Depositors as a Source of Market Discipline

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The failure of many savings and loan institutions in the 1980s bankrupted the Federal Savings and Loan Insurance Corporation (FSLIC), forcing the FSLIC to rely on massive federal subsidies. A similar crisis subsequently struck the banking system, and it now appears that the Federal Deposit Insurance Corporation (FDIC) will also go bankrupt and require taxpayer subsidies. The vast expense of these bailouts has focused the attention of policymakers and the public on reducing the risk exposure of the federal deposit insurance system. In response to this crisis, the U.S. Treasury issued a report in 1991 in which it made specific proposals for reforming deposit insurance. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) incorporated some of the Treasury Department's proposals. One controversial element of the FDICIA is a plan for reforming the deposit insurance system by shifting some of the risk of bank failures from the federal insurance fund to depositors themselves. This proposal rests on the premise that depositors who bear some of the risk of bank failure are likely to discipline weak institutions by threatening to withdraw their deposits. In this Article, Professor Mantripragada discusses the costs and benefits of depositor discipline and assesses the Treasury proposals and FDICIA provisions that are designed to promote depositor discipline. The author suggests that a maturity-based coverage limit would be preferable to the dollar-based limit retained by the Act.

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Introduction

The federal deposit insurance program began in 1934 with the establishment of the Federal Deposit Insurance Corporation (FDIC) to insure deposits in commercial banks and mutual savings banks, and the Federal Savings and Loan Insurance Corporation (FSLIC) to insure deposits in savings and loan associations. From that time, the program has successfully met its basic goals of protecting the small depositor, ensuring the stability of the banking system by eliminating bank runs, and providing a safe transaction asset for the economy. For most of its history, the program was financed entirely by insured depository institutions which paid premiums based on their total domestic deposits. In recent years, however, the program has encountered serious financial difficulties, requiring massive taxpayer subsidies and causing an unexpected shift of costs from insured institutions to taxpayers. The FSLIC’s insurance fund, which had a balance of $6.46 billion in 1980, became bankrupt in 1986 and showed negative balances of $6.33 billion in 1986 and $13.69 billion in 1987. Similarly,
the ratio of the fund to insured deposits declined from 1.28% in 1980 to -0.71% in 1986 and -1.47% in 1987. The bankruptcy of the FSLIC led to the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989. The savings and loan bailout plan under FIRREA was initially expected to cost the taxpayers about $166 billion. The cost estimates keep going up, however, and the actual cost will not be known until all the assets of the failed institutions are sold.

When Congress enacted FIRREA, the financial problems seemed to be confined to the savings and loan industry and the fund insuring its deposits. At that time, analysts thought the FDIC's Bank Insurance Fund (BIF) was financially strong. Subsequently, financial problems engulfed the BIF as well. The fund, which had a balance of $18.30 billion at the end of 1987, declined to $13.21 billion by the end of 1989. In 1990, for the third consecutive year, the fund is expected to incur a loss, currently estimated at $3 billion. The ratio of the fund to insured deposits has steadily declined since 1983. The ratio reached the statutory minimum level of 1.10% in 1987 and a still lower level of 0.70% in 1989. Moreover, it is expected to decline even further and reach

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3. This is the official cost estimate given when FIRREA was enacted in August 1989 and includes interest costs on borrowed funds over a ten-year period. Cost estimates different from the $166 billion are given by the Office of the Management and Budget, and by the General Accounting Office. The divergence of opinion about the estimates of costs to taxpayers is due to differences regarding the period over which the interest costs are computed, methods of estimating the costs (present value basis or not), and assumptions about the performance of the economy and the thrift industry. See Thomas F. Cargill, Money, the Financial System, and Monetary Policy 317-18 (1991).
4. The actual cost to the taxpayers will not be known until all the assets of the failed institutions are disposed of, there is no doubt that the cost will be quite substantial. The Bush Administration has said recently that it needs an additional $80 billion for resolving the savings and loan (S&L) failures—a figure considered by some to be a conservative estimate. See Paulette Thomas, Bush Administration Lets Out Seams on its Projections for Thrift Bailout, Wall St. J., June 24, 1991, at A3.
7. Since the 1991 annual report of the FDIC will not be available until the middle of 1992, and the 1990 annual report has not been made public as of this writing, official figures about FDIC balances in the insurance funds and the ratios of insurance fund to insured deposits for years subsequent to 1989 are not available. Hence only estimated figures reported in the financial press are provided here.
8. This was the statutory level prescribed before the passage of FIRREA. Under FIRREA, the level of the Bank Insurance Fund and the Savings Association Insurance Fund shall be 1.25% of the insured deposits or such higher percentage of estimated insured deposits, not exceeding 1.5%, as the Board of Directors of the FDIC determine. See FIRREA § 2.08.
9. See FDIC 1989 REPORT, supra note 5, at 114. The FDIC is required to give assessment credits to member depositories of an insurance fund if it expects the reserve ratio to exceed the designated level. This is to be done by reducing the assessed premiums to the members for the subsequent year. However, there are no specific penalties for letting the ratio go below the statutory level. When this happens, the FDIC is normally required to raise the assessment to member institutions for subsequent years to a level sufficient to restore the ratio to the statutory level. However, both the banking industry and the savings and loan industry have not been in robust financial health in recent years, and therefore could not absorb the increases.

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a record low of 0.5% in 1990. A reversal of this trend is not expected in the near future, and analysts expect the fund to have a sizeable deficit by the end of 1992. According to one estimate, the bank failure costs to the BIF over the period from 1991 to 1993 will range from $17 billion to $63 billion, with an estimated premium income of $28 to $31 billion.

There are actually two separate objectives in the federal deposit insurance program reform efforts. The first, and most immediate, is to restore a positive balance in the Bank Insurance Fund. The second, long-term objective is to institute structural changes which will ensure that another massive taxpayer bailout is never needed. There are several methods which might be used to achieve this long-term objective, including risk-related insurance premiums, improving the risk-based capital standards, privatization of deposit insurance, implementation of market-value accounting, and exposing depositors to potential losses (depositor monitoring or depositor discipline).

In February 1991, the Department of the Treasury submitted a report presenting its plan for modernizing the U.S. financial system. The report included proposals for reforming the federal deposit insurance program, some of which were incorporated in the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. The Treasury report and the FDICIA give depositor monitoring an important role in reforming the deposit insurance program.

This Article presents a comprehensive analysis of depositor monitoring, focusing on the provisions of the FDICIA. The Article criticizes the idea of dollar-based coverage, and then examines the strengths and weaknesses of an alternative system using maturity-based coverage. Part I of this article presents a brief review of the factors which contributed to the financial problems of the federal deposit insurance program. Part II explains the rationale for depositor discipline and discusses reasons for its past ineffectiveness. Part III presents different methods of promoting depositor monitoring, followed by a discussion of the conditions for effective functioning of depositor discipline and the problems in ensuring these conditions. Part IV analyzes the Treasury proposals and the provisions of the FDICIA for promoting depositor discipline. Finally,
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Part V offers a maturity-based deposit coverage limit as an alternative to the current dollar-based limit.\textsuperscript{13}

I. Factors Responsible for Deposit Insurance Losses

Any attempt to reform the federal deposit insurance program must begin by analyzing the factors which led to the present debacle. In large measure, these factors were not exogenous events but were, rather, shortcomings in the federal deposit insurance program itself. These shortcomings may be classified as defects in the system and defects in its supervisory and regulatory practices.

A. Defects in the Design of Federal Deposit Insurance

Since the defects in the design of federal deposit insurance are well documented elsewhere\textsuperscript{14}, they need not be discussed here in great detail. Briefly, the defects include the possible underpricing of federal deposit insurance, inequity and moral hazard associated with the flat rate premiums, and the absence of any built-in safeguards to protect the insurer.

1. Possible Underpricing of Federal Deposit Insurance

Some writers on the subject suggest that federal deposit insurance is under-priced.\textsuperscript{15} The bankruptcy of the FSLIC in 1986 and the depletion of the FDIC's Bank Insurance Fund lend powerful support to this view. Kane\textsuperscript{16} argued that the reported size of the insurance fund is likely to be overstated if certain costs, including all the contingent liabilities against the fund from possible future failures, are not properly accounted for. He also argued\textsuperscript{17} that the insurance system provides free coverage for unfamiliar types of risk-taking whose costs are not likely to be properly reflected in the premiums assessed. Also, since coverage by an insurance agency imposes indirect costs of various

\textsuperscript{13} In this Article, the terms depositor discipline, depositor-imposed discipline, depositor-induced discipline, and depositor monitoring are used interchangeably.


\textsuperscript{16} See Kane, Gathering Crisis, supra note 14, at 52-53.

\textsuperscript{17} Id. at 62-66.
types (costs of complying with the regulations) on the insured institutions, the explicit premiums have to be set lower. Another argument runs as follows. Only the federally-chartered depository institutions are required by their charters to be insured by the federal deposit insurance system; it is voluntary for the state-chartered institutions. In order to maximize any social benefits of deposit insurance, premiums have to be set lower than the fair market level to induce the state-chartered institutions to participate voluntarily. Only such a policy would encourage those institutions to join the insurance system. Since many state-chartered depository institutions have opted for federal deposit insurance, it may be argued that the system has provided underpriced insurance.

2. Inequity or Unfairness of Flat Rate Premiums

Under the flat rate system, the same premium rate is charged to all the insured institutions irrespective of the differences in risk. The flat rate structure is not equitable for all the insured. The inequity is that the flat rate system subsidizes the more risky institutions at the expense of the more conservatively managed institutions. In fact, the greater the risk assumed by an insured institution, the greater the value of the subsidy to it.

3. The Moral Hazard Problem

There is also a moral hazard problem associated with the flat rate system. Moral hazard refers to the propensity of the insured institutions to disregard the risk consequences of their actions, if the costs of such actions are shifted to the insurer. This problem arises when actions of the insured that increase either the probability or the size of the losses to the insurer have no bearing on the premiums the insured pays. It is important to note that we are talking about the explicit premium rates. If implicit costs such as those associated with regulatory restrictions, stricter compliance, and more frequent examinations of problem institutions are also taken into account, it is possible that more risky institutions do pay more non-premium costs. While more stringent and frequent inspections and additional compliance costs can impose implicit costs that differ from one institution to the other, mechanism do not exist to ensure that such differences are fair or consistent. Moreover, since the monitoring by the

18. See Buser et al., supra note 15, at 52.
20. See Mark J. Flannery, Deposit Insurance Creates a Need for Bank Regulation, FED. RESERVE BANK OF PHILADELPHIA BUS. REV., Jan./Feb. 1982, at 17; Avery et al., supra note 19; Kane, GATHERING CRISIS, supra note 14, at 14, 62; Kareken & Wallace, supra note 15.
insuring agency is not continuous, the sum of the current explicit and implicit costs is more likely to represent past risks than the present and future risks borne by the insured.

4. Absence of Built-in Safeguards for the Insurer

Private insurance companies try to control their risk exposure in several ways. Some of the more common tools that insurance companies employ to control their risk are: coinsurance, deductibles, risk-based premiums, and upper limits on the coverage. While all of these may not be appropriate for deposit insurance, it is surprising that none of these features is built into the system of federal deposit insurance. Under a coinsurance clause, the insured are required to assume a certain percentage of the loss incurred. In the case of deposit insurance, depositors in a failing depository institution would be unable to recover 100% of their deposit balances. Such a clause will give depositors an incentive to discipline the risk-taking behavior of their depositories. Such depositor monitoring would also benefit the insurer by curbing the risk-seeking behavior of the insured institutions. Under a deductibility clause, depositors will be responsible up to a stated amount of the loss before the insurer will assume any responsibility. The deductible may be applied for each loss or for total losses in a given year. Once again, the intent is to make the depositors exercise some monitoring of the depository institutions’ risk-seeking behavior. Risk-sensitive premiums will give a direct incentive for the insured institutions either to reduce their risk or not to increase it. Placing upper bound on the maximum loss the insurer is prepared to cover will make it possible to impose some market discipline, since others will have to bear the losses above that limit. While there are current statutory limits on the maximum coverage per depositor, there are no stated limits on the insuring agencies’ liability in regard to a given depository institution.

While the above design defects existed from the inception of the federal deposit insurance program, their adverse consequences did not become acute until after the deregulation of the industry in the 1980s. The federal deposit insurance system has remained essentially unchanged during its fifty-five years of existence, while the industry it insures has become more risky. Since under the flat rate assessment system all insured institutions pay the same premium rate per $100 of deposits, irrespective of their individual risk differences, it became necessary to devise some other means to control the risk assumed by the depositories. This was done by controlling the permissible activities (separation of commercial and investment banking, separation of banking and com-

merce, etc.), by controlling the interest paid on deposits (Regulation Q ceilings), and by giving regulators substantial discretionary powers to regulate the industry. Innovations in the market place, globalization of financial markets and other forces made such a highly regulated system unstable and obsolete.22

After nearly five decades of extensive regulation, the first major step for deregulating the industry was taken with the enactment of the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980. Among other things, the legislation provided for the phasing out of interest rate ceilings and permitted the depository institutions, particularly the thrift industry, to enter into new and more risky areas of business, such as commercial real estate lending, issuing of credit cards, etc. The deregulation of the industry continued under the Garn-St. Germain Depository Institutions Act of 1982.23 In addition, several state governments granted still broader powers to their state-chartered depository institutions. No attempt was made to contain the loss exposure of the federal insurance agencies by simultaneous reforms in the design of the federal deposit insurance system. The rate of assessment was not raised, the flat rate system of assessments continued, and no safeguards were built into the system to contain the loss exposure of the insurance funds. On the contrary, the de jure coverage limit for deposits was raised from $40,000 to $100,000 under the DIDMCA of 1980. The net result of the higher coverage limit and the new powers granted to the insured institutions was that the risk exposure of the federal insuring agencies increased substantially.24

B. Defects in the Supervisory and Regulatory Practices

As discussed earlier, defects in the design of the system created a tendency for risk escalation by the depository institutions. To keep the risk exposure of the insurance funds under control, the system has mainly relied on de jure limits on the insurance coverage on the one hand, and regulation and supervision on the other. The bankruptcy of the FSLIC and the current financial problems of the BIF represent a massive failure of the system of regulatory monitoring. The bank examination system has not kept pace with banking practices. The activities of the depository institutions have expanded under the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), the Garn-St.

22. See CARGILL, supra note 3, at 237-79.
23. For a description of the major provisions of the DIDMCA and the Garn-St. Germain Depository Institutions Act of 1982, see id. at 283-84, 286-88.
24. Some other factors which contributed to the increased losses were: increased volatility of interest rates particularly after 1979; increased inflationary pressures and the deregulation of interest rates; de facto geographic deregulation, entry of nonbanks, and increased competition; economic troubles in states dependent on agriculture and oil industries; and managerial fraud. For a detailed discussion of these factors, see Krishna G. Mantripragada, Deposit insurance: Origins, Problems, and Proposals for Reform 51-58 (Dec. 1990) (unpublished manuscript, on file with the author).
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Germain Act of 1982, and powers granted to several state-chartered institutions by their respective state governments. However, the staffing and training of the examiners failed to keep pace with the expanding powers of the depository institutions.

While the insuring agencies enjoyed wide powers to examine and control the insured institutions, they lacked the power to close insolvent depository institutions.25 This power resided with the chartering agency (the Office of the Comptroller of Currency, the Office of Thrift Supervision, or the state banking authorities), not the insurer. Also, the rules for closing insolvent depository institutions were not based on sound accounting practices. Regulators used the Regulatory Accounting Principles (RAP) to monitor the net worth positions of the depository institutions. Depository institutions with zero net worth were not closed. Instead, they were allowed to continue to operate long after that point, until the book value of the net worth under the RAP became zero.26 In many cases, the institutions were allowed to operate even beyond that point. This was done under what became known as capital forbearance programs.27 Capital forbearance meant that regulators would exercise restraint toward a depository institution and would not issue a capital directive to enforce the normal capital standards. Nor would a formal administrative action be taken to enforce capital standards or to take other actions relating to capital adequacy. By allowing depository institutions to operate with negative or zero net worth while the deposit insurance coverage was kept intact, the capital forbearance policies escalated the risks associated with moral hazard.

The insuring agencies’ failure resolution methods also contributed to the erosion of market discipline.28 The federal deposit insurance program started with an initial coverage limit of $2,500. The limit was raised several times until in 1980 it was raised from $40,000 to its current de jure limit of $100,000 per depositor, per account type, per insured institution. By splitting their deposits among different types of accounts and institutions, large depositors could get insurance coverage beyond the $100,000 de jure limit. When large depositors do this with the help of brokers, they are known as brokered deposits. The de

26. While market-value accounting is more useful than book-value accounting for regulatory purposes, it is not easy to implement. However, the main point here is that even the less stringent accounting standards of RAP were compromised under the capital forbearance programs, as the subsequent discussion reveals. For a full discussion of the issues relating to the implementation of market-value accounting for depository institutions, see Krishna G. Mantripragada, The Role of Market-Value Accounting in Reducing Potential Taxpayer Subsidies: The Case of Deposit Insurance, PUB. BUDGETING & FIN., Winter 1991, at 20.
The jure limit is meaningless as long as a depository institution is not officially declared insolvent, since the uninsured depositors may be withdrawn in full at any time up to the time of official declaration of insolvency. After a depository institution is declared insolvent, the losses to the uninsured depositors depend on how the failure of the institution is resolved. Insurance agencies primarily relied on a method known as purchase and assumption, which protects in full even the de jure uninsured deposits. This method has been used with conspicuous regularity for large institutions such as the Continental Illinois Bank in 1984, First Republic Bank Corporation of Dallas in 1988, and the Bank of New England in 1990. Thus, the depositors have an entrenched belief in the continuation of the "too big to fail" policy. This is a policy under which insurance protection is extended to all deposits (including the uninsured deposits) as a part of the supervisory reorganization of an insolvent depository institution. This is usually done to prevent a run on the bank in question and on other large banks. One consequence of the "too big to fail" policy has been the virtual disappearance of depositor monitoring as a check on the risk-seeking behavior of depository institutions.

Thus, defects in the design of the insurance system and a heavy reliance on what proved to be inadequate supervisory controls to regulate bank risk have contributed to heavy losses for both the insuring agencies and taxpayers. Hence, there has been an active exploration of alternatives for controlling the risk of depository institutions.

II. Depositor Discipline: Rationale and Methods

Depositor discipline is a potential supplement to the regulatory supervision of depository institutions. There are two issues that need to be addressed. One, why are depositors considered a source of disciplining influence on depository institutions? Two, what are the different methods by which depositor discipline may be induced?

A. Depositors as a Source of Market Discipline

Depository institutions are financial intermediaries. As such, they issue several types of liabilities: deposits, debt subordinated to deposits, common and preferred stock. They invest the funds primarily in two types of assets: marketable securities and loans. The difference in the interest rate earned on the assets and the interest rate paid on the liabilities is the interest margin. This is the basic source of profit for a depository institution. For any business, the risk

29. Id. at 39-49.
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associated with its investments will determine the risk to the suppliers of funds. The suppliers of funds will attempt to control their risk exposure either by restricting the risk assumed by the business, or by demanding a rate of return appropriate to the level of risk underlying the firm’s investments. This is what is usually referred to as market discipline or market control of risk.

Potential sources of such market discipline for depository institutions include depositors, holders of debt, and holders of preferred and common stock. Only a few depository institutions have debt (subordinated to deposits) or preferred shares in their capital structure. Common equity constitutes generally less than 7% of the assets. In a recent study done for the House Banking Committee, it was reported that between 1981 and 1990, equity finance ranged between 5.79% and 6.43% for all the insured banks. Depositories organized as mutuals do not have a separate group of equity shareholders. All funds are contributed as deposits. Since deposits constitute the bulk of the liabilities of depository institutions, depositors may be the most logical source of informal regulation. Moreover, while the depositors stand to lose in the event of a bank failure, they do not get to share in the extra profit the bank may make by pursuing a risky strategy. The shareholders, on the other hand, stand to gain if the risky strategy pays off. Thus the shareholders are not as likely as depositors to rigidly scrutinize the riskiness of bank asset portfolios. Consequently, depositors may be the best source of market discipline.

Absent deposit insurance, depositors would be more likely to withdraw their deposits from an institution either assuming or rumored to be assuming imprudent risk levels. Such actions by depositors can destabilize the banking system by creating runs on banks. With deposit insurance in place, depositor discipline works in a less destabilizing way. Deposit insurance breaks the normal link between the risk of a depository’s investments and the risk to its depositors by shifting asset risk to insurers.

The extent of depositor discipline in a regime of deposit insurance depends on the extent of protection offered by such insurance. Depositors can be a source of market discipline even with deposit insurance, provided there are limits on the insurance coverage. However, only the owners of uninsured deposits may be expected to do any monitoring. It should be noted that what is important is the depositors’ perception of the de facto limits on deposit insurance coverage, not the de jure limits. The greater the de facto protection extended to depositors, the weaker the depositor-imposed discipline. Under a


32. BARTH ETAL., supra note 10, at 20. The numbers would be smaller if computed in terms of market values.

de facto 100% coverage of all deposits, the depositor-induced market discipline will be non-existent.

The justification for deposit insurance is to eliminate the destabilizing effects of bank runs by reducing the temptation for depositors to pull their money out of a bank that is merely rumored to be insolvent. Unfortunately, such insurance, if very generous, provides little incentive for depositors to monitor a bank that may be pursuing policies risky enough to actually lead it toward insolvency. As a result of the failure resolution procedures followed by the insuring agencies, even the uninsured depositors have felt very little need to monitor their depository institutions.

Therefore, if an incentive can be created for increased depositor monitoring of depository institutions, it can be a good supplement to the monitoring by the regulators, and can act as a restraint on the risk-taking behavior of depository institutions thereby reducing the risk exposure to the FDIC. Since monitoring involves costs to the depositors, they will not monitor without an incentive. Such an incentive may be created by exposing the uninsured depositors to potential losses.

B. Methods of Inducing Depositor Discipline

There are several ways to induce depositor discipline, including: applying deductibles; introducing co-insurance; reducing the dollar limits on insurance coverage, capping the benefits per depositor, and strict enforcement of de jure coverage limits. These proposals represent variations of the same basic theme - an increase in the potential losses to the depositors and a corresponding reduction in the potential losses to the insurer.

Two ways to limit potential losses to the insurance fund and shift them to the depositors are instituting deductibles and/or co-insurance. While the intent of the two is the same, they operate in slightly different ways. In the case of deductibles, the FDIC would cover the deposits only after the deductible limit has been met. For example, if the deductible is set at $5,000, a depositor who

34. The incentive which can be created for depositors can only be a negative incentive, in the form of increased risk of potential losses in case of bank failures.
35. Short & O'Driscoll, supra note 21, at 11-23.
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had $7,500 in an insolvent depository will be covered by the FDIC for $2,500. Deductibles, however, are regressive. If small and large depositors have the same deductible, small depositors will lose a larger proportion of their deposits. One solution would be to make the deductible a percentage of deposits. In any case, deductibles have the potential to destabilize the banking system by creating an incentive for runs since depositors would be the first to bear any losses in an actual insolvency.

Co-insurance, on the other hand, would have the FDIC and the depositors share losses in some specified proportion, once again up to a stipulated maximum dollar limit on deposits. For example, in the United Kingdom, the insuring agency insures only 75% of the first 20,000 pounds sterling (approximately U.S. $34,500 as of October 18, 1991) of loss and the depositors bear the rest. McCulloch suggested that insurance coverage be lowered to 90 to 95 cents on the dollar up to the existing limit. Another possibility is to add a graduated coinsurance after reducing the existing coverage to $10,000. If co-insurance is applied only after a 100% coverage up to a modest amount (for example, $10,000 or $15,000), small depositors would not share the losses at all. This preserves the goal of protecting the small depositor. It must be noted that a program with deductibles and/or co-insurance may be more complex for an average depositor to understand than a program with a simple dollar limit on coverage.

The basic assumption of many proposals to reduce the existing coverage limit is that the de jure limit of $100,000 per depositor, per account, per institution is too generous. In practice, because of the failure resolution policies followed by the insuring agencies and the informal enforcement of the "too big to fail" policy, even this limit is seldom enforced. The increase in coverage to $100,000 in 1980 was a substantial increase in real dollars. The increase in coverage limit did not take place because the depositors were asking for it. Nor was there an imminent instability that would have been created in the system had the limit not been raised to the new level. Therefore, the coverage limit may be lowered to create an incentive for deposit monitoring. A reduction of coverage to $10,000 would result in coverage that exceeds the arithmetic average of about $8,000 of all insured deposit accounts in banks and thrifts. This lower limit will be good enough to protect small depositors and, if strictly enforced, will provide an incentive for the owners of uninsured deposits to carefully monitor the financial soundness of their depository institutions. Since the uninsured depositors can withdraw their funds in full as long as the institu-

40. See Thompson, supra note 38, at 34; see also Kane, supra note 19, at 202-209; Boyd & Rolnik supra note 36.
42. See Thompson & Todd, supra note 37, at 595-96; see also Kane, supra note 37, at 110.
tion is not declared insolvent, the potential deposit drain will act as disciplining device on the managers of depository institutions.

However, there could be serious political and economic problems involved with lowering the existing limit of $100,000. Banks, thrifts, and millions of households have made decisions assuming this coverage would continue. Furthermore, the potential savings from reduced dollar limits on coverage seem to be somewhat limited. According to one estimate, only five to six percent of total deposits in federally-insured depositories are in the range of $40,000 to $100,000.43

Reducing insurance limits will only work if such limits are strictly enforced. Uninsured depositors should not have escape routes. Currently, depositors can expand their coverage by spreading deposits at the de jure limit between several institutions. Therefore, some argue that the deposit coverage limit should be applied to each depositor, irrespective of the number of institutions where the deposits are held and the number of accounts over which they are distributed.44 Chairman Henry Gonzalez of the House Banking Committee suggested that it might be reasonable to limit the insurance protection to a maximum of three accounts per depositor.45

Thus, depositors can become a source of market discipline under a threat of potential losses. There are different ways in which such a threat can be created, namely reducing coverage limits and instituting deductibles and co-insurance. For such methods to work, however, the threats of their enforcement should be real.

III. Some Issues in Implementing Depositor Discipline

The enthusiasm for depositor discipline as a method of promoting market discipline is not universal.46 The primary reasons for hesitation are the inconclusiveness of the past studies on the subject and various practical problems in implementing depositor discipline.

A. Is Depositor Discipline the Best Form of Market Discipline?

It has not been established that market discipline by depositors is superior to other forms of market discipline. Reviewing prior studies on the subject,
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Baer and Brewer\(^{47}\) felt that the evidence of market discipline from uninsured depositors was either weak or non-existent, although their own study found some evidence favorable to market discipline by uninsured depositors. Baer and Brewer were not sure whether to push for market discipline via uninsured deposits without first assessing the costs and likelihood of runs on the banks relying on such deposits.\(^{48}\) After an analysis and comparison of 100% insurance, no deposit insurance, co-insurance\(^ {49}\), and subordinated debentures, Gilbert\(^ {50}\) concluded that co-insurance was not superior under any combination of assumptions. If the possibility of bank runs is ruled out, subordinated debt requirement provides the same degree of market discipline as co-insurance. Gilbert’s analysis of empirical studies on the market discipline potential of uninsured depositors yielded mixed results. The mixed results obtained by Gilbert and others are based on past experience, when deposit discipline did not exist in any meaningful sense. The reason for this may very well be the difficulties in ensuring the necessary conditions for its success.

B. Practical Problems in Implementing Depositor Discipline

While the idea of depositor discipline may be appealing in theory, there are several practical problems associated with its implementation. First, it is difficult to determine the appropriate level of risk to impose on the depositors. Second, an environment must exist that is conducive to effective depositor discipline. Finally, there are significant costs involved with depositor monitoring.\(^ {51}\)

1. Determining the Appropriate Level of Risk to Impose on Depositors

One basic issue germane to all of the proposals to enhance the risk exposure of depositors is how much risk should be shifted from the FDIC to the uninsured depositors. This determination requires the balancing of two opposing forces. A low coverage limit will create an incentive for increased depositor monitoring, but has a great potential for wide-spread bank runs and destabiliza-


\(^{48}\) Id. at 30.

\(^{49}\) Co-insurance, it may be recalled, is a method of inducing depositor discipline by making depositors share in the losses associated with bank failures.


\(^{51}\) See Edward J. Kane, Appearance and Reality in Deposit Insurance: The Case for Reform, 10 \textit{J. Banking & Fin.} 175 (1986) [hereinafter Kane, Appearance and Reality]; Kane, supra note 37, at 97; Jonathan R. Macey & Elizabeth H. Garrett, Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments, 5 \textit{Yale J. on Reg.} 215 (1988).
A generous limit, on the other hand, will ensure the stability of the banking system, but does not effectively promote depositor discipline, since it offers minimal incentive for depositor monitoring. Some appear to have taken the view that a threat of bank runs is a necessary price to pay for a more effective insurance system. Others would like to avoid bank runs at any cost, and actually argue for 100% coverage of all deposits rather than a reduction in the statutory limit. Both view points have valid arguments, however, it is difficult to decisively prove one or the other.

Neither approach can prove its case, because the relative magnitudes of the alternative costs, as well as the probabilities of incurring them, are not objectively measurable. Given our current understanding, the reality is that any selection of a coverage limit must be uncomfortably arbitrary and, for any amount of coverage greater than zero but less than 100 percent, there will be an unavoidable risk (of uncertain proportions) that neither bank runs nor bank risk-taking is sufficiently contained to preserve stability.

2. Conditions Necessary for Effective Depositor Monitoring

An effective depositor monitoring system is one which succeeds in curbing the risk-escalating behavior of depository institutions without destabilizing the financial system or leaving the small depositors unprotected. According to Garten, three conditions must exist for depositor discipline to work effectively: (1) there must be a group of depositors for whom risk is the primary concern in choosing a depository; (2) depositors must have access to information to judge the risks involved; and (3) the discipline imposed by depositors must be severe enough to be felt by the management of a depository, but not so drastic as to preclude an opportunity for the management to respond to the concerns of the depositors. Two more conditions may be added: (4) some banks must be allowed to fail, resulting in losses to depositors; and (5) the banking industry must be financially healthy and enjoy depositor confidence. The relevance of

53. See Kane, Appearance and Reality, supra note 51, at 175.
54. See Ely, supra note 43, at 1; Diamond & Dybvig, supra note 46, at 55; William E. Gibson, Deposit Insurance in the United States: Evaluation and Reform, 7 J. FIN. & QUANTITATIVE ANALYSIS 1575 (1972); William Field, The Case for Insuring All Bank Deposits, 19 AKRON BUS. & ECON. REV. 30 (1988). Incidentally, a 100% coverage will place small and large banks on the same footing, since under such policy "too big to fail" loses much of its operational significance.
55. Frederick S. Carns, Should the $100,000 Deposit Insurance Limit be Changed?, 2 FDIC BANKING REV. 14 (1989).
56. See Garten, supra note 46, at 131-32.
these conditions and the problems in ensuring their existence in the U.S. are discussed below.

Depositors may be classified as core depositors or investor-depositors. For the core depositors, the primary factors in the choice of a depository are convenience, value of contacts, etc. The investor-depositors primarily seek the best monetary returns for their deposits, given the risk level. The core depositors may not be very sensitive to minor risk (return) differences between depositories. This may be either because the convenience factor dominates their choices, or because the costs of monitoring and switching between depositories are prohibitive, or because they do not have enough information to meaningfully assess risk differences. However, even the core depositors become sensitive to sizeable risk differences, but at that point withdrawal of deposits and a run on the institution will be the consequence. The investor-depositors are not loyal to any particular depository institution. Therefore, their deposits are volatile by nature. They are much more sensitive to changes in risks or returns and, as such, can be a good source of depositor discipline. However, such investor-depositors, who are most likely to be the de jure uninsured depositors, are important only to a small number of large banks. Approximately three-fourths of all uninsured deposits are in 1% of commercial banks, or about 150 of them. In 1990, uninsured deposits accounted for 56% of total deposits at banks over $10 billion size, while they accounted for only 13% at banks under $1 billion. Therefore, depositor discipline can be a potential source of discipline only to a very small number of large depository institutions, unless the insurance coverage limit is drastically reduced from its current level.

Another important condition for an effective system of depositor-imposed market discipline is the availability of relevant information to depositors on a timely basis. The job of analyzing the risk of a depository is very complex and requires detailed information about its operations. Even the federal agencies have failed to correctly assess the risks of certain institutions. For example, City Federal Savings Bank, New Jersey’s largest savings association, was given a relatively high rating of “2” when the FDIC examiners visited it in 1988. When they left, the thrift was insolvent and was taken over by the regulators.

There are two kinds of information the uninsured depositors need: information necessary to judge the probability of a depository’s insolvency and information to judge the losses to themselves in case of an insolvency. There are serious questions about the availability of both types of information and its timeliness.

57. Id. at 138.
Most of the failures of depositories are due to problems with their loan portfolios. The seeds for a potential problem are sown long before the problem becomes obvious. According to one study, the potential for serious problems typically developed over a period of three to five years before the problems became visible to outsiders.\(^6\) Thus, by the time depositors detect the problem, fatal damage has already been done. In order to be effective, depositor discipline must be preventive. It should give management enough time to respond to the perceived concerns.\(^6\) Drastic discipline coming too late is not going to be effective except in destabilizing the system.\(^6\) In the absence of a systematic and timely flow of accurate information, depositors may be reacting to mere rumors about the financial health of a depository institution.

The uninsured depositors also need information relevant to the potential losses to themselves in the case of a failure. The eventual risk to the uninsured deposits depends not only on the probability of a depository institution becoming insolvent, but also on some other factors about which information is hard to obtain ex ante. These other factors include whether or not enough liquidity will be supplied by the Federal Reserve to an otherwise solvent institution experiencing a run, whether the regulators will act decisively to stop the contagious effect of some bank failures from spreading to other institutions, the timing of when an institution will be declared insolvent and taken over by the insurer, and which failure-resolution method will be adopted. These factors are highly relevant in determining the potential losses and concomitant risk to the uninsured depositors. Yet, information to assess this risk is usually unavailable since even the regulators will not have specific answers to these questions. It takes some time to make a decision on the future viability of a bank experiencing depositor discipline in the form of a run. Even more time will be needed to decide on the method of failure resolution, if the institution is declared insolvent. It is difficult to resolve these uncertainties to depositors unless some clearly-specified closure rules are strictly followed.

The third condition necessary to ensure effective depositor discipline is that the discipline imposed by depositors must be severe enough to be felt by the management of a depository, but not so drastic as to preclude an opportunity for the management to respond to the concerns of the depositors. This condition is intimately related to the availability of timely and relevant information to depositors. Trying to institute depository discipline with incomplete, inadequate, or inaccurate information available to depositors has a serious potential for


\(^6\) Some argue that depositors are a poor source of discipline, since they have little effective power to discipline the management. They can withdraw their deposits but, unlike shareholders, they lack the power to remove the management or alter its policies. See Peter J. Wallison, *Privatize Deposit Insurance*, WALL ST. J., Aug. 16, 1990, at A14.

\(^6\) See Garten, supra note 46, at 153.
destabilizing the system by causing bank runs. Ideally, rational depositors should investigate a rumor before reacting to it. However, they will not do so unless they have reason to believe that other depositors will also act rationally. For depositor-imposed discipline to work there must be symmetric or reciprocal rationality. Every depositor must act on the assumption that all other depositors will also be acting rationally. Unfortunately, reciprocal rationality is not probable because the size of a depositor’s loss does not depend on whether he acted rationally or not, but only on whether he acted in time or not. Depositors can reduce their loss if they act before other depositors have withdrawn their deposits.

Releasing more information to depositors so that they can effectively monitor the risk of depository institutions involves several thorny questions about who will release what kind of information about depositories, when, and to whom. What happens if the information falls into the hands of their competitors? What about the potentially destabilizing effects of overreaction to adverse information? Do all depositors have the necessary sophistication to monitor effectively, when the more sophisticated public regulators with access to a greater amount of information have not had great success in this regard?63

A system of depositor discipline on paper is useless without practical enforcement. For an effective system of depositor discipline to take root, some banks must be allowed to fail and depositors must be made to incur losses. This requires regulatory resolve because, as the system of depositor discipline starts to take effect and some banks are allowed to fail, the potential for bank runs will increase. In order for it to work fairly, depositor discipline also calls for the abandonment of the policy of “too big to fail.”64 Without such a change, depositor discipline will be tilted unfairly against small banks, which may be “too small to save.” However, it may be difficult to abandon the “too big to fail” policy if we wish to protect the availability of short-term credit, stability of the payments system, and the transmission of liquidity through the economy.65

Depositor discipline is a new idea to depositors. The potential for destabilizing effects on the banking system is low when public confidence in the banking system is high. Unfortunately, given the adverse publicity surrounding the financial health of the FDIC insurance funds and the health of the banking

63. It is not the intent here to suggest that the gathering of such information by depositors is impossible, and therefore depositor discipline is not feasible. The point is that when information needs to be gathered and processed, there are costs to be incurred in the process. If these costs are high, depositors try to explore the ways to avoid incurring them, if there are ways to do so. However, if the regulators are committed to the idea of depositor discipline, they can lower such monitoring costs by providing for adequate and smooth flow of relevant information. The costs of depositor monitoring are discussed further in the next section.

64. See Tom Hoenig, A Look at Deposit Insurance Reform, FED. RESERVE BANK OF KANSAS CITY INSIGHT, Aug. 1990.

65. See Randall, supra note 30, at 69.
industry, public confidence in the insurance system is currently maintained only because of the federal government guarantee of insured deposits, and the “too big to fail” policy. Trying to shift some of the risks to uninsured deposits at present does have the potential for unforeseen panics. Perhaps the transition to a system with somewhat greater degree of depositor discipline will be less disruptive when the financial health of banking system has been restored and the public confidence has returned.

3. Costs of Depositor Monitoring

Depositor monitoring involves both explicit and implicit costs. The explicit costs are the out-of-pocket costs incurred by depositors in monitoring the depository institutions. If depositor monitoring is to play a supplementary role to government regulation and supervision, as most suggest, the costs incurred by depositors will be in addition to the costs of regulatory supervision. The total costs of monitoring, when done by so many depositors in addition to the regulatory agencies, are bound to increase considerably. Such costs are likely to be substantial in the U.S. where there are a large number of depository institutions. The implicit costs of such a system include the time depositors or their agents will need to spend monitoring the depository institutions. There are opportunity costs associated with this time which include foregone income in other productive occupations or foregone leisure. There are costs to the society as well. The most important social cost is the potential destabilizing effect that bank runs, associated with increased depositor monitoring, will have on the banking system. When all these costs are calculated, it may be that depositor monitoring is not cost-effective to society.

For some depositors, it may be easier and more cost-effective to transfer deposits to financially sound or big depositories than to monitor small, marginal institutions. This is due to the belief that large depositories will not be allowed by the government to fail; they are simply “too big to fail.” Moving toward greater depositor discipline while continuing the policy of “too big to fail” will give large banks an advantage at the expense of small and medium-sized banks. Naturally, small, independent banks should be expected to oppose such a policy. They have offices in every congressional district and consequently wield substantial political clout.

IV. The FDICIA and Depositor Discipline

66. There were approximately 2,700 federally insured thrift institutions, 12,500 federally insured commercial banks, and 13,300 federally insured credit unions in the U.S. in June 1990. By way of comparison, Canada had less than a dozen commercial banks.
Depositor Discipline

The above discussion reveals that there are some practical problems in implementing an effective system of depositor discipline. While many of the key problems remain to be resolved, the Department of the Treasury has come out in favor of an increased role for depositor discipline, and the recently-enacted Federal Deposit Insurance Corporation Improvement Act of 1991\textsuperscript{67} (FDICIA) has incorporated some of the Treasury’s proposals. A presentation of these provisions and their assessment follows.

\textbf{A. Provisions of the FDICIA for Promoting Depositor Discipline}

The Treasury report identified over-extension of deposit insurance as one of the problems facing the federal deposit insurance program. It called for an increased role for depositor discipline in reducing the risk exposure of the FDIC, and made the following specific proposals in this regard\textsuperscript{68}:

1. In the short-run (with a two-year transition), a depositor should be limited to two insured accounts—one for an individual account and one for a retirement account—with a coverage limit of $100,000 for each account, per institution. In the long-run (over a five-year period), the goal should be to apply the $100,000 limit on a system-wide basis, after the FDIC has completed a cost-benefit study.

2. Elimination of the coverage of brokered deposits and non-deposit creditors, and pass-through coverage for institutional investors like pension funds and for bank investment contracts.

3. Limiting the coverage of uninsured deposits by requiring the FDIC to adopt the least costly resolution method. The report did not call for the abandonment of the “too big to fail” policy, but for a restricted application of it. In those cases where the uninsured deposits also may have to be protected to contain the systemic risk, the decision should be made jointly by the Federal Reserve and the Treasury. The extra cost incurred in protecting the uninsured deposits in such cases should be advanced to the FDIC by the Federal Reserve, with the FDIC repaying the advance with (banking) industry funds. A three-year phase-in period for the change in the current de facto policy of protecting all uninsured deposits was recommended.

The FDICIA has incorporated many of the Treasury’s proposals, which are described below.

1. \textit{Least-Cost Resolution Method}


\textsuperscript{68} U.S. DEPT OF THE TREASURY, supra note 12, at xiii-xiv, 16-31. In addition to the proposals described here, the Report recommends implementation of risk-based insurance premiums, capital-based regulation, feasibility studies of private reinsurance, common ownership between banks and industrial and commercial concerns, and securities powers for banking organizations. While these are relevant for modernizing the banking system and improving the federal deposit insurance system and regulation, some of them are not directly relevant to the idea of depositor monitoring and will not be examined here.
The FDICIA generally requires the FDIC to adopt the least costly of all the possible methods of resolution for each failed or insolvent depository institution. The Treasury report criticized the FDIC for routinely choosing the purchase and assumption method in most cases. Such a practice may not be the least costly of all methods and has historically resulted in the FDIC extending protection to uninsured depositors as well. In some cases, the purchase and assumption method, which precludes losses to uninsured depositors, may in fact be the least costly method; however, there are many other cases where another method, known as "insured deposit transfer", which does not require the FDIC to protect the uninsured depositors, may be cheaper. In the past, the FDIC usually chose the less costly of these two alternatives. The FDIC would either liquidate the depository institution and pay off only the insured depositors or employ the purchase and assumption method which extended protection to uninsured depositors. However, neither of these options necessarily represented the least costly of all the alternatives in each case.

The requirement that the FDIC adopt the least costly method of resolution will result in more losses to the uninsured depositors than in the past, except in those cases where protecting the uninsured depositors also happens to be the least expensive method of resolution of a failed institution.

2. Prohibition of Insurance Protection to Uninsured Depositors and Creditors

The FDICIA generally prohibits the FDIC from making payments to uninsured depositors and the creditors. "The Corporation may not take any action, directly or indirectly, with respect to any insured depository institution that would have the effect of increasing losses to any insurance fund by protecting: (I) depositors for more than the insured portion of deposits (determined without regard to whether such institution is liquidated); or (II) creditors other than depositors." This provision comes into force after December 31, 1994, or earlier as the FDIC may deem appropriate. The FDIC is required to prescribe regulations pertaining to the implementation of this policy no later than January 1, 1994 and the regulations shall take effect no later than January 1, 1995.

The curtailment of the ability of the FDIC to routinely extend its insurance protection to uninsured depositors will increase the risk to uninsured depositors and should lead to greater depositor discipline.

69. See FDICIA § 141.
70. See U.S. DEP'T OF THE TREASURY, supra note 12, at 26-27; see also KANE, GATHERING CRISIS, supra note 14, at 45-46.
71. See FDICIA § 141 (E).
3. **Tighter Scrutiny of Too Big to Fail**

While the effect of the two provisions discussed above is the prevention of overextension of deposit insurance, the Act does retain some flexibility and regulatory discretion. Exceptions may be made to the application of the least cost resolution requirement and the prohibition of payments to uninsured depositors and other creditors, if the compliance with those requirements would have serious adverse effects on economic conditions or financial stability, and if some other action or assistance would mitigate such adverse effects.\(^{72}\) The Secretary of the Treasury, upon the written recommendations from the Board of Directors of the FDIC and the Board of Governors of the Federal Reserve System, determines the exceptions to be made to the general policy. The costs to the FDIC of such assistance shall be recovered from one or more emergency special assessments on the members of the insurance fund in question.\(^{73}\)

Thus the Act retains the "too big to fail" policy, but attempts to curtail its scope. The owners of uninsured deposits should no longer expect a routine extension of federal deposit insurance protection. Consequently, the risk to uninsured depositors increases substantially.

4. **Changes in the Scope of Deposit Insurance Coverage**

The Act reduces the scope of deposit insurance coverage. The net amount due to any depositor at an insured depository institution is limited to a total of $100,000, excluding any amount in a trust fund.\(^{74}\) In addition, a separate coverage of up to $100,000 per participant per insured depository institution is available for retirement accounts.\(^{75}\)

Since the *de jure* limit is applicable at each insured depository institution, it is still possible for a depositor to spread his deposits at several insured institutions and get coverage several times the $100,000 limit.\(^{76}\) However, the ability of weaker depository institutions to attract brokered deposits is restricted by the Act. The Act requires the regulatory agencies to establish five levels of capitalization, from well-capitalized to critically undercapitalized.\(^{77}\) A depository institution that is considered undercapitalized is prohibited from soliciting

\(^{72}\) See FDICIA § 141(G)(i).
\(^{73}\) See FDICIA § 141(G)(ii).
\(^{74}\) See FDICIA § 311(b)(1).
\(^{75}\) See FDICIA § 311(b)(3).
\(^{76}\) However, the FDIC is required to make an informational study of the cost and feasibility of tracking the insured and uninsured deposits at all insured institutions, in order to investigate the feasibility of extending the $100,000 limit on a system-wide basis. The report of the FDIC's study is to be submitted to the Congress before the end of the 18-month period beginning on the date of enactment of the Act. See FDICIA § 311(d).
\(^{77}\) See FDICIA § 131. The five categories consist of: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized.
deposits by offering rates of interest significantly higher than the prevailing interest rates on insured deposits "...in (1) such institution's normal market areas or (2) in the market area in which such deposits would otherwise be accepted." 78

The Act retains the insurance coverage to participants or beneficiaries in employee-benefit plans on a more restrictive pro rata or pass-through basis. Effective one year after the passage of the Act, the FDIC shall not provide insurance to such deposits at insured institutions which, at the time such deposits are accepted, are prohibited from accepting brokered deposits. 79

B. FDICIA and Depositor Discipline: An Assessment

The Treasury report and the FDICIA have in effect rejected the idea of reducing the existing de jure coverage limit of $100,000. 80 This may be a recognition of the political reality regarding the chances for such reduction. Instead of trying to promote depositor discipline via a reduction of the dollar coverage limit, the Act attempts to do it through the following measures: reducing the number of insured accounts, restricting coverage of the brokered deposits and the pass-through accounts held by institutional investors, and requiring the FDIC to adopt the least cost method of resolution. The idea of a mandatory 100% coverage of all deposits is rejected, but the door is left open to that possibility on a case-by-case basis.

The main intent of these provisions is to decrease the risk to the FDIC's insurance funds and increase the risk to the uninsured deposits. The policy seems to be heavily influenced by the desire to reduce the loss exposure of the FDIC and the taxpayers. However, the situation does not necessarily have to develop into a zero-sum game. A reduced risk to the FDIC does not have to come at the cost of increased risk to uninsured depositors. It is possible that the overall risk of the banking system may decrease if some of the other provisions of the FDICIA work well. The FDICIA does not shift the entire burden of monitoring the risk of depository institutions to the uninsured depositors. It has other provisions designed to enable the regulators to better monitor and regulate the risk to the FDIC insurance funds. These are briefly described below. 81

The Act links the degree of regulatory supervision to the level of a depository's capital. As capital levels start falling below the minimum acceptable level set by the appropriate federal banking agency, progressively more severe and

78. See FDICIA § 301(c).
79. See FDICIA § 311(b).
80. For a detailed critique of the Treasury proposals, see Keeton, supra note 58, at 5-24. See also Edward J. Kane, Dissecting Current Legislative Proposals for Deposit Insurance Reform, in BANK STRUCTURE AND COMPETITION 126-35 (1991).
81. A full discussion of these provisions is beyond the scope of this paper.
Depositor Discipline

prompt supervisory intervention is imposed.\textsuperscript{82} The regulatory agencies are also required to fix a leverage limit (ratio of tangible equity to total assets) at which an insured depository becomes critically undercapitalized. The limit shall not be less than 2 percent of total assets.\textsuperscript{83} Within 90 days of an insured depository becoming critically undercapitalized, the appropriate federal banking agency must appoint a receiver for the institution, unless the agency, with the concurrence of the FDIC, takes some other appropriate action. Subject to some exceptions, the agency, however, shall appoint a receiver if such a depository is critically undercapitalized on average during the calendar quarter beginning 270 days after the date on which the institution became undercapitalized.\textsuperscript{84} Annual full-scope, on-site examinations of all insured institutions are required.\textsuperscript{85} The Act places some restrictions on the ability of the Federal Reserve System to advance funds to undercapitalized and critically undercapitalized depository institutions.\textsuperscript{86} This restriction becomes effective after two years from the date of enactment. The FDIC is also required to establish a risk-based premium assessment system in place of the current flat rate premium system.\textsuperscript{87} This system must be in place by no later than July 1, 1993.

It is difficult at this time to estimate the net effect of provisions that increase risk to uninsured deposits and provisions that attempt to reduce risk of bank failures by improving regulatory effectiveness. Since different sections of the Act will become effective on different future dates, the full impact of the FDICIA on depositor monitoring will not be felt until all the provisions become fully operational and until a few bank failures involving uninsured depositors have been encountered. If the provisions of the Act work effectively in curtailing the banking system's risk, the number of potential bank failures and the risks to insurance funds and uninsured depositors will be reduced. This would reduce the need for depositor monitoring. If the provisions do not improve the regulatory effectiveness in controlling bank risk, the FDIC's risk will simply be shifted to depositors. It is unclear whether increased depositor risk will lead to more effective depositor discipline.

There is no guarantee that depositor monitoring under FDICIA will be orderly, efficient or effective. It is risky to assume that things will necessarily work the way the Congress and regulators have envisioned. Particularly troubling is the fact that there is no systematic plan to ensure that the conditions for effective depositor monitoring will develop between now and the time when the FDICIA provisions will become operational. There is no plan to create a

\textsuperscript{82} See FDICIA § 131. These provisions are to become effective one year after the enactment of the Act.
\textsuperscript{83} See FDICIA § 131(c)(3)(A).
\textsuperscript{84} See FDICIA § 131(h)(3)(C).
\textsuperscript{85} See FDICIA § 111.
\textsuperscript{86} See FDICIA § 142(b).
\textsuperscript{87} See FDICIA § 302.
class of investor-depositors who are expected to be more sensitive to risk differences between depositories; all uninsured depositors are automatically assumed to be risk-sensitive investor-depositors.

The informational needs of the uninsured depositors are not adequately addressed by the FDICIA. As discussed earlier, one of the preconditions for effective depositor monitoring is the timely availability of detailed and sensitive information. Depositor monitoring will become even more complex and burdensome if the Treasury's recommendations to broaden the permissible activities of banking organizations and to permit cross-ownership between banks and industrial organizations are enacted into law. Further, there is no guarantee that the depositor discipline sought by the FDICIA will apply timely and correct pressure on the managements of depository institutions without destabilizing the system.

Also, as mentioned above, some depositories must be allowed to fail and uninsured depositors must be allowed to incur losses before depositor discipline can take root. Regulatory resolve to let some large depositories fail is questionable. The best time to usher in the system of depositor discipline without excessive disruption of depositor confidence is when the banking system is financially sound. There is an implicit assumption on the part of Congress and the regulators that by the end of the transition period provided by the FDICIA, the banking system will be in good financial health. This may not materialize.

The question surrounding the "too big to fail" policy is more ambiguous. Until now, uninsured depositors could assume that they would be protected as a matter of course in large bank failures. Under the FDICIA, the Secretary of the Treasury will decide whether a failing bank should come under the "too big to fail" policy, after a recommendation to that effect by the Board of Directors of the FDIC and the Board of Governors of the Federal Reserve. The policy injects new ambiguity by politicizing the decision to extend insurance protection to those other than insured depositors. The idea behind the policy is that if the uninsured depositors are not given unconditional guarantees, they will be forced to monitor the depository institutions more carefully. However, ambiguity in this respect would almost invite bank runs, since the uninsured depositors would prefer to be safe rather than rational.

There is also a notable inconsistency in the FDICIA policy. The Act prescribes that exceptions to the policy of not protecting the uninsured depositors should be made by the Secretary of the Treasury, upon the written recommendation of the FDIC Board and the Board of Governors of the Federal Reserve. Yet, the costs of such decisions are to be recovered from the industry in one or more special assessments. As explained previously, if the FDIC, the Fed, and the Treasury decide that uninsured depositors of an insured depository

88. These recommendations were not accepted by Congress.
need to be protected for systemic reasons, some of the benefits from such policy accrue to society. The costs associated with preserving the systemic benefits should not be shifted to the industry. Instead, either the Treasury or the Federal Reserve representing the taxpayers ought to bear such costs.

Keeton argues that the idea of limiting the protection of uninsured deposits only to those cases where failure to do so would disrupt the entire banking system, through chain reactions or the so-called contagion effect, is not necessarily sound. Such a view ignores "an even more important source of financial instability than spillover effects - a general loss of confidence by all uninsured depositors." Abandonment of "too big to fail" as a general policy, with exceptions limited only to failures with implications of systemic instability, increases the risk to uninsured depositors. It is incorrect to assume that this can be accomplished without adverse consequences. Uninsured deposits would flow to the largest banks or they would flow out of the banking system altogether.

It is unlikely that the new, restricted "too big to fail" policy will let some of the largest depositories fail, no matter how restrictively the policy is interpreted. Therefore, uninsured depositors may engage in a flight to safety. This flight would cause a serious and disruptive flow of uninsured deposits from small and intermediate banks to very large banks and would lead to a still greater concentration of uninsured deposits at large depositories. This would occur more easily under the Treasury's proposal to permit full interstate banking. In the extreme case, such a flight to safety may cause all uninsured deposits to end up with the largest banks which will not be allowed to fail, no matter how narrowly the "too big to fail" policy is promised to be interpreted. Since losses to the FDIC in cases involving very large depositories are likely to be large, it is doubtful if all such costs can be passed on to the industry in the form of higher premium assessments without seriously damaging the financial health of the industry. Hence, the FDIC or the taxpayers may have to absorb such losses. The net (unintended) effect of the new policy could be merely a shift of deposits from small and intermediate banks to very large banks without any reduction in the FDIC's overall risk exposure.

Another possible effect of the new policy is a shift of some uninsured deposits away from the banking system altogether. If there is no protection of implicit FDIC insurance, one of the major incentives for uninsured deposits to stay within the banking system will be lost. Some of the uninsured deposits may flow into money market mutual funds. Unencumbered by deposit insurance premiums and reserve requirements, such institutions will be able to offer a higher rate of return than the banks. Any such substantial flow of deposits away from the banking system will reduce the Federal Reserve's control over money supply and credit, with profound effects for the entire national economy.

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89. See Keeton, supra note 58, at 11.
Apart from the argument that promoting depositor discipline by introducing some uncertainty into the "too big to fail" policy may have the above unintended adverse consequences, Kane finds the Treasury's proposals seriously deficient in that they do not address the major problem of defective political and bureaucratic accountability.\(^{90}\) Under the proposals, regulators will continue to retain the discretion to extend "unlimited insurance coverage after the fact to formally uninsured obligations of a failing client."\(^{91}\) Moreover, there is no guarantee that the discretion given will always be exercised in the best possible interests of the taxpayers.

Taxpayers must reward rather than punish whistleblowers and ask politicians and deposit-insurance officials to surrender discretion they now enjoy with respect to the information they choose to report and the forbearances they choose to give.\(^{92}\)

What Kane finds particularly troubling is how such discretion was routinely abused in the past with massive financial consequences to the taxpayers.

There exists a systematic anesthetization of official consciences to the moral dimensions of the tradeoffs that political pressures leads them [the officials] to foist on the underinformed taxpayers.\(^{93}\)

The Treasury proposals and the FDICIA do not give adequate attention to the issue of protecting money stock or providing safe transaction assets to the economy. The official measures of money supply (whether M1, M2, or M3) include the total amounts in the specified categories of deposits, not just the insured portions of such deposits.\(^{94}\) In fact, M3 explicitly includes large-denomination time deposits (defined as those in amounts of $100,000 or more) which are clearly above the de jure limit of $100,000. When a depository is allowed to fail and uninsured depositors are not protected, the money supply shrinks for reasons unrelated to monetary policy.

It is difficult to project the net impact of the provisions of the FDICIA. Some provisions increase the risk to uninsured depositors; others reduce the potential number of failures. Many provisions of the Act will not become effective until some future date. The Act does not have any provisions to ensure that a system of effective depositor discipline will develop. The major factors

\(^{90}\) See Kane, supra note 80, at 126-35.

\(^{91}\) Id. at 132.

\(^{92}\) Id. at 128.

\(^{93}\) Id. at 129.

\(^{94}\) There is an exception in regard to one item included in M2—the small-denomination time deposits (defined as those in amounts less than $100,000). By definition, all such deposits are under the de jure limit.
which have shaped the reforms seem to be the goals of protecting small depositors and minimizing losses to the FDIC or the taxpayers. The goals of protecting the money supply and providing a safe transaction asset in the economy do not appear to have received adequate attention.

V. Maturity-Based Insurance Coverage: An Alternative

There is an alternative method of reducing the scope of the federal deposit insurance system. This alternative will not only protect small depositors and reduce the exposure of the FDIC's insurance fund, but will also protect the money supply and decrease the likelihood of bank runs. The alternative is important to consider in view of the fact that the FDCIA requires the FDIC to study the feasibility of authorizing insured depository institutions to offer both insured and uninsured deposit accounts. While the Act does not suggest the basis on which such segregation should be made, it does ask the FDIC to consider the following factors: (1) the risk such a system would pose to the deposit insurance system; (2) the disclosure standards which would be necessary to prevent customer confusion over the insured status of the deposits; (3) the required revisions or changes in the accounting standards; and (4) the manner in which the system can be implemented with least disruption to general stability and banking consumers' confidence. The FDIC is required to submit a report to the Congress before the end of six months from the date of enactment of the Act.

The alternative that should be considered seriously is to set insurance coverage limits in terms of the maturity of the deposits rather than to set dollar limits for coverage of all types of deposits. Under such a policy, deposit insurance will essentially be extended to all short-term or transaction deposits, since these are the closest alternatives to currency. The assets which may be acquired with such insured deposits may have to be carefully specified. Besides containing the FDIC's risk exposure and protecting the small depositor, such a policy would satisfy the objective of protecting the money supply from serious fluctuations arising from bank runs and failures. Deposits of longer maturities are actually financial investments and the government should not insure those investments, just as it does not insure other types of depositors' investments such as stocks, bonds, automobiles, or houses. Retirement account insurance may be shifted to the Pension Benefit Guaranty Corporation. Maturity-based coverage will make the depositors recognize an important

95. See FDCIA § 321.
financial principle—if they want higher returns they will have to sacrifice some liquidity and safety provided by deposit insurance.

The maturity-based coverage is also more flexible than the coverage based on a dollar limit. Under the dollar-limit system all depositors are given the same protection whether they want it or not. All depositors are exposed to losses in the same way once the coverage limit, which is arbitrarily set, is reached. Even if some of the depositors desire a larger amount of protection than the specified coverage limit, and are willing to sacrifice a higher return for such safety, it is difficult for them to get it under the present system. Under the maturity-based system depositors can seek greater safety for more of their deposits by shifting them into the insured, short-term maturities. This will involve a lower return, but depositors will have a choice. Those who wish to seek higher returns without the insurance protection can choose to keep a large portion of their deposits in the longer uninsured maturity ranges. The maturity-based coverage also makes it easier to identify depositors as core depositors or investor-depositors. Under the system, depositors self-select whether they will be uninsured depositors by choosing a maturity range. This will provide for better depositor monitoring than the dollar-limit system, which assumes that any depositor with more than $100,000 in his account is an investor-depositor. The maturity-based coverage will also eliminate the disadvantage of the smaller banks vis-a-vis the larger ones, since there will a 100% coverage for all deposits within the specified maturity limit.

The potential for destabilizing bank runs will also be reduced under the maturity-based coverage. The short-maturity deposits will be fully insured and their owners will not have to be concerned about the safety of their funds. The owners of uninsured, longer-term deposits have to be concerned about the financial safety of their depositories, but they cannot start a run because their funds will not be payable at par on demand. Hence, they or their agents will be forced to monitor their depositories more carefully.

Maturity based deposit insurance could heighten the traditional maturity mismatch problem of depositories, creating a further source of instability in the banking system. A dynamic and innovative financial system should, however, find a solution. For example, depository institutions may offer higher returns on the uninsured, longer-term deposits to reduce their own maturity mismatch problems.

A practical problem with setting coverage limits by the maturity of deposits is deciding what maturity limit should be chosen for coverage. Any choice of a maturity limit could be as arbitrary as the current dollar-size limit. One logical solution is to limit the protection only to those liabilities of depository institutions which are included in the official definition of money supply (M1 or M2) and to exclude others. This will serve the additional objectives of protecting the money supply and providing a safe transaction asset for the economy. This
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approach will not be effective, however, if depositors are led to believe that there will be a de facto guarantee of deposits of all maturities, whatever the formal rules may be.

More important than fixing the limits to coverage is the willingness to enforce these limits. Many of the past problems of the FSLIC and the FDIC arose not because of the absence of coverage limits, but because of the unwillingness to enforce the ones which existed. Liberal interpretation of the coverage limits and frequent and generous exemptions to the stated limits work against attempts to encourage depositor discipline. While a significant amount of evidence is not yet available to judge how serious the regulators are about enforcing the provisions of the FDICIA, there is already some criticism in this regard. Macey has argued that the way the FDIC has handled the recent cases of CrossLand Savings, FSB, and Brooklyn appears inconsistent with the provisions of the FDICIA. In this case, the FDIC decided to take over the institution after turning down two outside bids. Macey argues that the FDIC plan looks like the 1984 government takeover of the Continental Illinois Bank, and that, contrary to the intent of the FDICIA, it appears to violate the least-cost resolution requirement, and is an example of a dramatic extension of the "too big to fail" policy. Macey is particularly disturbed by the fact that, unlike the Continental Bank, CrossLand is a medium-sized bank, and unlike the Continental case there were private bidders available.

In the ultimate analysis, depositors as a group have enormous political clout and can always successfully pressure Congress to bail them out when their losses threaten to become substantial. As long as the legislators are inclined to pay attention to their voters, it is easier for depositors to try to influence their legislators than to monitor the health of depository institutions. As Ely points out, the political process "understandably and yet undesirably tilts towards economic losers." The losers and prospective losers in the financial system may never have to pay the full price of their action or inaction. This possibility alone seriously undermines the potential usefulness of any system of depositor discipline, whether enforced with dollar-based or maturity-based coverage limits.

Conclusion

The case for depositor discipline is fairly compelling on paper. Most of the problems with depositor discipline are in designing a workable system for implementing it. For an effective system of depositor discipline, certain preconditions are necessary. First, there must exist a class of risk sensitive depositors

who are given timely and relevant information. Second, any depositor discipline system must be structured to protect the stability of the banking system and prevent severe fluctuations in the money supply. Third, there must be regulatory resolve to enforce the system and allow uninsured depositors to suffer losses. Fourth, the system must not unfairly discriminate against small institutions. Finally, and most importantly, the banking system must be returned to financial health and public confidence restored before any depositor discipline system can be implemented. The Treasury proposals and the provisions of the FDICIA do not address these issues in any meaningful way. They provide a transition period, but there is no systematic plan to improve the conditions conducive to depositor discipline.