Cap the Financial Black Holes

By Fred Smith

A consensus is emerging that the rate of U.S. thrift and bank failures stems in large part from the perverse incentives of federal deposit insurance. But change will not be easy, given the prevalence of the "No Disasters on My Watch" philosophy of Congress and the Reagan administration.

In his first 100 days, the new president should offer a four-point program to resolve the growing financial-services crisis. It would acknowledge the need for a one-time Taxpayer Bailout, develop a Big-Bank Closure Plan, set a Taxpayer Liability Cap starting next year and thereby create incentives for Market-Based Deposit Insurance.

The president would note that American taxpayers have already and largely unwillingly assumed a massive future obligation in this area. He would admit that a further sizable hit on the Treasury was unavoidable but that, in return, the industry must assume greater responsibility for its own risks. The current system of profit-side capitalism, he might add, mixes poorly with loss-side socialism. At the same time, he must not forget that politically based regulation and insurance coverage of financial services are part of the problem, not the solution.

Consider how the limited deposit-insurance system of the 1930s evolved into the universal security blanket of today. After all, the original plan was intended only to reassure and protect "small depositors" while discouraging "bank runs."

Crisis Demanded Action

Those involved were well aware of the problems of government insurance. Banking industry spokesmen and key legislators at the time noted the "moral-hazard" risk of allowing depositors to escape all responsibility for their investment decisions. They viewed any decision to lump all financial institutions into a single risk category as foolish and inequitable. President Roosevelt made his concerns explicit, noting that there was no intent to encourage "unsound banking in the future."

Nonetheless, the banking crisis demanded action. The 1933 law insured all deposits up to $2,500 and imposed a fee on all domestic deposits of 1/12 of 1% to finance this "insurance" system. Similar guarantees were provided the S&Ls.

For decades, the federal deposit insurance system seemed successful. Indeed, had the original modest system been retained, things might not have gone awry. The initial $2,500 figure was soon raised to $5,000, but it stayed at that level for many years. Moreover, banking in the late 1930s first stabilized and then in the postwar era prospered along with the general economy. That led some to believe that disconnecting the pressure gauges had no adverse consequences.

The insurance limit was raised until in 1980 it reached the present $100,000—a jump far in excess of that justified by inflation. The S&L deposit coverage was expanded in a parallel but slightly slower fashion. Jake Garn, then chairman of the Senate Banking Committee, now concedes the last thrift increase—reportedly prompted by concerns that depositors would flee troubled institutions—was a serious mistake.

Yet, this tendency toward broad coverage, to protect everyone from everything, was present at the beginning. The deposit limit, for example, was never applied to the depositor but rather to the deposit, and the Federal Deposit Insurance Corp. and Federal Savings and Loan Insurance Corp. elected early to insure interest as well as principal liabilities. Deposits have become risk-free, encouraging the rush of funds to whatever institution offers the best interest rate today. Speculators no longer need even to broker their total investments to fit within the $100,000 limit, since, in practice, the FDIC and FSLIC now protect all deposits regardless of size.

Pending regulatory action, troubled financial firms are free to raise their yields and attract funds from better managed or more fortunate institutions. The FDIC and the FSLIC, political agencies, also suffer from the "Not on My Watch" syndrome and postpone action ("forbearance") in the hope that events—such as a rise in real-estate or energy prices on which problem loans are based—will render unnecessary costly and painful closures. In the meantime, the failed institutions play the long shots—with taxpayer guarantees.

> *After a date certain, insured institutions would have to cover additional deposits without adding to the federal liability.*

Even when the decision is made to discipline a failed institution, the agencies act to shield as many interests as possible. In principle, the FDIC/FSLIC should simply close the failed institution, sell its viable assets (including any good will and customer base that might exist) and pay off the insured depositors. This course, however, requires that the FDIC/FSLIC make evident the real costs of the failure. More typically, therefore, the FDIC/FSLIC arranges a Purchase and Assumption (P&A) agreement under which the failed institution is merged with a healthy financial-service firm.

P&A arrangements were once rather limited. The FDIC/FSLIC would strip away the worst loans, inject some cash, and provide some degree of regulatory relief that actually increased efficiency. Nowadays, with more severe and numerous cases, P&A agreements have come to rely more on various giveaways. These include guaranteeing the income stream of the remaining (often still dubious) loan portfolio of the failed institution, reducing the capital-adequacy requirements of the merged institution, and lobbying the IRS to provide special tax breaks. Like regulatory relief, these provisions are off-budget. Unlike regulatory relief, these features yield no positive economic results.

From time to time, more prudent regulators sought to reintroduce discipline. The FDIC/FSLIC authorities occasionally allowed large depositors in smaller S&Ls and banks to experience losses. Complacent speculators were shocked into action. Failing institutions began to lose funds. Unfortunately, one such failing institution was Continental Illinois Bank. It was a TBTF (Too Big to Fail) bank. Neither the FDIC nor the FSLIC had developed any detailed plan to liquidate such a large institution, and its imminent failure in 1984 caused them to retreat from their earlier resolve. The result was a return to the zero-risk coverage of earlier years and renewed complacency by speculators. More recently, efforts have been made to re-impose some costs on shareholders and general creditors, but depositors remain totally risk-free.

That reassurance has created an even worse "run" problem than was feared in the 1930s. The primary concern then was that individuals might panic and withdraw their savings from institutions that were in fact sound. The risk today is the reverse—that depositors lured by higher interest payments may rush to place deposits into failing institutions. Under the current deposit-insurance system, failing institutions act as financial black holes, fatally attracting deposits from sound institutions.

Some have urged re-regulation, thinking that stability can be regained. But the factors that have brought about limited deregulation were less legislative than technological and institutional. Computers and modern telecommunications have made it impossible to retain a Balkanized financial-service industry. Plus, denying troubled firms the chance to diversify their loan portfolios and to price more realistically might have forced them to incur even more risk in their traditional activities.

Others advocate a "narrow focus" for deposit-insured institutions, limiting them to secure but low-paying investments. The problem is that most funds likely would flow out of them to non-regulated, non-insured competitors, and the basic banking system would be left weaker than today.

A variant of risk-reduction would apply strict capital standards to vulnerable institutions, with closure following immediately upon failure to meet them. But that approach relies on adequate knowledge of what constitutes economic viability and independence of regulators from political control, two unlikelihoods.

Likewise, the hope for instituting wholly private deposit insurance, the most market-oriented solution, is not a realistic one over the near term. It would require the insurance industry to assume a massive liability in a politically charged field in which it has little experience.

Taxpayer Liability Cap

More feasible is a public bailout of the insured deposits already sunk, the acceptance by all relevant parties of a big-bank closure plan that will not be ditched in the heat of crisis, and the innovative third leg, a "taxpayer liability cap."

Under that element, each insured institution would receive notice that its deposit accounts as of a date certain were fully covered. Banks and thrifts that add to that deposit base would have several choices. They might 1) purchase federal insurance from other institutions that were reducing their deposits or that had access to other forms of insurance; 2) acquire private insurance; or 3) reconfigure their coverage via such options as co-insurance and deductibles. Institutions would be required to notify each depositor of the percentage of each account covered and would be free to limit the total for any single depositor.

Since the incremental insurance would be sold rather than granted as an entitlement, the subsidy feature of the current system would become more obvious. In the initial years, the level of private insurance required to fill any gap would be small, as the industry learned how to operate in this new and complex field.

The worst-managed institution would find insurance coverage dear and thus grow more slowly. The FDIC/FSLIC would face a slowly moderating problem rather than one continuously growing. Economic growth would render the subsidized insurance program an ever smaller sector of the deposit system. A sales tax on federal insurance transfers might be levied to reimburse the Treasury for the massive losses that have already been incurred.

Reforming the federal insurance system will never be easy. However, the current crisis affords opportunity. The fact that losses are rapidly mounting and the fear that the current system could not survive any big economic downturn create pressures for immediate action. Taxpayers might be willing to come to the rescue if it results in permanent improvements.

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