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 and capital-deficient thrifts. The cost of closing, reorganizing, or recapitalizing these institutions is estimated at more than $124 billion. 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 subsidies 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.

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, there should be 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-specification 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.
the federal deposit-insurance system that would help prevent another such crisis. 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.

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 institutions, then it might be more efficient to have the monitoring performed by a central bank.

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 would be triggered by the failure of a large bank, leading other banks to become insulinvent. If the primary purpose of a deposit-insurance system is to directly 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 potential 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. According to this view, a lack of 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 systems, then the type of coverage is more important than the degree of informationally disadvantage savers. 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 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. For example, perverse incentives built into these subsidies contributed significantly to the current crisis. Without meaningful reforms to the deposit-insurance mechanism, the amount of explicit subsidies is too high. The economic efficiency of our current system of deposit insurance is not susceptible to a rational and competitive market that corrects persistent and substantial inefficiencies.

Using Economic Principles to Evaluate Reform Proposals

Economic efficiency is the second criterion by which proposals for deposit insurance 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, usually unattainable, resource allocation.

The allocative efficiency of each reform proposal is the single most directly observable. 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 within a single institution. However, in the context of the current system of federal deposit insurance, it 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 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. Equity also implies that all depositors should be treated equally. That is, there should not be different treatment across banks of uninsured depositors, creditors, and equity holders when the same institution fails. Claims on the bank’s assets should receive the same treatment irrespective of the size, location, or type of insured institution.
A third motive for federal deposit in-

insurance is to examine the fun-
damental 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 in-

stitutions supervised in a way that re-
quires 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 impor-
tant because different objectives for deposit insurance could correspond to different methods of implementing a deposit-insurance system.

One widely cited justification for federal deposit guarantees is the need to protect the savings and transactions bal-

ances of small savers. If small deposi-
tors lack the sophistication and re-
sources to monitor the condition of their banks effectively (and the resources to absorb unpredictable losses), then per-
haps their accounts should be safe-
guarded. 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 con-
dition of their depository institution, then it might be more efficient to have the monitoring performed by a central-
ized agency. In addition, a centralized agency is likely to have lower informa-
tion costs than the total cost of the com-
bined efforts of a mass of small depositors. However, federal deposit insur-
ance is not needed to lower informa-
tion costs. These costs could be reduced simply by having an agency collect and disseminate information without guaranteeing deposits.

A third motive for federal deposit in-
surance is to prevent destabilizing bank

runs. Some economists believe that an individual bank run can become con-
tagious and result in a run on the entire banking system. If so, deposit in-

surance could reduce or eliminate the con-

tinuity of payment systems. Clearly, the type of deposit-insurance system we should adopt depends criti-
cally on our goals. For example, if the purpose of deposit insurance is to pro-
tect the savings and transactions bal-

ances of informationally disadvantaged small savers, then the coverage neces-
sary 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 coverage is important. Unfortunately, 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. Once again, however, deposit insur-
ance is not the only solution. The efficiency criterion requires that the depos-
itor be treated equally.

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 insur-
ance is to prevent destabilizing bank

runs. Some economists believe that an individual bank run can become con-
tagious and result in a run on the entire banking system. If so, deposit in-

surance could reduce or eliminate the con-

tinuity of payment systems. Clearly, the type of deposit-insurance system we should adopt depends criti-
cally on our goals. For example, if the purpose of deposit insurance is to pro-
tect the savings and transactions bal-

ances of informationally disadvantaged small savers, then the coverage neces-
sary 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 coverage is important. Unfortunately, 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. Once again, however, deposit insur-
ance is not the only solution. The efficiency criterion requires that the depos-
itor be treated equally.

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 insur-
ance is to prevent destabilizing bank

runs. Some economists believe that an individual bank run can become con-
tagious and result in a run on the entire banking system. If so, deposit in-

surance could reduce or eliminate the con-

tinuity of payment systems. Clearly, the type of deposit-insurance system we should adopt depends criti-
cally on our goals. For example, if the purpose of deposit insurance is to pro-
tect the savings and transactions bal-

ances of informationally disadvantaged small savers, then the coverage neces-
sary 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 coverage is important. Unfortunately, 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. Once again, however, deposit insur-
ance is not the only solution. The efficiency criterion requires that the depos-
itor be treated equally.

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 insur-
ance is to prevent destabilizing bank

runs.

Economic Consequences and Costs of the Current Deposit-Insurance System

The estimated $12.4 billion needed to

resolve the crisis is just the direct monetary cost of our current system of federal deposit guarantees. Other eco-

nomic consequences and costs include an overinvestment in risky assets and the subsidization of depository institu-
tions on the basis of risk and size. In

fact, perverse incentives built into these subsidies contributed significantly to the current crisis. Without mean-

ingful reforms to the deposit-insurance mechanism, the amount of explicit coverage. For example, consumer and corporate checking accounts would be fully insured under this system, while savings and investment vehicles such as money market deposit accounts and cer-

tificates of deposit would receive no, or only nominal, coverage.

Economic Consequences and Costs of the Current Deposit-Insurance System

The estimated $12.4 billion needed to

resolve the crisis is just the direct monetary cost of our current system of federal deposit guarantees. Other eco-

nomic consequences and costs include an overinvestment in risky assets and the subsidization of depository institu-
tions on the basis of risk and size. In

fact, perverse incentives built into these subsidies contributed significantly to the current crisis. Without mean-

ingful reforms to the deposit-insurance mechanism, the amount of explicit coverage. For example, consumer and corporate checking accounts would be fully insured under this system, while savings and investment vehicles such as money market deposit accounts and cer-

tificates of deposit would receive no, or only nominal, coverage.

Economic Consequences and Costs of the Current Deposit-Insurance System

The estimated $12.4 billion needed to

resolve the crisis is just the direct monetary cost of our current system of federal deposit guarantees. Other eco-

nomic consequences and costs include an overinvestment in risky assets and the subsidization of depository institu-
tions on the basis of risk and size. In

fact, perverse incentives built into these subsidies contributed significantly to the current crisis. Without mean-

ingful reforms to the deposit-insurance mechanism, the amount of explicit coverage. For example, consumer and corporate checking accounts would be fully insured under this system, while savings and investment vehicles such as money market deposit accounts and cer-

tificates of deposit would receive no, or only nominal, coverage.

Economic Consequences and Costs of the Current Deposit-Insurance System

The estimated $12.4 billion needed to

resolve the crisis is just the direct monetary cost of our current system of federal deposit guarantees. Other eco-

nomic consequences and costs include an overinvestment in risky assets and the subsidization of depository institu-
tions on the basis of risk and size. In

fact, perverse incentives built into these subsidies contributed significantly to the current crisis. Without mean-

ingful reforms to the deposit-insurance mechanism, the amount of explicit coverage. For example, consumer and corporate checking accounts would be fully insured under this system, while savings and investment vehicles such as money market deposit accounts and cer-

tificates of deposit would receive no, or only nominal, coverage.

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 con-

sidered in the context of both deposit-

insurance objectives and the regulatory and market structure of the insured in-

dustry. Because a trade-off can exist be-
tween 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 in-
tervention into markets on equity grounds. Equity is the second criterion by which the Treasury stands behind the FDIC and FSLIC. The efficiency criterion that requires that the market corrects persistent and substan-
tial inefficiencies. Failure does not imply that the institution always must be liquidated or otherwise disappear; rather, it means that the owners 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 costs 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 ef-
ficiency, that is, how close the resource allocation under each proposal is to some perceived optimal, mutually un-

attainable, resource allocation.

The allocative efficiency of each reform proposal is not directly ob-

served. 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 in-
centives built into deposit insurance, the pricing of the guarantees and the failure-resolution policies of the FDIC and FSLIC, should not sub-

sidize risk-taking either through cross-

subsidies between depositors institu-
tions or through the Treasury (to the extent that the Treasury stands behind the FDIC and FSLIC). The inefficiency criterion requires that when circumstances warrant, regula-
tors must allow banks and thrifts (regardless of size) to fail. Failure is the mechanism through which the market corrects persistent and substan-
tial 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 ability of resolve to close institutions when they are insolvent incurs the ultimate failure-resolution costs and decreases the efficiency of the financial system.

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of GAAP-Insolvent Thrifts</th>
<th>Assets (in billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>237</td>
<td>$67.8</td>
</tr>
<tr>
<td>1983</td>
<td>293</td>
<td>83.9</td>
</tr>
<tr>
<td>1984</td>
<td>445</td>
<td>115.5</td>
</tr>
<tr>
<td>1985</td>
<td>470</td>
<td>136.0</td>
</tr>
<tr>
<td>1986</td>
<td>471</td>
<td>137.2</td>
</tr>
<tr>
<td>1987</td>
<td>520</td>
<td>200.1</td>
</tr>
</tbody>
</table>

SOURCE: Edward Kane, The S&L Insurance Mess: How Did It Happen?” Washington, D.C., The Urban Inst-

ate, 1985, table 3-6.
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) incurred by the Federal Savings and Loan Insurance Corporation (FSLIC) were insolvent or in danger of failing. The cost of closing, reorganizing, or recapitalizing these institutions is estimated at more than $124 billion. 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 invested in this decade under the pressure of record bank failures and an increase in failure-resolution costs. In 1983, the FDIC experienced its first loss in the post-Depression era, as the book value of its fund balance shrank from $13.8 billion to $14.1 billion. Academic economists and private banking analysts estimate the real value of the fund to be significantly lower. 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.

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.

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, recapitalizing, or recapitalizing these institutions

Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101

Address Correction Requested:
Please send corrected mailing label to the above address.

Material may be reproduced provided that the source is credited. Please send copies of reprinted materials to the editor.