THE OHIO BANKING CRISIS: WHO'S TO BLAME?

Following the bankruptcy of Home State Savings and Loan of Cincinnati on March 15, Governor Richard Celeste of Ohio ordered the temporary closure of all seventy-one savings and loan institutions (S&Ls) insured by the private, but state-sponsored, Ohio Deposit Guarantee Fund. This extraordinary action was prompted by the apparent inability of the fund to absorb Home State's losses and the threat of a run on other S&Ls in the state. On March 20, the Governor signed legislation allowing the S&Ls to reopen only after they have applied for insurance from the Federal Savings and Loan Insurance Corporation (FSLIC).

The current wisdom seems to be that the Ohio crisis represents both the failure of deregulation in the financial services industry, and the fundamental weakness of private deposit insurance. Both conclusions are unwarranted. The evidence available suggests that deregulation had little to do with the Ohio crisis. And the "private" Ohio insurance fund, far from being an example of unregulated private enterprise, was severely weakened by state regulation--indeed, it was modeled closely on the federal insurance corporations rather than normal private insurance systems. Far from demonstrating that increased regulation is necessary, the Ohio situation actually shows the need for further deposit insurance reform to enable private insurance to do its job properly.

While all the facts are not yet available, the extreme action of closing all the thrifts may not have been necessary--and may have aggravated public concern. Many of the closed S&Ls were in a very strong position and bitterly opposed the closure. They had already begun the process of preparing for liquidation of sufficient assets to meet withdrawal demands--the normal method of dealing with runs and restoring depositors' confidence.

In addition, Home State's woes had very little to do with recent federal deregulation. The problem arose from the S&L's connections with a Florida securities firm that recently went into receivership.

It had nothing to do with the competition introduced in the financial industry.

Most important of all, the Home State crisis does not in any way indicate a failure of private deposit insurance or show a need for a federal monopoly over such protection. While the Ohio fund was in form a "private" insurance corporation, it was severely hampered and weakened by state regulations--rules that made it impossible for adequate coverage to be provided. Specifically:

* The Ohio law authorizing the fund required it to insure only state-chartered Savings and Loans in Ohio. This very narrow customer base made the Fund susceptible to default because it could not spread its risk widely. In fact, the fund held assets of only $136 million, substantially less than the expected losses of Home State. If the Fund had been permitted to recruit member institutions outside the state, thus increasing its asset base and more evenly spreading the risk geographically, it is highly unlikely that a run on one S&L in Cincinnati could have caused a run at all the other institutions in the state.

* The fund apparently had very little control over the activities of its insured institutions. This lack of control stemmed in large part from the fact that Ohio law required the fund to be owned by the member institutions themselves, rather than an independent insurer. A truly private, independent, profit-maximizing insurer would keep a careful eye on its insured institutions to prevent dangerous practices. But an insurance fund owned by the insured institutions themselves can hardly be expected to take serious exception to practices of its members.

The Ohio Deposit Guarantee Fund, rather than being an example of a truly private deposit insurance company, was in fact merely a government-sponsored private imitation of the federal deposit insurance corporation. Its inadequacies in no way reflect a failure of the private method of deposit insurance. Rather, the crisis merely underscores the need to permit the development of large and risk-based private sources of deposit insurance. In this way the risk can be spread widely and the collapse of a single institution could not overwhelm an insurance company's reserves.

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For further information:

"Closing of Ohio S&Ls After Run on Deposits Is One For the Books," Wall Street Journal, March 18, 1985, p. 1.

Catherine England and John Palffy, "Replacing the FDIC: Private Insurance For Bank Deposits," Heritage Foundation Backgrounder No. 229, December 2, 1982.

"What Ohioans Should Ask," Wall Street Journal, March 19, 1985, p. 28.