Deposit Insurance After FDICIA

A paper presented by **Bert Ely** at a conference titled

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Introduction

Deposit insurance is banking regulation's product warranty.i[i] That is, deposit insurance exists to protect insured depositors from regulatory negligence. In too-big-to-fail banks, deposit insurance protects all depositors as well as many other creditors. Therefore, it is appropriate to discuss the product warranty -- deposit insurance -- when addressing the question of whether or not banking regulation is necessary. A much more fundamental question also needs to be addressed: Has banking regulation become too important to leave to government?

The first section of the paper discusses how Congress, between 1989 and 1994, essentially eliminated taxpayer risk in federal deposit insurance by shifting the entire burden of regulatory negligence to healthy banks.ii[ii] Congress executed this shift in the aftermath of the S&L crisis and the banking problems of the 1980s and early 1990s.

The second section explains the shortcomings which still exist in deposit insurance and government banking regulation, specifically regulatory moral hazard, which can be quite costly to banks in light of the 1989-94 reforms. The third section of the paper will briefly explore the question of whether or not banking regulation is needed.

The final section of the paper summarizes various options for reforming deposit insurance and banking regulation, including abolishing bank regulation, abolishing deposit insurance (in effect, eliminating bank regulation's product warranty), reducing the

scope and coverage of deposit insurance, eliminating too-big-to-fail, the narrow bank concept, the increased use of subordinated debt in bank capital structures, and the cross-guarantee concept for privatizing banking regulation and its attendant deposit insurance, payment system, and systemic risks.

Congress Has Eliminated Taxpayer Risk From Federal Deposit Insurance[iii]

Stung by the S&L crisis, and its enormous cost to taxpayers, as well as by the commercial banking problems of the 1980s and early 1990s, Congress enacted numerous reforms which directly or indirectly have eliminated the taxpayer risk in federal deposit insurance. These reforms were intended to minimize deposit insurance losses while ensuring that all such losses will be imposed to the maximum extent possible on banks which do not fail. By eliminating the taxpayer risk previously posed by federal deposit insurance, Congress transformed federal deposit insurance from a government guarantee program into a genuine insurance mechanism, albeit a mechanism with serious cross-subsidy problems discussed below in the section on mispriced deposit insurance premiums.

The seven principal reforms divide into two broad categories -- minimizing deposit insurance losses and imposing *all* deposit insurance losses on bank capital.

Minimizing deposit insurance losses

Cross-guarantees among affiliated banks (1989) The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which launched the resolution of the S&L crisis in the aftermath of the bankruptcy of the Federal Savings and Loan Insurance Corporation, included a Across-guarantee" provision (Sec. 206, enacting 12 U.S.C. 1815(e)). This provision made all "commonly controlled" banks liable for the share of an insolvency loss in any one of the commonly controlled institutions that would otherwise be borne by the Federal Deposit Insurance Corporation (FDIC). That is, the FDIC experiences an actual loss in a failed bank only to the extent that it cannot recover its potential loss from affiliated banks of the failed bank. As a practical matter, the amount of this potential recovery is limited to the market value of the affiliated banks. Hence, for deposit insurance purposes, all banks in a multi-bank holding company or otherwise under common ownership or control are treated as if they were one bank for the purpose of absorbing at least some portion of the FDIC's share of a failed bank's insolvency loss. To some extent, the value of this provision to the FDIC has been diminished by interstate branching, which was authorized in 1994 (and is discussed on the next page). Nonetheless, it was an important first step which Congress took to minimize FDIC losses and remains an important loss-minimization tool for the FDIC.

Prompt regulatory action/least-cost resolution (1991) In many ways, prompt regulatory action (often referred to as prompt corrective action, or PCA) and least cost resolution (LCR), are the heart of FDICIA,iv[iv] which Congress enacted on November 27, 1991. Together, PCA and LCR represent the most important tool the federal government has to minimize deposit insurance losses in banks which have sunk into insolvency. At the

same time, they reflect a fundamental and understandable congressional distrust of the bank regulators in the aftermath of the S&L crisis and problems in the commercial banking industry. Briefly, regulations issued under the authority of PCA set trigger points in a bank's slide towards insolvency. These triggers are intended to force regulators to take timely corrective action in a failing situation or, barring a turnaround, to force the closure of a bank before it becomes insolvent. LCR is designed to minimize the FDIC's use of purchase-and-assumption transactions in failed bank situations because such transactions can protect the uninsured portion of deposits, which has the effect of raising the cost of a bank failure. Although not fully tested during a severe economic crisis, in theory PCA and LCR should minimize deposit insurance losses even during a crisis. The increasingly evident shortcomings in PCA are discussed in the next section of the paper.

Depositor preference in failed banks (1993) Although enacted as part of the 1993 budget reconciliation bill as a spending reduction measure and with no debate whatsoever over its deposit insurance implications,v[v] the depositor preference provision of the Federal Deposit Insurance Act serves as a potentially significant legal device for reducing FDIC losses in failed banks. Briefly, depositor preference gives both insured and uninsured deposits in domestic branches of a bank a liquidation preference over deposits in that bank's foreign offices as well as all other general, unsecured claims on that bank. Consequently, general unsecured claims which are <u>not</u> domestic deposits will absorb all of a failed bank's insolvency loss before the first dollar of loss will be borne by domestic deposits, and specifically by the FDIC as the insurer of the insured portion of domestic deposits. Depositor preference already is playing a role in reducing the FDIC's loss in the relative handful of banks which have failed in recent years.

Interstate banking and branching (1994) Although intended primarily to improve the operating efficiency and customer service of commercial banks, the Interstate Banking and Branching Efficiency Act of 1994 greatly improved the safety-and-soundness of the banking system by permitting large banks to operate regionally or nationally. The banking problems in Texas and other states during the 1980s as well as the banking crisis of 1930-33, during which time 9,000 mostly small, single office banks failedvi[vi] were greatly aggravated by state and national banking and branching restrictions and prohibitions. It is highly unlikely that even a future regional banking crisis, such as that which struck the Southwest in the mid-1980s or the New England banking crisis of the late 1980s and early 1990s, would be as severe, in terms of deposit insurance losses, as those crises were.

Imposing all deposit insurance losses on banks

Recapitalizing the deposit insurance funds Sec. 104 of FDICIA established the framework for building the Bank Insurance Fund (BIF) to a "designated reserve ratio" (presently 1.25% of insured deposits) and maintaining that ratio. FIRREA, which created the BIF and SAIF, established similar requirements for the Savings Association Insurance Fund (SAIF). Under the guise of the designated reserve ratio, the FDIC was able to levy a substantial tax on banks to build the BIF and SAIF to a 1.25% reserve ratio. Although

not used solely to build the BIF to a 1.25% ratio, the FDIC levied $27.9 billion of premiums on BIF-insured institutions from 1990 to 1995.vii[vii] From 1991 to 1996, the FDIC levied $8.5 billion of premiums, including $5.2 billion in 1996, on SAIF-insured institutions to build that fund to a 1.25% ratio.viii[viii] These huge assessments cannot be tapped to pay future deposit insurance losses, as is discussed in the next paragraph. Hence, they form a permanent investment base which generates interest savings on financing the federal debt.

Unlimited FDIC assessment power Of particular importance to taxpayers, Sec. 103 of FDICIA gave the FDIC a blank check, through the authorization of emergency special assessments, on the capital of all of the institutions insured by a particular fund to quickly rebuild that fund to the designated reserve ratio should prior losses have driven that ratio below the designated minimum. This unlimited assessment power gives the FDIC the power to draw heavily on the capital of the banking industry to cover deposit insurance losses should cross-guarantees, PCA, LCR, and depositor preference fail to minimize those losses. To the extent that the FDIC has to draw upon its $30 billion line-of-credit at the U.S. Treasury to meet short-term liquidity needs, those interest-bearing borrowings will effectively be repaid from future FDIC assessments.ix[ix] At June 30, 1999, the book value of the equity capital of all FDIC-insured institutions was $562.4 billion.x[x] almost three times the amount of the insolvency losses suffered by federal deposit insurance since the S&L crisis first erupted in the early 1980s.

Special "systemic risk" or too-big-to-fail assessments In addition to the emergency special assessment powers of FDICIA's Sec. 103, FDICIA's Sec. 141 codified the concept of too-big-to-fail (TBTF) and provided the means to pay for it. Specifically, this systemic risk provision (the so-called "systemic risk exception") authorizes the Federal Reserve and FDIC, with the concurrence of the Secretary of the Treasury and the President, to declare a bank TBTF. The FDIC may then protect, if necessary, *all* the liabilities of that bank against loss in order to "avoid or mitigate" the "serious adverse effects on economic conditions or financial stability" if the bank were liquidated under FDICIA's LCR provisions. The systemic risk provision of FDICIA also authorizes the FDIC to levy one or more emergency special assessments on the other members of the insurance fund to which the failed TBTF bank belonged to cover the cost of protecting the failed institution's creditors. Because of this provision, healthy banks, not taxpayers, will bear the cost of protecting *uninsured* creditors of TBTF banks from any loss. While widely criticized, the TBTF policy recognizes a cruel reality of the industrialized world -- there is too much risk, and therefore cost, to attempt to impose the insolvency loss in a large bank on its depositors and other creditors.

The Remaining Shortcomings of Banking Regulation and Deposit Insurance

Although the congressional actions discussed above eliminated, as a practical matter, the taxpayer risk posed by federal deposit insurance, many problems remain with government banking regulation and federal deposit insurance. This section of the paper will review certain of those problems; space does not permit a discussion of all of them.

Prompt Corrective Action does not work well in bad banks

As noted above, prompt corrective action (PCA) has been hailed as one of FDICIA's most important features. The failure of just 23 banks from 1995 to the present,xi[xi] an average of five failures a year, suggests that PCA is working even though PCA has not been tested by a banking crisis or even a recession. Two recent bank failures, though, suggest that PCA is seriously flawed in a manner which not even Congress can correct.

On June 23, 1998, BestBank, of Boulder, Colorado, was closed. At the time, it had $314 million of assets.xii[xii] The FDIC was BestBank's federal regulator since the it was a state non-member bank. The latest published loss estimate for BestBank is $223 million,xiii[xiii] which equals 71% of BestBank's assets at the time of closing. Ironically, on September 1, 1999, the very day that the latest BestBank loss estimate was reported, the Office of the Comptroller of the Currency, the regulator of national banks, closed the First National Bank of Keystone, located in a West Virginia town of that name. Keystone had assets of $1.12 billion on June 30, 1999.xiv[xiv] Based on the most recent loss estimate of $750 million,xv[xv] the Keystone failure already is indicating a loss rate of 67%; that percentage could go higher. These are appalling loss rates, reminiscent of some of the more egregious failures during the S&L crisis.

It is becoming increasing evident that PCA is based on two naive assumptions about government banking regulation -- call report data is reasonably accurate and regulators will move quickly and aggressively, particularly when faced with hostile regulatees. The BestBank and Keystone failures reflect the fallacy of these assumptions. Based on the last quarterly call reports they filed before being closed, both banks appeared to be at least adequately capitalized. One hundred and fourteen days before it was closed, BestBank was "well-capitalized," based on a book capital leverage ratio of 7.5%, a risk-adjusted Tier 1 capital ratio of 9.1%, and a risk-adjusted Tier 1 plus Tier 2 capital ratio of 10.3%.xvi[xvi] Sixty-three days before it was closed, Keystone was "adequately capitalized," based on a book capital ratio of 16.4%, a risk-adjusted Tier 1 capital ratio of 7.8%, and a risk-adjusted Tier 1 plus Tier 2 capital ratio of 8.4%.xvii[xvii] The difference in these two failures between the last reported leverage ratio and the most recent loss estimate, as a percentage of assets at the time of time of failure, is both quite similar and extremely shocking -- 78.5% in BestBank's case and 83.4% in Keystone's case.

Despite appearing to be at least adequately capitalized, both of these banks had long histories of regulatory difficulties and low CAMELSxviii[xviii] ratings which should have raised grave doubts among regulators about the value of the banks' assets and therefore their true capital level. During the last six years of its existence, BestBank was subject to nine state, FDIC, or joint examinations. Its composite CAMELS ratings were as follows: 4-4-3-3-3-4-3-3-5. Keystone was examined somewhat less frequently during its last four years, but did not stack up too well, either, in the CAMELS department. Its composite CAMELS ratings, as set by the FDIC, not the OCC, were as follows: 3-?-4-5, with the "5" rating tentatively assigned by the FDIC to Keystone eight months before it was closed.xix[xix] In January 1999, "Keystone also was added to the FDIC's eight-

quarter projected failing Bank list,"xx[xx] even though it was adequately capitalized at the time, based on its December 1998 call report.

Clearly, the call reports for these two banks did not reflect their true financial condition or their regulatory assessments, which raises this question: How much confidence can any outsider place in bank call report data? Or, to put this question another way, how can outsiders, such as owners of a bank's subordinated debt, differentiate accurate call report data from highly inaccurate data?

Further clouding the efficacy of PCA are long histories of regulatory problems and the intransigence, if not open hostility, of the managements of the two banks towards their regulators. For instance, in BestBank's case, a cease-and-desist order (C&D) was issued in January 1994 and canceled in October 1995, only to be followed by board resolutions in lieu of a memorandum of understanding in October 1995 (on the same date the C&D was canceled) and again in February 1997.xxi[xxi] Keystone's "rap sheet" goes back to at least 1991, eight years before the bank failed.xxii[xxii] A long laundry list of Keystone's problems and promised fixes is set out in a 15-page agreement entered into between Keystone and the OCC in May 1998.xxiii[xxiii]

The regulators have complained that their field examiners received extremely hostile treatment from the two banks, thus deterring the examiners from doing their job. Apart from the fact that such hostility should have signalled to the regulators that some was seriously amiss in these banks, the idea that a community bank can cow the federal government is ludicrous, especially in the aftermath of the FBI assaults at Waco and Ruby Ridge. Nonetheless, it has become increasingly apparent that, despite FDICIA, a renegade banker can cow bank regulators for years, thus gutting the intent of PCA. That is not *prompt* corrective action.

Government banking regulation lacks sufficient personal and organizational accountability

A most troubling aspect of government banking regulation and the deposit insurance losses that follow on the heels of inept regulation is the extremely limited accountability of bank regulatory personnel and their organizations. Behind every costly bank failure lies negligence on the part of readily identifiable regulatory personnel. Yet unlike war, where the blunders and battlefield disasters of generals and even lower-ranking officers are well-known, and officers are demoted, fired, or otherwise punished, rarely does that happen to bank regulators or bank regulatory agencies. At worst, they are dragged over the coals for a few hours at a congressional hearing.

Despite losses, measured on a present-value basis, of $150-$160 billion, it is difficult to identify any employee of an S&L regulatory agency who was fired because of the S&L fiasco, except possibly M. Danny Wall, the chairman of the Federal Home Loan Bank Board (FHLBB) from 1987 to 1989. Arguably the FHLBB suffered since Congress abolished it in 1989, but its regulatory responsibilities and personnel were merely shifted to the new Office of Thrift Supervision. Despite the FDIC suffering $36.4 billion of

losses in 1,607 bank failures in the 1981-94 period,xxiv[xxiv] it is not clear that any FDIC or other bank regulatory official was fired, forced to retire, demoted, or otherwise punished because of these failures and their enormous cost.

Deposit insurance premiums are not sufficiently risk sensitive

Although Sec. 302 of FDICIA (12 U.S.C. 1817(b)) directed the FDIC to establish risk-sensitive deposit insurance, even the FDIC itself has acknowledged the shortcomings of its risk-based premiums. Basically, they are not sufficiently risk-sensitive, with a range of just 27 basis points between the soundest banks and the riskiest.xxv[xxv] Further, FDIC premiums lag greatly, in some cases by several years, in responding to changes in a bank's condition.

Although most banks are not paying an explicit deposit insurance premium at this time,xxvi[xxvi] implicitly they are because of the substantial amount of premiums they had to pay in the early 1990s to build the BIF and the SAIF to the required 1.25% reserve ratio. The implicit premium rate is about 6 basis points, calculated as follows: Banks forego annual income on the deposit insurance premiums they paid to the FDIC to build the BIF and SAIF to a 1.25% reserve ratio. Assuming banks could earn a 6% yield on this forced loan to the government, this foregone income is equivalent to almost a 6 basis point deposit insurance premium.xxvii[xxvii] Hence, effective premiums for FDIC-insured deposits range from 6 basis points to 33 basis points since explicit premium rates presently range from zero to 27 basis points. In the author's opinion, based on his substantial research on the pricing of deposit insurance, this premium range is too narrow. The safest banks should pay no more than two basis points for insurance of <u>all</u> of their deposits while the riskiest banks should pay as much as 70-100 basis points.

Earlier this year, the FDIC considered charging a higher premium rate to as many as 573 banks, almost all of which did not pay any premium in 1998. The premium increase would have been levied on banks with CAMELS ratings of 3, 4, or 5 for bank management or asset quality.xxviii[xxviii] However, in response to a strong negative reaction to this proposal, the FDIC quickly announced that it was backing off from its initial proposal, having "decided to revise and delay until next year a plan to make more institutions pay for deposit insurance."xxix[xxix] This retreat by the FDIC does not negate the fact that deposit insurance premiums are underpriced for riskier banks. The FDIC's problem is that as a government monopoly it cannot properly price deposit insurance premiums because prices can be properly established only in private, competitive marketplaces where both buyers and sellers, or insureds and insurers, have a choice as to whom they do business with.

In her October 12 response to Rep. Leach, FDIC Chairman Donna Tanoue stated that "the FDIC is in the process of enhancing its risk-based premium system. . . . As part of this process, an off-site model is used to `flag' institutions for review of the appropriateness of the [premium rate] risk classification assignment."xxx[xxx] According to Chairman Tanoue, under this new system, "Keystone would first have been identified for review with the assessment risk classifications made in the fall of 1993 . . .

[the system] would have flagged Keystone in every subsequent assessment period in which it was initially assigned to the `A' [lowest premium rate] category."xxxi[xxxi] It will be interesting to see if the FDIC is any more successful in its next attempt to launch more risk-sensitive premium rates than it was earlier this year, particularly given the certain resistance of banks who will pay more. If more risk-sensitive premium pricing is initiated, it will be interesting to see how well bank regulators react to it since FDIC premium rates cannot be disclosed to the public.

Insufficiently risk-sensitive premiums create an unhealthy deposit insurance cross-subsidy

The combination of factors cited above, that is insufficiently risk-sensitive deposit insurance premiums, create an unhealthy cross-subsidy within federal deposit insurance that flows from sound, well-managed banks to weak, poorly managed banks. BestBank and Keystone are merely the two most recent examples of banks whose deposit gathering was subsidized at great cost to the thousands of healthy, well-managed banks. Although the taxpayer subsidy of deposit insurance has been eliminated, the subsidization of bad banking by good banks is alive and well. Despite its best intents, it is highly unlikely that the FDIC will make much headway in eliminating this cross-subsidy.

The deposit insurance cross-subsidy extends beyond premium rates

The cross-subsidy in deposit insurance is not limit to the pricing of deposit insurance premiums -- it extends banking regulation. That is, excessive regulatory costs are imposed on healthy banks to compensate for the inability of regulators and supposedly risk-sensitive premium rates to contain bad banking.

Excess capital requirements. Implicitly acknowledging that neither government banking regulation nor government pricing of deposit insurance will prevent unwise banking, Congress effectively mandated the Basle risk-based capital standards with regulations which tie prompt regulatory action, discussed above, to various measures of bank capital. Yet like FDIC insurance premiums, risk-based capital standards only very crudely reflect the actual riskiness of bank assets. This is particularly evident for loans to private-sector firms where no distinction in capital requirements is made between firms which are AAA-rated and those which have a junk bond status. Worse, capital ratios have been set high enough to minimize banking failures caused by a combination of inept management and regulatory failure,xxxii[xxxii] which means that capital ratios are too high for well-managed banks. Undifferentiated capital requirements for private-sector credit risks, coupled with the inability of regulators to sufficiently differentiate good banking from bad in establishing risk-based deposit insurance premiums, are the principal reasons why banking has steadily lost market share as a channel of financial intermediation. In effect, regulatory inefficiencies have created substantial regulatory arbitrage opportunities which financial services entrepreneurs, utilizing electronic technology, have increasingly capitalized upon, at banking's expense.

Excess regulatory compliance costs. Because of the regulatory shortcomings cited above and congressional distrust of the competency of the banking regulators, as FDICIA effectively proclaimed, Congress and the banking regulators have geared regulatory compliance burdens to the lowest common denominator in banking; that is, the poorly managed banks which are most likely to fail. This compliance burden is made worse by the inherent, one-size-must-fit-all nature of government banking regulation. This burden, which imposes higher operating costs on banks as well as regulatory straitjackets which impair the managerial flexibility of bank managers, further harms banking's competitiveness.

Federal deposit insurance discriminates against small banks

Theoretically, the $100,000 federal deposit insurance limit per depositor per bank applies to depositors in all banks of all sizes. However, the too-big-to-fail policy trumps any deposit insurance limit because all deposits as well as most other liabilities of a troubled TBTF bank will be protected against loss should the bank be declared insolvent and taken over by the government. As discussed above, Congress codified the notion of TBTF when it include the "systemic risk exception" in FDICIA. While no one knows where the dividing line is between banks which are TBTF and banks which are TSTS (too-small-to-save), realistically, America's largest banks are TBTF. Hence, as a practical matter, the $100,000 deposit insurance limit applies only to the thousands of TSTS banks. Ironically, TSTS banks will be levied with the emergency special assessments noted above to pay for the cost of bailing out the creditors of TBTF banks even though, by definition, TSTS banks are too small to ever benefit competitively from the potential for such a bailout.

Although Congress raised the deposit insurance limit to $100,000 from $40,000 in 1980, inflation has since reduced the limit to about $53,000, when the limit is measured in 1980 dollars. This decline has occurred at a time when consolidation within the banking industry, following the repeal of interstate banking and branching restrictions, has created the situation where many, if not most, TSTS banks are competing for deposits directly, often right across the street, against TBTF banks. Although the rate of inflation is quite low today, inflation nonetheless continues to erode the real value of the $100,000 deposit insurance limit as banking consolidation raises the percentage of deposits held by TBTF banks. Little wonder, then, that community banks have begun pressing for an increase in the nominal deposit insurance limit.

Deposit insurance does not explicitly protect payment and clearing systems, thereby creating systemic risk

One consequence of the $100,000 insurance limit is that payment and clearing system obligations of banks are not protected by deposit insurance to the extent they exceed $100,000 for any one counterparty bank. Consequently, if a larger bank with intraday liabilities to other banks far exceeding $100,000 experiences financial difficulty, there will be uncertainty as to whether or not its payment and clearing system obligations will be fully protected as there can never be absolute certainty that a particular bank is TBTF.

This uncertainty can be destabilizing to the payment and clearing systems in which the bank participates. If the bank does fail and it is not declared TBTF, then its inability to honor its payment and clearing obligations can ripple through the entire payment and clearance system, potentially causing widespread financial havoc. Ironically, then, the systemic stability deposit insurance is supposed to deliver may in one sense be destabilizing.

Is the underlying issue deposit insurance or banking regulation?

A key question in discussing banking regulation and its product warranty, deposit insurance, is which one is the underlying issue. For many, deposit insurance is the only issue because banking regulation, or at least *government* banking regulation, is a given. Hence, for these folks, the reform debate encompasses just deposit insurance -- whether or not to have it, who should or should not be protected, the amount of coverage, etc.

The title of this conference, "Is Bank Regulation Necessary?," suggests that bank regulation, not deposit insurance, is the underlying issue. I agree. But the title raises a second question: if banks need to be regulated by an outside party to ensure that they are operated in a safe-and-sound manner, should that party be a government entity or a private entity?

Banks are special, that is they are not like non-financial businesses, because their failure can have systemic consequences. Further, while insolvent non-financial firms can be reorganized and reinvigorated in Chapter 11 of the Bankruptcy Code, Chapter 11, as it now stands, does not provide a haven for rehabilitating troubled banks. This is the case because the Bankruptcy Code's automatic stay against creditors getting paid would block a bank in Chapter 11 from engaging in a key aspect of the banking business -- making payments on behalf of its customers. Hence, society legitimately has a special interest in ensuring the sound, *continuous* operation of banks and other entities that provide payment services.

Accepting the notion that banks are special and should be subject to whatever regulation is needed to ensure their solvency so as to assure continuous operation of the payments system and therefore systemic stability should not automatically lead to the assumption that only government can provide this service. In fact, with the collapse of the socialist economies, it becomes increasingly easy to envision the private-sector provision of many services long sought to be the province of government. For example, air traffic control, long seen as a necessary government activity, is increasingly viewed as a service that a private firm or firms might provide more efficiently and effectively. Canada has actually privatized its air traffic control system.xxxiii[xxxiii] Can banking regulation be far behind, given that Congress has already fully privatized the deposit insurance risk?

Options for Reforming Banking Regulation and Deposit Insurance

A discussion of the options for reforming banking regulation and deposit insurance lie beyond the scope of this paper or this conference -- they merit a separate conference.

However, it is useful to briefly catalog various options for reforming banking regulation and deposit insurance.

Abolish government banking regulation

Abolishing government banking regulation means that banks would be treated as if they were a general business corporation. In such a world, there would be no government deposit insurance. Hence, insolvent banks would be resolved under the Bankruptcy Code, which means that their deposit liabilities would be frozen until such time as a plan of reorganization or liquidation was approved by a bankruptcy court. However, because banks are special, as discussed above, the risk of bank runs and systemic instability would still exist. Private-sector insurers or guarantors of deposits might emerge, though, to protect the deposits and other liabilities of banks not regulated by the government against the insolvency of those banks.

Abolish deposit insurance

Abolishing deposit insurance while retaining government regulation of banks would merely state that government will not be liable for its regulatory errors, such as those seen most recently in the BestBank and Keystone failures. It is not clear, though, if the statutory abolition of deposit insurance would eliminate the practice of using taxpayer funds to protect depositors and other creditors of TBTF banks.

Reduce the scope and coverage of deposit insurance

Reducing the present $100,000 deposit insurance limit, beyond the extent to which inflation is steadily trimming its real value, is seen by its advocates as returning deposit insurance to its original purpose -- protecting only the smallest depositors and modest amounts in transaction accounts. A variation of this proposal is to impose a deductible on deposit insurance so that the smallest depositors (the proverbial widows and orphans for whom federal deposit insurance was initially intended) in a failed bank would be fully wiped out while larger depositors would receive less-than-full protection of their deposits. A variant of this proposal would provide only a certain percentage of protection, say 90%, up to specified dollar limit. By ensuring that every depositor in a failed TSTS bank suffers some loss should the bank fail, the assumption is that vigilant depositors will pressure government bank regulators to do the job they are being paid to do.

Eliminate the too-big-to-fail policy

Eliminating the too-big-to-fail policy essentially is designed to eliminate the deposit insurance discrimination against TSTS banks. Under this proposal, Congress would repeal the systemic risk exception it enacted in 1991. Possibly Congress would make it illegal, and maybe even a criminal act, for government officials to use taxpayer funds to protect uninsured depositors and other creditors in a large bank that regulators had let slip

into insolvency. Gary Stern, another conference participant, has long advocated eliminating TBTF.xxxiv[xxxiv]

The "narrow bank" concept

The "narrow bank" proposal envisions limiting banks that directly access the payments system to holding a narrow class of highly liquid, safe assets. Such assets would include U.S. Treasury bills and highly rated commercial paper. This proposal implicitly acknowledges the inability of government regulators to assess the value and soundness of less-than-liquid and less-than-absolutely sound assets. Interestingly, without any debate whatsoever, in 1993 Congress enacted a possibly superior form of the narrow bank concept when it adopted the depositor preference provision discussed above.xxxv[xxxv]

Increased use of subordinated debt in bank capital structures

Proposals to increase the use of subordinated debt in bank capital structures are premised on the belief that private marketplace participants, specifically the owners of bank subordinated debt, must be harnessed to wake up sleepy regulators. That is, owners of bank-issued subordinated debt, acting on less information as well as less timely information that regulators possess, will signal to regulators, by demanding higher interest rates on subordinated debt issued by a troubled bank, that the bank is experiencing difficulty. Presumably, regulators would then use PCA measures to prevent the bank from failing. Just as Congress gave PCA a tryout in FDICIA, the pending financial services modernization legislation (S. 900) would authorize "a study of the use of subordinated debt to protect the financial system and deposit [insurance] funds from `too big to fail' institutions."xxxvi[xxxvi]

The cross-guarantee concept for privatizing banking regulation and its attendant deposit insurance, payment system, and systemic risks

The cross-guarantee concept, long advocated by the author, would fully privatize banking regulation and its attendant deposit insurance risks. In effect, it proposes to allow individual banks to shift from one-size-must-fit-all government regulation to negotiated, contractual regulation.xxxvii[xxxvii] Further, a Across-guarantee" contract entered into by a bank and an ad hoc syndicate of voluntary guarantors (largely other banks) would guarantee all deposits (domestic and foreign) as well as almost all other liabilities of the guaranteed bank, including all intra-day payment and clearing system obligations. By guaranteeing all deposits as well as payment and clearing system obligations, the cross-guarantee concept will, as a practical matter, eliminate systemic risk. In effect, the cross-guarantee concept envisions unbundling the liability side of bank balance sheets by shifting all bank insolvency risk, as well as the responsibility for monitoring that risk, from bank creditors to bank guarantors.

Conclusion

Between 1989 and 1994, Congress essentially eliminated taxpayer risk from federal deposit insurance by shifting the entire deposit insurance risk onto the backs of healthy banks. This shift eliminate any taxpayer subsidy of deposit insurance. However, banks continue to be burdened by heavy government banking regulation as well as a government-imposed deposit insurance scheme that still is highly flawed. Numerous proposed reforms for deposit insurance ignore the role of government regulation in the banking business. However, if deposit insurance is merely a product warranty for government regulation, then reform proposals should focus primarily on how to achieve better banking regulation, whether provided by the government or the private sector.

Endnotes

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i[i].. Ely, Bert, "Regulatory Moral Hazard: The Real Moral Hazard in Federal Deposit Insurance," *The Independent Review: A Journal of Political Economy*, Vol. 4, No. 2, Fall 1999.

ii[ii].. The term "bank" encompasses all FDIC-insured institutions, including commercial banks, savings banks, and savings-and-loans. The term excludes credit unions.

iii[iii].. This section of the paper draws heavily on an earlier paper by the author, "Banks Do *Not* Receive a Federal Safety Net Subsidy," published in "Refuting the Federal Safety Net `Subsidy' Argument," The Financial Services Roundtable, Washington, D.C., September 1999.

iv[iv].. Prompt Regulatory Action constitutes Subtitle D of Title I of FDICIA (Sec. 131-133) while Least-Cost Resolution follows in Subtitle E (Sec. 141-143).

v[v].. Depositor preference was enacted as Sec. 3001 of Public Law 103-66 and is codified as 12 U.S.C. '1821(d)(11).

vi[vi].. Federal Deposit Insurance Corporation, 1983 Annual Report, Table on pg. 41.

vii[vii].. Federal Deposit Insurance Corporation, 1997 Annual Report, pg. 105.

viii[viii].. Ibid.

ix[ix].. This line of credit is authorized by 12 U.S.C. Sec. 1824(a). In addition, Sec. 1824(b) authorizes the FDIC to borrow from the Treasury Department's Federal Financing Bank. Sec. 1824(c) governs the repayment schedule for any such borrowings. Presumably, the interest rate on these borrowings will not be less than Treasury's borrowing rate given that, in setting the interest rate on Treasury loans to the FDIC, the Secretary of the Treasury will take "into consideration current market yields on outstanding marketable obligations of the United States of comparable maturity." This provision in Sec. 1824(a) should bar any taxpayer subsidy to banks through this

borrowing channel. Given the capital strength of the banking industry today, this line of credit could safely be canceled.

x[x].. "The FDIC Quarterly Banking Profile," Federal Deposit Insurance Corporation, Second Quarter 1999, Table II-C, pg. 16.

xi[xi].. "The FDIC Quarterly Banking Profile Graph Book," Federal Deposit Insurance Corporation, Second Quarter 1999, pp. 10 and 39, for data through June 30, 1999; news accounts for data thereafter.

xii[xii].. "Material Loss Review: The Failure of BestBank, Boulder, Colorado," Office of the Inspector General, Federal Deposit Insurance Corporation, Audit Report No. 99-005, January 22, 1999, pg. 1.

xiii[xiii].. Barancik, Scott, "Bank, Thrift Insurance Fund Reserves Hit Record Levels," *American Banker,* September 1, 1999.

xiv[xiv].. Based on call report data filed by Keystone with the FDIC.

xv[xv].. Rehm, Barbara, "As Congress Looks into W. Va. Failure, FDIC Points Finger of Blame at OCC,@" *American Banker,* October 18, 1999.

xvi[xvi].. Calculated from BestBank's call reports.

xvii[xvii].. Calculated from Keystone's call reports.

xviii[xviii].. CAMELS is an acronym for a bank performance measurement system. The six measurements are Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. The last measurement was added in December 1996; prior to that time, banks had a CAMEL rating. Regulators give each area of measurement a numerical score ranging from 1 (least concern) to 5 (greatest concern). Additionally, regulators give a bank an overall or composite score on the same 1 to 5 basis.

xix[xix].. "Response to Questions Submitted by The Honorable James A. Leach" appended to an October 12, 1999, letter from FDIC Chairman Donna Tanoue to Rep. Leach, pp. 1-3.

xx[xx].. Ibid., pg. 3.

xxi[xxi].. "Material Loss Review: The Failure of BestBank, Boulder, Colorado," Office of the Inspector General, Federal Deposit Insurance Corporation, Audit Report No. 99-005, January 22, 1999, pg. 6.

xxii[xxii].. "OCC Response to Letter from Chairman Leach Concerning First National Bank of Keystone, Keystone, West Virginia," appended to an October 12, 1999, letter from Comptroller of the Currency John D. Hawke, Jr., to Rep. Jim Leach.

xxiii[xxiii].. "Agreement By and Between The First National Bank of Keystone, Keystone, West Virginia, and the Office of the Comptroller of the Currency," May 28, 1998.

xxiv[xxiv].. Federal Deposit Insurance Corporation, 1998 Annual Report, table on pg. 120.

xxv[xxv].. "The FDIC Quarterly Banking Profile," Federal Deposit Insurance Corporation, Second Quarter 1999, bottom table on pg. 19.

xxvi[xxvi].. For the second half of 1999, 94.0% of BIF-insured institutions, holding 97.2% of BIF's assessable deposit base, and 92.4% of SAIF-insured institutions, holding 95.7% of SAIF's assessable deposit base, will pay no explicit deposit insurance premium. AThe FDIC Quarterly Banking Profile," Federal Deposit Insurance Corporation, Second Quarter 1999, top and middle tables, pg. 19.

xxvii[xxvii].. FDIC-insured deposits equaled 74.7% of total domestic deposits at the end of 1998 ($2.85 trillion/$3.814 trillion), as calculated from The FDIC Quarterly Banking Profile, Fourth Quarter 1998. The FDIC earned approximately a 6% yield on its Treasury securities in 1998. Assuming a minimum reserve ratio of 1.25%: .0125 x .06 x .747 ' 5.6 basis points.

xxviii[xxviii].. Barancik, Scott, "FDIC Staff is Developing A System to Make Some Well-Capitalized Banks Pay," *American Banker*, January 4, 1999, pg. 2.

xxix[xxix].. _____, "FDIC Puts Off Charging Riskier Banks More," *American Banker*, February 16, 1999, pg. 4.

xxx[xxx].. "Response to Questions Submitted by The Honorable James A. Leach" appended to an October 12, 1999, letter from FDIC Chairman Donna Tanoue to Rep. Jim Leach, pg.6.

xxxi[xxxi].. Ibid., pg. 7.

xxxii[xxxii].. The shortcomings of government banking regulation are the real moral hazard in federal deposit insurance, as discussed in "Regulatory Moral Hazard: The Real Moral Hazard in Federal Deposit Insurance," cited in footnote 1.

xxxiii[xxxiii].. Wald, Matthew L., "Canada's Private Control Towers," *The New York Times*, October 23, 1999.

xxxiv[xxxiv].. Stern, Gary, "A Response to Critics of Market Discipline," *The Region,* a publication of the Federal Reserve Bank of Minneapolis, September 1999.

xxxv[xxxv].. Ely, Bert, "Surprise! Congress Has Just Enacted What Amounts to a Core Banking System," *American Banker,* September 21, 1993.

xxxvi[xxxvi].. "Summary of Provisions in the Gramm-Leach-Bliley Act (S. 900)" posted to the website of the Senate Banking Committee over the weekend of October 23-24, 1999.

xxxvii[xxxvii].. The cross-guarantee concept has been described in numerous articles and papers, notably "Better Banking for America: The 100 Percent Cross-Guarantee Solution," by Rep. Tom Petri and Bert Ely, *Common Sense,* Fall 1995, pp. 96-112. Mr. Petri has introduced comprehensive legislation to enact the cross-guarantee concept, most recently in 1996 as H.R. 4318. Various articles and papers about cross-guarantees are posted at http://www.ely-co.com.