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THE PRESIDENT HAS SEEN

THE WHITE HOUSE

WASHINGTON

November 28, 1990

MEMORANDUM FOR THE PRESIDENT

FROM: ROGER B. PORTER RBP

SUBJECT: Lud Ashley's Memorandum

Lud Ashley's recent memorandum to you correctly identifies the problem in the banking industry. First and foremost, profitability is key. As Secretary Brady argued a week ago, the best guarantee of a safe banking system is a profitable banking system. I like to add "profitable and competitive," but the point is the same. Ashley identifies three issues which affect profitability.

1. "A restrictive, 50-year old regulatory yoke."

Any banking reform must include an end to the business restrictions which were imposed during the 1930's. This is necessary to rationalize the industry and to provide the needed injection of capital.

2. "Condition of the Bank Insurance Fund"

At present the Bank Insurance Fund has roughly $10 billion. That will fall quickly enough that by early next year stories will become commonplace that the fund will soon be broke. The Brookings Institution will soon release a report saying that a recession will sink the fund. This will prompt calls for action.

The most appropriate source for a recapitalization of the Bank Insurance Fund is the banking industry through some sort of one time levy. However, if the levy comes out of bank profits or capital, it may cause a serious problem at a time when we are trying to increase bank capital.

The Administration is currently thinking through a plan which would recapitalize the Fund with bank contributions which would be interest bearing preferred stock. The value of this stock could (if the auditors are obliging) be counted as capital for the banks. This is possibly the best solution, but needs to be thought through carefully before recommending it to you. If the issue comes up when you see Lud Ashley tomorrow you could simply state that your staff is looking at ways to recapitalize the Bank Insurance Fund while minimizing any adverse effect on bank profitability and soundness.

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3. "Implicit Promise by Government to Underwrite the Entire Banking System."

This is the key issue. The banks are unhappy with FDIC and Bank Insurance Fund monies being used to pay off uninsured depositors as well as insured depositors. The regulators have chosen to do this unilaterally. The banks maintain that the insurance premiums they have paid would prove adequate if they were not used to pay off uninsured depositors.

The government regulators have done this because they view a general bailout as cheaper. Uninsured depositors (deposits over $100,000) are often other banks or financial intermediaries. A loss of their funds would jeopardize their solvency leading to further bank closings. The implicit guarantee to uninsured depositors may keep "hot" money from moving out of troubled banks, thus potentially keeping these banks afloat. This is known as the systematic risk problem. The layman's term is the "too big to fail" problem.

Confidence on the part of depositors is crucial. Three years ago, when First Republic Bank of Texas, the largest bank in the state and the main correspondent bank for other banks in the state, got into trouble they had withdrawals of over $1.5 billion in roughly two hours before the regulators signaled that they were moving in and would not allow it to fail. This demonstrated how tightly interwoven our financial system is today.

Over the long-run, reducing the government's huge potential liabilities, as he suggests, is a worthwhile objective. It would certainly make small independent banks, which rely more heavily on deposits of less than $100,000, happy. But the challenge is getting from here to there.

A recent international conference revealed no enthusiasm on the part of other regulators around the world to depart from their current policy often called "constructive ambiguity." Under this policy regulators retain the option of protecting all depositors where they believe it is essential to the stability of the system while at the same time committing not to do it in every large bank failure. At this time, this is the de facto policy of U.S. regulators. Most other countries have a few, large banks.

A shift in our policy could disadvantage us in the international competition for large foreign deposits. When John Reed of Citibank was in yesterday, he indicated that the major New York banks were now having much greater difficulty attracting funds from abroad.

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Moreover, Chairman Greenspan and other regulators are adamantly opposed to a concerted renunciation of the too big to fail principle. Their fear is the effect it might have on undermining depositor confidence. Ashley is pointing in the right direction. But the crucial questions are timing and international cooperation.

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