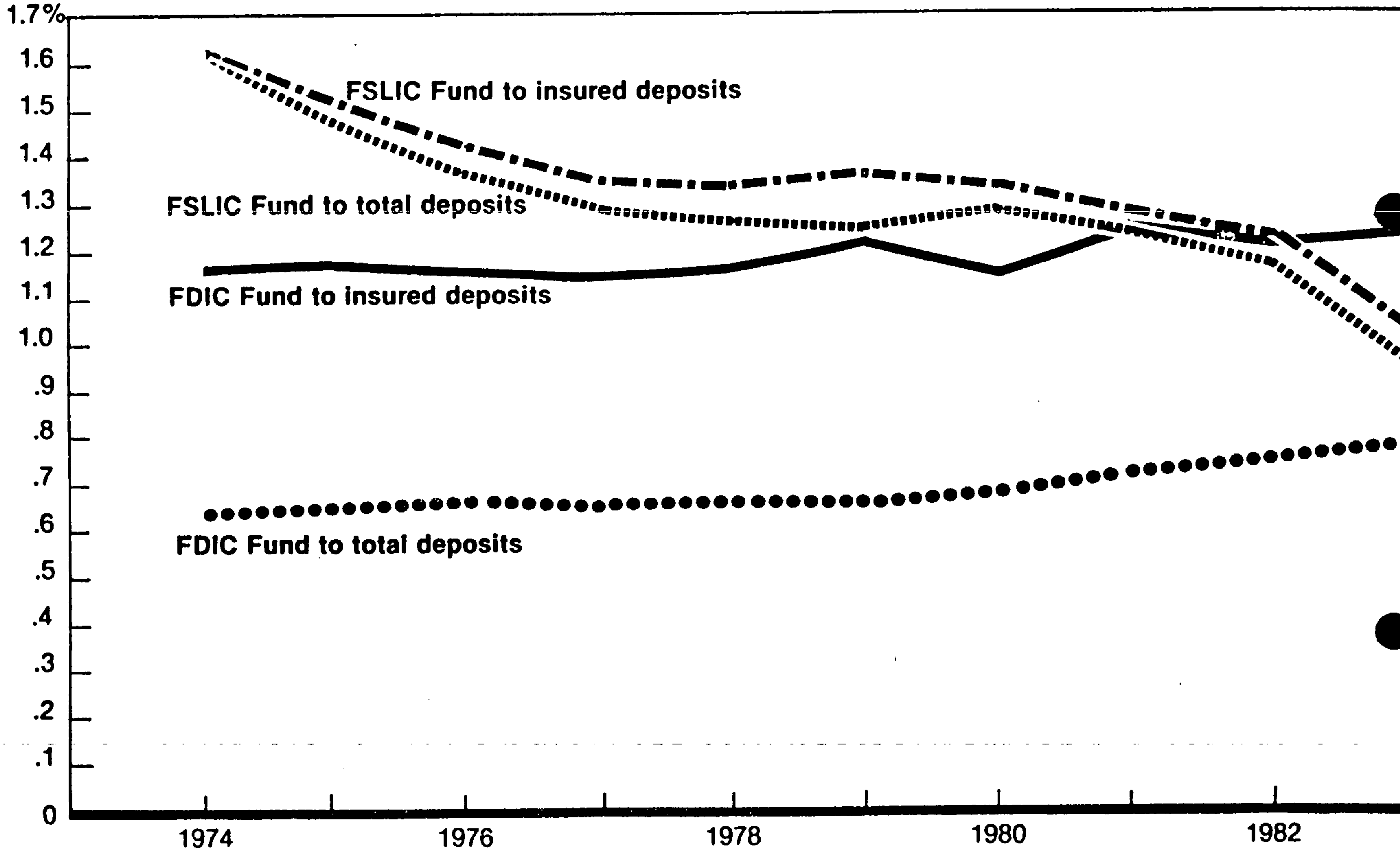

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Chart 15

ASSISTANCE CASES
(Excluding NWC's)

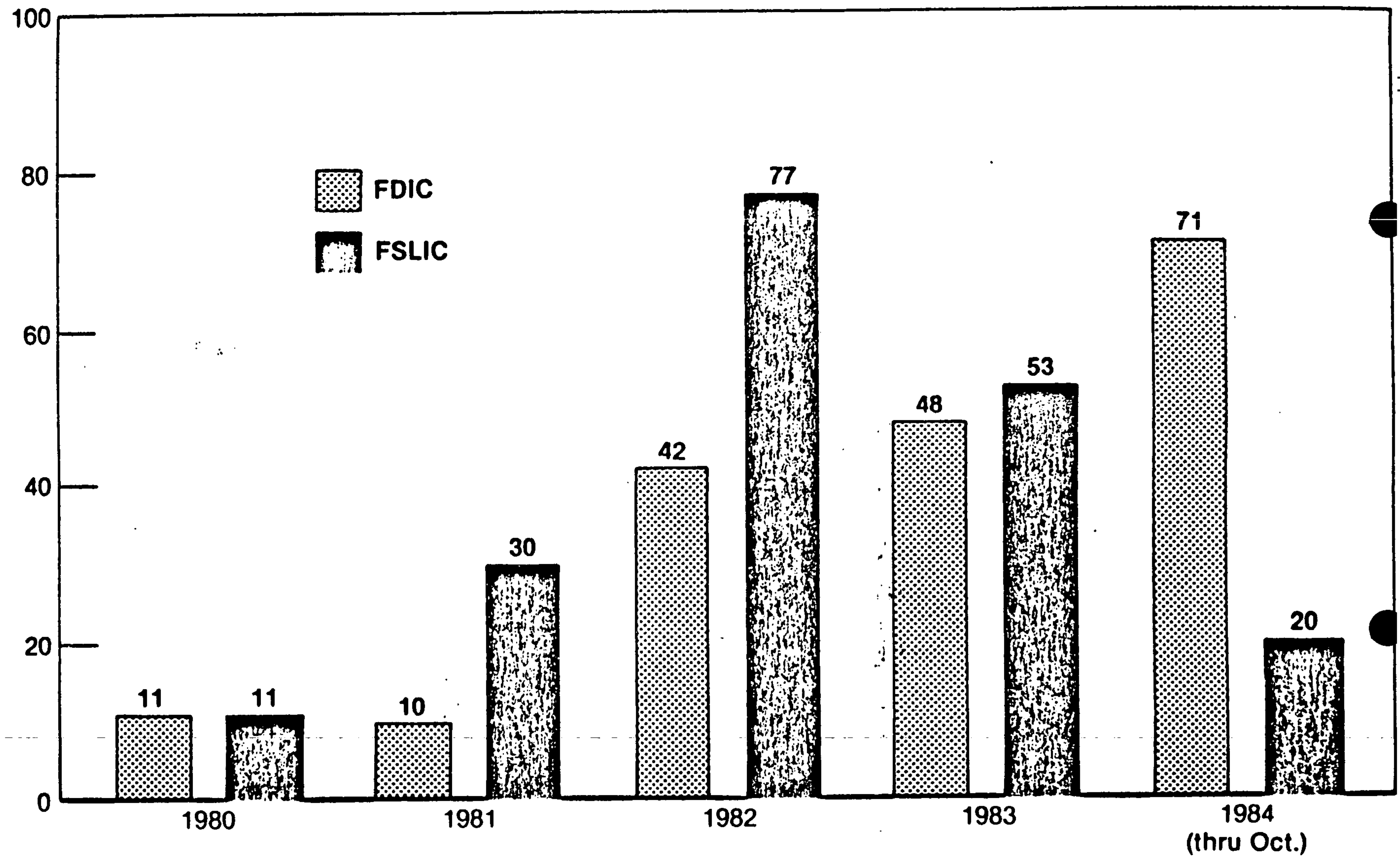

Chart 16

SIZE OF ASSISTED INSTITUTIONS

(assets for FSLIC; deposits for FDIC)
$billions