Feature Article:

Privatizing Deposit Insurance: Results of the 2006 FDIC Study

Foreword

*The Federal Deposit Insurance Corporation (FDIC) was required by the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 (FDIRCAA) to study the feasibility and consequences of privatizing deposit insurance, establishing a voluntary deposit insurance system for deposits in excess of the maximum amount of FDIC insurance, and increasing the limit on deposit insurance coverage for municipalities and other units of general local government. In February 2007, the FDIC sent its report to Congress. This article summarizes the FDIC's findings on the first issue: privatizing deposit insurance. Subsequent editions of the **FDIC Quarterly** will report the FDIC findings on the other two issues.*

Introduction

Since its inception in 1933, the federal deposit insurance system has promoted financial market stability, protecting the economy from the disruptive effects of bank failures as well as protecting the deposits of small savers. Notwithstanding the successes of the federal deposit insurance system, some have argued that a private deposit insurance system would be an improvement. The FDIC explored privatization arguments in great depth in 1998 as part of Confidence for the Future: An FDIC Symposium. After almost ten years and the enactment of the Federal Deposit Insurance Reform Act (FDIRA), the FDIC has revisited the privatization debate. This article presents the FDIC's most relevant findings.

The article begins with a review of the general arguments in favor of privatization. These generally are that privatization would diminish moral hazard, reduce unwarranted government supervision and regulation of depository institutions, and eliminate taxpayer responsibility for losses arising from systemic failure. The article next reviews specific privatization proposals and examines the validity of the assumptions underlying these proposals. The article concludes with a discussion of other considerations important to the debate about private versus public deposit insurance. These considerations include the historical record of private deposit insurance systems, the sufficiency of private capital to underwrite a private deposit insurance system, the cost of deposit insurance in the absence of the federal guarantee, and other public policy concerns.

The FDIC finds that the conclusions reached in 1998 continue to hold today—namely, that privatization is not a remedy for problems arising from deposit insurance.

Arguments for Privatizing Deposit Insurance

Privatization proponents generally maintain that the costs arising from a government-run deposit insurance system are greater than the benefits, that the problems associated with a government-run deposit insurance system are inherent and insurmountable, and that the only solution to the problems is to privatize deposit insurance. The various reasons given for this stance, as outlined in the next section, are different but overlapping and generally involve concerns about moral hazard, government supervision and regulation, and a perception that some institutions are "too big to fail."

Concerns about Moral Hazard. In the insurance context, the term "moral hazard" refers to the tendency of insured parties to take on more risk than they would if they had not been indemnified against losses. The argument is that deposit insurance reassures depositors that their money is safe and removes the incentive for depositors to critically evaluate the condition of their bank. With deposit insurance, unsound banks typically have little difficulty obtaining funds, and riskier banks can obtain funds at costs that are not commensurate with their levels of risk. Unless deposit insurance is properly priced to reflect risk, banks gain if they take on more risk because they need not pay creditors a fair

The Modern Deposit Insurance System

Although federal deposit insurance was implemented in the United States in 1933, the modern federal deposit insurance system has been shaped by legislative changes during the past two decades. In the 1980s, a crisis in the savings and loan industry culminated in the insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC) and taxpayer funding of the FSLIC's deposit insurance obligations. Almost concurrently, a similar crisis in the banking sector—the worst since the 1930s—nearly exhausted the resources of the FDIC's deposit insurance fund. Congress responded to the two crises by reevaluating the federal deposit insurance system and enacted a series of reforms. One was the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Many of FDICIA's provisions were designed to remedy the weaknesses in the deposit insurance system that the recent crises had brought to light. Specifically, FDICIA—

- Required the banking industry to recapitalize the deposit insurance funds, reducing the likelihood the public would have to fund deposit insurance obligations in the future.
- Permitted the FDIC to borrow up to $30 billion from the Treasury so that funds would be available to close and resolve insolvent institutions quickly.
- Introduced Prompt Corrective Action (PCA), which restricted the activities of banks with low capital levels and required timely closure of critically undercapitalized banks.
- Mandated that the FDIC use the least costly solution to resolve bank failures. An exception may be made in the case of systemic risk, which requires a recommendation by at least two-thirds of the FDIC Board of Directors and the Board of Governors of the Federal Reserve, and an emergency determination by the Secretary of the Treasury in consultation with the President.
- Introduced risk-based deposit insurance premiums so that riskier banks pay higher premiums, thereby mitigating moral hazard.

Recently, Congress again addressed deposit insurance, enacting the Federal Deposit Insurance Reform Act of 2005 (FDIRA), which built on the reforms instituted under FDICIA. FDIRA—

- Merged the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) into a single Deposit Insurance Fund (DIF).
- Allowed the FDIC to manage the level of the DIF within a certain range.
- Allowed the FDIC to charge risk-based premiums regardless of the level of the reserve ratio.
- Authorized a one-time credit toward future assessments for institutions that replenished the insurance funds in the early 1990s and provided for dividends when the reserve ratio reaches certain thresholds.
- Authorized future increases in insurance coverage levels to adjust for inflation and immediately increased the insurance coverage limit of retirement accounts to $250,000.

risk-adjusted return. A truly risk-based assessment discourages such risky behavior.[1] The moral hazard problem is particularly acute for insured depository institutions that are at or near insolvency but are allowed to operate freely because any losses are passed on to the insurer, whereas profits accrue to the owners. Thus problem institutions have an incentive to take excessive risks with insured deposits in the hope of returning to profitability.

Concerns about Government Supervision and Regulation. A major concern of some privatization proponents is the degree of government oversight they

[1] As discussed below, historically the moral hazard problem created by deposit insurance has also been mitigated by banking regulation and the supervision of depository institutions. Among the regulatory actions that have been used to reduce the risks associated with moral hazard are capital standards, examinations, safety-and-soundness regulations, and enforcement actions.

consider to be a by-product of government-sponsored deposit insurance. They argue that government-sponsored deposit insurance is responsible for intrusive regulations, product restrictions, and social obligations that are placed on insured banks and thrifts. They contend that without government-sponsored insurance there would be no need to subject banks to intense safety-and-soundness regulation and to limit the products they might offer or their business affiliations.[2] They claim that the regulations made necessary by deposit insurance not only limit choices and opportunities, they also hinder rapid response to changes in the business environment and are expensive. Inasmuch as costly regulations are imposed on only one segment of the financial industry (depository institutions), insured depository institutions are less competitive than financial providers that are not so encumbered. As described in the next section, many proponents of privatization therefore seek to decouple deposit insurance from the "full faith and credit" of the U.S. government, or otherwise reduce a perceived taxpayer risk, to remove the justification for federal supervision and regulation of the banking industry.[3]

Concerns about "Too-Big-to-Fail" (TBTF). Privatization proponents are especially critical of the systemic-risk exception provided in the Federal Deposit Insurance Corporation Insurance Corporation Improvement Act (FDICIA) because they argue that it has the potential to shift the costs for megabank failures to the taxpayer.[4] They argue that when Congress provided a statutory exception from the least-cost resolution in the case of systemic risk, it acknowledged that certain depository institutions were too big to fail. Thus, because of size or perceived importance to the financial system, large institutions' uninsured depositors and unsecured creditors are treated differently from those of smaller institutions. As long as the full-faith-and-credit backing of the U.S. Treasury supports deposit insurance, they allege that taxpayers inevitably will be responsible for any losses resulting from large bank failures.

[2] See Bank Administration Institute and McKinsey & Co. (1996) and Kovacevich (1996) for their arguments on deposit insurance and bank regulation.
[3] See Bank Administration Institute and McKinsey & Co. (1996).
[4] See Bankers Roundtable (1997).

Proposals for Privatizing Deposit Insurance: Commonalities and Differences

Consistent with concerns about moral hazard, proponents of privatization generally favor market-oriented alternatives to federal deposit insurance. One proposal would replace publicly provided deposit insurance with a system of cross-guarantees under which small groups of banks would form syndicates with joint and several liability for the deposits of banks that contracted with them.[5] Another proposal would convert the FDIC into a privately owned and operated insurance company, reducing the current system's reliance on regulation and guidance.[6] A third proposal would transfer ownership and management of the FDIC to the banks and would set an explicit limit on the use of deposit insurance in order to encourage market discipline.[7] A fourth would retain the FDIC as a public entity but would reduce its powers.[8]

A common theme among these proposals is a rollback of bank supervision and regulation. Most seek to reduce the regulatory and supervisory powers of bank regulatory agencies to allow banks to become competitive, full-service providers of financial products and services. One proposal would exempt banks from federal safety-and-soundness regulations and reporting requirements, replacing them with private restrictions by member banks.[9] This proposal would also abolish the FDIC and the regulatory and supervisory functions of the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). Another proposal would recognize well-capitalized, well-managed institutions with less extensive regulation, expanded product opportunities, and lower regulatory "taxes."[10]

Many proposals are particularly concerned with the issue of TBTF. Most proposals would provide deposit insurance coverage for small deposits only. All seek to protect the taxpayer from responsibility for a systemic collapse by preventing the insurer from funding a systemic-risk exception. Most proposals would eliminate

[5] Petri Proposal, introduced by Rep. Thomas E. Petri (R-WI) (U.S. Congress, House [1996]). This proposal was introduced once and was not discussed in the subsequent debate on deposit insurance reform.
[6] Bank Administration Institute and McKinsey & Company (1996).
[7] Kovacevich (1996).
[8] Bankers Roundtable (1997).
[9] Petri Proposal (U.S. Congress, House [1996]).
[10] Bank Administration Institute and McKinsey & Co. (1996).

the full-faith-and-credit backing of the insurer as well as the insurer's line of credit with the Treasury. However, one proposal sees the need for a bank-funded backup fund to explicitly protect insured deposits against a systemwide collapse.[11]

Evaluation of Privatization Claims

Can Privatization Alleviate the Moral Hazard Problem?

Proponents of privatization generally assume that the moral hazard fostered by deposit insurance can be eliminated through privatization. In fact, the problem of moral hazard is inherent in insurance itself, regardless of management or ownership. The private provision of deposit insurance does not by itself alleviate the moral hazard problem.

Although moral hazard was clearly problematic in the savings and loan crisis, subsequent improvements in federal banking regulation and supervision have given the FDIC better tools to control moral hazard. The moral hazard problem created by deposit insurance has been mitigated by capital standards, examinations, safety-and-soundness regulations, enforcement actions, and timely bank closure policies. In particular, Prompt Corrective Action (PCA), introduced under FDICIA, has been effective in preventing banks with low capital levels from taking on excessive risk in an effort to return to profitability while the FDIC bears the risk. A properly constructed risk-based premium assessment system can also address moral hazard, and the FDIRA has enhanced the FDIC's ability to manage the insurance fund and set premiums according to the riskiness of the insured entity.

Would Privatization Release the Banking Industry from Unnecessary Regulatory Constraints?

A privately funded and administered system of deposit insurance would not free the banking industry from all regulation and constraints. Many nations have privately administered deposit insurance systems and all still impose systems for bank supervision and regulation. Bank supervision predates the federal deposit insurance system. Many bank regulations do not flow from the FDIC as deposit insurer but instead are imposed by the chartering and supervisory authorities, including not only the FDIC, but the OCC, the OTS, the FRB, and state banking authorities. Much of the regulatory burden on insured institutions flows from statutes and regulations unrelated to deposit insurance. For instance, one month after the events of September 11, 2001, the USA PATRIOT Act was passed. The USA PATRIOT Act amended the Bank Secrecy Act, with which banks must comply. Several provisions and implementing rules were added to bankers' compliance obligations. Reporting requirements under such laws are unrelated to deposit insurance coverage and are unlikely to be eliminated if deposit insurance is privatized.

Public policymakers are unlikely to abandon concern for prudent banking practices if deposit insurance reverts to the private sector. In 1998, then U.S. Representative James Leach expressed this idea clearly when he noted, "Because a sound economy requires a safe and sound banking system, public liabilities exist even if public funds are not placed in jeopardy by statute."[12] Even without federal deposit insurance, policymakers would remain concerned about implicit public guarantees. These concerns likely would be manifest in government regulation designed to promote the efficient operation of the financial system and ensure the protection of taxpayers and individual savers.

It is more likely that, in addition to continued public regulation, a privately owned and profit-seeking deposit insurer would demand oversight. At a minimum, any prudently operated for-profit deposit insurer would probably require adherence to best practices and would insist on access to management and site visits to monitor the condition and riskiness of the institution it insured. It is unlikely that the private insurer would rely on market-generated information alone. Virtually all insurance policies—health, life, and liability—contain restrictions and limitations on coverage as well as conditions on approval in order to control risk.

For instance, American Share Insurance Company, a private primary and excess deposit insurer to credit unions, requires monthly financial reports from its members, examines them regularly, and supervises them closely. A review of the history of state-spon-

[11] Petri Proposal (U.S. Congress, House [1996]).

[12] Leach was speaking at the FDIC conference Confidence for the Future (FDIC [1998]).

sored deposit insurance plans also reveals that the more successful private insurers were extremely vigilant in regulating and supervising member banks. In the pre–Civil War Indiana plan, regarded by some as the best of the nonfederal deposit insurance plans, insured banks were branches of the State Bank of Indiana. Bank examinations were semiannual, and the directors of the State Bank had powers that exceeded those granted to bank regulators today. The State Bank of Indiana also had the authority to dictate whether banks in the state expanded or contracted the availability of credit, and on occasion it exercised this authority. In contrast (as described below), weak supervision of member banks was considered a major factor in the collapse of the Ohio, Maryland, and Rhode Island private deposit insurance plans in 1985 and 1991. It is unclear, therefore, how the change from a public to a private deposit insurance system would affect the regulatory constraints under which the banking industry operates.

Would Privatization Protect the Taxpayer from Responsibility for Losses from a Systemic Failure?

Several of the privatization proposals call for eliminating the government's ability to exercise a systemic risk exception to the least-cost resolution requirement in FDICIA. They maintain that when Congress provided a statutory exception from this requirement in the case of systemic risk, it acknowledged that certain depository institutions were too big to fail. They believe that uninsured depositors and creditors of large institutions may be treated differently than those of smaller institutions.[13]

Economic Policy Issue. The possibility of a systemic risk determination—which allows government intervention to prevent broader problems—is not simply a deposit insurance issue, but rather an economic issue that is best evaluated within the context of a wider public policy debate. Eliminating the possibility of a systemic risk exception would require a government commitment to allow banks—and in the broader context, other very large and important businesses—to fail even when their failure would jeopardize the stability of the U.S. financial system. If the failure of a private firm were to threaten the stability of the U.S. economy—whether that firm were a bank, a financial services company, or a nonfinancial business—it is unrealistic to assume that the government would not intervene in the national interest. History is replete with examples of such intervention.

In the United States, the federal government has provided financial assistance to avoid large corporate bankruptcies (for example, Chrysler and Lockheed), assisted the banking and financial sectors when they were threatened by the less-developed-country debt crisis in the 1980s, and provided financial aid to the Mexican government—an important trading partner—during that country's financial crisis in 1995.

More recently, ten days after the terrorist attacks of September 11, 2001, Congress passed a $15 billion package of direct cash infusion and loan guarantees to aid the domestic airline industry. Subsequently, when affordable commercial terrorism insurance became unavailable, Congress passed temporary legislation that established a federal government backstop for 90 percent of insured losses resulting from certain terrorist acts up to an annual $100 billion industry-aggregate limit.[14] (In December 2005 this legislation was modified to reduce the government's potential liability.)

Foreign governments have also intervened when their financial systems are in distress. In the early 1990s, Norway and Sweden stepped in when their banking systems came under severe stress. Japan has launched several expensive bailouts of its banks in the recent past, and the so-called "East Asian Tiger" countries (South Korea, Thailand, Indonesia, and others), responding to the global currency crisis in the late 1990s, undertook massive interventions to strengthen their financial sectors. In fact, the vast majority of industrialized nations in modern history have intervened to save their largest banks as a means of protecting their financial systems.[15]

Reduced Potential for a Systemic Situation. Reforms enacted in 1991 as part of FDICIA make a potential bank failure substantially less likely to pose a systemic risk. Certain provisions in FDICIA were designed specifically to reduce systemic risk. They include PCA (with the establishment of capital requirements), limits on interbank credit exposures, final net settlement

[13] See, for instance, Kovacevich (1996).

[14] The federal payment is subject to an insurance company deductible. An insurer's deductible is calculated as a percentage of the value of direct earned premiums.

[15] Caprio et al. (2005).

authority, and reinforcement of netting provisions for interbank payments. Additionally, authority provided by FDIRA has enabled the FDIC to make the premium structure more risk-focused and discourages moral hazard. Finally, the use of certain failed-bank resolution techniques, including the use of bridge banks and advance dividend payments to uninsured claimants, has mitigated some of the adverse consequences associated with bank failures. Overall, these powers and policies make it less likely that bank regulators and policymakers will need to invoke a systemic risk determination under FDICIA.

Greater Difficulty Making a Systemic Risk Determination. FDICIA also requires that in order to make a systemic risk determination and waive the least-cost requirement for resolving insolvent institutions, the Secretary of the Treasury, in consultation with the President, must determine that there would be "serious adverse effects on economic conditions or financial stability." Such a decision can be reached only after favorable written recommendations from both the FDIC Board of Directors and the Board of Governors of the Federal Reserve System, with at least two-thirds of the members of each board voting in favor of the recommendation. FDICIA further requires that the Government Accountability Office review any determination under this extraordinary exception.[16] These requirements ensure that a systemic risk determination can be made only after serious discussions at the highest levels of government.

Funding the Costs of a Systemic Risk Determination. FDICIA also affords taxpayers an additional layer of protection in the event of a systemic risk determination. The law requires that banks pay a special assessment to the FDIC to recoup the amount by which the resolution cost exceeds what it would have been under the least-cost resolution requirement.[17]

Systemic Risk and Too Big to Fail Are Not Synonymous. Finally, it is important to emphasize that the systemic risk exception does not protect large banks from failing: large banks can still fail, with stockholders, uninsured depositors, and creditors incurring losses. FDICIA permits the FDIC to waive the least-cost resolution requirement only where there is systemic risk, which might result in more protection for uninsured depositors and unsecured creditors than under a non-systemic bank failure. However, as mentioned above, FDICIA provisions make this scenario less likely.

Other Considerations: History, Availability, Cost, and Public Policy

Other considerations raise questions about the advisability of replacing public deposit insurance with a private system. One such consideration is the fate of past private deposit insurance systems in the United States.[18] Another is the ability of private capital to underwrite a private deposit insurance system. Cost in the absence of the federal guarantee and the public policy perspective on deposit insurance also are important considerations.

History and Lessons of Private Deposit Insurance in the United States

The state of New York implemented the first deposit insurance plan in the United States in 1829, and between then and the Civil War, five other states created programs. In all these programs, the emphasis was on protecting holders of banknotes rather than depositors. Three of the insurance plans failed, and the other three vanished soon after the establishment of the National Banking System. After the panic of 1907, eight mostly midwestern states created mutual deposit insurance systems. All these plans failed by 1931. After the 1930s, at least 30 additional nonfederal insurance plans were established to protect the deposits of all depository institutions—banks, thrifts, industrial banks and industrial loan companies, and credit unions. Most of these plans failed or ceased operation during the thrift crisis of the 1980s. Others were phased out when

[16] 12 U.S.C. § 1823 (c)(4)(G)(iv) (2001).

[17] 12 U.S.C. § 1823(d)(4)(G)(ii) (2001). The assessment is proportional to each bank's total assets less the sum of tangible equity and subordinated debt. Larger banks rely more than smaller institutions on non-deposit liabilities for funding. Therefore, the assessment would fall more heavily on large institutions (the likely source of systemic problems) than if the assessment were charged only on domestic deposits.

[18] Historically, private deposit insurance systems have acted as primary insurers (playing the FDIC's current role as insurer) or as excess deposit insurers (providing insurance in addition to the FDIC insurance limit). As discussed below, there are no longer any private primary insurers for banks and savings associations in the United States.

their sponsoring states decided, after witnessing the problems elsewhere, to require federal deposit insurance for all state institutions. Today, no private provider of primary deposit insurance to banks and savings associations remains. (American Share Insurance Company continues to provide primary and excess deposit insurance to credit unions.)

With a couple of exceptions, these private deposit insurance plans were sponsored by state governments, though the states did not back the plans financially. Almost all the plans were mutual insurance funds, though three of the early plans were based on a system of mutual guarantees in which banks guaranteed one another's banknotes. One completely privately held company began insuring credit union deposits in 1962, and several private companies provided reinsurance for deposits until they left the business in the mid-1980s.

Historically, private insurance plans have had to contend with two serious issues: concentration of risk and lack of liquidity in the midst of a crisis. Nearly all private insurance plans collapsed because of the failure of one or more large insured institutions. In many of these cases, insured depositors either were not protected (or were protected only with substantial assistance from state taxpayers) or received access to their funds only after a prolonged delay.

One study of the commonalities of failed private deposit insurance systems in the United States found that these systems typically shared five characteristics: (1) free exit from the system; (2) concentration risk (the failure of large institutions often brought down the entire system); (3) fraudulent acts by regulators, banks, and politicians; (4) limited regulatory powers; and (5) inaction on the part of insurers and state regulators.[19]

Many of the failed systems actually had relatively high reserve ratios when their crises occurred. However, they were unable to handle the failure of a very large member of their system. The system could not ensure immediate access to depositor funds (i.e., the system was not able to fulfill the liquidity function of an insurer), and this lack of liquidity eroded public confidence, which in turn led to runs on other member banks, overwhelming the entire system. Typically, deposits were frozen, and state governments had to step into the breach. Lacking funds to cover the insured deposits immediately, the states generally repaid them over a period of time, sometimes years.

In the more recent failures of private insurance systems (Ohio and Maryland in 1985, Rhode Island in 1991), many insured depositors had to wait months—and in the case of Maryland, years—to receive the full return of their principal.[20] Ohio was forced to commit $151 million of nontax revenues to support a bond issue to fund depositor claims; most Ohio depositors received full availability of their funds within six months. Maryland committed state-sponsored bond revenues sufficient to satisfy insured depositor claims over a *five-year period*. Some depositors did not receive their funds in full until 1989, four years after failure. Rhode Island requested and received a *federal* loan guarantee of the state bonds it issued to satisfy insured depositor claims. In the end, Rhode Island covered the losses on its own, and depositors eventually received their funds in full, although many had to wait at least a year after the failure of the state deposit insurance fund.

As the history of private deposit insurance systems suggests, private insurers have been unsuccessful in fulfilling all three of the responsibilities traditionally assumed by federal deposit insurance.[21] A private, industry-funded deposit insurer not only needs enough resources to protect small depositors but also must be capable of providing stability to the entire banking system, especially in times of great financial and economic turmoil. Insufficient public confidence in the deposit insurance guarantee could render the system unable to prevent or stem banking panics.

There are legitimate questions as to whether any private deposit insurance system could attain or maintain the necessary level of confidence in the deposit guarantee to prevent market instability during times of financial or economic turmoil. As history has shown, the insurance system must have not only the resources to handle isolated failures but the ability to handle catastrophes. Bank failures often come in waves—with one failure building on, and leading to, another. During a crisis, a private insurance fund typically must acquire financing from the banking industry through

[19] English (1993).

[20] Todd (1994).

[21] The responsibilities are to promote financial market stability by maintaining depositor confidence in the banking system, to protect the economy from the disruptive effects of bank failures, and to protect the deposits of small savers.

its line of credit—or from other private sources—at a time when the entire industry and perhaps the economy is in financial trouble. This is expensive in the short run, and related interest costs can hamper attempts to recapitalize the insurance fund for many years after the crisis has passed.

It is doubtful that depositors would continue to have confidence in a depleted or weakened insurance fund unless the U.S. Treasury stood behind the deposit guarantee. As Milton Friedman notes in his 1963 monetary history of the United States, 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. . . . [B]anking panics 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.[22]

Availability of Private Capital

Another consideration is whether enough capital is available to underwrite private deposit systems. In the 1990s, in keeping with a provision of FDICIA, the FDIC explored the feasibility of establishing a private reinsurance system for deposit insurance.[23] The resulting Marsh & McLennan study (2001) found that reinsurers had only limited interest in engaging in reinsurance agreements with the FDIC on terms acceptable to the FDIC. Doubts about the availability of sufficient private capital to fund a private deposit insurance system were reinforced by events following the terrorist attacks of September 11, 2001. As mentioned, subsequent to September 11, the private insurance/reinsurance industry required a government risk-sharing arrangement to continue providing commercial terrorism insurance. The small number of private insurance firms currently providing excess deposit insurance in the United States (as will be described in a forthcoming ***FDIC Quarterly*** article) also heightens concern about the sufficiency of private capital to support a private deposit insurance system.

Cost in the Absence of the Federal Guarantee

There is also the issue of cost. The Marsh & McLennan study found that a reinsurance company's price for excess deposit insurance coverage could be expected to be higher than if the FDIC were providing the coverage, because reinsurers' pricing would represent a free-market charge without government support.

Federal Reserve Chairman Alan Greenspan testified in 2002 about the likely cost of deposit insurance in the absence of the federal guarantee.[24] He stated that realistically, the government subsidy could not be eliminated because, without it, the average premium would need to increase to such a high level to insure against the improbable case of very large losses that most depository institutions would be discouraged from offering broad insurance coverage. He made the case that in deposit insurance, unlike life or casualty insurance, each insured loss is not independent of others. Deposit-run contagion produces a far larger extreme-loss tail on the probability distribution and therefore requires substantially higher premiums to offset this risk. No private deposit insurer would ever be able to match the FDIC premium and cover its risks.

Public Policy Perspective

An issue that has been infrequently addressed in this debate is the difference between the goals of a public deposit insurance system and the goals of a privately run system.[25] These differences are considerable. To maintain economic stability, public regulators historically have promoted the entry of newly chartered institutions into banking markets and have encouraged vigorous competition among banking organizations. Federal deposit insurance is available to all qualifying banks, and it is not easily terminated. In contrast, the major objective of a private system would be to maximize the profit of its deposit insurance business, not to achieve any public policy goal. Under a mutual guar-

[22] Friedman and Schwartz (1963), 440–42.
[23] FDIC (1993). The study was conducted in three phases beginning in 1993. The final report (Marsh & McLennan Companies [2001]) was completed in December 2001.
[24] Greenspan (2002).
[25] Hanc (1999).

anty system, one might expect members to be interested in minimizing cost, risk, and competition. To accomplish this, it would not be surprising if a mutual insurance system denied coverage to newly chartered or otherwise risky banks, or agreed to insure them only at very high rates or for very short-term contracts.[26]

Summary

Privatization may not eliminate moral hazard, as moral hazard is an effect of all types of insurance. Recent regulatory and statutory improvements in federal banking law have given the FDIC better tools to control moral hazard. Significant regulatory burden on banks is unrelated to deposit insurance, and this burden will not necessarily end with privatization. It is unclear how privatization would shield the taxpayer from responsibility for losses arising from a systemic crisis more completely than does current law. Government intervention in a systemic failure—to prevent broader problems—is a macroeconomic policy issue, not a deposit insurance issue. The powers and policies enacted in FDICIA and FDIRA have reduced the risk of a systemic failure as well as made it considerably more difficult to make a systemic risk determination and pass the associated costs to taxpayers. In fact, if privatization eliminates the special assessment provisions that allow the FDIC to recoup losses for a systemic risk determination from the banking industry, privatization could actually increase taxpayer exposure in a systemic crisis.

The failure of earlier private insurance systems, the availability of private capital to replace the federal guarantee, the cost of deposit insurance in the absence of the federal guarantee, as well as the public policy considerations, are other important factors in the privatization debate. A review of the record of private deposit insurance systems in the United States reveals that insufficient confidence in the private deposit insurance guarantee increased the fragility of these systems and rendered them unable to prevent panics. It is questionable whether a private insurer could enjoy a high degree of public confidence unless the government stood behind the guarantee. Additionally, the availability of private capital to underwrite a private deposit insurance system is limited—a finding reinforced by insurers' unwillingness, subsequent to September 2001, to provide terrorism insurance absent a government loss-sharing agreement. Overall, the evidence suggests that the costs of private deposit insurance would likely be prohibitively high, and it is questionable whether the goals of a private system would coincide with public policy goals.

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The authors are indebted to Kenneth D. Jones and Daniel A. Nuxoll of the FDIC and Marshall Reinsdorf for their extensive earlier work on privatization which served as a basis for this article.

[26] Ibid.

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