Deposit Insurance: A Skeptical View

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FEDERAL DEPOSIT INSURANCE is a classic case of the wrong solution offered for the wrong problem. It seeks to protect banks against the runs to which they would be prone under *laissez-faire,* in which they would not have the protection deposit insurance gives them. I argue that this solution is based on a false premise: under *laissez-faire,* banks would *not* in fact be prone to runs and would therefore have no need for protection against them. The real problem is not how to protect banks against runs but how to maintain their financial strength. There are good reasons to believe that the market would provide banks with appropriate incentives to solve this problem without any need for government regulatory intervention. Deposit insurance is the wrong solution because it undermines market incentives and thereby weakens the banking system.

The paradox of deposit insurance is that trying to make banks more stable by protecting them against runs only weakens them and makes them more likely to fail. Deposit insurance transforms a perfectly healthy banking system into a chronic invalid that can be kept alive only by ever-increasing doses of public funds. It is the most effective means yet devised to destroy

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a nation's banking system. The U.S. experience suggests that it has done so at a staggering cost to the long-suffering federal taxpayer.[2]

The Stability of Laissez-Faire *in Banking*

Suppose we had a competitive banking system with no deposit insurance or lender of last resort.[3] Depositors in a bank would be aware that they would stand to lose their funds if their bank failed. They would therefore want reassurance that their funds were safe and would soon close their accounts if they felt any danger of losing their funds. Bank managers would be acutely aware of this possibility. They would understand that their long-term survival depended on their ability to retain the confidence of their depositors.

Bank managers might try to keep depositors' confidence in various ways. They might reassure depositors that they were not taking excessive risks with their funds by pursuing relatively conservative lending policies and exposing these policies to outside scrutiny. The underlying principle is that a bank that is "good" will want to signal its goodness to its customers and will also want to distance itself from "bad" banks the public wants to avoid. A good bank might, for example, hire an independent auditor from time to time to examine its books and issue a report on its financial soundness. The auditor's report would be credible because in the long run the auditor's ability to attract business would depend on the reliability of his reports. Similarly, a good bank would be able to encourage people of proved ability and integrity to sit on its board of directors; their presence on the board would in turn send a strong signal to the public that the bank was in safe hands. The same desire to send out credible signals would also encourage good banks to do things such as develop reliable and accurate accounting conventions to demonstrate their soundness and publish validated accounts of their financial health.

A bank's management would also reassure depositors that their funds were safe by maintaining adequate capital. One function of capital is to give bank shareholders an interest in the safe management of the bank. The shareholders of a well-capitalized bank have a lot to lose if the bank incurs losses. This potential loss gives shareholders an incentive to monitor the bank to ensure that its managers do not take excessive risks at their expense. This incentive is strong because the shareholders are residual claimants to the bank's assets and must therefore bear all the marginal losses the bank might take. The residual nature of their claim also means that the shareholders provide some protection to depositors. If the bank has sufficient equity capital, any losses it takes are borne entirely by the shareholders and the depositors lose nothing. Bank capital thus provides a buffer that absorbs losses and maintains the value of deposits. The bank will be unable to honor all its deposit liabilities only if its losses are so large that they exceed the value of its capital (that is, if its net worth becomes negative and it becomes insolvent).[4]

Under a *laissez-faire* system, a bank's capital strength—the amount of capital it maintains relative to its potential losses—is determined by market forces. The better capitalized the bank is, the more reassurance it provides depositors, and other things being equal, the more attractive it will be to them. But capital is also costly. Greater capitalization results in lower return on equity, which displeases existing investors and discourages potential new ones. There is consequently a tradeoff between reassuring depositors on one hand and discouraging shareholders on the other. The optimal capital position gives depositors the right amount of protection, given the cost of providing it.

There is also a presumption that the market will in fact produce the right amount of protection. If customers want safe banks, they will not patronize banks they consider weak, and these banks will attract no business. If a bank is too

[2]A brief discussion inevitably leaves out many important issues. To prevent any misunderstanding, I do not suggest that all was well with the pre-FDIC regime or that the abolition of deposit insurance alone would solve all U.S. banking problems. For a discussion of why these problems took so long to reveal themselves, see footnote 7.

[3]This is a hypothetical *laissez-faire* benchmark. It is therefore not to be confused with the pre-FDIC regime, though it certainly has some similarities to that regime. The pre-FDIC regime still had various legal restrictions and interventionary agencies (for example, the Federal Reserve System) that would be absent under the *laissez-faire* benchmark.

[4]I am aware of course that the monitoring of bank management must take place in a world where information is scarce and asymmetrically distributed. Such factors constitute a large part of the reason intermediaries exist in the first place. However, the existence of these imperfections does not alter the fact that bank capital still plays an important buffer role.

strongly capitalized, however, it will be able to attract capital only by passing on its higher capital costs to its customers and its services will be too expensive to be competitive. *If bank customers want safe banks, as they presumably do, a competitive market will ensure that they get them. Indeed, banks will be exactly as safe as their customers demand.*

Historical evidence supports the claim that banks have been strong and stable in the absence of deposit insurance. Recent research into historical free banking systems and the U.S. banking system before the introduction of federal deposit insurance indicates that banks typically maintained strong capital positions and were able to keep the confidence of the public despite the absence of deposit insurance or an official lender of last resort.[5] Banks that were not considered sufficiently sound would lose depositors, and competition for market share would force them to maintain the margins of safety and soundness their customers demanded.[6] The evidence from the pre-FDIC period also indicates that bank runs were not the problem that later generations perceived them to have been—that later generations exaggerated the problem—and that the runs that did occur were normally restricted to problem banks whose financial positions were perceived as weak anyway. A typical run was a flight to quality in which depositors would withdraw their funds from weak banks and redeposit them in stronger banks in which they had confidence. Runs were not contagious panics in which depositors withdrew their funds from any bank they could. In short, the evidence indicates clearly that strong banks did not need deposit insurance to protect them from runs.

The Destabilizing Effects of Deposit Insurance

Suppose that we introduce deposit insurance into our hypothetical system of *laissez-faire*. Under *laissez-faire*, banks were forced to maintain their capital strength because they needed capital to reassure depositors and discourage them from running. But once we introduce deposit insurance we take away depositors' incentive to run and relieve bank managers of the need to maintain capital to keep depositors' confidence. Deposit insurance thus reduces the marginal benefit of maintaining capital. Because deposit insurance has little effect on the cost of capital, banks with insurance therefore tend to reduce their capital/assets ratios. (In other words, given that a bank can reduce its capital/assets ratio without facing a run, its rational response is to do so to increase the return it can pay on shareholder equity.) Note also that a bank would be under pressure to reduce its capital/assets ratio even if it wanted to maintain it because other banks that took advantage of insurance protection to economize on capital would be able to outcompete it by offering higher deposit interest rates. The fight for market share would then pressure the responsible bank to follow suit, whether it wanted to or not. Deposit insurance thus makes a strong capital position a liability, putting well-capitalized banks at a competitive disadvantage. The banking system now has a weaker—possibly much weaker—capital position, which means that banks are less able to absorb losses while maintaining their net worth. Deposit insurance thus weakens the banks and makes them more liable to fail.

Deposit insurance also encourages banks to take more lending risks. If a bank adopts a riskier lending policy, it can expect to keep the higher returns it will earn in the event the risks pay off. If the risks do not pay off and the bank becomes insolvent, some of the loss is passed back to the insurance corporation. Deposit insurance thus gives banks some protection against downside risk. The amount of that protection, and hence the incentive to take excessive risks, increases as the bank's capital position worsens. In the end, a bank with zero or negative net worth might face no downside risk at all. It would have everything to gain and nothing more to lose from irresponsible, shoot-for-the-moon lending policies that are almost certain not to pay off. The losses, of course, are then passed back to the insurance corporation and to the other banks or taxpayers that are forced to pay into the insurance fund. To make matters worse, deposit insurance also removes the market mechanism—a run—that would otherwise have put a weak bank out of business and stopped its irresponsible gambling. A zombie institution can always get funds simply by raising its deposit rates and can keep gambling at other people's expense until the regulatory authorities finally get around to closing it.

[5]See, for example, the case studies in Dowd (1992).

[6]See Kaufman (1988), for example.

A point eventually comes when the insurance corporation itself has accumulated so many bad debts that it too has become a zombie with no realistic hope of ever paying its debts. The deposit insurance crisis then escalates out of control. Because the insurance corporation no longer has the resources to close its problem institutions—that is, because it no longer has the funds to pay off their depositors if it closes institutions—it simply allows these institutions to continue operating and run up debts at what is now clearly the expense of the federal taxpayer.[7] The deposit insurance corporation now plays the same game with Congress that zombie insured institutions have been playing with the corporation. It seeks federal bailouts, ostensibly to put itself back on its feet, that just throw good money after bad and only postpone the day of reckoning. The insurance corporation seeks to hide its problems by watering down accounting and capital standards so that weak institutions can meet the regulatory requirements. It therefore replaces the relatively lax Generally Accepted Accounting Principles (GAAP) with the even laxer system of Regulatory Accounting Practices (RAP), which allows expected gains from future transactions, accounting forbearances and even (incredibly) unrecognized losses to count as capital for regulatory purposes.[8] As if that is not enough, the insurance corporation then exempts many institutions that fail to meet these requirements by allowing them to continue operating anyway. It seeks to justify itself by inventing elaborate theories of regulatory forbearance that are little more than smokescreens to cover its own failure to close problem institutions. If all else fails, the insurance corporation blames its difficulties on scapegoats like fraudulent or incompetent management in its problem institutions, oil price shocks, deregulation or just plain bad luck. Congress and the Administration go along with this game for political reasons, and nothing substantial is done to stop it. In the meantime, what might have been a relatively mundane public finance disaster of perhaps a few billion dollars is transformed into a catastrophe that will cost hundreds of billions of dollars to clean up (with the cost still rising).

Policy Implications

Conventional wisdom holds that deposit insurance is sound in principle but flawed in practice. Advocates of this view maintain that correcting deficiencies in the implementation of deposit insurance will resolve the problems insurance creates. I believe that this view is profoundly mistaken. It is the very principle of deposit insurance that is flawed, and no amount of patching will put the problem right. Deposit insurance is fundamentally incompatible with a safe and sound banking system because it tempts insured banks to play Russian roulette. The U.S. Congress therefore faces a simple but unpleasant choice. On one hand, Congress can make the economically sensible but politically difficult decision to come to grips with the problem at last by introducing a program to dismantle deposit insurance and let market forces rebuild the U.S. banking system. On the other hand, it can take the easy way out, as it has done so many times in the past, by doing nothing or by making cosmetic changes that amount to nothing. How much longer will Congress fiddle while the banking system burns?

[7]An interesting and important question is why these problems took so long to reveal themselves. Part of the answer, I suspect, arises from the increasingly erratic Federal Reserve monetary policies of the 1970s and 1980s. A more important factor, however, was probably the relatively tight regulation of banks and thrift institutions that existed from the 1930s until the late 1970s and early 1980s. This regulation managed to keep the moral hazard and adverse selection problems of the system under reasonable control. The deregulation that has occurred in recent years let the genie out of the bottle, as it were, and did much to escalate losses. However, it would be wrong to place the blame for the problems on deregulation (as many people have done). As the *laissez-faire* benchmark case illustrates, there is nothing wrong with bank competition provided it takes place within the right framework. The problem with deposit insurance is that it perverts that framework and thus converts normally healthy competitive pressures into destructive forces that need to be kept under control. Hence deposit insurance creates an artificial need for regulation. The most sensible course of action, of course, is to abolish both deposit insurance and the regulation that goes with it.

[8]See *Congressional Budget Office* (1990, p. 54).