Reflections On Deposit Insurance

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For many years deposit insurance was one of the few instances of government intervention in the economy that just about everybody—liberals and conservatives alike—agreed was a good idea. Since there was not much debate about deposit insurance, there was little discussion of it.

The savings and loan crisis has changed all this. No one believes that deposit insurance was the only cause of the crisis, and probably only a minority of those who have studied the crisis think it was the principal cause. Nonetheless, there is now widespread agreement among those in the best position to judge that deposit insurance has at least contributed to the thrift problem.

Deposit insurance is now getting a great deal of attention. The FIRREA (Financial Institutions Reform, Recovery, and Enforcement Act of 1989) law requires the Treasury Department to prepare a study of deposit insurance; the American Bankers Association has already published a proposal for reforming the deposit insurance system; and leading newspapers and financial periodicals currently are filled with articles about deposit insurance.

I.
NATURE OF THE DEPOSIT INSURANCE PROBLEM

How did deposit insurance contribute to the thrift crisis and what risks does deposit insurance pose for the commercial banking industry in the future? The response to this question is that deposit insurance presents a "moral hazard" to banks and other depository institutions. Moral hazard, as applied to deposit insurance, means that the managers of a thrift or a bank may have an incentive to acquire riskier assets than they should because insured depositors—secure in the knowledge that their funds are safe in any event—will not penalize the institution by withdrawing their funds or requiring that a risk premium be added to the rates paid on their deposits. The hazard is all the greater if, as in too many institutions at present, capital is relatively low so that shareholders—who often include managers—have only a modest amount of their wealth at stake in the institution. It seems clear in retrospect that the moral hazard associated with deposit insurance did in fact play a role in the thrift crisis, although it may not have been the initial cause of the crisis. Specifically, at least some thrifts invested the deposits entrusted to them in highly risky ventures that depositors would not have tolerated in the absence of insurance. With this unfortunate experience in mind, commercial bankers obviously need to be aware of the long-term risks that deposit insurance presents to the banking industry so that they can work with the appropriate regulators to evaluate and avoid these risks.

Attention must also be given to the problems deposit insurance may cause in the U.S. economy as a whole as well as in particular depository institutions and industries. Risk may be systematically underpriced in the U.S. economy because deposit insurance reduces the risk premium depository institutions have to pay when they compete for deposits. Loan rates may therefore not reflect adequately the risk associated with particular loans. If this is true, too many economic resources are being drawn to relatively high risk ventures and away from lower-yielding but economically more defensible projects. The apparent excess supply of office buildings and condominiums in many parts of the country currently suggests that there may have been a significant misallocation of capital in the United States over the last decade. Deposit insurance may have contributed to this misallocation. If this conjecture is accurate, it is essential to correct the problem quickly since America must allocate its capital resources as productively as possible to strengthen its competitiveness in today's highly efficient world markets.

II.
WAYS TO DEAL WITH THE PROBLEM

The key question, obviously, is: how should we reform the deposit insurance system? The recommendations that follow are not necessarily the views of the Federal Reserve as a whole although many of them are held widely in the System. Many also correspond to points Chairman Greenspan made in his testimony on deposit insurance reform on July 12, 1990, before the Senate Committee on Banking, Housing, and Urban Affairs.

Before considering what reforms should be made it should be recognized that whatever problems may be associated with deposit insurance, it has produced significant benefits since its inception back in the 1930s. In particular, no systemic runs on federally insured institutions have occurred during this period. Every effort must be made to preserve this benefit. The old adage about not throwing the baby out with the bathwater seems especially appropriate in the context of deposit insurance reform. Moreover, any attempt to overhaul overnight a system as popular and extensive as deposit insurance would be unwise. A better approach would be to set strategic goals for reform of the system and then develop a long-range, phased plan to achieve these objectives with minimum disruption. The following recommendations are in this spirit.

Accelerating and Improving Resolution Procedures

In dealing with the deposit insurance problem, the most urgent need is to accelerate the resolution of what are euphemistically called "capital-impaired" institutions: in plain English, insolvent or soon-to-be-insolvent institutions. This is the only sure way to protect the deposit insurance funds and prevent or at least limit further potential losses to taxpayers. Taxpayers are angry about their potential losses from the thrift crisis to date. They have no stomach for any further losses.

Accelerating the resolution process and protecting the insurance funds, of course, are easier said than done. One intriguing proposal for accomplishing this is the American Bankers Association's "final settlement payment" procedure put forward in March of 1990. Under this procedure, an insured institution would go into FDIC receivership immediately upon a determination that it was insolvent. On the next business day the FDIC would give insured depositors access to their full balances up to $100,000 and settle the claims of uninsured depositors and unsecured creditors through a "final settlement payment," the amount of which would be set so that the FDIC would break even over time in its receivership activities. According to the ABA this amount would be between 85 and 95 percent of uninsured and unsecured creditor claims. This plan is appealing because it would subject depository institutions to a greater degree of healthy market discipline than exists currently while at the same time giving uninsured depositors and unsecured creditors immediate access to most of their funds. It would also help neutralize the "too-big-to-fail" problem if it were applied consistently and therefore were a credible, permanent policy known in advance by depositors, bondholders, and other creditors. There may be legal or technical problems with this approach which have not surfaced yet, but, apart from this possibility, the ABA's proposal seems to have considerable merit. Any proposal that holds out a hope of halting the erosion of the insurance funds deserves serious consideration.

One particularly sticky problem involved in accelerating the resolution of insolvent institutions deserves mention—the question of what accounting system should be used in determining insolvency. It is well known that conventional accounting practices based on historical book values do not always accurately reflect the true current condition of an institution. Consequently, some economists and others have urged the adoption of market value accounting in some form. There are a lot of knotty practical problems involved in switching to market value accounting, and the solutions to all these problems are not clear yet. Changes along these lines may have to be considered, however, since it will not be possible to improve resolution procedures unless accurate and timely information on the true condition of insured institutions is available. If a way can be found to develop this information, it would then be incumbent on the supervisory agencies to review it at least annually for each insured bank in a full in-bank examination.

Finally, whatever specific procedures are adopted for resolving insolvencies, it is important that the Federal Reserve reinforce them in administering the discount window. In the past the Federal Reserve has provided extended credit on several occasions to undercapitalized institutions, including some that may have been insolvent on a market-value basis. This practice has evolved from the System's "lender-of-last-resort" responsibilities and has reflected its desire to help prevent or at least limit the disruption that may occur when individual institutions fail. The availability of extended credit from the window, however, may facilitate the withdrawal of uninsured funds from troubled institutions prior to resolution. If so, it would tend to undermine reforms such as the ABA's proposal since one of the principal benefits of these proposals would be the increased depositor discipline it would stimulate. Therefore, it may be desirable for the Federal Reserve to reevaluate its extended credit policies in conjunction with the larger effort to improve the deposit insurance system. In doing so, it should be kept in mind that the System can discharge its lender-of-last-resort duties to a very substantial extent by supplying liquidity to the banking system through ordinary open market operations.

Strengthening Capital Positions

Although improving resolution procedures is particularly urgent in order to prevent any further erosion of the insurance funds, more fundamental reforms are also needed. Among the most important of these is an additional strengthening of capital positions. Considerable progress in this direction has already been made with the new international risk-based capital standards, which are being phased in and will be completely in place by the end of 1992. Nonetheless, a strong argument can be made for even higher capital standards, as Chairman Greenspan has indicated quite forcefully.

Higher capital ratios would obviously benefit the deposit insurance system. First, they would enlarge the buffer protecting the insurance funds. Second, they would reduce the moral hazard in the system because shareholders would have a proportionately larger interest in an institution and therefore would impose greater discipline on managers. Beyond these direct benefits to the insurance system, higher capital ratios would make it considerably more likely that banks would be permitted to engage in a wider range of activities. This is so because the additional capital buffer would reduce the risk that the safety net of which deposit insurance is a part would be extended implicitly to these new activities. Smaller institutions may not find this last argument of great interest, but many observers of the U.S. banking industry believe firmly that bank powers must be extended if American banks are to maintain their competitive position in world financial markets.

One other argument for increasing bank capital merits special attention. In the present situation with relatively low capital ratios in many banks and, in practice, something approaching full coverage of all depositors, the government and the taxpayer effectively are bearing most of the risk associated with the depository industry. The savings and loan debacle has made both the government and taxpayers keenly aware of the nature and full dimensions of this risk. Consequently, it is likely that the government will demand increased control and regulatory authority over banks and other institutions if it is asked to continue to bear this risk. Some sharpening of supervision and regulation is probably needed in view of the thrift problem. But a wholesale increase in regulatory control and interference would not serve the interests of either banks or their customers. The innovative banking activity that has served the United States so well in the past would be stifled and the industry would wither. This is obviously a strong argument for increasing capital ratios. For that matter, it is a strong argument for any change that increases market and depositor discipline.

In short, there are several solid arguments for raising capital standards, and Chairman Greenspan stated in his testimony that the Federal Reserve currently is developing more specific proposals to accomplish this as smoothly as possible. Many bankers undoubtedly would like to know where they are going to find this capital and how much it is going to cost. Unfortunately, there is no simple answer to this question. An increased demand by the banking industry for capital would almost certainly raise its cost, and this in turn might lead to further structural changes and possibly slower growth in the industry. These things do not sound very desirable at first, but this kind of outcome might well be a blessing in disguise if, as is very likely, it were to increase the efficiency and therefore the viability of the banking industry over the longer haul. In any event, the alternative of greater regulatory control is almost certainly worse.

It would probably be acceptable, in this regard, to count fully subordinated debt along with equity capital toward fulfillment of required capital minimums. Most independent small and medium-sized institutions probably will find it less costly, however, to attract equity capital than investment in subordinated debt in the foreseeable future.

Other Measures

It has been emphasized already that the two most effective, practical steps that can be taken to deal with the problems in the deposit insurance system currently are (1) improving the procedures for resolving insolvencies and (2) increasing capital ratios.

There are a number of other useful measures, however, that would complement these two primary reforms.

Improved supervision clearly would be one such step. One of the great advantages of higher capital ratios is that they would reduce the pressure for any marked increases in regulation and supervision. Measured changes in supervisory activity such as annual in-bank examinations of all insured banks, however, would not be unduly intrusive and would benefit individual institutions as well as regulators. Another potentially helpful action might be to introduce a limited form of risk-based insurance premiums. Such premiums would link the price of insurance paid by a particular institution (and, indirectly, its customers) directly to the potential burden the institution is putting on the insurance fund and therefore give the institution an incentive to reduce this burden. It would not be a good idea, however, to base these premiums on a detailed categorization of assets according to risk. It is exceedingly difficult as a practical matter to define and rank such categories, and attempts might be made to manipulate the system in order to direct credit to favored industries. Consequently, any differentiation of premiums probably should be based primarily on capital adequacy.

Whatever other reforms may be made in the insurance system, some people will not be satisfied unless action is taken to reduce the system's overall coverage from present levels. These people argue that in practice the system currently covers virtually 100 percent of deposits and a substantial portion of other unsecured liabilities. They argue further that this situation and the subsidization of risk-taking it entails will inherently produce a continuing, significant misallocation of resources and make the economy correspondingly less efficient—a condition the nation can ill afford when it is locked in a global competitive struggle with the highly efficient Japanese and German economies.

This rather fundamental economic argument for reducing coverage is very persuasive. The question is: how should it be accomplished? The ABA proposal discussed above is one possibility. Another option, of course, would be to reduce the explicit insurance limit per account from the current $100,000 to something less. One does not have to be terribly astute to realize that this would be very difficult to achieve politically. It might also weaken the competitive position of U.S. banks in international money markets. A better approach might be to enforce the $100,000 limit more effectively by restricting the use of multiple accounts by individual depositors. This could be done in a straightforward way using social security numbers.

Perhaps the most productive way to limit coverage, however, would be to introduce—or at least study the possibility of introducing—some form of coinsurance for larger insured accounts. Coinsurance probably would be as effective or nearly as effective in increasing depositor discipline on institutions as a reduction in the insurance limit. It also would be easier to sell politically since the public is now well accustomed to deductibles in their automobile and health insurance plans. The public might well regard a system like this as a fair and reasonable effort to prevent a recurrence of the savings and loan problem. In considering such a system, however, it would be important to analyze carefully the implications of coinsurance for the competitiveness of U.S. depository institutions in world markets.

III.
CONCLUSION

These comments and observations can be boiled down to two main points. First, prompt and meaningful reform of the deposit insurance system is needed both to correct the distortions the present system has introduced into the economy and, more urgently, to prevent the savings and loan disease from spreading to the commercial banking industry. Second, there are a variety of feasible options for reform available. Accelerated resolution procedures and higher capital ratios are especially important, and, as indicated above, a number of other beneficial changes could be made to supplement and reinforce these fundamental reforms. Some of these changes may require some adjustments, both in the Federal Reserve and other regulatory agencies and in the banking industry. If the changes are made carefully and diligently, however, American banking and financial markets will almost certainly be much stronger and more efficient in the years ahead.