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GARY H. STERN
PRESIDENT

January 17, 2007

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington DC 20429

Dear Mr. Feldman:

The Federal Deposit Insurance Corporation (FDIC) has requested comments on its Advance Notice of Proposed Rulemaking for a "Large-Bank Deposit Insurance Determination Modernization Proposal" (2006 ANPR). This letter transmits my comments (which do not necessarily reflect the views of others in the Federal Reserve System).

In this comment, I make three points. They are:

(1) Given the net benefits of its suggested reforms, the FDIC must revamp the current insurance determination procedures; the question, therefore, is "how" not "if."

(2) The FDIC should reject, as time-inconsistent, proposals to address flaws in the status quo only when banks become riskier.

(3) The FDIC should adjust its proposals, based on industry input, to minimize costs while ensuring that the recommended approach remains credible and covers institutions for which the current system would not facilitate least-cost resolution.

In short, the FDIC's efforts will improve its core operations and implementation of critical legal responsibilities, thereby benefiting society as a whole. Concerns about costs can be addressed through consultation with the banking industry. I commend the FDIC for advancing this reform effort.

I now discuss in some depth the three points noted previously.

(1) Given the net benefits of its suggested reforms, the FDIC must revamp current insurance determination procedures.

In comments on the December 2005 ANPR on a "Large-Bank Deposit Insurance Determination Modernization Proposal" (2005 ANPR), I highlighted the benefits of modernizing the insurance determination process.[1] The (related) benefits are:

- creating the conditions under which the FDIC can resolve a large bank through least-cost resolution and avoid the systemic risk exception;
- instilling equity between large and smaller banks in the resolution process; and
- signaling uninsured large bank creditors that they face the risk of loss.

These outcomes should enhance the market discipline large banks face and thus improve society's well-being by facilitating efficient resource allocation.

I am encouraged that the FDIC assesses these benefits as potentially significant, justifying a revamping of the current determination process. The banking industry also appears to have an understanding of these core benefits, as articulated in trade association comments on the 2005 ANPR.

> Each association recognizes that the Federal deposit insurance system's viability depends on the principle that no financial institution is either too big or too small to fail. The development of prudent systems to prepare for and respond to the failure of any size institution is an important component of the corporation's [FDIC's] receivership functions. Further, the corporation should demonstrate that it is fully prepared to handle even a large bank failure, quickly and efficiently.[2]

However, the FDIC will not achieve the important objectives the associations set for the deposit insurance system nor will society benefit from the important attributes of deposit insurance that the associations highlight without reform of the determination process.[3]

The associations rightly note that these benefits come with costs that could outweigh the gains. And I have no doubt that the banking industry continues to face a heavy regulatory burden. But seeking to reduce regulatory burden by rejecting these proposals seems ill-advised for at least two reasons:

- I agree with the FDIC that information provided by the industry suggests relatively low implementation costs (recognizing the inherently subjective nature of such comparisons).

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[1] Comment letter of Gary H. Stern, February 7, 2006, in response to the 2005 ANPR.
[2] As quoted and discussed by Gary H. Stern and Ron J. Feldman in "Managing Too Big To Fail by Reducing Systemic Risk: Some Recent Developments," *The Region*, June 2006, p. 46.
[3] I have elaborated on this point previously. Specially, when commenting on the association's views I noted that "the FDIC's analysis of technical limitations of the current resolution process raises serious doubt that creditors of large banks will be as likely to suffer losses as creditors of small banks upon bank failure. Any reader of the FDIC's proposal should also be concerned about its current ability to respond effectively and quickly to a large bank failure. In other words, absent some reform, the conditions for credibly imposing a least-cost resolution on a large bank across several plausible scenarios do not exist." *Ibid*, 46.

- I see little chance for material reductions in the costs of bank regulation absent steps that reduce implied or direct government support for the banking industry and thereby enhance market discipline; government support that mutes market discipline typically justifies regulation. The FDIC's reform proposal should reduce implied support, particularly for creditors of large banks. Banks seeking to reduce regulatory burden should support such efforts.[4]

In sum, the FDIC's effort to revamp the current insurance determination system should yield net benefits and the FDIC should continue to pursue it. That said, one could introduce reforms that would not enhance social welfare, and some specific reforms suggested to the FDIC fall into that category.

(2) <u>The FDIC should reject, as time-inconsistent, proposals to address flaws in the status quo only when banks become riskier</u>.

The FDIC provides a logical case for why it needs the tools provided by the reform options (e.g., provisional holds) regardless of the elapsed time between resolution preparation and bridge bank opening. The need reflects the benefits of keeping the bank's operations/services continuously available, including the need for nightly processing, prior to and following failure. Expanding the time that bank creditors have to access their funds or bank customers have to access needed services should significantly reduce the potential for one bank's failure to "spill over" to another.

But should the FDIC seek new tools now or at a later point? The FDIC received comments to the effect that fixes to the determination process should occur in the future when overall banking conditions weaken or when specific institutions run into trouble. I do not find those suggestions workable or credible; they are a poor substitute for the current proposals. At the moment, change in the insurance determination process superficially seems unnecessary given the absence of bank failures. But consider the decision calculus when bank failures become more common or when a large bank finds itself in a condition sufficient to warrant significant supervisory concern.

In the first case, if many banks approach failure, the FDIC will face significant pressure from elected officials and the banking industry to avoid costs (note the opposition to this proposal today in an environment of strong banking returns). And, as opposed to implementing reform today, the costs of future reform may be particularly ill-timed and preclude actions that would materially increase a bank's chance of survival.

Likewise, in the second case, where the condition of a specific bank worsens, I would expect management and supervisors to focus on correcting underlying concerns and recovery. The bank may need to reduce, or already have reduced, staff when its condition weakens. Discussions of changes to deposit-related systems may strike many, perhaps even the primary supervisor, as a distraction and unlikely to pass a benefit/cost test.

[4] For a recent discussion of how safety net reduction must lead significant regulatory burden reduction, see "Perspectives on Current Banking Issues," by Gary H. Stern, *The Region*, September 2006, p. 5.

Both of these cases demonstrate the problem of time-consistency. The commitment made today by the FDIC to take action in the future will not seem worth implementing when the future arrives. The FDIC should continue to support versions of its current proposal and oppose reforms that will not facilitate least-cost resolution when push comes to shove. Moreover, such delayed reforms will fail to generate resource allocation benefits prior to bank failure. Bank creditors make decisions based, at least in part, on their expectations of the future. They too will understand the difficulties that the FDIC will likely face in implementing a delayed plan and will factor that consideration into the market discipline they apply today.

(3) The FDIC should adjust its proposals, based on industry input, to minimize costs while ensuring that the recommended approach remains credible and covers institutions for which the current system would not facilitate the least-cost resolution.

The questions posed in the 2006 ANPR, the open request extended by the FDIC to meet with interested parties, and the modifications made to the 2005 ANPR indicate a desire by the FDIC to incorporate industry suggestions that reduce costs without materially detracting from the proposal's benefits. The FDIC should ensure that such flexibility characterizes this initiative going forward.

The FDIC highlights the potential to reduce costs by working with vendors providing service to many covered banks. I certainly encourage the industry and the FDIC to work together to exploit vendor-related economies of scale. Joint or coordinated efforts of the covered institutions, consistent with relevant laws and policies governing information sharing, may also offer some cost savings.

Reducing the number of institutions covered under the proposal offers another option for cost savings, and I encourage the FDIC to explore the viability of such an option in a rigorous way.

This initiative need not cover "a lot" of institutions to accomplish its objectives. The concentration of total domestic deposits and deposit accounts, even those holding deposits greater than $100,000, suggests that deep coverage of deposits and deposit accounts could occur with materially fewer covered institutions than the 160 noted in the 2006 ANPR. In practice, this would likely reduce the number of Tier 2 Covered Institutions.

At the same time, the FDIC should ensure that it reforms the determination process for all banks that in the current system have a meaningful probability of receiving something other than a least-cost resolution. The number of deposit accounts held by a bank may offer a reasonable proxy for that risk. But the FDIC may need to consider other metrics as well, perhaps focusing on uninsured creditors or the potential for a liquidity problem. While this option is more challenging, the FDIC should consider using nonpublic, nonstandardized reporting data in this analysis. For example, perhaps the amount of integration among relevant management information systems at a bank could signal greater concern about implementing a least-cost resolution. Regardless of implementation, the FDIC should seek coverage only for those institutions where the current system raises the specter of an exception to the least-cost resolution.

Finally, the FDIC's future proposal should not incorporate a compromise that unintentionally undermines the credibility of the reformed system. In particular, the FDIC must ensure that banks have made required changes to their systems and that the systems produce acceptable output. Testing on an infrequent basis or in a less-than-robust manner may limit the FDIC's, bank creditors' and the public's confidence that the reforms will produce the desired results.

Sincerely,

Gary H. Stern
President