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Privatize Deposit Insurance

by Jeffrey Rogers Hummel

Amidst all the groping and furor over the savings and loan crisis, no public official has pointed a finger at the ultimate culprit. The Bush Administration admits that the nation's ailing S & L industry will cost the government at least $90 billion. That would be the most expensive bailout in U.S. history—bigger than those for Lockheed, Chrysler, New York City, and Western Europe (through the Marshall Plan) combined, even after adjusting for inflation. But contrary to popular perceptions, the crisis stems not from too little regulation, but too much. It all can be traced to the perverse influence of government deposit insurance.

The federal government first insured deposits in reaction to the Great Depression. A scramble for currency among depositors had led to runs on nearly 10,000 banks. This liquidity crunch forced otherwise solvent institutions into emergency sales of their assets. Unnecessary bank failures, a one-third collapse in the money supply, and deflation were the result. To protect the economy from future panics, the newly established Federal Deposit Insurance Corporation (FDIC) guaranteed small depositors against any losses.

Comparisons with other countries now suggest that the regulations already existing in the 1920s were responsible for the precariousness of the American banking system. Canada, for example, permitted its commercial banks to open branches nationwide and had yet to set up a central bank. Not one Canadian bank failed during the Great Depression.

However plausible the justification of deposit insurance for U.S. commercial banks, it certainly did not apply to savings and loan associations. Unlike banks, S & L's at that time didn't offer checking accounts or any other deposit that served as a medium of exchange, nor were they plagued by runs. Yet S & L's got similar guarantees with the establishment of the Federal Savings and Loan Insurance Corporation (FSLIC) in 1934.

Government deposit insurance may have dampened the danger of bank runs, but only at the cost of incurring another danger. Private insurance companies have long been aware of what is called "moral hazard." If you protect someone from the painful consequences of risk, he will have less incentive to avoid risky actions. Insurance against fire or automobile accidents thus can be so complete that it fosters carelessness and leads to more fires and accidents.

One way insurance companies get around the moral-hazard problem is with a deductible, which makes the insured bear some of the cost of risky actions. Private insurance companies also vary premiums according to actual risks; otherwise they lose money. Government deposit insurance, in contrast, ignores these sound principles. It therefore subsidizes risk-taking by depository institutions. They pay the same premium regardless, and their depositors have no financial reason to impose market discipline by doing business elsewhere.

Not until the 1980s, however, did this moral-hazard time bomb explode. Pervasive government regulation protected banks and S & L's from competition while simultaneously restricting their portfolios to safe assets. Only after the inflation and climbing interest rates of the 1970s required these institutions to bid actively for de-

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posits did the government initiate financial deregulation. Unfortunately, deregulation did not go far enough. By leaving deposit insurance untouched (except to raise coverage), it rewarded the managers of banks and S & L's who gambled with their depositors' money. All the colorful headlines about cowboy bankers and corporate swindlers overlook the way that the regulatory environment distorts the normal market curbs against such behavior.

Government favoritism for insolvent banks and S & L's aggravates the crisis. If the FDIC and FSLIC were truly interested in protecting the small depositor, they would close insolvent institutions and pay off the depositors directly. Instead, they usually arrange purchase and assumption agreements that merge failed institutions with healthy ones. Big depositors are protected as well as small in a short-term solution that merely compounds long-term difficulties.

The crisis has reached such epic proportions among S & L's that the FSLIC no longer has enough resources even to arrange bailout mergers. Growing numbers of bankrupt institutions continue to compete with sound S & L's, driving the interest paid to depositors still higher. Genie Short and Jeffrey Gunther of the Federal Reserve Bank of Dallas point out in a recent study that "such policies penalize the more conservatively managed institutions over the more aggressive ones."

Indeed, no regulatory sleight of hand can magically transform bad loans into good. Without enough income from these loans, the failed but still operating "zombie" institutions can pay interest to their current depositors only with money from new depositors. The regulators thereby sanction an escalating chain letter that makes the final accounting ever more expensive. When they take over an S & L themselves, the regulators still are powerless to do anything else without outside funds.

None of the Administration's proposals address the root cause. Attempting to re-regulate the S & L industry by imposing, for instance, higher capital requirements, will simply destroy it. Market forces already are unleashed. The competitive survival of banks and S & L's compelled financial deregulation. The regulatory haven that gave banks and S & L's a tidy market-sharing arrangement cannot be reconstructed.

If Congress increases insurance premiums, the sound institutions will be the ones to pay. This will further punish the very kind of management that should be encouraged. Nor can government ever adequately administer variable premiums. "A rational system of risk-based insurance premiums offered monopolistically by a public agency is simply impossible," argues Gerald O'Driscoll of the Federal Reserve Bank of Dallas. Without the feedback of profit and loss, bureaucrats have neither the information nor the incentive for matching premiums to risk.

And foisting the cleanup bill on the taxpayer is not merely unjust but also tempts politicians and bureaucrats to try the same scam again. How much longer will the taxpayer be expected to cough up the cash for the government's self-serving and disingenuous pledges? How much higher will the price tag have to soar? Unfortunately, some undeserving group must take the hit for the irretrievable S & L losses, but the depositors at least voluntarily assumed a risk when they accepted fabulous political promises at face value. If the depositors want compensation, let them turn not to the much-abused and long-suffering taxpayer but to the managers of the failed S & L's, perhaps to the sale of government assets, and ultimately to the personal liability of the politicians and bureaucrats who perpetrated this outrage.

Only one solution can overcome moral hazards in the banking and thrift industries: private deposit insurance. The government must dissolve the FDIC and FSLIC and remove all remaining regulations upon depository institutions. The first step would permit the competitive forces of the market to arrange actuarially sound insurance that protects depositors without subsidizing insolvency. The second step would help depository institutions gain the geographical and asset diversity necessary to shore up liquidity during runs.

The S & L crisis is just the tip of the moral-hazard iceberg. Although not yet visible, deposit insurance creates the same perverse incentives for commercial banks. The FDIC already rates 10 percent of these institutions in the problem bank category, within an industry with $2 trillion worth of deposits. Unless deregulation proceeds to the privatization of deposit insurance, the nation soon faces a larger crisis throughout the banking industry. □