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Deposit Insurance Reform:
A Personal View

The S&L and banking industries have been in the headlines a lot lately. (Although Saddam Hussein's invasion of Kuwait has provided a small respite.)

The enormity of the crisis of insolvent thrift institutions is absolutely staggering.

1. And tales of fraud and mismanagement at failed institutions, coupled with allegations of regulatory permissiveness, have made attention-grabbing news copy.

B. There's no denying that all these factors have contributed to the crisis.

C. But one of the major causes of the problem hasn't received nearly enough attention. That is, our flawed system of deposit insurance.

D. Indeed, the key to avoiding crises like this in the future is to reform the deposit insurance system.

E. So, today, I'd like to discuss briefly the problems with the current system.

F. And then I'd like to put a reform proposal on the table to get your comments and reactions.

1. This proposal addresses the key flaws in the current system.

2. Importantly, it also addresses some of *your* concerns about other proposals that are being circulated; namely, what we do about the insurance ceiling.

3. In this sense, I think this proposal offers a solution to the problem that is fair to depositors and *all* institutions, regardless of size.

II. Turning first to the problem and its background,

A. The basic problem is one that has been there since deposit insurance was introduced in 1934.

1. 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.

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2. Moreover, the less capital, or net worth, an institution has, the greater is its incentive to "bet the bank" on risky ventures. This is a big problem since a large number of institutions are thinly capitalized.

    a. If a private insurer were to offer a flat rate premium for all levels of risk, it wouldn't be in business very long.

    b. Come to think of it, there are striking examples of state government-sponsored insurance funds that have foundered for the same reason.

    c. And, of course, the insolvency of FSLIC is the most recent consequence of such a faulty approach.

B. But if these perverse incentives have been there all along, why has the problem become so serious only in recent years?

1. Adverse economic conditions and increased competitive pressures were the catalysts, depressing market value net worth.

    a. The interest-rate spike in 1980-81 sharply reduced the market-value net worth of much of the S&L industry.

    b. And the downturn in the farm-belt and the oil patch impaired the capital of a good number of banks as well as thrifts.

2. At the same time, increased competition in the financial services industry has reduced bank and thrift franchise values.

    a. With diminished franchise value, less was at risk when institutions encountered difficulties. So, bet-the-bank gambles became more enticing.

3. However, the most important contributor to the magnitude of the problem was the regulators' mistaken policy of forbearance when capital positions deteriorated.

    a. The policy rested on the false hope of a spontaneous recovery in asset values.

    b. It also accommodated politicians' reluctance to recognize the budgetary realities of closing insolvent institutions.

    c. But it underestimated the strength of the "go-for-broke" incentive I mentioned a moment ago.

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C. FIRREA addresses this problem of inadequate capital to a certain extent. And it restricts the opportunities for regulatory forbearance. So, we're likely to see fewer bet-the-bank gambles in the future.

D. But by itself, FIRREA cannot solve the problem.

III. So, let me now sketch out for you the broad contours of a permanent reform proposal.

A. This proposal deals with the problem of insufficient net worth and at same time addresses two vexing problems (the insurance limit and "too-big-to-fail") in a way that I think is fair to all institutions.

B. My approach to deposit reform is based upon several assumptions.

1. The need to prevent destabilizing runs is the primary rationale for deposit insurance.

2. Market discipline is the most effective means of controlling risk taking...

3. ... And equity and subordinated debt holders are the best sources of market discipline.

a. Small depositors cannot be expected to monitor the performance of depository institutions and be a source of market discipline.

b. This means they should be insured to guarantee that they don't precipitate runs.

IV. These assumptions lead to a deposit insurance reform proposal that has several key elements:

A. The first is a prompt resolution rule; this rule must be consistent, and firmly applied.

1. We must abandon forbearance.

2. This is the key, both to limiting the liability of the insurance fund, and to encouraging the development of market discipline.

3. To make this workable, we need to specify clearly some risk-adjusted minimum level of capital. Below this, an institution would be closed or reorganized.

a. At the end of this year, the new international, risk-based capital standards will begin to be phased in.

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(1) These standards apply to banks, but because FIRREA requires that bank and thrift standards be comparable over time, they will affect your industry, too.

b. I'm pleased that many institutions already meet the fully phased-in international requirements.

c. But quite frankly, I think we need higher capital in the bank and thrift industries. Probably higher even than the fully phased-in standards will require.

4. Now, I'll be the first to admit that raising more capital won't be easy or cheap.

a. ROE isn't exactly what one might call stellar -- in either the bank or the thrift industry.

b. And I've heard it said many times that because of this, the only way to raise additional capital is to increase risk so that the return to investors won't fall.

c. But let me stress that the regulators can't allow this to happen; higher risk would defeat the purpose of higher capital standards.

d. The point is, we need to eliminate the deposit insurance subsidy that currently is capitalized into bank and thrift equity values.

e. Then, *and only then*, will investors put a premium on well-capitalized institutions -- just the way they did before deposit insurance was put in place, and the average equity capital ratio was around 20 to 25%!

5. The transition, of course, may be painful. For example, it's likely that higher capital requirements will accelerate the trend towards consolidation.

a. In fact, in the thrift industry, we may find that the problem isn't really capital adequacy at all.

b. Instead, the problem may be that there are simply too many institutions in the industry.

B. In any event, to enforce higher capital requirements, it would be useful to have a kind of "progressive discipline," in addition to the ultimate threat of prompt reorganization.

1. The first step would be to require institutions whose capital approached the minimum to raise additional equity

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capital.

a. If they couldn't do that, they would be subjected to increasingly stringent regulatory limits on their behavior.

b. For example, as Chairman Greenspan suggested in recent congressional testimony on deposit insurance reform, we could require an institution to:

(1) cut dividends;

(2) restrict its use of brokered deposits.

(3) slow asset growth or even downsize; and/or

(4) divest affiliates.

2. But I'd also take Chairman Greenspan's proposal one step further, and base capital requirements on market valuation wherever possible. Market value, not book value, determines the liability of the insurance fund.

3. Certain components of the balance sheet lend themselves well to this approach.

a. For example, traded securities, whether they are held for investment or in a trading account, can be easily valued using market data.

4. On the other hand, valuing loans will always be difficult because loans are not regularly trade in the open market. But even here, we can be more realistic.

a. We know that the book value of a loan overstates its market value whenever the market rate on a comparable new loan is above the older loan's contractual rate.

b. Likewise, it's obvious that classified loans are not worth what their book values imply they're worth.

c. Let's put this information to use.

5. There may be legal problems with enforcing a market-value closure rule, but we have to overcome them.

a. 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.

b. Moreover, if we can't close insolvent institutions, we won't have market discipline, either.

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(1) Investors must know their funds are at risk.

C. I believe market discipline is desirable, not only from equity holders, but from certain classes of liability holders, as well.

1. In theory, prompt closure of near-insolvent institutions would eliminate the need for debt-holder discipline *and even* for a deposit insurance fund.

2. But regulators can and do make mistakes regarding the valuation of a portfolio.

3. So, we need investors with the same incentives as the regulators.

a. In fact, investors ideally ought to have even stronger incentives than regulators to monitor institutions and force the closure of insolvent ones.

D. I might note that subordinated debt-holders also should be considered an important source of market discipline, particularly on the large institutions that have access to such debt markets.

1. These liability-holders can't run the way depositors can, so their funds provide the same buffer against losses as equity.

2. Moreover, subordinated debt-holders have the same incentives as an insurer to monitor an institution and even to *close* it when it becomes insolvent. This means they can augment the discipline imposed by shareholders.

E. The final element of this 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.

1. 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 helpful.

2. I would leave the "small depositor" insured, and hence eliminate this potential source of runs.

3. Such an approach doesn't sacrifice much market discipline.

4. And it leaves large depositors as a source of discipline.

F. In summary, the keys to reforming deposit insurance are: prompt resolution, maintenance of adequate capital, and strict application of a $100,000 insurance ceiling.

1. Reducing the insurance ceiling further and/or adopting co-

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insurance, as some have advocated, are unlikely to produce much in terms of market discipline and probably are politically infeasible, anyway.

V. Now let me say a few words about "Too big to fail."

A. With the reforms I've outlined, *no* bank or S&L will be too big to fail.

B. The TBTF policy has been part of the problem.

1. It has produced virtually 100% coverage of all liabilities.

2. It also has greatly limited depositor and other liability-holder discipline.

3. The TBTF policy has amplified the risk of systemic failure of the payments system. (That is, one institution's failure causing other institutions to fail.) Under TBTF, there is little incentive for one institution to scrutinize the condition of the larger institutions through which it conducts its payments business.

C. If all institutions, regardless of size, were subject to the same rules regarding closure or reorganization, interbank lending would be subject to market discipline, and the risk of systemic failure would be reduced.

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

VI. In conclusion,

A. Failure to reform deposit insurance and diminish the incentives it creates for excessive risk taking will lead to additional insurance fund crises.

B. It will also make it more difficult for financial institutions to obtain expanded powers from regulators and legislators.

C. Prompt resolution of near-insolvent institutions and greater reliance on market discipline are essential to true deposit insurance reform.

1. With an approach along the lines I've presented, I think we can get rid of TBTF and keep the level of insurance protection at $100,000.

2. This will help constrain undue risk taking in our financial system. At the same time, it will maintain protection of

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small depositors and the protection against runs that we have come to expect.

3. Best of all, it will mean that we shouldn't ever have to bail out the insurance funds again.

D. Now, I'm interested in hearing your comments...

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