Economic Principles and Deposit-Insurance Reform

by James B. Thomson

The dramatic rise in interest rates during the late 1970s and early 1980s wreaked havoc on the balance sheets of savings and loan (thrift) institutions. As their cost of funds rose above what they could earn on their asset portfolios, thrift institutions began to lose billions of dollars. By the end of 1982, 237 thrift institutions began to lose billions of dollars. By the end of 1982, 237 thrift institutions had failed. The attendant economic consequences of these failures is estimated at more than $124 billion. Furthermore, approximately 500 additional thrifts are above normal risks of failure; the expected future cost associated with these failures is not included in the FDIC's loss estimates.

The current system of federal deposit insurance subsidizes risk-taking by depository institutions, resulting in increased failure-resolution costs and decreased efficiency for the entire financial system. Reforms to the deposit-insurance system should consider both the policy objectives and the attendant economic consequences and costs of deposit guarantees.

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The federal deposit-insurance system that would help prevent another such crisis. Numerous proposals for deposit-insurance reform have been advanced. The purpose of this Economic Commentary is to speculate on one way that requires that they have access to federal deposit guarantees, or are they simply special because they have access to these guarantees? While often ignored, these fundamental questions are important because different objectives for deposit insurance could correspond to different methods of implementing a deposit-insurance system.

One widely cited justification for federal deposit guarantees is the need to protect the savings and transactions balances of small savers. If small depositors lack the sophistication and resources to monitor the condition of their banks effectively (and the resources to absorb unpredictable losses), then perhaps their accounts should be safeguarded. Deposit insurance is but one of many ways to achieve this.

It has also been argued that federal deposit insurance is needed to improve the informational efficiency of the financial sector. If it is relatively costly for some depositors to evaluate the condition of their depositary institution, then it might be more efficient to have the monitoring performed by a centralized agency. In addition, a centralized agency is likely to have lower informational costs than the total cost of the combined efforts of a mass of small depositors. However, federal deposit insurance is not needed to lower informational costs. These costs could be reduced simply by having an agency collect and disseminate information without guaranteeing deposits.

A third motive for federal deposit insurance is to prevent destabilizing bank runs. Some economists believe that an individual bank run can become contagious and result in a run on the entire banking system. If so, deposit insurance could remove or reduce the incentives for bank runs and thus stabilize the banking system.

A rational bank run is one that occurs because depositors have good information that their depository institution has (or may) become insolvent. This type of run should not be contagious, and in fact should act as a form of market discipline on bank management. An irrational bank run is one that occurs because poorly informed depositors mistakenly believe that their depository institution has (or may) become insolvent. If the primary purpose of a deposit-insurance system is to provide liquidity to insolvent banks, then the system should insure only the deposits of customers who are likely to act on poor information.

Unfortunately, deposit-insurance systems cannot differentiate between rational and irrational bank runs. Consequently, the desirable market discipline of occasional rational bank runs is sacrificed to remove the potentially destabilizing effects of irrational bank runs. Once again, however, deposit insurance is not the only solution. A properly functioning lender of last resort can prevent irrational bank runs from becoming systemic bank runs by providing liquidity to solvent institutions experiencing runs, thus removing the destabilizing effects of irrational bank runs without precluding rational bank runs on insolvent institutions.

The need to protect the nation’s payments system is the fourth reason often cited to justify federal deposit guarantees. According to this view, a lack of the payments system could be triggered by the failure of a large bank, leading other banks to become insolvent. By guaranteeing the payments-related liabilities of banks, deposit insurance immunizes the payments system from bank failures. An objection to this view is that providing direct guarantees of payments-system transactions achieves the same result with greater efficiency. Furthermore, as in the case with systemic bank runs, a properly functioning lender of last resort could immunize other banks (and the payments system) from the effects of a single bank failure.

Clearly, the type of deposit-insurance system we should adopt depends critically on our goals. For example, if the purpose of deposit insurance is to protect the savings and transactions balances of informationally disadvantaged small savers, then the coverage necessary is less than the current explicit limit of $100,000. On the other hand, if the purpose of deposit insurance is to protect the payments system, then the type of account insured is more important than the amount of explicit coverage. For example, consumer and corporate checking accounts would be fully insured under this motive, while savings and investment vehicles such as money market deposit accounts and certificates of deposit would receive no, or only nominal, coverage.

**Economic Consequences and Costs of the Current Deposit-Insurance System**

The estimated $124 billion needed to resolve the crisis is just the direct monetary cost of our current system of federal deposit guarantees. Other economic consequences and costs include an overinvestment in risky assets and the subsidization of depository institutions on the basis of size and risk. In fact, perverse incentives built into these subsidy contributions significantly to the current crisis. Without meaningful reforms to the deposit-insurance mechanism, the amount of explicit incentives for this situation to be repeated.

As presently priced and administered, federal deposit insurance subsidizes risk-taking by depository institutions in two ways. First, the FDIC and FSLIC provide a risk-related subsidy to all insured depository institutions. Second, insured institutions that are safe and well-managed subsidize the risk-taking behavior of the “high-fliers” of the industry. In both cases, the amount of the risk-related subsidies increases with the degree of risk assumed by the institution and leads to an overinvestment in risky assets in the economy.

Currently, the failure-resolution policies of the FDIC and FSLIC have resulted in a system of federal deposit insurance that is based in favor of large institutions. For example, the FDIC has never liquidated a bank with more than $600 million in assets, thereby providing the deposit insurance for all deposits in such institutions. On the other hand, small banks have been liquidated routinely, and some uninsured institutions in these situations have suffered losses. This perceived assurance against liquidation has given large depository institutions a competitive advantage over small ones in issuing large, uninsured deposits.

**Using Economic Principles to Evaluate Reform Proposals**

Equity and efficiency are the two basic principles economists apply when evaluating programs such as federal deposit insurance. The concepts of equity and efficiency must be considered in the context of both deposit-insurance objectives and the regulatory and market structure of the insured industry. Because a trade-off can exist between equity and efficiency, the “best” deposit-insurance system may not rank as the top proposal in terms of either criterion alone.

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**Table 1: Estimates of FSLIC Loss Exposure to GAAP-Insolvent Thrifts**

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of GAAP-Insolvent Thrifts</th>
<th>Assets in billions</th>
<th>FSLIC Loss Exposed in billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>237</td>
<td>$67.8</td>
<td>$3.08</td>
</tr>
<tr>
<td>1983</td>
<td>293</td>
<td>83.9</td>
<td>4.98</td>
</tr>
<tr>
<td>1984</td>
<td>445</td>
<td>115.5</td>
<td>16.89</td>
</tr>
<tr>
<td>1985</td>
<td>470</td>
<td>136.0</td>
<td>22.14</td>
</tr>
<tr>
<td>1986</td>
<td>471</td>
<td>137.2</td>
<td>33.76</td>
</tr>
<tr>
<td>1987</td>
<td>520</td>
<td>200.1</td>
<td>69.51</td>
</tr>
</tbody>
</table>

Some economists believe that an individual bank run can become contagious and result in a run on the entire banking system. If so, deposit insurance could prevent destabilizing bank runs. A rational bank run is one that occurs because depositors have good information about their depository institution and only become insolvent. This type of run should not be contagious, and in fact it should act as a form of market discipline on bank management. An irrational bank run is one that occurs because poorly informed depositors mistakenly believe that their depository institution has (or may) become insolvent. If the primary purpose of a deposit-insurance system is to protect insolvent banks, then the system should ensure only the deposits of customers who are likely to act on poor information.

One widely cited justification for federal deposit guarantees is that they have access to federal deposit guarantees, or are they simply special because they have access to these guarantees? While often ignored, these fundamental questions are important because different objectives for deposit insurance could correspond to different methods of implementing a deposit-insurance system.

The Purpose of Deposit Insurance

What are the policy objectives of deposit insurance? Are depositary institutions special in some way that requires that they have access to federal deposit guarantees, or are they simply special because they have access to these guarantees? While often ignored, these fundamental questions are important because different objectives for deposit insurance could correspond to different methods of implementing a deposit-insurance system.

One widely cited justification for federal deposit guarantees is that they need to protect the savings and transactions balances of small savers. If small depositors lack the sophistication and resources to monitor the condition of their banks effectively (and the resources to absorb unpredictable losses), then perhaps their accounts should be safeguarded. Federal deposit insurance is but one of many ways to achieve this.

It has also been argued that federal deposit insurance is needed to improve the informational efficiency of the financial sector. If it is relatively costly for some depositors to evaluate the condition of their depository institution, then it might be more efficient to have the monitoring performed by a centralized agency. In addition, a centralized agency is likely to have lower informational costs than the total cost of the combined efforts of a mass of small depositors. However, federal deposit insurance is not needed to lower informational costs. These costs could be reduced simply by having an agency collect and disseminate information without guaranteeing deposits.

A third motive for federal deposit insurance is to prevent destabilizing bank runs. Some economists believe that an individual bank run can become contagious and result in a run on the entire banking system. If so, deposit insurance could prevent destabilizing bank runs. A rational bank run is one that occurs because depositors have good information about their depository institution and only become insolvent. This type of run should not be contagious, and in fact it should act as a form of market discipline on bank management. An irrational bank run is one that occurs because poorly informed depositors mistakenly believe that their depository institution has (or may) become insolvent. If the primary purpose of a deposit-insurance system is to protect insolvent banks, then the system should ensure only the deposits of customers who are likely to act on poor information.

Unfortunately, deposit-insurance systems cannot differentiate between rational and irrational bank runs. Consequently, the desirable market discipline of occasional rational bank runs is sacrificed to remove the potentially destabilizing effects of irrational bank runs. Once again, however, deposit insurance is not the only solution. A properly functioning lender of last resort can prevent irrational bank runs from becoming systemic bank runs by providing liquidity to solvent institutions experiencing runs, thus removing the destabilizing effects of irrational bank runs without precluding rational bank runs on insolvent institutions.

The need to protect the nation’s payments system is the fourth reason often cited to justify federal deposit guarantees. According to this view, a lack of default on the payments system could be triggered by the failure of a large bank, leading other banks to become insolvent. By guaranteeing the payments-related liabilities of banks, deposit insurance immunizes the payments system from bank failures.

An objection to this view is that providing direct guarantees of payments-system transactions achieves the same result with greater efficiency. Furthermore, as in the case with systemic bank runs, a properly functioning lender of last resort could immunize other banks and thus stabilize the banking system.

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Economic Consequences and Costs of the Current Deposit-Insurance System

The estimated $124 billion needed to resolve the crisis is just the direct monetary cost of our current system of federal deposit guarantees. Other economic consequences and costs include an overinvestment in risky assets and the subsidization of depository institutions on the basis of risk and size. In fact, perverse incentives built into these subsidies contributed significantly to the current crisis. Without meaningful reforms to the deposit-insurance mechanism, the amount of explicit and implicit guarantees for deposit insurance is likely to continue.

The problem is not that deposit insurance is being inefficient. Instead, the problem is that the degree of risk assumed by the institution and leads to an overinvestment in risky assets in the economy. Currently, the failure-resolution policies of the FDIC and FSLIC have resulted in a system of federal deposit insurance that is based in favor of large institutions. For example, the FDIC has never liquidated a bank with more than $100 million in assets, thereby providing de facto 100 percent insurance for all depositors in such institutions. On the other hand, small banks have been liquidated routinely, and some uninsured depository institutions have suffered losses. This perceived assurance against liquidation has led to larger depository institutions and a competitive advantage over small ones in issuing large, uninsured deposits.

Using Economic Principles to Evaluate Reform Proposals

In order to evaluate deposit insurance, the efficiency of the insurance system must be examined. Efficiency is a relative concept, we typically judge the efficiency of a proposal relative to the market outcome. For a deposit-insurance system to be equitable, it must treat all financial institutions alike. As discussed earlier, the current system of federal deposit insurance is not equitable because the failure-resolution policies of the FDIC and FSLIC are based in favor of large depository institutions. A second example of the inequity of the current system is in the area of capital regulation. If capital is costly to obtain, then the equity criterion implies that all insured institutions should be subject to the same set of regulations as a condition for receiving federal deposit guarantees. For instance, if a minimum capital ratio is specified as a condition for receiving deposit guarantees, then all insured institutions should be subject to the same capital requirements. However, most thrifts are currently required to hold only half as much capital as banks.

Equity also implies that all depository institutions should be treated equally. That is, there should not be differential treatment across banks of uninsured depositors, creditors, and equity holders when the institution or large class of claims on the bank’s assets should receive the same treatment irrespective of the size, location, or type of insured institution. Otherwise, the presence of deposit insurance changes the relative cost of funds and equity capital across institutions.

Efficiency is the second criterion by which deposit-insurance reforms should be judged. Economists are usually concerned with allocative efficiency, that is, how close the resource allocation under each proposal is to some perceived optimal, usually unattainable, resource allocation.

The allocative efficiency of each reform proposal can be directly observed. However, judgments about the relative efficiency of alternative deposit-insurance systems can be based on the incentives built into each one. From an efficiency standpoint, the incentives built into deposit insurance, through the pricing of the guarantees and the determination of the costs of the FDIC and FSLIC, should not subsidize risk-taking either through cross-subsidies between depository institutions or through the purchase of the deposits of the FDIC and FSLIC. The equity criterion implies that all insured institutions should be subject to the same set of regulations as a condition for receiving federal deposit guarantees. For instance, if a minimum capital ratio is specified as a condition for receiving deposit guarantees, then all insured institutions should be subject to the same capital requirements.
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By late 1988, nearly 500 thrifts were either GAAP-insolvent or in danger of failing. The cost of closing, reorganizing, or recapitalizing these institutions is estimated at more than $124 billion. Furthermore, approximately $50 billion in additional withholding taxes are above normal risks for failure. The expected future cost associated with these failures is not included in the FSLIC loss estimates.

In contrast, the fund of the Federal Deposit Insurance Corporation (FDIC) remains solvent, despite having eroded in this decade under the pressure of record bank failures and an increase in failure-resolution costs. In 1988, the FDIC experienced its first loss in the post-Depression era, as the book value of its fund balance shrank from $18.3 billion to $14.1 billion. Academic economists and private banking analysts estimate the real value of the fund to be significantly less. In fact, the private group known as the Shadow Financial Regulatory Committee estimates that the true reserve balance of the FDIC fund, net of estimated unbooked losses, is only $400 million.

On February 6, 1989, the Bush administration announced a plan for resolving the thrift crisis that includes provisions to recapitalize the insolvent FSLIC and to close nearly 500 savings and loan institutions that are currently insolvent or in danger of failing. The Bush plan also contains provisions for strengthening the FDIC’s fund. Conspicuously absent from this proposal are fundamental reforms to...
The seven principles of insurance are: Principle of Uberrimae fidei (Utmost Good Faith), Principle of Insurable Interest. Principle of Uberrimae fidei (a Latin phrase), or in simple English words, the Principle of Utmost Good Faith, is a very basic and first primary principle of insurance. According to this principle, the insurance contract must be signed by both parties (i.e., insurer and insured) in an absolute good faith or belief or trust. The person getting insured must willingly disclose and surrender to the insurer his complete true information regarding the subject matter of insurance. The insurer's liability gets void (i.e., legally revoked or cancelled) if any facts, about the subject matter of insurance...