Some Concerns about Deposit Insurance for a Less Regulated Financial System

by Allan H. Meltzer

Passage of the Garn-St. Germain bill recognized some of the changes that have occurred in the financial system for more than a decade. The bill permitted older institutions to respond more directly to competition from newer financial institutions. Additional changes are likely to occur in the future, either by additional legislation or in its absence. Without a determined -- and mistaken -- effort to prevent these changes by new legislation, it seems likely that the restrictions in the McFadden Act, the Bank Holding Company Act, Glass-Steagall, and the Saving and Loan Holding Company Act will be modified in the next decade either by legislation or by innovation that circumvents existing laws.

There are three main reasons for the more rapid pace of innovation in the past decade. First is the combination of high inflation, restrictions on deposit interest rates and prohibition of interest payments on banks' required reserves. This combination creates opportunities for depositors and financial institutions to gain from reclassifying deposits. Second is rising financial wealth. Even if inflation ends and restrictions on interest payments are removed, competition between banks and non-banks will continue to blur the former distinction between commercial and investment banking activities. There is a larger clientele to be served. Third, new technology provides new opportunities.

The deposit insurance system developed when the separation between commercial and investment banking was clearer than it is likely to be in the

future. All of our experience with the present system comes from a period in which the financial system was more heavily regulated than it is likely to be in the future. The future risks imposed on the present insurance system are likely to be different -- and in some ways greater -- than in the past. The staff's paper "Deposit Insurance and Market Discipline" discusses some of the risks that now arise, but the paper is concerned mainly with the effect of asset or liability size.

Asset or liability size of failed banks is one part of a larger problem. The larger problem is to decide on insurance coverage. What is to be insured? Which risks are insurable? Which risks can be reduced by pooling, and which are simply transferred or redistributed?

The staff's paper points out that the insurance system has reduced the fear of a banking panic or of bank failures so much that very few uninsured depositors have systematic programs to evaluate banking risk. There are some obvious benefits in this low level of fear. The risk of an old-fashioned banking panic is reduced.

There are some costs also. The principal cost arises from the "all or none" nature of perceived risk, a system that encourages depositors to perceive increased risks long after the increase occurs delays and bunches adjustment. A system in which people perceive risks at low cost encourages the most risk averse to withdraw early. Gradual loss of deposits encourages gradual adjustment of portfolios to reduce risks.

The Problem of Incentives

Can the insurance system provide incentives for people to learn about risks at low cost? The learning must be done by the depositor and the financial institution. Ideally, the uninsured depositor should receive

compensation for the risk he takes, and the financial institution should see the rising price of holding a more risky asset portfolio. As risk increases, interest rates on uninsured deposits should rise with the increase in risk and insurance premiums, per dollar of insured deposits, should increase. The rise in these payments raises the cost to the bank and provides information to depositors, to the managers of the financial institution, to the stockholders and the directors. The increased cost (and the information) gives the bank an incentive to adjust its portfolio and to lower risk.

The present system of fixed (constant) deposit insurance premiums encourages excessive risk taking. The problem is greatest at institutions with relatively low value of equity, for example many savings and loans. The reason is that risk and return are related. If the financial institution holds a more risky portfolio, it earns a higher return. If the risks come due, the institution may fail. The deposit insurance fund pays the insured depositors. The uninsured depositors may receive high interest rates to compensate for the additional risk, but the insured depositors do not. The fixed insurance premium acts as a subsidy to risk taking by the owners.

The staff paper reports on another type of incentive problem. Deposits in foreign branches of domestic banks are not included in the insurance base, but they are treated like insured deposits if the bank fails. This procedure encourages financial institutions to hold deposits at foreign branches.

A related issue is the definition of an insured liability. Currently, bank money market accounts are insured, but money market mutual funds are not. Brokerage accounts are insured by SIPC, but mutual funds are not. These distinctions are arbitrary, and they create incentives for innovations that blur the distinctions.

Some Guiding Principles

Five principles should be observed in any change:

(1) premiums for deposit insurance should be related to the risk of the asset portfolio and should rise with risk;

(2) all financial institutions that issue liabilities with fixed nominal values should be eligible for insurance;

(3) the precise relation and responsibilities of the lender of last resort should be made explicit;

(4) depositors should be allowed some choice of the amount of insurance they wish to buy and the amount of risk (and compensation for risk) they wish to take; and

(5) the problem of single bank failures should be separated from bank runs and multiple failures.

There are alternative ways of organizing. The deposit insurance system can be operated by private companies with re-insurance offered by FDIC. Or, FDIC can offer insurance up to a fixed level of deposits. Additional insurance could then be purchased by depositors from private insurance companies. These additional purchases would be voluntary and would reflect portfolio risk.

"Very Large" Bank Failures

The social cost and private cost of bank failures differ. Deposit insurance lowers the cost of bearing risk of an individual bank failure by pooling risks and reducing costs of acquiring information. Only the lender of last resort can prevent a bank panic or a wave of bank failures.

The staff memo discusses some problems raised by the failure of a "very large" bank. The most important role of government, in such an event,

is to prevent other financial institutions or banks failing as a result of attempted conversion of deposits into currency.

The memo does not distinguish between insolvency and illiquidity. A bank that is illiquid can continue to operate if assets are sold, at market prices, to obtain cash. This may require reductions in the value of equity and debt and reorganization, as would occur in a Chapter 11 bankruptcy. Large banks typically have a high ratio of negotiable CD's and debentures to insured deposits. A Chapter 11 type of bankruptcy would permit the owners of these liabilities to share in the loss. The bank could continue to operate under appointed managers.

A Final Comment

The staff memo recognizes, particularly on page 14, that "the" problem changes. Regulation cannot adjust constraints to new circumstances. Markets are more efficient and probably more effective at disciplining lenders.

I have not tried to offer a "plan" for deposit insurance. Instead, I have tried to suggest the functions that deposit insurance can -- and those it cannot -- perform. I have tried also to sketch some ways in which choice and marginal cost pricing of risk can be introduced. And, I have suggested that some changes must be made. In a less regulated financial system, with fixed deposit insurance premiums, financial institutions that take large risks are subsidized.