

I. Introduction

II. Deposit Insurance System & Regulation

- A. Rationale for deposit insurance
 - 1. Federal deposit insurance has a long and controversial history
 - a. legislative proposals date back to 1886
 - b. over 150 proposals introduced until finally enacted in the Banking Act of 1933
 - c. took the banking crisis of the Great Depression, but only accepted hesitantly
 - 2. Initial fears, eventually panned out in the last decade
 - a. thought that it would prove to be exceedingly costly
 - b. unfairly subsidize poorly-managed banks
 - c. even FDR said, "the minute the government starts to guarantee bank deposits, it will run the risk of a probable loss."
 - 3. Deposit insurance was introduced at the state level in early 1800s
 - a. to protect communities from abrupt fluctuations in bank deposits (economic disturbance)
 - b. to protect individual depositors from catastrophic loss
 - c. however, it was never clear that this system was needed to protect from bank panics or runs (even if it was, the Fed can use open market operations and the discount window)
 - d. so, it seems that reform must center around how much protection we want to afford depositors and how much exposure we want to subject taxpayers
- B. Negative Effects of Deposit Insurance
 - 1. intricate system of rules and regulations to protect the insurance fund (taxpayers) and to guard against unfair subsidies to poorly managed banks
 - 2. proved to be operational handicaps in a fast-paced world
 - a. technology allowed unregulated interlopers to unfairly compete
 - b. fluctuations in inflation highlighted the inflexibility of a rigid system of rules and regulations

III. Price Stability and Sound Banking

- A. Credit analysis
 - 1. decisions to limit bank risk are based on
 - a. the value of collateral in secured loans
 - b. and on projections of the ratio of a borrower's current assets to current liabilities in unsecured loans of working capital

2. unexpected price changes can invalidate assumptions underlying the loan; the standards of loan evaluation can be preserved under conditions of price stability
- B. Price instability
1. accounts for many of the problems of financial institutions here and abroad, but also for the plight of U.S. deposit insurance agencies
 2. price fluctuations of the late 1970s and early 1980s coupled with the regulatory environment and deposit insurance limits of \$100,000 per account encouraged the system to undertake greater risks
 - a. bank managers and shareholders are not penalized for poor management since depositors are all but unconcerned with risk
 - b. insurance is not priced for risk (flat fee)
 - c. the manner in which deposit insurance agencies settle failures, guaranteeing non-insured parties not included under the deposit insurance system, tends to worsen already apathetic market pressures
 - d. problems are compounded by the incentives of managers, once an institution is in trouble, to take greater and greater risks

IV. Deposit Insurance Reform

- A. To restore proper market discipline, federal deposit insurance coverage must be more correctly priced or limited
- B. There are numerous proposals to limit the insurance
1. at the very least, \$100,000 per account should be strictly observed -- protection should not be extended to uninsured claimants when handling a failure
 2. at the Cleveland Fed, we believe that the current statutory limit should be reduced
 - a. for those who desire more protection, co-insurance could exist above the limit
 - b. the Banking Act of 1933 included a permanent plan for co-insurance that was never instituted
 - c. a reduction would be quite consistent with the major objective of insurance -- protection of depositors from catastrophic loss
 1. the \$2,500 limit that was originally enacted (1934), is worth about \$25,000 when adjusted for inflation today
 2. moreover, studies at the Cleveland Fed indicate that the average insured deposit account in both banks and thrifts is only about \$8,000

V. Closure and the "Too Big To Fail" Doctrine

- A. Strict enforcement of the deposit insurance ceiling means that we do not extend insurance to uninsured depositors and other creditors
1. exceptions are not made for size of institution or type of charter
 2. in particular, the "TBTF" doctrine must be done away with

- B. Failure of any organization carries many negative connotations, but what does it really mean?
 - 1. does not mean that the assets disappear
 - 2. assets are relocated and put to more efficient use
 - 3. existence of failure removes the need for taxpayers to prop up an unhealthy institution
 - 4. threat of failure strengthens market forces and discipline

VI. Loosening of the Regulatory Reins

- A. Only after reform of deposit insurance and the allowance of failure for badly-managed institutions can market incentives be expected to perform
- B. Only then, can managers in the financial services industry be freed from restrictive rules and regulations
 - 1. managers and shareholders alike would be forced to more carefully weigh risks and share in the outcomes of their decisions
 - 2. the ability to attract and maintain deposits would be based on the quality of business decisions, not on a deposit insurance subsidy of taxpayers
- C. Role of government authorities would change
 - 1. would not be an enforcer of rules and restrictions, but monitor and supervise in order to ensure that prescribed financial condition guidelines were being observed
 - 2. 3-tier system
 - a. institutions meeting the highest financial condition standards would operate without any restrictions on their activities
 - b. institutions falling short would be subject to some restrictions
 - c. those institutions that failed to meet some minimum standards would be given 90 days to recapitalize and reorganize or be closed by the supervisor
 - 3. government authorities would not only supervise, but would also help disseminate information so that markets can make well-informed decisions

VII. Conclusion

- A. Comprehensive reform should be undertaken soon
 - 1. we will never find the "best" time to institute reforms
 - 2. present state of thrift industry should not deter efforts
- B. Reform should be based on re-installation of market forces
 - 1. deposit insurance limited
 - 2. "TBTF" doctrine done away with
 - 3. regulations loosened
- C. Fed can contribute to sound financial services industry by adopting a monetary policy that pursues zero inflation