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# FRBSF WEEKLY LETTER

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## Reforming Deposit Insurance

The deposit insurance system is facing a crisis of historic proportions. The Federal Savings and Loan Insurance Corporation (FSLIC) is insolvent to the extent of at least \$90 billion; bank and thrift failures are at record highs; the Federal Deposit Insurance Corporation (FDIC) just experienced its first-ever decline in reserves; and some economists think the FDIC's reserves may be inadequate.

Many blame these problems on adverse economic conditions, such as high and volatile interest rates and troubles in the farm belt and the oil patch. Others argue that unscrupulous bank and thrift management and inadequate supervision and regulation are to blame. And some fault deregulation, expansion of powers, and increases in the ceiling for deposit insurance coverage. All of these factors may have hastened the deterioration of the deposit insurance funds. They also may be partly responsible for the timing and intensity of the problem.

But economists have long argued that at the root of the current problem is an inherently flawed deposit insurance system. By employing a flat-rate pricing system that does not relate the insurance premium to the risks that are being insured, deposit insurance provides an incentive for excessive risk taking. This is the so-called "moral hazard" of deposit insurance.

This *Letter* evaluates ways to reform the deposit insurance and regulatory systems to eliminate this moral hazard. Such reform is vital to ensure that problems similar to those we are facing today do not recur.

### **Resolving current insolvencies**

The obvious and necessary first step towards deposit insurance reform is to deal with the institutions that currently are insolvent or near-insolvent. Insolvencies should be resolved as quickly as possible, through liquidations or through acquisitions by strongly capitalized firms, whichever is least costly. And institutions near insolvency should be required to raise additional capital as soon as possible.

Although resolving current insolvencies quickly will help to limit the costs of the current problem, it will do little to ensure that similar problems do not recur. Thus, it is desirable to move beyond current difficulties to design a system that has desirable long-run properties.

A variety of reforms have been proposed. In general, these proposals fall into one of two main categories. The first involves enhancing depositor surveillance of institutions' risk taking. The second focuses on providing bank capital holders with appropriate incentives to control risk taking. Because enhanced depositor surveillance might reduce banking system stability, I argue that it would be better to strengthen bank capital and ensure that banks maintain sufficient capital over time to absorb losses.

### **Depositor surveillance**

Depositor surveillance of bank and thrift risk taking could be enhanced in many different ways. For example, the ceiling for insurance coverage could be lowered from \$100,000 to \$40,000, or even \$20,000. Alternatively, co-insurance could be instituted, whereby each deposit account would be only partially insured. Or insurance coverage could be limited to deposits used to fund risk-free assets such as Treasury securities. This last approach, known as the "narrow banking" proposal, would in effect shift the saving-lending intermediation functions banks now perform to uninsured institutions.

There is no doubt that such measures would induce at least some depositors to monitor carefully the health of banks and thrifts and thus would penalize those institutions that undertake excessive risks by requiring them to pay higher deposit rates. However, almost by definition, increased depositor surveillance also means that institutions will be exposed to an increased risk of depositor runs. Not only would the probability of runs on individual institutions increase, but perhaps the entire banking system would become less stable. Even under the narrow bank proposal banking stability could be threatened

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since "wide banks," where the actual saving-lending intermediation would take place, would have no deposit insurance. A less stable banking system could, in turn, lead to a less stable financial system and economy.

Some proponents of diminished depositor protection argue that scaling back deposit insurance coverage would cause only a *little* more banking instability, and that a little more instability would be a small price to pay for reducing the moral hazard for excessive risk taking. But it is questionable whether there is such a thing as just a little instability—partial coverage might lead to nearly the same degree of instability as no coverage.

## Eliminate deposit insurance?

Others go even further and argue that a run on an individual bank would *not* lead to runs on other banks. They argue that since an increased likelihood of runs would not lead to an unstable banking system or an unstable economy, there is no fundamental economic reason for deposit insurance. Moreover, eliminating deposit insurance altogether has the advantage that it eliminates the incentive for excessive risk taking, whereas proposals to merely scale back coverage do not.

The notion that government deposit insurance is not necessary to ensure banking system stability is not universally accepted, even among free-market economists. And there is contrary theoretical and empirical evidence in support of a centralized deposit insurance system. Thus, it seems unlikely that the debate over whether deposit insurance performs a vital economic function will be resolved any time soon.

Perhaps even more important, proposals to eliminate deposit insurance do not seem to have much popular appeal. The public has grown used to a system in which bank runs do not occur. Neither the public nor the Congress is likely to embrace proposals that solve the deposit insurance problem by increasing the likelihood of runs. This is especially so in light of the history of banking panics and runs in the U.S. prior to the advent of deposit insurance.

In lieu of increased depositor surveillance of institutions' risk taking, some have advocated stronger direct limitations on risk taking. But

most economists argue that such an approach is ineffective when there are strong countervailing economic incentives. It usually is more effective to alter the underlying incentives. In essence, this means that appropriate incentives must be given to those providing non-deposit sources of funds—either equity holders, other liability holders, or both—to police risk taking.

## Market-value capital

One way to change underlying incentives would be to institute risk-based insurance premia. While sound in principle, most economists believe such an approach is currently not feasible. An alternative would be to provide insured institutions with incentive to maintain strong market-value capital positions. Capital provides a buffer to depositors and the insurance funds against fluctuations in the values of bank and thrift portfolios. The more capital, the greater the protection against loss. And higher capital actually *reduces* banks' incentives to increase asset risk. With more of their own capital at risk, bank and thrift owners will be more concerned about potential losses from the risks they take. In contrast, the owners of an institution with very little capital have strong incentives to engage in bet-the-bank, go-for-broke strategies since they enjoy all the gains if their investments fare well, but only a fraction of the losses if their investments perform poorly.

For capital regulations to be fully effective, it is essential that capital be measured on a current, or market-value, basis, not on the historical cost, or book-value, basis used now. Market-value capital is the difference between the market values of an institution's assets and liabilities. In essence, this means that regulators need to mark down (or up) the values of an institution's assets and liabilities to reflect changes in interest rates and/or credit risk. Marking institutions' assets and liabilities to their current values is essential because it is the current value, not the past value, that determines the insurer's exposure and influences an institution's risk-taking incentives. Market-value capital has the added advantage that it cannot be manipulated to disguise institutions' true financial health as easily as book-value measures can.

## A market test

To provide depository institutions with incentives

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to maintain sufficient market-value capital ratios, institutions whose capital fell below some pre-determined amount, say, 10 percent, would be subjected to a market test of their solvency. An institution with capital below 10 percent would be required to bring its capital ratio back up to standard within a short time. A market-value solvent institution should have no trouble raising its capital ratio, either by issuing new capital securities or by selling assets and using the proceeds to retire liabilities. Moreover, the possibility that the market might misjudge an institution's true solvency would give it an incentive to hold more capital in the first place.

If the institution could not raise its market-value capital ratio, this would be *prima facie* evidence that it was market-value insolvent, and regulators would need to take prompt action to liquidate or sell it. There is little economic rationale for allowing insured institutions that are unable to maintain their capital ratios above some prudent level to continue in operation. In fact, allowing them to do so can greatly increase the risk exposure of the insurance fund.

A number of objections have been raised to this type of proposal. However, each of these objections can be addressed. First, many argue that market value capital regulation simply is not feasible, primarily because many of banks' assets are loans for which there are not readily ascertainable market values. However, market participants routinely evaluate the values of banks' portfolios when they purchase and sell bank equity, subordinated debt, and other securities. Thus, while market-value accounting may never be perfect, it need not be so for market-value capital regulation to be effective, as the behavior of private investors in bank and thrift securities seems to attest.

Second, some argue that there may be ethical or even legal problems with giving regulators the authority to close institutions that are not book-value insolvent. An alternative would be to grant the insuring agency authority to promptly remove a poorly-capitalized institution's insurance guarantee, giving existing insured depositors a reasonable chance to withdraw their deposits if they so desired. In fact, the FDIC has requested such

authority in its reform proposal. Although such an approach probably would force insolvent (and possibly even some marginally solvent) institutions into bankruptcy, it would not precipitate runs since deposit insurance would remain in force for existing depositors.

Third, it is argued that equity capital is a far more costly source of funds than insured deposits. Consequently, heavy reliance on equity capital could cause the banking industry to become less profitable and shrink. But one of the reasons that equity capital now appears to be more costly is that deposit insurance is underpriced, at least for institutions that are financially weak. And even if equity capital were *truly* more expensive, it is possible to permit institutions to count long-term subordinated debt (which cannot run) as regulatory capital.

A final problem is ensuring that bank and thrift regulators have the incentive and the wherewithal (in the form of adequate reserves) to strictly enforce market-value capital standards. If the current incentives are not deemed sufficient, regulators could be subjected to specific penalties for failure to strictly enforce capital requirements and/or provides specific rewards for strict enforcement.

#### **Credible commitment**

Strengthening capital requirements and subjecting banks and thrifts to market tests of solvency would provide insured institutions with incentives to maintain strong capital ratios. Such an approach has considerable appeal as a way to reduce the moral hazard of deposit insurance. However, for this or any other reform to succeed, it is essential that bank and thrift regulators credibly commit themselves to strictly follow a policy that alters the risk-taking behavior of bank and thrift managers. Regulatory reform cannot succeed if bank and thrift executives know that they can pursue high-risk strategies and then invoke special exceptions or expect forbearance. In fact, it was just such forbearance that got us into the mess we are in today.

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