The Role of Deposit Insurance in the Emerging Financial Services Industry*

William M. Isaac†

Revolutionary changes are now taking place in the financial system. A structure put into place a half century ago, at the bottom of the Great Depression, is crumbling, and a new structure is rapidly taking shape. In part, these changes are deliberate but, in larger part, they result from the forces of economics and technology. The central question facing the federal government today is not whether change will or should continue but, rather, how to assure that the resulting financial structure will be one that best serves the public interest.

Deposit insurance has been an integral part of the financial system for a half century. It is responsible, in considerable part, for the structure of depository institutions that has evolved and the nature of the supervision and regulation of depository institutions. It is, therefore, impossible to consider any government response to the changing structure of the financial services industry without addressing the role of the insuring agencies. Congress recognized this in the Garn-St. Germain Depository

* This Article is based on the in-depth comments and recommendations submitted to Congress by the FDIC pursuant to section 712 of the Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469, 1544.
† Mr. Isaac is Chairman of the Federal Deposit Insurance Corporation. In April 1978, he accepted, with the consent of the Senate, a six-year presidential appointment to the Board of Directors of the FDIC; he was elected Chairman of the Board in August 1981. Mr. Isaac is also the Chairman of the Federal Financial Institutions Examination Council (see Title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, 92 Stat. 3641, 3694) and a member of the Depository Institutions Deregulation Committee (see Title II of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132, 142) and of Vice President Bush's Task Group on Regulation of Financial Services. Before joining the FDIC, Mr. Isaac was general counsel and corporate secretary for a bank holding company and its subsidiaries, following several years' association with a private law firm.
1. The FDIC was created by the Banking Act of 1933, ch. 89, § 8, 48 Stat. 162, 168. The current statutes governing the operations of the FDIC are codified at 12 U.S.C. §§ 1811-1832 (1982).
2. The adoption of a deposit insurance program in 1933 was outside the mainstream of financial reform legislation of the time. The insurance legislation was not a part of the Roosevelt Administration's program and many persons, both within and outside of the Roosevelt Administration, held out little hope for its success. The record of state attempts to operate deposit insurance systems, a record extending back more than a century prior to 1933, was not encouraging. See S. KENNEDY, THE BANKING CRISIS OF 1933 214-23 (1973).
3. There are three deposit insurance agencies: The FDIC insures deposit accounts in commercial and mutual savings banks; the Federal Savings and Loan Insurance Corporation insures accounts in savings and loan associations; and the National Credit Union Administration insures accounts in credit unions.
Institutions Act of 1982 (Garn-St. Germain Act), when it directed the deposit insurance agencies to address insurance issues likely to be of significance in the new financial environment.

To provide perspective on these issues, the first two sections of this Article briefly discuss the history and current status of federal financial services regulation in general, and of deposit insurance in particular. The third section then explains why current efforts to deregulate substantially the financial services industry will create intolerable strains on the existing deposit insurance system. Ameliorating these strains will require a fundamental restructuring of the deposit insurance system: The traditional relationships among the deposit insurance agencies, depository institutions, and the deposit-holding public must be altered to account for the changes introduced by deregulation. The final section discusses the necessary alteration of these relationships.

I. Federal Regulation of Financial Services

A group of federal statutes adopted in the early and mid-1930s—including the Banking Act of 1933, The Home Owners' Loan Act of 1933, the Securities Act of 1933, and the Securities Exchange Act of 1934—established a neatly compartmentalized and tightly regulated financial structure. The statutes carefully differentiated and in some instances made highly specialized the powers of financial institutions, so that, for example, only investment banking houses could underwrite corporate securities and only commercial banks could offer demand deposit services. In general, Congress contemplated a system of specialized financial institutions, with some necessary overlap.

Depository institutions were subjected to a number of new regulations. For example, the cost of deposits was regulated for the first time at the federal level, with a zero interest ceiling on demand deposits, and administratively determined ceilings on savings and time deposits. In addition, entry into the business of accepting deposits became more tightly regulated

Deposit Insurance

because of the deposit insurance programs. In connection with its provisions allowing national banks to establish branches for the first time, the 1927 McFadden Act precluded interstate bank branching, with intrastate bank branching continuing to be governed by state law. New legislation in 1956 prohibited interstate bank expansion by multi-bank holding companies.

These statutes either created or maintained separate regulatory systems and agencies, such as the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board. Coordination among these agencies, each of which had regulatory jurisdiction over a different field of financial services, was not a matter of primary concern. The various groups of financial institutions were sufficiently insulated by reason of their carefully drawn spheres of activity to make unnecessary any special provision for coordination among the various regulatory agencies.

The rationale for establishing this kind of system was clear: to prevent a recurrence of the type of catastrophic financial collapse that had occurred between 1930 and 1933. Underlying much of the new legislation was a pervasive belief—which extended to nonfinancial fields—that excessive competition was a primary cause of the economic collapse. The new system was intended, among other things, to restrain competition, not only among financial industry groups but also within the banking industry itself.

As happens with any set of regulations superimposed on an essentially competitive business, some erosion occurred over the years in the various lines of demarcation and in other constraints. The system, however, remained essentially unchanged until the late 1970s, when it began to disintegrate rapidly. This disintegration primarily resulted from the communications-computer revolution, an extended period of high inflation and high interest rates, a new attitude among government regulators toward

9. For example, the Banking Act of 1935, ch. 614, § 101, 49 Stat. 684, 702, required any state nonmember insured bank to obtain the written consent of the FDIC prior to establishing any new branch. The factors to be considered in granting such approval included "[t]he financial history and condition of the bank, the adequacy of its capital structure, its future earnings prospects, the general character of its management, the convenience and needs of the community to be served by the bank, and whether or not its corporate powers are consistent with the purposes of this section." Id. at § 101, 49 Stat. at 688.


12. See supra note 1.

competition among financial institutions (now viewed as a desirable objective rather than something to be prevented), and the entrepreneurial imagination of some financial managers, particularly as the financial demands from the public became larger and more complex.

The recent changes in the industry are well known. Regulations limiting interest rates paid on deposits have largely disappeared; the powers of thrift institutions were expanded when it became apparent that specialization in long-term, fixed-rate lending to purchasers of residential properties could not be sustained in a period of high and volatile market interest rates; and new financial technology is utilized to do business over broader geographic areas than were contemplated in the legislation of a half century ago. We are rapidly reaching a situation in which virtually any financial service may be offered by any financial institution on a nationwide basis. Deregulation—the more usual term for the dismantling of the system constructed in the early 1930s—is in full swing.

These structural changes in the financial sector of the economy create the need to reevaluate the role of deposit insurance in our financial system. Such a reevaluation, however, should not underestimate the significance of deposit insurance to our financial system. This significance is perhaps best illustrated by the agreement between two of the nation's leading economists—persons whose views are usually thought of as being at opposite ends of the economists' spectrum—on the importance of the deposit insurance sections of the Banking Act of 1933. Professor Milton Friedman has observed: “Federal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic and, indeed in our view, the structural change most conducive to monetary stability since state bank note issues were taxed out of existence immediately after the Civil War.”

Professor John K. Galbraith has described the creation of the FDIC in the following terms: “The anarchy of uncontrolled banking [was] brought to an end not by the Federal Reserve System, but by the obscure, unprestigious, unwanted Federal Deposit Insurance Corporation. . . . In all American monetary history no legislative action brought such a change as this.”

Deposit insurance, which was quickly extended to savings and loan associations and later to credit unions, has not only been a positive force for

---


15. Id. at §§ 401-09, 94 Stat. at 151-60 (codified in scattered sections of 12 U.S.C.).


Deposit Insurance

monetary stability, but it has also given the federal government a direct financial stake, of a type and magnitude not found with respect to any other industry, in the future course of deregulation. For this reason, Congress, in the Garn-St. Germain Act, directed the three federal agencies insuring deposits or share accounts to address the following questions:18

— the current system of deposit insurance and its impact on the structure and operations of depository institutions;
— the feasibility of providing depositors the option to purchase additional deposit insurance covering deposits in excess of the general limit provided by law and the capability of the private insurance system to provide risk coverage in excess of the general statutory limit, either directly or through reinsurance;
— the feasibility of basing deposit insurance premiums on the risk posed by either the particular insured institution or the category or size of the depository institution, rather than the present flat-rate system;
— the feasibility of revising the deposit insurance system to provide greater protection for small depositors while creating greater incentives for large depositors to monitor their bank’s activities; and
— the adequacy of existing public disclosure regarding the condition and business practices of insured depository institutions, and providing an assessment of changes which may be needed to assure adequate disclosure.

Each of these items touches on an important aspect of the insurance program. The discussion that follows places these questions in the broader context of deposit insurance reform and summarizes the FDIC’s views and recommendations. Despite the specificity of these questions, it seems evident that Congress really was raising the fundamental question of


In addition to these listed issues, Section 712 of the Garn-St. Germain Act directed the insurance agencies to analyze the impact of expanding insurance coverage on the adequacy of the insurance funds and the feasibility of consolidating the three separate insurance funds. Because the rate of bank failure is directly related to general macroeconomic conditions, the adequacy of the deposit insurance funds cannot be judged according to standard actuarial principles. Nevertheless, the record of the past 50 years suggests that the income flow and size of the FDIC’s deposit insurance fund are adequate today and should be adequate in the future, assuming that the institutions whose liabilities are insured will receive the proper degree of supervision from the market and/or from the government. The FDIC also believes that merging the FDIC and the FSLIC into a single agency would be both feasible and efficient because the functions of thrift institutions and commercial banks are now so similar that virtually the only legal distinction between them is the nature of the insurance attached to the liabilities of each. See supra text accompanying note 15. The Bush Task Group on Regulation of Financial Services, however, has recommended that the separate regulatory and insurance structure for thrifts be maintained and that the definition of “thrift” be tightened. Institutions that do not meet a portfolio test — based on a relatively high percentage of residential loans — would not be eligible for regulation as thrifts and would instead be regulated as banks and insured by the FDIC. Although the two deposit insurance funds would be continued under the Bush Task Group’s proposal, the FDIC and FSLIC would adopt common capital and accounting standards for banks and savings and loans.
whether the existing deposit insurance program should be altered to accommodate or help shape the sweeping changes that are taking place in the nation’s financial system.

II. The Current Status and Objectives of Deposit Insurance

Any inquiry into the role of deposit insurance in a deregulated environment must begin with the objectives of the insurance program. It is then necessary to examine how these objectives are implemented in actual practice. This inquiry is essential to determining whether, or to what extent, significant reform is necessary, and whether any recommended changes will serve the public interest.

A. Deposit Insurance Objectives

The subject of deposit insurance was debated in the U.S. Congress for at least 50 years prior to its adoption in 1933, and fourteen states had initiated deposit insurance systems at various times between 1829 and 1917, several of which continued until the 1930s. From this record, two public policy objectives consistently emerged: First, deposit insurance should protect depositors of modest means from the consequences of bank failure and, second, such insurance should protect communities, states, and the nation against the economic consequences of wide-spread bank failure.

The first of these objectives requires little elaboration. Because most individuals require a bank in which to deposit savings or for paying small checks, there are many people who must rely on the banking system and yet who have little ability to protect themselves against the risk of a bank’s closing. There has probably never been a better or more elegant statement of this particular objective than by a committee of the New York legislature in 1829, when that state was about to adopt the nation’s first deposit insurance system:

The loss by the insolvency of banks falls generally upon the farmer, the mechanic, and the laborer, who are least acquainted with the condition of banks and who, of all others, are most illy able to either guard against or to sustain a loss by their banks’ failure.20

The second objective of deposit insurance relates to its role in promoting financial stability.21 The modern version of this objective emphasizes that

21. In much of the academic literature, the financial stability role of deposit insurance is identified
Demand deposits, the principal liability of most banks, comprise a major portion of the nation's total money supply. In a fractional reserve banking system, a stampede by depositors seeking to convert deposits into cash would produce a severe contraction of the nation's money supply, with devastating macroeconomic consequences. Deposit insurance can prevent such panics by guaranteeing payment to depositors if their bank fails.

The backers of deposit insurance legislation in 1933 also saw other, more immediate and practical benefits. One was the belief that government intervention, through a deposit insurance program, might help restore public confidence in a banking system that had virtually collapsed. Today, the maintenance of public confidence in banking is simply an alternative formulation of the FDIC role in promoting financial stability.

At the time, many also believed that only a deposit insurance program would enable smaller independent banks to survive and compete successfully with larger banking institutions. Thus, the nation's smaller banks, particularly those in areas especially hard hit by bank failures, were among the most vigorous supporters of the deposit insurance legislation.

The FDIC has managed to satisfy the cluster of aspirations and objectives of those who sought the adoption of deposit insurance legislation. First, confidence in the banking system did, in fact, reappear, even though initial insurance coverage was only $2,500 per depositor. (This limit was quickly raised to $5,000, where it remained until 1950.) Such confidence has not been misplaced. Between 1933 and 1982, the FDIC made disbursements in 620 insured bank failures to protect over six million depositors, resulting in recovery by depositors of $19.7 billion, or 98.9% of insured and uninsured deposits in failing banks. Second, although periods of monetary or financial instability have occurred during the past fifty years, such circumstances have not been caused or exacerbated by monetary "panics" or by the waves of bank failures that had plagued the American economy prior to 1933. Indeed, the total number of insured bank failures since 1933 has not been much greater than the average number of bank failures in any single year during the prosperous 1920s, and far below the rate of bank failures from 1930 to 1933, when some 9,000 commercial banks closed their doors.

Finally, to the extent that preservation of the existing structure of the

as the only significant or proper objective assigned to the deposit insurance program. See, e.g., Scott & Mayer, Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform, 23 STAN. L. REV. 857, 858-59 (1971).

22. For a general discussion of the political turmoil surrounding the creation of federal deposit insurance in 1933, see S. KENNEDY, supra note 1, at 214-23.

23. Id. at 222.

24. See generally M. FRIEDMAN & A. SCHWARTZ, supra note 16.

The banking industry was an objective of deposit insurance, that goal has been largely attained. Although numerous factors other than deposit insurance played a part in shaping the present banking structure, the banking structure in 1984—whether viewed in terms of the number of banking institutions or their distribution by size (size in “real” terms, of course)—does not differ significantly from that which was in place on January 1, 1934, when federal deposit insurance became effective.

B. The Development of FDIC Operating Procedures for Problem Banks

When the record of the past half century is viewed in terms of policy actions taken by the FDIC or by the Congress, it is evident that the financial stability objective of deposit insurance is of special importance. Initially, the Congress only provided the FDIC with authority to arrange for the payment of depositors, up to the insured maximum, after a bank was closed and placed in liquidation. In 1935, however, a seemingly insignificant amendment to the Banking Act of 1933 gave the FDIC the authority to facilitate mergers among insured banks whenever the FDIC found that a merger would eliminate a weak institution. The Congress believed that such power would enable the FDIC to avoid larger disbursements at some future time, when many such banks could be expected to fail. By the late 1940s, the FDIC had transformed the assistance of bank mergers into an alternative method of handling failing banks; by the middle 1960s, the merger-assistance program was thoroughly integrated into FDIC procedures for protecting depositors, complete with cost tests, the use of receiverships in arranging assisted mergers, and the introduction of "premiums" and bidding procedures. What emerged is known today as the purchase and assumption (P&A) transaction.

During the past 30 years, the majority of bank failures, and practically all large bank failures, have been handled through P&A transactions. In this kind of transaction, the FDIC replaces the bank's bad assets with cash, and all deposits and other liabilities (other than subordinated debt) of the failed bank are assumed by another (existing or new) bank. As a result, no general creditor incurs any loss, despite the closing of a bank. On a few occasions the FDIC has provided direct assistance to banks that were open but would otherwise have failed. Recently, it has also provided direct assistance to facilitate open bank mergers of failing savings banks.


27. In this type of transaction, the FDIC provides additional capital directly to a failing bank, which is then merged into another bank without ever being closed. Two recent examples of FDIC direct assistance to facilitate open bank mergers of failing savings banks are the acquisition of Oregon
Deposit Insurance

In these transactions, as in P&A transactions, all depositors are made whole.

The FDIC frequently uses the P&A transaction when handling a distressed bank for several reasons. In most instances, a P&A transaction costs the FDIC less than paying insured depositors the amount of their insured deposits. This savings results because the acquiring institution is usually willing to pay an attractive premium to acquire a failing bank, once its bad assets have been purchased by the FDIC. In addition, the P&A transaction is almost always less disruptive for individual depositors, bank loan customers, local merchants, and the general community. Furthermore, if the distressed institution is large, the FDIC is almost forced to arrange a P&A transaction to prevent disruptive consequences to financial markets. The failure of a large banking institution might bring down other commercial banks and adversely affect public confidence to such an extent as to initiate the kind of banking crisis that deposit insurance was intended to prevent. The P&A transaction thus enables the FDIC to implement its monetary stability objective in a way that might be impossible if the FDIC only had the option of directly paying insured depositors.

The development and increasing use of the P&A transaction as one of the two principal ways of protecting depositors of failing banks were accomplished largely by FDIC administrative action. The Congress, however, has recently implied that it supports this method of dealing with problem banks. The Garn-St. Germain Act relaxed the conditions under which the FDIC can provide assistance to distressed insured banks. Under earlier law, such assistance hinged upon a finding that the continued operation of the institution was essential to its community. The Garn-St. Germain Act changed the criterion to a finding that "severe financial conditions exist which threaten the stability of a significant number of insured banks or of insured banks possessing significant financial resources . . ." 28 Thus, any future assessment of the objectives of deposit insurance policy, as well as the methods of implementing that policy, must place heavy emphasis on the maintenance of financial stability. Indeed, that objective already is, or may soon be, "first among equals." This objective of maintaining financial stability, however, will pose tough questions for planning the role that deposit insurance should play in a deregulated financial system.

III. Deposit Insurance in a Deregulated Environment: The Problem

Deregulation of financial institutions is, in itself, an important policy objective. Prior Administrations have made this clear, but none more so than the present Administration. This objective can be stated briefly as follows: Consistent with the need to maintain a sound financial system, the constraints on commercial banks and on other financial institutions that prevent the public from obtaining the benefits of competition among all financial institutions must be removed.

Against this background, what is the problem posed for, and by, deposit insurance? Banks, after all, have funded themselves for many years with deposits that are federally insured; does it make a difference if these funds must soon be purchased at market rates rather than at regulated rates, or over a broader geographic area, or if they may now be employed in a variety of new financial services?

To a certain extent, even before the pace of deregulation accelerated dramatically, the fact that privately owned and competitive financial institutions were funded in substantial part by liabilities insured by an agency of the federal government posed problems. This was the reason for the adoption of an extensive system of federal supervision and regulation of banks. Yet a significant contraction in the scope of regulation has commenced which has not been matched by a contraction in the government's deposit insurance obligation. Although the logical relationship would appear to be a concurrent reduction both in regulation and in the government's deposit insurance obligation. Although the logical relationship would appear to be a concurrent reduction both in regulation and in the government's deposit insurance program, most signs now point to further expansion of the government's insurance obligation. This expansion is due, in large part, to the use of the P&A transaction.

Until the 1970s, the FDIC's use of the P&A transaction could be seen as nothing more than a commendable financial innovation, enabling the FDIC to protect the depositors of failing banks in a manner that was least


30. Normally, as any corporation invests in riskier assets, it will have to pay more for its borrowed funds; lenders will demand a higher rate of return to compensate them for bearing the risk associated with the corporation's investment plan. In this way, the capital market acts as a rather strict discipliner of overly zealous managers. This market discipline, however, will obviously not be effective when most of a corporation's liabilities are insured by the federal government. Since the risk faced by such lenders will not increase as the firm invests in marginally riskier assets, the lenders have no reason to demand a higher rate of return and no incentive to monitor management's activities. Moreover, when insurance premiums are fixed, as deposit insurance premiums currently are, and when the potential loss is already greater than shareholders' equity, the marginal expected costs of additional risk will be borne entirely by the insurer, whereas all of the marginal expected benefit accrues to the firm's shareholders. Obviously, then, some mechanism is required to prevent insured banks from taking excessive risks. Since the federal government bears the potential costs of excessive risks, it is not surprising that it would be the one to step forward to regulate the risk incurred by the banking industry.
Deposit Insurance

disruptive to the affected communities, most calculated to preserve financial stability, and, in many cases, most cost efficient. Having developed the P&A transaction, however, the FDIC is now virtually compelled to use it in any case involving a large distressed bank. During the 1970s, there were a sizable number of large distressed insured banks (more than a few in the multi-billion dollar category) and, with one exception, all large cases have been handled through either a P&A transaction or direct assistance.\(^1\) It is not possible to say precisely when attitudes in the business and financial community began to change, but there seems little question that sophisticated users of banking services are increasingly aware that the FDIC's options are limited and that, in most cases, all deposits will be treated as if they are fully insured regardless of their size.

The scope of the government's insurance obligation has also expanded in other ways. Insurance coverage, which was raised to $10,000 in 1950, is now set by statute at $100,000 per depositor—a ten-fold increase. If the coverage increase had been linked to the rate of inflation (measured by the Consumer Price Index), insurance coverage today would be only about $40,000 per depositor. Moreover, it is not unusual to hear suggestions that the scope of deposit insurance be increased further, but rarely or ever are there suggestions that it be reduced.

In the Garn-St. Germain Act, the Congress further broadened the insurance responsibility of the deposit insurance agencies by adding assistance programs for failing depository institutions to their functions.\(^2\) Although such programs may be sound public policy, they indicate again that the breadth of the federal government's insurance commitment is still growing at a time when regulation, which buttresses that commitment, is diminishing.

Because of this trend, deposit insurance may come to exert a perverse effect—furthering rather than containing financial instability. This may happen if the combination of government underwriting of deposit risk and the natural tendency of depository institutions to take advantage of this implicit federal subsidy is not checked by off-setting constraints imposed by government, or by the market, or by both.\(^3\) Indeed, an increasingly fragile financial structure might be unable to resist even minor shocks. A significant side effect of a more unstable financial system would be a sub-

---

1. The one exception is the Penn Square Bank of Oklahoma City, Oklahoma. Penn Square Bank had $517 million in assets and $470 million in deposits when it was closed by the Comptroller of the Currency on July 5, 1982. The FDIC paid insured depositors up to the insurance limit of $100,000 and estimates that its liquidation of the bank will produce a 65 percent recovery for depositors' balances in excess of $100,000.


3. See supra note 30.
stantial increase in the cost of deposit insurance. Alternatively, the prevention of such fragility could require the slowing down or end of deregulation. Put somewhat differently, comprehensive government insurance of bank liabilities is inconsistent with deregulation of the institutions responsible for those liabilities. Therefore, the federal government cannot allow deregulation to proceed much further without addressing the issues posed by deposit insurance. Yet, checking the deregulation movement would mean thwarting an important public policy objective—the attainment of more effective competition among financial institutions.

IV. Adapting Deposit Insurance to a Deregulated Environment: Some Possible Solutions

The FDIC believes that meaningful deregulation requires significant simultaneous reform of the ways in which the deposit insurance programs now operate. This section discusses possible reforms of the internal policies and procedures of the FDIC and, in the course of the discussion, addresses the specific questions posed by the Congress in the Garn-St. Germain Act.

The reform recommendations of the FDIC can be analyzed in various ways. Our approach is to consider first those recommendations that call for action by the government (primarily by the FDIC) and, second, those recommendations that look to the private sector for assistance. Before looking at these recommendations, however, a brief comment on the view that banking deregulation may be accomplished without significant changes in the deposit insurance system may be useful.

A. Deregulation and the Need for Deposit Insurance Reform

Some have suggested that banking organizations can be deregulated without altering the current deposit insurance system, at least insofar as product and geographic deregulation are concerned. This could occur by requiring that new, nontraditional banking activities be conducted not by the bank itself, but by affiliated corporations within a holding company structure. Transactions between the bank and its affiliates would be prohibited or strictly regulated. Deposit insurance would relate only to the bank, which would, in effect, be insulated from the other affiliates in the holding company.

This type of proposal has recently been suggested to the Congress by the Treasury Department. Although no precise tabulation has been made, the weight of opinion seems to be that it is impractical to think that

---

Deposit Insurance

the future of the bank can be separated from the future of the company of which it is a part. The public will inevitably view the bank and its holding company as one institution. The FDIC shares this view.

On the other hand, some commentators contend that real separation of a bank’s activities from those of its affiliates has never been actively attempted or pursued by regulatory authorities and that the proposed separation is workable, both legally and practically. Regardless of the respective merits of the arguments, this type of reform lies beyond the scope of this Article. It is nonetheless a reform that is certain to be before the Congress and should therefore not be disregarded.

B. FDIC Initiatives

Basing deposit insurance premiums on the riskiness of a bank’s operations has long been a serious reform proposal. Proponents of risk-related deposit insurance premiums argue that a constant insurance assessment rate (currently equal to 1/12 of one percent of assessable deposits, less a net assessment credit based on FDIC expenses and losses) fails to penalize banks that pose a high risk to the deposit insurance fund. Moreover, fixed insurance premiums may encourage excessive risk-taking by banks because the insurer bears all the marginal expected costs of additional risk but all marginal expected benefits accrue to the bank’s shareholders. For this reason, insured banks must be extensively supervised. Proponents of a risk-related premium argue that most restrictions on bank activities, and much bank supervision, could be eliminated if each bank’s insurance assessment reflected the risk that the bank’s operations pose to the insurance fund.

Although the use of risk-related premiums is theoretically appealing, the FDIC has concluded that establishment of an “ideal” risk-related premium system is not feasible. Under an “ideal” system, the insurance fund would be fully compensated for all risk-taking. Such a system would, however, entail unrealistic data requirements and require risk quantification techniques not currently available. Even if these problems could be overcome, the resulting FDIC authority over banks—much of it necessarily judgmental in nature—would be far greater than any governmental

36. Section 7(d) of the Federal Deposit Insurance Act, 12 U.S.C. § 1817(d) (1982), provides for a refund to insured banks for a part of the excess of insurance assessments (i.e., premiums) collected during the year by the FDIC over related operating and insurance expenses. In accordance with this provision, the FDIC makes refunds by way of crediting the individual banks for the amounts otherwise due for insurance assessments in the following year—hence the expression “assessment credit.”
37. See supra note 30.
agency should have in an economic society based on free enterprise principles.

In the FDIC's view, however, simple fairness dictates that moderate differentials in deposit insurance rates should be implemented to reward sound bank management and to penalize banks that refuse to conform to elementary standards of acceptable bank behavior. Accordingly, the FDIC proposes a risk-related premium program that relates premiums to reasonably sound measures of risk, with a maximum premium differential equal to the assessment credit. In addition, the FDIC will seek authority to charge banks for any disproportionate amount of supervisory time required to correct problem bank situations.

The limited program envisioned by the FDIC may, over time, evolve into a program that more closely meets the objectives of an "ideal" system. At this stage, however, attempting to institute a full-blown, risk-related assessment program is impractical and possibly harmful. 38

C. Private Sector Initiatives

The FDIC has concluded that the best solutions to the problems set forth above entail mobilizing the resources of the private market. Several possibilities are quite promising.

Disclosure — One very useful type of reform would simply be an extension of existing practice. Specifically, the FDIC believes that improving the required public disclosure of bank information could enhance the market's ability to control the behavior of banks. 39 The effectiveness of such disclosures, however, depends in part on the interest in, or usefulness of, the information provided—the interest and usefulness of information being a function of the extent to which additional risk is shifted from the FDIC to the private sector. Nevertheless, even if the allocation of risk between the FDIC and the private sector did not change, existing private sector surveillance of banks should intensify with improved disclosure.

The FDIC has developed a policy statement setting forth minimum standards for bank disclosure. This policy encourages uninsured depositors to request necessary additional information from banks that do not

38. Although risk-related premiums are conceptually appealing, particularly in an environment of deregulation, there are costs and tradeoffs to consider. For example, the supervisory costs necessary to apply risk measurements could be very substantial depending on the comprehensiveness and precision desired, and in addition to increased supervisory costs, a risk-based system could entail an expensive appeals program.

Deposit Insurance

adequately comply with the disclosure standards.

In addition, Bank Call Reports\textsuperscript{40} are presently being revised to make them more comprehensive for purposes of risk analysis. Additions to these documents will provide regulators and the public with data on credit risk (loan quality) and interest rate risk, areas not previously covered in these reports.\textsuperscript{41} Finally, the FDIC is also considering adopting a policy under which it would publicize its statutory enforcement actions against banks. Under the proposed policy, the FDIC would publish its final orders near the time of their effective dates in the \textit{Federal Register}.

\textit{Reducing effective insurance coverage} — Since insured depository institutions have an incentive to assume more risk than the market would permit in the absence of insurance, banks have been subject to a set of statutory and regulatory constraints on their activities.\textsuperscript{42} Wholesale deregulation of insured depository institutions, with no change in the existing insurance system, could therefore pose financial stability problems for the FDIC and the economy. A common sense approach to this problem would be to reduce the de facto level of insurance coverage so that some important portion of deposit liabilities is placed at risk. The reduction in insurance coverage should result in better private-sector policing of bank risk-taking activities. Moreover, this type of reform would satisfy the mandate of the Garn-St. Germain Act because the feasibility of obtaining more effective discipline of banks from bank depositors, particularly those with larger balances, is precisely one of the matters that the Congress directed the deposit insurance agencies to examine.\textsuperscript{43}

How might such a reduction in de facto insurance coverage be obtained? The FDIC could accomplish such a reduction by abandoning the use of the P&A transaction and direct assistance procedures and henceforth following a policy of paying depositors in failed insured banks only the amounts of their deposits up to the statutory ceiling of $100,000. Such a policy would unquestionably attract attention from large depositors, and also is consistent with the public policy objective of protecting unsophisticated depositors with modest balances.

There are, however, several problems with this approach. First, it would expose communities in which bank failures occur to needless distress. As discussed earlier, the P&A transaction provides a means by which the FDIC can handle bank failures, while avoiding the disruptive

\textsuperscript{40} Call Reports are filed by all insured banks at the end of each calendar quarter and consist of a balance sheet, income statement, and other schedules.

\textsuperscript{41} This revision raises issues of competitive equity because savings and loan associations are not required to disclose data on loan quality.

\textsuperscript{42} \textit{See supra} note 30.

\textsuperscript{43} \textit{See supra} text accompanying note 18.
consequences of such closings. More importantly, reducing the protection of uninsured depositors would seriously impair the FDIC's ability to achieve its second public policy objective: protecting the public from the destabilizing effects of bank failure. Although no one can be certain as to how much of a destabilizing effect such a change would have, if the FDIC were to place all uninsured depositors at substantial risk, many competent observers believe that the failure (or even reports of serious difficulties) of large banks might set off a chain of problems, threatening otherwise sound institutions. In short, such a program would increase the probability of bank runs and therefore have the destabilizing effect that the FDIC was established to prevent.

Various reform possibilities exist, however, between the two extremes of providing a de facto 100 percent insurance coverage for all depositors and paying off depositors only up to the insurance maximum. The policy most attractive to the FDIC combines the continued use of the P&A transaction in most instances with the introduction of some risk-bearing by depositors with sizable balances. Specifically, the FDIC is considering a procedure through which it would make an immediate appraisal of the assets of a failed bank and estimate the ultimate total recovery on those assets. The FDIC would use this estimate to determine the extent to which depositors in the failed bank are protected. To illustrate, assume that the FDIC estimates that recovery on the assets of a particular failed bank would equal eighty percent of all claims of the depositors (or of the FDIC on behalf of depositors it has paid) and general creditors. The FDIC could then structure a transaction, similar to the current P&A transaction, but in which only insured deposits and, in this case, eighty percent of uninsured deposits and other liabilities would pass to the acquiring bank, along with an equal volume of failed bank assets and cash (less any premium that the acquiring bank might be willing to pay). A variant on this approach could provide, by statute, that only a fixed percentage (such as seventy-five percent) of deposit balances over $100,000 could be recovered, irrespective of the ultimate recovery on assets.

A transaction modified in either of these ways would retain many of the advantages of the present P&A transaction. Most of the goodwill and deposit relationships of the former bank would be preserved. Although uninsured depositors would lose a portion of their funds, they would retain immediate access to most of their deposits. If the initial recovery were based on an estimate of the actual recovery, additional amounts would be paid to depositors if the actual recovery exceeded the estimated recovery. Returning to the example above, if the actual recovery exceeded eighty percent, the additional amount recovered would be distributed to the depositors. Should the FDIC's ultimate recovery fall short of its initial esti-
mate, then presumably the FDIC’s share of the loss would exceed that of the uninsured general creditors. (In a regular P&A transaction, it should be remembered, the FDIC bears all of the loss.)

A modified P&A transaction, although still providing uninsured depositors with a substantial portion of their deposits, would nevertheless expose them and other general creditors to some risk of loss. This exposure to loss would create incentives for depositors to avoid risky banks and to be more vigilant in monitoring the activities of the banks they select. The modified P&A transaction also could be used for very large banks because the proposed program allows even the largest uninsured depositors immediate access to a substantial portion of their deposits.

Even this modified approach could create some financial instability. Some observers with whom the FDIC has consulted have warned that any exposure to risk by large depositors may have destabilizing effects. Such exposure, for example, could cause the problem of bank runs to recur. In the FDIC’s view, however, the suggested program is sufficiently modest that it is unlikely to have such adverse consequences. Moreover, if large depositors are already aware of their existing level of risk and monitor it closely, as many of these same critics assert, then a marginal increase in risk exposure should not have the kinds of dramatic consequences suggested.

Non-government deposit insurance — Another alternative is private deposit insurance. The private insurance industry might be capable and desirous of shouldering a larger portion of the deposit insurance burden, now borne almost entirely by the federal government. Moreover, if the FDIC is successful in modifying its P&A transaction procedures along the lines described above, large depositors may eagerly seek supplemental insurance. For this reason, Congress, in the Garn-St. Germain Act, requested an analysis of the feasibility of offering excess coverage at the purchaser’s option and the capacity of the private insurance industry to provide such excess coverage.44

It would be redundant for the FDIC to offer such excess coverage (since the FDIC, for all practical purposes, now insures virtually all deposits) unless such an offer were part of a program to replace the P&A transaction and other procedures with the former policy of providing insurance protection solely through deposit payoffs up to the insurance maximum. The major problem with the FDIC providing such additional coverage is the difficulty of pricing additional risk. Such a plan would be impractical for the same reason that risk-related premiums are impractical: With current methods of measuring risk, one could never be certain

44. See supra text accompanying note 18.
that the government agency was pricing risk accurately and fairly. If the FDIC felt confident that risk could be priced appropriately in this situation, then, of course, it would be confident that such pricing could be done for all deposits.

Private insurance companies would face a similar problem of risk pricing. Quite apart from pricing problems, however, private insurance companies would also encounter serious capacity constraints. Therefore, private insurance coverage will continue to be fairly narrow in scope, focusing on individual customers or selected institutions. The FDIC discussed this subject with representatives from a selected group of companies and found little reason to believe that the private sector can make comprehensive insurance programs available.

The FDIC's conclusion on the infeasibility of private insurance coverage may be premature. If the FDIC modifies its P&A procedure, the demand for excess insurance coverage might stimulate the development of private industry initiatives, a possibility that should not be dismissed. To the extent that the private sector is capable of offering additional insurance coverage, new market forces will be exerted on banks to reduce risk, a development welcomed by the FDIC.46 The FDIC believes, however, the development of private-sector deposit insurance should be left to the free play of the market, without subsidization from the FDIC.

Increasing the risk of junior creditors — Enhanced market discipline of banks may be obtained in ways other than increasing depositor risk. Intermediate and long-term subordinated debt affords certain advantages over deposits in creating market discipline of banks. Subordinated lenders are apt to be more sophisticated at evaluating credit risk. Having made a loan or investment, they generally cannot rapidly liquidate their investment without incurring some loss when a bank becomes financially troubled. For this reason, they view the borrower's (bank's) operations from a long-term perspective. Unlike stockholders, their return is fixed, and they generally receive no benefit from increased risk. Unlike depositors, they cannot count on being bailed out when a bank fails. If a bank does fail, the investment of subordinated creditors in the bank provides a protective cushion to the FDIC. Thus, subordinated creditors generally have both the ability and incentives to monitor carefully a bank's risk-taking behavior.

Fashioning a system in which junior creditors play a larger part in

45. Private sector insurers could be expected to monitor closely a bank's investment activities and to alter insurance premiums in accordance with the riskiness of a bank's portfolio. This would internalize the cost of additional risk to the bank and thus avoid the potential problem of excessive risk-taking by banks. See supra note 30.

212
applying market discipline to banks is not difficult. This could be accomplished, for example, by changing capital adequacy standards, which provide for a required minimum level of capital relative to assets, to include the further requirement that a specific portion of capital be subordinated debt. The contract between the bank and its subordinated debt holders could be expected to constrain the bank's risk-taking activities. This, of course, would be a significant step. Although the FDIC does not recommend this approach at present, it considers the approach worthy of serious consideration.46

Conclusion

In the final analysis, proposals intended to enable the FDIC to fulfill its public interest objectives in a changed financial environment must reflect a judgment on a probable best course. Although some recommend that the FDIC await the unfolding of events, the FDIC is convinced that the risks of maintaining the status quo are unacceptably high. Its core conclusions and recommendations with respect to restructuring the relationships among the FDIC, banks, and depositors include the following:

—The success of deposit insurance may be attributed in part to extensive regulation of banks, including constraints on interest payments, powers, and expansion opportunities.

—The responsibilities of the deposit insurance system are expanding at a time when regulation is contracting, setting up a potentially dangerous situation.

—The institution of new and more extensive supervision and regulation of banks would choke off the present deregulation movement and its promise of a more competitive financial system. To attempt to price deposit insurance so as to compensate adequately for any new risk that banks may assume is impractical, although the FDIC does recommend a modest step in that direction.

—Accordingly, the private sector should assume some modest portion of the risk now borne fully by the federal government. The most attractive way to accomplish this objective appears to be a modified P&A transaction, combined with better financial disclosure by banks, the enactment of a depositor preference statute,47 and possibly some control over de-

46. The notion that a specific portion of bank capital be in the form of subordinated debt makes good sense in theory. The FDIC, however, is not in a position to evaluate the immediate impact that such a requirement would have on a bank's ability to rearrange its capital structure and the market's willingness to support such moves. Consequently, the FDIC is not ready to make a concrete proposal.

47. A depositor preference statute would make all other liabilities of the bank, with possible exceptions for a few immaterial accounts, subordinate to the claims of depositors in the event of liquidation.
Any transfer of risk to the private sector is potentially destabilizing. This is intended and desirable to a certain extent. Banks unable to handle the new opportunities presented by deregulation should not be protected from market discipline. It is uncertain whether the destabilizing consequences will prove to be too great. In the FDIC’s judgment, however, there is great potential for massive, systemic problems if changes along the lines recommended are not implemented.

Some will also ask how the private-sector can be expected to evaluate accurately the condition of banks if the FDIC is not capable of instituting a risk-related premium system. After all, the FDIC is in a better position to reach judgments on the condition of individual banks due to its superior access to information, such as bank examination reports, which is not available to the private sector. Although this position is plausible, the FDIC believes that improving the flow of information to the private sector through more extensive disclosure can rectify this situation. The fundamental question remains, however, concerning the extent to which such disclosure is consistent with maintaining a stable financial system.

The FDIC will continue to utilize its supervisory powers to work with individual banks to solve problem situations. It will also use its enforcement powers when cooperation cannot be obtained. The FDIC can go further, of course, but substituting the FDIC’s judgment for that of bank managers and the market would inject the FDIC into bank management to an extensive degree. Such a course of action would reverse the trend of deregulation and produce a banking system which is essentially government directed. The FDIC prefers the judgment of the market which, though harsh on occasion, has generally served the nation well.

The FDIC is not suggesting that banks and other financial institutions

48. The straight brokering of deposits to insured institutions operates by a money broker, acting on its own or at the request of an institution or institutions, soliciting deposits from its customers. The customer may send deposits directly to the bank at the request of the broker or the broker itself may transfer the customer’s funds to the institution, having the deposit registered in its name as nominee or agent for the customer. Another variation is for the broker to engage in the practice of selling participations in large denominations of certificates of deposit. So long as the broker informs the institution that the deposits are being held by the broker as nominee and the broker maintains records to reflect the individual ownership interest, FDIC insurance applies to each individual customer to the maximum of $100,000. The FDIC is concerned that the multiple insurance coverage afforded in relation to such deposits, which can be accumulated quickly and in large amounts, fails to encourage market and institution analysis in their placement. The availability of these funds to all institutions, irrespective of financial and managerial soundness, reduces market discipline. Although deposit brokering can provide a source of liquidity, it also makes it possible for poorly managed institutions to continue operating beyond the time at which natural market forces would have otherwise precipitated their failure. This impediment to natural market forces results in increased cost to the FDIC in the form of either greater insurance payments or higher assistance expenditures if the institutions are later closed because of insolvency.
Deposit Insurance

be thrown open to the unrestricted consequences of market-driven decisions. It does support a modest move toward co-responsibility or co-insurance between the public and private sectors. The deposit insurance and supervisory framework can no longer afford merely to react to evolutionary change; it must be structured to deal with the dynamics of the financial services industry in the future. The FDIC believes that its proposed changes in the structure of financial services regulation will enable deregulation to proceed unchecked, but not at the cost of creating an unstable financial system.