

Cato Institute Policy Analysis No. 54: Private Deposit Insurance: Stabilizing the Banking System

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Catherine England

Catherine England is a senior policy analyst at the Cato Institute.

Executive Summary

Banking regulation is at a crossroads unlike any since the 1930s. Fundamental decisions are being made that will shape the future of the financial services industry. At the heart of the issue is the role the federal government should play in the banking industry of the future.

Since Adam Smith published the *Wealth of Nations* in 1776, many individuals have been convinced that the laissez-faire approach to business is the soundest. Advocates of free markets generally argue that it is impossible for any government entity, however well intentioned, to direct an individual firm or an entire industry as efficiently as the impersonal, seemingly uncoordinated market is able to do. In making this case, three fundamental flaws are commonly associated with attempts to either protect or centrally control a particular sector of the economy.

The Problems of Government Intervention

The first of these is the "knowledge problem." A market generates a continuing stream of information through the price mechanism. Consumers' changing tastes and demands are reflected by the prices they are willing to pay for a product. The relative scarcity of the resources needed in production is constantly reflected in the prices businessmen must pay for labor and materials. In general, the importance consumers attach to the products of any industry is constantly reflected in the changing profits earned by manufacturers operating within various sectors, as well as through the costs to firms of raising both debt and equity capital.

No government agency, regardless of the extent of the resources placed at its command, can hope to gather the information that is automatically made available through the market process. By the time reports have been filed and processed in Washington or the state capitals, the information is already dated, as market conditions change daily if not hourly. And once the data are compiled, additional time is required before a decision can be made and implemented. As a result, firms within centrally directed industries must always lag behind their free-market counterparts in meeting the needs of consumers and responding to changing resource prices and conditions. This was one of the primary objections raised by opponents of the industrial policy plans introduced in 1982 and 1983. As Richard McKenzie argued:

To assume that government officials can, with reasonable clarity, assess the wants and needs and calculate acceptable trade-offs of those living across this enormous nation is to assume cognitive skills so far undemonstrated by any group of men or cluster of computers.[1]

The second of the problems generally identified as endemic to the central control of any industry is the "political problem." Any decision made through the political process is subject to the use of political criteria couched in "efficiency" rhetoric. Because government agents are rewarded through political means rather than market mechanisms, their decisions will reflect the outcomes of political power struggles rather than the desires of consumers as expressed through their purchases. As McKenzie explains:

Decisions . . . will be subject to the influence of politically powerful interest groups. Established firms will tend to be treated favorably because they exist, have supporting votes from their laborers and suppliers, and have the profits available to sway the allocation decisions. Because many new companies have only limited constituencies, they will tend to bear the burden of the subsidies given to established firms. Many potentially profitable firms will be thwarted by the potentially heavy tax burden that will be imposed on them if or when they emerge.[2]

These political and informational drawbacks lead to the third problem usually associated with government planning. Because the managers and employees of centrally directed industries are generally more interested in manipulating the political process than in serving their customers efficiently, industries that are heavily regulated or protected soon become unable to compete in dynamic markets. The existence of government protections often leads to inflated salaries and costs structures. Firms operating with extensive government regulation frequently lack the innovative nature enjoyed by companies subject to market pressures. Government officials prove unable to adapt regulations as rapidly as market conditions change, and managers and employees often exhibit a reluctance to keep pace with quickly changing conditions. In short, centrally directed industries eventually find themselves unable to compete in anything but a protected marketplace. When changing economic or technological conditions force on existing firms a recognition of new realities, these firms frequently find they lack the flexibility to survive in the new environment.

As a result of these considerations, many people agree in general with the statement by Sir John Cowperwaithe, financial secretary for Hong Kong from 1961 to 1971, explaining his government's "hands off" attitude toward business in Hong Kong:

For I still believe that, in the long run, the aggregate of the decisions of individual businessmen, exercising individual judgement in a free economy, even if often mistaken, is likely to do less harm than the centralized decisions of a Government; and certainly the harm is likely to be counteracted faster.[3]

Is Banking Different?

Even among those who preach the advantages of free markets in general, however, most believe that banking[4] is somehow an exception. It is widely argued by the most vocal advocates of less government involvement in the economy that banks are inherently unstable and, therefore, should be regulated. Supposed externalities and other "market failures" are presumed to create a situation in which government agents can ensure the long-term safe operation of the nation's banking system better than the market. Problems are acknowledged, but, it is argued, revising the rules or putting new people on the job will set things right again.

In fact, banking is just as subject to the pitfalls inherent in a heavily regulated, protected industry as any other sector of the economy. Indeed, the importance of the financial services industry to the country's overall economic health makes it crucial that public policy create conditions that will generate a smoothly operating, stable financial services industry. And contrary to conventional wisdom, extensive federal regulation of the banking sector robs it of the crucial ability to innovate and adapt to changing conditions.

In reviewing the history of banking regulation, Thomas Huertas noted:

A cartel carries within it the seeds of its own destruction. By attempting to mandate extraordinary profits for the industry as a whole, a cartel spurs each of its members to incur extraordinary costs . . . in order to increase their market share.[5]

But the story does not end there. Huertas goes on to explain:

No market is an island, and no cartel can prevent non-members from designing and offering close substitutes at a

competitive price. If these substitutes prove attractive to consumers, cartel members may find themselves in a situation where costs are abundant, but customers scarce. If this occurs, the rules of the cartel will not coddle members, but condemn them to extinction as business flows to the unregulated market. If its members are to survive, a cartel must adapt. . . . If the cartel does [not], it may spark the very crisis it was intended to prevent.[6]

In the financial services industry, recurring crises have required periodic regulatory adjustments to enable traditional depository institutions to retain their deposit bases. The crisis of the late 1970s, when banks, prevented by law from offering market rates of interest, lost many of their formerly reliable middle class depositors to money market mutual funds, was merely the most recent and severe.

But unlike earlier crises, when creating new deposit instruments or removing interest-rate ceilings on some deposits "solved" the problem, structural weaknesses apparent today are a result of regulations directly or indirectly restricting the loan portfolios of financial institutions. There is no more clear example than the savings and loan industry. Hopelessly saddled with their "safe" investments-- those long-term, fixed-rate mortgages--countless thrifts have watched their capital slowly dissolve until the Federal Savings and Loan Insurance Corporation was forced to redefine "adequate capital" and implicitly condone what is often called "creative accounting." If thrifts were required to reveal the market value of their assets and liabilities, federal authorities would be forced to place a good portion of the industry on its "problem" list and declare many thrifts insolvent.

Similarly, problems faced by banks in many farming states, while attributable to a wide range of factors, can be blamed in large part on an inability to expand geographically. As a result, many of these institutions have inadequately diversified earnings portfolios and are totally dependent on the health of the agriculture markets. Thus, a weak farm sector threatens the survival of a large number of these "agricultural banks."

It takes no more than the past 10 years of banking history to demonstrate that all the weaknesses generally associated with a centrally directed industry are applicable to banking. As the general price level became more unstable during the 1970s, banks found their customers increasingly unhappy with the services and interest rates depositories were allowed to offer. Rather than being able to adapt and innovate, however, banks and savings and loans were locked into their existing positions. Less regulated firms responded to bank customers' dissatisfaction with checkable accounts, and offered accounts requiring moderate minimum balances, paying market rates of interest, and fully backed by marketable securities. Further, technological advances allowed institutions enjoying more freedom to service consumers' needs by reaching across state lines. Yet even while many depository institutions were losing their core deposits to less regulated competitors, the public debate about change dragged on. Indeed, it was industry participants, unaccustomed to making pricing and marketing decisions and fearful of additional competition, that offered the greatest resistance.

The inevitable rigidity arising with government involvement makes dangerous the extensive regulation of any sector-- especially one in which conditions change as rapidly as they do in the financial services industry. By the time a crisis is recognized as such and the necessary steps are taken to implement a response, much structural damage already may have taken place. Consequently, the regulatory system presents one of the most serious threats to the future stability of the nation's banks and thrifts.

Three Myths about the Banking Industry

Despite the lessons of the past decade, there are still those who protest that a free market in banking would be even more dangerous than the existing regulatory system. It is necessary, therefore, to address three common myths about the banking industry.

Myth 1: The failure of one bank can cause a multiple contraction of the money supply as loans are recalled. Part of the economic hardship of the 1930s is believed to have been caused by the "call loans" outstanding when banks began to experience runs. Call loans allowed bankers to demand payment when they chose; as a need for cash arose, bankers sought to liquidate these loans in an effort to meet depositors' demands. Thus, there was a sharp contraction in the funds available to businessmen just when a general expansion was desirable.

The situation today is very different, however. If most loans are not already provided with a contractual schedule for

repayment or refinancing, they certainly would be under a free-market system, for debtors would undoubtedly attempt to assure the stability of their own sources of funds. Further, even with call loans, an immediate contraction in commercial credit, and hence the money supply, is not a necessary outcome. Loans are assets; as such, they can, theoretically, be sold to other lenders and/or investors to meet a bank's need for immediate cash.

There are, however, two regulatory conditions that inhibit the development of a private market for liquidity. The first is the Glass-Steagall Act, which limits the ability of bankers to deal in securities. With more freedom, markets might develop for mutual fund-type instruments that packaged small-business or business-inventory loans, for example, thus providing a secondary market for the loans generated by commercial banks. Given an active secondary market, prices for loans held in a bank's portfolio would be more easily generated, and cash would be more readily available.

The second obstacle is the Federal Reserve System's role as "lender of last resort." Existing law requires that the Federal Reserve Banks lend to depository institutions only on the basis of approved collateral. When the Fed is forced to step in, it gets first choice of available assets to back its loans. Thus, the Federal Reserve, the so-called lender of last resort, assumes very little risk in lending to troubled institutions,[7] and potential private creditors vanish because they are unable to adequately collateralize their loans. As a consequence, existing law limits the ability of private markets to deal with liquidity crises. If there is a role for a central bank, it surely is to act as a true lender of last resort, i.e., one that provides funds after private resources have been exhausted, rather than driving private sources of liquidity out of the market.

Removing these two legal obstacles would help provide an environment in which a bank facing a liquidity crisis could sell its assets to raise cash. Debtors might have to repay their loans to another creditor, but where loans were economically justifiable, there should be no shortage of credit, and there should be no significant contraction of the money supply.

Myth 2: Consumers are incapable of judging the quality of a depository institution. On its face, this statement may be true. But if so, the public's inability to adequately monitor depository institutions is a result of existing government intervention, not a justification for continuing it. Indeed, the current situation was foreseen by the New York Clearing House Association in 1918 when it protested an early bill to introduce national deposit guarantees:

Our people should be allowed to exercise wholesome discrimination in the banks they select, as well as in their business activities in general. Individuality and individual initiative are cardinal qualities of success, and these qualities would be impaired if people are to be taught by legislation to rely upon the government to help them in their ordinary individual transactions and in the exercise of ordinary judgment.[8]

The American Bankers Association echoed these sentiments in 1932 in its statement opposing the formation of the Federal Deposit Insurance Corporation:

[A federal guarantee of deposits] encourages unsound banking because there is no need for a depositor, knowing that his deposit is guaranteed, to discriminate between the bank which is carefully and prudently managed, and one whose management is not so prudent and which, with a deposit fund more easily augmented because of the guaranty, will make loans and investments regarded as unsafe by the more carefully managed bank.[9]

Consumers are currently "helpless" in the face of banking risks because politicians and bankers have made them so. Like the doctors of old, bankers and politicians are wont to pat depositors on the back and tell them, "don't worry; don't ask questions about the long-term impact of a particular policy; just let us take care of you." Despite the frequent assertion that policymakers "know best" and should have the power to impose their will on all the customers of the nation's financial institutions, however, consumers can and should take the responsibility for monitoring their depository institutions and imposing market disciplines. Undoubtedly, markets for information would develop to aid bank customers in differentiating among depository institutions. Bank-rating services could be expected to arise, just as money market funds are now ranked by experts who then sell their information. For those whose needs are not sophisticated enough to warrant direct subscription to such services, newspapers and magazines would probably be able to provide summaries of the relevant information, or financial reporters would develop their own measures of stability. As a report submitted to the governor of Idaho in 1924 concluded, "The future strength of our banking system must depend upon the development of sound, conservative banking, and discrimination on the part of the public

which will encourage such banking." [10]

Myth 3: The failure of one bank can cause a "domino effect" by spreading panic among consumers. This is the "banking is inherently unstable" argument. But in fact, very stable unregulated banking markets have existed in the past. When consumers have been unable to count on the government to oversee depository institutions, the market has historically devised very effective means of providing information to bank customers and disciplining unsound banking institutions. In these cases, depositors with much less information than a twentieth-century bank customer have proven able to discriminate between sound and unsound institutions, avoiding panics by driving unsound banks out of the market while rewarding prudently managed institutions with growth and stability. [11]

Further, given that existing regulations effectively attempt to force all banks into the same mold, there is some reason to be concerned when a failure reveals fundamental weaknesses at one institution. By removing regulations and allowing more diversity within the industry, by providing more market information and teaching bank customers to choose depository institutions on the basis of their strengths and the services they offer, deregulation should minimize the likelihood (if it does exist) of irrational depositor panics and unjustifiable runs.

The domino effect does present a potential threat where correspondent accounts are concerned. Without deposit insurance, however, smaller bankers placing correspondent accounts could be expected to more closely monitor the banks with which they developed such a relationship, perhaps demanding some additional form of security that would assure the safety of these deposits in the event of a failure.

In short, evidence is growing that the "inherent instability" traditionally associated with the banking industry is the result of continuing government involvement in it. Throughout U.S. history, the colonial and then the state and federal governments have attempted to use the nation's banks as instruments for implementing fiscal policy. [12] Even during the so-called free banking era, the states were heavily involved in regulating the banks and using them to create a market for state bonds. There are, therefore, few periods when free market banking has been put to the test.

Weaknesses in the Existing Deposit Insurance System

Before substantive banking deregulation can take place, the problems with the current system of federal deposit insurance must be identified. Basic weaknesses in today's deposit insurance system were noted a full century before the FDIC was established. In 1832, New York State introduced the idea of guaranteeing banks' creditors against losses with the Safety Fund Act. Each bank was required to contribute a specified portion of its capital to a fund that would be used to pay depositors and other creditors (primarily noteholders) if a member bank failed. Critics of the fund argued that the flat-rate contribution scheme would cause low-risk institutions to subsidize less prudent bankers. Furthermore, by eliminating the risk to which depositors and noteholders were subject, it was believed that the safety fund reduced the incentives of bank customers to monitor and discipline individual bank behavior. [13]

In 1918, a national deposit insurance system was proposed. Both the New York and Chicago clearing house associations opposed the legislation. In its statement, the New York association argued:

Should such a proposition be enacted into law, any national bank, however inexperienced its official managers; however limited its capital resources compared to the field of its activities; however given to risky adventure; however venturesome in buying deposits by paying excessive rates of interest; however wanting in the proven qualities which time and experience have shown to be indispensable to successful bank management, such a bank would, nevertheless, be able to solicit business, truthfully claiming that their deposits were protected . . . by the combined financial strength of the whole national system. [14]

Similarly, the Chicago association protested:

[The national guarantee system] proposes to tax good banks to support bad; to penalize honesty, ability, experience and training to compensate for incompetency, dishonesty and ignorance; it removes from banking the essential characteristic on which success in the business has been based, viz., the necessity for maintaining reputation for character, prudence, foresight, sagacity and conservatism. It proposes to place the reckless and speculative banks on the same level with the best managed and the most conservative, which will lead to competition calculated to drag all of

them down to the least meritorious.[15]

These sentiments were echoed in the 1930s during the debates over instituting a federal system of deposit insurance. A March 26, 1933 New York Times article was headlined: **BANKERS WILL FIGHT DEPOSIT GUARANTEE/ [PENDING MEASURE] WOULD CAUSE, NOT AVERT PANICS, THEY ARGUE/ BAD BANKING WOULD BE ENCOURAGED AND HONESTY DISCREDITED, SAY FOES.**

Despite these warnings the FDIC was established, modeled after the safety-fund systems developed 100 years earlier. But unlike earlier systems, the federal deposit guarantee fund was coupled with an extensive regulatory system defining the prices depository institutions could pay for deposits, the services they could offer, and the places where their services could be offered

As rapid technological innovation and the economic upheavals of the past decade have made banking deregulation a reality, questions have arisen about the sound operation of banks that operate with less federal oversight. Accordingly, attention has turned, once again, to the system of deposit insurance.

Recent economic literature includes a number of articles identifying the basic weaknesses of the deposit insurance system. Flat-rate insurance premiums not only force relatively safe banks to subsidize those more likely to fail, but they provide no disincentives to excessive risk taking. Furthermore, through arranging mergers for troubled institutions, federal insurers traditionally have provided 100 percent de facto protection to all depositors in banks of any size. Deposit insurance thus tends to remove the market mechanisms that discourage risk taking.[16]

Without regulation, then, the current system of federally provided deposit insurance would give bank managers and their stockholders an incentive to take on additional risk in an effort to improve their returns. As a result, there is widespread agreement with John Karaken's statement that "if insuring creditors of commercial banks in the way they have been insured since mid-1933 is justified, then so is regulation of so-called insured banks." [17]

Band-Aid Reform: Federal Variable-Rate Premiums

Despite widespread recognition of the moral-hazard problem inherent in the current system of deposit insurance, many analysts believe that adjustments in the present system can overcome the basic objections to it. Accordingly, William Isaac, chairman of the FDIC, has asked Congress for the authority to establish and administer risk-related insurance premiums with the goal of adding another weapon to the FDIC's arsenal for controlling risk.

Certainly, it should be possible to distinguish the nation's soundest banks from the weakest, and there is much to recommend a policy that charges premiums in line with the risk each institution represents to the insurance fund. But potential problems arise when a variable-rate premium is administered by a government monopoly.

Any federally administered system of variable premiums would have to be based solely on objective criteria, so that examiners could point to a statistical analysis when assigning a bank to a risk category.[18] While ratios and trend analyses can provide important clues to the risk associated with an institution, however, they cannot incorporate the most important variable in determining whether an institution will thrive or fail--the ability and experience of the bank's management.

Even if federal insurers could produce an objective formula that accurately reflected current risk, economic and technological changes would create a need to adjust that formula. At a minimum, there would be accountants, lawyers, and economists immediately at work searching for ways bankers could undertake additional risk without having it fully reflected in the official rating formula. But any adjustment could prove politically difficult, for it would of necessity place some institutions in riskier categories merely through a reinterpretation of existing information. It is likely, therefore, that substantive changes could be made in the means used to assign risk only in the face of overwhelming evidence. Thus, fine-tuning the system in an attempt to move it toward ever more accurate risk measurement would prove impossible for practical reasons.

Furthermore, federal insurers will always be subject to political pressures. Regulatory decisions about the relative risk of various loan categories--especially any attempt to project the future risks represented by a new type of loan-- would

be subject to substantial public debate, challenge, and review. Imagine, for example, how the loans by larger banks to Third World countries would have been handled under a system of variable-rate premiums. Even if FDIC examiners had identified these assets as potentially risky and had attempted to discourage additional exposure with higher premiums, chances are the banks would have appealed and won, as implicit public policy at the time encouraged Third World lending.[19]

Indeed, FDIC risk-related premiums conceivably could be used to promote social goals. The number of loans to women-owned businesses, for example, or mortgages to specified sections of a city could be given special treatment in calculations designed to assign risk.

As a result of political realities, federal insurers could be expected to raise premiums after an institution had encountered difficulties, thus potentially serving to exacerbate a bank's problems rather than prevent them.[20] Political pressures could be brought to bear to forgo higher premiums--especially in the case of the nation's largest banks--in the fear that such an adverse indication would generate panic among depositors.

Finally, and most important, the monopoly position of the federal deposit insurers should be considered. As Mark Flannery, a professor of finance at the University of North Carolina at Chapel Hill, and Aris Protopapadakis, an economist with the Federal Reserve Bank of Philadelphia, have noted: "the usual economic argument that a pricing system generally leads to efficient decisions does not apply when a single party unilaterally sets prices." [21] Similarly, in one of the earlier works examining the link between federal regulation and the current federal deposit insurance system, economists Kenneth Scott and Thomas Mayer pointed out that the current system has no way of determining the "correct" or optimal degree of risk taking. Without any market feedback, there is no mechanism through which to discover the amount of risk banks should be allowed to take on in their role as institutions facilitating the movement of financial capital throughout the economy.[22]

In sum, suggestions for reforming the system by introducing additional market and regulatory discipline are weakened by political realities and inflexibilities and a necessary reliance on objective criteria. These considerations create an insoluble dilemma as long as the assumption of federal deposit insurance is retained. The solution lies in turning to privately provided deposit insurance.

The Promise of Private Deposit Insurance

Imagine private deposit insurance funds that are not a creation of the states or their member institutions, but rather are separate entities, providing a service to banks and their customers. These private insurers need not arise from among the companies offering property and casualty insurance, however. Given current problems among property/casualty insurers, it is more likely that an entirely new industry would develop that specialized in insuring financial risks.

In attempting to survive in the long run while earning a profit, private insurers should have an incentive to monitor and exercise control over the institutions they insured, both to anticipate potential drains on the insurance fund and to limit the risk to which the fund was exposed. In doing so, private insurers might employ a number of tools. Variable insurance premiums could be assessed, for example, as frequently as the insurer felt was necessary to adequately monitor the changing behavior of bank managers and provide continuing feedback about acceptable and unacceptable practices. Ultimately, the insurer should have the power to remove a bank's management or cancel its insurance after due public notice.

It is important that a decision to cancel a deposit insurance contract be made public and that a specified lead-time be provided before guarantees are actually removed. The bank's customers would thus have an opportunity to decide whether to leave their deposits in the uninsured institution, accept whatever new deposit-guarantee program the bank's management secured, or withdraw their funds before existing insurance coverage was removed. If enough depositors decided to take their money elsewhere, the original insurer would be forced to take over the bank's operations and either liquidate or sell the institution.

Oversight by a private guarantor would be superior to regulation by federal authorities in several important ways. Chief among them would be the flexibility theoretically available to private insurers monitoring the behavior of bankers.

Unlike his federal counterpart, the private insurer could view each bank as a separate entity, taking into consideration subjective attributes that determine the degree of risk faced by any one institution. These attributes could include the skill, experience, and commitment of a bank's management and/ or the economic health of the community and region in which the bank operates. A wide range of possible considerations would make prudent oversight decisions vary among banks, but a private insurer would be able to apply rules tailored to the strengths and weaknesses of each institution.

In addition, by eliminating the need to submit for public comment every proposed change in their methods of measuring risks, private insurers could engage in a constant search for better ways to evaluate or control risks. Such ongoing experimentation with and reevaluation of risk-management techniques would make a more flexible system of oversight more likely to identify and avoid potential crises.

Any private insurer who systematically under- or overvalued the assets of his member institutions would soon be out of business. Under a system of privately provided deposit insurance, a banker who felt that he had been placed in an unjustifiably high risk category would have an alternative: he could seek the opinion of another insurer and, if offered a better deal, move his insurance account elsewhere.[23] On the other hand, any insurer who systematically undervalued the risk to which his fund was exposed would unnecessarily undermine his own profits and could eventually find himself unable to meet his obligations. Private guarantors would therefore have every reason to determine and acknowledge the "true" financial condition of a member bank; they would be likely to institute tougher accounting requirements, including carrying assets and liabilities at their market values.

Effective private deposit insurers should also escape another trap of federal insurers by making an effort to measure future risk, rather than assessing existing or past risk. There would obviously be extensive use of data describing an institution's current condition in assessing premiums and defining acceptable activities. But the broader goal among private insurers should be to identify and discourage potentially dangerous activities as they are undertaken, rather than waiting until problems actually begin to surface. For many private guarantors, this could be limited to seeing that a bank's portfolio is adequately diversified, that it is not overly dependent on the continued health of one sector of the economy. Other insurers might attempt to go further, however, developing models that predict the risk exposure of a particular bank in the event of higher interest rates or a stronger dollar. These insurers could be expected to play a more active role in shaping the portfolios and products of their insured institutions.

Competition would, however, force private insurers to set their overall requirements so as to allow member institutions to attract funds efficiently and invest them profitably. But the options and tradeoffs available to private entities improve the opportunities for mutually agreeable arrangements. A banker who wants to offer a new service of which his insurance fund initially disapproves may agree, for example, to raise additional capital or hold more reserves in exchange for being allowed to expand his operations. In the end, the interests of the insurance fund and the bank are, after all, the same. The stronger the institutions it insures, the stronger the insurance fund.

This reveals a primary difference between the focus of private guarantors and that of the federal insurance funds. The FDIC was established to protect the system as a whole. Its regulatory decisions and judgments when dealing with any particular institution are determined by what is best for the banking industry, rather than for a single bank. Furthermore, as the Continental bailout shows, federal regulators are further constrained to place short-term stability considerations ahead of long-term ones.

In contrast, decisions by one insurer would not be automatically applied, either explicitly or implicitly, to institutions insured by other guarantors or even to other banks insured by the same fund. Thus, private insurers could be expected to concentrate on maintaining the health and stability of each individual member bank or thrift institution. Ironically, this emphasis on maintaining healthy individual institutions should lead to a more stable system overall. Indeed, one advantage of private insurance is that it would make a 1930s-style failure less likely. By decentralizing decision making and allowing depository institutions to respond with more flexibility to changing economic conditions, private insurance would reduce the chance that any adverse event or series of events would devastate the entire industry. Increased diversity among financial institutions would help add stability system-wide.

Recent "Private" Failures

A number of so-called private deposit insurance funds have failed recently. The collapse of a private insurance fund for industrial banks in Nebraska was the first to receive national attention. In March, the Ohio Deposit Guarantee Fund (ODGF) was forced to close when its largest member, Home State Savings Bank, folded. Most recently, the governor of Maryland limited withdrawals from S & Ls insured by the Maryland Savings-Share Insurance Corporation (MSSIC) when these thrifts began to experience heavy withdrawals by nervous depositors who were concerned about the fund's ability to handle the simultaneous failure of two institutions.

But labeling the Ohio, Nebraska, and Maryland funds "private" deposit insurance is misleading. True, they were all "privately owned" in the sense that they were technically owned by their member institutions. But it is equally true, then, that the 12 regional Federal Reserve Banks are privately owned, for their stock is held by member banks. No one would suggest, however, that any of the regional Federal Reserve Banks is a private institution or that the regional banks are particularly responsive to market signals.

The privately owned state insurance funds were creatures of their state legislatures. The state legislatures established the rules under which they operated, defined acceptable and unacceptable activities for the institutions they insured, and basically made the state insurance funds subservient to the state banking commissioners. These institutions resembled the deposit insurance funds described earlier only in having the adjective "private" applied to them.[24]

The arguments that impel us toward private guarantees are therefore no less sound because the state-sponsored insurance funds have proved unstable. Federally provided deposit insurance is simply incompatible with a deregulated market, and without deregulation the banking system will jolt along from crisis to crisis until the entire structure collapses. But while a significant change in the status quo is necessary, it is as important to consider how that change will-come about as it is that the process be begun.

A Proposal for Introducing Private Deposit Insurance

Past advocates of private deposit insurance have proposed phasing in private insurance and establishing a target date by which the system should be operative.[25] But how far in the future should a target date be set? What if a crisis intervenes? What if the private insurance market fails to develop properly or consumers show significant dissatisfaction with the new system? What should one do with banks that are unable to obtain private insurance by the deadline?

A system of tiered deposit insurance would eliminate these ambiguities and questions by letting the market decide them. By deciding where to deposit their funds, consumers would determine the pace at which deregulation should proceed as well as whether federal deposit insurance should be continued

Suppose each bank could choose among several federal deposit insurance plans. At one extreme, a bank might be allowed to insure 100 percent of its deposits, extending explicit protection even beyond that available today. In return for providing its depositors with complete federal coverage, however, the bank would be subject to extensive government regulation: stringent capital adequacy requirements, high reserve requirements, limited investment opportunities, restrictions on its ability to branch, etc.

At the other extreme, a bank could be allowed to choose to provide no federal insurance to its depositors. In that case, it would be subject to no federal regulation of its activities--no federally established reserve requirements[26] or capital adequacy requirements, no restrictions on the types of business in which it could engage or the range of products it could offer, no limits on its branching ability,[27] and so on. Forgoing its federal deposit guarantees would leave a bank totally deregulated.

Obviously, such a plan should have intermediate options; initially, neither extreme would be particularly popular. These middle options could take a number of forms. They could represent a specified percentage of each deposit. For example, federal authorities could offer as intermediate choices to insure 75 cents, 50 cents, or 25 cents of each dollar deposited. It might be simpler, however, if tiered deposit insurance were patterned on the current system. Banks would be offered deposit guarantees that covered, say, the first \$100,000 of every deposit, the first \$50,000, or the first \$10,000. As the bank chose to provide less federal insurance coverage to its depositors, it would be subject to

correspondingly fewer federal regulations.

To facilitate the deregulation of institutions that chose less deposit insurance, current regulations would be divided into broad categories--branching restrictions, powers restrictions, capital requirements, and reserve requirements, for example. A bank choosing 100 percent federal deposit insurance would be subject to regulation in all these areas. A bank electing to provide federal guarantees for the first \$100,000 of deposits could escape geographic restrictions, for example, while an institution opting for \$50,000 federal coverage would face federal restrictions only in the areas of powers and adequate capital. Similarly, a bank electing to provide \$10,000 insurance would be required to satisfy federal regulators only with regard to capital-adequacy standards. A depository institution offering no federal guarantees would be totally deregulated.

Banks would, of course, be required to display information about the federal insurance plans they chose, so consumers could select their depository institutions with a full understanding of what federal guarantees were available. Thus, each banking customer could determine the mix of federal guarantees and services optimal for him before deciding where to place his deposits.

Banks offering the maximum federal insurance could cater to retirees, for example, or to smaller banks placing correspondent accounts and concerned primarily with the security and immediate availability of their funds. Such customers would naturally accept relatively low interest on their deposits and would expect only the most basic banking services.

Other, less conservative consumers might opt for less federal insurance because geographic accessibility was more important to them or because the convenience of one-stop shopping for financial services ranked high on their list of desirable bank characteristics. Indeed, any one consumer or family could place deposits in several institutions--a "nest egg" in an institution providing maximum federal coverage, a transactions account in a bank providing less coverage but a broader range of services or wider geographic access to funds, and investment funds in a third establishment without federal insurance but offering higher returns and growth potential.

When tiered deposit insurance was first introduced, most banks would probably choose to retain much of their federal deposit insurance. A great deal of uncertainty would exist about how affected depositors would react to losing their federal guarantees. Further, many banks are currently too weak to move out of the federal deposit insurance system. They lack the capital necessary to obtain private deposit insurance, and their depositors would remove their funds without some guarantee. But a few banks--those with more risk-loving depositors, those whose depositors held smaller accounts, or those with adequate capital reserves--might elect to accept less insurance in return for being allowed to exercise more freedom.[28] If those banks proved able to attract and retain customers while turning less regulation (along with less federal insurance) into an advantage, other banks undoubtedly would begin to move away from the federal deposit system. As time progressed, more banks would relinquish at least some of their federal deposit insurance in exchange for operating in a less regulated environment.

While some banking customers might be willing to hold uninsured deposits, others would require some protection for their funds. A bank's decision to accept less federal deposit insurance would not mean its customers would be unprotected. Private deposit insurance could provide a natural supplement to or replacement for federal guarantees.[29]

In addition, potentially powerful market controls could be introduced. Without federal guarantees, depositors, especially those with relatively large accounts, could be expected to exercise a great deal more caution in selecting a bank and in monitoring its activities. The fear of alienating their large depositors should cause the managers of institutions to behave in a more prudent, cautious manner. By thus bringing the risk-taking propensities of bankers more in line with those of the general public, a more stable system could well result.

But the possibilities for a banking system controlled through market discipline do not end here. In the absence of federal guarantees, depositors with smaller accounts could demand transactions and savings accounts backed solely by government securities or AAA corporate bonds, for example. Or it might be that only institutions with relatively high capital/ asset ratios would find they were able to grow beyond a certain size. Or stockholders might find that by contractually expanding their liability in the event of failure beyond their actual investment, they could attract additional deposits.

Furthermore, banks themselves, either in particular cities or regions or through establishing nationwide networks, could institute specific standards through self-regulatory organizations. Such organizations conceivably could economize on developing and marketing new products and services and could potentially provide liquidity to fellow members during a crisis.

Unfortunately, the banking industry has been directly regulated and protected for so long that there is no way to know what mechanisms might be devised to ensure bankers maintain acceptable standards of prudent operation, or even to know what might constitute acceptable standards. A free-market banking system, offered new opportunities and constrained by currently untried disciplines, could develop into something completely different from anything we could imagine today.

Finally, and most important, this system would reduce the probability of system-wide failure. Any regulatory system that makes decisions for all depository institutions places all institutions at risk if events unfold in an adverse manner. A tiered system of deposit insurance, on the other hand, would have the advantage of creating wider diversity among the nation's financial institutions. Some banks would operate under government-imposed restrictions. Others would, by choice, enjoy more freedom. But even among the institutions insured by private funds, there would undoubtedly be differences in the powers banks exercised. As a result, if a lending fad turned sour, as the loans to LDCs did, some institutions would be at risk, but not all. If investments in life insurance companies took a turn for the worst, a handful of banks would face problems, but others could stand ready to receive deposits on the basis of their relative stability. If a regulatory decision about branching restrictions proved unduly limiting, a few depositories would suffer, but others would avoid the crisis. There is no good reason for all depository institutions to be treated identically, and a strong argument can be made that differential treatment would significantly reduce the opportunities for systemic crises.

Furthermore, there is every reason to believe the market would impose more stringent disciplinary measures on depository institutions than would government regulators. The case of money market mutual funds is an apt analogy. These funds are generally viewed as safe institutions in which to invest; in fact, to date none have failed. But a successful money market fund is carefully scrutinized not only by those who invest in it (and who do so without any sort of federal guarantee), but also by industry observers who earn their living by rating such funds. The market has set certain standards of operation.

On the other side of the coin, there is growing evidence that the overall health of the credit union industry has deteriorated since the implementation of federal guarantees for credit union member shares. Since depositors need no longer assure themselves of the safety of their funds, credit unions have found they can reduce their capital in relation to their liabilities.

Mistakes in judgment will never be completely eliminated, and bank failures will result. The question is whether those errors should impose costs on the entire system, or remain limited to the bank or banks directly involved. By decentralizing decision making, a tiered deposit insurance system would make the latter scenario the more likely.

Toward a New System

The challenge is to devise a system that maximizes the long-run stability of the financial services industry while promoting the efficient operation of each institution. Adaptability is important, but so is an ability to control the degree of risk undertaken in the search for profits.

Federal and state regulations have proven particularly unsuited to such a task. Their political nature makes them slow to adapt, and the resulting inflexibility often turns "safety nets" into "hangman's nooses," as heavily protected depository institutions find they are unable to compete in a dynamic market.

A fully developed market for private deposit insurance holds more promise for securing long-term stability in the banking industry. The problem arises in determining how to introduce private guarantees. The banking industry is currently in a relatively weak condition, and private deposit insurance funds obviously need time to grow, develop, and win the consumer confidence crucial to a system that operates on fractional reserves.

Tiered deposit insurance would satisfy these criteria. Requiring bankers to choose between full federal guarantees and deregulation would offer them an incentive to move out of the federal system, while encouraging them to do so with caution. It is time to challenge the deposit insurance status quo, to expect depositors to take some responsibility for adequately diversifying their personal portfolios, and to begin looking for long-term solutions to the problems confronting depository institutions today.

FOOTNOTES

[1] Richard B. McKenzie, "National Industrial Policy: An Overview of the Debate," Heritage Foundation Backgrounder no. 275 (Washington, July 12, 1983), p. 23.

[2] *Ibid.*, p. 24.

[3] Alvin Rabushka, *From Adam Smith to the Wealth of America* (New Brunswick: Transaction Books, 1985), p. 142.

[4] "Banking" will be used throughout to refer to all depository institutions, including savings and loans and credit unions.

[5] Thomas F. Huertas, "The Regulation of Financial Institutions: A Historical Perspective on Current Issues," in *Financial Services: The Changing Institutions and Government Policy*, ed. George J. Benston (Englewood Cliffs, N.J.: Prentice Hall, 1983), p. 26

[6] *Ibid.*

[7] There are many who argue that loans by the Federal Reserve Banks should be fully collateralized to protect taxpayers. This is to avoid a situation in which a Federal Reserve Bank might lose money on a loan, reducing its ability to return profits to the Treasury. In such a case, taxpayers would have to indirectly pay for the defaulted loan of an institution. Many more important costs are imposed on taxpayers by the operation of the Federal Reserve System, however, and the current rules of operation inhibit the development of private markets that could largely negate the need for the Federal Reserve to intervene at all.

[8] Thomas B. Paton, "Federal Guaranty Fund for Bank Depositors," Brief in behalf of the American Bankers Association filed with the House Committee on Banking and Currency, April 9, 1932, p. 14.

[9] *Ibid.*, p. 5.

[10] *Ibid.*, p. 13.

[11] See, for example, Arthur J. Rolnick and Warren E. Weber, "New Evidence on the Free Banking Era," *American Economic Review* (December 1983): 1080-91; or Lawrence H. White, *Free Banking in Britain* (Cambridge: Cambridge University Press, 1984).

[12] See, for example, F. Ward McCarthy, "The Evolution of the Bank Regulatory Structure: A Reappraisal," *Federal Reserve Bank of Richmond Economic Review* (March/April 1984): 3-21.

[13] *Ibid.*, p. 8.

[14] Paton, p. 14.

[15] Paton, p. 15.

[16] See, for example, Kenneth E. Scott and Thomas Mayer, "Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform," *Stanford Law Review* (May 1971): 857- 902; Catherine England and John Palffy, "Replacing the FDIC: Private Insurance for Deposits," Heritage Foundation Backgrounder no. 229 (December 2, 1982); Eugenie D. Short and Gerald P. O'Driscoll, Jr., "Deregulation and Deposit Insurance," *Federal Reserve Bank of Dallas Economic Review* (September 1983): 11-23; or John H. Karaken, "Deposit Insurance Reform, or Deregulation

is the Cart, not the Horse," Federal Reserve Bank of Minneapolis Quarterly Review (Spring 1983): 1-9

[17] John H. Karaken, "The First Step in Bank Deregulation: What About the FDIC?" American Economic Review (May 1983): 198.

[18] Scott and Mayer, pp. 893-94.

[19] Mark J. Flannery and Aris A. Protopapadakis, "Risk-Sensitive Premia: Some Practical Issues," Federal Reserve Bank of Philadelphia Business Review (September/October 1984): 8.

[20] See *ibid.*; and Laurie S. Goodman and Sherrill Shaffer, "The Economics of Deposit Insurance: A Critical Evaluation of Proposed Reforms," Yale Journal on Regulation 2, no. 1 (1984): 154.

[21] Flannery and Protopapadakis, p. 7.

[22] It can, in fact, be argued that the current regulatory system is designed to allow less than the optimal degree of risk taking among banks. Until recently, failures among banks were virtually nonexistent. Such an observation suggests an industry facing few competitive pressures and protected from (or forbidden from assuming) a normal level of business risk. See, for example, Scott and Mayer, p. 873.

[23] This assumes that his depositors find the two insurance funds equally acceptable.

[24] For a more detailed discussion of the shortcomings of these state insurance funds, see Catherine England, "Private Deposit Insurance? Yes," Consumers' Research Magazine (July 1985).

[25] See, for example, Bert Ely, "Private Sector Deposit Guarantees: An Alternative to Federal Deposit Insurance," unpublished manuscript, May 4, 1984; Short and O'Driscoll; or England and Palffy.

[26] This discussion will, for simplicity's sake, ignore the implications of proposed changes in monetary policy.

[27] Obviously, branching restrictions are, for the most part, currently the result of state laws, but it is convenient here to consider all regulations as if they emanated from the federal level. Furthermore, Congress is generally recognized as having the power to preempt the state branching laws.

[28] Under the plan I envision, depository institutions would have the option of moving either out of or back into the federal insurance fold. Such freedom is consistent with allowing consumers to choose the type of arrangement they prefer and would, I believe, encourage more experimentation than a plan that forbade depositories from repurchasing federal deposit insurance once they had left the system. Whether the federal deposit insurers--the FDIC, the FSLIC, and the NCUSIF--would have the option of refusing any of those who desired to renew their federal guarantees is an open question.

[29] A possible alternative to the traditional means of providing deposit insurance would place additional emphasis on individual depositor protection. Suppose depositors could choose, upon placing their funds within an institution, whether or not they wanted deposit insurance--just as an individual borrowing money is now asked whether he wants the credit life insurance supplied by his banker. Within a single institution, then, some depositors might be insured, while others would not be insured. Those customers forgoing insurance would undoubtedly demand a higher return on their funds. Indeed, Allan H. Meltzer suggested such a plan in 1967. He argued not only that each depositor should be permitted to choose the portion of his deposit balance he wanted to insure against loss, but also that "premiums should be paid by depositors at rates based on the risk of failure by the bank of their choice." See his article, "Major Issues in the Regulation of Financial Institutions," Journal of Political Economy 2 (August 1967): 497.