What can be done to reduce the risk of future banking crises?

The New Safety Net

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On the heels of the banking and thrift crises of the 1980s and early 1990s, the United States dramatically reformed the federal government safety net for depository institutions. Lawmakers intended the reforms to reduce both the probability and cost of such crises in the future. Indeed, economists have blamed poorly designed safety nets for contributing to the outbreak and high cost of banking crises in the United States and around the world. Has the latest round of U.S. banking reform, which began in 1991 with the enactment of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), ensured the stability of U.S. banks? Or is there still much to be done to reduce the probability and cost of future bank and financial crises?

THE SAFETY NET

The United States' government-established banking safety net is comprised of three distinct components:

- Deposit insurance provided by the FDIC.
- Lender-of last-resort (LLR) facilities provided by the Federal Reserve System.
- The Federal Reserve's guarantee of daylight overdrafts for large-dollar interbank transfers on Fedwire.

Although the safety net operates through the banks, its purpose (with very rare exception) is to protect bank depositors (and, possibly, other creditors) but not bank shareholders.

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Deposit insurance The Banking Act of 1933, among other things, introduced federal government deposit insurance. The act was intended to improve bank safety at a time of massive bank failures and fears of a banking system breakdown.

Between 1929 and 1933, the number of commercial banks declined from about 25,000 to about 15,000, mostly because of failure. In addition, to aid banks still operating, many states and even the federal government (for one week in March 1933) declared "bank holidays" during which most, if not all, bank activities were suspended. By effectively "freezing" deposits, the so-called holidays caused as much disruption as good.

Enactment of national deposit insurance was not easy. Since before the Civil War, a number of states had provided or sponsored deposit insurance and had, on the whole, experienced bad results. Bank failures often increased, and the resulting losses drove many of the insurance funds into insolvency. On the federal level, lawmakers had unsuccessfully introduced some 150 deposit insurance bills before the 1933 act. Most of those bills met strong opposition from large banks. But small, unit banks (banks without branches), which failed more frequently, favored the efforts as a way to help them compete with larger banks. To gain the support of larger banks, the writers of the 1933 act included provisions prohibiting interest on demand deposits and imposing ceilings on the interest rates payable on time deposits. The act also slightly expanded branching authority, which also benefited large banks.

The Banking Act of 1933 contained two deposit insurance plans: a temporary emergency plan and a permanent plan that was scheduled to go into effect by July 1, 1934. Under the temporary plan, a new, federally chartered corporation, the Federal Deposit Insurance Corporation (FDIC), covered deposits up to $2,500. The permanent plan was to broaden that coverage to protect 100 percent of the first $10,000 of a deposit, 75 percent of the next $40,000, and 50 percent of the remainder.

Under the temporary plan, all insured banks were required to pay assessments equal to one-half of one percent of their insured deposits, with one additional assessment if needed. The permanent plan provided for an initial

BEFORE THE SAFETY NET: Anxious depositors wait outside a Depression-era bank.

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assessment of one-half percent with unlimited subsequent assessments of one-quarter percent.

However, the permanent plan never went into effect; it was superseded first by a 1934 act that extended the temporary plan to 1935, and then by the Banking Act of 1935 that contained a new plan. The 1934 extension of the temporary plan and the 1935 new plan both provided full coverage for deposits up to $5,000.

In theory, the superseded 1933 permanent plan would have made the banking industry responsible for FDIC losses because the potential assessments on insured banks were unlimited. The federal government was neither explicitly nor legally obligated to cover any FDIC losses that were not covered by assessments on the banks themselves.

However, the Banking Act of 1935 established a different structure that remained in effect until the 1991 enactment of FDICIA. The structure provided for an annual assessment on all insured banks equal to one-twelfth of one percent of their average total deposits, payable in two installments. Lawmakers, in passing the act, apparently intended to permit the accumulation of a substantial fund for the FDIC to use to cover future losses. However, by limiting the assessments on insured banks to a maximum annual amount, the 1935 act effectively placed the risk of catastrophic loss on the FDIC and, hence, on the federal government. A similar structure applied to the Federal Savings and Loan Insurance Corporation (FSLIC), established in 1934. If institution failures ever exhausted either insurance fund, the respective industry had no obligation to replenish it. That is exactly what occurred in the late 1980s and early 1990s, when a large number of thrift and bank failures exhausted both the FSLIC's and the FDIC's funds. In that case, the federal government had to recapitalize the FSLIC, which by then had been reformed as the Savings Association Insurance Fund (SAIF) under the control of the FDIC.

Besides assisting smaller banks, lawmakers intended deposit insurance to protect the liquid assets of small, unsophisticated depositors and to prevent depositor runs that Congress thought might threaten both the solvency of individual banks and – in severe cases – initiate a general run to currency. Such a run could cause a downturn in the macroeconomy by reducing aggregate reserves in the banking system, triggering a larger contraction in money and credit, and seriously disrupting the payment system.

Through time, the perceived purpose of deposit insurance implicitly expanded to include all depositors and, at times, other creditors at banks that were viewed as too impor-

tant to fail for economic or political reasons. At the same time, the public increasingly came to perceive the government as ultimately responsible for rescuing the insurance funds if and when the banks and thrifts were unable to finance all the losses. However, until the 1990s, there was no legislation that explicitly recognized those changes in perception, although legislation up to that time had increased insurance coverage to $100,000. Thus, much of the expanded role of deposit insurance was ex ante conjectural, but, to the extent that it shaped expectations and behavior, it often became ex post de facto.

Lender of Last Resort and Fedwire Finality The Federal Reserve System was established by the Federal Reserve Act of 1913, partially in response to a perceived need for a lender of last resort. In theory, a lender of last resort (LLR) would enable otherwise healthy banks to continue operations in the face of a liquidity crisis caused by the public's increased demand for cash — presumably at a time of financial panic. Initially, such assistance was provided solely to targeted individual banks through the discount window, but in more recent years it has also been provided to the financial markets in general through open market operations.

LLR facilities are widely perceived as intended to protect the financial system as a whole, not individual banks. A 1971 internal Federal Reserve Committee report to the board of governors confirmed that role:

> The system should not act to prevent losses and impairment of capital of particular financial institutions....[Rather] the System should intervene... only when liquidity pressures threaten to engulf whole classes of financial institutions whose structures are sound and whose operational impairment would be seriously disruptive to the economy.

All discount window lending is not LLR related. Federal Reserve regulations identify four appropriate uses of the window:

- **Adjustment credit** – short-term credit to meet temporary bank requirements for funds or to cushion persistent deposit outflows.
- **Seasonal credit** – to assist smaller depository institutions on a longer-term basis in meeting regular seasonal needs for funds unavailable from regular sources.
- **Extended credit** – assistance to depository institutions when credit is not available from other sources to meet exceptional needs of the individual institutions, such as sustained depository drains and impaired access to money markets.
- **Emergency credit for others** – advances to individuals, partnerships, and nondepository corporations under unusual and exigent circumstances when credit is not otherwise available.

Only the last two types of credit extensions represent LLR safety net operations. The first two deal primarily with perceived structural market imperfections that primarily affect smaller banks and do not have broader implications.

The Fed introduced Fedwire, which connected all member banks to all Federal Reserve banks, in the 1920s. But Fedwire did not become a meaningful part of the safety net until the 1970s. Fedwire permits banks to make electronic (nonpaper) real-time large-dollar payments of funds by transferring among themselves funds that they have on deposit at the Federal Reserve banks. Under Federal Reserve Regulation J, all transfers are final and irrevocable when the Fed credits the reserve account of the receiving bank. Starting in the 1970s, the banks' use of Fedwire increased sharply when the Fed removed its charge for using the wire and the comptroller of the currency ruled that Fed funds were exempt from the regulatory ceiling on bank loans to any one borrower. At the same time, banks increasingly began to overdraw their balances at the Fed during the day.

Because the Fed did not monitor the transfer flows in real time, and computed a bank's balance only at the day's end, the Fed gave little attention to banks overdrawing their accounts during the day as long as there was no deficit at the end. The Fed's policy of finality, however, exposed it to potential losses if a paying bank were unable to meet its obligations at the end of the day. The Fed's assumption of the receiving bank's risk implicitly made the large dollar payment system embodied in Fedwire an important component of the safety net.

BENEFITS AND DRAWBACKS

Despite the widespread doubts and warnings at the time of enactment, federal government-sponsored deposit insurance was widely acclaimed as a great success for almost 50 years. Bank failures from 1934 through the 1970s were few, runs on individual banks rare, and general runs into currency virtually nonexistent. Indeed, in their classic 1963 book, *A Monetary History of the United States, 1867-1960*, Milton Friedman and Anna J. Schwartz wrote,

> Federal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic, and, indeed in our view, the structural change most conductive to monetary stability since state bank notes were taxed out of existence immediately after the Civil War.

But things changed abruptly in the early 1980s. The flaws of the existing deposit insurance structure became increasingly visible in the form of risk-taking moral hazard behavior by the banks and poor agency behavior by the regulators. The deposit insurance structure adopted in 1935, which effectively placed the risk of catastrophic loss on the FDIC and the federal government, reduced the incentives of well-run banks to monitor and control risk-taking by badly managed banks. Although they could protect themselves against loss by limiting their direct exposure to badly managed or risky banks, their annual obligation to the FDIC remained the same — one-twelfth of one percent annually — whether or not the FDIC's insurance fund was in surplus or deficit. The only change to this obligation came in times of large surpluses, when

the FDIC provided rebates on additional premiums.

The introduction of insurance also reduced the incentive of most depositors to monitor their banks for risk — a deficiency that was compounded by the fact that the banks were not charged risk-related insurance premiums that would have offset the reduced vigilance of their depositors. Insured banks, accordingly, had strong incentives to take risks. As a result, they increased the risk exposure of their asset and liability portfolios and reduced their capital ratios. At the same time, the decreased likelihood of the loss of funds by depositor runs permitted economically insolvent or near-insolvent banks to continue operations and even to grow by expanding their deposit bases.

In effect, the safety net transferred much of the responsibility for disciplining banks from the marketplace to the regulators, who often showed themselves to be poor agents for their healthy-bank and taxpayer principals. As a result of political pressure or a reluctance to take unpopular or controversial steps, the regulators often engaged in forbearance, delaying the imposition of sanctions on troubled banks and the resolution of insolvent institutions. In the absence of strong market discipline, governments were also able to use banks to pursue their own economic, political, and social agendas. This sometimes involved the use of credit allocation that both misallocated resources and increased banks' risk exposure, often resulting in eventual losses.

The safety net transferred much of the responsibility for disciplining banks from the marketplace to the government regulators.

The combination of weak market and regulatory discipline permitted insured institutions to operate with higher leverage than the market would have permitted in the absence of insurance. But through the 1970s, the adverse consequences were not generally visible, primarily because the banks were sheltered (by relatively primitive telecommunications technology and favorable regulation) from strong competition both among themselves and with other types of financial institutions. That helped to increase the franchise values of banks and had some limiting effect on their risk taking.

Through time, however, advances in technology reduced the effectiveness of protective regulations and ultimately forced their removal. But the resulting deregulation in the 1970s and 1980s was often poorly implemented and accompanied by reduced monitoring and supervision by the regulatory agencies. This permitted some institutions to increase their risk exposures substantially and to engage in what was essentially fraudulent behavior. Many banks, including some very large banks, found themselves with insufficient capital to absorb losses from increased competition, improvident risk taking, and a more volatile macroeconomy. The last included the bursting of asset price bubbles in real estate, energy, and energy-related products, which triggered a series of steep regional recessions. Those started in the energy belt among the southwestern states and, from 1985 through 1993, traveled to New England, the mid-Atlantic, and eventually to California. In addition, there was a national recession in 1990 and 1991.

During that period, regulators often failed to resolve insolvent institutions promptly, and occasionally even denied the existence of the problem. The possible reasons for that behavior were many: regulators were unprepared and overwhelmed by the large number of insolvencies, they thought the insurance funds were inadequate to resolve all insolvencies, they were concerned about calling additional attention to the problem and igniting widespread public fear and runs, they bowed to political pressures from the banking industry or Congress, and they feared stains on their own records. Insolvent banks continued to operate by implicitly substituting public capital (the perceived government guarantee) for private capital. But as the magnitude of the problem increased, the cost of continued regulatory delay became more widely visible. The government's large implicit and hidden liability, equal to much, if not all, of the negative net worth at insolvent insured institutions, became clearer to the public. Increased transparency and public concern forced the regulators to accelerate the process of formally recognizing and resolving insolvencies. The high cost of the debacle also strengthened attempts to reform the insurance structure, so as to decrease the potential for future moral hazard behavior by banks and poor agency behavior by regulators.

As in many other countries, it became evident that U.S. deposit insurance had become a classic example of the well-known time inconsistency problem in public policy. Favorable immediate or short-term effects were more than offset, in time, by later unfavorable long-term effects.

Lender of last resort and fedwire finality The other two components of the safety net encountered similar, although less serious, problems. According to both the theory of LLR lending and Federal Reserve statements, emergency lending through the discount window is restricted to solvent banks that are experiencing liquidity problems. For example, the 1971 Federal Reserve Committee report argued that, in providing emergency lending to member banks as lender of last resort,

> The Federal Reserve will be prepared to give prompt and sympathetic consideration to providing the needed credit assistance to a troubled member bank, after having obtained the assurance of the chartering authority that the bank is solvent.

A similar consideration was applied to emergency credit assistance to others. Emergency credit should not be extended to insolvent institutions.

Nevertheless, the Fed frequently continued to use its LLR facility to provide support to economically insolvent institutions through the discount window. A 1991 congressional study reported that, in the late 1980s, some 90 percent of the 418 banks that had received extended emergency credit through the Fed discount window subsequently failed. Moreover, almost all of those loans went to banks that had received the worst possible CAMEL (Capital, Assets, Management, Earnings, and Liquidity) ratings by the regulators, so the Fed knew the borrowing banks' precarious financial position. Recipients of Fed discount window assistance included a number of large banks that eventually failed, such as the Franklin National Bank, the Bank of New England, the Continental Illinois Bank, and the First Republic Bank of Texas. In part, those banks used Fed discount window support to fund withdrawals by uninsured depositors. Since Fed lending is fully collateralized, it effectively stripped the banks of some of their remaining good assets. That increased the eventual cost of the failure to the FDIC and the remaining unprotected depositors.

At the same time, until 1986, the Fed permitted bank users of Fedwire to incur unlimited daylight overdrafts free of charge. As noted above, that shifted the cost of defaults away from receiving banks, to the Fed. Because the Fed's operating profits are ultimately transferred to the Treasury Department, that effectively put taxpayer funds at risk. It also reduced the need for transacting banks to monitor each other. Through time, as daylight overdrafts increased in volume and value, the Fed first imposed per-bank exposure ceilings in March 1986 and then interest charges in April 1994. But the interest rates charged have been, and continue to be, far below market rates; they have only slowed, but not reduced, the growth in overdraft volume. Indeed, in 1995, the Fed cut in half a long-scheduled increase in the interest charge because Fed officials feared a loss in volume to CHIPS, a private network competitor.

Thus, similar to deposit insurance, the Fed's readiness to provide underpriced support to troubled institutions through its LLR and Fedwire facilities has expanded the safety net and reduced the need for market discipline. That, in turn, has contributed to the fragility of the banking system, the subsequent high number of bank failures, and the high cost of banking crises.

RECENT REFORMS

The banking and thrift crises of the 1980s increased awareness of the inefficient and costly structure of the existing safety net. That, in turn, motivated reforms to improve the structure by reducing moral hazard and poor agency performance. The long-run cost of achieving the purposes of the safety net under the Depression-era structure was far too high.

Although lawmakers and other federal officials enacted several small, early reforms, the first large grouping of important reform measures was enacted in FDICIA at the end of 1991. At that time, the high and rapidly rising costs of resolving the financial crisis of the savings and loan industry and the resulting insolvency of FSLIC became increasingly visible. There was also widespread fear that commercial banks and the FDIC might go down the same costly path.

Deposit insurance The enactment of FDICIA in 1991 radically changed the structure of the deposit insurance system that had been adopted in 1935. As noted above, the 1935 plan placed a limit on the assessments that could be required of insured banks. During the long period of banking tranquility after 1935, the fixed assessments permitted the FDIC to accumulate a substantial insurance fund, but placed the risk of catastrophic loss ultimately on the federal government.

In effect, FDICIA and DIFA shift the risk of losses away from a safety net supported by government and toward the insured banks.

The structure adopted in FDICIA in part harked back to the unimplemented "permanent" plan in the 1933 Banking Act. That plan provided for insured banks to pay additional assessments as needed by the FDIC, without upper limit. The potential effect of that arrangement was to place some of the risk of catastrophic losses on the banking industry, because the FDIC would have been empowered to collect additional assessments as needed to cover losses and maintain solvency.

FDICIA reverted to that structure. It authorizes the FDIC to set semiannual assessments on insured banks "when necessary" and without explicit limit as to amount, in order to maintain a "reserve ratio" equal to at least 1.25 percent of estimated insured deposits. If the reserve ratio declines below the designated amount, the FDIC can set assessment rates "that are sufficient to increase the reserve ratio… to the designated reserve ratio not later than one year after such rates are set." Because the premiums are charged on all deposits at domestic offices while insurance covers only the first $100,000 in any account, large banks pay proportionately higher premiums than small banks and may be expected to be most sensitive to premium increases. The Deposit Insurance Funds Act (DIFA) of 1996 amended FDICIA to require that, if the reserve ratio rises above 1.25 percent, premiums may be charged to only the riskiest insured institutions. Currently, less than 10 percent of all insured institutions holding less than five percent of all domestic deposits are assessed premiums. Thus, with the fund effectively fixed at a specific percent of bank deposits, losses will have to be paid

by the remaining insured institutions on a pay-as-you-go basis. In effect, there is no "fund."

To deal with the possibility that catastrophic losses might deplete the FDIC's resources faster than it can collect assessments from the banking industry, FDICIA provides the FDIC with a $30 billion line of credit at the Treasury. Its borrowings under the line become a liability of the borrowing insurance fund and the Secretary of the Treasury may not make the loan unless the FDIC demonstrates that its income from assessments will be sufficient to amortize the outstanding principal and pay the interest on the loan. Federal statute authorizes the FDIC to impose special assessments on insured institutions "to repay amounts borrowed from the Secretary of the Treasury."

In effect, the new structure places the risk of losses on insured banks rather than on the federal government. The FDIC effectively becomes a collection agency and an intermediary between the banking industry and the U.S. Treasury. Thus, it is no longer totally accurate to describe insured deposits at banks as "federally insured." The resources of the banking industry stand behind the FDIC.

The deposit insurance law does retain language that appears to suggest a continued federal government obligation. For example, the 1989 Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) requires each insured bank to display "a statement that insured deposits are backed by the full faith and credit of the United States Government." That language, which preceded the FDICIA reforms, is not by itself a full faith and credit guarantee of insured deposits; at most, it creates a moral obligation of the federal government. As a practical matter, the obligation would exist anyway, because it is not conceivable that the federal government would permit insured depositors to suffer losses in a government-sponsored deposit insurance scheme. However, after FDICIA, the federal government has no obligation to make any payments to insured depositors unless and until the resources of the banking industry as a whole are fully exhausted. Further, the government has no obligation—moral or otherwise—to make payments to uninsured depositors or other creditors.

The new FDICIA structure provides incentive for well-managed banks to monitor and control the risks taken by other banks. That is because the well-managed banks are responsible for losses caused to the deposit insurance fund. However, the law does not yet provide banks with the tools to implement that incentive.

Restrictions on daylight overdrafts on Fedwire As noted, since 1986 the Federal Reserve has required users of Fedwire both to apply caps on individual bank credit exposures to other banks and to pay interest on daylight overdrafts. The current interest charge on such overdrafts is 0.38 percent. The introduction of those two measures has decreased the relative volume of daylight overdrafts somewhat and thereby also the risk exposures of banks to other banks.

Restrictions on too-big-to-fail The safety net has suffered mission creep over time. Increasingly, it protected de jure uninsured as well as insured depositors, and even other creditors of banks considered by the regulators as "too big to fail." In reality, large banks were permitted to fail, but some or all uninsured stakeholders were frequently protected. That is, the banks were "too big to impose losses on uninsured depositors." In 1984, the Continental Illinois Bank of Chicago was the last insolvent bank that was not legally failed at the time of resolution. All later-resolved banks up to the enactment of FDICIA were failed, but uninsured depositors and, at times, other creditors — including Fed funds sellers and depositors at overseas offices — were protected against loss.

At the same time, federal officials progressively reduced the definition of "big" so that, in 1990, it encompassed banks as small as the National Bank of Washington (D.C.), which had assets of only $2 billion and was only the 250th largest bank in the country. Although losses to its uninsured depositors were unlikely to trigger repercussions elsewhere, the bank's owners and large depositors were politically well connected. The bank was "too well connected to fail."

The resulting question of fairness in the disparate treatment of large depositors at small and large banks, as well as the increasingly costly moral hazard and agency problems for large banks, resulted in the inclusion of restrictions on "too-big-to-fail" in FDICIA. FDICIA prohibited the FDIC from protecting uninsured depositors in resolutions that resulted in losses to the FDIC, but provided a systemic risk exemption in emergencies when the failure to protect the depositors "would have serious adverse effects on economic conditions or financial stability." But invoking that exemption requires the written recommendation of two-thirds of the FDIC's board and the Federal Reserve's board of governors, and the approval of the secretary of the treasury in consultation with the president of the United States. The secretary of the treasury must then file a written notice with Congress, stating the basis for the determination.

Moreover, if the FDIC suffers a loss in the process of protecting the uninsured depositors at very large banks, it must recover the loss through a special assessment on all other banks, according to their total assets. That should provide another incentive for the larger banks to lobby against assistance to their financially strapped competitors. In addition, the General Accounting Office (GAO) must prepare a written report evaluating the basis for the determination and its impact on the behavior of other banks and uninsured depositors. Those provisions are likely to make regulators more cautious in invoking the too-big-to-fail exemption. Indeed, since the enactment of FDICIA, no bank has been declared too big to fail, although no really large money center banks have failed. The Depositor Preference Act of 1993 has further decreased the likelihood that non-deposit creditors (e.g., Fed funds sellers or depositors at overseas offices) would be protected by subordinating their claims to uninsured depositors at domestic offices and the FDIC.

Restrictions on Federal Reserve LLR lending Evidence that the Federal Reserve had lent widely through the discount

window to insolvent and near-insolvent banks in the 1980s, increasing the cost of the banking crisis, led to the inclusion of provisions in FDICIA that would restrict Fed discount window lending. Statute limits such lending to no more than 60 days in any 120-day period, unless the bank's primary regulatory agency or the chairman of the board of governors certifies in writing after an examination that the bank is viable.

Moreover, if additional credit is extended to a bank that is classified as "critically undercapitalized" beyond five days after the bank is so classified, and the bank subsequently fails with a loss to the FDIC, the board of governors is required to reimburse the FDIC in an amount equal to the lesser of (1) the loss that the Fed would have suffered on the increases in the amount of loans made in the absence of any collateral pledge (in effect, as if it were an unsecured loan), or (2) the interest the Fed received on such an increase in lending. The latter is almost always sure to be smaller and, thus, be the Fed's cost of lending to failed banks. Any loss suffered by the Fed in lending to failed banks must be reported to Congress no later than six months after incurring the liability.

Curtailment of moral hazard behavior by banks FDICIA attempts to reduce excessive bank risk-taking by both increasing the cost and decreasing the opportunity for moral hazard behavior. Because weak or insolvent banks have an incentive to "gamble for resurrection," FDICIA attempts to reduce both the probability that a bank will approach insolvency and the length of time it may operate in that condition. Regulators are required to impose timely and progressively harsher sanctions as a bank's capital-asset ratio deteriorates. Regulators may also impose additional discretionary sanctions to increase the cost of declining performance and encourage the bank to mend its ways and return to profitability. The length of time a bank may operate in weak condition is reduced both by the cost of the sanctions to the bank and a "closure rule" that requires the regulators to resolve an institution in a timely fashion once its equity capital-asset ratio has declined below a low positive tripwire value.

Curtailment of poor agency behavior by regulators The mandatory timely action required of regulators as a bank's capital declines is also intended to prevent or limit poor agency behavior by making it difficult for regulators to delay corrective action. Lawmakers designed the sanctions to be the same, or similar, to sanctions that the market imposes on financially deteriorating firms not protected by a safety net. That way, regulatory discipline standing in the shoes of market discipline will mimic market discipline. The regulatory regime promotes rules to equal standing with discretion. By calling attention to the threat of harsher mandatory sanctions if improvements do not occur, the regime strengthens bank responses to discretionary sanctions and increases their effectiveness.

FUTURE REFORMS

Despite lawmakers' efforts to reform the safety net, there are many improvements that can be implemented to further improve bank security. Below, we list several areas that we believe still need to be reformed.

Deposit insurance As noted above, the FDIC and the federal government no longer bear the risks of bank failures associated with deposit insurance, unless the banking system's resources are totally exhausted. The risks now fall on solvent insured banks. The FDIC remains as the principal policy-making institution, and as an intermediary between the banks that pay for the losses and the depositors who receive insurance coverage. However, as government funds are not likely at risk, the new structure reduces the FDIC's incentive to prevent losses. Although FDICIA sets up mandatory requirements for action by regulators once specific data on banks become available, recent events have shown that the regulators can, and do at times, defer action. Without strong incentives to act on a timely basis, the regulators may not be prepared to take the difficult steps mandated by FDICIA.

The most effective cure for that problem would be to place the responsibility for implementing FDICIA on an agency responsible to the insured banks — the ultimate payers in the current system — rather than on an agent responsible to Congress. The FDIC could remain as a general oversight body, in much the same way that the Securities and Exchange Commission oversees the activities of the National Association of Securities Dealers in implementing securities laws and regulations.

Such a reform would permit banks to establish a truly risk-based premium system that imposes significantly higher costs on those banks that exhibit risky behavior whenever the fund declines below 1.25 percent of insured deposits. Alternatively, lawmakers could modify the current legislation to remove the statutory ceiling of 1.25 percent and permit increases in the fund commensurate with banks' risk exposure. That would permit more effective use of risk-based premiums.

Although Congress has authorized the FDIC to establish a risk-based insurance premium, the agency did not implement the steeply graduated structure that would be necessary before the statutory maximum reserve ratio was reached and premiums on most banks suspended. That failure should not surprise us, given the political opposition such a system would engender from weaker banks and the weak incentives of the FDIC to press forward. On the other hand, insured banks that will ultimately bear the losses associated with a poorly administered deposit insurance system have strong incentive to establish and enforce an effective risk-based premium, as well as other mechanisms for controlling excessive risk-taking by their fellow insured banks. For more than 50 years, such a structure of self-monitoring and regulation has functioned well in the securities industry, where the National Association of Securities Dealers (NASD)—an industry group to which all securities brokers and dealers must belong —bears the principal responsibility for investigating the conduct of members and enforcing both the securities laws and the association's Rules of Fair Practice.

One of the most effective and necessary future reforms of the U.S. deposit insurance system would be to change the law to permit the banking industry itself to gain some control of the liability placed on insured banks by FDICIA. Under such a structure, the FDIC could remain as the prima facie insurer. Of course, in such a structure, it would be necessary to prevent anti-competitive behavior and other abuse.

Lender of last resort FDICIA requires the Federal Reserve to pay interest to the FDIC when a bank to which it lent at the discount window fails with a loss to the FDIC. But the interest cost is very small and unlikely to deter Fed lending to troubled institutions — apart from embarrassment when the bank's failure and the Fed's loss are reported to Congress. Earlier draft versions of FDICIA had stronger penalties for Fed lending to banks that subsequently failed and produced losses to the FDIC. The Fed would have had to share in the loss because it would have been required to lend on a non-collateralized basis and to have equal standing in liquidation with uninsured depositors, the FDIC, and all other creditors. The directors of each reserve bank, who need to approve all discount window loans, would likely be more cautious in making loans under those conditions, rather than on a fully collateralized basis. Federal Reserve officials lobbied hard against that provision and succeeded in weakening it significantly to the current lower penalty. The initial reform should now be adopted.

In addition, except in unusual circumstances, Fed LLR support should be restricted to open market operations to the market as a whole. That policy in itself would eliminate the moral hazard consequences of Fed lending to insolvent or failing institutions. It would also quiet much of the controversy over whether large banks are considered too big to fail.

Fedwire Reducing the subsidy to the banks in the form of below-market interest rates on daylight overdrafts would diminish the Fed's risk exposure on Fedwire. The interest rate charged to banks that incur intraday overdrafts should be increased to market levels. In addition, the possibility of eliminating daylight overdrafts altogether, by transmitting only good funds (payment versus payment or payment versus delivery) on Fedwire should be explored. That would shift all the credit risk to the private sector, where it would be priced more efficiently. Financial markets in the United States today appear sufficiently broad and mature to develop an efficient and safe intraday market.

CONCLUSION

The safety net protecting commercial banks and thrift institutions in the United States contained a number of flaws that, over time, decreased rather than increased the stability of the financial system. In the 1980s, the U.S. economy and taxpayers incurred significant costs from that instability.

Lawmakers made several important improvements to the safety net through FDICIA in 1991, but much was left undone. It is now time to make the additional and necessary improvements in the safety net's structure. We recommend a number of reforms to discourage moral hazard risk-taking behavior by banks, and poor agency behavior by regulators.

Because the deposit insurance system in the United States is now effectively a private system with all costs borne by the member institutions until their resources are exhausted, control over its management should shift from the government to the banks and thrifts that are ultimately responsible for its losses. Among other benefits, the shift would create the necessary incentives for the introduction of a true risk-based insurance premium structure and impose greater discipline on troubled banks.

An agency responsible to the healthy banks, which would bear the costs of bank failures, would have significant incentive to implement and enforce the FDICIA's mandatory regulatory sanctions on troubled insured institutions. That would include timely resolution of insolvent institutions. The federal government should encourage the establishment of such an agency instead of continuing its dependence on the FDIC as currently structured, because it has few incentives to make politically difficult decisions.

Federal Reserve LLR liquidity should be provided almost exclusively through open market operations to the market as a whole and, if directed at individual institutions, should be provided only on an uncollateralized basis. Thus, the Federal Reserve will share in any loss resulting from the failure of the borrowing institution after Fed lending has kept it afloat. Finally, we recommend that the Fed charge a market rate on daylight overdrafts through Fedwire, and seriously explore eliminating daylight overdrafts entirely. R

READINGS

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