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Is this Risk Insurable?
A Response to Sebastian Schich

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Abstract

In his paper "Challenges Associated with the Expansion of Deposit Insurance Coverage during Fall 2008" Sebastian Schich of the OECD has written an excellent overview of the current situation of bank deposit insurance in the industrial economies of the world. He finds that, facing a crisis of confidence leading to visible bank runs, bank supervisors nearly everywhere resorted to raising deposit insurance limits, in some cases to "unlimited" status. Some of these changes have limitations of scope or duration, but some of the political changes of recent years (expansion of the European Union, for example) call into question whether any limits will be observed or whether recently granted expansions of deposit insurance will be recalled in due time. There are, however, important lessons to be learned from the American experience with deposit insurance, which has been present in the United States since 1933 but only in recent decades in numerous other developed economies. Alternatives to deposit insurance do exist and still could be tried anywhere, taking regional differences into account, as long as an adequate institutional structure is in place first. In any case, the alternatives would be cheaper and more efficient than the fairly explicit subsidy of the banking industry that present systems of deposit insurance entail.

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1 Summary of Article

Sebastian Schich, of the Organization for Economic Cooperation and Development in Paris, France (OECD), has prepared a useful overview of the international aspects of the deposit insurance problems that arose when the current banking crisis began to unfold during 2007 (Schich 2009). The principal focus of his article is the institutional structure of deposit insurance, always a worthy object of study, but the whole panoply of lender of last resort (LLR) and other emergency responses of financial regulators is swept into his analysis.

A formal timeline of the current crisis might begin even before the bank runs at Northern Rock, a United Kingdom savings and mortgage lending institution, became publicly visible depositors' queues on September 14, 2007. For example, Bear Stearns, a United States investment banking corporation, announced June 22, 2007, that it had to liquidate one hedge fund that it had sponsored but would commit $3.2 billion to rescue another firm-sponsored hedge fund. Also, the U.S. Federal Reserve issued a press release August 10, 2007, acknowledging extraordinary funding pressures in the interbank market and reminding banks and the public that the Fed's discount window was available to meet such funding requirements.

Once the banking crisis genie was out of the bottle, it spread globally, bringing the International Monetary Fund (IMF) into a hurried series of bailout loans for developing economy banking systems. Previously, the IMF was worried that it needed new sources of income because it had made so few loans in recent years that the flow of interest income was drying up. The European Bank for Reconstruction and Development and the European Central Bank responded to similar requests for assistance from the transitional economies of Eastern Europe and the newly admitted members of the Euro Zone. An Agence France Presse posting on March 21, 2009, said that the European Union had agreed to commit € 50 billion ($68 billion) to loans for Eastern Europe and € 75 billion ($103 billion) to fund an expansion of the IMF's lendable resources.

Any analysis of cross-border aspects of deposit insurance would benefit from at least brief mention of the role of foreign exchange swap agreements in propping up bank depositors' confidence. The U.S. authorities (primarily the Federal Reserve) expanded foreign currency swap lines (exchanges of liabilities that amount to extensions of U.S. dollar credit from the United States to the foreign central bank counterparties) from zero to $554 billion between the fall of 2007 and year-end 2008. About $400 billion of that total was for European counterparties, and it is generally assumed that the bulk of the swaps funded onward extensions of credit to banking systems in the East. At the end of March 2009, the aggregate U.S. currency swaps had been reduced to $327 billion, with European credits comprising most of the total (as of year-end 2008, the Federal Reserve no longer is publishing a timely country-by-country report of swap drawings) (see Willoughby 2009).

Schich makes the important general point that most industrial economies (the OECD members) approved significant increases in the amount, duration, and scope of government-provided deposit insurance as an initial step to contain the spread of the crisis. Nine of the OECD countries, including Germany, approved unlimited deposit insurance. Some of those countries, like Denmark, Iceland, and Ireland, were dealing with banks whose liabilities dwarfed their home economies. The United States temporarily raised the deposit insurance limit to $250,000 until year-end 2009.

Although it is understandable for the authorities to wish to increase deposit insurance coverage in an effort to contain bank runs, Schich properly identifies the problem of overshooting in that regard. New Zealand, for example, another small economy with large banks (intriguingly, all the large banks are Australian), raised its deposit insurance limit to the equivalent of U.S.$544,000. Those with unlimited insurance may find it difficult to reimpose limits, he writes. Countries like the United States, with temporary increases, may encounter substantial political pressures to continue those increases beyond the scheduled expiration dates.

The extent of coverage of cross-border deposits is a tricky matter, Schich notes. I agree, but intuitively it should be a lesser problem in large, isolated, continental economies like the United States and Australia and a greater problem in smaller countries geographically close to each other, a situation that prevails in Europe and the financial centers of East Asia. However, even the United States is not free of the problem of competition from offshore deposits: Cayman Islands, Bahamas, Panama, and other banking centers in the Western Hemisphere often compete with U.S. banking offices for deposits, but what usually happens is that U.S. depositors place their funds with, say, the Cayman Islands branch of Citibank or the Panama branch of JPMorgan Chase. Under U.S. deposit insurance rules, such deposits are uninsured (because they are not domestic deposits). Schich reports that, under EU rules, home country deposit insurance coverage prevails for out-of-country deposits within the EU. Under U.S. rules, any foreign bank accepting retail deposits at a U.S. branch (non-business deposits under the federal deposit insurance ceiling amount) must obtain federal deposit insurance. Some branches do this, but most do not.

2 Alternative Approaches to Problem of Depositor Confidence in Banking Panics

Schich makes a number of useful suggestions for how to improve the efficiency of deposit insurance regimes in the face of multiple bank insolvencies. Limiting the scope and duration of insurance in order to avoid moral hazard (the temptation to engage in riskier behavior induced by the presence of insurance) is always a good idea.

Unfortunately, Schich proposes that *contagion* (bank runs that spread beyond the most insolvent institutions) be contained by giving banking supervisors the right to intervene with powers greater than those available to the supervisors under general bankruptcy law. This is by now a standard assumption in international financial circles, but it also may be a case of special pleading. Most bank holding company insolvencies are resolved quite nicely (even if not always to the complete liking of bankers and their supervisors) in U.S. federal bankruptcy courts. Also, *contagion* appears to connote irrationality of depositors in running on other banks once the first bank is affected negatively. Instead, bank runs may appear rational when there are reasonable grounds for suspecting the insolvency of the target of the run. For example, once the banking troubles of Iceland became public knowledge *after* the seizure of its three largest banks in the first week of October 2008, it was rational for depositors to test the solvency of banks from countries similarly situated, like Ireland.

The following passage, from the Irish Times.com, October 9, 2008, illustrates the point just made:

> Jaakko Kiander of the Labour Institute for Economic Research in Helsinki warns against a false sense of security.
>
> "The Irish economy is extremely open, much more than Finland used to be, and Ireland could easily face a big external shock if US and European economies slide deeper into recession, hurting Irish exports," Kiander says.
>
> Talking about the economic pressures Ireland faces today will not cause a banking crisis any more than talking about a fire drill will cause a fire. On the other hand, Kiander warns that not talking about possible economic pressures for fear of a psychological snowball effect only panders to an inherent weakness of the financial industry.
>
> "The financial industry is always short-sighted and always in denial," he says. "They always think they're very clever and have good risk-assessment, but they always repeat old behaviour patterns."

In the United States, expanding the use of the Federal Reserve’s discount window was combined with increased deposit insurance limits to restore depositors’ confidence in the banking system. The Federal Reserve’s weekly H.4.1 statistical release, “Factors Affecting Reserve Balances,” shows steady and rapid growth of discount window lending (and initially a rapid diminution of Treasury securities purchased and held outright) from August 22, 2007, through the most recent statement, covering March 25, 2009. Total Federal Reserve credit was \$2.1 trillion (up from \$867 billion on the 2007 date), currently divided roughly 50-50 between open-market operations and foreign exchange swaps, on the one hand, and discount window operations, on the other hand.

Most of the bank supervisory authorities have rescued general creditors, senior subordinated debt holders, and even some preferred stockholders in the current round of debt rescues. It is an unsustainable premise to have deposit insurance cover such claims, and Shich rightly notes that thought needs to be given to how, if at all, to charge deposit insurance fees to holders of banks’ paper in categories that might be subject to bailout on the same level as depositors. It is irrational, after all, to charge premiums for insured deposits only and then to attempt to bail everyone out. Moreover, the size of the average (mean) or, better yet, median insured deposit account is much smaller than the new limits embraced by nearly all the supervisors: In the early 1990s, in the United States, the median was estimated at about \$3,000 per account, and it is unlikely in the present environment that the median account would exceed \$15,000 per account.

3 Degrees of Moral Indifference: Applicability of the United States Model of Deposit Insurance to Foreign Banking Systems and Cross-Border Deposits

Deposit insurance was invented, in its modern form, in the United States as part of the Glass-Steagall Act of June 20, 1933. Earlier, at the creation of the Federal Reserve in 1913, Southern and Western bankers had asked for deposit insurance in order to compete against their larger bank brethren, but Congress rejected the proposal.

American financial writer Martin Mayer, in his 2001 book, *The Fed*, p. 159, describes the creation of the permanent Federal Deposit Insurance Corporation (FDIC) thus:

> (George Moore, later chairman of Citicorp, who was in and out of Washington during the deposit insurance debate as a gofer representing James Perkins, then president of National City Bank of New York, remembered communicating the argument that “the competence of bankers is not an insurable risk.”) Roosevelt didn’t want deposit insurance either, but the Democrats in the House of Representatives refused to go along with the other financial-sector reform measures in the Glass-Steagall Act until deposit insurance was firmly in the bill.

The intellectual case for deposit insurance for small depositors is limited, at best, in societies that still have postal system savings banks. In the United States, such a system existed from 1911 until 1958. Also, U.S. savers may purchase up to $5,000 per person per year of U.S. Treasury savings bonds in denominations as small as $50, and the bonds may be cashed after six months. Treasury bills may be purchased in denominations as small as $100 and with normal initial maturities as short as 90 days. Thus, it is unclear what the intellectual case for the usual functions of deposit insurance in the United States is if full faith and credit Treasury securities, which readily may be turned into cash on very short notice, are so easily available (*see generally*, Todd 1991).

One is driven inescapably to the conclusion that the principal function of deposit insurance in a modern society is to subsidize the lending and investment functions of the banking system. In the face of alternative investments that are essentially as safe as a government-insured deposit, the government must be making a positive statement to the effect that it really, truly, deeply wishes the public to hold its savings and liquidity balances inside the banking system and nowhere else. One understands the convenience of this arrangement for the bankers and their kept politicians (there are now more than 70 members of the House Financial Services Committee, a notorious bailiwick for attracting political campaign contributions, nearly one-sixth of the membership of the entire U.S. House of Representatives), but where is the benefit for the general public that would justify continuing this arrangement?

The case is doubtless the same in most OECD member countries. As Schich notes, in order to prevent banks from appearing to be wards of the state with respect to deposit insurance, efforts have been made in the United States and elsewhere to introduce some countervailing discipline in the form of premium assessments reflecting value at risk. Experience, however, has shown that during good times, the resulting reserves of the deposit insurance fund always appear to be too high, preventing the societally more efficient use of that money in profitable investments for the banks. In bad times, the fund reserves are nearly always too low, and the FDIC has concluded that the risk in the United States currently is that the fund’s reserves will become calamitously low. The FDIC’s reserve fund has fallen to about $19 billion as of year-end 2008. Since 1991, the FDIC’s statutory borrowing line from the Treasury has been capped at $30 billion. The Senate Banking Committee is proposing to raise that limit to $100 billion or even $500 billion to avoid premium assessments to restore the reserve fund to the required level (about $50 billion) that otherwise would devastate banks’ earnings over the next few years:

> The FDIC would be able to borrow as much as $500 billion until the end of 2010 if the FDIC, Fed, Treasury secretary and White House agree such money is warranted. The bill would allow it to borrow $100 billion absent that approval. Currently, its line of credit with the Treasury is $30 billion (Paletta 2009).

Like everything else associated with the current banking crisis, enormous public debts would be undertaken for no good purpose—the same effect (protecting the public's funds) can be accomplished with other devices and for a much lesser cost.

4 Conclusion: Different Regions Have to Retain Depositors' Confidence in Different Ways during Banking Panics—It Is Unclear that Anything is Gained from International Cooperation from One Continent to the Next

My main purposes in this review are to illustrate that the United States is the main source of modern deposit insurance systems, that our rationale in creating deposit insurance was weak at the beginning and became progressively weaker over time, and that actually existing deposit insurance tends to cost more than it is worth from a public benefit standpoint. One of the few admissible rationales for deposit insurance is that it is useful in stopping a banking panic, once such a panic erupts (Schwartz and Todd 2008). However, in a properly functioning supervisory system, one never should allow a bank to remain open in a weakened condition to the point of courting a bank run in the first place. Most bank runs do have an underlying rationality to them, after all.

In his 1987 book, *What Should Banks Do?* Robert Litan reintroduced an idea whose germ was the Chicago Plan for banking reform in 1933 (Litan 1987). Writing well before the 1999 repeal of the Glass-Steagall Act separation of commercial from investment banking, Litan proposed that modern U.S. commercial banks should be required to split their functions further into wholesale and retail divisions. Essentially, retail banks would accept consumers' deposits, have direct access to the Federal Reserve's payments network, and be allowed to invest only in government securities and other assets rated safe (despite recent failures of the rating agencies, this might be worth pursuing). The retail bank would resemble a regulated public utility company. It could operate without deposit insurance because all its assets would be marked to market daily and would be safe investments. Also, its payments system fees structure would be lower than at modern commercial banks because it would not have to support the infrastructure of commercial lending and securities investments.

The wholesale bank, in Litan's plan, would not accept consumers' deposits (only business deposits and those above the pro forma deposit insurance ceiling). It would have to fund itself only from uninsured deposits and by selling its own obligations in the market. It would be allowed to make commercial loans and to purchase securities for its own account for investment. Such a bank could be allowed to fail without concern for protecting the payments system or the retail deposit base. Such a banking system could exist without deposit insurance.

The brave new world of derivatives largely has come along since Litan's book was published, but it is clear that the retail bank would not be allowed to engage in derivatives trading. In my opinion, neither should the commercial or wholesale bank, but that issue can be resolved another day (no one who is already too big or too important to let fail should be allowed to engage in derivatives underwriting or trading, which simply squares or cubes all the liabilities).

A final way of resolving the deposit insurance dilemma from the U.S. experience is to observe what happened to our investment banks once they abandoned the former partnership form of organization after 1979 and became corporations (a few of the older form of partnerships remain, but they are much smaller than the investment banking behemoths of recent years). In a partnership, all the senior managers' personal assets are on the line for the repayment of firm liabilities. This sobering reality tends to induce caution with respect to new endeavors, ranging from international balance of payments lending to derivatives underwriting and trading. In contrast, all the large corporate investment banks have signed up with the Treasury Department for Troubled Assets Relief Program funding (TARP money).

Each region of the world will have to reorganize its banks so as to resolve the deposit insurance dilemma in a way that is consistent with the customs and practices of that region. International cooperation that enforces foreign methodologies on a region that is not yet prepared intellectually or emotionally, let alone structurally, to receive them is doomed to fail. Nevertheless, and especially because the United States lies at the root of both deposit insurance and the current crisis, we bear a special burden in educating the world about what we have (and have not, at least not yet) learned about the institutional structure of banking and deposit insurance. If fortune smiles on the rest of the world, it will avoid our worst mistakes and profit from our best examples. But the beginning of wisdom in this arena is, always and everywhere, to get the institutional structure right and then to seek to identify the personages who could run it properly.

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