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NO MORE BANK BAILOUTS

A Proposal for Deposit Insurance Reform

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Introduction and Summary

The U.S. Government's role as a financial guarantor poses an unprecedented threat to the taxpayer. The President's 1991 budget proposal noted that the total amount of all deposits held in U.S. banks, thrifts, and credit unions -- approximately $3 trillion -- is a contingent liability of the federal government. With this admission of its liability, the Administration acknowledged its concern about the escalating costs of financial failures and the fact that it does not know how to stop either the rising costs or the rising number of failures.[1] In fact, taxpayer exposure may be as high as $5 trillion if other financial guarantee and credit programs are taken into account.[2]

Financial guarantee programs were originally designed to pay off depositors of failed institutions. In recent years, however, they have taken on a different function: financing the buyout of failed or failing banks. Mixing these two functions has contributed to the escalation of the government's potential liability.

The purpose of this paper is to propose a new system for providing financial guarantees -- one that both insures individual savers and protects the capacity of financial institutions to support the transactions essential for economic stability and growth. A new system is needed for the obvious reason that the size of the government's liability has gotten out of hand: whatever gains may accrue to individuals in their role as savers may well be lost when they are required, as taxpayers, to foot the bill. But there are other reasons as well: to separate the different purposes that government guarantees serve in protecting consumers/savers, communities, and the economy as a whole: to ensure that

financial guarantees enhance, rather than impede, the role of the financial system in promoting economic growth: and, to clear the way for revitalizing the government's function as a guarantor and regulator in a new and different financial environment.

In the case *of financial guarantee programs intended to protect savings, this paper argues that coverage should be based on the aggregate holdings of individual savers rather than on individual accounts or institutions.* Individuals would be protected from loss of a set amount, independent of whether their assets are confined to one institution or spread throughout a variety of accounts in federally regulated institutions: bank, thrift, or credit union deposits: mutual funds; or pension plans governed by the Employee Retirement Income Security Act (ERISA).

Providing equal coverage for different types of savings instruments held in federally regulated institutions means that all institutions must be regulated with equal attention to soundness and stability. That will require a corollary agenda for reform -- an overhaul of the regulatory framework that revitalizes the tools of regulation to reflect current needs and practices.

In the case of protecting funds needed for current transactions (e.g., payrolls, purchases, bills, and other payments that support ongoing economic activity), this paper argues that limiting insurance for these accounts is unrealistic. For example, if even the smallest institution fails, the current $100,000 in coverage will not ensure that local payrolls are met. The subsequent interruption in payments down the line will result in a widening circle of losses,

Thus, all transactions accounts must be 100 percent insured. Insured transactions balances must be held in the form of noninterest-bearing demand deposits, in a federally regulated depository institution, and invested in a portfolio of loans and liquid assets that meets accepted standards of diversification in terms of economic sectors and maturity. Depository institutions will be allowed to deduct a reasonable amount from earnings on their investments for profits and to cover the cost of reserves that are held in the Federal Reserve banks. The remainder -- the interest foregone by depositors -- will be paid into the insurance fund.

To make the case for this new framework for federal financial guarantee programs, this paper first outlines the history and purposes of financial guarantees and describes the structural changes that have undermined a system that worked so well in the past. It then presents detailed proposals for reforming federal insurance of savings and transactions deposits.

An Overview of Federal Financial Guarantee Programs

Federal deposit insurance for commercial banks and thrift institutions was authorized in the 1930s after decades of debate and experimentation in state programs. The success of these federal insurance programs in restoring confidence in depository institutions after the wave of bank failures in the early years of the Depression was seen by economists, including Milton Friedman and Anna Schwartz, as the "most important structural change in the banking system" and a fundamental contribution to U.S. monetary and financial stability (1963, p. 434). The growing perception of deposit insurance as a cornerstone of financial stability and its record in providing protection at minimal cost led to the creation, in 1970, of insurance funds for securities firms and credit unions and, in 1974, for pension funds.

Meanwhile, some states also administered funds that insured the depository institutions that they chartered, and, in the period between 1969 and 1972, most states set up guarantee funds for the insurance industry, which is the only segment of the financial services industry that is solely regulated by states. All of these guarantee funds were introduced for the same purpose as federal programs: to protect customers and to provide liquidity in the event of failures.

The deposit insurance funds for commercial banks, thrifts, and credit unions insure individual deposits up to $100,000. They generate income by charging insured institutions premiums based on their total domestic deposits and from interest received by investing these premiums in U.S. Government

securities. Federal deposit insurance funds have always had the authority to

borrow from the Treasury, and that authority was significantly expanded in 1989.[3]

The deposit insurance funds were originally intended for use in paying off depositors of failed insured institutions. In 1935 they were granted additional authority to undertake preventive actions and the form of assistance gradually changed. Since 1960, the funds have been used more often to lend to, presumably, stronger institutions for the purpose of acquiring banks that are failing or about to fail. Such operations are known as “supervisory mergers” or “purchase and assumption” transactions.

Unlike the deposit insurance agencies, the Securities Investor Protection Corporation (SIPC) is not a government agency. It is a private membership corporation whose members are securities brokers who handle cash and securities of U.S. resident customers. Its authority is more limited than the deposit insurance funds in that its reserves cannot be used to assist mergers or make loans to troubled broker-dealers: they can only be used to pay off customers in the event of insolvency. Moreover, SIPC protection extends only to the return of cash and securities to the customers of the failed firm, not to market losses affecting the value of the securities.[4]

The Pension Benefit Guaranty Corporation (PBGC) was established under the Employee Retirement Income Security Act (ERISA) of 1974, to insure basic benefits in cases where pension plans terminate without adequate funds to pay vested beneficiaries. The PBGC is government-owned and covers all qualified private sector plans with benefits defined and guaranteed by the employer. Defined contribution plans -- those that are constituted by contributions from both the employee and the employer, that are not guaranteed by the employer, and that do not specify the ultimate amount of benefits -- are not covered. The PBGC is financed primarily by premiums paid by covered plans, but it also derives income from selling the assets of terminated plans, from investment income, and from charges levied on employers who terminate plans. It, too, is authorized to borrow (up to $100 million) from the U.S. Treasury.

In the mid-1980s, the PBGC was the guarantor for the pension benefits of approximately 38 million American workers who were covered by more than

112,000 plans. It was faced by a gap of liabilities over assets of more than $1.3 billion. Despite increases in premiums, the PBGC's negative net worth rose to $1.8 billion in September 1990. At that time, its cash flow was positive and funds were adequate to meet current obligations. But the PBGC's exposure to possible losses from underfunded plans of financially troubled employers totaled $8 billion, or about 10 times its annual premium income (The *Wall Street Journal,* 1991, p. 2).

Another segment of the public's savings -- that held by insurance companies -- is also protected by guarantee funds which are administered by individual states. In most states, surviving companies are charged premiums to pay for claims against insurers that have been declared insolvent. Because there is no pre-existing pool on which to draw, policy holders and annuitants face uncertainty and lengthy delays before receiving benefits. While no retirement benefits were lost in the 1983 collapse of Baldwin-United, the GAO warns that benefits may not now be secure for three to four million retirees with insurance annuities. The recent insolvency of Executive Life may well result in losses (U.S. GAO, 1991).[5]

The growing number of individuals whose retirement funds are invested in annuities and guaranteed investment contracts sold by insurance companies and the immense growth in mutual funds over the last two decades make it clear that the original rationale for differences in the various systems of protection has eroded. If the objective is still to protect small savers, the focus on depository institutions is misplaced. The bulk of the funds of small savers are held in tax deferred retirement plans and invested in or by institutions -- banks, mutual funds, and insurance companies -- across the whole spectrum of the financial services industry. Moreover, if the intention to "protect communities, states or the Nation against the economic consequences of bank failure"[6] remains valid, then the focus on deposit insurance for small savers as the primary federal program for providing protection is also misplaced.

The exclusion of securities and insurance companies from the original proposals for federal financial guarantee insurance programs is not surprising. In the 1930s, the savings and transactions accounts of households and small

businesses were held primarily in banks. As the cycle of business failures and bank closures gained momentum, the public lost confidence in banks and withdrew deposits. At that point, the failure of banks was itself the cause of economic dislocation. Losses of demand deposits were more immediately disruptive than losses of savings, The inability of individuals and businesses **to** meet payment schedules -- salaries, rent, supplies, etc. -- slowed or even halted economic activity in many regions of the country. Hence, the emphasis was placed on insuring the institutions themselves rather than the customers.

In the six decades that have followed the enactment of deposit insurance, changes in the financial system have altered the ways in which savings are channeled into investments. As noted, the majority of small savings are now managed by private pension plans and another sizable portion -- the savings of public school teachers, policemen, firemen, and other state and local government workers -- are held in state and local pension plans that are not federally insured .[7]

Insurance companies have also become more directly involved with consumers over the years as life, health, disability, homeowner, and automobile insurance have become increasingly indispensable for the financial security of households. Securities firms, too, have become more involved in managing the savings of households, competing successfully with banks and insurance companies to manage pension funds and Individual Retirement Accounts(IRAs). And mutual funds now manage a significant portion of the nation's transactions balances held in money market funds. Thus, insurance companies and securities firms meet more of the financial needs of American families now than in the past, and reach as broad a spectrum of savers and investors as depository institutions.

The average American family views its expanded and rechanneled use of financial services as essential to its economic stability. The proliferation of financial guarantee programs reflects this public perception. The result has been a dramatic escalation in federal (and state) liability for financial guarantee programs. As former Securities and Exchange Commission (SEC) Commissioner Bevis Longstreth observed, it has become more difficult to "draw the circle"

around those financial transactions and assets that should be protected to achieve the original objectives of the various financial guarantee programs (U.S. Congress, 1983). It has also become increasingly clear that these various programs cannot cope with the mounting problems in the financial system. The pools of guarantee funds are too small and the burden of higher premiums on institutions struggling for survival is too great. And if these programs cannot cope with the current situation, they will be counter-productive. Existing guarantee programs will undermine, not promote, stability and confidence in the financial system.

Current Proposals for Reform

It is ironic that many who are eager to restructure the U.S. financial system in truly radical ways -- by allowing the formation of multifunctional financial conglomerates that include depository institutions, and by permitting them to be owned by commercial and industrial firms -- are unwilling to confront the implications of the unknown level of risk posed by the government's huge credit and financial guarantee programs. The Administration's proposal for modernizing the financial system deals with the issue of financial guarantees in ways that are both narrow and conventional.* It focuses only on depository institutions, ignoring the role of pension funds in channeling savings. The amount of coverage proposed fails to distinguish between the differences in protection needed for transactions balances as opposed to savings vehicles. Further, it perpetuates a system of insuring institutions instead of individuals, a system that can only result in the continuation of costly government intervention to prevent failures of large banks.

The Administration's proposal gives priority to ending the institutional segmentation that, even now, functions to moderate the spread of problems from one financial sector to another. In encouraging the proliferation of financial conglomerates without a coherent program for reforming the financial guarantee system, it appears to advocate ever-freer financial markets with ever-growing

government protection and liability. The rationale for marrying such contradictory notions is expediency -- to find a quick source of new capital for banks and to enhance banks' ability to compete with other financial service providers in national and global markets.

One reason for the concern about the adequacy of banks' capital is the fact that the financial system itself -- especially the banking sector -- has been steadily expanding into the business of offering financial guarantees. New and innovative concepts that take off from such traditional instruments as letters of credit and acceptances have swollen the off-balance-sheet liabilities of banks to levels that finally persuaded regulators to take steps to limit their growth. Capital adequacy standards will eventually require capital backing for these contingent liabilities. But in the meantime, the propensity of banks, like the Federal Government itself, to guarantee customers (for a fee) that a loan will be forthcoming if another source of credit dries up, or to guarantee that a direct investor will be paid if a borrower defaults, will inevitably tip the balance toward a wider number of bank failures, especially in an era of slow growth, and will thus increase the likelihood of a systemic crisis. Should this occur, the tighter knot of enmeshment formed by the overlapping of private and public financial guarantees would undercut the government's ability to halt the slide.

A further indication that the Administration's proposal fails to confront reality is reflected in its failure to recognize that financial crises and the diminishing role of banks have more to do with macroeconomic policy than with excessive (or insufficient) regulation or institutional segmentation. Confronted by unstable economic and financial conditions for more than two decades, U.S. financial institutions necessarily engaged in a quest for new markets to stabilize profits. In the 1970s, this led to the creation of money market mutual funds by securities firms to offset the ravages of inflation on markets for stocks and bonds. It also led the largest U.S. banks to expand abroad. But the brief success of US. banks in the global arena was undercut by domestic economic mismanagement.

When U.S. banks dominated the ranks of the largest banks worldwide, the United States was the world's largest creditor nation. Now that the United States is the largest debtor, U.S. banks are necessarily at a disadvantage compared with

banks from creditor nations. A low U.S. savings rate coupled with budget and trade deficits leave U.S. banks without surplus funds to channel into markets at home and abroad, unlike their more successful foreign competitors. And while a falling dollar will improve the trade balance, it adds to U.S. banks' competitiveness problems in the short run by lowering the value of their assets and capital relative to that of banks from countries with strong currencies, making it even harder to attract capital.

The remedies prescribed by the Administration -- more powers and products for banks, infusions of capital from non-traditional sources, regulatory relaxations -- are further manifestations of the focus on protecting international capital. Lost in this perspective is concern for what may happen to more vulnerable participants in the financial system -- in particular, community banks and their customers -- and the average taxpayer who remains liable for excessive losses. Moreover, these prescriptions will not overcome the major competitive disadvantages faced by the larger banks. Putting U.S. banks on a level playing field with their foreign competitors will require putting the U.S. economy on a managerial par with other developed economies.

More importantly, failure to address our macroeconomic problems will further weaken the U.S. financial system as a whole. No system -- whatever its institutional and regulatory structure -- can remain sound and protect its customers by promoting growth while operating in an unstable macroeconomic environment. Thus, the Administration's proposals for institutional and regulatory restructuring are more likely to perpetuate instability than to address the narrow issue of banks' competitiveness on which they are focused.

Administration proposals give priority to higher capital standards, and link deposit insurance premiums and expansion of banks' activities to capital ratios. As one observer has noted, emphasizing the primacy of capital for soundness could lead to the neglect of equally important measures such as asset quality, management ability, liquidity, and earnings stability (Friessen, 1991, p. 13A). Moreover, higher capital standards offer little protection if institutions fail to diversify assets.

In the case of banks, satisfying diversification requirements has meant limiting loans to a single borrower in relation to capital. The inadequacy of this standard has been used to support proposals for interstate branching which would, presumably, improve diversification by preventing the concentration of a depository institution's loans in a limited geographic region (U.S. Department of the Treasury, 1991, pp. 49-50; Woodward, 1990, p. 15). While experience shows that economic weakness can be concentrated in specific regions while others are unaffected, this is not the only kind of weakness that has plagued the banking system in recent years.

Concern for diversification has not yet included the problems that emerge because of sectoral concentrations outside the context of geography. While many small banks failed in the farm belt, many large banks -- some with worldwide branch networks -- have also been weakened by overlending to specific types of borrowers: real estate investment companies (REITs), operators of tankers, and less developed countries (LDCs) in the 1970s; and commercial real estate developers, borrowers for highly leveraged corporate acquisitions, and management buyouts in the 1980s. When the ratio of a banks loans to one sector or type of borrower rises significantly relative to total loans, concentrations develop that are as detrimental to soundness as are more traditional violations of diversification standards. New guidelines are needed to prevent sector-al concentration and to improve the ways in which diversification requirements are applied and implemented in the context of the current financial and economic environment.

The current crisis has generated attempts to find the equivalent of a magic bullet -- a single strategy, like capital standards or the "safe" bank -- that will inoculate the system against unsoundness. Such narrow approaches ignore the extensive body of law and regulation governing the financial system, the wealth of strategies it contains to implement the many different objectives of financial regulation, and the continued validity of its unifying theme: recognition of the special nature of the financial system and its role in transforming financial capital into economic activity and growth.[9] Regulatory strategies designed to

prevent institutional concentrations and conflicts of interest (and to ensure access to credit) have been ignored as the trend toward deregulation has gained momentum in the wake of financial instability. But the link between soundness regulation and protection is such that the regulatory issues cannot be ignored in any proposal for reforming the mechanisms for protection. The need for new strategies is imperative.

Reforming deposit insurance -- or, as this paper argues, the financial guarantee system as a whole -- will not solve the basic problems of instability that confront the financial system. But it is a needed response to the proliferating costs that accompany instability. No one argues that reform is not needed or is an issue that can be put on the back burner for a year or two. There are, in fact, a number of proposals for deposit insurance reform and the public debate reflects the necessary sense of urgency. But most of the proposed changes fail to come to grips with the real scope of the problems that must be addressed and many could actually exacerbate the problems they intend to solve.

Meanwhile, the FDIC's administrative response to the mounting crisis -- raising insurance premium assessments -- can be characterized as too little too late. Despite losses amounting to 70 percent of gross assessments in 1981-82 -- compared with losses averaging 9 percent of assessments in the period 1934-1980 -- the FDIC failed to raise premiums until rising bank failures and declining insurance reserves reached levels that threatened confidence in the insurance fund. In 1984, even as the list of problem banks rose to more than 800 institutions, the FDIC continued to rebate that portion of assessments not used to cover expenses, and relied primarily on earnings from investments for reserve growth (U.S. Congress, 1986, pp. 345, 352).[10] Rebating assessments during periods of earnings growth and raising premiums during periods of difficulty has a procyclical effect, putting additional pressure on banks during a period of economic weakness and declining profits. Moreover, the sharp increase in premiums from 12 cents to 19.5 cents per $100 of deposits in January 1991, and the planned increase to 23 cents by mid-year, will fall most heavily on community and regional banks without access to noninsured foreign deposits. Thus, they pose a greater threat to insured consumer deposits while lowering the

relative cost of large Eurodollar deposits. The growing perception that the FDIC's response could prove counterproductive may limit efforts to increase premiums further.

Requiring that banks raise their capital-to-asset ratios from the 5 percent level that prevailed earlier in the decade to 8 percent by 1992, and requiring that half their capital be in the form of equity, are regulatory responses that are difficult to implement in a period of economic weakness." Pressure for higher U.S. capital standards began in the early 1980s[12] and the need for uniform capital adequacy standards has been recognized by all the major industrial countries. It is a constructive response -- widely advocated by academics, regulators, and members of Congress -- to cushion the effects of losses and reduce the amount of insurance coverage needed to protect depositors.[13] But it is a reform that is more easily implemented when banks are profitable. It is unlikely to significantly augment protection for depositors in the near-term.

Those who advocate implementing stronger capital standards also tend to favor prompt intervention to deal with institutions on the brink of insolvency. Some also favor the adoption of variable insurance premiums based on capital-to-asset ratios: i.e., the lower the capital ratio, the higher the premium. Again, these are constructive proposals if the current system of insuring institutions remains unchanged. But they are strategies that could and should have been implemented earlier to be effective as preventive measures.

It is beyond the scope of this paper to enumerate and critique all the currently proposed mechanisms for continuing to insure depository institutions.[14] Moreover, most witnesses before the Congressional Committees and most members of Congress favor more than one proposed mechanism (Riegle, 1990, footnote 14, S 13826). As yet, no single reform proposal or package of mechanisms has developed the support needed for enactment.

Few of the current proposals have attempted to sort out the differences in protection needed for savings and for transactions accounts. One that has -- Robert Litan's 1986 proposal for a "safe" or "narrow" bank that is required to invest all deposits in U.S. Treasury obligations (1987, pp. 164-89) -- points up

the limitations of attempts to perpetuate a system of insuring institutions. The Litan proposal ignores one of the key functions of a private banking system: intermediation. The objective of a system that moves private savings into productive private investment is to enhance economic activity both in the local community, as underscored by the Community Reinvestment Act, and the nation as a whole. The opportunity to invest individual savings in government securities already exists. It can be done directly by buying marketable bonds or savings bonds or by investing in a government bond mutual fund. If there is a need to expand these opportunities -- to provide that demand as well as savings deposits are invested in government securities -- it might be better to propose the reestablishment of a postal savings system rather than divert commercial banks from more useful purposes in supplying the credit needs of households, businesses, and communities.

Overall, the irrelevance of current proposals for reform are the outcome of a failure to identify appropriate goals for financial guarantee programs in the current financial and economic environment, and to evaluate the effectiveness of existing programs. The conceptual poverty of these proposals is implicit in their thrust -- to shore up and perpetuate current mechanisms.

The Need to Reframe Reform Proposals

The savings and loan (S & L) crisis has tended to focus reform efforts on protecting savings and minimizing government (i.e., taxpayer) liability. The heretofore vague and seemingly contingent relationship between the protected saver and the liable taxpayer has been made clear. Certainly minimizing the taxpayer's liability is a worthy objective but, in reality -- across the entire spectrum of financial guarantees for pensions, annuities, and savings deposits -- the saver and the taxpayer are one and the same. However, sorting out the fairness in paying the bill does require shaping the system to betterfit the needs and appropriate responsibilities of individuals.

Constructing a system that will minimize taxpayer liability in the context of current and future financial and economic instability -- the likely context for at least half of the coming decade -- requires shifting insurance coverage and its cost from institutions to individuals.

Posing a choice as to who pays the premiums for deposit insurance clarifies the issue of who gets protection. If the financial institution pays the premium, it is insured. It is the client of the insurance agency and its depositors are relegated to the role of nominal beneficiaries. This has tended to encourage a "save the institution" mentality on the part of the insurance agency and its Congressional watchdogs. Of course, depositors, too, are protected in this process. But only up to a point -- the point at which the losses of institutions exceed the pool of funds their premiums have created. At that point, the depositor loses because the benefit of his protection will be taxed away.

The system of insuring institutions has led to distortions in regulatory emphasis as well. Regulatory objectives have tended to move in the direction of fostering institutional profitability. Profitability is certainly an important measure of the soundness of institutions and, in the normal course of events, constitutes an additional umbrella of protection for depositors. But insuring institutions in periods of financial and economic instability or weakness means that institutional profitability is the only assurance of protection, short of the taxpayer, because profitability determines the viability of the insurance fund itself. Insuring institutions gives priority to the entrepreneurial activities of depository institutions in pursuit of profits at the expense of their prudential obligations. And the depositor has been assumed to have primarily entrepreneurial objectives as well -- to be more concerned with interest earnings than with the safety of principle or the possible consequences of failure for tax liability.

The search for stable profits in an unstable financial and economic environment necessarily requires an unending game of innovation. Financial institutions and their regulators have focused on guessing what new products, powers, or markets are most likely to ensure continued profitability. The problem is that financial innovation, whatever else it has done, has made no

positive contributions to economic stability and may have had negative effects. In any event, innovation is no guarantee of profitability for financial institutions in the face of economic weakness.

Finally, the system of insuring depository institutions rather than their depositors does not work anymore. It has already broken down in the case of the S & L crisis and has resulted in a level of costs that will retard economic growth for years to come. The enormity of this outcome is only now beginning to be recognized. As recognition develops, the weaknesses of proposals that tinker at the margins of the current system will become clearer and the search for more radical solutions will intensify.

It is in that context that the following alternative proposals are offered. They propose a different option -- insuring individual savers and the transactions balances of businesses and other economic sectors rather than institutions -- and attempt to sketch out how such a system might work. The overall objectives of these two proposals are to provide sufficient protection for the saver/taxpayer at a known and affordable cost, to avert the economic dislocation that results when banks fail, and to preserve the role of depository institutions in financial intermediation. These proposals will not solve all the problems confronting the financial system, but they provide a more realistic framework for dealing with those problems than do the proposals they replace.

An Alternative Proposal for Protecting Savings

Constructing a fair and rational system for protecting savings in the 1990s would include the following key elements:

1) **All** *individuals and households would be required to purchase financial guarantee insurance to cover savings up to a given amount.* They would do this by accepting a lower rate of interest on insured deposits than could be earned on uninsured deposits. The lower rate would reflect the deduction for the insurance premium. A compulsory system is necessary to ensure that all savers are covered, that reserves are adequate, and that liability for losses is fairly distributed.

2) *Covered assets could be held in a variety of accounts in federally regulated institutions: bank, thrift, or credit union deposits: mutual funds; or pension plans governed by ERISA.* A financial guarantee program must focus on all channels for savings if it is to offer adequate protection for the average saver whose primary savings are deferred income that may be invested in pools or other vehicles chosen by employers.

3) *Premiums would be collected from the interest or gains on covered savings assets, offset by a full tax deduction. The* amount of the premium would be deducted by the institution and paid directly into the insurance fund before the accrued interest or gains are credited to the saver's account. Statements on premiums paid would be added to reports on earnings and filed with the individual's tax form as a deductible item. A compulsory system involving individuals will only work if paying premiums is relatively automatic and painless: that is, if it does not involve earned income.

4) *The amount of savings in the various accounts of individuals will be reported to the Internal Revenue Service by financial institutions, and records of aggregate savings of individuals and households will be maintained by the insurancefund.* This requires modifying the current reporting system to include all principal amounts in addition to interest income and the fair market value of IRA accounts that are currently reported for individual Social Security numbers.

5) *While financial institutions would be exempted from paying premiums, they would also lose their special tax status, including tax deductions on loan loss reserves in the case of depository institutions.* A neutral tax system for financial institutions will ensure that they share equally with individuals and households in any tax increases needed to offset losses by the insurance fund and enhance their stake in soundness.

6) *Strategies for soundness regulation would be revitalized to reflect changes in institutional structure; to reflect the need to regulate all institutions that handle the core savings of individuals and families with equal regard for*

soundness and stability; and *to* enhance *the efficiency of* ***the financial system*** in accomplishing *the goals of its* ***role*** *as an* ***intermediary*** between *savers* and *borrowers.*

7) Insurance reserves would *be* invested in U.S. government obligations as *they are now.* Continuing this practice under a regime in which individuals pay premiums clarifies the relationship between the individual's role as saver/taxpayer. Since the assets of the fund are those for which savers/taxpayers are already liable, savers' premiums will reduce their tax liability if failures are contained. If failures exceed acceptable levels and seriously deplete reserves, the impetus for action to address problems will be enhanced by a tax liability that kicks in earlier in the slide.

This basic framework could be elaborated or modified in a number of respects. For example, it could better reflect the needs of savers by doubling the amount of coverage for a given Social Security number if the aggregate accounts were held in the names of two people (husband and wife, parent and child, etc.) or by expanding coverage for households on the basis of the number of dependents. Thus, individuals might be insured up to a maximum of $100,000; couples up to $200,000 and families could be granted an additional $25,000 for each dependent. While these figures are arbitrary -- coverage could be lower or higher depending on the evolution of information about the value of the average family's total savings -- they suggest the potential for adding flexibility to the framework that would address the needs of individuals and households rather than those of institutions.

Obviously, the savings of individuals and households will grow over time and may exceed the maximum amount covered by insurance. At that point, the effect of limiting coverage will introduce an element of coinsurance for older or more affluent households. This does not detract from the advantages of limiting coverage since all savers will be assured that a basic portion of their funds is safe, while the remainder, exempt from premiums, will earn the higher rate that is the reward for risk. But the amount of coverage should be reviewed at periodic intervals to maintain its adequacy in relation to changes in the rate of inflation.

Increased coverage on that basis will automatically increase the flow of premiums into the insurance fund and maintain the needed ratio of reserves to liabilities.

Small savers could be given additional advantages such as a waiver of premium payments on aggregate accounts under $10,000 (again, a hypothetical figure), or on a sliding scale for premiums based on gross income. To emphasize the protection of pension benefits, all pooled savings in either defined benefit or defined contribution plans of individuals over age 50 (hypothetically) with a gross income below a given level could be covered if coverage of other savings accounts were reduced by an appropriate amount. Coverage should be extended to state and local government pension plans. The fact that state and local government pension plans are no less vulnerable to economic weakness than are private plans (as demonstrated in the New York City crisis in the mid- 1970s) suggests that including them in a national financial guarantee program would be desirable. Moreover, these funds are very large and cover primary savings for millions of moderate income Americans whose work is vital to society and the economy.

Proposing that state and local pension plans be covered raises difficult political issues in the context of this proposals recommendation that covered assets be held in federally regulated institutions or pension plans regulated under ERISA. Combining both recommendations would either require that all pension fund regulation be turned over to the Department of Labor or that all states be required to adopt ERISA guidelines in administering plans. The latter would appear to be the more feasible solution and, in fact, many states do follow ERISA guidelines. However, some oversight responsibility by the Department of Labor could be authorized to monitor compliance with the guidelines.

Requiring federal regulation also leaves an obvious and important gap in coverage of assets held by insurance companies. But this is only one reason for advocating that insurance be regulated at the federal level. The major reason is that insurance companies now manage one-third of the nation's pension assets, offer other savings vehicles for small savers, and are the primary providers for the nation's health insurance system. Other reasons include differences in the

quality of regulation from state to state, the questionable effectiveness of state guarantee funds for this industry, and the fact that the industry is dominated by a number of large companies that operate nationwide and cannot be effectively supervised by individual states.

Finally, questions about the effectiveness of financial regulation must be addressed. This means more than simply rearranging the responsibilities of regulatory agencies. What is required is a thorough reexamination of the objectives and tools of regulation no matter what reforms are undertaken.

Protecting Transactions Balances

Before considering a financial guarantee program that protects funds needed for current transactions, one must accept a fundamental premise: it is unrealistic to limit insurance coverage for accounts that are necessary to sustain economic activity. The current $100,000 limit on coverage is clearly inadequate in the case of employers, whether it be for large or small businesses, farmers, nonprofit organizations, or state and local governments. If payrolls are not met, the interruption of payments down the line will result in a widening circle of losses. In the case of regional or money center banks that have large customers and hold clearing balances for other financial institutions, inadequate coverage of transactions balances can result in even broader repercussions, causing dislocations to any number of communities, or even the nation as a whole.

Because these repercussions are too destructive, the "too big to fail" approach has become a reality under the current system. But it is a reality that encompasses small as well as large banks, that involves any account, of whatever size, that can precipitate a chain of events that results in economic dislocation. A small community bank that holds the demand deposits of the local hospital is too big to fail because its failure means that all salaries will not be paid, all supplies cannot be purchased, and care cannot be provided for all patients. In this context, the FDIC's inclination to prevent failure and thus cover uninsured deposits may be justified. But the current system fails to take into account the

differences in protection needed for savings and transactions balances and thus the criterion for "too big to fail" is the size of the institution, not the size or function of the deposit.

A more effective and affordable means for safeguarding transactions balances requires the following key elements:

1) Coverage must be *unlimited. The* transactions accounts of General Motors or IBM, like those of the local hospital or municipal government, must be protected regardless of the multimillion dollars involved. Clearing balances of other financial institutions must also be covered and unlimited coverage would also extend to individuals.

2) *Insured transactions balances must be clearly defined as noninterest-bearing demand deposits in federally regulated depository institutions that are payable at par with no limit on the number of withdrawals.* Foreign deposits -- which are interest-bearing time deposits, not demand deposits -- are excluded. Funds held in money market mutual funds or money market funds in depository institutions are also excluded from this form of coverage, but would be covered as part of an individual's aggregate savings accounts.

3) *The interest that depositors forego will be assumed to be equivalent to the interest on Treasury bills.* Depository institutions will be allowed to deduct a reasonable profit from earnings on the loans and other assets in which transactions balances are invested, deduct the cost of holding reserves against these balances with Federal Reserve Banks, and pay the remainder of the earnings into the insurance fund at short, periodic intervals.[15] Like the fund for savings, premiums will be invested in U.S. government securities.

4) *Transactions balances must be invested in a segregated pool of loans and investments that will receive special attention from regulators.* These assets must meet accepted standards with respect to liquidity, maturity, and diversification in terms of loans to individual borrowers, economic sectors,

and loan characteristics. If a depository institution's portfolio meets those standards, it will be permitted to advertise that its transactions balances are insured.

5) *If the assets held by a depository institution as backing for insured transactions balances fail to meet accepted standards, the institution will be required to set aside loan loss reserves equal to 100 percent of substandard assets within a given time frame, and to write off nonperforming loans against reserves as needed to maintain sufficient earnings on assets to pay insurance premiums.* Transferring bad loans from a pool that backs transactions balances into one that backs time deposits will be prohibited.

6) *In cases where institutions fail to take the necessary steps to improve the quality of assets or appear unlikely to be able to do so, permission to advertise that transactions accounts are insured will be withdrawn and institutions will be required to advertise that funds deposited in both transactions and savings accounts after a certain date will not be insured.* While this will certainly create runs on individual institutions and result in failures, funds will move to other depository institutions that offer insured transactions balances. Thus, a generalized loss of confidence in depository institutions will be avoided by an explicit assurance that institutions permitted to accept insured deposits will remain sound.

Two of the elements in this proposal require additional explanation. One is the emphasis on soundness regulation which appears unavoidable given the instability in the current financial and economic environment. The other is the requirement that insured transactions balances in depository institutions be noninterest-bearing. The noninterest-bearing feature has obvious practical value in terms of providing sufficient funds to build up and maintain adequate reserves in the insurance fund. Moreover, it will restore the ability of depository institutions to attract funds at a cost that is significantly below the return on the asset, paying the lowest amount of interest in their portfolio -- i.e., the Treasury bill -- and enable them to pass on lower costs to borrowers. This is because

unlimited insurance coverage will encourage depositors to hold the funds they need for transactions in banks. But the fact that they are noninterest-bearing will discourage the use of transactions balances as investment assets and thus will limit the insurance fund's aggregate exposure.

The context for this proposal also requires additional emphasis. Transactions balances are a very specialized instrument. Until the 1970s, commercial banks had a monopoly on their issuance and, since 1933, banks have been prohibited from paying interest on demand deposits. The fact that funds could be withdrawn at par whenever the depositor needed them was thought to be a sufficiently attractive feature to warrant withholding interest payments as a way of compensating banks for the risk involved in guaranteeing their return on those conditions. However, as the macroeconomic environment became less stable, resulting in historically high rates of inflation in the 1970s and early 1980s, the old rationale governing the handling of checkable deposits was undermined. The development of money market mutual funds forced banks to offer interest on demand deposits through repurchase agreements and sweep accounts, and the clamor for fairness between large and small customers of banks led to the authorization of limited transactions features for interest-bearing savings accounts in all depository institutions. Even though inflation per se offers no justification for interest earnings on short-term balances used for immediate payments, the inflationary environment contributed to a pervasive focus on higher returns that ignored the possibility that a higher return could jeopardize the possibility of getting any return at all.

Unlimited insurance coverage on noninterest-bearing demand deposits will increase the volume of these deposits and reduce banks' cost of funds. This will improve the profitability of banks without the necessity for higher risk loans. The present $100,000 limit on insurance coverage has encouraged depositors to hold a significant portion of their transactions balances outside depository institutions. At the same time, the cost of the banks' role as intermediaries between depositors and borrowers has risen as a result of the deregulation of interest rates on time deposits and the shift of transactions deposits into

interest-bearing accounts. To maintain profitability, banks must translate these higher costs of attracting deposits into higher interest rates on the loans they make, and hence into higher costs for borrowers. As a result, banks have lost prime customers to the commercial paper market where highly rated commercial firms can now borrow more cheaply. They are left with weaker loan portfolios and greater incentives to make the higher risk loans that increase profits than in the past. And, their weaknesses as intermediaries between depositors and borrowers have increased the risk to the payments system.

The risk to the payments system posed by the systemic weakness of depository institutions is a major issue in the debate on reform. The fact is that there are no other institutions that can serve as efficient intermediaries in transferring payments under the current structure for clearing transactions balances. Only depository institutions have access to the clearing arrangements used to transfer payments between third parties. A money market mutual fund can only offer the customer the opportunity to write a check against the fund's account in a bank. Money market mutual funds only have access to the payments system through banks, and they cannot -- and are not required to -- permit withdrawals of funds at par. Access to the Federal Reserve's discount window might improve their ability to return funds at par, but moving money market mutual funds from a peripheral to a central position in offering transactions balances would require reinventing the banking system so that such funds would function as banks do now.

Recognition of this dilemma is responsible for much of the support for the "safe" bank proposal. But the "safe" bank enhances the soundness of its role in the payments system by abandoning its role as an intermediary between depositors and borrowers. However, both functions are necessary in a system that uses the lending activities of private depository institutions as the fulcrum for money creation. This proposal differs from "safe" bank proposals in that it seeks to preserve a structure in which deposits are invested in private loans that fuel productive investment.

No strategy for protecting customers of financial institutions will succeed if

the system fails to function as a dynamic catalyst in promoting economic growth. Financial guarantee programs can bolster confidence and mitigate the effects of financial failures, and soundness regulation can prevent the excesses that result in nonperforming loans and insolvencies. But they are not sufficient to promote growth by themselves. Further proposals for reforming the structure and regulation of the financial system must be forthcoming to ensure that financial institutions perform their economic function. This proposal for reform of financial guarantee programs is only the first step in that process.

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Endnotes

1. In February 1991, the Federal Deposit Insurance Corporation (FDIC) announced that it expected 180 banks to fail in 1991 and 160 in 1992. Insurance reserves were expected to fall to $4 billion in 199 1 and to $2.4 billion in 1992. These figures were based on the assumption that the recession would end in six months. If that were not the case, bank failures would be higher (230 in 199 1, 2 10 in 1992) and reserves lower (zero in 199 1, minus $5 billion in 1992). Based on these estimates, the FDIC plans to raise premiums from 19.5 cents per $100 of deposits (up from 12 cents in January 199 1) to 23 cents by mid-year, and to borrow $10 billion from the Federal Financing Bank (Rehm, 199 1, pp. 1 and 12).

2. Aside from the enormity of this figure, the GAO points out that programs have been badly managed, that little (and largely inaccurate) information is available on current losses, and that these programs pose an unknown level of risk (1989, p. 2).

3. Before the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), authority to borrow from the Treasury was limited to $3 billion for the Federal Deposit Insurance Corporation (FDIC), $750 million for the Federal Savings and Loan Insurance Corporation (FSLIC), and $100 million for the National Credit Union Association (NCUA). Under FIRREA, administration of the fund for savings institutions was shifted to the FDIC and provisions made for its recapitalization. These provisions included payments into the fund, now called the Savings Association Insurance Fund (SAIF), by the Treasury, of amounts sufficient to bring the fund up to $2 billion in each fiscal year during the period 1992-99. The FDIC's limit for direct borrowing from the Treasury for the Bank Insurance Fund (BIF) was raised from $3 billion to $5 billion. In addition, the FDIC was authorized to issue notes or incur obligations backed by the full faith and credit of the United States for either BIF or SAIF up to 90 percent of the fund's gross assets (maintaining net worth equal to 10 percent of gross assets), and also to borrow up to $5 billion more than net worth from other entities (such as the Federal Financing Bank) if it reduces its borrowing from the Treasury.

4. SIPC has no direct authority to borrow from the U.S. Treasury. However, it is subject to oversight by the Securities and Exchange Commission (SEC) and the U.S. Congress, and has legislative authority to borrow up to $1 billion from the U.S. Treasury through and with the approval of the SEC.

5. Losses in the Executive Life insolvency involved defined contribution pension plans which are not insured by the PBGC. It is not clear that the state guaranty funds will be able to cover the losses and debate has begun on whether or not pension plan sponsors will make good the losses to individual account holders.

6. Deposit Insurance in a Changing Environment, a study of the current system of deposit insurance pursuant to section 712 of the Garn-St. Germain Depository Institutions Act of 1982. submitted to the U.S. Congress by the Federal Deposit Insurance Corporation (FDIC, 1983. p. vii).

7. Total holdings in private and public pension plans are just under $3 trillion dollars. The Pension Benefit Guaranty Corporation's (PBGC) liability -- limited to qualified, private, defined, benefit plans -- was $700 billion at year-end 1988 (U.S. General Accounting Office, 1989, Appendix IV, p. 40). While banks manage about one-third of the assets held by these plans, the assets are generally held in trust, not as bank deposits. Moreover, about one-third of the assets in pension funds are managed by insurance companies.

8. With respect to deposit insurance, the Treasury proposes a "reduction of (the) overextended scope of deposit insurance" that would reduce coverage of multiple insured accounts by limiting individual coverage to $100,000 per institution with a separate $100,000 coverage for retirement savings held in depository institutions. It also recommends setting a goal for limiting coverage to $100,000 across all depository institutions after the submission of an eighteen-month FDIC feasibility study. Other recommendations include eliminating "pass-through" coverage for pension funds, eliminating the coverage of brokered deposits and nondeposit creditors, and limiting coverage of uninsured depositors (U.S. Department of the Treasury, "Conclusions and Recommendations," 199 1, p. 16).

9. For a more extensive discussion of these strategies, see U.S. Congress (1986).

10. See also Rehm, 1991.

11. Even the commercial and industrial firms that the Treasury proposal envisions as sources for recapitalizing banks will find it difficult to divert resources for this purpose in a recession. And, given the high levels of debt in the corporate sector, raising capital standards for banks above current levels -- or even maintaining current standards -- could make banks less attractive acquisitions for these companies than other financial firms. Consumer and commercial finance companies are likely to continue to be more attractive as affiliates of commercial and industrial firms because of their lower capital standards and the fact that they are not regulated as financial institutions and not subject to restrictions on intercompany transactions.

12. An earlier warning about the need to address the erosion in banks' capital/deposit ratios was given by Donald D. Hester, Professor of Economics, University of Wisconsin (1976).

13. G. Thomas Woodward, Specialist in Macroeconomics for the Congressional Research Service, notes that recommendations "for tough capital standards

and quick intervention are nearly universal" (1990, p. 13, footnote 12). Among those testifying before the Senate Committee on Banking, Housing, and Urban Affairs, in April, May, June, and July 1990 who supported these recommendations were Kenneth Scott (Stanford University), George Kaufman (Shadow Financial Regulatory Committee), James Barth (Auburn University), and Federal Reserve Board Chairman Alan Greenspan (Woodward, 1990). See also statement of Senator Donald W. Riegle, Jr., Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate, on introducing S. 3103. Comprehensive *Deposit Insurance Reform and Taxpayer Protection Act of 1990,* which contains provisions for strengthening capital standards and prompt intervention (Riegle. 1990).

14. Other reform proposals that have been discussed include reducing the maximum for deposit insurance coverage below the current $100,000 level: dropping coverage for interbank deposits: implementing a mutual deposit guarantee plan: restricting brokered deposits: a developing reinsurance scheme that would have the FDIC purchase private insurance to reduce its risk and/or improve its ability to assess risk in setting risk-based premiums: and enforcing a coinsurance structure that would provide coverage for only a given percentage of deposits.

A useful summary and analysis of these proposals is provided in Woodward (1990) together with a selected list of witnesses at the April-July 1990 Senate hearings who support or oppose some of the various proposals. For example, support for reducing deposit insurance, seriously discussed in the FDIC's 1983 report (FDIC, 1983, p. xvi), has apparently evaporated. It was opposed in testimony before the Senate Banking Committee by Peggy Miller (Consumer Federation of America), Sherry Ettleson (Public Citizen), and Kenneth Scott (Stanford University) (Woodward, 1990, p. 21, footnote 22).

Those supporting variable or risk-based premiums were Lawrence Connell (San Jacinto Savings Association), Ulrich Cartellieri (Deutsche Bank AG), Kenneth Scott (Stanford University), and Jane Uebelhoer (Association of Community Organizations for Reform Now). Uebelhoer however, wanted variable premiums based on the social desirability of the investment of the bank. Opposed to risk-based premiums were Lowell Bryan (McKinsey and Co.) and George Kaufman (Shadow Financial Regulatory Committee) (Woodward, 1990, pp. 20-21, footnote 21). The difficulties in implementing risk-based premiums are outlined by Robert Litan (1987, pp. 154-56) and in US. Congress (1986, pp. 366-67).

The mutual deposit guarantee plan -- a system in which each bank would be guaranteed by a consortium of other banks -- was proposed by Bert Ely (Ely & Company) (Woodward, 1990, p. 18, footnote 19). Restrictions on brokered deposits were favored by E. Gerald Corrigan (Federal Reserve Bank of New York) and Bruce Maffeo (formerly of the Justice Department) (Riegle, 1990).

15. Hyman P. Minsky suggests that banks be allowed to charge fees for handling insured transactions accounts, making the function a profit center for banks as are vendor discounts on credit cards and currency exchanges. By relieving pressure on the interest rate differential needed to cover the costs of information and confidentiality, these fees would help preserve access to borrowing by smaller, nonpublic companies.

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