

# The Reform of Federal Deposit Insurance: The Options

## Introduction

In the light of the continuing crisis in the savings and loan associations (S&L) industry, which resulted in the exhaustion of the industry's deposit insurance fund, the current pressures being experienced by the banking industry's own deposit insurance fund and the wealth of evidence that structural deficiencies in the deposit insurance programme have contributed to a serious undermining of the stability of much of the US financial system, the US Treasury is currently involved in a review of federal deposit insurance arrangements. The outcome of this review, with accompanying recommendations, is expected by early 1991 at the latest. The reform options being considered and the issues they raise form the substance of this article.

## The current federal deposit insurance arrangements<sup>1</sup>

### *The insurance agencies*

The federal deposit insurance programme was instituted in 1934 in the wake of the collapse of some four thousand banks in the three previous years of the Great Depression. The intention was to avoid a repetition of such events by reducing the incentive for depositors to

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<sup>1</sup> Technically speaking, deposit insurance is not insurance but a financial guarantee (KANE, 1986b).

participate in (or, indeed, initiate) potentially-ruinous deposit runs and by reducing the likelihood of collapse from mismanagement through an intensification in supervision.

The Federal Deposit Insurance Corporation (FDIC) was duly established to help supervise<sup>2</sup> and provide deposit insurance to banks, with the Federal Home Loan Bank Board (FHLBB), through its insurance arm – the Federal Savings and Loan Insurance Corporation (FSLIC) – and the National Credit Union Share Insurance Fund (NCUSIF) performing the same duties in respect of savings and loan associations (plus some federal savings banks) and credit unions<sup>3</sup> respectively. FDIC/FSLIC insurance is mandatory for federally-chartered institutions, state-chartered members of the Federal Reserve System (FRS) and, by legislative decision of individual states, other state-chartered institutions.

Until the enactment of the (Garn St-Germain) Depository Institutions Act of 1982, the FDIC's insurance fold embraced only commercial banks and state-chartered mutual savings banks. With the introduction of this piece of legislation, however, a new category of institution was added – those mutual savings banks which elected not to change their insurance agency on switching to a federal charter. This remained the position until August 1989 when, following enactment of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), the insurance responsibilities of the FHLBB were transferred to the FDIC (FSLIC was insolvent). The FDIC thus became responsible for the administration<sup>4</sup> of deposit insurance – provided through the medium of the new Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF)<sup>5</sup> for commercial banks and S&Ls respectively – for virtually<sup>6</sup> the whole of the US deposit-taking sector.

<sup>2</sup> Supervisory responsibilities are shared with the Federal Reserve System and the chartering bodies, *i.e.* the Comptroller of the Currency and State Banking Commissions.

<sup>3</sup> As the focus of this article is on commercial banks and S&Ls, the arrangements applicable to credit unions are not developed further.

<sup>4</sup> Supervisory responsibilities for S&Ls were vested in a new institution, the Office of Thrift Supervision (OTS), following the demise of the FHLBB.

<sup>5</sup> SAIF's resources are only to be used to help resolve *future* S&L problem institutions. The Resolution Trust Corporation (RTC) was created to resolve all insolvent S&Ls passed on to it by the OTS during the period 1989 until August 1992, with the FSLIC Resolution Fund being established to handle all pre-January 1 1989.

<sup>6</sup> Some state insuring agencies continue to operate.

### *Insurance coverage*

Following enactment of the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) in 1980 the limit of insurance coverage was raised (from \$40,000) to \$100,000, the level at which it remains today. Depositors holding accounts at the domestic offices of an insured institution receive complete protection up to this level.<sup>7</sup> Although the coverage is applied on a per customer per bank basis, coverage can be extended by holding a number of accounts under different names in a single institution. 'Large' depositors may also gain additional protection by virtue of the fact that, in the event of a failure, they will only be asked to repay an amount equal to their net indebtedness to that institution; that is their total deposits may be offset against loans even if they exceed the \$100,000 limit.

Apart from the *de jure* protection received, depositors enjoy additional benefits by virtue of the actual 'failure resolution' policies adopted by the insurance agencies in practice.<sup>8</sup> This has meant that *de*

<sup>7</sup> Since 1982, the 'full faith and credit' of the federal government has backed the insurance agencies' guarantees; and apart from raising premium income in the normal fashion (*see* the text), the agencies also have emergency lines of credit at the Treasury.

<sup>8</sup> For example, in its handling of bank failures, the FDIC has always opted for one of the following policies (for a more detailed discussion and a critique *see* HORVITZ, 1986b):

a) Merging the failed bank into a sound one, with the acquiring institution often receiving a subsidy for its pains. The acquirer is obliged to assume all the liabilities of the failed bank and can elect to take on all, or part or none of its assets. If it takes over the 'good' assets of the failed institution only, the resolution is termed a 'clean bank purchase and assumption', and if it takes on board all the assets of the failed institution the resolution is termed a 'whole bank purchase and assumption'. ('Open bank' assistance may also be provided on the occasions on which a bank is not technically closed yet the FDIC wishes to facilitate a merger.)

b) Letting a bank fail, paying off its insured depositors and, as receivers, liquidating its assets for the benefit of other creditors (the so-called 'pay-off' method).

c) Taking over and temporarily managing a failing or insolvent institution with a view to restructuring it and selling it in the future (the rescue of Continental Illinois in 1984 and of the large Texan bank holding company M Corp in 1989 are recent examples of this form of resolution).

d) Selling a failed institution's insured deposits only (the so-called 'deposit transfer' or 'modified pay-off' solution). Under this arrangement, uninsured depositors receive an immediate credit for the amount of their claims that the FDIC estimates will ultimately be recovered, an advantage for them as compared with the 'pay off' solution as they gain immediate access to some of their funds. The acquiring bank pays a premium in such situations and may lease or buy the dead institution's premises and equipment.

In practice, the 'purchase and assumption' resolution has proved the most popular, partly because of the requirement imposed upon the FDIC to choose that method which

*facto* coverage for depositors, at least in 'large' institutions,<sup>9</sup> has become unlimited.

### *The premium structure*

Ever since their introduction, federal deposit insurance premiums have always been levied on a flat rate basis as a percentage of 'assessable deposits'. In the early days this percentage was set at 0.083 (*i.e.* 8.3 basis points) but the current position<sup>10</sup> is that contributors to BIF pay at the rate of 12 basis points whilst contributors to SAIF pay at the rate of 20.8 basis points. However, under FIRREA, the assessment rate on BIF-insured institutions is due to increase to 0.15 per cent (*i.e.* 15 basis points) on 1 January 1991, and on SAIF-insured institutions to 0.23 per cent on the same date, thereafter falling back to 0.18 per cent on 1 January 1994 and, finally, to 0.15 per cent on 1 January 1998.<sup>11, 12</sup> Assimilation of the assessment rates for the two classes of institution was thus planned for completion by the end of 1997, but the recent decision taken by the FDIC to

minimises the cost to the insurance fund. The problem with this approach, however, is that the indirect costs and perhaps longer-term costs to the fund risk be ignored. Most importantly, the refusal to entertain the imposition of losses on uninsured depositors, at least in those of large institutions (the resolution of the failed Penn Square National Bank of Oklahoma in the early 1980s is a rare exception), may store up trouble for the future because of the associated loss in market discipline. Although the 'modified pay off' approach was adopted by the FDIC in 1984 as a means of combining the economies associated with 'purchase and assumptions' with the discipline-enhancing aspects of 'pay offs' (uninsured creditors suffer losses unless the liquidation proceeds prove sufficient to meet all claims), it was abandoned in 1986 in favour of solutions which protected *all* depositors, for stability reasons.

<sup>9</sup> This is a result of the adoption of the so-called 'too-big-to-fail' doctrine. Examples of this are the FDIC's decision in 1984 to guarantee *all* the deposits (and other debts) of Continental Illinois, an episode repeated in respect of the depositors of the First Republic Bank of Texas in March 1988.

<sup>10</sup> First adopted in August 1989.

<sup>11</sup> The FDIC is empowered, under FIRREA, to set deposit premiums at whatever level it chooses, subject to a maximum assessment rate of 0.325 per cent and a maximum year-to-year increase of 0.075 per cent.

<sup>12</sup> Additional powers given to the FDIC under FIRREA allow it to resolve creditors' claims and force the merger of healthy and unhealthy banks into a holding company. The latter, so-called 'cram-down', merger powers were thought necessary to ensure that *all* the financial resources of healthy banks may be used before the insurance fund is called upon; whilst the former powers allow the FDIC to determine which categories of claimants should receive full refunds (usually insured and uninsured depositors) and which should receive *pro rata* payments in line with receivership collections.

recommend an increase in the assessment rate for BIF-insured institutions for 1991 to 0.195 per cent may upset this schedule.

It should also be noted that fund contributors are entitled to rebates if the funds exceed a certain size (currently 1.25 per cent of insured deposits for BIF-contributors, for example), but the surge in claims in recent years has precluded recent payouts.<sup>13</sup>

### The case for reform

#### *Market discipline*

Most of those arguing for reform of federal deposit insurance stress the need, first and foremost, to increase market discipline in the deposit-taking sector; and much of the fault for the evident lack of discipline is laid firmly at the door of the existing insurance arrangements. In particular, the flat rate premium structure creates potentially serious 'moral hazards' for management and directors, and the extent of coverage, both *de jure* and *de facto*, provided to depositors creates an additional worrying form of moral hazard.

With respect to the management and directors of deposit-taking intermediaries, the 'moral hazard' arises because the explicit premiums charged by the insurance agencies do not take any account of the relative 'riskiness' of that institution, be that measured by capital adequacy, managerial skill, portfolio diversification, variability in investment returns or whatever. Thus, the danger arises that, because of the very existence of deposit insurance, designed partially as a means of stabilising the deposit-taking and wider financial system, management is induced to assume a greater level of risk than would otherwise be the case. Such a move, of course, would be taken in the expectation of raising portfolio returns and in the knowledge that, because of the blanket coverage (at least up to \$100,000 – *see below*) given to depositors, funding costs would not rise accordingly, thereby boosting margins. The problem becomes ever more serious as an

<sup>13</sup> Indeed, the projected decline in the size of the BIF fund – to around \$11 billion by the end of 1990 or 0.6 per cent of insured deposits – is the reason for the recent FDIC decision to recommend a higher than expected increase in the premium for 1991 (*see the text*).

institution's capital solvency declines, as the normal safeguards against excessive risk-taking evaporate. For example, in an institution operating with near zero or, indeed, negative net worth the temptation for management to attempt to 'gamble' its way out of insolvency by assuming ever-increasing levels of risk is overwhelming as, presumably, the potential for further damage to be done to career advancement, should the strategy prove unprofitable, is limited. Similarly, the lower the level of capital in the institution, the less concerned the shareholders are in exercising restraint over the management.

Such a desperate scenario is precisely that alleged by many (e.g. Kane, 1985; Barth, 1990; Scott, 1990) to characterise the post-1980 savings and loan association industry, the problems of which necessitated the FIRREA legislation in 1989 and continue to bedevil the administration (Hall, 1990). And even in the commercial banking sector, where one would expect shareholder restraint to be applied more forcefully,<sup>14</sup> there are ominous signs that a repeat performance, but probably on a smaller scale, may be on the cards.<sup>15</sup>

As for depositors, the blanket *de jure* protection offered up to \$100,000 per customer account per bank (adopted as a means of stabilising the deposit-taking sector), means that the majority need not concern themselves with attempting to assess the relative riskiness of the deposit institutions – all that matters to them are the prospective deposit rates on offer.<sup>16</sup> Even for those, relatively rich, depositors with over \$100,000 to invest, the deposit brokerage system and the opening of multiple accounts in different names allow for extension of *de jure* protection beyond this limit in a virtually costless

<sup>14</sup> This is because the vast majority of S&Ls are 'mutuals', owned by their depositing and borrowing customers. Such a wide disposal of ownership interests, as compared with the normal stockholding form of operation, inevitably weakens the effective restraint that can be exercised over management and directors.

<sup>15</sup> As noted earlier, the FDIC has already recommended a steeper than expected premium for 1991 for BIF-insured institutions, in the expectation of an unacceptable decline in the fund's resources; and, only recently (11 September 1990), the General Accounting Office, the investigative arm of Congress, has added its name to the list of siren voices by warning that "not since its birth during the Great Depression has the federal system of deposit insurance for commercial banks faced such a period of danger and uncertainty as it does today" (Charles Bowsher, Comptroller General).

<sup>16</sup> Even concerns about possible liquidity 'losses' are minimised by virtue of the FDIC's chosen tactics for resolving insolvent institutions – see note 8.

fashion. On top of this, the resolution strategies preferred by the FDIC, as part of a 'too-big-to-fail' policy, ensure that *de facto* coverage, at least for depositors with the favoured 'large' institutions, is virtually unlimited.

#### *Other problems arising from the flat rate premium structure*

As a result of the adoption of an imperfect (in an actuarial sense) pricing structure for deposit insurance, serious inequities and inefficiencies are created. The most serious inequity is that small and conservatively-run institutions and the generality of taxpayers in effect subsidise the larger and more risky institutions (Kane, 1985, p. 35). As is evident in the administration's current bail out of the S&L industry, the chickens have already come to roost as far as the taxpayer is concerned, and the populace has been warned to brace itself for further shocks as the problems in the commercial banking industry unfold. While the FDIC is doing its best to minimise the size of the eventual 'tab' that the general public will be asked to pick up – in the form of higher tax payments, reduced public provision of services, higher inflation, higher interest rates or a combination of these – by raising insurance premiums as rapidly as the law allows, the likely size of the 'hole' in banks' balance sheets is likely to swamp their efforts.

One form of reaction to this situation which the administration can take, of course, is to call for an intensification in the prudential regulation and supervision exercised by the appropriate supervisory authorities. Indeed, many (e.g. Kane, 1985) view these controls and regulations as the *implicit* premiums which regulators have to levy, *ex post*, to deal with the *ex ante* risk-taking induced by the imperfectly-priced deposit insurance. On their own, however, no matter how sophisticated and extensive the regulatory and supervisory framework, they represent an inefficient and ineffective means of solving the problem; inefficient because of the resource costs involved and ineffective because of the asymmetry in information available to the deposit institutions and their supervisors/regulators and because of the inevitable reaction lags inherent in the regulatory process.

### *The appropriate accounting framework*

The final problem associated with current federal deposit insurance arrangements is the accounting framework adopted by both the industry and the regulatory agencies. Accounting procedures adopted by both classes of institutions usually conform to Generally Accepted Accounting Principles (GAAP), the standards laid down by the accounting bodies, although the regulators do occasionally employ their own standards, especially in the assessment of capital adequacy. To a large degree, however, it remains the case that too little attention is paid to market value accounting, the book value conventions of historic cost accounting remaining in the ascendancy.

Although there are legitimate concerns about switching to market value accounting – it would be costly, in auditing and supervisory terms, to implement; it is not always precise; it might increase fluctuations in reported earnings for deposit institutions; it would disadvantage deposit institutions *vis-à-vis* those companies not subject to it – the *net* benefits would appear to be substantial (Kane, 1986a; Benston, 1989; White, 1989). In particular, greater use of market value accounting would facilitate the assessment of risk for both deposit institutions and regulators alike. Additionally, as far as regulatory agencies are concerned, it would enhance the efficacy of traditional capital requirements and facilitate assessment of the net worth of institutions hopefully, in the process, rendering speedy resolution of insolvent institutions a more likely outcome.

In summary, critics of the present arrangements want reform to deliver more market discipline, reduce inequities and inefficiencies and elicit a flow of more meaningful accounting data that will facilitate both an objective assessment of an institution's riskiness and net worth and a speedy resolution of insolvencies. In brief, a more cost-effective federal deposit insurance programme is called for. Failing this, more radical proposals, such as the 'narrowing of banks' (Litan, 1987) or the phasing out of *government-provided* deposit insurance (England, 1989), may have to be entertained.

### The options

#### *To increase market discipline*

The optimal solution, in theory, would be to introduce risk-related premiums and co-insurance for depositors. This action could be reinforced by ending the current abuses of the \$100,000 *de jure* maximum by applying the limit to the depositor rather than the deposit, and by ending the 'too-big-to-fail' doctrine – implying a greater willingness on the part of the FDIC to adopt resolution policies which, on occasions, impose losses on uninsured and, if the co-insurance principle is adopted, insured depositors alike. A further measure would be to reduce the *de jure* protection provided below the \$100,000 level.

*Variable rate premiums.* Although there is widespread support for this proposal from both academics and regulators alike (Scott and Meyer, 1971; Gibson, 1972; Merton, 1978; McCulloch, 1981; FDIC, 1983; FHLBB, 1983; Bierwag and Kaufman, 1983; Kane, 1985; White, 1989), a number of bodies and individuals [Horvitz, 1983; Goodman and Shaffer, 1984; Benston and Kaufman, 1988; American Bankers' Association (ABA), 1990] oppose its introduction. While its proponents stress its potential to discourage excessive risk-taking by reducing the moral hazard facing management, its critics point to the harm it might do to institutions already in trouble (higher premiums on top of higher capital requirements might finish them off) and to the practical difficulties of devising a sound (in an actuarial sense) and effective system. Expanding upon the latter point, sceptics (*e.g.* Horvitz, 1983) doubt the insurer's ability to assess *ex ante* risk in an acceptable fashion. Supporters, however, whilst conceding the difficulties involved, argue that the problems are not insuperable (Kane, 1986b), even entertaining the idea of introducing some form of *ex post* settlements of gains/losses between the insurer, the insured institutions and their stockholders (Kane, 1985, Chapter 6). Many also favour trying to extend the role played by private insurers in the deposit insurance arena (Benston, 1983; FDIC, 1983; Kane, 1985),<sup>17</sup>

<sup>17</sup> None of these individuals/bodies believe that private insurers should totally displace public insurance. This is because of the non-diversifiability of much of the industry's risk, which is intimately linked to the business cycle through the government's macroeconomic policy, and the problem of establishing credibility, a prerequisite of maintaining stability. [If a federal government guarantee had to be provided to ensure this then little improvement on the present structure would be secured (BAER, 1985).]

in order to ensure that market, as well as bureaucratic and political, pressures are brought to bear on the premium-setting process.<sup>18</sup> In particular, "adaptive efficiency" (Benston, 1983) would be maximised as public insurers would be forced to keep abreast of business developments in the industry and to respond more speedily than otherwise might be the case.

*Depositor co-insurance.* Advocates of the adoption of the co-insurance principle,<sup>19</sup> (which includes the Council of Economic Advisers) which is applied in the UK (Hall, 1987) and elsewhere, point to the need to ensure that depositors consider both risk and prospective rates of return when assessing which deposit institutions to invest in (e.g. Kane, 1985). Others, however, despite the potential gains in market discipline to be reaped, are more reluctant to incur the increased exposure to systemic risk such a move would imply. This helps to explain the apparent lukewarm response that both the FDIC and the Federal Reserve Board have given the proposal as well as the ABA's rejection of the proposal (ABA, 1990). Yet others (Fama, 1985; White, 1989) oppose it on more fundamental grounds namely, that regulators, let alone depositors, find it most difficult to differentiate institutions according to the levels of risk to which they are exposed. If the regulatory agencies, with their vast data banks on institutions and direct access to management cannot appraise effectively what chance have depositors, forced to rely solely upon published information? Consequently, is it right in all fairness to ask depositors to perform such a difficult task, mistakes in which might prove so potentially damaging to their financial health?

*Reduced protection for depositors.* Apart from implementing co-insurance for depositors, the level of legal protection afforded depositors could also be cut by reducing the maximum coverage below

<sup>18</sup> One suggestion is that the FDIC reinsures part of its exposure in the private sector as a way of eliciting a market perception on the relative riskiness of different institutions. If one rules out incompetence, however, it is not intuitively obvious why private insurers, with only limited access to information as compared with the regulatory agencies, should be expected to provide a more 'efficient' set of premiums than the FDIC itself. Notwithstanding this, Kane argues for private sector insurance or reinsurance of at least some layers of deposit-insurance coverage which may be supplementary to those receiving *de jure* protection (KANE, 1985).

<sup>19</sup> One variation on this is to place a limit on the cumulative amount that depositors are able to collect from the insuring agencies, although this would reduce the 'first round' benefits for market discipline that the standard co-insurance arrangements would secure.

the \$ 100,000 mark (Kane, 1985) and/or by blocking the loopholes available under the present arrangements due to the operation of deposit brokers<sup>20</sup> (ABA, 1990) and the application of the limit to the depositor rather than the deposit.

If the first route is chosen, the question inevitably arises "what is the appropriate level?" While the choice must necessarily be somewhat arbitrary, Kane has suggested a principle-based approach – namely that it be "sufficient to protect the transactions and precautionary balances of household customers" (Kane, 1985).<sup>21,22</sup> At the time of writing, Kane believed this would translate into a level of approximately \$10,000,<sup>23</sup> which he further suggested be indexed for inflation. If this recommendation had been adopted at that time the current figure would be well below \$20,000, a low figure even by UK standards.<sup>24</sup>

Although few argue against curtailment of the abuse of the current arrangements,<sup>25</sup> opposition to the lowering of the legal limit of protection is more widespread (White, 1989; ABA, 1990). Irrespective of any feelings about the 'fairness' of the current level, opponents stress the potentially destabilising consequences of implementing a cut, a view no doubt shared by the FDIC and the Federal Reserve Board.

<sup>20</sup> Regulatory changes introduced under FIRREA do already, to a degree, lessen the impact of the 'abuse' arising from the use of deposit brokers.

<sup>21</sup> He also raised the possibility of restricting protection to transactions accounts only (*i.e.* excluding time deposits).

<sup>22</sup> This approach could be justified on the grounds that the government is responsible for preserving the integrity of the monetary system rather than on consumer protection grounds.

<sup>23</sup> He also canvassed the idea that *optional* supplementary cover, in \$10,000 tranches, be made available on a differentially-priced basis.

<sup>24</sup> Since 1987, resident-owned sterling deposits held with UK-authorized institutions have been protected to the tune of 75 per cent of the first \$ 20,000 per institution (HALL, 1987).

<sup>25</sup> Clear evidence that the deposit brokerage system is exploited by troubled institutions is contained in KANE, 1985 (p. 133). He reports that during 1982 and 1983, more than half of the insured institutions closed by FSLIC had brokered deposits in excess of their other deposits; and roughly 16 per cent of the total deposits of the 72 commercial banks which failed between February 1982 and October 1983 were brokered funds.

Criticism of these arrangements led both the FDIC and FSLIC to propose, in 1984, limiting insurance coverage on the aggregate of funds placed in any single institution through any one broker to \$100,000. The proposals, however, were not adopted owing to successful political lobbying by the brokerage industry. Nevertheless, both agencies, after 1984, increased reporting frequencies for those institutions heavily reliant upon brokered funds; and those which raised more than 5 per cent of their deposits from CD brokers became susceptible to further examination.

*Removal of the de facto protection provided above the \$100,000 level.* Despite the opposition of the FDIC and the Federal Reserve Board, which would argue for the retention of discretion, many individuals and organisations, including the ABA (ABA, 1990) have argued for removal of the *de facto* protection provided to depositors beyond the \$100,000 level. In part, this has resulted from the adoption of a 'too-big-to-fail'<sup>26</sup> doctrine by the supervisory authorities, eager to contain the systemic risks that the failure of a large bank might entail.<sup>27</sup> The FDIC, however, is also partly to blame by virtue of its preference for 'purchase and assumption' resolutions rather than 'pay offs', modified or otherwise. Such policies have led to calls for (statutory) constraints to be placed on the FDIC and the Federal Reserve in respect of their handling of troubled institutions (Kane, 1985).<sup>28</sup> The ABA has taken this one step further by promoting a 'final-settlement-payment' case resolution method as a replacement for the FDIC's preferred strategy of 'purchase and assumption' (ABA, 1990).<sup>29</sup>

<sup>26</sup> The clearest indication of this was given in September 1984 when the Comptroller of the Currency announced that none of the nation's largest eleven banks would be allowed to fail.

<sup>27</sup> Although it should be noted that, as exemplified by the rescue of Continental Illinois in 1984, even guaranteeing *all* deposits (and, indeed, other debts!) does not necessarily stop deposit runs – depositors may still fear liquidity losses, especially if the solvency of the insurance fund is called into question.

<sup>28</sup> There is some evidence [GREENSPAN (Chairman of the Federal Reserve Board), 1990] that the Fed is now also concerned about the moral hazard created by the adoption of a 'too-big-to-fail' policy.

<sup>29</sup> The main components of the plan are that, when a Bank's equity capital falls to zero, the following should occur:

- (i) Its primary regulator should declare it insolvent and the FDIC should take over control in its receivership capacity;
- (ii) Insured accounts should be credited with 100 per cent of the balance up to \$100,000;
- (iii) Holders of uninsured accounts and unsecured creditors should become claimants on the receivership and their claims should be settled by a 'final-settlement-payment' determined in such a way that the FDIC's receivership function breaks even over time (an amount of between 85 per cent and 95 per cent of general creditors' claims is thought likely to be paid out under this approach);
- (iv) The institution should reopen for business either as a 'bridge' bank or as part of another bank or bank holding company.

Subject to this the ABA would like to see the FDIC obliged to handle the resolution in the manner that would prove least costly to the insurance funds.

### *To reduce inequities*

As noted earlier, current arrangements involve the small and conservatively-run institutions, together with taxpayers, subsidising the large and less-conservatively run institutions. The measures just outlined, by increasing market discipline by one means or another, would all serve to reduce such inequities. If implemented as a package, the maximum benefits would accrue, including protection of the insurance fund and thus the interests of the taxpayer. If the latter considerations are paramount further measures, however, might be considered.

*Higher insurance premiums?* The first of these is to raise insurance premium levels, as indeed was done under FIRREA. This only really makes sense if the flat rate structure is retained as arbitrary increases in risk-related premiums would seriously undermine the system through the distortions induced in business behaviour. A one-off increase would of course, however, in all likelihood accompany a switch from the flat rate to a variable rate structure.

*Higher capital requirements?* An alternative to this is to raise capital requirements. Once again though this should only be considered for the non risk-based measures which, arguably, are superfluous once an appropriately-specified risk measure is operational. And even as an interim measure, the potential for destabilisation,<sup>30</sup> as profitability is further eroded and institutions are tempted to remedy the situation by assuming a riskier profile in the expectation of boosting earnings,<sup>31</sup> has to be set off against the benefits derived.

### *To reduce inefficiencies*

Of the reform options already discussed, the majority of which, if introduced, would reduce efficiency losses, the proposal to introduce risk-related premiums deserves further analysis. This is because, as noted earlier in the discussion, the current practice of levying flat rate premiums and then seeking to alleviate the resultant problems by levying implicit premiums through the imposition of

<sup>30</sup> This is also true for increases in flat rate premiums.

<sup>31</sup> This is assuming that risk-related premiums are not in operation or, if they are, that neither they nor the risk-based capital requirements are adequately specified in the eyes of the institutions (HALL, 1989).

capital and other supervisory and regulatory requirements is seen as inferior, on efficiency and efficacy grounds, to the introduction of risk-related premiums (Kane, 1985). Thus even though, in principle, appropriately-specified risk-related capital requirements are an alternative to risk-related deposit insurance premiums, few express a preference for them. Rather, they are seen as a necessary complement to risk-related deposit insurance (Benston *et al.*, 1986, p. 305; Flannery, 1989; White, 1989) if social welfare is to be maximised.

#### *To increase cost-effectiveness*

Apart from those already listed, other measures which might be adopted to increase the cost-effectiveness of the deposit insurance arrangements embrace the more widespread use of market value accounting, improvements in the supervisory process, reforms in the FDIC's operational procedures to ensure speedier resolution of insolvent institutions and the fostering of greater competition between insurers, both private and public.

Support for the more widespread adoption of market value accounting is certainly strong within the academic community (Kane, 1985; Benston, 1989; White, 1989; Scott, 1990) and appears to be finding more favour with the regulatory agencies. Whether the accountancy profession and, more importantly, the deposit-taking industry itself can be persuaded of its merits is more doubtful, however.

Recent calls for improvements in the supervisory regime governing the operations of deposit-taking institutions have come from both the General Accounting Office and the ABA (1990). The former body would like to see improvements being made in the auditing process, while the latter argues for more resources to be devoted to training bank examiners and boosting their numbers and pay.

Reform of the FDIC's operational procedures in resolving insolvent institutions is a subject already touched upon by this article. Suffice it to say, there is a strong body of opinion (Kane, 1985; ABA, 1990; Scott, 1990) favouring speedier resolution of insolvent institutions, a development which might be facilitated by limiting the

discretion available to the FDIC through the promulgation of 'rules' for its adoption (ABA, 1990).<sup>32</sup>

The final item, the fostering of greater competition amongst insurers, both public and private sector, has also been dealt with earlier and would appear to command quite widespread support within both the academic and regulatory agency fraternity.

#### **Radical alternatives**

The two most widely-discussed alternatives to reforming federal deposit insurance in the manner outlined above are the 'narrowing of the bank' proposal and the displacement of federal deposit insurance with private deposit insurance.

The former approach, based on the work by Litan (1987), envisages restrictions being placed on the use to which insured deposits are put. Accordingly, insured deposits may only be invested in a narrow range of 'low risk' assets, more risky activities being funded from uninsured sources.<sup>33</sup> While such an approach might reduce the need for such a substantial package of back-up supervisory arrangements and the claims on the insurance fund – indeed the very need for deposit insurance might become redundant in this scenario! – the major drawback is that potentially-significant economies of scope would be denied the institutions (Benston and Kaufman, 1988; White, 1989).

The second proposal, often associated with the work of Bert Ely, is even more radical in that it postulates the complete displacement of federal deposit insurance with private deposit insurance. In Ely's model (1985), this would be effected through the introduction of a

<sup>32</sup> This idea might be extended by introducing prudential 'rules' whereby a certain form of remedial action is triggered automatically once an institution passes a certain prudential threshold which for the sake of argument, might be a given level of 'core' capital (this could be dovetailed with the Basle Committee's approach to the assessment of capital adequacy). The greater the breach of the threshold, the greater the severity of the remedial action triggered, perhaps culminating in the enforced closure of an institution before its net worth in market value terms is exhausted (Benston *et al.*, 1986, p. 309).

<sup>33</sup> Scott (1990), for example, proposes that insured accounts be fully collateralised by a pool of actively-traded securities at all times, with holdings of non-traded (or non-securitised) assets being funded with non-insured borrowings or investment accounts.



system of industry cross-guarantees, the institutions themselves providing the depositor protection. While few, as noted earlier, accept that total displacement of the public sector is either practicable or desirable in this respect, not least because of the associated systemic risks (Horvitz, 1986a),<sup>34</sup> a greater role for private insurers is, nevertheless, envisaged.

## Conclusions

Despite the success of the prevailing federal deposit insurance arrangements in preventing deposit runs, many argue that reform is long overdue. It is not clear, however, what the optimal reform package should comprise. Most of the options have been considered in some depth in this article and the favoured measures, at least in principle, are clearly identified. Nevertheless, sufficient doubts about the practicalities of implementing some of these preferred measures – most notably risk-related premiums – remain so that the administration may necessarily be obliged to fall back on a ‘second best’ solution, whatever the Treasury recommends. This will entail making a number of trade-offs, the most important of which is discipline *vis-à-vis* stability. Moreover, political pressures, such as those arising from the present clamour to protect the banks’ insurance funds in the face of a threatened FSLIC-style insolvency, will undoubtedly serve to cloud the picture. Whatever decision is reached, however, reform of some description is both inevitable and desirable.

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<sup>34</sup> Ely’s proposal is open to the same criticism if the aggregate level of bank capital is inadequate, as pointed out by EISENBEIS and HORVITZ (1986).

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