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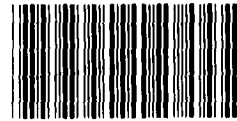
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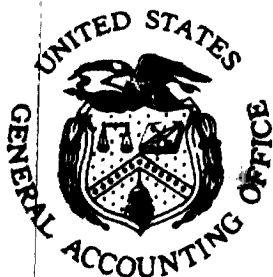
An Economic Overview Of Bank Solvency Regulation

Depository financial institutions in the United States are subject to extensive regulation. One aim of certain of these regulations is to maintain the safety and soundness of financial institutions. The cost of solvency regulation, however, is its inhibiting effect on competition. Serious questions have been raised as to whether the benefits of all the current types of solvency regulations justify this cost.



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In this report, GAO discusses the considerations that justify solvency regulation of depository financial institutions. The report shows that some of the goals of this regulation are achieved by the existence of a deposit insurance system and that many regulations can be justified only as a necessary adjunct of such a system. The costs and benefits of these regulations are discussed within this context. GAO also reviews some criticisms of, and proposed changes in, the existing deposit insurance system.



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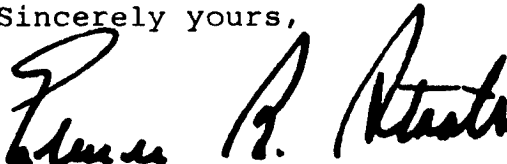
The Honorable Benjamin S. Rosenthal
Chairman, Subcommittee on Commerce,
Consumer and Monetary Affairs
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

In response to your request, this report examines the objectives, costs, and benefits of solvency regulation of financial institutions. The report focuses on the relationship of solvency regulation to the existing system of deposit insurance. It discusses the benefits and costs of various rules and regulations imposed to maintain bank solvency and reviews possible alterations in the current regulatory and insurance systems. We feel the report provides a useful analysis of the economic literature on solvency regulation and will be useful to Congress in evaluating proposed changes in the forms of solvency regulation.

As arranged with your office, unless you publicly announce the contents earlier, no further distribution of this report will be made until 30 days after the report date. At that time, we will send copies to interested parties and make copies available to others upon request. .

Sincerely yours,


Comptroller General
of the United States

D I G E S T

Representative Rosenthal, Chairman of the House Subcommittee on Commerce, Consumer and Monetary Affairs, expressed a desire for GAO "to consider certain economic aspects of bank regulation that merit careful attention by Congress." In response to Representative Rosenthal's request, this report examines the objectives, costs, and benefits of regulations intended to maintain the safety and soundness of financial institutions, the relationship of such regulation to the existing systems of deposit insurance, and the critiques of and proposals for altering these regulations and insurance systems. The Congress can use this information as a basis for evaluating proposed changes in the forms of solvency regulation.

SCOPE AND METHODOLOGY

In the past 20 years, economists have written a large number of careful analyses dealing with isolated aspects of bank regulation. However, the various regulations interact in complex ways that hinder systematic analysis and make consideration of proposed changes difficult.

In this report, GAO extensively reviews the economic literature and provides a discussion of the important issues in solvency regulation. GAO's analysis focuses on the interrelationship between solvency regulation and the deposit insurance system. Within this context, the benefits and costs of various rules and regulations are discussed. In addition, the theoretical discussion is related, where relevant, to evidence contained in numerous empirical studies, and alternatives to the current deposit insurance system are reviewed. Excluded from consideration are regulations which may affect bank safety and soundness

but whose avowed purposes are quite different: consumer protection laws, credit allocation devices, and measures used in the conduct of monetary policy.

EXTENT AND PURPOSE OF SOLVENCY REGULATION

Extensive regulations intended to maintain the safety and soundness of financial institutions abound in the United States. Federal agencies control entry into the banking industry and the maximum interest rates that banks, savings and loan associations, and mutual savings banks may pay on deposits. (However, the Depository Institutions Deregulation and Monetary Control Act of 1980 provides that the power of Federal agencies to set legal maximums on deposit interest rates will expire in 1986.) Federal laws prohibit banks from buying certain kinds of assets and from engaging in various activities. Types of assets which nonbank depository institutions are permitted to hold are even more circumscribed. (The Act of 1980 has liberalized the range of permissible assets.)

By and large, the laws that created regulatory agencies and set the bounds of permissible banking activity were enacted in response to financial crises occurring at various points in the Nation's history. In general, each new set of laws was enacted and each new regulatory agency was created with inadequate consideration of its relation to existing laws and agencies. Although many of the earlier laws and regulations aimed at maintaining bank safety and soundness may have been made redundant by subsequent legislation, they continue to exist and many exact a social cost greatly exceeding their social benefit. Existing side by side with this regulatory activity, and to some extent bound up with it, are the Federal insurance systems for bank deposits and saving and loan shares. While these systems have generally worked well, critics have identified what they regard as undesirable features and potential problems. These critics have proposed changes in the systems (see p. 24).

Solvency regulation for financial institutions has two basic objectives:

- to maintain the supply of money and the smooth functioning of the credit system, and
- to safeguard the assets of certain classes of depositors.

FINDINGS CONCERNING SOLVENCY REGULATION

Most economists writing on the effects of soundness regulation have found that when existing banks are subjected to competition from new entrants, they charge lower interest rates on loans, pay higher interest rates on deposits, lower their fees and service charges, increase their ratio of loans to assets, and generally improve their performance from the standpoint of both their business and individual customers. Similarly, these dimensions of performance are better where branch banking is permitted (see pp. 15-16).

No similar consensus exists on the regulations of activities open to banks. An expansion in the types of services banks offer should benefit the consumers by increasing competition. On the other hand, activity restrictions may be required to insure the smooth functioning of the deposit insurance system, to prevent conflicts of interest, and to prevent huge concentrations of conglomerate power (see p. 18).

Capital adequacy requirements are an important adjunct of an effective (uniform premium) deposit insurance system. Unfortunately, there are no generally accepted formulas for determining "adequate" levels of capital (see p. 20).

ISSUES IN DEPOSIT INSURANCE

Economics literature dealing with deposit insurance is far less substantial than literature on the effects of bank safety and soundness regulation. Although there

is not a consensus that glaring problems exist in the present system, a number of eminent economists have pointed to potential problems when dealing with large-bank failures (see p. 24):

--Federal deposit insurance has made the possibility that isolated failure of a small- or medium-sized bank will set off runs on sound banks remote, but what about the failure of a giant bank (one having deposits greater than \$0.5 billion)? In the 1970s for the first time, several large banks did fail. Admittedly, these failures did not cause runs on other institutions. Nevertheless, there are reasons to believe that in certain circumstances, failure of a giant bank may cause extreme public concern about the soundness of an entire segment of the banking system (see p. 29).

--The Federal Deposit Insurance Corporation (FDIC) is required only to protect (to the extent its resources permit) the insured depositors in failed institutions. But in dealing with an actual failure, one of the methods available to the FDIC (the purchase and assumption method) effectively protects uninsured depositors and nondeposit creditors, as well (see p. 31). Under this method, stockholders also generally fare much better than is normal for the stockholders of a failed company. In the case of failure of a giant bank, the FDIC is constrained by the finite size of its fund to use this method. Uninsured depositors and nondeposit creditors can thus achieve insured status, de facto, by investing only in giant banks. Stockholders, too, can achieve a measure of protection.

--Handling the failure of a giant bank may be made much more difficult by the current statutory division of responsibility among Federal (and, in some cases, State) agencies (see p. 36).

The first two of these points suggest that the question of how to protect a giant bank's small depositors without protecting its equity

holders and other creditors and without precipitating runs is a difficult one.

Some distinguished economists have criticized the uniform premium feature of the deposit insurance system. They make the following arguments:

- The existing deposit insurance system charges uniform premiums to all banks rather than varying the premium with the riskiness of a bank's activities (see p. 25). It thus provides an incentive for banks to undertake risky activities and to minimize their capital. The need to combat this problem of "moral hazard" provides an element of justification for some of the types of regulations discussed in this report.
- A system in which a bank's deposit insurance premiums varied with the riskiness of its activities would eliminate the problem of moral hazard and its concomitant rationale for objectionable regulations (see pp. 19-21).
- The major obstacle to such a variable premium deposit insurance system is the problem of finding a rational method for setting the rates. It is at least questionable whether a Government agency (or a private firm) with a monopoly on deposit insurance could develop such a method (see pp. 26-27).
- A rational system for assessing premiums might be developed through the spur of competition among private insurers. It is doubtful, however, that the degree of public confidence in a purely private deposit insurance system would be sufficient to prevent runs on bank. It may be possible to achieve a variable premium system, however, if the system were a joint public-private venture with definite limits on the liability of the private insurers (see p. 28).

Those who argue against such a venture assert that: even private insurers lack the data to produce an actuarially sound system;

the interdependence between banks must be considered in judging a single bank's riskiness; one source of risk for both individual banks and the banking system arises from the unpredictability of monetary policy; recent performance of private insurers in other areas shows that they are capable of serious errors of judgment in assessing risk; and since the Government would have to be involved, much of the alleged benefits of market discipline would not materialize.

AGENCY COMMENTS

A draft of this report was sent for comment to the Federal Reserve Board, The Federal Home Loan Bank Board, The Federal Deposit Insurance Corporation, and The Comptroller of the Currency. After the Act of 1980 was passed, the report needed to be completely revised to reflect the many changes contained in the act. GAO then discussed the revised draft with these agencies. These oral comments superseded the earlier comments GAO received, and either clarified or added technical points. The agencies did not officially comment on the report.

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CHAPTER 1

INTRODUCTION

The operations of financial institutions, in general, and of banks, in particular, are highly regulated in the United States. One aim of this regulation is to maintain safety and soundness of these institutions. Federal agencies control entry into the banking industry and the maximum interest rates that banks, savings and loan associations, and mutual savings banks may pay on deposits. 1/ Federal laws prohibit banks from buying certain kinds of assets and from engaging in various activities. Permissible assets of the other sorts of institutions are even more circumscribed. 2/ Required levels of banks' capital are specified both in laws and by examiners from the regulatory agencies.

By and large, the laws that created regulatory agencies and set the bounds of permissible banking activity were enacted in response to financial crises occurring at various points in the Nation's history. In general, each new set of laws was enacted and each new regulatory agency was created with inadequate consideration of their relation to existing laws and agencies. As a result, although many of the earlier laws and regulations aimed at maintaining bank safety and soundness may have been made redundant by subsequent legislation, they continue to exist and may exact a social cost greatly exceeding their social benefit. In particular, the existence of an effective deposit insurance system greatly reduces the justification for certain types of solvency regulation of financial institutions. Certain aspects of the present Federal deposit insurance system have been criticized and alternative systems have been proposed. This report is a survey of these matters, in response to Representative Rosenthal's request for GAO "to consider certain economic aspects of bank regulation that merit careful attention by Congress." This report does not deal with forms of regulation which may well affect bank safety and soundness but whose avowed purposes are quite different: consumer protection laws, credit allocation devices, and measures used in the conduct of monetary policy.

1/The Depository Institutions Deregulation and Monetary Control Act of 1980 (hereafter referred to as the Act of 1980) provides that the power of Federal agencies to set legal maximums on deposit interest rates will expire in 1986.

2/These restrictions have been relaxed somewhat by the Act of 1980.

OBJECTIVES, SCOPE, AND METHODOLOGY

Economists have become increasingly interested in bank regulatory issues in the past two decades. The number of studies, produced by competent impartial scholars, dealing with one aspect or another of solvency regulation is now quite large. However, the various issues involved in solvency regulation and deposit insurance have numerous complex ramifications and interrelationships that hinder systematic analysis of those issues and complicate consideration of proposed changes. Rather than engage in additional research on some isolated aspect of soundness regulation, we felt we could make a more valuable contribution by producing a discussion that logically organizes the issues, coherently sorts out the questions raised by their complicated interrelationships, and synthesizes the studies dealing with these questions. The objective of this report is to provide such an analysis and synthesis of issues, which will serve as a basis for improved evaluation of proposed changes in financial regulatory policy where relevant published data bearing on the issues under discussion are presented and analyzed.

To understand the types of solvency regulation to which financial institutions are subject, and why some of these regulations make others redundant, it is first necessary to understand the reasons for this regulation. For this purpose, "reasons" does not mean historical explanation, how, for example, a specific banking panic led to enactment of a particular piece of legislation. Rather it means considerations that justify regulation. Chapter 2 discusses these reasons and provides the groundwork for chapter 3, which examines the existing detailed sets of rules and regulations.

Chapter 3 begins by dividing all the solvency rules and regulations to which financial institutions are subject into several major types. As a prelude to the task of discussing the costs and benefits of regulation, it is briefly shown that many of the goals of solvency regulation are achieved by deposit insurance alone. Thus, most regulations can be justified only as a necessary adjunct of a deposit insurance system. It follows that an important component of a discussion of the costs and benefits of different types of regulation involves a determination of whether they are, in fact, necessary for the purposes of insuring deposits. The bulk of the chapter then discusses the costs and benefits of the various types of regulation.

Chapter 4 deals with problems that have been pointed out and changes that have been proposed in the current system of deposit insurance. The analysis is divided into two major

sections. The first discusses issues that arise from the uniform premium structure of the system. The second analyzes potential problems for the system posed by the failure of one or more giant banks. Chapter 5 summarizes our findings.

At this point, two caveats in connection with the scope of the report must be entered. The first concerns the treatment of different types of financial institutions. While the problems arising from the regulation of banks have been given first priority, in some cases identical problems arise from the regulation of savings and loan associations and mutual savings banks. In other cases, separate problems arising from the regulation of these nonbank deposit institutions are of interest. In still other cases, the relative situation of all three types of institutions must be considered in appraising proposed changes in the regulation of one of them. Thus, while the primary focus is on solvency regulation for banks, and while it has not been attempted to provide symmetrical analysis in every instance of the regulation of the other types of institutions, the effects of such regulation are discussed at numerous points.

The second caveat relates to the question of the administrative structure of Federal regulation of financial institutions. The piecemeal enactment of laws and creation of agencies to regulate financial institutions may have led to costly redundancy. It has had at least one other consequence: the current regulatory structure, i.e., the multiplicity of regulatory agencies and the division of responsibility among them, is rife with anomalies, inconsistencies, and inefficiencies. In a speech to the American Bankers Association Convention in October 1974, the Chairman of the Board of Governors of the Federal Reserve System, Arthur F. Burns, characterized the current bank regulatory structure as a "jurisdictional tangle that boggles the mind." [40, p. 11] ^{1/} However, a previous GAO issue paper [41] has surveyed the arguments in favor of and against consolidation of responsibilities in a single agency. With one exception, therefore, the present report avoids this question. The exception occurs at the very end of the report in the discussion of potential difficulties for the current system of deposit insurance in handling the failure of a giant bank.

^{1/}All sources that are quoted and used in the report appear in the bibliography, appendix I. The number in brackets corresponds to the source's number in the appendix.

CHAPTER 2

REASONS FOR SOLVENCY REGULATION

There are two distinct justifications for being concerned with the solvency of the banking system. The first stems from a belief that banks are so vital to a smoothly functioning economy that they cannot be allowed to fail. The second is the view that individuals with small deposit balances must be protected against bank failure.

THE ROLE OF BANKS AND MONEY IN THE ECONOMY

Banks provide three major "products," demand deposits (checking accounts), loans to businesses and individuals, and savings deposits. 1/ The largest proportion, by far, of any developed country's money supply consists not of coins or currency but of the demand deposit liabilities of commercial banks. While some of these deposits are obtained by the public in exchange for currency, the bulk of them (and, therefore, the bulk of the money supply) is created by the commercial banking system in the process of granting loans. This process is a critical lubricant for economic activity. Finally, savings deposits provide a low-risk, highly divisible investment asset that enhances the ability of households to cope with differences between the time path of their income and that of their desired consumption. 2/

The key role of banks in creating and safeguarding money and in extending credit provides the most frequently cited rationale for bank solvency regulation. The argument is advanced at both the "macro" (economy-wide) and "micro" (individual bank or community) levels. At the macro level the need is to prevent financial panics. The failure of one bank may cause massive numbers of depositors in other banks (some or all of which may be perfectly sound) to panic and to attempt to convert their deposits to currency. Panics can thus cause widespread bank failure. Any such failure wave means a sharp drop in the money supply which, almost surely, will seriously

1/Current developments, some of which are noted in chapter 3, are blurring the distinction between demand and savings deposits, but the discussion here uses the traditional distinction.

2/For example, most individuals will not wish to stop consuming goods and services simply because they no longer generate income in the form of wages or salaries.

disrupt economic activity. Thus, since control of the money supply is central to maintaining economic stability, and since such control cannot be assured if the banking system is vulnerable to financial panic, Government regulation of banking is presumed necessary.

In the case of an isolated bank failure, the direct losers are, of course, equity holders and unprotected depositors and perhaps some creditors. However, there are those who feel that these losses are overshadowed by the decline in local economic activity that would accompany cessation of a bank's intermediary function. One exponent of this view has suggested that there is no greater community disaster than bank failure in a one-bank town. Others have countered that bank credit is moveable over great distances at low cost and that a bank's economic role in a local community could be more easily replaced than that of a local manufacturing plant.

The provision of checking accounts by banks leads to another rationale for regulation. The use of checks as a means of payment is socially efficient. Their use lowers the transaction costs of economic exchange, increases the volume of exchange, and thereby enhances general economic welfare. But, the value of a checking account to a person partially depends upon how many other people use and accept checks (just as the value of a telephone depends upon how many people have a telephone). Solvency regulation lowers the risk (and therefore the cost) of holding demand deposit-balances, which is essential for widespread use of checks as a payment vehicle.

On the other hand, it could until recently have been argued that the regulatory system encouraged over-use of checking accounts.

"Banks cannot pay interest on demand deposits, so they compete by providing checking services at below-cost prices. Bank customers devote resources to minimizing the size of their demand deposits (a socially wasteful activity, since such deposits can be created at low cost) and write an excessive number of checks (since they are not bearing the cost of handling those checks)." [16, p. 107]

This argument for solvency regulation is no longer valid since the Act of 1980 provides that by the beginning of 1981 all deposit-type financial institutions may offer interest yielding third-party-payment accounts to noncorporate customers.

Finally, solvency regulation lowers or eliminates the risk attached to savings deposits. Such deposits, under the

present regulatory framework, are virtually risk free. Left to its own devices, the free market would probably develop more-or-less imperfect substitutes for insuring these deposits. Perfect substitutes would probably not emerge, however. It is difficult to see how the private sector by itself could produce risk-free deposits. Even private deposit insurance schemes would not guarantee totally riskless deposits--insurance companies may also be subject to failure.

SAFEGUARDING DEPOSITS

The second distinct justification for solvency regulation is related to protection of depositors. One author has distinguished between "elite" suppliers of capital, a group of persons in the higher brackets of income and wealth who are the predominant individual investors in the bonds and stocks of corporations, and "public" suppliers of capital, those who own deposits in a commercial bank or other financial intermediary. [5, pp. 1-102] Large numbers of adults are public suppliers of capital. The greater regulation of financial institutions than of other corporations is, then, explained by the desire to protect public suppliers of capital. Why are they thought to need special protection beyond the full disclosure requirements that Federal law imposes for the benefit of elite suppliers of capital? Four reasons can be identified.

First, it may be argued that it is easier for dishonest management to steal from financial institutions than from other corporations, and statistics do show that the proportion of bank failures due to fraud and self-dealing is extraordinarily high, while the proportion of nonfinancial corporate failures due to these causes is negligible. [5, pp. 12-13] However, most financial regulation is clearly aimed not at dishonest management but at limiting the risks honest management can take. [5, p. 14]

As a second possible reason for protection, it might be argued that the risk level of a financial institution is peculiarly subject to being changed abruptly and without timely notice to capital suppliers. It is much more difficult to quickly and secretly sell off the physical assets of a non-financial corporation and radically change the character of the business than it is to dispose of a loan portfolio in secondary markets and replace it with a much riskier one. [5, p. 14] However, far from justifying anything like the extensive regulation that currently exists, this affords a reason only for requiring management to disclose proposed changes in risk levels and to give public suppliers of capital an opportunity to opt out at a fair price.

A third reason that could be adduced for the protection of public capital suppliers is that high information costs make a free market inappropriate. An elderly retired person who wishes to put \$200 in a savings account might find that a substantial portion of the \$200, as well as much time and effort, would be required to obtain information about the riskiness of the account. An opponent of regulation would respond that, in its absence, the market would provide informational services, such as those supplied by Standard and Poor and Moody's, concerning such accounts. Further, if this did not happen, it would show that even the efficient cost of getting usable information to public suppliers of capital exceeds the benefits to be gained from it, and thus regulation is inappropriate. The latter argument, however, is negated by the free-rider problem. Information cast in terms usable to public suppliers might be efficiently produced and delivered by one or more producers, might yield an overall benefit greatly in excess of the cost of production and delivery, and yet might not be privately supplied because of the difficulty of preventing people from using it without paying. Nevertheless, this only provides justification for public provision of information about risk, not for attempting to control risk, as current regulation does.

A defender of existing regulations might respond by suggesting that their role is to change the relevant information and, thus, to reduce radically the cost of communicating it to public suppliers of capital. Through regulation, the Government has made small claims on financial institutions virtually riskless, and, over time, even the most ignorant public suppliers of capital, those who would have to expend the greatest amount to obtain and be able to use relevant information, have learned that if they want safety they can just put money in the bank. However, if the only goal of public policy is the public provision of useful information about the relative riskiness of deposits in different financial institutions, it is just not credible to argue that the cheapest way to achieve this goal is through substantive risk-reducing regulation. Regulatory agencies could make public the results of the examinations they currently conduct, at little additional cost, and eliminate a number of current-risk-reducing regulations, which impose high social costs.

Objections have been raised about disclosing adverse information since this might increase the possibility of bank runs. In response, Professor Jack Guttentag has argued as follows:

"The basic rationale of an 'almost free' disclosure policy is that it will on balance stabilize the

banking system because bankus malum non facit saltum ('banks don't go bad in one leap') [sic]. If the market becomes aware of a deteriorating situation at an early stage, its reaction will be salutary taking the form of rising risk premiums demanded on the banks liabilities. In contrast, when information becomes available only at a late stage in the deteriorating process, the market's reactions will be extreme and disruptive.

To a considerable extent the counter argument for nondisclosure is circular. If a bank's condition deteriorates from condition A to condition D and the market has not been aware of it, letting the news out may precipitate a run and frustrate the efforts of the authorities to restore the bank to health. (Even then nondisclosure may not be the best policy because when the bank is large, usually bad news gets out anyway, but in an incomplete and perhaps distorted form that may have a more serious effect on public confidence than the unvarnished truth.) Within an environment of complete or almost complete disclosure, however, the market would become aware when the bank's condition went from A to B and B to C and its response at each stage could constrain the bank from ever reaching D." [14, pp. 510-1].

The fourth argument for protecting public suppliers of capital assumes that many would not understand, or would deliberately ignore, even simple consumer-oriented ratings of financial intermediaries supplied by a government-sponsored source. Hence, the only effective way of communicating information to these households, it is urged, is to render the institutions so safe that only the simplest signals ("absolutely safe" or "not absolutely safe") are needed. The argument has been subtly recast. The problem is no longer high information costs, or, more generally, market imperfections, but rather personal imperfections. It is consistent, however, to be acutely conscious of human imperfections and yet oppose governmental protection of citizens from their own errors on the ground that it is impossible to choose rulers who know what is wrong with other people's preferences.

More concretely, the discouragement of high-risk banks through solvency regulation confers the benefit of preventing certain groups of persons from making harmful (to them) choices at the cost of removing beneficial options to other groups of persons. (For example, small savers without important financial responsibilities who are young and have enough

human capital to make them reasonably certain of an adequate future income will clearly be better off if allowed to take more risk and earn a higher expected return, if they so desire.) It is not obvious that society's welfare is maximized by subordinating the interests of one group to those of another. In general, there is no way to determine a priori whether risk-reducing regulations will increase or reduce social welfare. Any attempt to make a judgment in a particular case requires considerable information on consumer preferences, which is difficult to obtain even in principle, let alone in practice.

CHAPTER 3

COSTS AND BENEFITS OF SOLVENCY REGULATIONS

One of the major elements in the solvency regulation of depository financial institutions is a set of detailed rules that fall into five different categories. These include (1) restrictions on new entry and on creation of branches, (2) restrictions on the activities in which particular financial institutions may engage, (3) constraints on balance sheets, (4) regulations to prevent insider misconduct, and (5) constraints on pricing. The task of this chapter is to discuss the costs and benefits of these sorts of rules and regulations. However, the Act of 1980 provides that the power of regulatory agencies to set ceilings on the interest rates financial institutions may pay on deposits--the pricing constraints just mentioned--will expire in 1986. Therefore, analysis of the effects of the ceilings was not considered necessary. This chapter discusses the costs and benefits only of the first four categories of regulations.

RELATION OF SOLVENCY REGULATIONS TO DEPOSIT INSURANCE

A recurring theme in the analysis to follow of each sort of regulation is its relationship to a system of deposit insurance. One intended benefit of all five types of rules is to contribute to the maintenance of solvency of individual financial institutions. But it is essential to recall from the last chapter that the two basic reasons for public policy to be concerned about solvency are the need to maintain the money, credit, and savings deposits that the banking system makes available and the desire to protect depositors, particularly those with small accounts.

Public policy needs to be concerned with failures of individual banks only as they cause runs on perfectly sound ones, undermine confidence and, at worst, cause the system to collapse. 1/ The existence of a credible deposit insurance system greatly mitigates this possibility. 2/ Well-functioning deposit insurance also fully achieves the goal

1/A qualification to this statement for the case of one-bank communities will be evaluated in the section of this chapter on entry restrictions.

2/Under the current system of Federal deposit insurance, failure of a very large bank might cause the sort of problems mentioned in the previous sentence. This matter is discussed

of protecting small depositors. Thus, in terms of the solvency rationale for regulation, detailed rules yield net social benefits only as they are necessary adjuncts of an effective system of deposit insurance. It has been seriously questioned whether all five categories of rules can be justified in this manner.

RESTRICTIONS ON NEW ENTRANTS AND ON CREATION OF BRANCHES

New entrants

Since 1935, a federally chartered bank wishing to obtain Federal deposit insurance has had to be certified by the Comptroller of the Currency. A State-chartered bank that belongs to the Federal Reserve System and wishes to obtain Federal deposit insurance has had to be certified by that institution's Board of Governors. A State-chartered bank not belonging to the Federal Reserve System and seeking deposit insurance has had to apply to the FDIC. Since few banks can successfully attract deposits without deposit insurance, Federal agencies have thus been given a virtual veto power over the existence of even State-chartered banks. ^{1/}

The Banking Act of 1935 set forth the criteria (now contained in the Federal Deposit Insurance Act) that these agencies are required to consider in certifying or approving banks for Federal deposit insurance. One frequently cited study concluded that in the 26-year period beginning in 1936 these requirements caused the rate of entry into banking to be, on average, 50 percent smaller than it would have been in their absence. [29, pp. 11-50] The model and assumptions of this study were severely criticized by a subsequent pair of authors who estimated that the rate of entry was 39 percent lower than it would have been had the entry restrictions not existed. [6, pp. 445-460] While the rate of new bank formation

in the next chapter. Furthermore, under the current system, a possibility exists that even failure of a small bank might undermine confidence in the system because of the increasing degree to which banks are tied together through bank funding markets (Federal fund sales and purchases, Eurodollar borrowing, correspondent balances, compensating balances, etc.).

^{1/}In most cases, even those organizers of a new bank who believe they can operate successfully without deposit insurance will be subject to this Federal veto. Qualifying for Federal deposit insurance is a condition for the granting of a charter in almost every State.

has increased somewhat in the 1970s, it seems likely that the agencies, in their decisions concerning chartering and certification for Federal deposit insurance, have continued to limit new entry into banking. What have been the costs and benefits of this limitation?

The intended benefit of the power to restrict entry by withholding Federal deposit insurance, contained in the Banking Act of 1935, was the reduction of the incidence of bank failure. Even before the catastrophic experience of 1929-33, the number of bank failures during the generally prosperous period from 1921 through 1928 averaged around 631 a year. Before 1921, in contrast, the annual number of failures had exceeded 200 only in the panic year of 1893. Most of the failed banks were small; more than 90 percent of them were in communities of less than 25,000 inhabitants, and 85 percent had total assets of less than \$1 million. These banks were victims of the urbanization that began in earnest in the 1920s as population and purchasing power of rural areas declined. Furthermore, although the 1920s were generally prosperous, they were difficult times for farmers, who, in large numbers, were unable to repay mortgage loans extended from 1916 to 1920 when farm income had grown rapidly. Many banks failed as farmers could not repay these loans.

Most observers felt that another reason for the wave of bank failures in the 1920s was that in the preceding 40 years there had been a "charter race" between the Comptroller of the Currency and State banking authorities. In 1921 there were more than 29,000 banks. County seat towns of less than 1,500 people often boasted three or four banks, and a Midwestern county with a population of 10,000 was blessed with 18. A general feeling prevailed that in 1921 the Nation had been "overbanked" and the wave of failures was inevitable.

One author has noted that

"there is no clear-cut generally accepted definition of overbanking, and consequently no proof that it has been a major cause of failure (unless one accepts as proof the tautology that since a bank failure reduces the number of banks, it follows that the pre-failure number of banks must have been excessive)." [38, p. 137]

Nevertheless, the result of the belief in overbanking was the portion of the Banking Act of 1935 that sets forth criteria that the regulating agencies must consider when passing on applications for Federal charters and/or Federal deposit insurance. Among other criteria, including capital adequacy

and character of management, the regulators are to consider the "convenience and needs of the community."

In most other lines of business, the number of firms needed to serve the "needs of the community" is determined by market forces. But with the experience of the 1920s in mind, the authors of the Banking Act of 1935 obviously felt that the consequences of bank failure were too serious to allow the market to work its will and that the judgment of regulators was required. However, as discussed in the previous section, the advent of effective Federal deposit insurance has eliminated the phenomenon of an isolated bank failure precipitating runs on, and perhaps causing the ultimate failure of, sound banks.

The only problem that is not met by effective deposit insurance alone is the temporary loss of credit availability and deposit facilities when a bank fails in a one-bank community. Local economic activity will be adversely affected until new banking services are in place. But, while some feel that there is no greater community disaster than bank failure in a one-bank town, others have countered that bank credit is moveable over great distances at low cost and that the consequences of a decision of the dominant employer in a small community to move or cease operations would be far more serious and enduring.

Furthermore, it is undoubtedly the case that in some instances, were it not for restrictions on entry, the town in question would have had more than one bank and been spared the temporary need to do without banking services. Finally, it is rare today for inhabitants of one-bank towns to be seriously inconvenienced by failure of their banks. When the chartering authority determines that a bank must be closed, it generally arranges for new banking facilities (a branch of a large banking organization) to be in place within a day or two. Depositors, by and large, are aware that this is the case. When the Frontier Bank of Covelo, California failed in 1965, despite the fact that it was the town's only bank, "hardly anyone could be found even talking about it."
[38, p. 142]

Critics of entry restrictions thus argue that given effective deposit insurance it is difficult to argue that the consequences of an individual bank failure are so catastrophic that the regulators' assessment of the "needs of the community" must be substituted for the workings of the

market 1/ and that any benefits of restriction on entry are more than slight.

The possible benefits of entry restrictions should be weighed against the costs that may be associated with such restrictions. What are the costs? In theory the existence of abnormal profits in an industry attracts new entrants who tend to compete them away in the long run. Entry restrictions prevent the operation of this process. Thus, one would expect a major cost of entry restrictions to be a lack of competition, resulting in higher profits than would be earned in their absence.

The values of a great many "performance variables" determine a bank's profits. These include interest rates charged on each type of loan, interest rates paid on deposits, fees and service charges, ratio of salaries to total expenses, ratio of each type of loan to total loans, ratios of loans, securities, and cash to total assets, ratio of demand deposits to total deposits, and others. The values of these variables for banks protected from competition by entry restrictions should differ systematically from the values for banks not so protected. One would expect the protected banks to charge higher interest rates on loans, pay lower interest on deposits, charge higher check fees, have lower ratios of loans to assets, and differ similarly with respect to the other performance variables. If such differences are, in fact, a consequence of entry restrictions, this consequence is clearly a major cost of the restrictions.

Do banks protected from competition by entry restrictions, in fact, exhibit values of performance variables systematically different from those exhibited by banks not so

1/The Community Reinvestment Act of 1977 directs the regulatory agencies to consider the credit needs of the community and performance of the applicant in serving those needs when considering certain types of applications. The motive here is very different from that which produced the similar mandate contained in the Banking Act of 1935. The aim of the 1935 Act was to use the chartering and insurance-granting powers of the Federal agencies to prevent bank failure. The aim of the more recent Act was to use those powers to deal with a situation in which, it was alleged, creditworthy borrowers were refused loans on the basis of their race or neighborhood. As noted earlier, this report does not attempt to evaluate the effects of rules associated with this latter aim.

protected? A number of authors have investigated this question by comparing the performance of existing banks before new entry occurred in their markets with their performance after new entry forced them to compete. [4, pp. 22-30; 10, pp. 65-78; 27, pp. 469-512; 23; 25, pp. 1587-1604] While no study finds that every single variable is affected by entry in the manner outlined in the previous paragraph, every study finds that a large majority of the variables examined behaves in this way.

Critics of entry restrictions argue that the number of studies is sufficiently large and their findings are in sufficient agreement that taken together they constitute very powerful empirical support for the proposition, derived from economic theory, that new entry significantly improves performance. A very heavy burden of proof lies with anyone wishing to argue otherwise. They conclude that performance differences between banks protected from competition by entry restrictions and those not so protected are a significant cost of such restrictions.

While the protection of existing banks from competitive forces is, in all likelihood, the greatest cost of restriction of new entrants into the banking industry, there are also the costs of the legal and administrative machinery associated with obtaining a bank charter. These would be reduced, though not eliminated, if policy were changed to eliminate the "community needs and convenience" criterion, but retained the requirements pertaining to the capitalization of the proposed bank and the character of the applicant.

In weighing the costs of a higher number of isolated instances of bank failure against the benefit of increased competition that such a policy change could be expected to produce, it should also be noted that increased competitive pressures rarely lead to sudden unanticipated collapse. Banks whose long-term viability is threatened by these pressures should be able to either exit gracefully or achieve necessary economies of scale by affiliation with other institutions. Yet "the economic and legal investigation preceding a merger decision is even more complicated than that required before approval of a charter." [32, p. 169] ^{1/}

^{1/}The Bank Merger Act of 1966 amended the Federal Deposit Insurance Act by expanding the procedure to be followed by the regulatory agencies in considering and approving bank mergers.

Branching

Any existing bank wishing to open a new branch office must apply to one of the regulatory agencies. The "convenience and needs of the community" criterion is applied as in the case of those wishing to establish or obtain Federal deposit insurance for a new banking organization. Interstate branching is prohibited. In addition, each State has its own law dictating the extent to which it allows chartered banks to branch. The McFadden Act (as amended) subjects banks with Federal charters to the branching laws applicable to the State-chartered banks of their respective States. 1/ While there has been some movement on the part of the States to liberalize their branching laws, statewide branch banking is far from the rule. In 1978 only 11 States had no statutory limitations whatsoever on the location of branches.

One of the motives for restricting branching is the same as that for restricting new entrants, prevention of individual bank failure due to "overbanking." The case for this argument is questionable. In fact, a not uncommon view has been that branch banking increases the stability of the banking system:

"One of the early arguments for branch banking was that the geographical diversification associated with branching results in greater deposit stability and makes branch banks less vulnerable to adversities in a specific local market. The available evidence supports this view.

The wave of failures of unit banks in the 1920s and 1930s gave special force to the argument that branching increases deposit stability and bank soundness, particularly since Canada (which had a banking system composed of a relatively small number of large branch banks) did not suffer this problem. However, the U.S. during the 1930s opted for deposit insurance rather than extensive branching as a solution to the problem of bank failures." [13, pp. 99-100]

Advocates of restrictive branching provisions might concede this point but would raise the specter of an extremely concentrated industry with just a few banks, each controlling

1/Prior to passage of the McFadden Act, there was no explicit legal authorization for nationally chartered banks to create branches. Thus, ironically, the purpose of the Act was to liberalize these banks' branching possibilities.

massive resources. In summarizing the evidence on this question, however, Professor Guttentag finds that

"the spread of branch banking into nonmetropolitan areas tends to increase competition, at least in the short run. Concentration at the State and metropolitan area levels rises over time with branching, but adverse effects on competition tend to be neutralized by expansion in the size of market areas and perhaps by relatively easy entry."
[13, p. 107]

He goes on to ask whether, given liberal branching laws and enough time, the banking structure in the United States would assume the very highly concentrated character found in most other developed countries. While admitting that no one can answer this question with certainty, Professor Guttentag offers the following reasons for believing that extreme concentration would not occur. First, since large numbers of sizable banks now exist, liberalized branching "will not necessarily lead to the extensive concentration characteristic of countries which have had free branching since the early stages of financial evolution." [13, p. 107] Second, the United States does not sanction many practices accepted in foreign countries that contribute importantly to banking concentration, such as predatory tactics designed to drive competitors out of business and mergers and holding company affiliations among competitors. Third, "branching costs rise with distance between offices and in a large country this imposes a constraint on expansion through branching."
[13, p. 107]

Another benefit of restrictive branching policy is said to be that a locally owned bank will have a greater stake in the community and be more responsive to local needs than a branch of a bank whose main office is elsewhere. However, opponents of such policy point to empirical studies which find that, with only a few exceptions, local consumers and business customers are better served by branches than by unit banks when judged by comparative performance in such dimensions as variety of services offered, loan to asset ratios, percentage of consumer loans, interest rates on consumer loans, percentage of business loans extended to local customers, and others. ^{1/} As was true about the evidence

^{1/}[33, pp. 227-230; 36, pp. 511-550; 7, pp. 43-47; 8, pp. 30-39; 12, pp. 157-167, 298-307; 20; 15; 23; 22; 18, pp. 143-188; 34, pp. 201-366].

concerning the effect of new entry, critics of restrictive branching provisions assert that the number of studies is sufficiently large and their findings are in sufficient agreement that taken together they constitute powerful empirical support for the proposition that freedom to establish branches improves performance. The burden of proof must lie with anyone wishing to argue otherwise. Thus, they point to the performance of the banking system, when restrictive branching provisions exist, as a serious cost, not benefit, of those provisions.

Finally, the protection afforded existing banks by branching restrictions is diminishing. Through holding company parent corporations, banks are able to compete for loans, though not for deposit business, by creating nonbank financial firms. Such firms have been created by industrial conglomerates and insurance companies, as well. Furthermore, as noted on page 5, the Act of 1980 authorizes all deposit-type financial institutions to offer third-party payment services to non-corporate customers by the beginning of 1981. In addition to third-party payments, this Act increases competition in a number of other areas including credit cards, consumer lending, and trust powers. Also, in June 1979, the Federal Home Loan Bank Board formally proposed that savings and loan associations in the Washington, D.C. metropolitan area be permitted to establish branch offices across State lines. 1/

ACTIVITY RESTRICTIONS

Although commercial banks are subject to far fewer constraints on permissible activities than are other financial institutions, significant limits persist. While banks now engage both directly and indirectly through the holding company device in many nontraditional activities, such as equipment leasing, they are restricted by statute or regulation from engaging in certain non-banking activities. For example, banks generally may not operate as brokers or dealers in corporate stock or underwrite corporate stocks or bonds.

In addition the amounts that national banks and member banks of the Federal Reserve System can lend to a single customer are limited.

1/Federally chartered savings and loan associations are not subject to the McFadden Act, but the Federal Home Loan Bank Board has generally regulated their ability to establish branches as if they were.

The preceding sections have shown that, given effective deposit insurance, it is difficult to argue that entry restrictions are needed for the maintenance of solvency. Activity restrictions cannot be dismissed as easily. Much depends on the type of insurance system. ^{1/} Presently, all banks pay the same premium per dollar of deposits. Thus, the problem known as "moral hazard" arises. A bank's premium will not rise if it increases the riskiness of its activities. Incentives are thus provided for banks to do just that. To prevent banks from acting on these incentives, the insuring authority imposes activity restrictions. Under an alternative system, a bank would find its premiums varying directly with the riskiness of its activities. Even under the current system, some believe it is possible for the insurers to abolish activity restrictions and deal with moral hazard by setting differing capital and liquidity requirements for each bank commensurate with the riskiness of its activities. Both of these proposals assume the insurers are competent to assess relative degrees of risk, an assumption that is by no means universally accepted. If these alternatives are not feasible, it would appear that some degree of activity restriction is a necessary adjunct of a deposit insurance system.

A second benefit of activity restraints is said to be that they prevent conflicts of interest. For example, a traditional argument against permitting commercial banks to underwrite corporate securities is that this could create potential conflicts of interest for bank managers. To the extent that the general proposition is valid, a complete examination and revision of current activity restrictions is in order. The existing trust operations of commercial banks pose conflict of interest issues as troublesome as any likely to arise if current restrictions were relaxed.

A third benefit claimed for activity restrictions is that they prevent banks from acquiring massive political and economic power. If banks could engage in all sorts of activities and own all kinds of businesses, they might well become huge enterprises with tentacles reaching into all areas even without violating any current antitrust laws. The issue is of obvious importance but a discussion of the pros and cons of large conglomerate businesses and of giving such businesses a banking arm is beyond the scope of this report.

The cost of activity restrictions is the same as that of restrictions on entry and pricing: inefficient businesses

^{1/}Therefore, the discussion in this paragraph, of necessity, touches on matters that are really the province of the next chapter.

are protected from competition with banks. A smaller quantity and variety of services is provided at a higher price.

CAPITAL REQUIREMENTS

The relationship of capital requirements to deposit insurance

As noted on page 19, some believe it preferable to deal with the problem of moral hazard inherent in a fixed premium deposit insurance system by varying each bank's capital requirements with the riskiness of its asset portfolio, rather than by using activity restrictions. Whether or not such variation is feasible, the insurer of a bank's deposits, charging a premium independent of the riskiness of that bank's portfolio, must be concerned with the bank's capital adequacy. This is due to the essential similarity between the role of such an insurer and that of a private lender. Private loan contracts often impose restrictions on the borrower's behavior and may provide for direct supervision of its business by the lender. The purpose, however, is not to substitute the lender's judgment for the borrower's in the general conduct of the borrower's business. It is

"rather to prevent acts that would benefit the borrower or other creditors at the expense of the lender, such as siphoning off the borrower's assets to the stockholders in the form of dividends, increasing the riskiness of the business, or pledging some of the assets to another creditor." [1, p. 384].

Designing, negotiating, and enforcing provisions of a loan contract that restrict the behavior of the borrower and allow a measure of direct supervision by the lender entail costs to both parties. The riskier the loan the greater the costs, and the greater the loan as a fraction of the borrowing firm's value, the riskier the loan. This follows from the fact that the greater the loan as a fraction of the borrowing firm's value, the greater is the incentive for the borrower to take the sorts of action harmful to the lender, which the restrictions are designed to prevent. Since the borrower and lender generally have an interest in minimizing the costs of executing the loan, a widely used way of reducing the loan's riskiness is to keep a substantial margin of capital between the value of the borrower's assets and the value of the loan.

Now a bank paying a deposit insurance premium that does not vary with the riskiness of its portfolio "will have the same incentive to alter the value or risk of its assets as a borrower, and the less capital the bank has, the greater

this incentive will be." [1, p. 386] Hence, just as a private lender is concerned with a borrower's capital, under the current fixed rate premium system of deposit insurance, the Government must be concerned with bank capital levels. Just as a private borrower wishing to extend a loan may be required to contribute additional equity capital, the Government has denied banks with weak capital bases permission to expand their activities in ways that increase risk.

Turning from the question of whether bank regulators ought to be concerned with the level of bank capital to the question of their actual effect on that level, one widely cited study, (which, to be sure, may not reflect the experience of the past decade) concluded that there was no effect:

"the investment process in commercial banking functions almost as if the apparatus set up to regulate it did not exist. Bankers do not respond to any of the regulators' standards of capital adequacy, including that which asks them not to substitute deposit insurance for capital." [28, p. 16]

This conclusion was attacked in a subsequent study which found that banks given low soundness ratings by regulators did increase their rate of capital formation in the subsequent period and that regulators seem to concentrate their jawboning efforts at the most "under-capitalized" banks. [26, pp. 1111-21]

The administration of capital requirements

While the laws restricting bank entry, bank branching, levels of interest rates on deposits, and the activities that banks may engage in are quite specific, there is somewhat of a legal vacuum regarding the regulation of capital adequacy. ^{1/} While State and Federal laws generally prescribe minimum initial capital requirements, they do not dictate how a bank's capital must increase as its assets and liabilities grow. Perhaps this is just as well since there is considerable doubt that required capital ratios can be set across the board, on other than a purely arbitrary basis. Prudent capital ratios will vary with the quality and character of a bank's assets, the competence of its management, and the stability of the economic environment in which it operates. Banks differ greatly with respect to these characteristics.

^{1/}All federally insured savings and loan associations have capital requirements that are specified in statute supplemented by implementing regulations.

While it is therefore extremely difficult to determine the level of capital that is "adequate" for any particular bank, it seemed reasonable to regard the decline in capital asset ratios of commercial banks that has occurred since 1950 as disquieting. The ratio of total capital to total assets of all insured banks fell from 6.8 percent to 6.1 percent. 1/ However, this average ratio conceals a great diversity of experience. For insured banks whose asset size is \$500 million or less, the ratio was either constant or actually increased during the crucial decade of the 1970s. For insured banks whose assets are in excess of \$500 million, the ratio declined, with the decline being especially sharp for those banks whose assets are \$5 billion or more (here the decline was from 6.1 percent in 1970 to 4.8 percent in 1979). 2/

REGULATIONS TO PREVENT INSIDER MISCONDUCT

A host of regulations have been imposed on bank managers to restrict the potential scope of insider misconduct. These regulations are essentially an administrative substitute for common law remedies through private litigation. The solvency regulations discussed up to this point seek to enhance bank soundness by supplementing the restrictions imposed on banks by common law. In contrast, the insider misconduct regulation seeks to enhance soundness by using a more efficient scheme for policing managerial behavior than that available under the common law system of privately enforced rights.

Thus, the nature of this regulation is fundamentally different from the anticompetitive and portfolio-constraining restrictions discussed in earlier sections of this chapter. An assessment of its usefulness in maintaining bank soundness would entail an examination of the inadequacies of common law remedies and of the costs and effectiveness of administratively policing managerial behavior. Clark has noted, however, that "there is no established theory, comparable in quality to microeconomic theory * * * upon which one can build a meaningful a priori argument about the effectiveness

1/For purposes of measuring capital adequacy, the Federal Financial Institutions Examination Council has computed three capital ratios: total capital to total assets, equity capital to total assets, and equity capital to risk assets. All three ratios show the same downward trend for the period 1950-79.

2/The decade of the 1970s was selected for use in this comparison because the ratio was available by asset size of bank for this decade only.

of insider misconduct regulation." He also notes that "there has been no extensive empirical research measuring how much insider misconduct is actually deterred." [5, p. 85] An assessment of the costs and benefits of insider misconduct regulation is, therefore, beyond the scope of this report.

CHAPTER 4

COSTS AND BENEFITS OF THE CURRENT

SYSTEM OF DEPOSIT INSURANCE

Perhaps the two most eminent currently-active scholars in the field of monetary economics are Professors Milton Friedman and James Tobin. Although they are poles apart in their views on most topics in this field, they appear to be in agreement that the current system of deposit insurance has produced tremendous benefits. Friedman states that "Federal deposit insurance * * * has succeeded in achieving what had been a major objective of banking reform for at least a century, namely, the prevention of banking panics." Furthermore,

"banking panics (prior to the advent of Federal deposit insurance) have occurred only during severe contractions and have greatly intensified such contractions, if indeed they have not been the primary factor converting what would otherwise have been mild contractions into severe ones. That is why we regard Federal deposit insurance as so important a change in our banking structure and as contributing so greatly to monetary stability--in practice far more than the establishment of the Federal Reserve System." [11, pp. 440-442]

Tobin has written that

"deposit insurance is certainly one of the most successful reforms ever adopted in the United States, as even a cursory glance at banking history before and after demonstrates." [37, p. 508]

Despite this meeting of the minds, various other observers have noted certain anomalies and shortcomings in the current system of deposit insurance and have offered proposals for change. These matters are the subject of this chapter. They are discussed under two major headings. The first of these deals with questions relating to how the deposit insurance program is funded. The second discusses the implications for deposit insurance of a new problem that has emerged in the 1970s, the failure or precarious condition of very large banks. 1/

1/The terms "very large banks" and "giant banks" are used interchangeably in this discussion. Admittedly, the terms are not very precise. However, there is no agreement in

One important question that falls under both of these headings is whether it would be desirable to switch from the current method of relying upon a previously accumulated insurance fund to a pay-as-you-go system in which the size of the annual assessments is determined by the cost of operations in the previous few years. This question has assumed much greater relative importance in the wake of the large bank failures of the 1970s, and it is discussed in the second major section of this chapter. The discussion in the first major section will take for granted the current approach of building up an insurance fund and will be concerned with possible improvements in determining premiums for this fund.

PROPOSALS FOR CHANGING THE PREMIUM STRUCTURE

The current premium structure of the deposit insurance system is the feature that gives rise directly or indirectly to many of the criticisms and proposed changes in the system. A uniform rate per dollar is applied by the FDIC (and by the Federal Savings and Loan Insurance Corporation (FSLIC)), to total "assessable" deposits in each institution. ^{1/} The actual (uniform) premium rates at which institutions' deposits are assessed have been described as being based not "on loss probabilities but upon some largely arbitrary numbers written into the governing statutes by Congress." [35, p. 837] However, staff officials of the Federal Reserve Board have taken issue with this characterization, asserting that "at least in the case of the FDIC, * * * assessments reflected an attempt by Clark Warburton of the FDIC to calculate an actuarially sound premium for the banking system." [9] In any case, the fact that premiums do not vary with the riskiness of an institution's activities has led to a number of proposals for change. Various commentators have asserted that economic efficiency could be increased by charging different premiums to different institutions, encouraging private insurers to get into the business, and/or switching from a funded system to a pay-as-you-go system. The first two of these issues will be discussed in this section. Discussion of the last one, as noted above, is reserved for the

the literature on a precise definition. Jack M. Guttentag speaks of the "billion dollar bank in trouble." [14, p. 508] Paul M. Horvitz presents a table of data implying that in his view giant banks are those with deposits of \$0.5 billion or greater. [17, p. 592]

^{1/}"Assessable" deposits are calculated by subjecting total deposits to various adjustments.

following section on implications for the deposit insurance system if giant banks should fail.

Costs and benefits of a variable premium system

Proponents of a system in which a financial institution's deposit insurance premiums vary with the riskiness of its activities have asserted that several benefits would flow from its adoption. First, it would facilitate the relaxation of the detailed solvency rules and regulations discussed in the previous chapter. As noted at several points in that chapter, a uniform premium system gives rise to the problem of "moral hazard" in that it provides incentives for banks to minimize their capital and to undertake risky activities. A respectable case can be made that activity restrictions and regulation of capital levels are required to counter these incentives. ^{1/} A variable premium system would substantially reduce the moral hazard involved in insuring deposits, thus eliminating one sort of justification for these rules and regulations.

Second, the proponents of a variable rate premium system argue that it gives the insuring authority much more flexibility in enforcing proscriptions. Under the current system the agencies have at their disposal only

"a limited arsenal of blunt weapons. One is expulsion of recalcitrant institutions, but that is a weapon of last resort and much too strong to be used effectively in run-of-the-mill cases." [35, p. 888]

The other main tool is the issuance of cease and desist orders. Raising insurance premiums is said to be a much less drastic way of dealing with these problems.

The third advantage is that the process of setting premiums would result in a more careful balancing of the social costs and benefits of risk avoidance. The socially optimal amount of risk is greater than zero. An arbitrary prohibition of risk-taking implies

"a reduction in total welfare for the economy. This is indeed a danger with a deposit insurance system; while the FDIC, the FSLIC, and the other supervisory agencies have an obvious interest in minimizing the frequency of failures, they have no corresponding incentive to assure that insured institutions take

^{1/}See the discussion on pp. 19-21.

as much risk as they should. To protect their own status the insuring and regulating agencies have a tendency to overdo safety; from their point of view there can hardly be too much safety." [35, pp. 872-73]

Some opponents of a variable premium system argue that, in principle, the problem of moral hazard can be dealt with just as well by retaining the system of uniform premium rates and varying each bank's required capital level, as by switching to a variable premium system. The problem, in practice, is the same with either alternative: finding a satisfactory method of measuring the riskiness of each institution's portfolio.

"Setting an appropriate rate structure for premiums is an extremely difficult task rivaling the current regulatory problems of determining how much capital is adequate for a given bank. Interrelationships within a portfolio make a determination of risk an individual bank matter, and broad-based rules of thumb for setting premiums could prove inadequate and inconsistent with regulatory objectives. Thus rather than streamline regulation, variable rate premiums will provide an all too perfect substitute for the setting of current capital adequacy requirements." [39, pp. 251-52]

Other participants on both sides of the debate point to differences between the problem of setting insurance premium rates and evaluating capital adequacy of individual banks. One opponent of variable rates has argued that the existence only of the "limited arsenal of blunt weapons" that Scott and Mayer complained about is actually a virtue:

"The problem of setting variable rates is no more difficult, conceptually, than evaluating the capital adequacy of individual banks--something bank examiners presumably do every day. In fact, examiners do not do this very well. When they make mistakes and demand higher capital than the banker thinks necessary, the banker has several options: He can argue, stall, compromise, or refuse to raise capital. These options would not be available if the bank received a bill for higher insurance premiums. My point is simply that if a government agency does not know what it is doing, it is better not to give it a lot of power to enforce its rules. The "mushiness" of the present system, whereby the examiner must

nag and harass to get the bank to meet his view of capital adequacy is better than one that would give greater enforcement power to the FDIC."
[16, p. 109]

Private deposit insurance

Some proponents of the variable rate premium system point to what they assert is another difference between the problem of setting premium rates and evaluating capital adequacy, bank by bank. While setting appropriate capital levels can only be a task for Government regulators, they argue, a system of deposit insurance in which private companies alone, or with the Government, insure deposits can be envisioned. Their presumption is that market competition between private insurers would stimulate development of a rational system for assessing premiums, would restrain insurers from requiring excessive safety, and would encourage them to find the best feasible subcategorization of risk classes.

Most advocates of a private deposit insurance system acknowledge that the Government would have to continue to play a role in such a system. Private firms cannot be expected to insure deposits against a massive wave of bank failures caused by, among other things, gross errors in national macroeconomic policy, such as occurred from 1929 to 1933 when the Nation's money stock fell by one-third. For this reason, and others, it is doubtful that a purely private deposit insurance system would serve the most important function the present system has fulfilled--the prevention of bank runs.

How could the task of insuring deposits be divided between the Government and private insurers? Two schemes have been proposed. One alternative would be to require that each financial institution obtain private insurance for some portion of its deposits, with the FDIC providing the remainder. The second is an arrangement in which private companies would insure deposits against bank failure due to robberies and fraud by outsiders, defalcations and misappropriations of funds by insiders, and poor management. The FDIC would then insure against failure due to gross errors in macroeconomic policy.

Opponents of these schemes make several points. First, even private insurers would lack a means of determining actuarially sound premiums. Bank failures have been so infrequent that insufficient data exist to make the requisite calculations. Even if this were not the case, past experience would be of little use if the shift to a variable rate

system were accompanied by other major changes in the nature of regulation (e.g., a much freer entry policy). Second, the recent performance of insurers of computer-leasing agreements suggests that private insurers are hardly immune from severe errors in risk evaluation. Several private insurers suffered very heavy losses on policies extended to computer-leasing firms. The premium schedules did not adequately reflect the cost or speed of technological advances in the data processing industry. Third, if the latter division of labor suggested in the previous paragraph were utilized, disputes would inevitably arise as to whether a particular bank failure was due to inept decisions by management or by national economic policymakers. Fourth, to maintain a level of confidence in the deposit insurance system sufficient to prevent bank panics, the Government would (implicitly or explicitly) have to reinsure the private insurers. Much of the advantage claimed to flow from the discipline of market competition in providing insurance might, therefore, be lost. Fifth, the interdependence between banks must be considered in judging a single bank's riskiness. Sixth, one source of risk for both individual banks and the banking system arises from the unpredictability of monetary policy.

RAMIFICATIONS OF A GIANT BANK'S FAILURE FOR DEPOSIT INSURANCE

Federal deposit insurance has, up to now, prevented banking panics. Since its inception, there has been no instance in which threatened or actual failure of one bank led to a breakdown of confidence in the entire banking system and to runs on other banks. However, until the mid-1960s, all banks that failed were very small. In the 1941-64 period, the largest bank to fail had only \$17 million in deposits. The 1965-75 period, however, was marked by the failure of several much larger banks, with deposits ranging from \$93 million to \$1.4 billion.

Failures of giant banks have important ramifications for deposit insurance. First, isolated failures of giant banks are more likely to precipitate banking panics than are isolated failures, or even not so isolated failures, of small banks. [14, p. 508; 24, p. 518] 1/ Second, as stressed at

1/"Failure of a large bank, with losses to many depositors, may have substantial undesirable repercussions. The damage to general public confidence may be very serious. Just how serious we cannot tell at this point, since we have always avoided such failures up to now. It may be wise public policy to continue to avoid testing the stability of public

various points in this report, the aim of solvency regulation is, or should be, to protect the money and credit system from breakdown and to protect depositors; not to preserve individual banks that get into trouble. Allowing an individual giant bank to fail, however, might cause great difficulties for the Federal deposit insurance system, as it is presently designed and structured. Third, problems of interagency coordination are especially important in handling the failure of a giant bank. These three points and some proposed reforms to deal with them are the subject of this section.

Why failures of giant banks are "different"

There are four reasons why an isolated failure of a giant bank is more likely to set off runs on other banks than is the failure of one or more small banks. [24] First, the former is likely to be much more dramatic and involve much more publicity. Second, the causes of giant bank failure are likely to be different from those of smaller banks. In a majority of cases, the latter stem from dishonest management; in the remainder, from inept management. In both instances, depositors in other banks can reasonably attribute the failure to unique problems of the failed bank and remain sanguine about their own bank's safety. But a giant bank is more likely to be brought down by unpredictable adverse developments that cause a large block of its assets to go sour. Since the giant banks tend to hold similar assets, if one of them goes under, creditors of other giants may have good grounds for worry. Suppose, for example, that a foreign government with large indebtedness to many giant banks declares a debt moratorium that precipitates the collapse of one of them. This could well start a run on the others.

Third, while it is by no means inevitable that, in case of failure, owners of large deposits will lose all or even part of that portion of their account exceeding the \$100,000 insurance maximum 1/ they are more likely than owners of small accounts to withdraw their deposits at the first sign of

confidence in the banking system in this way." [17, p. 594] Admittedly, the few very large bank failures of the 1970s were not accompanied by panics. However, the number of such failures was too small to justify a confident statement that, on the basis of this experience, the points to be discussed in this section can be dismissed as not worth worrying about.

1/This point will be developed in the next subsection.

trouble. This process will be much more dramatic and visible at a giant bank since such banks have far greater numbers of accounts exceeding \$100,000 than do small ones.

Finally, and closely related to the third point, giant banks make much greater use of short-term nondeposit funds, such as negotiable certificates of deposit, than do other banks. Such funds are not legally insured by the FDIC. Again, as discussed below, it is not at all inevitable that the lenders of these funds will lose them in case of bank failure. Nevertheless, they are more likely to remove them at the first opportunity than are small depositors. The concept of a run on an individual bank should be broadened to include its inability to renew short-term nondeposit borrowing as they run off.

The FDIC's problems in dealing with failure of very large banks

The FDIC generally handles a bank failure in one of two ways, either by the deposit payoff method or by the purchase and assumption method. ^{1/} Under the deposit payoff method, insured depositors are paid off very promptly, and the uninsured depositors, the general creditors, and the FDIC share the proceeds of (an often lengthy) liquidation. When the purchase and assumption method is used, an existing bank acquires the failed institution and there are no losses to any depositors or to lender of nondeposit short-term funds.

How does the FDIC decide which method to use in a particular case? The law provides that in order to facilitate a merger or the assumption of the failing bank's liabilities, the FDIC may make loans, purchase the assets, or guarantee the liabilities of the failing bank, if its Board of Directors believes this will "reduce the risk or avert a threatened loss to the Corporation." While this language is exceedingly ambiguous, the FDIC has interpreted as mandating that the cheaper of the two methods be used in any particular case. In general, banks have close ongoing relationships with their business customers. Use of the deposit payoff method

^{1/}Two other rarely used methods are available in some circumstances. The FDIC may make a loan or otherwise render assistance to the failing bank. The law allows this alternative to be used only when the FDIC deems the continued existence of the failing bank to be "essential to provide adequate banking service in the community." Also, a so-called Deposit National Bank may be organized.

necessarily severs this relationship between the failed bank's loans to customers and their deposits in the bank. In contrast, use of the purchase and assumption method allows these relationships to continue. Recognizing their value, the acquiring bank is usually willing to pay a premium for the assets and deposits of the failed bank, reducing the net loss to the FDIC. For that reason, the purchase and assumption method is often preferred. 1/

Under current arrangements, however, the purchase and assumption method may be required in handling failure of a giant bank, even when it would not be cheaper in the long run. The FDIC's resources consist of the deposit insurance fund (totaling \$10 billion in September 1980) built up from assessments over the years and an authorization to borrow up to \$3 billion from the U.S. Treasury. Failure of a giant bank would result in a sizeable, immediate reduction in the fund, if the payoff method were used. It is conceivable that when the liquidation proceedings had been completed every penny would have been restored and the payoff would have been a cheaper alternative, in the long run, than purchase and assumption. Nevertheless, the required temporary drain on the fund could make use of the payoff method impossible.

For this reason, there is a widespread feeling that giant banks cannot be allowed to fail outright. But there are several problems connected with making it explicit policy that giant bank failures will definitely be handled by the purchase and assumption method. One problem is that current practice imparts a degree of randomness as to whether funds exceeding \$100,000 in a deposit account and short-term non-deposit funds are protected by the FDIC. When the purchase and assumption method is used they are, but when the deposit payoff method is used they are not. An explicit policy of handling giant bank failure by the purchase and assumption method would be tantamount to explicitly providing insurance for all deposits and all short-term nondeposit funds in giant banks, while not doing so for other banks. One observer has noted that

"this constitutes an interesting twist to the traditional view that deposit insurance favors small

1/In the 1952-69 period, payoffs were used in 60 percent of failures, but from 1970 through 1977 they were used in only 32 percent. Thus, uninsured depositors have fared better in the 1970s.

and especially new banks, allowing them to compete (insofar as concerns safety) on equal terms with giant banks. The twist is that deposit insurance also favors giant banks as against those of 'intermediate size' and this advantage grows increasingly more pronounced (a) the more dependent banks become upon liability management (which involves sale of largely uninsured liabilities) and (b) the riskier becomes the general banking environment." [14, p. 508]

A second problem is that it can be extremely difficult to arrange a merger for a giant bank in trouble. As a general rule, a failing bank can only be absorbed smoothly by a larger institution. When the failing bank is large, there may be few or no suitable buyers. The problem is particularly acute in States that allow little or no branching. The buying bank would not be able to use the physical office or offices of the failed bank. As long ago as the late 1920s, the Comptroller of the Currency urged that branching laws be liberalized to lessen this problem. Even where unlimited statewide branching is allowed, however, there are States in which there would be no feasible buyer of a failing large bank. 1/

Proposals for change

A number of proposals have been advanced singularly or in concert to deal with the problems discussed in the previous two subsections. The criteria on which decisions will be made as to the method used in handling failure of a large bank need to be reconsidered. As noted in the previous section, the method generally chosen is the one that will minimize costs. Given the consequences of giant bank failure discussed on pages 30-31, some argue that minimizing the cost to the FDIC is a singularly inappropriate criterion. 2/

To prevent runs by uninsured depositors and by lenders of nondeposit short-term funds and to remove the element of

1/H.R. 7080, introduced in the U.S. House of Representatives in April 1980, would authorize emergency interstate acquisition of large institutions.

1/Even apart from the problem of giant banks failing, more than one observer has noted the unfairness of a system in which depositors and lenders of short-term nondeposit funds who are not legally insured may be insured de facto, but whether they are or are not so insured is determined after-the-fact and depends on the method chosen by the FDIC to handle a particular failure.

uncertainty in their actual (as opposed to their legal) status vis-a-vis the insuring authority, whose procedures are biased in favor of the uninsured creditors of giant banks, it has been proposed that all deposits (not just the first \$100,000 in each account) be insured. [24, p. 520] Professor Guttentag has even suggested that all short-term liabilities, deposit and nondeposit alike, of all banks be one hundred percent insured. [14, pp. 509-510] It is recognized that this will remove any constraint on the risk exposure of banks imposed by large depositors and the lenders of nondeposit short term funds. Therefore, this proposal is often linked to the proposal for a variable premium insurance system, discussed in the first section of this chapter.

It was noted on page 32 that it might be impossible to use the deposit payoff method in the case of failure of a giant bank, due to the large (even if temporary) reduction in the size of the insurance fund, even if it would be cheaper in the long run. A more general, related problem is that the existence of the fund

"instills in the minds of the public, including banks and even some regulators, the notion that the resources available from the Federal Government for dealing with bank failure are limited to the amount in the fund (plus the FDIC's three billion dollar line of credit at the Treasury)." [14, p. 512]

If, in fact, the Government would always act during a crisis as if it had an unlimited commitment to insure deposits, regardless of the size of the fund, the notion of a limited fund needlessly limits confidence in the insurance system.

To deal with these problems, it has been suggested that the deposit insurance fund be abolished and replaced by a "pay-as-you-go" system. A further virtue of such an alternative arrangement is that society's capital would be better utilized. The fund's assets consist of U.S. Government securities, which have a lower rate of return than bank capital has. In 1969,

"if one assumes that these [FDIC and FSLIC insurance] funds could have earned 10 percent more as private capital than they did as government capital, the existence of the two funds resulted in a social loss of \$643 million, hardly a trivial sum." [35, p. 899]

In a pay-as-you-go system, the Treasury would be obligated to advance the necessary funds to the FDIC (and FSLIC) and would subsequently be reimbursed. One alternative would

be a system with no deposit insurance fund. Insuring agencies would raise assessments after-the-fact to repay the loans. Another would be a system in which the fund is large enough to handle minor failures but not those amounting to twice, for example, the average yearly payouts over some preceding period. 1/

Abolishing or reducing reliance on the insurance fund would mitigate a related but distinct problem. In a general financial panic, it may be beyond the managerial resources of the regulators to arrange for absorptions of all failing institutions into solvent ones. Widespread use of the deposit payoff method may be necessary. But, as noted in the previous paragraphs, the assets of the insurance funds of the FDIC and FSLIC consist of U.S. Government securities. During a major panic it may be impossible for these agencies to find a buyer for the securities other than the Federal Reserve Banks. If they refused to buy, the payoff method could not be used. Reduced reliance on the fund and more reliance on routine borrowing from the Treasury clearly would mitigate this potential difficulty.

Against this proposal, however, the Treasury would have to sell securities to obtain funds for the FDIC unless it maintained a standing fund. Even the brief delay needed for this purpose could have a serious impact on confidence in the banking system during a period in which a crisis threatened. If it were also the case that the national debt was near its ceiling, legislative action to raise the ceiling would be required. The attendant delay could again have a serious cost in terms of public confidence.

A further argument against relying on the insurance fund is that it would aggravate cyclical variations in bank profitability. Given that the FDIC's losses would rise during economic downturns, it is argued that assessments would have to rise during such periods. If bank profitability declines during downturns, this condition would be aggravated by rising assessments. "One way of reducing this disadvantage is to adjust rates slowly, repaying Treasury loans over some substantial periods, such as five years." [35, p. 899]

1/In addition to regular premiums of 1/12 of 1 percent of savings accounts, current statutes allow the FSLIC to levy an additional premium up to the full amount of all its losses and expenses. No association, however, may be assessed an amount greater than 1/8 of 1 percent of its savings accounts in any one year. (Savings and Loan Fact Book 77, p. 106).

Problems arising from the division of
responsibility among Federal agencies

The roles played in handling a bank failure by Federal agencies other than the FDIC place definite limits on the latter's freedom to work out a solution. While this is true of every bank failure, it is hard to imagine that a less than optimal resolution of a small- or medium-sized bank's isolated failure can be of much harm. The need for coordination between and the differing interests of different Federal agencies pose a serious problem only in the case of a giant bank failure. The FDIC's former director of research has noted: "The existing law concerning failures was not designed for the large bank situation * * * the current structural and statutory system [does not] provide an easy means of dealing with a situation in which large banks may fail." [17, p. 598] He has used the 1974 failure of the Franklin National Bank to illustrate this point (Franklin had \$1.44 billion in deposits and is the largest case of bank failure in the FDIC's history). He states:

"The end result was a very happy one from the public interest point of view. Governor [of the Federal Reserve Board] Sheehan has said that we were lucky and that the process took too long * * * I disagree with his view of our 'luck,' but it is true that the successful resolution of the problem required extraordinary effort and cooperation among different agencies. I would prefer not to rely on such continued cooperation any more than I would on luck." [17, p. 598]

Under current regulatory arrangements, the FDIC has primary examination responsibility only for state-chartered banks not belonging to the Federal Reserve System. In the case of a member bank, information must always come second hand through the Comptroller's Office or the Federal Reserve. The account the FDIC receives of a particular situation may be greatly influenced by how these agencies would like the situation resolved. Professor Guttentag has proposed that the entire responsibility for bank examination at the Federal level rest with the FDIC. [14, p. 505] Others have urged that, at a minimum, the FDIC should exercise full examination authority over a member bank once it has determined that it is in danger of failing.

Currently, however, only the chartering authority, either the Office of the Comptroller of the Currency or a State Banking Department, can actually make the determination that a troubled bank is insolvent and that it must be closed. They will attempt to avoid having to make this finding by arranging a merger.

The FDIC is not involved in such prefailure negotiations. If the other authorities are unsuccessful and must close the bank, it then falls to the FDIC either to pay off the depositors or (much more frequently) to arrange for the failed bank to be absorbed into another one.

One former FDIC official has noted that this

"divided responsibility * * * is inefficient and likely to be counterproductive. If the Comptroller negotiates with some potential buyers at one stage and the FDIC with others, it is hard to see how optimal terms could be arrived at. Under present arrangements, the FDIC may not get into the picture until too late to work out the best deal, and the Comptroller or the Federal Reserve are inhibited in their negotiations by lack of knowledge of what the FDIC would be willing to do." [17, p. 599]

Thus, a strong case can be made for the FDIC having sole responsibility for these negotiations, whether or not its financial assistance will prove necessary.

As part of this increased negotiating responsibility, the FDIC would need greater control over the timing of a bank closing. One step would be to give it the authority to make the determination that a bank is insolvent and must be closed. A less drastic change would be to give the FDIC control over the flow of liquidity to the troubled bank. This could be accomplished either by requiring the Federal Reserve to honor an FDIC request to extend credit to a problem bank or by having the FDIC take over this liquidity-providing function. Appropriate financing for the latter alternative would have to be devised.

To end on a positive note, the Federal Financial Institutions Examination Council ^{1/} has, since its inception in 1978, fostered improved cooperation in these matters.

^{1/}The Council was created by the Federal Financial Institutions Regulation and Interest Rate Control Act of 1978. It consists of the Comptroller of the Currency, one member of the Board of Governors of the Federal Reserve System, and the Chairmen of the Federal Deposit Insurance System, the Federal Home Loan Bank Board, and the National Credit Union Administration.

CHAPTER 5

SUMMARY AND CONCLUSIONS

This report examines the objectives, costs, and benefits of regulation aimed at maintaining the solvency of financial institutions, the relationship of such regulation to the existing systems of deposit insurance, and the critiques of and proposals for altering this regulation and the insurance systems. In the past 20 years, economists have written a large number of careful analyses dealing with isolated aspects of these issues. However, the various restrictions interact in complex ways which hinder systematic analysis and make consideration of proposed changes difficult. Therefore, rather than undertake our own research on some aspect of solvency regulation, we felt the greater need was to pull together the existing theoretical analyses and empirical studies. The greatest contribution would be a discussion that logically organizes the diverse issues, coherently sorts out their complicated interrelationships, and relates them to the evidence contained in other studies. The purpose of this report is to provide such a discussion.

After a discussion of the objectives of solvency regulation, the costs and benefits of three types of such rules and regulations were analyzed. The first two of these were restrictions on entry and branching and on the activities in which financial institutions may engage. The third was regulation of bank capital adequacy.

The report then turned to an analysis of the deposit insurance system. The first half of this discussion dealt with problems created by the current uniform premium system and considered the costs, benefits, and feasibility of a variable premium system of deposit insurance. The second half of the discussion dealt with potential problems for the system of Federal deposit insurance, as presently administered, that would be posed by the failure of one or more giant banks and considered some alternative arrangements.

FINDINGS CONCERNING RESTRICTIONS ON ENTRY AND PERMISSIBLE ACTIVITIES

Most of the professional economics literature dealing with the effects of soundness regulation finds that when existing banks are subjected to competition from new entrants, they charge lower interest rates on loans, pay higher interest rates on deposits, lower their fees and service charges, increase their ratio of loans to assets, and generally improve their performance from the standpoint of both their business customers and their individual customers. Similarly, these

dimensions of performance are better where branch banking is permitted.

No similar consensus exists on the regulation of activities open to banks. An expansion in the types of services banks offer should benefit the consumers of these services by increasing competition. On the other hand, activity restrictions may be required to assure smooth functioning of the deposit insurance system, to prevent conflicts of interest, and to prevent huge concentrations of conglomerate power.

Capital adequacy requirements are an important adjunct of an effective (uniform premium) deposit insurance system. Unfortunately, there are no generally accepted formulas for determining "adequate" levels of capital.

ISSUES IN DEPOSIT INSURANCE

The professional economics literature dealing with deposit insurance is far less substantial than literature on the effects of solvency regulation. The majority of experts do not believe that glaring problems exist with the present system. However, a number of eminent economists have pointed to potential problems for that system in dealing with large-bank failures:

- The possibility that isolated failure of a small- or medium-sized bank will set off runs on sound banks has been rendered exceedingly remote because of Federal deposit insurance. Is the case of a giant bank's failure (one with deposits in excess of \$0.5 billion) different? During the decade of the 1970s, for the first time, several large banks did fail. These failures did not cause runs on other institutions. Nevertheless, there are reasons to believe that in certain circumstances failure of a giant bank may cause extreme public concern about the soundness of an entire segment of the banking system, the existence of deposit insurance notwithstanding.
- The FDIC is legally bound to protect (to the extent its resources permit) only the insured depositors in failed institutions. But in dealing with an actual failure, one of the methods available to the FDIC effectively protects uninsured depositors and non-deposit creditors, as well as insured depositors. Under this method, stockholders also generally fare much better than is normal for the stockholders of a failed company. In the case of failure of a giant bank, the FDIC is constrained by the finite size of

its fund to use this method. Uninsured depositors and nondeposit creditors can thus achieve insured status, de facto, by investing only in giant banks. Stockholders, too, can achieve a measure of protection.

- Handling the failure of a giant bank may be made much more difficult by the current statutory division of responsibility among Federal (and, in some cases, State) agencies.

The first two of these points suggest that the question of how to protect a giant bank's small depositors without protecting its equity holders and other creditors and without precipitating runs is a difficult one.

Several distinguished economists have criticized the uniform premium feature of the deposit insurance system. They make the following arguments:

- The existing deposit insurance system charges uniform premiums to all banks rather than varying the premium with the riskiness of a bank's activities. It thus provides an incentive for banks to undertake risky activities and to minimize their capital. The need to combat this problem of "moral hazard" provides an element of justification for some of the types of restrictions criticized in this report.
- A system in which a bank's deposit insurance premiums varied with the riskiness of its activities would eliminate the problem of moral hazard and its concomitant rationale for objectionable restrictions.
- The major obstacle to such a variable premium deposit insurance system is the problem of finding a rational method of setting the rates. It is at least questionable whether a Government agency (or a private firm) with a monopoly on deposit insurance could develop such a method.
- A rational system for assessing premiums might be developed through the spur of competition among private insurers. But it is doubtful that the degree of public confidence in a purely private deposit insurance system would be sufficient to prevent bank runs from occurring. It might still be possible to achieve a variable premium system, however, if the system were a joint public-private venture in which definite limits were set to the liability of the private insurers.

Those who argue against such a venture assert that: even private insurers lack the data to produce an actuarially sound system; the interdependence between banks must be considered in judging a single bank's riskiness; one source of risk for both individual banks and the banking system arises from the unpredictability of monetary policy; recent performance of private insurers in other areas show that they are capable of serious errors of judgment in assessing risk; and since the Government would have to be involved, much of the alleged benefits of market discipline would not materialize.

AGENCY COMMENTS

A draft of this report was sent for comment to the Federal Reserve Board, The Federal Home Loan Bank Board, The Federal Deposit Insurance Corporation, and The Comptroller of the Currency. After the Act of 1980 was passed, the report needed to be completely revised to reflect the many changes contained in the act. We then discussed the revised draft with these agencies. These oral comments superseded the earlier comments we received, and either clarified or added technical points. The agencies did not officially comment on the report.

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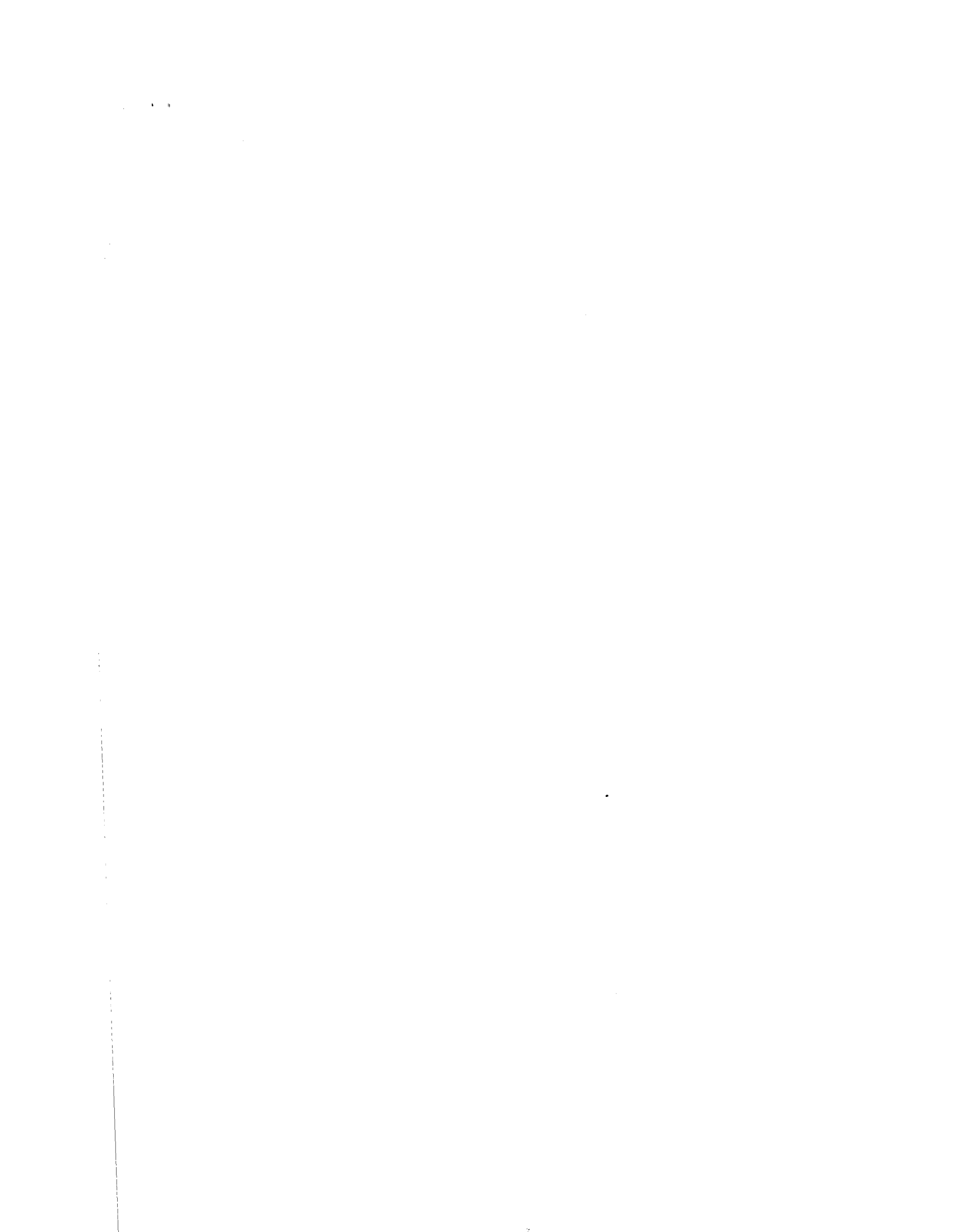
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