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Deposit Insurance Reform: A Personal View

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Last August, as you know, Congress passed a landmark piece of legislation, called FIRREA. The goal of that legislation is to recapitalize the thrift deposit insurance fund and to resolve the crisis of insolvent institutions.

There's no doubt FIRREA is having an enormous impact on the thrift and even the banking industries. I'll highlight just a few of its provisions. First, it provides the funds to close down insolvent thrift institutions, although evidence is coming to light to suggest that FIRREA probably has not provided enough funds to do the job. Second, FIRREA raises insurance premiums. The new law also raises the capital requirements for solvent thrifts. Finally, it gives bank and thrift regulators more fire power to deal with weak and insolvent institutions.

These provisions should alleviate the immediate crisis in the thrift industry, assuming the necessary funds are forthcoming. But we all know that as far-reaching as FIRREA is, it wasn't designed to reach beyond the present crisis. The deposit insurance system still needs fundamental reform, and if we don't do something to fix this system soon, another crisis is a distinct possibility. Therefore, it is gratifying that, as one of the provisions of FIRREA, Congress directed the Treasury Department to study the deposit insurance system and to make recommendations by February of next year to reform it.

In the spirit of debate on this issue, I'd like to offer my views on some of the problems with the current system, and then I'd like to put a reform proposal on the table to get your comments and reactions. This proposal addresses the key flaws in the current system. Importantly, it also addresses some of *your* concerns about other proposals that are being circulated; namely, how we handle "too big to fail" and what we do about the present $100,000 insurance ceiling. In this sense, I think this proposal offers a solution to the deposit insurance problem that is fair to depositors and *all* institutions, regardless of size.

How Did We Get into This Mess?

Turning first to the deposit insurance problem and its background, I want to point out that the basic problem is one that has been there since deposit insurance was introduced in 1934. Insured institutions have incentives to take on more risk than they would if they weren't insured because they don't have to pay higher premiums for higher risk. Moreover, the less capital an institution has, the greater is its incentive to "bet the bank" on risky ventures. This has been a big problem since a large number of insured institutions have been operating with thin capitalization.

If a private insurer were to offer a flat rate premium for all levels of risk, it wouldn't be in business very long. As a matter of fact, there are striking examples of state government-sponsored deposit insurance funds that have foundered for the same reason. And, of course, more recently our experience with FSLIC has provided ample evidence of the problems with such an approach.

But if these perverse incentives have been there all along, why has the problem become so serious only in recent years? Adverse economic conditions and increased competitive pressures were the catalysts, in the sense that they depressed the market value net worth of many in the industry. Specifically, the interest-rate spike in 1980-81 sharply reduced the market-value net worth of much of the S&L industry, while the downturn in the farm-belt and the oil patch a few years later impaired the capital of a good number of banks and thrifts.

At the same time, increased competition in the financial services industry has reduced bank and thrift franchise values. With diminished franchise value, less is at risk when an institution encounters difficulties. As a result, the owners of a financially-weak institution find bet-the-bank gambles more enticing than they did in earlier periods.

Another important contributor to the magnitude of the problem, however, was the regulators' mistaken reliance on a policy of forbearance when capital positions deteriorated. This policy rested on the false hope of a spontaneous recovery in asset values. It also arose because of politicians' reluctance to recognize the budgetary realities of closing insolvent institutions. Such a policy underestimated the strength of the go-for-broke incentive I mentioned a moment ago.

FIRREA addresses this problem of inadequate capital to a certain extent, and it restricts the opportunities for regulatory forbearance. Consequently, it should limit the occurrence of bet-the-bank gambles. But by itself, FIRREA at best provides only an interim solution to the deposit insurance problem.

A Proposal for Getting Out of the Mess

Let me now sketch out for you the broad contours of a permanent reform proposal. This proposal deals with the problem of inadequate net worth. At the same time, it addresses problems that most independent bankers consider vexing. Thus, the reforms I'll outline should restructure the deposit insurance system in a way that is fair to all institutions, regardless of size.

My approach to deposit insurance reform is based upon several assumptions. First, I believe that the need to prevent destabilizing runs is the primary rationale for deposit insurance. Second, market discipline is the most effective means of controlling risk taking by financial institutions. Third, equity and subordinated debt holders and large depositors are the most likely sources of market discipline. Small depositors cannot be expected to monitor the performance of depository institutions and be a source of market discipline. Consequently, small depositors should be protected by insurance in order to prevent runs that have no useful disciplinary value.

These assumptions lead to several key elements of this deposit insurance reform proposal. The first, and most important, is a prompt resolution rule; this rule must be consistent and firmly applied. Forbearance must be abandoned. This is the key both to limiting the liability of the insurance fund and to encouraging the development of market discipline.

To make such a rule workable, we need to specify a risk-adjusted minimum level of capital below which an institution would be closed or reorganized. This rule could be combined with a kind of "progressive discipline," whereby institutions whose capital was approaching this minimum would be subjected to increasingly stringent regulatory limits on their behavior.

Some may ask why I'm proposing capital regulation as part of the solution when risk-adjusted deposit insurance premiums might appear to be a more direct approach. The answer is that risk-based capital regulation and risk-adjusted premiums are functionally equivalent; higher risk can be offset with either, and the insurance fund will be protected. However, I think that capital regulation is administratively simpler. More importantly, it directly, and I believe more effectively, addresses the bet-the-bank problem inherent in low-net-worth institutions.

To make this prompt resolution rule effective, we also need to augment book-value measures of capital with market valuation wherever possible. The market value of net worth, not the book value, determines the potential claim on the insurance fund. Certain components of bank balance sheets lend themselves well to this approach. For example, traded securities, whether they are held for investment or in a trading account, can be valued easily using market data.

On the other hand, the valuation of loans will always be difficult because loans are not regularly traded in the open market. But even here, I think we can be more realistic. We know, for example, that the book value of a loan overstates its market value whenever the interest rate on a comparable new loan rises above the older loan's contractual rate. Likewise, it's pretty obvious that classified loans (that is, those that the regulators classify as either substandard, doubtful, or loss) are not worth what their book values imply they're worth. Let's put this information to use.

There may be legal problems with enforcing a market-value closure rule, but we have to overcome them. After all, if we can't close institutions that are insolvent (or perilously close to insolvency), we can't limit the liability of the insurance fund. We need only look at what happened to the thrift insurance fund for proof of this point. Moreover, if we can't close or reorganize insolvent institutions, we won't have market discipline, either. Investors must know that their funds are at risk for them to have an incentive to monitor an institution's health.

I believe market discipline is desirable, not only from equity holders, but from certain classes of liability holders, as well. In theory, prompt closure of near-insolvent institutions would eliminate the need for debtholder discipline *and even* for a deposit insurance fund. But regulators can and do make mistakes regarding the valuation of a portfolio. This leads me to conclude that we need investors with the same incentives to monitor institutions that regulators have. In fact, investors ideally ought to have even stronger incentives than regulators to monitor institutions and force the closure of insolvent ones.

I might note that subordinated debt-holders also should be considered an important source of market discipline on the behavior of financial institutions, particularly the large institutions that have access to such debt markets. These liability-holders can't run the way depositors can, so their funds provide the same buffer against losses as equity does. Moreover, since subordinated debt-holders have the same incentive as the insurer to monitor an institution and even to *close* it when it becomes insolvent, they augment the market discipline imposed by shareholders.

The final element of this reform proposal is to limit deposit insurance to $100,000, preferably on a per capita basis, if a practical way could be found to do this. Unlike some in Congress and elsewhere who advocate rolling back the statutory limit, I just don't think a lower limit is necessary or even very helpful. My approach would leave the "small depositor" insured, and hence would eliminate this potential source of runs. At the same time, it doesn't sacrifice much market discipline, and it leaves large depositors as a source of discipline.

In summary, the keys to reforming deposit insurance are prompt resolution, maintenance of adequate capital, and strict application of the $100,000 insurance ceiling. Reducing the insurance ceiling and/or adopting co-insurance, as some have advocated, are unlikely to produce much more in terms of market discipline and probably are politically infeasible, anyway.

Too Big To Fail

Now let me say a few words about "too big to fail." With the reforms I've outlined, *no* bank will be too big to fail. The so-called "too big to fail" policy has been part of the problem because it has produced virtually 100% coverage of all liabilities and in so doing, has greatly limited depositor and other liability-holder discipline. Moreover, "too big to fail" has amplified the risk of systemic failure of the payments system -- that is, one bank's failure propagating to other banks and causing them to fail -- because it provides little incentive for scrutiny of interbank deposits. If all institutions, regardless of size, were subject to the same rules regarding closure or reorganization, interbank lending also would be subject to market discipline, thus reducing the risk of systemic failure.

Eliminating the "too big to fail" policy may require a phase-in period, but this policy must go if we are to keep big banks from turning into financial "welfare dependents" and enjoying a competitive advantage over smaller institutions.

It's encouraging to note that the New York Clearing House Association recently argued in favor of eliminating "too big to fail," and the ABA, likewise, is proposing the elimination of "too big to fail."

Conclusion

In conclusion, failure to reform the deposit insurance system and diminish the incentives it creates for excessive risk taking will lead to additional insurance fund crises. Moreover, failure to reform this system will make it more difficult for banks to obtain expanded powers from regulators and legislators. In recent weeks, for example, both Chairman Gonzalez of the House Banking Committee and Senator Sasser have suggested that deposit insurance reform is the *quid pro quo* for expanded powers. Specifically, they want an end to "too big to fail," and I agree.

Prompt resolution of near-insolvent institutions and greater reliance on market discipline are essential to true deposit insurance reform. With an approach along the lines I've presented, I think we can get rid of "too big to fail" and keep the level of insurance protection at $100,000. This will help constrain undue risk taking in our banking system. At the same time, it will maintain the protection of small depositors and the protection against runs that we have come to expect. Best of all, it will mean that we shouldn't ever have to bail out the deposit insurance funds again.