"Challenges in Deposit Insurance Reform"

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Public policy debate over the federal deposit insurance system has come to the fore only in recent years. How the deposit insurance system is affected by -- and also affects -- bank and thrift behavior was not debated in 1980 when the Congress increased deposit insurance coverage and passed legislation that paved the way for the removal of deposit-rate ceilings and provided new powers for thrifts.

What has happened since 1980 so that we now have a session on "Depository Insurance in Crisis?" The answer, of course, is that failures among depositories have jumped sharply, and the problem lists for banks and thrifts have ballooned. These developments have meant a dramatic escalation in the expenses of the deposit insurance funds. The situation for the Federal Savings and Loan Insurance Corporation (FSLIC) is particularly critical, as its reserves have fallen appreciably. Moreover, it is reported that there are hundreds of insolvent thrifts, and the resolution of those cases would be beyond the capacity of the FSLIC's current reserves.

Deposit Insurance and Risk

The losses to the Federal Deposit Insurance Corporation (FDIC) and the depleted reserves of the FSLIC have put the spotlight on the deposit

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insurance system. However, these losses are symptoms. The more fundamental problem with the deposit insurance system (or any government guarantee) is that it subsidizes and encourages risk-taking.

The connection between deposit insurance and risk-taking is a simple one. With federal insurance, depositors and other creditors of a bank or thrift generally have less incentive to monitor the soundness of the institution. This point is particularly relevant in a system with virtually 100 percent deposit coverage. Thus, with extensive insurance coverage, there is only limited feedback from the cost of liabilities when a bank or thrift takes on additional risk. Without the feedback from the cost of deposits, risky investments appear to be more lucrative to a bank or thrift, and they are more likely to be undertaken than would be the case if there were no insurance.

Connection with Innovation

The distorted risk-return tradeoff for depositories shifts to the regulators much of the task of keeping risk-taking in check. One avenue used by regulators is not to allow institutions or their holding companies to engage in certain activities. Such limits in part are justified as being necessary to isolate the distortions to risk-taking introduced by deposit insurance. It would be naive, however, to think that this is the only reason we have laws limiting the provision of financial services by banks. But the interest of banks in new activities and the desire of other institutions to own banks are motivated in part by the attraction of federal deposit insurance.

There is much more to financial innovation, however, than the desire to take advantage of the deposit insurance system. Innovation, in part, reflects the responses of banks and other financial institutions to changes in the demand and supply conditions for financial services. I could cite many examples. One is the increased demand for the management of risk that has come with the economic uncertainty of the 1980s. Another is the rapidly increasing supply of low-cost financial services that has resulted from improvements in computing and communications technologies.

Many new powers sought by banks may actually lead to a reduction in risk through greater diversification. This does not contradict my earlier assertion that deposit insurance encourages risk-taking. With or without deposit insurance, banks as well as thrifts will diversify where it is economical to do so in an attempt to minimize their risk relative to their expected return. However, the large number of banks specializing in agricultural lending and thrifts in mortgage lending indicates that diversification may be costly and often curtailed by regulation. Much of the specialization we still observe stems from such things as limits on branching and interstate banking, or special tax incentives for thrifts to invest in mortgage-related assets. Without these obstacles, we would see more risk reduction through diversification. Similarly, expanded powers for banks could reduce "needless" (non-profitable) risk exposure for them

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and, thus, for the FDIC. This seems to have been recognized to some extent in the regulation of thrifts, which have been granted relatively broad powers.

The Challenge to Deposit Insurance

Although I favor expanding bank powers, I am aware that there is legislative and regulatory concern that such expansion could broaden the scope for risk-taking, possibly nullifying the potential gains from diversification. In replying to this concern, it has been suggested that new powers be allowed primarily through holding company subsidiaries and corporate separability be enforced between the bank and the holding company. In principle, this approach would insulate the deposit insurance guarantee, which applies to bank deposits, from the broader powers afforded holding companies. There is considerable question, however, as to whether effective separation is possible. And, if it were, it is likely that the synergies of organization, marketing, and brand name identification that now exist between bank and nonbank subsidiaries within a holding company would be lost.

Given doubts about the effectiveness of enforcing corporate separateness, the regulatory goal of isolating the influence of deposit insurance will continue to dampen progress toward allowing innovation in the provision of financial services by banks and to some extent by thrifts. The challenge in deposit insurance reform is to protect depositors and to maintain stability among banks and thrifts, while minimizing the distortions to risk-taking and thereby limiting the need to restrict the ability of depositories to engage in profitable activities.

The Appeal of Market Discipline

If we were to focus only on minimizing the distortions that deposit insurance has on risk incentives, the ideal would be to reduce the intrusion of federal deposit insurance and to maximize reliance on the incentives in the market to bring about the optimal allocation of resources and risk. This is precisely why a move in the direction of greater market discipline is so appealing. Key proposals in this regard are those that would increase the risk to depositors and hence rely more heavily on depositor surveillance to check bank risk. The usefulness of many of the other approaches for tapping the incentives in the market, such as greater disclosure of information to depositors and private deposit insurance, rests on the feasibility of shifting greater risk to depositors.

The Feasibility of Reliance on Depositors

The question is whether it is possible to increase depositor risk while still protecting depositors and maintaining stability in banking. In this regard, the continued insurance of "small" deposits does not seem controversial. While some persons have pondered the possibility of abolishing federal deposit insurance altogether, most serious proposals for reform would retain some minimal amount of coverage.

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The more substantive debate revolves around whether we can provide insurance only on some deposits and still maintain an acceptable degree of stability among banks and thrifts. The critical question is whether holders of liquid deposits (those that can be withdrawn freely on short notice) can be placed at greater risk without exposing the payments system and credit markets to possible disruptions from system-wide runs on banks and thrifts.

In principle, we could eliminate deposit insurance and still prevent bank runs, but only by changing the fundamental nature of deposit contracts. Without federal deposit insurance, holders of liquid deposits might "run" because, by withdrawing funds before anyone else, they can avoid bearing their share of the losses of an institution thought to be insolvent. Depositors could be prevented from escaping their liability, for example, if the liability connected with liquid deposits could be imposed retroactively for some period after the time of withdrawal. If such an approach were taken, which I do not think is at all likely, there would be greater depositor surveillance and a meaningful risk premium paid even for liquid deposits.

Without the protection of federal deposit insurance, depositors also could be expected to seek out market options for reducing risk. For example, depositors would have more incentive to divide their funds among a larger number of financial institutions. Moreover, if runs were not a concern, we could rely on private deposit insurance. Private insurers, however, would not provide general indemnification against the insolvency of a bank or a thrift and probably would retain the right to cancel coverage on relatively short notice. Nevertheless, the private market still might find it profitable to insure against events such as fraud, insider abuse, or isolated economic events like the closing of a factory in a community.

Private insurance itself, however, would not eliminate the incentives for runs that stem from the nature of liquid deposit accounts. Consequently, with the prevailing belief among policy makers that runs are a concern because of the large volume of liquid deposits at banks and thrifts, an acceptable approach to reforming deposit insurance in the near term is not likely to be one that relies on a significant increase in risk to liquid deposits.

The Alternatives to Increasing the Risk to Liquid Deposits

Longer-term debt. Putting bank and thrift longer-term, and therefore less liquid, liabilities at greater risk is one alternative for generating more market discipline without exacerbating the run problem. However, if deposit insurance were subsidized and short-term accounts covered, banks and thrifts would have little incentive to attract uninsured longer-term funds. They would have to be given a reason to hold such liabilities. We already have something along these lines in that total capital requirements can be satisfied partly by subordinated debt.

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Risk-related insurance premiums. In order to increase the discipline imposed on individual institutions, the FDIC and the FSLIC have been pressing for authority to charge risk-related insurance premiums. This option may be adopted by the Congress at some point, but probably not with much bite. For example, the bills introduced this year call for premiums, currently at 1/12th of a percent of deposits for banks, to rise at most to 1/6th of a percent. That difference is not large enough to differentiate between institutions that pose a large and immediate threat to the insurance funds and those that do not. The small added premium would suffice neither to cover the funds' added risk nor to dissuade weak institutions from taking on additional risks. Besides the operational difficulty the insurance agencies would encounter in appropriately measuring and pricing risk, the practical problem of charging a rate sufficient to cover the full risk posed by problem institutions could be insurmountable.

Capital requirements. The imposition of "risk-related capital requirements" is another option currently being pursued by the federal bank regulatory agencies and the Federal Home Loan Bank Board. This option has many of the operational problems of accurate *ex ante* risk assessment that imposing risk-related premiums would have. Unlike variable insurance premiums, however, the regulatory agencies do not need new legislation to implement risk-related capital requirements. In fact, the Federal Home Loan Bank Board recently announced new variable capital requirements for savings and loans and the Office of the Comptroller of the Currency, the FDIC, and the Federal Reserve are reviewing proposals for capital requirements that explicitly take into account, among other things, certain off-balance-sheet activities. Regulatory standards for additional capital in relation to the *ex ante* risk assessment of an institution would help in resolving the insurance dilemma.

Closure Policy and Market Valuation

Risk-related capital is not really a radical concept in the regulatory framework. In principle, required capital is supposed to reflect the risk of an institution. The experience over the past several years, however, makes it clear that this has not always been the case. Many institutions have been allowed to operate without capital, let alone risk-related capital.

Indeed, the tendency for the regulatory process to permit undercapitalized banks and thrifts to continue operating with the hope that they can regain financial well-being has been criticized (and correctly so) as being at the root of the problems facing the deposit insurance funds. This has prompted what could be the most promising proposals for deposit insurance reform: 1) The adoption of a longer-term strategy for more prompt closures to resolve problems before they impact heavily on the insurance funds; and 2) greater reliance on market-value rather than book-value accounting measures.

Looking at these proposals in the context of the traditional approaches to bank and thrift regulation, all that is being suggested is

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that capital requirements be enforced more stringently and the measure of capital used be more relevant to the losses that will be borne by the deposit insurance funds. When a bank or thrift fails and has to be liquidated or merged, it is the market values of the assets and liabilities that count. And, since losses measured on a book-value basis generally lag those realized on a market-value basis, banks and thrifts are not closed until it is too late.

Tough Issues for Implementation

The potential gains from using market valuation and closing institutions on time are striking. As has been pointed out in numerous articles on deposit insurance reform, if a bank or thrift could be closed before the market value of its capital fell to zero, then the FDIC and FSLIC would be completely protected. (The insurance funds still would have to cover administrative costs and losses resulting from measurement errors, however.)

It is of interest to note that if regulators really were successful in closing problem institutions in time, all liability holders would be protected from risk. Although "uninsured" depositors conceptually would provide surveillance and market discipline, in fact, they would be "free riders" and rely on the regulators to monitor banks and thrifts. Bank and thrift regulators would serve the functions of monitoring institutions, requiring capital, and closing institutions if the market value of capital approached zero.

In practice, however, we can expect to fall short of the ideal. First, measurement errors in determining the market values of assets and liabilities might be large. In addition, banks and thrifts could not be monitored continuously, and the value of an institution's capital could decline below zero between examinations.

To guard against the second problem, regulatory actions often would have to be taken even before an institution's net worth reached zero. Some institutions estimated to have a positive but low level of capital might have to be forced to liquidate or to merge with another institution (if the shareholders were unwilling or unable to raise new capital quickly). In such cases, since the market valuation of an institution by the insurance fund or other regulatory agency would have to be largely subjective, the regulatory agencies would be vulnerable to lawsuits, especially where action is forced. Although the legal costs could be large, they probably would be preferable to the potentially much larger losses sustained because institutions systematically were closed too late. Moreover, allowing institutions to operate only if they have positive market-value capital removes one of the most serious distortions that arises from deposit insurance -- the incentive of managers of negative net worth institutions to "bet the bank."

Even if the regulatory agencies had the power and incentives to close depository institutions promptly, it is likely that some failed banks and thrifts would have negative net worth. In those cases, the federal deposit

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insurance funds could be protected further if bank and thrift equity holders were liable for losses exceeding their original investment. In fact, something similar to this approach was actually in effect prior to the early 1930s, when stockholders of nationally chartered banks could be held liable for more than the amount of paid-in capital. However, the chance that such a policy would be resurrected for banks and thrifts is probably slim.

Conclusion

The central issue facing deposit insurance reform is how to balance the distortions resulting from deposit insurance against the instability of banking that might result from not having deposit insurance. Although we could devise ideal structures that would allow both full market discipline and protection against bank runs, practical considerations in the near term limit placing substantially increased risk on holders of liquid deposits. Given this fact, if we are to maintain the advantages of free enterprise in banking and to encourage institutions to expand their activities, the incentives for the stockholders and long-term debtholders must be appropriate. In short, this means that there must be adequate capital and capital holders must bear the burden of losses in the banking and thrift industry.

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