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BEYOND THE BAILOUT: LONG-TERM SOLUTIONS TO THE CRISIS IN FEDERAL DEPOSIT INSURANCE

INTRODUCTION

George Bush has won generally favorable reviews for his plan to bail out the bankrupt Federal Savings and Loan Insurance Corporation (FSLIC). The bailout plan, unveiled February 6, carries a staggering official price tag of $126 billion over the first ten years. It may cost even more.

The high price tag, however, is not the main problem with the Bush plan. Fundamentally more troubling is that neither the plan nor the public debate over the funding for the bailout addresses the key question of how the federal deposit insurance system should be reformed to prevent a future crisis. Bush's proposal focuses on bailing out FSLIC and reorganizing some aspects of the existing regulatory structure, but fails to address the underlying cause of the thrift crisis — a deposit insurance system that encourages and subsidizes high-risk lending by managers of thrifts. The Federal Deposit Insurance Corporation (FDIC), which insures bank depositors, is built on the same structural flaw.

Correcting the Structural Defect. The basic problem shared by FSLIC and FDIC is that, unlike most forms of private insurance, the premiums paid by thrifts and banks do not reflect the risks actually covered by the insurer. They are flat rate premiums, based on the total deposits of each institution. The result: institutions that engage in risky loans and investments pay the same premiums as more prudent institutions for the same protection extended to depositors. Unless this structural defect is corrected, a future crisis is likely in the American thrift industry, and perhaps even in the banking industry.

When considering the bailout plan, lawmakers must recognize that the bankruptcy of FSLIC is not the result of regulatory ineptitude that can be solved by hiring more and better regulators. Although FSLIC's parent, the Federal Home Loan Bank Board, apparently has mismanaged the crisis, the potential for financial disaster is built into the very structure of federal deposit insurance system. Similarly, although fraud and ineptitude on the part of managers played a major role in the insolvency of many thrifts, it would be a mistake to assume that better management would have prevented the problem.

Encouraging Risk. The fact is that financial incentives created by the current structure of federal deposit insurance encourage even the most honest and competent thrift managers to pursue imprudently risky investment strategies.

Similarly, the FSLIC crisis is not due to deregulation of the nation's financial markets; renewed regulation thus is no answer. The thrift industry was sinking long before the limited deregulation enacted in 1980 and 1982. Re-regulation simply would make thrifts less able to compete domestically and internationally with other institutions. They would be weakened, not strengthened, by new regulation.

Beyond "Restructuring." Several plans to correct the inherent problems in federal deposit insurance have been suggested. The most attractive would reduce the role of government regulators and strengthen the role of market prices in controlling excessive risk-taking. These proposals range from varying insurance premiums to account for risk – as proposed in 1984 by then-Vice President Bush's Task Group on Regulation of Financial Services – to limiting the insurance coverage available to each depositor. Under one proposal, the total federal insurance guarantee would be capped at its present level and institutions would be issued tradeable insurance certificates.

In addition, the federal deposit insurance system – regardless of the extent of reform – would benefit from loosening financial services regulation. Deregulation should go beyond a "restructuring" of financial services regulation – a euphemism for redrawing regulatory turf boundaries – and allow institutions greater authority to diversify their risks. The stabilizing influences of greater liberalization would decrease the risk faced by the federal deposit insurance system, to the benefit of taxpayers and depositors.

THE DECLINE AND FALL OF THE SAVINGS AND LOAN INDUSTRY

The scale of the problem in the United States savings and loan industry is staggering. Nationwide there are about 3,000 thrifts, with assets totalling about $1.3 trillion. Some 1,000 thrifts are insolvent or nearly so. The latest estimated cost of the Bush Administration's bailout plan to stabilize the industry is $126 billion over the first ten years – and likely will total much more.

Some policy makers blame the industry's enormous troubles on the partial deregulation of thrifts in the early 1980s. But the seeds of today's disaster actually were sown in 1932, with the creation of the present thrift regulatory system. The most important purpose of federal deposit insurance, introduced for banks in 1933 and thrifts in 1934, was to protect the money of small savers from bank runs. But other goals were sought by the bank and thrift regulations, such as fostering home ownership and local banking.

Keeping Banks at Home. As a result, thrift industry activities long were essentially limited to investing in home mortgages. Banks and thrift institutions also were barred from operating outside their home state, or, in some areas, even their home city. The effect of these regulations, many of which are still in force, was to prevent diversification of risk and guarantee instability in the financial services industry.

The condition of thrifts deteriorated significantly in the late 1970s. During this period, the development of innovative financial products outside the banking and thrift industries, such as money-market accounts, combined with high interest rates, forced thrifts to increase substantially the interest they paid depositors in order to keep their customers. This in turn caused thrift profits to plunge as the return on mortgage portfolios fell below depositor interest rates. In some cases, due to interest rate limits, thrifts were even unable to offer the rates needed to attract and retain savers. As a result, before any significant deregulation, the industry's liabilities exceeded the market value of its assets by more than $150 billion. The thrifts were in serious trouble, and Congress tried to help.

More Powers for Thrifts. The response was a series of deregulatory steps. Under the Depository Institutions Deregulation and Monetary Control Act of 1980, ceilings on interest rates paid by banks and thrifts gradually were lifted, and thrifts were permitted to offer new types of loans and interest-bearing checking accounts. In 1982, the Garn-St.Germain Act increased the powers of thrifts, so that they began to look even more like banks. The 1982 Act even allowed thrifts to invest funds in certain activities closed to banks. Thrifts also were permitted to make equity or direct investments in high-risk speculative commercial real estate ventures.

By the time of this limited deregulation, however, a large portion of the savings and loan industry already was unprofitable or insolvent. At least granting additional new powers to healthy thrifts probably prevented the failure of many marginal institutions. By contrast, giving these same powers to insolvent thrifts was a major mistake; they now had nothing to lose by making excessively risky investments in a desperate attempt to get back into the black.

Growing Crisis. Making matters worse, since flat rate federal deposit insurance treats all firms the same, depositors had no reason to avoid the riskier institutions – in fact, they were attracted to them, because they tended to offer the highest rates. At the same time, the maximum insured amount per depositor per bank was increased in 1980 from $40,000 to $100,000, further encouraging the flow of deposits to insolvent or nearly insolvent thrifts. The Federal Home Loan Bank Board (FHLBB) contributed to the growing crisis by relaxing its enforcement of capital standards and delaying insolvency determinations.

Preventing Balanced Portfolios. Despite this lax regulatory attitude to weak thrifts, other aspects of the thrift industry remained dangerously overregulated, weakening the stronger thrifts. For example, stringent laws prevent geographic expansion – especially across state lines. These restrictions have made it difficult and costly for financial institutions to balance their loan portfolios across different regions of the nation. This over-concentration of thrift loan portfolios has been a major cause of thrift failures.[1] A high proportion of today's sick thrifts, for instance, are in the "oil patch" states – Louisiana, Oklahoma, and Texas. When the economies of these states soured in the mid-1980s, due to the drop in energy prices, these thrifts suffered heavily because their loans were dependent on the economies of their states. Similarly, many farm state banks and thrifts failed earlier in the decade when the farm economy soured. Had the portfolios of these institutions been more balanced geographically, many of these failures could have been prevented.[2]

THE PERVERSE INCENTIVES OF FEDERAL DEPOSIT INSURANCE

The root problem that must be confronted by policy makers seeking a permanent solution to the thrift crisis is the fact that risk is subsidized by the deposit insurance system. Without reform, the perverse incentives flowing from this subsidy will make it impossible to bring long-term stability to the industry – no matter how much is spent to bail out FSLIC.

Any insurance system must deal with the problem of "moral hazard." This concept refers to the incentive for insured parties to alter their behavior, after the insurance contract has been written, in ways that increase the insurer's risk. Simply put, individuals and firms tend to be more careless if they know that their losses will be paid by someone else. Private insurance companies deal with moral hazard in a variety of ways. Automobile insurance companies, for example, adjust rates to reflect the driving records of their customers.

1 See Bert Ely, "The Big Bust: The 1930-1933 Banking Collapse – Its Causes, Its Failures, Its Lessons," in Catherine England and Thomas Huertas, eds., *The Financial Services Revolution: Policy Directions for the Future* (Washington, D.C.: Cato Institute, 1988).

2 The value of geographic balance perhaps was best illustrated during the Great Depression. Although large numbers of U.S. banks failed during that period, Canada, which faced similar economic problems but allowed nationwide banking, did not experience a single bank failure.

The federal deposit insurance system, however, does nothing to control moral hazard.[3] Because federal deposit insurance rates are the same for all institutions, regardless of their practices, and because depositors can be confident that the federal government will cover all losses, the institutions and their customers are free to play a game of "heads I win, tails you lose."

Discouraging Savers' Oversight. Risk-taking effectively is subsidized because making risky loans or other investments results neither in higher insurance premiums nor in loss of anxious depositors. Similarly, savers have no incentive to monitor the financial position of their bank or thrift. In fact, the thrift regulators actually have discouraged such monitoring. Last December, for instance, the Federal Home Loan Bank of Topeka, which, as part of the Home Loan Bank system is the thrift regulator for that part of the country, admonished local thrifts not to use phrases such as "most secure," "safest," or "best-managed" to attract depositors. "The relative strengths or weaknesses of an institution," the regulator explained, "have no bearing on Federal Savings and Loan Insurance Corporation protection to insured depositors."[4]

The result of this federal insurance policy has been a kind of "reverse run" on thrifts, in which savers are encouraged to move their funds to riskier institutions (since these typically pay above market rates) and away from more prudent institutions. This, in turn, has forced healthy thrifts and other financial institutions to pay artificially inflated interest rates.[5] More generally, the moral hazard problem has resulted in skewed investment in the economy, as financial resources have been misallocated to projects that otherwise would not have been funded.

Covering State Regulators. The moral hazard problem also extends to regulators. Many financial institutions insured by FSLIC and FDIC are chartered and regulated by the states. Federal deposit insurance, however, creates incentives for state regulators to adopt unwise regulations. For example, if state banking regulators allowed popular but unsound banking practices, federal deposit insurance would cover any depositor who suffered losses. The state regulators thus can take credit for any benefits from their regulations, but suffer no harm for problems they may cause.[6]

The Bush Administration proposes that a substantial portion of the FSLIC bailout should be paid for by additional deposit insurance assessments on all thrifts. Some lawmakers propose using funds from banks. Yet this merely would penalize the cautious and well-managed institutions. In effect, funds

3 The problems of federal deposit insurance have long been recognized and discussed in the scholarly literature. See, for instance, Edward Kane, *The Gathering Crisis in Federal Deposit Insurance* (Cambridge, Mass.: MIT Press, 1985).
4 Cited in Warren Brookes, "Market-based S&L Reform?" *Washington Times*, January 12, 1989.
5 See Genie D. Short and James W. Gunther, "The Texas Thrift Situation: Implications for the Texas Financial Industry," Financial Industry Studies Department, Federal Reserve Bank of Dallas, September 1988.
6 See Henry N. Butler and Jonathan R. Macey, "The Myth of Competition in the Dual Banking System," *Cornell Law Review*, May 1988.

would be moved from prudent institutions to compensate the depositors of the less prudent. This would do nothing to correct the basic moral hazard problem. The subsidy of risky institutions by the more prudent would continue.

IS BETTER REGULATION THE SOLUTION?

Reviewing the failures of past regulatory mistakes, some lawmakers now propose improved regulation as the answer to the thrift problem. In addition, the Bush Administration plan includes tougher government oversight of industry lending practices and other new rules. The management of the savings and loan insurance fund, for instance, would be placed in the hands of the FDIC, while federal regulators would be able to overrule state regulators to ensure the safety and soundness of thrifts.

Seeking an Accurate Picture. Federal regulators also are trying to improve regulations and enforcement procedures. For example, the Federal Home Loan Bank Board finally is moving toward the adoption of "Generally Accepted Accounting Principles" (GAAP), the accounting system used almost universally in the private sector. Until now, it has used a system known as "Regulatory Accounting Principles" (RAP), which provides a less accurate picture of an institution's financial situation. An even better form of accounting for thrifts would be "market value accounting," which records asset values according to their real market value.

The Bank Board also has proposed new regulations that would raise the cash cushion that thrifts are required to maintain. Current regulations require thrifts to maintain cash, Treasury bills, or other such low-risk liquid forms of capital equal to 3 percent of total assets. The Bank Board has proposed increasing the amount of capital that thrifts must maintain and tightening the definition of what constitutes capital. This would ensure that a higher level of equity capital is available to back a thrift's liabilities. The proposed new rules also would link capital requirements to the risk levels of a thrift's loans and other investments. High-risk equity investments in commercial enterprises, for example, would require six times the capital required by a home mortgage. Alternatively, under the Bush plan, thrifts would be placed directly under FDIC capital rules, which are tougher than the Bank Board's current rules and already tied to risk.

Interfering with the Market. The regulators' dilemma, however, is that the immediate imposition of these guidelines could help drive hundreds more thrifts into insolvency. But the capital adequacy guidelines would be meaningless unless coupled with strict rules calling for the automatic closing of institutions that fall below minimum standards.

Another major problem with risk-based capital adequacy requirements is that they distort the lenders' incentive structure in a way that interferes with the role of the market in channeling financial capital to its best uses. Favorable treatment of home mortgage loans, for example, artificially increases the supply of the funds available for home mortgages and draws them away from potentially more valuable uses.

Despite these problems, several changes could be made that would aid regulators (and depositors) in identifying problem banks and thrifts at an early stage and thus reduce the likelihood of large taxpayer losses in the future. The use by regulators of market value accounting, for instance, would give a better picture of an institution's financial condition. Similarly, rules should be established to require the automatic closure of thrifts when the market value net worth falls below a certain fraction of total assets. A prompt closure rule would allow for the liquidation of firms without substantial losses to the insurance fund. It also would reduce the moral hazard problem by preventing thrifts from getting deeper into trouble as they pursue an "all-or-nothing" survival strategy.

Lagging Behind. Despite their advantages, however, the limitations of such regulatory tools also must be recognized by policy makers. Regulations that depend on accurate accounting information, whether under Generally Accepted Accounting Principles or market value accounting, are inadequate by themselves because by its very nature accounting information takes time to collect and process. Thus, although the gathering of more accurate information will help, the picture it gives always will lag behind the real economic situation. Moreover, there simply are too many thrifts to be watched as closely as is necessary. No matter how accurate the accounting information is, an institution's financial status could shift quickly from bad to bankrupt between the periodic visits by regulators.

Good regulatory oversight clearly is necessary to improve the operation of federal deposit insurance. Indeed, when there are no market incentives for controlling risk, regulation is crucial to the protection of the federal insurance fund. But it cannot be a permanent substitute for deeper structural reforms that would introduce continuous, powerful market incentives to encourage good thrift management.

PROPOSALS FOR LONG-TERM REFORM

A fundamental reform of deposit insurance should aim at increasing market incentives in the system. Ideally the system should be transferred to the private sector. Deposit insurance is simply too important to be left in federal hands. Private deposit insurers would have the normal insurance incentives to structure insurance contracts to encourage banks to control their insolvency risk and thus reduce overall risk to the banking system. Several plans for such private insurance have been outlined, either using third-party insurance companies or "cross-guarantees" among insured financial institutions.[7]

If privatization should prove politically difficult in the short run, other options are available that would capture at least some of the benefits of market incentives within the overall system of federal deposit insurance. Among them:

◆◆ **Tie the insurance premiums to the risk associated with each institution's lending portfolio.**

Under this approach, the current system of flat-rate premiums would be replaced with premiums based on the risk associated with each thrift's management policies and investment portfolio. In this way, the premium would reflect the true risk of default by the institution. This would force banks and thrifts with speculative investments to pay higher insurance premiums to cover the increased risk for the FDIC or FSLIC. This was endorsed in 1984 by then-Vice President Bush's Task Group on Regulation of Financial Services.

The main problem with this otherwise attractive approach is that it is unlikely that government regulators would able to estimate risk accurately without a market to guide them. The are, moreover, subject to strong political constraints that could skew their decisions. It would be very difficult, for example, for government regulators to increase insurance premiums for a troubled institution because of inevitable political pressures to aid a firm "in need."

◆◆ **Reduce the amount of insurance per depositor.**

Each account in a bank or thrift is now insured up to $100,000. Ronald Reagan's Council of Economic Advisors recommended early this year that this be lowered to $40,000 or less. They noted that the current level of coverage is well beyond the coverage envisioned when the federal deposit system was created in the 1930s, with a per account limit of $2,500. The limit also could be applied to individual depositors, rather than to each account.

By reducing the limit of protection, large depositors would have the incentive to monitor the performance of financial institutions, in the same way that stockholders monitor publicly traded corporations. These depositors, unlike federal regulators, would have their own money at stake and would not be subject to political or bureaucratic constraints.

By protecting deposits up to $40,000, the bulk of deposits would remain insured. The average thrift deposit today is only about $8,400. Even those with larger deposits would be better off. Though their insurance limits would be lower, their savings – and tax dollars – would be safer due to the market discipline introduced by the change.

7 Catherine England and John Palffy, "Replacing the FDIC: Private Insurance for Bank Deposits," Heritage Foundation *Backgrounder* No. 229, December 2, 1982; Bert Ely, "Private Sector Depositor Protection is Still A Viable Alternative to Federal Deposit Insurance," *Issues in Bank Regulation,* Winter 1986, pp. 40-47.

◆◆ **Stop compensating uninsured deposits.**

Even with a $100,000 limit, many bank and thrift accounts nevertheless exceed that level. Yet in practice these deposits often are treated as if they are fully insured. This is because, under current policies, FSLIC and the FDIC often will reorganize an institution to prevent it from closing. To make sure large depositors have an incentive to monitor the financial health of institutions, Congress should declare its clear intent that uninsured deposits should not be protected.[8]

◆◆ **Introduce co-insurance and deductibles.**

Under a co-insurance plan, deposit insurance coverage could be limited to a portion, say 80 percent, of the total amount deposited (up to the maximum amount). Depositors thus would lose up to 20 percent of their account in the event the bank or thrift failed. If there were a deductible, depositors would pay a portion of their own losses before federal insurance is "triggered." This would give depositors a greater incentive to monitor the quality of the financial institution in which they keep their funds.

◆◆ **Establish "narrow" banks.**

Under a plan suggested by Brookings Institution economist Robert Litan, federal insurance would be made available only to institutions investing in low-risk assets, such as Treasury securities, commercial paper, and perhaps Federal Reserve Deposits. Such "narrow" banks would operate like money market mutual funds investing in safe assets – except that they would have direct access to Federal Reserve funds and other aspects of the banking system.

Other institutions still could make loans and invest in other activities, such as banks and thrifts do today, but their depositors would not be eligible for federal insurance guarantees. In this way, federally insured institutions could not use the federal guarantee to engage in risky business activities. Depositors could keep their money in safe, cautious institutions, but they also would have the option to invest elsewhere at their own risk if they desired a higher interest rate.

Separating Risky Assets. Through this system, depositors who desired to protect their savings fully from losses would be able to do so, fulfilling the most important function of federal deposit insurance. Moreover, taxpayers would bear little risk, as the institutions would be inherently safe. At the same time, the bulk of deposit and lending activity likely would be conducted outside the federal safety net using private methods of risk control. By separating risky assets from federal insurance, the narrow bank proposal would relieve the structural problems of federal deposit insurance.

8 See Kenneth E. Scott, "Deposit Insurance and Bank Regulation: The Policy Choices," Working Paper No. 46, The John M. Olin Program in Law and Economics, Stanford Law School, August 1988.

One potential problem with this narrow banking proposal, however, is that it might cause a massive reduction in insured deposits. Because their low-risk investments would have low yields, narrow banks would only be able to pay very low interest rates on deposits, probably even less than "pass book" accounts before bank deregulation. As a result, most funds likely would tend to flow to non-insured institutions. Nevertheless, narrow banks would offer an essentially riskless alternative to the current system.

◆◆ **Cap the total federal guarantee and issue tradeable insurance certificates.**

Under the current system, there is no limit on the total size of the federal deposit guarantee – and thus the total exposure of the taxpayer. A plan proposed by Fred Smith and Melanie Tammen of the Washington-based Competitive Enterprise Institute, however, would cap the aggregate federal guarantee and create a market for insurance certificates. The total federal guarantee would be capped at its present level, which is now about $2.7 trillion of bank, thrift, and credit union deposits. Each insured institution would be assigned its *pro rata* share of this guarantee, in the form of insurance certificates. Financial institutions then could trade these certificates to insure some or all of their accounts.

Selling Insurance Certificates. Under this plan, a market for deposit insurance would be created, with a *de facto* cost for risk. High risk institutions would likely find themselves unable to attract depositors unless they not only retained their *pro rata* share of deposit insurance certificates, but purchased additional certificates in the market to cover their deposits. They would have to pay for these extra certificates; this would be a disincentive to excessive risk-taking. Institutions with a reputation for safe and sound banking practices, by contrast, would be able to sell some of their certificates, perhaps offering their depositors a choice of government insured, privately insured, and uninsured accounts. Well managed institutions might be able to sell most of their federal deposit insurance certificates. Poorly managed institutions would have to purchase additional insurance certificates if they desired to increase their deposits.

The plan also would limit the federal guarantee in a politically palatable manner. Unlike an across-the-board reduction in the level of coverage for depositors, no depositor would be forced to accept reduced insurance coverage. Instead, depositors would enjoy a range of options – they could move savings to an institution offering insurance, or keep them in a riskier institution offering higher rates but with less insurance protection. Moreover, since the total amount of federal insurance would be capped at a certain level, the importance of federal insurance would shrink over time as the economy and total deposits grew.

Tempting Regulators. A potential problem with the Smith-Tammen plan, however, is that the transfer of insurance certificates could result in a greater total risk than under the current system, even though the total amount of insured deposits at risk would remain the same. The reason for this is that, since risky thrifts naturally would value insurance more than safer thrifts, transfers of insurance certificates would tend to be from lower-risk to higher-risk institutions. Smith and Tammen attempt to deal with this "adverse selection" problem by allowing federal regulators to veto transfers. This adds to the complexity and cost of an otherwise simple idea. In addition, regulators would be tempted to interfere with the operation of the insurance certificate market to reduce the government's exposure.

The Smith-Tammen plan could be improved by coupling it with some of the features of the other proposals. A major step would be to encourage depositors to take a more active interest in institutions by reducing the per depositor coverage before determining the size of the federal guarantee.

A second potential problem that should be explored is the fact that, although the cost of insurance certificates would reduce some of the incentives for excessive risk-taking, the risk premium would go to the holders of the certificates, not into the insurance fund. Regulators faced with increasingly risky institutions would receive no funds to cover the cost of that risk.

CONCLUSION

The FSLIC crisis demonstrates dramatically that the time has come for substantial reforms in the entire deposit insurance system. Unless the $126 billion plus bailout for FSLIC is accompanied by fundamental insurance reforms, it will be nothing more than an expensive short-term fix. Congress thus must combine the short-term bailout of FSLIC with structural reform of the federal deposit insurance system.

Dealing with the Primary Culprit. These reforms should not include re-regulation. In some areas, supervisory rules may have to be tightened. Accounting and closure rules, for instance, should be made tougher. But regulatory changes will not go to the heart of the problem. The primary culprit is the federal deposit insurance system, which creates perverse incentives for bank and thrift managers, depositors, and state and federal regulators. The incentives created by the current system subsidize managers who take excessive risks with deposits.

So far, the Bush plan for the thrift industry contains little addressing the fundamental problems of deposit insurance. He has proposed that the Treasury Department undertake an eighteen-month study of the federal deposit insurance system, and make recommendations for reform. But this likely will be too little, too late. Once bailout money for FSLIC is approved by Congress, there will be no pressure for far-reaching reform – until the next crisis.

Toward an Ultimate Solution. Various reforms of the insurance system have been offered, ranging from risk-related insurance premiums to tradeable insurance coverage. The ultimate solution may be a combination of the various plans. What lawmakers should do is to evaluate such reform ideas carefully – not just bail out FSLIC and assume that the underlying problem has disappeared.

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