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REPLACING THE FDIC: PRIVATE INSURANCE FOR BANK DEPOSITS

INTRODUCTION

The collapse of Penn Square National Bank in Oklahoma City this past summer was one of the nation's largest bank failures in recent years. Since the start of 1982, 34 other banks have closed their doors or been forced to merge with healthier institutions. Few depositors in the failing banks lost any sleep worrying about the safety of their accounts, however; they knew that, despite the problems at the banks, their personal accounts were insured by the Federal Deposit Insurance Corporation (FDIC).

To these depositors and to tens of millions of Americans, the FDIC symbolizes the strength of the U.S. banking system. Ironically, however, the FDIC may be contributing to the system's seeming new fragility. It is possible that the fail-safe guarantees provided by FDIC have become a license for permissiveness to some bankers. Since the FDIC does not penalize speculative bankers for taking excessive risks, the FDIC eliminates a major incentive for bankers to handle depositors' money prudently. Had incentives existed that rewarded prudence, banks such as Penn Square might not have followed the road to financial ruin.

In the wake of the Penn Square collapse, the Federal Reserve System, the Comptroller of the Currency, and the FDIC--the government agencies explicitly charged with the task of maintaining the integrity of the banking industry--were accused of negligence in examining and monitoring the Oklahoma City bank.

The FDIC has been singled out for especially severe criticism. Its dual roles as the primary guarantor of deposits and a principal actor in bank regulation and liquidation would have led to considerable discussion of FDIC actions in any case, but the Corporation's decision to pay depositors of Penn Square rather

than orchestrate a merger has led to considerable comment from all sides of the political spectrum.

Did the FDIC do the "right" thing? Could it have prevented Penn Square's demise? These questions have fueled more basic speculation about the role of FDIC and its future in a safer American banking system.

Students of the banking system agree almost universally that serious problems exist; most agree on the nature of these problems. Debate rages, however, over the precise solutions. The Depository Institutions Act of 1982, passed just before Congress recessed for the elections, included an amendment requiring the agencies insuring deposits at various institutions to consider solutions to the system's recognized problems and to offer suggestions within six months. If these recommendations amount merely to "fine tuning" the present system, they will be sadly inadequate. The only cure for the ills of the present system is for federally provided deposit insurance to be phased out and replaced with a private system of insurance.

THE FDIC'S BACKGROUND AND PRESENT-DAY STRUCTURE

The creation of the FDIC and enactment of other banking reforms during the Depression stemmed from the popular misconception that bad banking practices, compounded by excessive competition and speculation, had caused the bank failures of the 1930s. Congress responded by limiting bank competition, increasing federal supervision of financial activities, limiting banks' asset acquisition powers, restricting their rates to depositors, and establishing capital standards. But the reform viewed by Congress as central to an immediate restoration of confidence in the financial system was the creation of a federal system of deposit insurance.

Support for the new system was by no means universal. President Franklin Roosevelt and the banking community opposed its introduction. As the New York Times headlined on March 26, 1933:

BANKERS WILL FIGHT DEPOSIT GUARANTEE
[PENDING MEASURE] WOULD CAUSE,
NOT AVERT PANICS, THEY ARGUE
BAD BANKING WOULD BE ENCOURAGED
AND HONESTY DISCREDITED, SAY FOES

The lead paragraph stated: "[T]here is one proposal that bankers here still vigorously oppose--any plan for guaranteeing bank deposits. Attempts to guarantee bank deposits, the bankers say, have always ended disastrously. The plan puts a premium on bad banking and drives sound bankers out of business....The chief arguments of the bankers against a bank deposit guarantee law," the Times article concluded, "are that it encourages bad banking,

discredits honesty, ability, and conservatism, and would cause and not avert panics. They say that a loss suffered by one bank jeopardizes all banks."

The legislation nonetheless passed. Creation of the FDIC was part of the Banking Act of 1933. Offered as an amendment to the Federal Reserve Act, the FDIC was empowered:

to purchase, hold and liquidate, as hereinafter provided, the assets of banks which have been closed; and to insure the deposits of all banks.

Insurance coverage originally was limited to \$2,500 per depositor, per bank. This was raised to \$5,000 in mid-1934, and has since increased to \$100,000.

Bank failures dropped off sharply after the creation of the Corporation--from 4,004 in 1933 to 61 in 1934 (see Table I). Unquestionably, the provision of federal deposit insurance enhanced confidence in the system and reduced the threat of banking runs, which had been a major cause of earlier failures. But there were other more significant forces that also contributed to the substantial decline in bank failures.

First, more than 9,000 banks had failed in the four turbulent years preceding the introduction of federal insurance. Most weak banks (and some that were not so weak) thus had been eliminated. Those institutions that had survived until 1934 commanded confidence

Table I

<u>Year</u>	<u>Number Bank Failures</u>	<u>Business Failure Rate*</u>	<u>M₁**</u> (billions)
1928	499	109	26.10
1929	659	104	26.64
1930	1,352	122	25.76
1931	2,294	133	24.14
1932	1,456	154	21.11
1933	4,004	100	19.91
1934	61	61	21.86
1935	32	62	25.88
1936	72	48	29.55
1937	83	46	30.91

*The business failure rate is defined as the number of failures per 10,000 business enterprises.

**M₁ is equal to demand deposits in commercial banks plus cash in the hands of the public.

Source: Historical Statistics of the U.S.: Colonial Times to 1970, Bureau of the Census, September 1975, pp. 1038-1039, 912, 992.

from the public by the very fact of their survival.

Secondly, not only the bank failure rate, but also the general business failure rate, slowed dramatically during the period from 1932 to 1934 (see Table I). While the business failure rate peaked in 1932 and bank failures did not peak until 1933, the lag indicated by these statistics is not unusual. Because the primary products of banks are business loans, the health of the banking industry usually lags slightly behind the upturn of the business cycle. Therefore, bank failures would have slowed in 1934 without the institution of deposit insurance.

Finally, growth in the money supply (see Table I) also tended to reduce bank failures in 1934. M1, the most appropriate measure of the money supply for that period, fell to its low of \$19.9 billion in 1933. The 25 percent decrease in M1 from 1929 to 1933 is generally cited as a primary cause of the bank failures. Thus it is not surprising that when the Federal Reserve began pumping money back into the economy in 1934, increasing bank reserves provided the liquidity necessary to stabilize the banks.¹

In short, while creation of the FDIC can be credited with having had a positive impact on confidence in the banking system, it alone did not save the system. Other, not entirely unrelated, forces combined during the period around 1934 to slow the rate of bank failures. While the drop in bank failures might have been slower without the FDIC, evidence indicates that failures still would have declined substantially after 1933. In spite of these facts, federal deposit insurance was viewed by many as the salvation of the banking system. Coverage expanded rapidly. By 1980, 98.2 percent of the commercial banks in the United States were insured by the FDIC; 79.9 percent of total deposits were covered.

The FDIC uses three basic means to insure deposits:

1) A failed institution can be merged into a healthy bank which agrees to accept full responsibility for all deposits, including the uninsured portion of the larger deposits. Frequently, the FDIC must subsidize the merger. Example: In July 1974, when the Comptroller of the Currency declared Long Island's Franklin National Bank insolvent, the FDIC assumed \$2.083 billion of Franklin's assets to facilitate a merger with the European American Bank.²

¹ For a discussion of the role of the Federal Reserve System during the Depression, see Milton Friedman and Anna Schwartz, A Monetary History of the United States, 1867-1960 (Princeton, N.J.: Princeton University Press, 1963).

² Frank J. Fabozzi, ed., Case History of Bank Failures (Hempstead, New York: Hofstra University, 1981) p. 341.

2) Failures are not always called failures. A large bank may be supported with loans or other aid rather than being merged or liquidated. Example: In April 1980, the FDIC kept First Pennsylvania afloat by lending it \$325 million in the form of five year, low interest subordinated notes.³

3) If all else fails, the FDIC will pay depositors in full for the insured portion of their deposits. The institution is then liquidated. Example: In July 1982, the FDIC reluctantly concluded that Penn Square National Bank had too many contingent liabilities to be considered as a possible merger partner by other banks. The decision was made to close the bank and pay depositors--even though nearly half of the deposits at Penn Square were uninsured.

As an insurance premium, the FDIC charges its member banks .083 percent of total deposit balances--a flat rate based solely on the total deposits in the bank. From this income, the FDIC pays its expenses and maintains its insurance reserve fund. After covering expenses, losses, and additions to its reserve fund, the FDIC returns 60 percent of its remaining premium income to the insured banks. These refunds have historically lowered the cost of deposit insurance to between .03 and .04 percent of a bank's total deposits though today's effective rate may be slightly higher.⁴

The reserve fund, which serves as the FDIC's first line of defense in the event of bank failures, amounts to \$12.3 billion, or less than 2 percent of total insured deposits. The FDIC also has a \$3 billion line of credit with the U.S. Treasury Department. Analysts feel that the Federal Reserve System and the Treasury would provide funds beyond this, however, should serious failures threaten.

Premiums and Risk Taking

By charging a flat percentage premium, the FDIC violates a fundamental rule of insurance. Insurance premiums in general are based on the perceived risk of the activity being underwritten. There is, however, little correlation between the total deposits of a bank and its potential risk of failure. More relevant factors are the quality and integrity of the management, the relative security of the bank's loan portfolio, and the amount of capital available to back up the portfolio. The FDIC's flat-rate insurance premium creates the wrong kind of incentives for banks, for it may actually encourage excessive risk taking by depository institutions.

³ Ibid, p. 48.

⁴ Mark Flannery, "Deposit Insurance Creates A Need for Bank Regulations," Federal Reserve Bank of Philadelphia, Business Review, January/February 1982, p. 18.

Imagine a banking system without deposit insurance. Banks decide to take on more risk because riskier loans generally command a higher interest rate. The default rate is higher on such loans, but the interest on those paid back should more than offset the bad loans lost. With careful management, carrying some "risky" loans in a portfolio can prove to be profitable.

Problems mount when a bank takes on too much risk by concentrating a significant portion of its loan portfolio in one region⁵ or one industry. In these cases, the bank may be threatened because of reduced demand in a single sector of the economy. Risk of that sort--where the health of the institution is too dependent on a narrow set of factors--is most dangerous to the bank.

As a bank takes on more portfolio risk, chances increase that more loans will turn bad and, subsequently, that the bank will start losing assets and be unable to pay its depositors. In the absence of deposit insurance, depositors detecting this dangerous trend in their bank will demand higher interest rates to cover their own increased risk,⁶ or will move their funds to a safer bank. This threat from depositors provides an effective discipline, limiting the risk a bank carries as it forces the institution to internalize the cost of taking on a riskier loan portfolio.

Most depositors, of course, are unable to monitor their banks well enough to determine the degree of risk to which their deposits are exposed. Deposit insurance thus becomes desirable. Naturally, deposit insurance increases the bank's costs because of the charge for premiums. This means that banks must pay lower interest on deposits. But depositors accept the lower rate in return for the peace of mind provided by knowing their deposits are safe.

The burden of monitoring the bank thus is shifted to the insurance company. As a bank begins to take on a more questionable loan portfolio, thus increasing its chances of failure, insurers, theoretically, should protect themselves--by raising premiums, for example. This forces the bank to internalize, in other words to bear, themselves, the cost of taking on more risks--as does the threat of action by uninsured depositors in the theoretical case described earlier with no deposit insurance. While riskier portfolios may carry higher interest rates, part of that potential increase in profits will be offset by higher insurance premiums.

⁵ This situation cannot always be avoided because of current banking laws. One of the strongest arguments for interstate banking is the increased safety that would result as banks established more diversified portfolios.

⁶ This assumes a world with no ceiling on the amount of interest that may be paid to depositors.

In a freely operating bank system, therefore, insurance premiums would vary according to risk. The FDIC, however, does not do this. Its flat-rate fee is set by law. Bankers can increase the risk of their portfolios--and hence their potential yield--without any corresponding increase in insurance costs.

The type of incentive thereby provided is reflected in banking policy today as banks shift their emphasis from safety to the maximum employment of funds. As Hobart Rowen noted in the Washington Post shortly after the Penn Square fiasco, "The object of many big banks is to make as many big loans as possible, not to restrict lending to the most reliable possible customers." Felix Rohatyn, a senior partner in the major New York investment banking firm of Lazard Freres and Company, adds that an emphasis on performance has replaced more conservative attitudes in banking over the past 20 years. Quality restraints, Rohatyn claims, have been replaced by the desire for growth.⁷

Is it any wonder that Penn Square concentrated heavily on risky loans? Seeking quick growth and faced with no offsetting costs, the bank chose to make loans to risky new oil drilling companies.

Banking law prevents the FDIC from dealing with situations like Penn Square by "punishing" risky behavior through increases in insurance rates. At the same time, adequate federal monitoring of the more than 14,000 insured banks in the U.S. has become impossible. Consequently, the FDIC and other banking agencies have turned to regulation instead.

Excessive Regulation

Rules and regulations touch almost every aspect of banking operations. For example, banks are required to maintain specific capital/asset ratios. In a system without the FDIC, prudent banks with a higher than average risk exposure would maintain higher capital/asset ratios. More conservative banks could safely maintain lower ratios. The federal regulators, however, apply uniform standards. Conservative banks thus are required to hold too much capital, while some over-adventurous bankers may be holding too little. The measures used to determine the capital/asset ratio are also standardized. As a result, they are inappropriate for some banks.

Reserve requirements imposed on banks are another restrictive and costly government regulation. These requirements supposedly serve a two-fold purpose. They control the money supply and ensure that banks have enough reserves on hand to meet depositor requests for cash. Different banks, however, need different

⁷ Hobart Rowen, "Could Our Bank System Crumble?" Washington Post, August 22, 1982, pp. C1-C2.

reserve levels to meet depositors' requests for money. The share of volatile accounts varies enormously among banks and through time, and most banks can predict with fair accuracy their cash needs. Yet government agencies require uniform reserve levels of all banks of a similar size. These standardized reserve requirement ratios clearly leave many institutions holding more money than is necessary for safety.⁸

Excessive capital and reserve requirements brake the expansion of conservative banks. This reduces not only these banks' potential for growth, but also the available pool of loanable funds, thus affecting the growth potential of the economy as a whole. Paperwork requirements, designed to assure federal authorities of compliance, add to the costs of regulation.

A recent study by the United Bank of Denver attempted to measure the total cost of compliance with government regulations. Researchers concluded that regulation costs approach 91 percent of the bank's after-tax income of \$13.1 million, or more than \$11 million each year.⁹ This is a conservative estimate. It includes only the explicit, out-of-pocket costs of complying with examinations and reports and maintaining reserve requirements. No attempt was made to calculate the enormous costs of forgone investment opportunities caused by banks having to comply with the myriad of restrictions imposed by government regulators.

Mergers

Another problem with FDIC insurance concerns the merger policy pursued by the agency and encouraged by other federal banking authorities. Because deposit insurance applies only to the first \$100,000 in an account, large depositors still need to monitor the institution holding their money. Should a bank begin to take on too much risk, these depositors (often other financial institutions) should identify this dangerous trend and should effect a change by threatening to move their funds to a safer bank. In most cases, however, large depositors fail to do this.

Consider the Penn Square fiasco. Credit unions, savings and loan associations, and a number of banks (including two of the nation's top ten) were caught with uninsured funds in a failed bank and could lose a considerable amount of money. Clearly, no one expected the FDIC to allow Penn Square to fail. Federal banking authorities have a history of avoiding outright bank

⁸ This paper is concerned only with reserve requirements as a safety measure and does not consider their role in controlling the money supply.

⁹ Harold R. Smethhills, Jr., "The Cost of Government Regulation: How Much is Enough?" Bank Compliance, Winter 1981, p. 14.

failure at almost any cost.¹⁰ When a bank cannot be saved, the FDIC typically does everything possible to arrange a merger with a healthy bank. The FDIC subsidizes these mergers and, in return, the acquiring institution agrees to take responsibility for the liabilities of the acquired bank. As a result, depositors with balances above \$100,000 receive implicit deposit insurance above the legally insurable limit.

Confident that the FDIC would follow the usual merger policy, banks and other financial institutions were quite willing to place funds with Penn Square and enjoy rates of interest that otherwise would have made sophisticated investors suspicious. Hence, the actions of Chase Manhattan, Continental Illinois, and the other banks, savings and loans, and credit unions with money in Penn Square were completely rational, given the past performance of the FDIC--just as the actions of Penn Square itself were arguably rational, given the current flat-rate insurance premiums. The FDIC now seems to realize this. Chairman William Isaac recently admitted,

[D]eposit assumption transactions involving failing banks have the major disadvantage, under current law, of making all general creditors whole and thereby eroding marketplace discipline. We are considering the desirability of a statutory change to permit deposit assumptions without providing a complete bailout for larger creditors.¹¹

CORRECTING THE FDIC'S SHORTCOMINGS

a) Variable FDIC Premiums

One remedy for the FDIC's shortcomings would be to allow the agency to vary its premiums depending on a bank's riskiness. Bank examiners, as a matter of course, already assign banks to one of five categories according to the soundness of their operations.¹² Under the current system, however, this categorization of banks has little real impact. Banks assigned to higher risk categories are sometimes examined more often, but that is about the extent of the effect of these categories.

¹⁰ This "failure phobia" of federal banking authorities also helps explain the willingness of banks to take on foreign debt. Most observers expect that in the event defaulted foreign loans seriously endangered a U.S. bank, the banking authorities would provide some sort of "bail-out" to prevent the bank's demise.

¹¹ William M. Issac, Chairman Federal Deposit Insurance Corporation, in a speech before the American Bankers Association's convention, October 19, 1982, p. 6.

¹² Banks receiving a ranking of "one" are considered the strongest while those placed in category "five" are considered to be in imminent danger of failure.

Insurance premiums could vary according to risk category. This would give banks an incentive to follow a more prudent lending policy. As banks took on a more risky loan portfolio and were assigned to a higher risk category, their premium costs would increase, thus discouraging excessive risk taking.

The trouble with this proposal is the monopoly position of the federal banking authorities. Riskiness of a loan portfolio cannot be measured easily. Suppose a bank's management disagrees strongly--perhaps correctly--with the risk assessment. Where could the banker register his protest? In fact, the bank management's only source of appeal would be the agency that hired and trained the examiner.

If there is any doubt that risk assessments by federal authorities might be something less than completely accurate, consider again the Penn Square case. At the time of its failure in July 1982, Penn Square National Bank was officially listed in category "three." Category "three" banks are recognized as having problems, but failure is considered "only a remote possibility."

b) Choice of Federal Insurer

As a partial solution to this monopoly problem, it has been suggested that banks be able to choose between insuring with the FDIC or with the Federal Savings and Loan Insurance Corporation (FSLIC). Competition between the two agencies would then solve the monopoly problems of FDIC risk-based insurance.

For effective competition between the two agencies to develop, however, both would need the authority to examine all depository institutions--making independent judgments as to the risk exposure of a particular bank or savings and loan. Effective competition for the insurance premiums would further require that the insurer control the examination and regulation of the particular bank. This is not the case today. Various agencies are responsible for examination, regulation, and insurance. These powers would have to be concentrated in the FDIC and FSLIC.

Even if the necessary redistribution of power were politically feasible, the government agencies probably would soon argue that coordination of their policies was necessary to reduce overlap. This would eliminate competition.

Furthermore, as government agencies, the FDIC and FSLIC make no profit and therefore would have few incentives to increase the efficiency of their operations. Neither would they have much reason to reduce the multitude of rules and regulations applied to depository institutions or to minimize the cost of deposit insurance.

Establishing federally supplied variable-rate insurance, even with "competition" between the two insuring agencies, would fail to resolve the shortcomings of the present system. Excessive risk taking might be discouraged, but the over-regulation problem would not be addressed.

c) Ending Merger Activities

Another reform proposed is for the FDIC and FSLIC to stop arranging mergers. By allowing banks to fail and reimbursing depositors only to a specified ceiling, incentives would be created for larger depositors to keep close track of the activities of their banks.

Mark Flannery, a professor of finance at the University of Pennsylvania, recommends that the extent of federally provided deposit insurance be reduced to cover only the first \$10,000 to \$20,000 of each account.¹³ Small savers would be protected while larger depositors, most of whom have the expertise necessary to monitor their bankers and the power to affect their behavior, would be given the incentive to do so. This makes sense, however, only if federal banking authorities stop arranging mergers. Flannery's suggestion also fails to address the problem of over-regulation and inflexibility, and it offers no incentives for regulators to change their present behavior.

The above proposals attempt merely to fine tune the current system of deposit insurance as a service of government. What would happen if the government no longer provided such insurance?

THE PROMISE OF PRIVATIZATION

An ideal deposit insurance system must provide safety and flexibility.

The extensive bank failures of the 1930s led Congress and the federal banking authorities to determine that the savings of large numbers of people must never again be jeopardized. The authorities failed to distinguish, however, between ensuring the safety of deposits and ensuring the safety of banks. Over the past 50 years, federal banking authorities have chosen to pursue the latter goal as a means of achieving the former. This has contributed to the morass of rules and regulations surrounding the banking industry. The cost of this approach is becoming more apparent as depository institutions find themselves unable to meet rapidly changing technological and economic conditions.

A flexible system is needed for banks to be able to accommodate this rapid market evolution. It is impossible for today's Congressmen and regulators to imagine conditions under which banks will operate in 2030, just as it was impossible for those of the 1930s to picture conditions today. It is the bank depositor who ultimately bears the burden of this inflexibility. Individuals and businesses purchasing financial services have a wide variety of needs. Placing tight controls on depository institutions in an effort to protect them from failure also prevents their developing methods

¹³ Flannery, op. cit.

of better serving customers.

The challenge is to devise a system that will meet the safety demands of depositors--especially the small, unsophisticated depositors--while allowing for maximum efficiency and flexibility. The evidence indicates that this can be done only through the private market.

Congress should eliminate the FDIC and allow banks to choose private insurance to meet their needs. If the federal government is to retain any insurance function at all, it should be confined to that of "insurer of last resort"; that is, it should provide "catastrophe" coverage, stepping in with assistance only when insurance losses reach a specified, unacceptable level.

Private insurers would undoubtedly charge variable insurance premiums depending on the risk exposure of each bank. Matching a bank's insurance premium to the risk of its portfolio would force it to internalize the cost of its decisions, thus discouraging unreasonable portfolio risk.

Even if the FDIC were to charge variable rates, there would still be a monopoly problem. Under a private competitive system a bank that was unhappy with the premium being charged by its insurer could shop around for a better deal. Competition provides incentives for improved performance. Insurance companies would have to strike a balance between offering a bank an attractive deal and ensuring that its premium was sufficient to cover the risk of failure properly. Moreover, competition would lead to more efficient examinations, appraisals, and regulation, thus lowering the cost of insurance to depositors and bank stockholders.

A private insurance system also would eliminate the merger problem. If large depositors could no longer count on federal banking authorities to bail out a troubled bank, they would create additional incentives for safer banking operations by threatening to move large deposits elsewhere or insisting that the bank obtain additional insurance to cover their funds in the event of failure.

Banks also would be supervised more efficiently. If private insurers were made responsible for paying depositors in the event of failure, they would have strong incentives to monitor banks closely--especially as problems began to develop. These insurers would, quite properly, concern themselves with the capital/asset ratios, the reserves, and the type of loans held by the bank. If private insurers could monitor such details, setting standards for banks as part of a total insurance package, why should federal banking authorities continue to exercise this power? After all, who would have the greater incentive to promote the safe operation of depository institutions--private companies with their money on the line or government regulators? Thus, most of the regulations imposed on banks could be eliminated.

Companies providing deposit insurance through the private markets also could be expected to take an active interest in other areas of a bank's operations. For example, a bank's decision to offer a new service to its customers would certainly be of interest to its insurer. Similarly, a bank's ability to open a new branch without weakening its position would clearly be investigated by the company (or companies) providing its insurance. As with other aspects of a bank's operation, private insurers would have a much stronger incentive than government employees to carry out this oversight efficiently. Government regulation of these matters, therefore, would be unnecessary.

The enhanced flexibility resulting from a private insurance system would be just as important as the improvement in efficiency. It is in this respect that privately provided deposit insurance has great advantage. The logistics of examining thousands of banks requires that arbitrary, but uniform, standards and guidelines be established to ensure that each is dealt with fairly. Yet, banks are not identical. Differences in management, location, target markets, and competitive situations make uniform standards inappropriate for many banks. Private insurance companies, each overseeing a smaller number of institutions, could tailor insurance programs to meet the needs of individual banks. This would allow each bank to adopt to its own market and customer needs. A higher capital/asset ratio could be used to offset lower reserves--and vice versa. Similarly, new services could be offered to depositors if the bank reduced the risk exposure of its loan portfolio.

The advantages of such flexibility would be enormous. Individual banks would benefit because they could adjust to changing conditions within their communities. Customers would be better served, since banks would be better able to meet their needs, be more profitable, and thus, pay depositors higher rates. Flexibility would be assured by the competitive nature of a privately provided insurance system. To keep existing clients or attract new ones, an insurance company would have to offer banks a more attractive package than did its competitors.

A system of privately provided deposit insurance offers key advantages. It would enhance the safety of deposits within the system and increase the ability of the banking system to adjust to changing conditions and needs of consumers. It would reduce the burden of over-regulation, thereby increasing the available loan pool and contributing to the long-run health of the economy.

PRIVATIZATION--A BLUEPRINT

Though private insurance would represent a significant change in the direction of current U.S. banking policy, it is not an untried direction. Federally provided deposit insurance is not only just 50 years old, it is also unique to the United

States. No other major banking system has government provided deposit insurance.¹⁴ Banks in most countries--including the super-cautious Swiss--offer no deposit insurance at all. Yet, these banking systems do not suffer from a lack of customer confidence. Even in this country, there are billions of dollars of uninsured deposits. The owners of the more than \$200 billion in money market funds do not seem to be losing sleep over the lack of federal deposit insurance. Furthermore, credit unions in several states are now being allowed to opt out of government insurance systems and obtain private coverage. Private companies set higher standards for providing insurance than do their government counterparts, forcing many credit unions to reduce their risk exposure before they will be accepted. Credit unions are evidently willing to make such adjustments, however, as demonstrated by the growing number of such institutions choosing to protect their depositors through private insurance.

The privatization proposal still raises many questions. Among them: How would a contemporary private insurance system differ from pre-FDIC days in which thousands of banks failed? There are important differences between the financial world of the 1930s and 1980s, and therefore, it is unlikely that history would repeat itself.

In the first place, almost all banks that failed in the Depression were unit banks--banks with no branches. From 1921 to 1931, only seven suspensions occurred in banks with more than ten branches. California, the principal statewide branching state, experienced few failures. Canada, with countrywide branching had only one failure--and that was in 1923.¹⁵ Unlike branching banks, unit banks cannot meet deposit claims and losses in one area with funds and offsetting profits in another. In other words, they are more vulnerable to the effects of bank runs and local adverse economic fluctuations. So the trend to statewide branching and interstate banking in the coming decade should further reduce the chances of massive bank runs and bankruptcies.

Second, a contemporary private insurance company would be more diversified and thus safer than its equivalent during the Depression. Deposit insurance in the early 1900s consisted largely of state legislated companies subject to the same structural inadequacies as the FDIC today and subject to the same restrictions on diversity suffered by the unit banks. When a couple of local banks failed, the entire state insurance system would be jeopardized.

¹⁴ Nor does any other country have a banking system as fractured as ours. The existence of nationwide branching in other countries helps to stabilize their banking systems. If one region happens to suffer from especially poor economic conditions, losses at those branches may be absorbed through the profitable operation of branches in other parts of the country.

¹⁵ George J. Benston, "How Can We Learn from Past Bank Failures?" Bankers Magazine, Winter 1975, p. 21.

Third, the insurance system today is capable of instilling the consumer confidence necessary to make its guarantees effective. Insurers have become masters at diversifying risk and assessing premiums in complex cases. Consider the range of business undertaken by companies such as Lloyds of London and Prudential. Further, eighteen private companies currently insure credit unions throughout the country with considerable success. According to Sam Rizzo, President of the National Deposit Guaranty Corporation of Columbus, Ohio, this has provided valuable experience toward the design of a bank deposit insurance system.

How would the transition be handled? It is important that the transition to private deposit insurance be gradual and cautious. This would allow time for the market to adjust, resulting in a smooth and orderly transition. A transition period of, say, seven years would also allow time for the development of the insurance market and the education of consumers.

One possible scenario would be to gradually reduce the size of an insurable deposit over a period of three to seven years. During the first year of the phase-in period, the FDIC's role as merger-maker would be eliminated. The insured portion of each deposit would also be lowered from \$100,000 to, say, \$85,000. In succeeding years the insured portion of deposits would continue to be reduced in a stepwise fashion. The larger, more sophisticated depositors would thus move out of the system first. These depositors, with the market power to affect bank behavior, would press the management of questionable banks to strengthen their financial positions or obtain supplementary insurance. By the end of the phase-in period, when the smallest depositors finally gave up their federal deposit insurance, the banks and the private insurance companies would have gained the experience necessary to assure the safety of smaller depositors; the new system would have been allowed time to adjust and prove its viability.

One lesson of the pre-1930s experience with private or regional deposit insurance is that an insurance company should avoid concentrating its accounts in one part of the country. Today's insurers pursue geographic diversity, as well as reinsurance, as a matter of course, particularly for potentially large claims. Certainly the industry would be no less prudent when insuring the banking system. The chances of a bank failure's causing an insurance company failure thus are slim. Insurance companies would probably insist that very large banks obtain insurance from several sources.

Consumer confidence is critical for the success of any insurance undertaking. To assure consumers of the system's soundness, it might prove necessary for the government to approve deposit insurers. Such oversight should be kept to a minimum, however, and might not be needed. The great advantage of private insurance would be flexibility. Bankers and insurers could negotiate individual contracts that reflect the conditions of individual institutions. Government oversight of insurance companies might

place unwarranted restrictions on these contracts, thereby recreating many of the problems it was designed to solve.

How would a system of private insurance deal with entry?
The general arguments for reducing regulation also apply to the regulation of entry into the industry. More liberal entry conditions would increase competition and result in better service for bank customers.

The Heritage Foundation study, "The Case for Banking Deregulation," argued that bank chartering agents should do no more than assure themselves of the existence of adequate capital and the good character of the founders before granting a bank charter.¹⁶ A simple requirement that a new bank must obtain deposit insurance before it could operate would have a similar result. Private insurers would not risk their funds if the prospective founders were, say, convicted felons, or if an insurance inspector felt that the new bank did not have a reasonable chance of survival.

Questions have been raised concerning the willingness of private insurers to guarantee the deposits of new institutions. A competitive insurance system, however, would treat these accounts much as banks treat loans to new enterprises. Because of their increased risk, new ventures, would pay higher premiums. Individual insurance companies might also guarantee only a part of their deposits, in order to spread their risk among several companies. But a new bank with reasonable prospects should have little trouble in finding adequate insurance for its deposits.

Should all banks be required to obtain private deposit insurance?
Not all U.S. banks carry FDIC insurance. Since the goal of private insurance is to provide more, not less, flexibility than the present system, insurance should not be required by the government.

Most banks probably would need deposit insurance to satisfy, and therefore retain, depositors. At those few banks whose depositors did not demand insurance, the message would be that the depositors felt secure with their funds uninsured, or that the bank's rate of return was high enough to compensate for the risk the depositor takes. Why should these consumers be forced to accept something they clearly feel is unnecessary?

Requiring a certain level of deposit insurance, moreover, would necessitate the drawing of arbitrary lines. When would an account be a "deposit" for the purposes of requiring deposit insurance? As new instruments were developed to meet changing demands, new decisions would have to be made. As long as customers

¹⁶ See, Catherine England, "The Case for Banking Deregulation," Heritage Foundation Background No. 174, March 26, 1982.

were told whether their financial assets were insured or not, they should have the right to place funds in an uninsured account in return for a higher rate of interest.

Would a private insurance system dry up venture capital for new enterprises? Some critics of private insurance fear that true risk related premiums would reduce the supply of capital to new or risky enterprises. Under the present system, some banks (Penn Square, for example) are able to specialize in risky portfolios because the bank and the borrower are subsidized by the FDIC's flat-rate premium structure. If an insuring agency were to vary the premium rate with portfolio risk, however, it would inhibit the concentration of risky loans in single banks. The critics maintain that a system of private insurance, therefore, would reduce the supply of loans to new ventures, which, though risky, are responsible for much innovation and economic progress. This need not be the case.

Most banks would continue to seek some high return/high risk loans to boost their portfolio yield. In moderation, these more risky loans would not influence the individual bank's insurance premiums. In fact, diversified portfolios with the prospect of higher return might actually lower premiums. Only when a bank became overly aggressive, loading its portfolio with high risk or nondiversified loans, would the entire portfolio be endangered, as opposed to individual loans. At that point, a private insurer would demand higher premiums and the bank would be forced either to charge risky loan customers higher rates for their money or to reduce the overall risk exposure of its loan portfolio.

A private insurance system would result not in the disappearance of risky venture capital, but in its more even distribution among the banking industry. Needless to say, some excessively risky enterprises, which now receive support from overly aggressive banks thanks to the subsidies of the FDIC premium structure, would be unable to obtain funds. But this would be an accurate determination by the market that the probable return from the venture did not justify its risk.

What happens in the event of massive failures? The specter of 1930s-type bank failures still haunts the American public, despite the many differences between the 1930s and present-day banking. The manner in which a private insurance system would respond to widespread failures is, in fact, important. Public confidence in the system is crucial to its smooth operation, and the private insurance industry is as averse as any other industry to losses due to widespread failures among its clients.

Today, the FDIC's resources fall far short of those that would be needed in the event of massive bank collapses. The failure of any significant number of banks would quickly deplete the FDIC's \$12.3 billion reserve fund and \$3.0 billion line of credit with the Treasury. And at this juncture, neither the Federal Reserve System nor the Treasury Department would be required to do anything further.

It is a common assumption, however, that the Federal Reserve and the Treasury would extend support beyond their legal obligations in the event of a catastrophic series of bank failures. Cannot the same assumption be made concerning a system of privately provided insurance? The federal government undoubtedly would take steps through one of the remaining banking agencies to support the financial system, should the need arise.

Professor George Kaufman of Loyola University, suggests that a trigger mechanism be used. Should a pre-set number of banks fail, say 100 or 200, the federal government would step in to pay depositors, releasing insurance companies from further obligations in a crisis situation. Alternatively, the trigger mechanism might be geared to the total asset size of failed banks. This would allow more weight to be given to large banks since they place a greater strain on the insurance system when they fail.

Such a trigger mechanism would serve a two-fold purpose. First, it would reassure the public and the insurance industry that, in the unlikely event of massive structural failure, the federal government would take final responsibility for supporting the system. Secondly, it would prevent the financial institutions or their insurers from asking for a "bail-out" at the earliest sign of trouble. Pressure would not be easily mounted if the law stated explicitly when the government was to step in.

Finally, it should be noted that, even without some sort of trigger mechanism, insurance companies would be willing to take on the risks involved in insuring deposits. The argument that private insurers would not insure deposits because of the banking industry's alleged sensitivity to changes in the business cycle is unfounded. Banks have, in fact, weathered the vagaries of the business cycle better than most businesses. Failures resulting from restrictive monetary or other government policy, could be viewed for insurance purposes as analogous to an "act of God." Casualty insurance companies continue to provide insurance for homes in coastal towns despite the chances that a hurricane could result in heavy payment requests. Furthermore, these companies do not expect to be released from their obligations simply because events beyond their control led to an extensive drain on reserves.

In short, private insurance companies would anticipate the possibility of a large bank failure through diversification and reinsurance--the same methods used to spread risks on other insurance contracts. Furthermore, in its role as "protector of the currency," the Federal Reserve System could be expected to step in with emergency aid in the event of a catastrophe just as it would now despite the absence of a statutory requirement that it do so.

CONCLUSION

The current system of federally provided deposit insurance creates perverse incentives. It encourages excessive risk taking by banks and a lack of concern regarding banking practice among the larger, more sophisticated depositors. The logistics of insuring more than 14,000 banks has led to the substantial regulation of these institutions. Richard Pratt, Chairman of the Federal Home Loan Bank Board, has pointed out the problem: As long as insurance premiums do not fit the banks' risk, banks must be regulated to fit a fixed insurance premium.

The troubles facing depository institutions will not disappear as the economy begins its recovery. They may lie dormant until another economic crisis, but the inherent defects of the existing system will continue to haunt the banks and savings and loan associations. American depository institutions must be freed from the regulatory chains in which they are now confined. Otherwise, rapid technological and economic changes will pass them by, leaving them to sell an antiquated product designed for the 1930s.

But widespread efforts to deregulate the industry face a slim chance of success without substantial reform of the deposit insurance system. The only reform that can guarantee a safer and more flexible banking system is the privatization of the deposit insurance function.

A move toward a private system is not a leap in the dark. Money market funds do not have federal deposit insurance--though many funds are covered by private insurance. No other major government with a free banking system provides deposit insurance for its banks. Credit unions in many states are beginning to move from a government-sponsored system to private deposit insurance. Much is known from these experiences about the operation of a world without federal deposit insurance. Removing the strong government influence on U.S. banking that stems from its unique federal deposit insurance system would bring the industry more in line with the rest of the world and the rest of U.S. industry. Even government officials are beginning to admit that private sector insurance may be superior to the federal version. At a conference sponsored by the Securities and Exchange Commission in early October, Federal Home Loan Bank Board Chairman Pratt suggested that a private deposit insurance system, with some sort of federal reinsurance, is an idea worthy of serious consideration. On the same panel, C.T. Conover, Comptroller of the Currency, agreed with Pratt's suggestion.

The Depository Institutions Act of 1982 requires federal authorities to consider ways in which problems with the current system of deposit insurance might be solved. In this endeavor, the FDIC must be recognized as a relic of a bygone banking age; the banking industry should be allowed to enter the 1980s by dismantling the FDIC; and private insurance companies

should be allowed to take over insuring of deposits--a task for which they are eminently more qualified than is the federal government. FDIC has proved that, while it can rescue banks, it cannot prevent failures. A system of private insurance, marshalling time-tested market incentives, will create an environment in which the malaise of shaky financial institutions can be detected early and restored to health.

Catherine England
John Palffy
Policy Analysts