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Mr. Robert E. Feldman
Executive Secretary
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Mr. Feldman:

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

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

- The FDIC must reform current insurance determination procedures which hinder its ability to carry out the least-cost resolution of a large bank.

- The FDIC's Board of Directors should focus on net benefits when evaluating the comments received on the ANPR and choosing which option to implement.

- The features of Option 2 are necessary but may not prove sufficient to correct weaknesses in the insurance determination process.

- The FDIC should give serious consideration to implementing Options 1 and 3.

- A reformed insurance determination regime should apply to all large banks for whom the current regime could prevent a least cost resolution; the same insurance determination scheme need not apply to all covered institutions.

I now discuss these five points in greater detail.

(1) <u>To ensure effective use of society's resources, the FDIC must reform current insurance determination procedures which potentially could hinder its ability to carry out the least-cost</u>

resolution of a large bank. The ANPR identifies a serious limitation in the FDIC's current ability, under certain circumstances, to resolve a large institution in the least cost manner. The problem facing the FDIC results from the interaction of two distinct issues. First, as I understand the ANPR, the FDIC could face material, technical challenges in (a) determining which deposits are insured and which are uninsured at a large bank and (b) segregating the insured from the uninsured immediately prior to and after failure. These problems are most acute at large banks with multiple, unintegrated deposit tracking systems, a category which may include many large and systemically important institutions. Second, for reasons noted below, the FDIC expects to resolve a large bank through its bridge bank authority. This authority allows it to keep the operations of the failed bank up and running without providing assistance to a wide array of creditors.[1]

The segregation problem seems particularly serious; some large banks' deposit tracking systems would not facilitate the FDIC's need to put "holds" on uninsured deposits transferred from a failed bank to a bridge bank. Absent such holds, depositors would have free access to uninsured deposits transferred to the bridge bank.[2]

The inability to determine which deposits are insured arises from the absence of two variables in banks' deposit tracking systems. First, banks may not have a single unique identifier for all deposit accounts associated with a depositor. Second, banks do not have systems that readily allow the FDIC to determine the insurance category in which each deposit account falls.

Faced with these limitations, the FDIC could restrict depositors' access to their funds at the bridge bank in order to ensure that only insured deposits receive government backing. In the extreme, without a mechanism to place automatic holds on uninsured deposits, the FDIC could decide to release deposits to depositors only after manual review. Given the time a manual review would consume, such an approach could lead to the lapse of several days between bank closure and bridge bank opening.

Such a response, however, would negate the essential reasons for using the bridge bank. As the ANPR notes, bridge banks minimize the chance of spillover failures, and resulting government bailouts aimed at containing spillovers, by maintaining the operations of the failed bank and providing depositors with ample liquidity. Bridge banks also allow the FDIC to maximize the value obtained from the failed bank's assets and franchise. As a result, imposing tight restrictions on access to depositor funds is neither attractive nor particularly practical.

In the face of insufficient technology to segregate deposits or information to determine the insurance status of deposits, therefore, the FDIC would likely prefer to provide depositors with access to deposits even if they might be uninsured. This preference, even if understandable, undercuts least cost resolution and puts pressure on policymakers to invoke the systemic risk exception of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

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[1] Murton, Arthur J. 2005. "Resolving a Large Bank: The FDIC's Perspective." In Douglass D. Evanoff and George G. Kaufman, eds., *Systemic Financial Crise: Resolving Large Bank Insolvencies*. World Scientific, pp. 415-420.
[2] The FDIC would not have to apply holds on deposits to the degree that other creditors absorb all resolution losses. While not implausible, history suggests that large bank depositors will likely face some loss—albeit a potentially smaller one relative to that experienced by depositors of failed small banks—after resolution.

Invoking the systemic risk exception due to limitations in the resolution process (as opposed to preventing a true systemic crisis) could contribute to substantial resource misallocation in the economy over time.

(2) The FDIC's Board of Directors should focus on the net benefits of reform options when evaluating comments received on the ANPR and choosing one to implement. The ANPR asks commentators for their views on the marginal costs of implementing three options to address current determination weaknesses. Banks and software providers have the information and experience to identify these costs. And given their informal feedback to date, these firms may suggest that Options 1 and 3 consume more resources than Option 2.

These costs should certainly be kept to a minimum, but costs are only one side of the equation. The FDIC Board of Directors acts on behalf of taxpayers and society as a whole. Thus, it will surely review the costs and benefits of the options and focus on net benefits. As already noted, creating the conditions for imposition of least cost resolution of a large bank is the first and most important benefit of the options. This outcome, in turn, should increase market discipline/reduce moral hazard. More market discipline and less moral hazard means a higher standard of living, as resources flow to their best uses. This benefit is difficult to quantify but the limited evidence available suggests that it is potentially large.[3]

Transferring as much of the risk of bank failure to uninsured creditors has rightly driven bank resolution policy since the turbulence of the 1980s and early 1990s. Expansive creditor coverage during those years, as the FDIC has noted, "fostered the belief that all deposits of large banks were 100 percent insured. This belief severely limited the discipline that depositors might otherwise have exerted on the behavior of banks."[4]

FDICIA's least cost mandate has, in fact, led to a significant reduction in the percent of uninsured deposits of failed banks that have received full protection. But the reduction in uninsured coverage at failed banks has come in the context of small bank failures. A second benefit of the proposal, therefore, is to instill equity in the resolution process. The probability that an uninsured bank creditor receives coverage should not depend on what are apparently correctable and technical features of the resolution process.

A third benefit of reforming the insurance determination process, particularly via the public regulatory process, concerns its "signaling effect." Large bank insolvency in the United States is an extremely rare event and so, fortunately, policymakers do not have many opportunities to take actions that credibly put large bank creditors at risk of loss. The insurance determination proposal, therefore, offers a particularly important opportunity to convince creditors of their exposure. While these creditors may not expect full coverage, available evidence suggests they currently expect some government protection.[5]

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[3] Stern, Gary H. and Ron J. Feldman. 2004. *Too Big to Fail: The Hazards of Bank Bailouts*. Brookings Institution Press.
[4] Federal Deposit Insurance Corporation. 1997. *History of the Eighties: Lessons for the Future*. December. p. 40.
[5] For a recent example, see Morgan, Donald P. and Kevin J. Stiroh. 2005. "Too Big to Fail After All These Years." Federal Reserve Bank of New York Staff Report Number 220. September.

(3) <u>The features of Option 2 are necessary but may not prove sufficient to correct weaknesses in the insurance determination process</u>. After deciding to correct weaknesses in the current insurance determination regime, the FDIC Board must choose one of the many reforms available. Option 2 would address current limitations on the FDIC's ability to put holds on deposits. Any reform worth implementing must allow for segregation of uninsured deposits; the absence of this capability underlies the need to reform the insurance determination process in the first place.

Clearly Option 2 represents a necessary change. There are reasons to question, however, whether it sufficiently addresses failings with the insurance determination process. As already noted, the FDIC currently must use incomplete data to determine which deposits are likely insured and which are not. Options 1 and 3 would generate the information (e.g., the unique owner identifier and insurance category for each account) the FDIC requires to more accurately and promptly make that determination. As the ANPR notes, "Without these data the FDIC would have to identify account owners and each account's insurance category based primarily on the name and address fields and tax identification numbers, as is the case with the current process."[6]

As an outsider, and without the experience of a large bank failure, it is difficult for me to determine the precise degree to which this additional information reduces the likelihood that policymakers will invoke the systemic risk exception. I cannot rule out that by making use of information already available on bank systems, the FDIC could still manage to impose a least-cost resolution. That said, in certain cases, it also seems plausible that the additional insurance category and unique identifier data would generate material benefits. For example, where a bank's failure is rapid and unexpected, its deposit base large by number of accounts, as a relative source of funding, and concentrated among less common forms of insurance categories, and its deposit records fragmented across a number of systems, the FDIC may be challenged using current methods to determine which deposits are insured.

(4) <u>The FDIC should give serious consideration to implementing Options 1 and 3</u>. Option 1 follows the model of Option 2 but builds on it by addressing both the segregation weakness and challenges in sorting deposits into insured and uninsured status. Thus, if Option 2 proves insufficient for the reasons noted above, then the extra benefits offered by Option 1 could offset the extra costs. That is, Option 1 may be the minimum reform needed to address what ails the process of identification of insured deposits.

Once the FDIC decides that Option 1 is a minimum standard, then it seems reasonable that the FDIC give Option 3 serious consideration. The difference in benefits between Option 3 and Option 1 appear to be of a different nature then the difference between Options 1 and 2. Specifically, by having insurance determination assessment tools reside on the information technology of the bank, Option 3 would provide something closer to a "real time" measure of the insured/uninsured deposit split. More ready assessments of the split may prove helpful in the crisis environment likely to accompany a large bank failure. The more accurate data generated under Option 3 might also free the FDIC from having to impose temporary holds; under Option 3

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[6] Federal Deposit Insurance Corporation. 2005. "Large-Bank Deposit Insurance Determination Modernization Proposal." December 13th. p. 73,658.

the FDIC could more confidently debit depositors' accounts based on the amount of their uninsured deposits. Option 3 would also seem to reduce operational risk by limiting the number of data/software transfers between the FDIC and the failing bank and by better integrating the insurance determination program into the day-to-day processes of the bank.

(5) The reformed insurance determination regime should apply to all large banks for whom the current regime significantly raises the likelihood of invoking the systemic risk exception; the same insurance determination scheme need not apply to all covered institutions. The benefits of insurance determination reform come from increasing the odds of imposing least cost resolutions on large banks. Thus, on benefit/cost grounds, the FDIC is correct in limiting these reforms to a small number of the nation's largest banks. The question is how small should this group be?

Underlying any decision on which banks should fall under the new insurance determination regime is the potential for that banks' failure to lead to invocation of the systemic risk exception. If the FDIC has confidence that under the current determination regime, it can carry out a least cost resolution on a particular bank, then that bank should not face the new determination process. There are likely several proxies for determining which banks pose the greatest risk of invocation of systemic risk, including number of deposits, fragmentation of deposit systems, dependence on uninsured deposits, use of deposits whose insured status is difficult to ascertain, etc…Perhaps all these proxies are correlated with a simple measure such as dollar value of deposits. Certainly using such a simple metric has desirable features such as low cost of implementation and reduction of "private information" that could be transmitted to the public.

However, the FDIC must make sure that it minimizes the number of institutions identified as "not covered" that could end up with insurance determination issues. Society will incur a significant cost if policymakers have to invoke the systemic risk exception in these circumstances for a relatively small institution.

Moving from which banks receive coverage to the type of coverage they receive: The benefit/cost analysis noted above should determine which banks receive which reform. Option 3, for example, may have a positive benefit/cost ratio for the largest institutions and not for smaller ones.

Sincerely,

Gary H. Stern
President