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Economic Principles and Deposit-Insurance Reform

by James B. Thomson

The dramatic rise in interest rates during the late 1970s and early 1980s wreaked havoc on the balance sheets of savings and loan (thrift) institutions. As their cost of funds rose above what they could earn on their asset portfolios, thrift institutions began to lose billions of dollars. By the end of 1982, 237 thrifts (with $67.8 billion in assets) insured by the Federal Savings and Loan Insurance Corporation (FSLIC) were insolvent by generally accepted accounting principles (GAAP).[1]

The initial response of Congress and the Federal Home Loan Bank Board to the thrift crisis was a policy of capital forbearance. Capital requirements were relaxed for the industry as a whole, and insolvent and capital-deficient thrifts were allowed to operate because if interest rates declined, the institutions stood a chance of recovering.

This policy of capital forbearance entailed a high degree of risk. By buying time to deal with the insolvency problem, the ultimate cost of resolving the problem could have become smaller. Unfortunately, the outcome was disappointing, as both the number of insolvent institutions and the cost of resolving these insolvencies rose through the end of 1987 (see table 1).

By late 1988, nearly 500 thrifts were either GAAP-insolvent or in danger of failing. The cost of closing, reorganizing, or recapitalizing these institutions is estimated at more than $124 billion.[2] Furthermore, approximately 500 additional thrifts are above normal risks for failure. The expected future cost associated with these failures is not included in the FSLIC loss estimates.

In contrast, the fund of the Federal Deposit Insurance Corporation (FDIC) remains solvent, despite having eroded in this decade under the pressure of record bank failures and an increase in failure-resolution costs. In 1988, the FDIC experienced its first loss in the post-Depression era, as the book value of its fund balance shrank from $18.3 billion to $14.1 billion. Academic economists and private banking analysts estimate the real value of the fund as being significantly less. In fact, the private group known as the Shadow Financial Regulatory Committee estimates that the true reserve balance of the FDIC fund, net of estimated unbooked losses, is only $400 million.

On February 6, 1989, the Bush administration announced a plan for resolving the thrift crisis that includes provisions to recapitalize the insolvent FSLIC and to close nearly 500 savings and loan institutions that are currently insolvent or in danger of failing. The Bush plan also contains provisions for strengthening the FDIC's fund.

Conspicuously absent from this proposal are fundamental reforms to

The current system of federal deposit insurance subsidizes risk-taking by depository institutions, resulting in increased failure-resolution costs and decreased efficiency for the entire financial system. Reforms to the deposit-insurance system should consider both the policy objectives and the attendant economic consequences and costs of deposit guarantees.

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the federal deposit-insurance system that would help prevent another such crisis.[3] Numerous proposals for deposit-insurance reform have been advanced. The purpose of this *Economic Commentary* is to examine the fundamental economic principles that should be used in evaluating these reform proposals.

■ The Purpose of Deposit Insurance

What are the policy objectives of deposit insurance? Are depository institutions special in some way that *requires* that they have access to federal deposit guarantees, or are they simply special because they have access to these guarantees? While often ignored, these fundamental questions are important because different objectives for deposit insurance could correspond to different methods of implementing a deposit-insurance system.[4]

One widely cited justification for federal deposit guarantees is the need to protect the savings and transactions balances of small savers. If small depositors lack the sophistication and resources to monitor the condition of their banks effectively (and the resources to absorb unpredictable losses), then perhaps their accounts should be safeguarded. Deposit insurance is but one of many ways to achieve this.

It has also been argued that federal deposit insurance is needed to improve the informational efficiency of the financial sector. If it is relatively costly for some depositors to evaluate the condition of their depository institution, then it might be more efficient to have the monitoring performed by a centralized agency. In addition, a centralized agency is likely to have lower information costs than the total cost of the combined efforts of a mass of small depositors. However, federal deposit insurance is not needed to lower information costs. These costs could be reduced simply by having an agency collect and disseminate information without guaranteeing deposits.

A third motive for federal deposit insurance is to prevent destabilizing bank runs. Some economists believe that an individual bank run can become contagious and result in a run on the entire banking system. If so, deposit insurance could remove or reduce the incentives for bank runs and thus stabilize the banking system.

A *rational* bank run is one that occurs because depositors have good information that their depository institution has (or may) become insolvent. This type of run should not be contagious, and in fact should act as a form of market discipline on bank management. An *irrational* bank run is one that occurs because poorly informed depositors mistakenly believe that their depository institution has (or may) become insolvent. If the primary purpose of a deposit-insurance system is to prevent irrational bank runs, then the system should insure only the deposits of customers who are likely to act on poor information.

Unfortunately, deposit-insurance systems cannot differentiate between rational and irrational bank runs. Consequently, the desirable market discipline of occasional rational bank runs is sacrificed to remove the potentially destabilizing effects of irrational bank runs. Once again, however, deposit insurance is not the only solution. A properly functioning lender of last resort can prevent irrational bank runs from becoming systemic bank runs by providing liquidity to solvent institutions experiencing runs, thus removing the destabilizing effects of irrational bank runs without precluding rational bank runs on insolvent institutions.

The need to protect the nation's payments system is the fourth reason often cited to justify federal deposit guarantees.[5] According to this view, a default on the payments system could be triggered by the failure of a large bank, leading other banks to become insolvent. By guaranteeing the payments-related liabilities of banks, deposit insurance immunizes the payments system from bank failures. An objection to this view is that providing direct guarantees of payments-system transactions achieves the same result with greater efficiency. Furthermore, as in the case with systemic bank runs, a properly functioning lender of last resort could immunize other banks (and the payments system) from the effects of a single bank failure.

Clearly, the type of deposit-insurance system we should adopt depends critically on our goals. For example, if the purpose of deposit insurance is to protect the savings and transactions balances of informationally disadvantaged small savers, then the coverage necessary is less than the current explicit limit of $100,000. On the other hand, if the purpose of deposit insurance is to protect the payments system, then the *type* of account insured is more important than the *amount* of explicit coverage. For example, consumer and corporate checking accounts would be fully insured under this motive, while savings and investment vehicles such as money market deposit accounts and certificates of deposit would receive no, or only nominal, coverage.

■ Economic Consequences and Costs of the Current Deposit-Insurance System

The estimated $124 billion needed to resolve the thrift crisis is just the direct monetary cost of our current system of federal deposit guarantees. Other economic consequences and costs include an overinvestment in risky assets and the subsidization of depository institutions on the basis of risk and size. In fact, perverse incentives built into these subsidies contributed significantly to the current thrift crisis. Without meaningful reforms to the deposit-insurance mechanism, there are strong incentives for this situation to be repeated.

As presently priced and administered, federal deposit insurance subsidizes risk-taking by depository institutions in two ways. First, the FDIC and FSLIC provide a risk-related subsidy to all insured depository institutions. Second, insured institutions that are safe and well-managed subsidize the risk-taking behavior of the "high-fliers" of the industry.[6] In both cases, the amount of

TABLE 1 ESTIMATES OF FSLIC LOSS EXPOSURE TO GAAP-INSOLVENT THRIFTS

Year	Number of GAAP-Insolvent Thrifts	Assets (in billions $)	FSLIC Loss Exposure (in billions $)
1982	237	$ 67.8	$ 3.08
1983	293	83.9	4.98
1984	445	115.5	16.89
1985	470	138.0	22.14
1986	471	137.2	33.76
1987	520	200.1	69.51

SOURCE: Edward Kane, *The S&L Insurance Mess: How Did It Happen?* Washington, D.C.: The Urban Institute, 1989, table 3-6.

the risk-related subsidies increases with the degree of risk assumed by the institution and leads to an overinvestment in risky assets in the economy.

Currently, the failure-resolution policies of the FDIC and FSLIC have resulted in a system of federal deposit insurance that is biased in favor of large institutions.[7] For example, the FDIC has never liquidated a bank with more than $600 million in assets, thereby providing de facto 100-percent insurance for all depositors in such institutions. On the other hand, small banks have been liquidated routinely, and some uninsured depositors in these institutions have suffered losses. This perceived assurance against liquidation has given large depository institutions a competitive advantage over small ones in issuing large, uninsured deposits.

Using Economic Principles to Evaluate Reform Proposals

Equity and efficiency are the two basic principles economists apply when evaluating programs such as federal deposit insurance. The concepts of equity and efficiency must be considered in the context of both deposit-insurance objectives and the regulatory and market structure of the insured industry. Because a trade-off can exist between equity and efficiency, the "best" deposit-insurance system may not rank as the top proposal in terms of either criterion alone.

Some have argued for government interference into markets on equity grounds.[8] Equity can be used to justify federal deposit insurance if it corrects biases or favoritism existing in the absence of deposit insurance. Because equity is a relative concept, we typically judge the equity of a proposal relative to the market outcome.

For a deposit-insurance system to be equitable, it must treat all financial institutions alike. As discussed earlier, the current system of federal deposit insurance is not equitable because the failure-resolution policies of the FDIC and FSLIC are biased in favor of large depository institutions. A second example of the inequity of the current system is in the area of capital regulation. If capital is costly to obtain, then the equity criterion implies that all insured institutions should be subject to the same set of regulations as a condition for receiving federal deposit guarantees. For instance, if a minimum capital ratio is specified as a condition for receiving deposit guarantees, then all insured institutions should be subject to the same capital requirements. However, most thrifts are currently required to hold only half as much capital as banks.[9]

Equity also implies that all depositors should be treated equally. That is, there should not be differential treatment across banks of uninsured depositors, creditors, and equity-holders when those banks fail. Each class of claimants on the bank's assets should receive the same treatment irrespective of the size, location, or type of insured institution. Otherwise, the presence of deposit insurance changes the relative cost of funds and equity capital across institutions.

Efficiency is the second criterion by which deposit-insurance reforms should be judged. Economists are usually concerned with allocative efficiency; that is, how close the resource allocation under each proposal is to some perceived optimal, yet usually unattainable, resource allocation.

The allocative efficiency of each reform proposal cannot be directly observed. However, judgments about the relative efficiency of alternative deposit-insurance systems can be based on the incentives built into each one. From an efficiency standpoint, the incentives built into deposit insurance, through the pricing of the guarantees and the failure-resolution policies of the FDIC and FSLIC, should not subsidize risk-taking either through cross-subsidies between depository institutions or through the Treasury (to the extent that the Treasury stands behind the FDIC and FSLIC).

The efficiency criterion requires that when circumstances warrant, regulators must allow banks and thrifts (regardless of size) to fail. Failure is the mechanism through which the market corrects persistent and substantial inefficiencies. Failure does not imply that the institution always must be liquidated or otherwise disappear; rather, it means that the owners and management are replaced. As we have found in the thrift industry, the lack of resolve to close institutions when they are insolvent increases the ultimate failure-resolution costs and decreases the efficiency of the financial system.

Conclusion

The current thrift-industry debacle will be expensive to resolve. Of the estimated $124 billion needed to resolve the crisis, at least $40 billion to $60 billion will come directly from the taxpayer. With this commitment of taxpayer money should come a reexamination of the objective of the deposit-insurance system and far-reaching reforms in its design so that a crisis of the current magnitude is not repeated.

Any changes to the deposit-insurance mechanism should be made with a clear understanding of the associated costs and benefits. Society needs to be more aware of the size and value of government guarantees, like deposit insurance, and the public should make strenuous efforts to ensure that the costs of providing these guarantees do not exceed the benefits.

Policymakers should consider deposit-insurance reforms in the context of the overall evolution of the financial services industry and also in the context of other regulatory reforms. The result should be a deposit-insurance system with modest, well-specified objectives that are easy to understand and administer. With this in mind, federal deposit insurance should be structured in a fashion that accomplishes its goals with minimal disruption of market forces.

Footnotes

1. See James Barth and Michael Bradley, "Thrift Deregulation and Federal Deposit Insurance," *Journal of Financial Services Research,* vol. 2 (1989–forthcoming).

2. The $124 billion includes $50 billion for prior case resolutions and $74 billion for restructuring insolvent thrifts. The $124 billion estimate does not include financing costs of $81 billion ($150 billion) if the spending is financed over 10 (30) years at current market interest rates. See Barbara Pauley, "The Thrift Reform Program: Summary and Implications," New York: Salomon Brothers, April 1989.

3. See Edward Kane, *The Gathering Crisis in Federal Deposit Insurance*, Cambridge, MA: MIT Press, 1985, chapters 5 and 6; and Edward Kane, *The S&L Insurance Mess: How Did It Happen?* Washington, D.C.: The Urban Institute, 1989.

4. Some economists question whether federal deposit insurance is needed at all. After all, the liabilities of other financial intermediaries are neither explicitly nor implicitly guaranteed by the federal government. Many of these institutions compete head-on with banks and thrifts for funds and provide many of the same services as insured depository institutions.

5. This role for deposit insurance is the motivation for the safe-bank proposals of Litan and others. See Robert Litan, *What Should Banks Do?* Washington, D.C.: The Brookings Institution, 1987.

6. For a discussion of this point, see Edward Kane, *The Gathering Crisis in Federal Deposit Insurance,* Cambridge, MA: MIT Press, 1985, chapter 3.

7. The failure-resolution policies of the FDIC and FSLIC are the process through which implicit guarantees are issued to uninsured depositors, general creditors, subordinated creditors, and even stockholders. For a discussion of FDIC failure-resolution policies, see Daria Caliguire and James Thomson, "FDIC Policies for Dealing with Failed and Troubled Institutions," *Economic Commentary,* Federal Reserve Bank of Cleveland, October 1, 1987.

8. See Arthur Okun, *Equality and Efficiency: The Big Tradeoff,* Washington, D.C.: The Brookings Institution, 1975.

9. One feature of the original Bush administration proposal is uniform capital requirements for banks and thrifts by June 1991. The Bush administration has indicated to the Congress that it will veto any legislation for resolving the thrift-industry crisis that waters down this provision.

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