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April 14, 2008

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 a Notice of Proposed Rulemaking on two matters: "Processing of Deposit Accounts in the Event of an Insured Depository Institution Failure" and "Large-Bank Deposit Insurance Determination Modernization." This letter transmits my comments (which do not necessarily reflect the views of others in the Federal Reserve System).

In the first matter, the FDIC should ensure that it has established transparent and credible rules regarding the timing of deposit account processing in times of failure. The proposed rule achieves that goal.

In the second matter, the credit and financial market disturbances of 2007 and 2008 reinforce my prior comments on earlier versions of the proposed rule and add urgency to the proposal. The FDIC must implement an improved insured deposit determination process as soon as possible. These disturbances suggest a high cost to maintaining the status quo, and I commend the FDIC for moving this proposal forward.

I elaborate on these two points in the rest of this comment.

<u>"Processing of Deposit Accounts in the Event of an Insured Depository Institution Failure"</u>

When it closes a bank, the FDIC could determine the balances of deposit accounts in many ways, reflecting varying potential treatment of sweep programs, accounting for time differences across an institution's branches, and a host of other issues. One set of balance determination rules may not clearly trump another based on a set of objective measurements (and I do not have the expertise to make that valuation in any case). Critically important, however, is the transparent establishment of the rules and credible enforcement of them.

The FDIC staff, banks, sophisticated depositors, and those advising less sophisticated depositors need a clear set of rules that allows them to determine deposits which are insured. Absent clear rules, the depositor could suffer unexpected and avoidable losses. Alternatively, depositors who are confused about the insured status of balances at a potentially weak bank, or who do not believe the FDIC can credibly enforce its rules, have incentive to withdraw their funding. The latter tendency facilitates, on the margin, bank runs and defeats the purpose of deposit insurance.

My general reading of the proposal suggests that it provides a fairly transparent guide to the rules regarding account balance determination and sets up a credible system for implementation; the FDIC will have rules preventing ad hoc determinations from occurring on a case by case basis (recognizing that no set of rules covers every contingency). That said, the FDIC should incorporate reasonable suggestions for improvement, particularly improvements that reduce the cost of compliance. The specifics of the rules, again within reason, may matter less than their overall transparency and credibility.

“Large-Bank Deposit Insurance Determination Modernization”

I emphasized the importance of advance preparation for large-bank resolution in prior comments.[1] Such preparation should help limit the support policymakers offer creditors of failing depositories. Specifically, as the FDIC has noted, enhancing the insurance determination process reduces the chance that policymakers will invoke the systemic risk exception of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) for technical reasons rather than true concern over spillovers. This outcome has the benefit of reducing potential resource misallocations arising from implied guarantees of large-bank creditors. I further argued that policymakers will not achieve this desired outcome by implementing a new determination regime only at the time when banks are in trouble.

The credit market disturbances of 2007 and 2008 reaffirm these arguments. I urge the FDIC to move as quickly as it can to implement a new insurance determination process.

Five features of the market disruptions seem particularly relevant and supportive of the FDIC’s proposal, and I discuss them first. I then comment briefly on the costs and benefits of the proposal in light of the current turbulence. I conclude with a few comments on the specific questions raised by the FDIC in the proposal.

[1] I cover other issues as well. See the comment letter of Gary H. Stern, January 17, 2007, in response to the 2006 ANPR and the comment letter of Gary H. Stern, February 7, 2005, in response to the 2005 ANPR.

Proposal and Recent Credit/Financial Market Turmoil

Recent events lend support to the FDIC's proposal. I will highlight five links between recent events and the proposal.

First, several very large financial institutions (FIs) moved from reasonably strong financial positions to what observers characterized as near failure in short periods of time. I recognize that, to date, commercial banks and thrifts have not been among the firms reduced to a transparent state of near failure. But without question, several banks and thrifts suffered significant and unexpected losses. And a defining feature of the past year has been a series of market disturbances heretofore believed so unlikely as to approach irrelevance. Recent events confirm that low-probability, high-cost outcomes do occur, perhaps with more frequency than anticipated. Given this experience, policymakers cannot consider large banks immune from an evaporation of funding, catalyzed by concerns about credit quality. This same combination has brought down other FIs. In short, the market disturbance validates an important FDIC premise for its proposals, one rejected by many commenters: Large banks can fail. Further, the failure can occur quickly, the loss at failure can be large, and the spillovers from the failure can raise real concerns.

Second, the market turmoil reinforced the benefits of an *ex ante* system that provide creditors of failed banks with *ex post* rapid access to their available funds. Such systems reduce creditors' need to pull funding from banks, an action that can quickly shift the banking system to a "bad equilibrium" of runs and panics. The absence of such a system in England—combined with a generally low level of deposit insurance—seems to have encouraged runs on Northern Rock.[2] The insurance determination proposal has at its core a desire to make funding available to depositors, via a bridge bank. Again I believe recent events have validated the FDIC's approach.

Third, responses during the recent tumult reinforce the need for bank policymakers to actively manage the implied safety net. During the market disturbances, observers speculated about the potential support uninsured creditors of large FIs might receive. One can reasonably presume such expectations have grown. Such expectations can lead creditors to underprice risk and encourage FIs to take on "too much" risk. These expectations will not ebb on their own. To the degree that policymakers want to reduce these expectations, they must plan for FI resolutions, focusing on steps that allow them to impose losses on creditors without significantly exacerbating the potential for spillovers. The FDIC's insurance determination proposal offers one such targeted reform. Indeed, reducing the likelihood that uninsured creditors receive government support, particularly in cases where policymakers have serious doubts about the systemic risk posed by the FI's failure, motivated the insurance determination proposal in the first place.

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[2] See remarks of Martin J. Gruenberg, vice chairman, Federal Deposit Insurance Corporation (FDIC) on *The International Role of Deposit Insurance,* The Exchequer Club, Washington, D.C., November 14, 2007.

Fourth, recent events reaffirm the need for policymakers to act before bad outcomes occur. During the recent turmoil, policymakers had to focus on the immediate problem at hand. Moreover, what constituted the pressing issue of the day varied considerably over time. In a given month, policymakers had to focus, for example, on a specific troubled institution. During the next month, policymakers may have faced unforeseen weakness in what had been a liquid, short-term capital market. Timing a change in the insurance determination process to coincide with these shocks seems imprudent at best. Moreover, taking steps that put creditors at risk of loss during the middle of a crisis could have spillovers that policymakers urgently want to avoid. The FDIC's effort to advance this proposal prior to the disturbance is the model to follow.

Finally, large financial institutions have been at the epicenter of recent events, and some of their creditors benefited most directly from the policy response. To the degree that this reduces creditors' risk of providing funds to large banks, smaller institutions face a cost disadvantage. This outcome offers one example of the resource misallocation generated by implied federal support. Policymakers should not address the small-bank disadvantage by propping them up as well. Such expansion would simply compound allocation concerns. Instead, the government must take steps to target safety net management at large banks, precisely what the FDIC proposes.

Costs and Benefits

The notice of proposed rulemaking includes more explicit measures of proposal cost. Based on initial industry-supplied data, the FDIC estimates the one-time implementation cost of the proposal at $75 million and ongoing costs at about $5 million. Even at this early stage of estimation, the expected costs are not trivial.

But the benefits should not be trivial either, even if putting a figure on them is quite challenging and likely to produce imprecise results relative to the cost estimates. These benefits arise, as noted, by reducing distortions caused by implied guarantees. As I have argued in prior comment letters, I believe the benefits will exceed the costs.

To the degree the policy change improves resource allocation, it should lead to higher output. Total output is enormous. Even if improved resource allocation has very small positive effects on output, the overall effect would generate substantial benefits relative to the estimated costs. Consistent with this general finding, one estimate suggests that resource misallocation associated with the thrift crisis (related in part to pervasive government support for bank creditors) dwarfs the very large transfer payments from bailouts.[3] This result is not altogether surprising given the association of implied guarantees with infrequent but very high-cost events like the poor resource allocation that precedes systemic financial events.

[3] See Gary H. Stern and Ron J. Feldman, *Too Big to Fail: The Hazards of Bank Bailouts* (Brookings Institution Press, Washington, D.C., 2004) for a discussion of the costs of implied guarantees. Page 24 of that book highlights the estimate mentioned.

Specific Comments on the Proposal

I conclude with responses to a few questions raised by the FDIC in the proposal. The need to continue to seek cost savings in the initiative, without reducing its ability to achieve core objectives, is a common theme in these comments.

Definition of covered institution. As articulated in a prior comment, the FDIC should cover all institutions for which it thinks the proposal substantially reduces the chance of unnecessary invocations of the systemic risk exception. I do not know what this standard implies for the current asset size cutoff . *A priori,* the number of covered institutions need not be "large" and, in theory, could certainly be smaller than the current number covered. Reducing the number of covered institutions is a simple way of reducing the proposal's cost.

Transparency of provisional holds to customers. Both banks and the FDIC would benefit from failed banks' customers ability to know the amount of funds they have available. At a minimum, this would reduce the need for customers to contact the bank or FDIC and, more generally, would reduce the destabilizing "lining up" of customers at branches. This does not imply that banks must personalize the notification (e.g., when customers review their balances online). A generic notification (e.g., a "banner" statement indicating the general levels of holds applied on various examples of accounts) may provide similar benefits at a lower cost. I encourage the FDIC to work with the industry to develop the most cost-effective tool for achieving the key communication objective.

Unique depositor identifier. The FDIC dropped its prior requirement of having the largest covered institutions provide a unique identifier for depositors. The FDIC provided a limited discussion of this decision, making it difficult to evaluate. The current proposal suggests that this decision will still allow the FDIC to impose a least-cost resolution. To the degree that this is the expected outcome, I support the decision to reduce costs by removing the unique identifier requirement.

Very truly yours,

/s/

Gary H. Stern
President