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Lessons from the Collapse of Three State-Chartered Private Deposit Insurance Funds

by Walker F. Todd

The collapse of the Rhode Island Share and Deposit Indemnity Corporation in January 1991 ended a two-decades-long cycle of failure of state-chartered deposit insurance funds. Although these failures exhibited common characteristics, they also differed markedly in many respects. This article explores the three leading failures — in Rhode Island, Ohio, and Maryland — and draws some lessons for the design and viability of private deposit insurance plans.

The January 1991 collapse of the Rhode Island Share and Deposit Indemnity Corporation (RISDIC) was the last in a series of post–1970 failures of state-chartered, privately operated deposit insurance funds for thrift institutions, industrial banks, and some credit unions. The failures began in Mississippi in 1976 and continued in Nebraska and California (1983), Ohio and Maryland (1985), Utah and Colorado (1987), and Rhode Island (1991). By February 1989, even the Federal Savings and Loan Insurance Corporation's (FSLIC) authority to accept new conservatorships or receiverships was effectively suspended. The Resolution Trust Corporation was created the following August to administer the resolution of insolvent thrifts whose deposits were FSLIC insured, and the FSLIC was abolished (Kane [1992]; U.S. House of Representatives [1985]).

This *Economic Commentary* analyzes the collapse of RISDIC with a view toward distinguishing the elements of failure and resolution that it shared with other large state-chartered deposit insurance funds — principally the Ohio and Maryland funds — from those that were unique to Rhode Island. Also examined are the factors that led to differences between the solution chosen by state and federal officials in Rhode Island and those used in Ohio and Maryland. Finally, inferences are drawn from these episodes for the design and viability of private deposit insurance plans.

Background

Federal deposit insurance did not exist until 1933, but several states introduced private deposit insurance schemes in the early part of this century. By 1933, however, all of the state plans had failed (Todd and O'Driscoll [1993]). In the 1950s, interest in private deposit insurance was revived: Ohio enacted its private deposit guaranty association law, covering building and loan and savings and loan associations (S&Ls) in 1955, and Maryland enacted its private deposit insurance law for S&Ls in 1962. RISDIC was chartered in 1969 and commenced business in 1971 with 40 member credit unions and insured share accounts of $134 million.[1]

During the late 1970s and early 1980s, a secular rise in interest rates adversely affected the profitability of many thrifts, and their loan and investment powers were expanded without a proportionate increase in the accuracy of accounting rules or in effective supervision. These factors eventually brought to light net-worth crises in both the federal and state-chartered thrift institution deposit insurance systems (Kane [1989, 1992]). Such problems, sometimes exacerbated by fraud, first overwhelmed the smaller state-chartered insurance funds (Mississippi, Nebraska, and a small California fund for "thrifts and loans"), and then affected the largest state-chartered funds (Ohio and Maryland) by 1985. The FSLIC itself is now generally recognized to have been effectively insol-

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vent on a market-value accounting basis by 1980, even though that insolvency was not publicly acknowledged by the responsible officials until late in the decade.[2]

Officials in charge of most of the remaining large state-chartered private deposit insurance funds took steps after the Maryland collapse in May 1985 to prevent similar problems in their states. In Massachusetts, North Carolina, and Pennsylvania, for example, the comparable deposit insurance funds generally urged members who could qualify to apply for federal deposit insurance as soon as possible. They remained in business only as backup insurers for deposits in excess of the $100,000 federal limit (the Massachusetts model) or for institutions that were too small to qualify for federal deposit insurance — typically, those with less than $5 million of total deposits (see Kane [1992]).

Rhode Island officials, on the other hand, ignored the disturbing signs from Ohio and Maryland and even *raised* RISDIC's insured deposit limit to $500,000 (with unlimited coverage on certain accounts) in late 1985. Despite explicit warnings from the Rhode Island attorney general and the Federal Reserve Bank of Boston, no plan for the orderly winding up of RISDIC's affairs was implemented (Gregorian [1991]; Syron [1991]). A bill filed in 1986 to require federal deposit insurance for qualifying RISDIC institutions failed in the legislature and was never reintroduced (Pulkkinen and Rosengren [1993]; Gregorian [1991]).

Also, adverse trends regarding the solvency of the largest RISDIC member, Marquette Credit Union, were noted in the outside auditor's report on RISDIC as early as 1981. Marquette had $339 million of total assets at book value when it was closed in January 1991 and held about one-fifth of all deposits insured by RISDIC.[3] However, the emergence of problems at specific institutions could easily have escaped the notice of RISDIC's board of directors, who apparently did not review examiners' reports and who had no audit committee looking over the work of RISDIC's outside audit firm (Gregorian [1991]). The RISDIC board shared one significant trait with the failed Maryland insurance fund: A majority (15) of its members were representatives of the insured institutions, and only three directors were appointed to represent the public interest. In Maryland, the insured institutions appointed eight of the 11 directors (ibid. and Preston [1986]).

The precipitating factors in RISDIC's collapse were two failures of insured institutions during 1990 that essentially depleted the funds available to RISDIC and precipitated runs on other insured institutions in November and December of that year, after the second institution (Heritage Loan and Investment Company) failed on November 16. Those runs deeply wounded a third insured institution, Rhode Island Central Credit Union, which was on the brink of failure due to termination of its credit line by its principal liquidity lender on December 31, 1990. RISDIC's board of directors met that day and requested the appointment of a conservator to take over its affairs. These events prompted Governor Sundlun to order all RISDIC-insured institutions closed as his first significant act upon assuming office on January 1, 1991 (Gregorian [1991]).

■ Common Factors in the Downfall of the Ohio, Maryland, and Rhode Island Funds

The private deposit insurance funds in all three states had some common characteristics that led in various degrees to their ultimate collapses. All were dominated by the regulated industry (state-chartered S&Ls in Ohio and Maryland and credit unions in Rhode Island), and all seemed to have considerable influence in their state legislatures regarding the expansion of their lending and investment powers (as distinguished from the lesser restraining influence of the relevant state supervisory and regulatory bodies).

The problems of the largest insured institutions were identified in supervisory examinations or outside audits years before the final collapses of the insurance funds in each state. However, for a variety of reasons — summarized in one account as a lack of necessary supervisory "clout" — ineffective corrective actions or, as in Ohio, virtually no corrective actions at all were taken.[4]

The state political authorities in each case initially attempted to deny the magnitude and seriousness of the insurance fund's problem once the insolvencies of the insured institutions posing the largest risks to the fund were revealed. They used devices like 1) the self-evidently deficient capitalization of the successor fund in Ohio (Kane [1992]), 2) the appointment of conservators instead of receivers in all three states once the largest insolvent insured institutions and the funds themselves were shown to be profoundly insolvent and not merely temporarily illiquid (see Todd and O'Driscoll [1993]), and 3) strategies based on the groundless assumption that the FSLIC (Ohio and Maryland) or the National Credit Union Administration (Rhode Island) would take the worst cases off their hands without substantial injections of state funds.[5]

The primary common element among the collapses of the three funds was their incapacity to exercise sufficient supervisory authority to limit risks or to impose effective risk-based deposit insurance premiums to make unwise risk-taking more costly for the insured institutions creating the largest risks.[6] In the absence of effective restraints on risk-taking, and without adequate insurance reserves or assurance of replenishment following recognition of loss, any large loss was bound to undermine public confidence in each fund and to trigger rational runs by depositors on other institutions insured by the same fund if the solvency of those other institutions was also questionable. In each of the three states, the political authorities waited until runs had spread to several other institutions insured by the same fund before closing all the privately insured firms or imposing limitations on withdrawals.

■ RISDIC's Collapse versus Those in Ohio and Maryland

Some factors, however, clearly separate the collapse of RISDIC from the Ohio and Maryland failures. The principal economic factor behind the failure of RISDIC-insured institutions was real estate loan and investment losses in New England, which were particularly severe between 1989 and 1992 (Randall [1993]; Syron [1991]). The failures of the privately insured institutions in Ohio and Maryland causing the largest losses were attributable to imprudent involvement with fraudulent government securities dealers.[7] Real estate loan and investment losses were significant in the Maryland crisis and in Ohio for institutions other than Home State, the largest failed S&L.

While geographic concentration of lending and investment risks generally exacerbates the tendency of depository institutions to fail during regional economic downturns, the extreme degree of geographic concentration in Rhode Island, combined with the particular nature of the primary loan and investment risk of the RISDIC-insured institutions (real estate), made the proportional loss from book value during the regional downturn much greater, on a fundwide basis, than actually occurred in Ohio and Maryland (Syron [1991]). Fund losses did not exceed 10 percent of insured deposits in Ohio and Maryland, but in Rhode Island, that share approached one-third.

In each of the three states, the private deposit insurance fund had become fairly large before the final crisis struck: Ohio had $4.2 billion of insured deposits in 70 institutions, with $130 million available to the insurance fund; Maryland had $7.2 billion of insured deposits in 102 institutions, with $175 million available to the insurance fund; and Rhode Island had $1.8 billion of insured deposits in 46 institutions as of September 30, 1990, the last calendar quarter before Governor Sundlun closed the 45 remaining institutions, with $25 million available to the insurance fund (Federal Reserve Bank of Cleveland [1985]; Gregorian [1991]). In Rhode Island, the comparative importance of the RISDIC problem was somewhat more pronounced than in the other two states because RISDIC insured 357,000 individual accounts, about one for every three residents.[8]

Some notable differences emerged in the failure resolution techniques used by state and some federal officials in the three states studied. In Ohio, the governor proclaimed an emergency bank holiday that required all institutions insured by the failed private fund to close until they were either assured of receiving federal deposit insurance or sold or merged into a federally insured institution. The remaining institutions, except for Home State, the largest and most profoundly insolvent firm, were allowed to reopen under the supervision of the state's Division of Savings and Loans on a limited-withdrawals basis, in most cases not more than $750 per account per month (later increased to $1,000).

While *all* depositors of institutions insured by the failed fund were denied access to their funds during the emergency holiday period (March 15–21, 1985), the combination of full and partial reopenings on and after March 21 enabled depositors at 59 of the 68 remaining institutions to gain at least partial access to their money by March 25. The State of Ohio committed $151 million of nontax revenues (including liquor monopoly and lottery surpluses) to support bonds issued to fund the reopenings, and full access to deposits was restored at all but one small institution ($59 million of assets) by January 3, 1986. Depositors of all but three institutions received full availability of funds within six months after the March closings (Federal Reserve Bank of Cleveland [1985]).

In Maryland, queues of depositors seeking to withdraw their money from Old Court Savings and Loan, the largest severely impacted privately insured institution (nearly $1 billion of total assets), were shown on television newscasts on May 9, 1985, and such visible runs then spread to other privately insured institutions, especially Merritt Commercial Savings and Loan Association. The $200 million estimated loss at Old Court alone exceeded the $175 million available in the Maryland private insurance fund. By May 13, conservators were appointed for both Old Court and Merritt, and on May 14, Governor Hughes proclaimed a state of emergency that limited withdrawals from all privately insured S&Ls to $1,000 per account per month. By January 1986, more than $1.15 billion of Maryland deposits were still frozen, not even available for partial withdrawals.

The eventual solution involved a combination of state-sponsored bond issues and a continuation of withdrawal limitations at Old Court and Community to provide a full return of principal over five years: Some Maryland depositors were not repaid in full until 1989. However, state authorities decided to avoid a complete closing of all privately insured institutions, totally froze the claims of depositors at only three institutions, committed sufficient state-sponsored bond revenues to cover all insured deposits over five years, and avoided "haircuts," or partial final payouts to depositors (Preston [1986]; Federal Reserve Bank of Cleveland [1985]). The Maryland solution differed substantially from the Ohio and Rhode Island solutions because of the lengthy delay in the full return of insured deposits and the avoidance of a complete closing of all privately insured institutions.

In Rhode Island, depositors obtained the full return of their principal far less quickly than in Ohio but far more quickly than in Maryland. While both Ohio and Maryland officials requested federal financial assistance to resolve their deposit insurance fund problems, only Rhode Island received such direct assistance, a federal loan guarantee for bonds issued by the Depositors Economic Protection Corporation (DEPCO). DEPCO is the state-chartered entity whose bond issues funded the liquidations of the remaining RISDIC-insured institutions and provided some liquidity to the frozen claims of depositors in RISDIC-insured institutions (U.S. House of Representatives [1991]).[9] As in Ohio, Rhode Island authorities ordered all privately insured institutions completely closed, which had the effect of freezing all deposits until the affected firms were sold, merged, or liquidated. Fortunately, from the depositors' viewpoint, there were no involuntary haircuts or discounted returns of their deposit principal.

■ Differences in Resolution Methods

The resolution methods employed in these three states show that some methods are superior to others for specific purposes, but each state also experienced shortcomings in the resolution methods actually chosen. In Ohio, the emergency closing of all privately insured S&Ls forced state officials to deal with the crisis in a more comprehensive way and more rapidly than would likely have been the case if a regime of partial withdrawals had been pursued from the beginning. Further, the Ohio solution was also the cheapest of the three in terms of the expenditure of state-controlled funds, and it caused a more rapid return to full availability of the principal amount of deposits for nearly all depositors, with no direct federal financial assistance.

In Maryland, the emergency restriction on withdrawals tended to stop the runs on both solvent and insolvent institutions and temporarily relieved state political officials of some of the sentiment of urgency that was present in Ohio. However, this measure may have unnecessarily constrained the search for a solution for depositors with frozen claims.

In Rhode Island, the emergency closing of all RISDIC-insured institutions halted the runs, but may have inadvertently created long delays for depositors in obtaining full access to their deposit principal. About two-thirds of all depositors' claims were still frozen for the greater part of 1991, and doubts regarding the soundness of Rhode Island's state-supervised institutions contributed to a second series of runs that forced the late January 1991 closing of a much larger institution, Old Stone Bank of Providence ($1.9 billion of total assets), a state-chartered savings bank insured by the Federal Deposit Insurance Corporation. Old Stone's depositors were not delayed in gaining access to their funds because their accounts were covered by federal deposit insurance (Vogelstein [1993]). The percentage of losses in Rhode Island was so large (approaching one-third of RISDIC-insured deposits) that a state-only solution appeared politically impractical. In 1993, however, DEPCO took a special charge of $31.9 million for complete defeasance of the remaining federally guaranteed bonds. By so doing, the state has in fact achieved an entirely state-funded solution.

Unfortunately, from the taxpayers' vantage point, depositors' potential losses in Rhode Island were distributed over a pool of taxpayer households that was roughly identical to the pool of depositor households. In Ohio and Maryland, depositors' losses could be distributed over larger population sets because depositor households represented a small share of taxpayer households. Therefore, it was unlikely that Rhode Island's chosen solution was politically feasible without the federal government bearing the residual risk of loss via the $180 million federal loan guarantee for the 1991 series-A DEPCO bond issue.

■ Conclusion

RISDIC was the last of the large state-chartered private deposit insurance funds. Its failure, along with the earlier fund collapses in Ohio and Maryland, tends to support some general inferences regarding private deposit insurance, cross-guarantee arrangements, private clearinghouses, and the like, but it also provides far less support than might be imagined for other general inferences. Foremost among those supported is that great care must be taken in any private deposit insurance fund or analogous arrangement to prevent the largest institutions from exercising undue influence over examinations, accounting matters, premium adjustments for risk, and the timing and basis of appointment of receivers and conservators. Steps to ensure the independence of a majority of the insurance fund's directors would help to prevent such undue influence. But it probably is too strong an inference to conclude from the Ohio, Maryland, and Rhode Island examples that private deposit insurance cannot work anywhere: It can and should work properly if the structural independence of the governing board of the insurance fund deprives the most politically influential institutions of the fruits of their influence in the matters mentioned above.

However, as in Rhode Island, the existence of any kind of federal safety net (in that case, a federal loan guarantee; in cross-guarantee plans, the availability of federal deposit insurance as a backup) tends to create a moral hazard problem for state and private insurance fund officials: Why should they become more effective in assessing and responding to increased risk in their insured institutions if a federal rescue of some sort is achievable?

Footnotes

1. See generally Federal Reserve Bank of Cleveland (1985), Preston (1986), and Gregorian (1991). Credit unions and, prior to 1980, S&Ls typically offered share accounts, a legal concept analogous to but distinct from deposit accounts. In an uninsured mutual savings association, the holders of share accounts are, literally, the owners of the association and share in its profits and losses to the extent that they exceed regulatory net-worth minimums.

2. See Kane (1985, 1989, 1992) for background materials on the collapse of thrift deposit insurance funds in the 1980s. The role of improper accounting methodology in enabling the industry's problems to intensify is addressed specifically in Thomson (1992).

3. One of the principal problems with the institutional structure of RISDIC identified in the 1991 investigative report to Rhode Island Governor Bruce Sundlun was a high concentration of insured deposits in large undercapitalized credit unions. For example, the three largest institutions held about 45 percent of all RISDIC-insured deposits (about $800 million of the $1.8 billion total as of September 30, 1990) (Gregorian [1991]). See also Syron (1991).

4. See Pulkkinen and Rosengren (1993).

5. See generally U.S. House of Representatives (1985), Federal Reserve Bank of Cleveland (1985), Preston (1986), Gregorian (1991), and Syron (1991).

6. The incapacity of the state-chartered private deposit insurance funds to rein in the risk-taking of the largest institutions was also a common element in the collapses of state funds in the early part of the twentieth century (Todd and O'Driscoll [1993]).

7. See U.S. House of Representatives (1985) and Preston (1986) regarding Ohio and Maryland. Large insured institutions in these states engaged in collateralized reverse repurchase transactions covering U.S. government securities with securities dealers that required excess collateral from the S&Ls that were borrowing funds. Meanwhile, the securities dealers' collateral custody arrangements were deficient: They used custody receipts for the same collateral to cover multiple pledges. Safe collateral procedures are distinguished from those used in Ohio and Maryland in Stevens (1987).

8. The average (arithmetic mean) RISDIC-insured account was less than $6,000, but the mean is skewed upward by the comparatively small number of high-dollar-value accounts. The median account value probably was somewhat less than $6,000.

9. See Federal Deposit Insurance Corporation Improvement Act of 1991, section 431. In the May 24, 1991 field hearing of the House Banking, Finance, and Urban Affairs Committee, Rhode Island Governor Sundlun noted that the state's congressional delegation had two requests before Congress for a $150 million outright grant and a $150 million low-interest loan to DEPCO. Governor Sundlun made a third proposal, the one actually enacted, to have Congress provide a federal loan guarantee for a DEPCO bond issue in an amount between $150 million and $210 million. The amount approved was $180 million (U.S. House of Representatives [1991]).

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