

THE WHITE HOUSE
WASHINGTON

DATE: 11-25

FROM THE PRESIDENT

TO: Roger Pontre

My friend Lud
Ashley sent me
the attached

I'd like to have
your comments
particularly on
"A" page 2

Thanks

THE WHITE HOUSE
WASHINGTON

DATE: 11-25-90

FROM THE PRESIDENT

To: Nick Brady

Please comment on
"A" page 2
of Lud's letter
(attached)

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November 15, 1990

To: President Bush
From: Lud Ashley

In connection with your focus on banking and financial industry matters, here are some observations that may be relevant.

Just as mismanagement of thrift industry regulation produced unhappy consequences, so the archaic regulatory structure for U. S. banking is producing very unhappy and politically dangerous consequences of its own. Chief among these are a credit crunch as the economy slips toward recession and a deposit insurance fund for commercial banks that, unless recapitalized, very soon will be exhausted.

Most bankers understand that bank regulators have had no alternative but to toughen their classification of commercial real estate and highly-leveraged transactions. (They do regret, however, that the required actions were so abrupt — they mandated immediate additions to reserves against loans that had been booked over several years.) They also know, however, that with the capital markets shunning bank issues, the only way to meet higher capital standards is to downsize the bank. Combined with tough lending standards, this means a slowdown in lending activity. Their concern, if I understand it accurately, is not so much over being directed to reserve against high-risk loans — an issue that is now moot — as it is over lack of certainty with respect to regulatory treatment and, more fundamentally, whether it is possible for the banking industry as presently structured to be profitable.

Not much has been said about the condition of the Bank Insurance Fund but, despite the higher premium assessments that banks are and will be paying, the Fund is being drawn down to dangerously-low levels by a near-record volume of bank insolvencies. The banking industry is keenly aware, as most policymakers are or soon will be, that without some form of recapitalization, the Fund will soon be unable to meet its requirements. All agree that there are only two alternatives for replenishing the Fund, i.e., via the Treasury and U. S. taxpayer or the banking industry. Although bank

earnings generally are poor, and despite the fact that banks already are scheduled to be paying substantially higher deposit insurance premiums, most bankers take the view that they must be part of the funding solution if there is to be a private banking industry in the United States. They also feel very strongly, however, that there has been government mismanagement of bank regulation and that basic reforms are essential in the deposit insurance system if banking is to respond to the current funding crisis.

At the risk of overstating the point, the crisis in banking is attributable to a restrictive, 50-year old regulatory yoke that has robbed banking of its ability to compete against non-regulated providers of financial services, both domestic and foreign. Because of this structural straitjacket, banks have been forced into riskier lending at the same time that government regulators have taken it upon themselves to extend the Federal safety net to uninsured as well as insured depositors, i.e., to underwrite the entire banking system.

Given the lessons of the thrift disaster, there can be no argument that any short-term strategy must rely to a considerable extent on more effective regulatory discipline — higher capital standards; early closing procedures; higher FDIC assessments of banks; restrictions on assessments using insured deposits; etc. This will be, as I understand it, the basic thrust of the Treasury's proposals. Such an approach, however, has two built-in problems: continued reliance on government discipline serves to insulate banking from the healthy effects of private sector discipline that can be provided by the markets; and such reliance carries with it the implicit promise by government to continue to underwrite the entire banking system.

✓ Most bankers believe that the only way to reduce the government's huge potential liabilities that derive from the current system of blanket guarantees is to begin a transition toward a greater private sector role in the management of banking risk. The key objective of this strategy would be to transform the FDIC guarantee from the first line of defense to the role of a backup for whatever private sector insurance options may be deemed desirable. As this occurs, government gradually would relinquish its current (and unsustainable) role as chief disciplinarian in lieu of a system in which the private sector assumes this role over depository institutions.

In other words, the role of government in the regulation of the banking system would diminish in proportion to the shrinkage of the Federal guarantee. The result will be a safer, healthier banking system fully able to meet competitive challenges, both domestic and foreign. Merely relying on government-sponsored and directed discipline will not achieve that result.

"A"
What does this mean?

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