CBO TESTIMONY

Statement of
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before the
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives

September 26, 1990

NOTICE

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Mr. Chairman, I am pleased to have this opportunity to appear before the Committee. This morning I will report on the results of CBO's analysis of proposals for reforming federal deposit insurance that was conducted at the Committee's request. This study, *Reforming Federal Deposit Insurance,* is being transmitted to the Committee today. My statement makes the following points:

- o Federal deposit insurance is best viewed as an assurance policy on the safety of deposits. In the U.S. economy, these deposits are the primary element in the money stock, which is the means of payment for the economy. Because all share the benefits of assuring the safety of these deposits, even those who are not depositors, the insurance system need not be fully self-sustaining. In the event of a catastrophe, taxpayers are a legitimate insurer of last resort.

- o To be effective at achieving the goals of preventing contagious bank runs, protecting small depositors, and minimizing taxpayer costs, the system relies heavily on prudential regulation, examination, and supervision of depository institutions. In large measure, the costs we bear today for the thrift bailout stem from the breakdown of this regulatory system.

- The options that have been proposed for restructuring federal deposit insurance range from making minor modifications to the current system to introducing major structural changes. Each option has advantages and disadvantages--none is a magic bullet that will solve all of the problems.

- CBO has found that the best way to sort through these options is to determine how each proposal addresses the insurer's (which is ultimately the taxpayer's) risk. Most proposals suggest that something can be learned from the ways in which private insurers recognize and reduce risk.

- Underlying the variety of proposals lies a consensus on two points: that capital requirements be strengthened, and that prudential supervision of depository institutions be enhanced. Strengthening capital can mean increasing the amount of capital an institution must hold, making the closure rule more explicit with regard to a minimum level of capital, and assigning risk-based capital requirements. Enhancing supervision can mean improving government regulatory practices or placing greater reliance on market forces.

BACKGROUND

The United States has operated a system of federal deposit insurance for more than 50 years. It was established in response to the financial crisis of the 1930s when the public's lack of confidence in the banking system contributed to thousands of bank failures. For many years, the federal guarantee of deposits contributed to the stability of the depository institutions industry. This industry, which includes commercial banks, thrifts, and credit unions, provides financial services required by a healthy, growing economy. Recent events, however, have revealed that the current structure of the federal deposit insurance system is far too costly.

Deposit insurance provides two major benefits that contribute to the safety of depository institutions. First, public confidence in the government's guarantee of deposits minimizes the likelihood of contagious bank runs. Second, the safe haven provided by insured deposits protects small and unsophisticated depositors from loss. Achieving these objectives ensures depositories of a relatively stable supply of funds that they may lend to borrowers.

The major drawback of deposit insurance is that it creates a moral hazard that may affect the decisions of a depository's owners and directors. Insured depositors have little incentive to withdraw their funds if they feel that a depository has undertaken excessive financial risks; thus, financial institutions, especially those in trouble, have an incentive to undertake riskier investments than if deposits were uninsured. Without insurance, the threat of withdrawals by depositors curbs the degree of risk that a depository is willing to take and still be able to service its deposits. An insured system reduces such market discipline, and puts heavy reliance on regulation and supervision to make sure that depositories are prudently managed.

Even in the normal course of business, some depositories are expected to fail. As a result, the federal deposit insurer can expect some losses. The federal deposit insurer provides for these losses--much as a private insurer would--by establishing a reserve fund and by making an arrangement with a financial backer in case the fund's loss is greater than its reserves.

Under the current structure, the federal deposit insurer requires depositories to hold certain levels of capital to serve as a first line of defense against losses. The insurer assesses a premium on insured depository institutions to accumulate its reserve. This fund avoids the need for the federal deposit insurer to request appropriations from the Congress every time a loss occurs. Instead, the burden of financing losses is put on the primary beneficiaries--depository institutions and depositors. The federal deposit insurer is also able to borrow within limits from the Treasury in the event that the fund is unable to handle current losses, and it can ask taxpayers to foot the bill in the event of a catastrophe, as it has recently. The justification is that all Americans benefit from avoiding systemwide bank runs and from maintaining a viable financial system.

By making federal deposit insurance an unconditional guarantee to qualified depositors, which is equivalent to an entitlement program, the government is ultimately at risk for losses up to the total amount of all insured deposits. While the risk of total loss is minuscule, any loss beyond roughly 1 percent of all insured deposits would bankrupt the insurance funds--that is, current claims on the funds would exceed their immediate resources.

The need to draw on resources beyond those held in the insurance funds' reserves has to be viewed as extraordinary or catastrophic. Two situations can cause such a catastrophe. First, a temporary systemwide financial calamity caused by events beyond their immediate control could put a large number of depositories in jeopardy. Such a crisis lies beyond the scope of the federal deposit insurer to address, and is probably best left to be handled by the Federal Reserve System in its role as lender of last resort. Second, a permanent, structural change in the depository industry to a more competitive environment could cause many depositories to leave the industry. While some restructuring would take place without cost to the insurer, as insolvent depositories are absorbed by healthy ones, the government might also have to resolve many insolvent or failing depositories. The thrift crisis stemmed from a combination of these two situations.

Distinguishing between the two types of catastrophe can be difficult. In the early 1980s, regulators may have misjudged the problems of the thrift industry by viewing them only as a temporary systemwide crisis. Because the early 1980s were characterized by high and volatile interest rates and a severe recession, the thrift regulators granted relief to troubled institutions in the hope that the crisis would pass and the industry would grow out of its difficulties. These special breaks were insufficient to cope with an industry that was going through a permanent change associated with deregulation. Thus, uncompetitive depositories that should have been closed were allowed to stay open. Beyond the intended safety net, regulatory forbearance prevented the aggressive but self-correcting attributes of a competitive environment from functioning.

The temporary problems associated with macroeconomic conditions combined with the permanently increased competition both within the thrift industry and with other financial institutions to precipitate a catastrophe for the Federal Savings and Loan Insurance Corporation (FSLIC). The inherent problem of moral hazard associated with deposit insurance was exacerbated because regulators were reluctant to debit the fund for which they were responsible. Without regulatory intervention, insolvent institutions were virtually invited to "gamble for resurrection" by undertaking inordinately risky strategies. All gambles entail losses, and the thrifts were no exception. FSLIC became insolvent. Consequently, the federal budget will carry the burden of making good on the government's insurance pledge.

One lesson from this experience is that the crisis could have been averted and the cost minimized if regulators had correctly assessed the situation in the early 1980s and used their authority to close institutions rather than assist them to remain open. This did not happen for many reasons. Some important ones are imbedded in the current structure of federal deposit insurance. Although the federal deposit insurance funds for commercial banks and credit unions appear to be better able to deal with circumstances in those industries, the catastrophe that bankrupted the FSLIC could happen to these other funds as well. Correcting the deficiencies of the current structure of federal deposit insurance reduces the likelihood that a similar crisis will ever happen again.

DEPOSIT INSURANCE REFORM

The task of reforming federal deposit insurance is extraordinarily complex. Straightforward solutions to the revealed weaknesses in the federal deposit insurance system are not readily apparent. Many useful suggestions for reform have been proposed; selecting the best set of reform measures will be difficult because of the many dimensions of the problem. Most reform proposals have the common theme of applying some aspect of standard insurance practices to the federal deposit insurance system. Thus, at the risk of oversimplifying, we adapted a system of concepts--borrowed from standard insurance practices--that provides a useful framework to evaluate the strengths and weaknesses of the various reform proposals.

In the standard insurance relationship, one party (the insured) seeks protection against a specified risk by paying a premium to another party (the insurer) who agrees to compensate the insured in the event that a loss occurs from the risk specified in the contract. By covering the risk, the insurer is exposed to the potential losses. To address its exposure, the insurer typically employs a combination of three practices: underwriting risks by setting the limits of coverage and premium charges in such a way as to minimize the exposure of the insurer to catastrophic loss; controlling risks of the insured from overexposure to danger; and transferring to others risks that it cannot avoid but does not want to bear.

Underwriting Risk

Private insurers assume risk through underwriting by determining how much risk to insure and the appropriate premiums to be charged. They also review the insurance policy periodically to see how conditions may have changed. The unconditional nature of the government guarantee limits changing how risk is assumed, but higher premiums can be charged and the amount of deposits covered can be altered. In addition, risks that are usually assumed can be limited by more careful chartering of new institutions that are allowed to offer insured deposits.

Underwriting also involves covering risk by making provisions for expected losses. The insurer establishes a reserve for normal losses and arranges for external funding in the event that it suffers an abnormal or catastrophic loss. Reserves were established in each of the federal insurance funds so that normal losses could be handled without requiring special Congressional appropriations. Because insured depository institutions and their customers are viewed as the primary beneficiaries, depositories are charged a premium, which they pass on to customers through higher fees for financial services. This process gives the fund an appearance of being self-financing. In the case of the FSLIC, however, these reserves were insufficient to handle all of its losses.

The chief difference between the operation of federal deposit insurance and other forms of insurance provided by the private sector is in underwriting. Private insurers would never underwrite deposits as the federal government does, for three reasons. First, private insurers will typically only insure independent events--that is, when the risk of insuring one thing is unaffected by insuring another. Deposit insurance is different because the insurer's guarantee of deposits at one institution can affect others. If depositors lose confidence in the insurer's ability to cover its potential liabilities, they can trigger a contagious spread of bank runs, thus creating a self-fulfilling condition. Second, federal deposit insurance provides an unconditional guarantee of depositor's funds, regardless of the risk taken by an insured depository. A private insurer could not provide this absolute assurance of safety. Third, deposit insurance implicitly extends coverage beyond the contract amount. Because they operate for the public good, the federal deposit insurance funds have covered more than the explicitly stated $100,000 per account. A private insurer would not extend such coverage.

The most prominent proposals for changing how much risk is assumed through underwriting suggest restricting coverage to the individual or lowering the coverage ceiling below the current $100,000 limit. These changes in the terms of the insurance contract would reduce the taxpayers' potential liability by offering less insurance, but they would offer less protection both to depositors and to depositories.

Limiting coverage to an individual could be difficult to implement and might encourage large depositors, including group depositors such as pension funds, to withdraw their money from depositories and place them elsewhere. Lowering the coverage ceiling below $100,000 could have the same effect. These large withdrawals may not present a problem to the economy as a whole, since many close substitutes are available. For example, large depositors might choose to place their funds in Treasury securities or similar investments. These alternatives, however, might increase the overall cost of financial services to the economy. Large withdrawals might also undercut the profits of some depositories. An abrupt change could create further instability in the financial system, but a long phase-in to new standards may alleviate this problem.

Several proposals have recommended increasing the size of the cushion provided by the reserves by increasing the premium assessments. This increase would allow the insurance funds greater flexibility in deciding how to resolve insolvent institutions, and would enable them to handle more cases before needing to tax the public. The risk of insuring deposits, however, would not change. The only change would be in shifting the burden of financing the insurance. Moreover, there is a limit on how high premiums can be driven before the viability of the industry, which already faces strong competition from nondepository institutions, would be threatened.

A further concern in underwriting is monitoring the solvency of both the insured depositories and the insurance fund itself. Greater use of market-value accounting has been proposed for monitoring the riskiness of depositories. Insured depositories could be required to value their assets and liabilities on a market basis, which would provide better information and enhance the regulators' ability to spot problems earlier than they can now using the generally accepted book-value methods. Monitoring the solvency of the insurance fund is also critical. Improved public reporting by the federal insurance agencies of their contingent liabilities would help.

Controlling Risks

Private insurers expend considerable effort to control the risks they insure and to prevent any loss from occurring. They accomplish this by adjusting premiums to discourage risky activities or by trying to affect the behavior of the insured through incentives, such as charging lower premiums for good drivers or nonsmokers. Rather than affecting the behavior of insured depositors, the federal deposit insurer controls risks through prudential regulation, supervision, and examination of the insured depository institutions.

One set of strategies for controlling risk would rely on the market more than on the government regulator to provide that supervision. Calling on market forces may create a more effective level of supervision--by forcing prompt remedial action and closure, if necessary--than can be provided by the government alone. The market is likely to be less forgiving. But market supervision would also discipline imprudent depositories, possibly by causing withdrawals and effecting bank runs, which is just what the system has tried since the 1930s to avoid. Furthermore, under certain circumstances, some institutions probably should be assisted because liquidation would impose too high a cost.

Other strategies for controlling risks seek to improve the operation of deposit insurance. Federal regulators could require owners of depositories that offer insured deposits to hold more equity in their institution. This requirement places a greater burden on insured depository institutions, but the greater stake that owners have in their institutions provides greater incentives for them to act prudently. The rule used by federal regulators to determine when to close an insolvent institution could also be strengthened, which could avoid past mistakes of regulatory forbearance. The deposit insurer could require risk-based capital levels or assess risk-based insurance premiums as another incentive for more prudent management. Further market discipline can also be introduced by explicitly threatening to impose losses on uninsured creditors.

One proposal would radically change the amount and quality of risk held by depositories--the so-called narrow bank proposal. It requires that insured deposits be pledged against either risk-free assets, such as Treasury securities, or certain secure assets that are easily valued on a market basis. The greatest merit of this proposal is that it minimizes the risk of guaranteeing deposits. Its chief disadvantage is that it requires a radical restructuring of the depository industry, with highly uncertain consequent adjustments in financial markets.

Transferring Risk

One way for an insurer to reduce risk is to transfer a portion of the risk to others: either back to the insured through coinsurance, or to another insurer through reinsurance. Federal deposit insurers currently use neither of these strategies. Several reform proposals, however, include these features.

Coinsurance would place a greater burden of risk on depositors by requiring a deductible that the insured must pay to replace its own loss. This strategy, used in a number of foreign insurance systems, is similar to reducing coverage but is more effective because a deductible exposes the insured depositor to some loss, regardless of the limit on coverage. Because of this exposure, depositors would invoke greater discipline on depository institutions. Most experts, however, doubt that reliance on individual depositors alone could provide the level of discipline needed.

Alternatively, the insurer may reduce a portion of its coverage by sharing some of the risk with other insuring agents. Such reinsurance could be accomplished in three ways. One extreme form of reinsurance would transfer all risks to the private sector by establishing an industrywide self-insurance system. Several other countries have used this strategy, although they apparently still retain an implicit government guarantee. Another proposal would require the federal insurer to buy private insurance for a portion of its potential liabilities. Finally, insured depositories could be required to issue a class of subordinated debt, which would absorb some of the risk of the institution. Holders of this debt would be sophisticated financially but low on the repayment list, thus they would have both the means and incentive to evaluate risks.

The benefit of these strategies is that each would create additional incentives through the marketplace to discipline depositories. Each strategy would lower the potential liability of the government by putting others at risk for some portion of the potential losses. The drawback of these strategies, however, as with those for reducing coverage, is that they fail to provide the same level of assurance that the current system does. For example, although self-insurance or reinsurance offers the illusion of full protection of depositors, these strategies retain the same implicit guarantee that now exists if a catastrophe were to occur.

CONCLUSIONS

All of the proposals to reform federal deposit insurance suggest strategies to contain the problem of moral hazard and to reduce the exposure of taxpayers to the risk of guaranteeing deposits. Two fundamental approaches are offered.

The government may either strengthen its regulation, primarily through the use of stronger capital requirements and a better closure rule, or share some of the risk of insurance and the responsibility for supervision with the marketplace. The regulatory approach would design measures to make sure that regulators of depositories will act differently than they did in the thrift crisis and that, when they do act, they will have the powers and resources needed to do the job. The market approach would change the burden of risk and the incentives for all parties--the depository institutions, their depositors and other creditors, and even the regulators, who are not immune to market pressure--so that the depositories will manage the funds entrusted to them more prudently.

Although different, the regulatory and market approaches are not mutually exclusive. Both approaches can be used to create a safer, sounder, and less costly deposit insurance system than currently exists. One danger, however, is that imposing too many controls can overburden the depositories, make them unduly cautious in their lending, and threaten their ability to compete against other financial services. Another danger is of so weakening the protections of federal deposit insurance that its fundamental success in preventing runs, protecting depositors, and providing the basic money services on which our economy depends will be undercut.

One limitation of this analysis must be mentioned. CBO has analyzed deposit insurance reform apart from the prospect of reforming other regulations applying to depository institutions. Moreover, the analysis is limited in its consideration of international competition. CBO has shed light on only one facet of policy questions surrounding depository institutions. Other policy questions, such as bank powers, housing issues, international considerations, and transition rules will also be important as the Committee pursues its deliberation of deposit insurance reform.