

DEPOSIT INSURANCE REFORM: SOME OVERLOOKED ISSUES

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Last year, Congress passed the Financial Institutions Reform, Recovery and Enforcement Act to deal with the thrift crisis. While this legislation focused mainly on treating the symptoms of the thrift problem, it did require the Treasury to study deposit insurance reform and report back to Congress by next February. In the meantime, however, as cost estimates for resolution of problem thrifts have escalated, so too has the sense of urgency surrounding deposit insurance reform. In fact, Congress recently held hearings on the subject, well in advance of completion of the Treasury study. Consequently, whether you think that such reform is a bad idea or a good idea, it is indeed one whose time is rapidly approaching.

Unfortunately, whenever there are strong pressures on policymakers to reach significant and far-reaching decisions quickly, some important issues can be overlooked. Deposit insurance reform is no exception. In fact, the risks of an oversight are quite large, as deposit insurance has come to have a broad role in our financial system. In addition, the large number of reform proposals may tend to complicate the debate without necessarily clarifying the issues. Accordingly, in the next few minutes I would like to set

forth a framework for categorizing various proposals and discuss some issues that I believe should be considered, carefully and thoughtfully, before deposit insurance reform becomes a reality.

Deposit insurance was intended originally to protect small depositors and help prevent runs on banks. A side effect, however, was what has become known as the moral hazard problem: that is, if bank owners and managers have nothing to lose, what is to stop them from attracting insured deposits at high rates of interest and investing them in very risky undertakings? Currently, bank shareholders, to the extent that their equity has value, and government bank supervisors share this responsibility; however, given the existing deposit insurance program, the cost of bad decisions and bad luck is borne primarily by the deposit insurance funds. And, as we have come to learn so painfully, losses that exceed the net worth of the funds are borne by us, the taxpayers.

Some proposed reforms would strengthen the powers of bank supervisors. Others would require depositors to assume a greater share of the costs of bank failures. Accordingly, the depositors would be expected to take on increased responsibility for assessing and limiting bank risk. Let's consider each of these proposed types of reform in turn.

The argument in favor of increased powers for bank supervisors is that banks have assumed too much risk and that supervisors should be given greater power to limit

risks. On its face, this seems to be a very reasonable proposition, especially in view of some of the stories we have heard about the thrifts. Unfortunately, however, it is all too easy to overlook the disadvantages of this approach; consequently, I want to focus on these. Two examples should illustrate both the proposed reforms that would increase powers for bank supervisors and the potential disadvantages associated with doing this. One proposal being considered is the introduction of deposit insurance premiums based on the risks assumed by banks as perceived by bank supervisors. The second proposal would require bank supervisors to apply progressively stronger discipline on banks whose capital ratios fall below the established standards. Now, how could these proposed reforms possibly have serious disadvantages? What have we overlooked?

First, these proposals assume that bank supervisors are able to determine both the risks facing banks and the current market values of all bank assets and liabilities. Second, and much more serious, is that such bank supervision and regulation will, at the margin, stifle bank innovation and competition. To see why, consider that, from the bank supervisor's perspective, the best of all possible outcomes would be zero bank failures--which could occur only if even the most bungling bank management couldn't possibly fail. In order to reduce the chances of bank failure, supervisors will inevitably exaggerate the risks involved in new services or banking practices and retard their adoption.

Moreover, one easy way to reduce the potential number of bank failures would be to restrict the extent of competition in banking. How? Simply by imposing restrictions both on the more aggressive banks and on new entry into banking.

The key issue I want to emphasize is not whether good and valid reasons for strengthening the powers of bank supervisors actually exist. In fact, they do exist. My point is simply that there are costs associated with doing so. And, these costs, the potentially adverse social consequences of such regulatory actions, are often overlooked when the regulatory bandwagon rolls by.

Now, what about the proposed reforms that would increase the role of depositors in limiting banking risk? These proposals include reducing the size of the insured account, introducing some form of co-insurance and, perhaps, limiting the total number of insured accounts that any individual can hold regardless of where they are held. The intent of these proposals is to increase the risk or cost of bank failure borne by depositors. Now, of course, these proposed reforms will be for naught unless the notion that some banks are too big to fail is also eliminated. Otherwise, depositors will reduce their risks by shifting to those banks that they perceive as too big to fail. In this case, the reforms would simply raise costs at the smaller banks without limiting the risks assumed by the larger ones. Given the recent history of banking supervision in this country, the mere announcement that, henceforth, no bank

will be considered "too big to fail" probably would not convince depositors at the biggest banks that their funds were at risk. I will leave it to your imagination to think of what might actually convince such skeptical depositors.

Now, why would anyone really believe that giving depositors an increased regulatory role would be a good idea? What are the advantages of adding an additional bank risk "enforcer"--the bank depositor--to the game? At first glance, many individuals would consider such reform to be a step backwards, a reversion to times when banking risks were seemingly increased, not decreased, by the actions of uninsured depositors. Could increasing the role of depositors really be a good idea? What have we overlooked here?

First, deposit insurance reforms that place depositors with accounts in excess of the insurance limit at risk might enhance the effectiveness of bank supervisors in disciplining the more risky banks. The more risk-averse depositors will place their funds with the less-risky banks; other depositors will force the riskier banks to pay higher interest rates for deposits. Thus, depositors, as well as bank supervisors, will point out to bank shareholders and management that greater risk is costly.

These actions by large depositors will also reinforce bank supervisors' actions aimed at having banks achieve and maintain adequate capital ratios. Other things the same, banks with higher capital ratios are less risky banks. If

less risky banks are able to attract funds at lower interest costs, banks will find that it pays them to increase their capital ratios.

An additional overlooked benefit from this reform is that, if banks as a group maintain higher capital ratios, supervisors will be able to change the focus of their efforts. Instead of second-guessing management decisions at each and every bank, they will be able to concentrate more of their resources on those banks in poor financial condition and those who persist in engaging in higher-risk activities.

Finally, the proposed reforms that place greater risks on large depositors might reduce the losses to the bank insurance funds by limiting the discretion of bank supervisors to offer forbearance to troubled banks. The mass exodus of large depositors from troubled banks would force bank supervisors to deal with those problems much more quickly than they have in the past. Our experience over the last decade shows clearly that losses to the deposit insurance funds generally increased substantially whenever the supervisory agencies granted forbearance.

Up to now, we have considered only the positive consequences of deposit insurance reforms that increase risks of large depositors. However, there is something about nature that abhors a "free lunch." And, unfortunately, these reforms also have some important, often

overlooked, implications for international competition in banking services and for the scope of authority of U.S. banking supervisors.

Our previous discussion, like many discussions of deposit insurance reform, ignored the fact that U.S. banks compete in an international banking arena. Suppose that, as a result of deposit insurance reform, large depositors at U.S. banks now find their deposits to be riskier, even those deposits at the largest U.S. banks which, previously, had been too big to fail. What would you expect them to do when they also discover that, unlike the new U.S. policy, the governments of other developed countries are willing to guarantee all deposits at their countries' banks--even those at their branches in the U.S.? Obviously, large depositors will simply shift their deposits to the offices of foreign banks operating here and abroad. The net result would be to reduce the relative size and importance of the U.S. banking industry worldwide.

Another overlooked consequence of these reform proposals is that they will place increased pressures on the Federal Reserve System. Any deposit insurance reform that places large depositors at greater risk will increase the probability that, occasionally, there will be depositor "runs" on individual banks; even less often, perhaps because of unusually bad news affecting many banks, there may be runs on large numbers of banks. Thus, such reforms will contribute to increased importance of the Federal Reserve's

role as the nation's "lender of last resort." This increased pressure on the Federal Reserve has both a "good news" and a "bad news" aspect to it. First, the good news is that the Federal Reserve has learned an important lesson from the 1930s, when its failure to act forcefully enough as a lender of last resort, according to some monetary history writers, contributed to the resulting economic downswing. We certainly would not make that mistake again.

However, the bad news is that, in acting as the lender of last resort, the Federal Reserve might have to take considerable losses on its loans to troubled banks. How would this happen? In the event of a widespread depositor run on many banks at the same time, the Federal Reserve might have to concentrate more on preventing a nationwide liquidity crisis than on determining the solvency of the banks it lends to or the quality of their collateral. At such a time, it is extremely difficult to determine, particularly on such short notice, which banks are solvent and which are not; this is especially true if the news that triggered the banking crisis raises substantial doubts about the underlying values of assets at many banks. Under these conditions, the Federal Reserve could end up with substantial losses. The irony in this situation is that the federal government would not eliminate its exposure to losses if it reduces deposit insurance coverage and presumably shifts the risk to depositors.

Is this "shifty" operation a good idea anyway? Ultimately, Congress will have to make that decision. However, there is a story about the Fed's operation in the early 1930s that might help to illustrate the potential conflicts that any central bank faces during a banking crisis. One day, in the midst of the nation's worst banking crisis, the president of a small bank called the Fed. Panic-stricken, he explained that his bank faced a run by depositors and that he needed our help. The Fed official who took the call, noticing that the Fed had an outstanding loan to this bank, told the bank's president that an armored car would be dispatched immediately. When the armored car arrived at the bank, the president ran out, shouting "You arrived just in time. Bring the cash in right away." The Fed staff member who accompanied the armored car said, "Bring it in? We're here to get ours back."

Now, as I noted earlier, the Fed has learned a lot about central banking since the early 1930s. The point of the story, however, and the point of my entire discussion is simply that reform of the nation's deposit insurance program is likely to have considerably greater consequences than have been generally recognized. In particular, the various proposals intended either to strengthen the role of bank supervisors or to induce greater depositor discipline of banking risk have broad but often overlooked implications

for the operation of our banking system. Let us hope that these implications will not remain overlooked when Congress gets down to debating the merits of these various proposals.