"Deposit Insurance: Addressing Its Moral Hazard Effect"

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Introduction

In the more than 40 years that I have worked in bank regulation and supervision at the FDIC and the Federal Reserve Bank of Kansas City, as well as in monetary policy on the Federal Open Markets Committee, I have had the opportunity to observe firsthand the sense of security that deposit insurance gives bank customers and creditors, with the objective of providing increased financial stability. Unfortunately, I also have observed that deposit insurance, like any insurance system, inherently invites its own abuse—moral hazard—that can cause unintended serious destabilizing effects on an economic system.

While this experience does not provide me with the ability to outline a fail-safe solution to remedy this conflict, it does offer me some insight on the matter that I want to share with you, my colleagues, here today. Deposit insurance serves a most useful purpose, and I am not implying that its use be discontinued because of the moral hazard side effects. I am suggesting, however, that we can mitigate those effects if we, as insurers and supervisors, insist on good oversight through sound bank supervision, reliable capital standards, and insurance pricing that holds banks accountable for the risk profile they choose.

Moral Hazard

The principle function of deposit insurance is to promote confidence in the banking system and thus financial stability. With such guarantees, depositors and creditors have no reason to run—not when problems occur at banks other than where they place their money, nor when they suspect their own bank might fail. However, such guarantees and the associated loss of market discipline, as a check against institutional excess, invite systematic excessive risk-taking: the moral hazard effect.

While preventing runs on solvent institutions is desirable, preventing runs at any cost on all institutions, even those that are insolvent, is not. The threat of failure serves to ensure that banks remain more sensitive to risk, and it inhibits the industry from trending toward excessive risks. Without the discipline provided by depositors and other creditors inclined to withdraw their funds when they suspect a bank of being unsafe, banks have an incentive to take on such exposures. As this occurs, particularly in the largest banks, the risk is often borne by the public, which backstops the financial safety nets.

In the United States, for example, the risks are borne by the healthy banks that fund the deposit insurance system; by their customers who pay the costs through higher loan rates and lower deposit rates; and ultimately by taxpayers, as we learned during the most recent financial crisis.

Since deposit insurance and government guarantees dramatically decrease the incentive of insured depositors to monitor and discipline banks, the responsibility of preventing banks from imposing the costs of excessive risk taking on the public safety net falls to other mechanisms, namely bank supervisors and capital. Advocacy and support of both are important functions of the deposit insurer.

Counterbalances

With this in mind, I will focus most of the remainder of my comments on the role of bank supervision and capital in counterbalancing the moral hazard dilemma. Historically, these tools, when used effectively, have proved invaluable in assuring the banking sector is deserving of the public's confidence. In good times, however, they are often strongly opposed by the industry and, worse yet, they sometimes go unused by both supervisors and insurers.

Paul Warburg, a German-born New York banker during the Great Depression and an early advocate for the Federal Reserve System, observed this phenomenon as he commented on the public's attitude leading up to the Great Depression:

> *In a country whose idol is prosperity, any attempt to tamper with conditions in which easy profits are made and people are happy, is strongly resented. It is a desperately unpopular undertaking to dare to sound a discordant note of warning in an atmosphere of cheer, even though one might be able to forecast with certainty that the ice, on which the mad dance was going, was bound to break. Even if one succeeded in driving the frolicking crowd ashore before the ice cracked, there would have been protests that the cover was strong enough and no disaster would have occurred if only the situation had been left alone.*[1]

Such attitudes can be as prevalent today as they were before the Great Depression. As they develop and as the crowd noise drowns out calls for prudence, supervisors and insurers must force the crowd from the proverbial ice. To fail in this duty, supervisors and insurers cannot hope to protect their insurance fund from loss or to protect the economy and the public from the inevitable correction and its resulting economic suffering. It is exhausting work, and it is most difficult to accomplish in the boom period just before a crisis.

Having described the demands of the challenge, I am also confident that it can be managed. It requires a commitment of bank owners in the form of equity capital. And it requires bank supervisors and insurers to apply sound supervisory principles, anchored by the rule of law, irrespective of the enthusiasm and the politics of the moment.

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[1] Paul M. Warburg, The Federal Reserve System, Vol I, Addendum II, "The Stock Exchange Crisis of 1929," The Macmillan Company, 1930.

Supervision

Good supervision involves setting standards, collecting and analyzing information, and ultimately applying judgment and demonstrating courage in conveying that information to financial firms and other market participants.

Ultimately, however, the keystone on which the successful application of these principles rests is the willingness of supervisors and deposit insurers to do their job. It requires having healthy skepticism and asking tough questions. It requires the independence and courage to convey adverse findings to bank management and, when appropriate, to the public. And it requires doing all of this even, and especially, in an environment of growth, when it is often easier to accept the prevailing view. Supported by facts and experience, it is the supervisors' and deposit insurers' responsibility to stand against the madness of crowds.

In 2006 and 2007 in the United States, there were clear signs that problems were surfacing, and yet supervisors were slow to act. Even when guidance was issued about commercial real estate, the U.S. regulatory agencies quickly backed down after the industry raised objections. In hindsight, the regulators were correct in their projections, and the mistake was in backing down.

More serious perhaps was that the regulatory agencies appeared to have actually joined the siren song of "this time it's different," judging from the absence of any supervisory actions against some of the world's largest and most complex firms and the decision to cut back on systematic examinations in the years leading up to 2008. All the exam findings in the world and all the model warning signals are of little use if leaders of the regulatory bodies fail to carry the message forward.

Supervisors can make a difference, but doing so requires knowledge, analytical and communications skills, and guts.

Owner Equity Capital

The purpose of bank supervision is to verify that banks are operating soundly and to assure that operational or portfolio weaknesses are addressed. However, supervision should not attempt to eliminate all business risk. It should not attempt to shield firms from the consequences of individual wrong business decisions. That is the role of ownership capital. To be useful, the measure of capital should be simple, understandable, and enforceable.

Unfortunately, capital adequacy today is judged by a number of highly complex and opaque risk-based measures. One such measure, using internal models, shows tier 1 capital ratios of 14.38 as a percent of risk-weighted assets for U.S. G-SIBs. But then you learn that risk-weighted assets represent only 40 percent of total assets at these firms. No other industry is allowed to remove 60 percent of its assets from the balance sheet when its financial condition is assessed. This serves to mislead and give the perception of strength, especially when excessive risk is the order of the day.

A more dependable measure of capital strength is the tangible leverage ratio. It requires that you take tangible equity capital and divide it by total assets. This measure, which market investors rely on most consistently, shows that U.S. G-SIBs have a ratio of 6.6 percent, compared with a ratio of nearly 9 percent for the other institutions in the U.S. banking industry. European G-SIBs have a tangible capital ratio of 4.6 percent.

To appreciate the significance of these different percentages, compare them with the conservative estimates of U.S. bank losses during the 2008 crisis that show the industry lost approximately 7 percent of assets. At that time, tangible capital was about 3 percent. Mistakes will occur, but there is no excuse for condoning capital measures that mislead and capital levels that are unable to absorb even modest losses, and which in the end require the taxpayer to pick up the pieces of the financial industry.

It has been suggested that relying on the more strict leverage ratio as the principal measure of capital adequacy might cause lending and economic growth to slow. Some also argue that requiring higher capital standards would cause bankers to take on greater risks to boost returns. However, research related to each of those topics suggests the assertions are not valid. The Bank of International Settlements found that a 1 percentage point increase in the equity-to total assets ratio is associated with a 0.6 percentage point increase in annual loan growth.[2] Other data[3] show that the U.S. banks that entered the crisis in 2008 with higher capital levels had more modest declines in loans and recovered more quickly through the cycle. Concurrently, the banks going into 2008 with the lowest capital levels, including the largest banks, experienced the most dramatic declines in lending and highest rates of failure or bailout. The data are clear that strong capital allows for more flexibility in managing through the business cycle. Finally, data show that banks with higher equity capital have higher price-to-book values[4], demonstrating that competing from financial strength pays off.

From a supervision program perspective, moving away from risk-based capital measures toward an assessment of adequacy based on tangible equity would generate more reliable information from which to make supervisory judgments and would free up billions of dollars from supervision budgets currently spent computing and analyzing risk-based measures that are too-often gamed.

Rather than regulators assigning weights broadly across the industry, risk-based capital is better used by management to allocate capital on an internal basis with that process being subject to examination. Further, risk-based capital and models can be useful components of the supervision process for stress testing different economic scenarios, but the extension of their use as the principle forward measure of adequacy too often misinforms the investment community and the broader public. History also shows, especially in the recent financial crisis, that the leverage ratio, not risk-based capital, has always been a more useful measure and predictor of solvency for regulators and the public.

Adequate capital as measured using a leverage ratio, in combination with strong bank examinations and supervision practices, is the best means to ensure sound banks, a safely funded insurance system, and a strong economy.

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[2] Gambacorta, Leonardo; Shin, Hyun Song; BIS Working Papers No. 558: Why Bank Capital Matters for Monetary Policy, April 2016, https://www.bis.org/publ/work558.pdf

[3] Lending Through The Cycle: https://www.fdic.gov/about/learn/board/hoenig/lending-through-the-cycle.pdf

[4] Global Capital Index: https://www.fdic.gov/about/learn/board/hoenig/capitalizationratio2q2017.pdf

Deposit Insurance Pricing

The final tool I will mention for counterbalancing moral hazard involves the pricing of deposit insurance, specifically, the use of risk-based premiums against currently held assts. A well-designed risk-based premium system can help to mitigate moral hazard by making it more costly for insured institutions to undertake risky activities or practices. If institutions are faced with higher premiums for taking actions that expose the deposit insurance fund to greater risk, this can serve as a deterrent to excessive risk taking. Higher premiums for actions that expose the DIF to greater risk can serve as a deterrent to institutions that engage in excessive risk taking.

Designing and implementing an effective risk-based premium system is not easy. It requires a great deal of data and sophisticated analytics to get it right. Even then, political realities make it difficult to charge adequately for the full risk exposure that well-connected, but high risk, institutions may pose to the insurance fund. For these reasons, it is important to keep in mind that risk-based pricing of deposit insurance should not be viewed as a substitute for strong supervision and capital standards, but rather as a potentially useful complement under those circumstances that allow for the development of a robust premium system tied to risk.

Conclusion

I will close by referring you to a book that is available at the back of the room entitled *Integrity, Fairness and Resolve*. It is a biography of an American bank examiner, Bill Taylor, who was the head of the Federal Reserve's Division of Bank Supervision and then was chairman of the FDIC. Bill taught that good supervision requires information gathering and validation, experience, leadership, and true courage. As insurers of the banking industries in each of our countries who must deal with and control for the risk that our insurance protects against, we require those same traits and, thus, I recommend the book to you as a lesson in leadership and courage.

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The views expressed are those of the speaker and not necessarily those of the FDIC.

Thomas M. Hoenig is the Vice Chairman of the FDIC and the former President of the Federal Reserve Bank of Kansas City. His material can be found at http://www.fdic.gov/about/learn/board/hoenig/.