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HOW TO AVOID ANOTHER BANKING CRISIS

INTRODUCTION

The recent problems at Continental Illinois Bank and Trust Company seem to have raised the specter of 1930s-style crashes and bank runs. A number of editorialists and news commentators point to the near-failure of the nation's ninth largest bank as "proof" that a deregulated banking system would not work.

For consumers of banking services and the economy as a whole, however, this message fails to identify the true culprit in the Continental Illinois debacle. The seeds of Continental's fate were sown long ago when the bank's management decided to invest in a fairly concentrated, potentially volatile loan portfolio. More important, these investment decisions were made possible, even encouraged, by the existing system of federal deposit insurance and regulatory oversight. Until the real causes of Continental's troubles are addressed, other banks can be expected to stumble and even collapse. To correct these problems, a greatly expanded reliance on market forces is needed.

THE CURRENT SYSTEM'S WEAKNESSES

The 1933 and 1934 laws that were designed to regulate, and restore confidence in, the nation's banking system bear a large share of the responsibility for the problems facing the financial services industry today. This is particularly true of federal deposit insurance. These insurance practices actually create a "moral hazard"--they encourage insured depository institutions to take additional risks. As a result, they are a potentially destabilizing force within the industry.

There are two problems with practices at the Federal Deposit Insurance Corporation (FDIC).[1] First, while the private insurance industry attempts to adjust premiums to reflect the risk presented by the insured, the FDIC charges each insured bank at the same rate--a set percentage of its total domestic deposits--regardless of how well or how poorly the institution is run.

Second, federal regulators traditionally have protected deposits exceeding the legally insured limit (currently $100,000) by arranging the mergers of failing institutions if at all possible. The acquiring bank was then made responsible for all deposit liabilities of the acquired institution.

These policies removed many of the disincentives for taking on excessive risk generally faced by bank managers. Because bank management did not pay a higher premium to the FDIC when it invested in a risky loan portfolio, there was no explicit penalty for such behavior. Consequently, any additional profits realized if the loans paid off accrued solely to the bank. Nor have large depositors, whose funds theoretically are at risk, had a strong incentive to discipline risk-loving bankers. Until recently these depositors had good reason to feel almost as secure as their counterparts with accounts containing only a few hundred dollars.

Because the system of deposit insurance provided no direct means for discouraging excessive risk-taking, regulation of the industry has been viewed as an important mechanism for controlling the activities of banks, and hence, the risk exposure of the federal government. Thus, the Depression-era banking legislation not only sought to insure the safety of deposits, but also attempted to limit the competition engaged in by banks, thereby minimizing the number of possible failures. As a result, regulations arose limiting the interest that could be paid depositors, the range of services that could be offered by a bank, and the types of assets in which a bank could invest its funds. State regulations, meanwhile, have often limited the ability of banks to establish branches through which they could gather deposits and expand customer service.

Many of these 1930s efforts to provide stability have proved to have been misguided. Historical hindsight as well as additional

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1 These problems have been widely discussed in a variety of sources. See, for example, Catherine England and John Palffy, "Replacing the FDIC: Private Insurance for Bank Deposits," Heritage Backgrounder No. 229, December 2, 1982; John H. Kareken, "Deposit Insurance Reform of Deregulation Is the Cart, Not the Horse," Quarterly Review, Spring 1983, Federal Reserve Bank of Minneapolis, pp. 1-9; Eugenie D. Short and Gerald P. O'Driscoll, Jr., "Deregulation and Deposit Insurance," Economic Review, September 1983, Federal Reserve Bank of Dallas, pp. 11-21; and Orin S. Kramer, "Putting More Pain into Bank Failures," Fortune, February 20, 1984, pp. 135-142.

experience with rapidly changing market conditions have shown that such restrictions are contributing to current problems. For example, the interest rate restrictions established during the Depression to limit the competition for deposits proved almost fatal to many depository institutions in recent years when sustained inflation rates led depositors to search for financial instruments paying a market rate of return. Banks and thrift institutions found themselves unable to compete as money market mutual funds offered even relatively small savers significantly higher returns. Similarly, savings and loan associations were seriously weakened by statutory requirements that their loan portfolios be devoted almost exclusively to long-term home mortgages. Unable to diversify, savings and loans were forced to bear an inordinate degree of risk, particularly during the period when interest rates were moving steadily upward. Most recently, Illinois branching laws limiting Continental to a single office have been criticized as a potential contributor to the bank's difficulties. Rather than being able to finance its growth through expanding its base of small depositors, Continental was forced to enter the higher-cost market for large, uninsured deposits. The result was not only higher costs, but also a more volatile deposit base.

Thus, as economic and technological changes have forced market responses that dictate some degree of deregulation, concern has grown over the role the FDIC plays in encouraging risk-taking among depository institutions. Recognizing the problems inherent in the existing system, and concerned that deregulation be allowed to proceed so that similar troubles may be avoided in the future, William Isaac, Chairman of the FDIC, has devised a two-part plan for introducing additional market discipline into the system.

EFFORTS TO REFORM THE SYSTEM

Isaac's first step was to serve notice to depositors with accounts exceeding $100,000 that they could no longer count on the FDIC to bail them out in the event of a failure. When Penn Square Bank in Oklahoma was allowed to fail in July 1982, a number of large depositors, including Continental Illinois, were surprised to find themselves left to sustain significant losses. During early 1984, the FDIC continued this course by letting large depositors stand in line with other general creditors awaiting liquidation of failed banks' assets, despite the fact that mergers were arranged with healthy institutions.

In addition, Isaac has been advocating congressional action to allow the introduction of risk-related premiums. He has argued that all banks should be assigned to one of three risk categories and that their total yearly premiums should, to some degree, reflect the competitive risk the institutions represent to the insurance fund.

These policy changes are moves in the right direction. The reaction of the federal banking authorities to the Continental

Illinois scare, however, has been a retreat in the FDIC's efforts to introduce market discipline into bank management. And the fact that Continental came so close to failing has raised anew in the minds of many an unfounded fear that a less regulated banking system would somehow prove unstable.

IMPLICATIONS OF THE CONTINENTAL ILLINOIS DECISION

Events at Continental Illinois in early May demonstrated how well the FDIC's efforts were working. Isaac's actions during the past two years had convinced depositors with accounts exceeding $100,000 that they could no longer rely on an automatic federal bail-out. But when many of these depositors viewed their funds at Continental as being at risk and began behaving rationally by withdrawing them, the federal banking authorities stepped in. To stem the flow of funds, the FDIC and the Federal Reserve System guaranteed that all depositors and other creditors of Continental would be made whole regardless of the cost.

In taking this step, the federal banking regulators, in effect, created a two-tiered banking system. They appear to have placed the nation's largest banks above the new market disciplines that have been introduced, thus providing these banks with a significant advantage in attracting funds that was not provided to their smaller competitors.

Over the past two years, depositors with accounts exceeding $100,000 in smaller banks increasingly have been forced to bear a risk that funds placed in a poorly run bank may be lost. This has been a change for the better. The threat that the larger, more sophisticated depositors will move their accounts if exposed to excessive risk is potentially much more effective than any regulatory action could be in curbing excessive risk-taking. With the Continental decision, however, federal regulators placed the nation's larger banks outside this new market discipline rule. Depositors with accounts of more than $100,000 in very large banks need not worry about their funds being at risk. With their sweeping guarantees at Continental, the FDIC and the Federal Reserve Board have removed the incentive for depositors to monitor the behavior of bank managers--at least at some banks.

As a result, the message sent by the Continental decision has potentially far-reaching consequences. It may do more to encourage concentration of the U.S. banking industry than deregulation could. In fact, under a deregulated system with market discipline applying equally to all banks, smaller banks would have certain advantages in attracting deposits. Smaller banks would be less likely to establish subsidiaries through which to offer a broad range of financial services. Because these banks would probably remain more concerned with narrow banking interests, they could be more easily monitored by their large depositors. In addition, any one large depositor could be expected to exert greater influence on the behavior of individuals managing a

smaller bank. But, other considerations remaining equal, there would be little point in taking the trouble to monitor a small bank now that implicit 100 percent insurance has been provided depositors in the larger banks. The result of the government's decisions concerning Continental Illinois will almost certainly be a flow of deposits exceeding $100,000 to the nation's biggest banks.

A bank's growth to a size which makes it "too large to be allowed to fail" thus becomes an important asset. Large banks, whose status might be unclear in the event of pending failure, may well attempt to grow rapidly, thereby guaranteeing their own future existence and share of large depositors. Such efforts could trigger a "growth at all costs" policy in some banks, increasing the risks these managers are willing to undertake. The result would be a potentially weaker, increasingly unstable banking system requiring ever increasing government guarantees.

ADVANTAGES OF A MARKET SYSTEM

Attempts to protect the financial industry and the economy from the shocks of a large bank's failure, therefore, create incentives that could lead to increasing instability and additional government involvement. This repeats the whole cycle of excessive regulation, leading to unnecessary risk exposure and ever more instability.

The escape from this dilemma is a deregulated, market-disciplined banking system. Existing weaknesses within the banking system merely require that the steps toward that environment be well considered and carefully taken. It is crucial to the success of a deregulated financial industry that federal deposit insurance incorporate market discipline to the broadest extent possible. Ultimately, the system should be privatized.

First, blanket guarantees, like that given Continental, should not be available--regardless of the bank's size. Should a run by the large depositors of a particular bank become a threat, some orderly means of payment by federal regulators could surely be devised that would prevent the panic from spreading to other institutions. Even an announced policy of guaranteeing, say, 70 to 80 percent of deposits in excess of $100,000 would be better than the Continental decision. Such a policy would, first, ensure a degree of market discipline at large banks, as depositors were forced to bear a certain amount of risk. In addition, a demand for private deposit insurance might be generated by those depositors who stood to lose a portion of their funds.

Second, Congress should allow the FDIC to introduce risk-related premiums. While the risk of failure presented by a particular institution is of an admittedly subjective nature, private firms regularly make such judgments. The safety of bank stocks as an investment, the large, negotiable certificates of

deposit offered by banks, and at least some portions of a depository's loan portfolios are regularly scrutinized by a wide range of private individuals and firms, including investment counselors and private consultants. The FDIC should be allowed to purchase this information to compare with the assessments of its own and other federal bank examiners in assigning banks to risk categories.[2]

These composite FDIC risk classifications also should be made public. While many will argue that such information could serve to destabilize the industry by causing large shifts of funds out of banks placed in the more risky categories, it is exactly this threat that will serve most effectively to encourage more prudent behavior among bankers.

Gradually the maximum deposit covered by federal deposit insurance should be reduced. This would encourage the development of private deposit insurance alongside, if not in place of, federally provided insurance. Private deposit insurance would benefit the economy in general and consumers of banking services in particular.[3]

For example, private providers of deposit insurance would be much more responsive to early indications that an insured depository institution was taking on additional risk. The decision to invest in a highly concentrated, potentially volatile loan portfolio would undoubtedly be penalized from the beginning, regardless of how promising such loans might appear initially. In addition, private insurers would have much more flexibility in responding to the risk presented by an insured institution. The development of a new line of financial services might be permitted without an increase in premiums if the bank first raised additional equity capital.

Broadly based deregulation of the banking industry is, therefore, not necessarily inconsistent with stability, safety, and the security of depositors' funds. Ultimately required is an increased reliance on and willingness to accept additional market discipline of the banking industry--including risk-based premiums and, eventually, private deposit insurance.

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2 The lack of expertise among the federal regulators when compared with their private sector counterparts is especially apparent where loans to particular, specialized industries are concerned. For instance, the FDIC cannot be expected to evaluate a loan portfolio containing a large percentage of energy loans nearly as efficiently as can private analysts who specialize in appraising energy securities.

3 For a more complete discussion of this point, see England and Palffy or Short and O'Driscoll.

CONCLUSION

The troubles at Continental Illinois and other banks do not stem from deregulation. They come from the regulatory and deposit insurance system.

In some cases, regulations designed in the 1930s to limit competition have failed to protect banks and, instead, left them dangerously exposed when they were unable to respond to rapidly changing economic conditions. In other instances, regulators have found they were unable to prevent excessive risk-taking activities because of inadequate or perverse incentives provided by the tools at their disposal.

The answer to today's banking problems is not additional regulation or more powerful regulators, which would only generate a future crisis as market conditions changed more rapidly than regulatory behavior. What U.S. banking needs is more reliance on market discipline and less on regulation.

Federal banking authorities should once again establish that the funds of large depositors are at risk, regardless of the size of the bank in which they are placed. The FDIC should be allowed to apply risk-based premiums, using information and assessments available in the private sector to assist in assigning risk categories. Finally, the size of deposit covered should be reduced gradually. This would increase the market pressure from depositors, which would create stronger incentives for prudent banking behavior and the development of a market for private deposit insurance.

Only when federal authorities begin to understand and use the power of market discipline can deregulation proceed in an orderly fashion.

Catherine England
Policy Analyst