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How to Get Off the Back of a Tiger, Or, Do Initial Conditions Constrain Deposit Insurance Reform

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Merging Commercial and Investment Banking

Proceedings A Conference on Bank Structure and Competition

**Risks
Benefits
Challenges**

Federal Reserve Bank of Chicago

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TABLE OF CONTENTS

I. Special Address

The Customer Is Always Right: The Case for Functional Regulation of Financial Services <i>Hans H. Angermueller</i>	1
---	---

II. Financial Innovations and the Merging of Commercial and Investment Banking Activities

Introductory Remarks on the Merging of Commercial and Investment Banking <i>Martha R. Seger</i>	11
Financial Innovations and the Merging of Commercial and Investment Banking Activities <i>William J. McDonough</i>	19
Financial Innovation: Opportunities, Risk, and Regulation <i>John G. Heimann</i>	27
Clubs, Markets, and Variations on a Theme by Senator Glass <i>Alex J. Pollock</i>	32
Financial Innovations and the Merging of Commercial and Investment Banking Activities <i>Jack M. Guttentag</i>	41

III. Expanding Bank Powers: International Perspectives

An Introduction to Expanding Bank Powers: International Perspectives <i>William S. Ogden</i>	49
Expanding Bank Powers: A Canadian Perspective <i>Allan Popoff</i>	54
Comments on Expanding Bank Powers: An International Perspective <i>W. Peter Cooke</i>	62
Expanding Bank Powers: International Perspectives <i>Yuko Oana</i>	70
Risks and Profitability in the Banking System: Assessment and Prescription <i>Thomas S. Johnson</i>	78

IV. Benefits of Expanded Bank Powers for Community Banks

Problems of Community Banks and their Need for Expanded Powers <i>P. Michael Laub</i>	86
The Thrift Institutions' Experience with Service Corporations <i>Harold Olin</i>	101
Benefits of Expanded Bank Powers for Community Banks <i>O. J. Tomson</i>	118

V. Asset Sales

The Paradox of Loan Sales <i>Gary B. Gorton and Joseph G. Haubrich</i>	123
Why Commercial Banks Sell Loans: An Empirical Analysis <i>Christine Pavel and David Phillis</i>	145

VI. Interest Rate Swaps

Credit Risk and the Scope of Regulation of Swaps <i>Clifford W. Smith, Charles W. Smithson, and L. Macdonald Wakeman</i>	166
Alternative Explanations of Interest Rate Swaps <i>Larry D. Wall and John J. Pringle</i>	186
Discussion of Practical Aspects of Interest Rate Swaps <i>Linda T. Rudnick</i>	206

VII. Failures and the Regulatory Response

An Examination of Bank Failure Misclassifications Using the Cox Model <i>Stephen W. Looney, James W. Wansley, and William R. Lane</i>	214
The Ohio S&L Crisis in Retrospect: Implications for the Current Federal Deposit Insurance Crisis <i>J. Huston McCulloch</i>	230
How to Get Off the Back of a Tiger or, Do Initial Conditions Constrain Deposit Insurance Reform? <i>Claudia Campbell and Hyman P. Minsky</i>	252

HOW TO GET OFF THE BACK OF A TIGER,
OR,
DO INITIAL CONDITIONS
CONSTRAIN DEPOSIT INSURANCE REFORM?

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The legislation in the Congress to refinance and restructure the Federal Savings and Loan Insurance Corporation (FSLIC) makes it clear that Federal deposit insurance is not, and never was, actuarially sound. It matters little whether the result of the current higgling and haggling in Congress is a capital infusion into FSLIC of 5, 15, 25 or 40 billion dollars, whether the infusion is an outright transfer of funds from the Treasury or a subterfuge, such as an endorsement of borrowings, or whether the legislation reforms or leaves the basic structure of deposit insurance unchanged. What matters is that Congress is ratifying what was always implicit: Federal deposit insurance is a pledge of the full faith and credit of the United States.

Although the Congressional debate centers around the FSLIC and the thrifts, what is done will affect the Federal Deposit Insurance Corporation (FDIC) and the banks. The underlying issues in the debate are the structure of central banking and the manner in which the full faith and credit of the Federal Government is to be exercised.

The pledging of the government's faith and credit took place in the aftermath of the massive debt deflation of 1929-33.¹ The specialized deposit insurance agencies were created in response to the perceived failures of the Federal Reserve in this crisis. The reforms of the financial structure in the 1930s aimed to prevent the recurrence of another such crisis.

In terms of the great rules-versus-authorities argument of the 1930s about the use of central bank powers, Federal deposit insurance substituted certainty, or a rule, for the recently unreliable, discretionary, and perhaps wrong-minded interventions by the Federal Reserve.² In recent years, however, the FDIC and the FSLIC have not followed set and sure procedures in response to the failure of insured institutions. They have used considerable discretion in the resolution of institutional insolvency. One of the proposals that emerges in what follows is that Congress rescind the discretion permitted the Federal deposit insurance agencies; deposit insurance should be an isle of

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certainty in a turbulent, uncertain world. Discretion is reserved for the Federal Reserve, the Treasury and the Congress.

Finally, the aptness of any reform depends not only upon its content but also upon the economic and financial conditions that rule when it is introduced. The introduction, in today's environment, of risk-adjusted premiums or capital requirements and greater public disclosure of problem institutions, that are among the proposals to reform deposit insurance, would make it more, not less, likely that insurance payoffs will be required. In addition, these reforms would increase system instability. A stability-enhancing response would be for Congress to accept that it has an open-ended, contingent liability and to set in place a well-funded, institutional structure to fulfill its obligations.

Like the problem of the traveller who, having ridden safely across a rapid and turbulent river on the back of a tiger, must now get off without being eaten, the dilemma in deposit insurance reform is how to increase the robustness of the financial structure without precipitating catastrophic instability.

I. The Agenda For Reform

Although deposit insurance has been in place since 1934, problems with this structure have only become apparent in the past 15 years as the size and number of failed banks and thrifts have risen sharply. A major concern reflected in proposed reforms is the exploitation by deposit institutions of the risk transference made possible by the structure of deposit insurance. Insurance makes institutions more willing to take risk because premiums are not risk-adjusted and, in many cases, all depositors are protected. This lowers the marginal cost of risk, increases the quantity of risk and, as a result, raises the proportion of insured institutions that are likely to become insolvent and require a payoff by the insurer.³ The cost of these payoffs is transferred to less exposed institutions through higher insurance premiums.

Risk transference is part of the problem of moral hazard implicit in any insurance contract. Moral hazard arises in an insurance contract because insurance reduces incentives to prevent the condition that results in a pay-off, i.e. start a fire, have a baby, become unemployed, etc. The deposit insurance guarantee may reduce both the likelihood of a run and the efforts of management to prevent one. Management may become more careless about risk exposure.

A related issue is that management may respond to losses in a perverse fashion in the presence of deposit insurance protection. If equity is impaired by losses, then the ratio of assets controlled to the market valuation of a stock thrift or bank will become high. Management may "bet the bank" rather than retrench in order to recoup losses. Another variant of this same theme is that incentives are present for bank managers to convey the assets of the institution

to their own private "purses". Such an institution survives only because of deposit insurance protection.

The view that deposit insurance will be exploited is not new. At the time of the passage of the Federal Deposit Insurance Act in 1933, Irving Fisher proposed risk-adjusted premiums and the Bankers Magazine argued that bankers would become careless under the protection of deposit insurance.⁴ Peltzman found a negative association in the mid-1960s between capital investment and the proportion of deposits insured.⁵ He concluded that banks were substituting deposit insurance for bank capital. More recently Kane has argued that flat rate premiums subsidize risk, allowing banks to increase risk (and expected return) without paying an appropriate premium.⁶

Suggested solutions to the moral hazard problem are similar to those used to contain moral hazard in other types of insurance contracts. They include the imposition of risk-related premiums or capital requirements, coinsurance by depositors, reduced willingness to keep an insolvent institution open, and increased public disclosure of the condition of the insured institutions. It is argued that the proper pricing of risk will reduce the level of risk exposure in the banking system to reflect the premium costs of increased exposure. Because this approach assumes that responses to price changes are stabilizing, appropriate prices will prevent risk-augmenting behavior. The adverse repercussions of assessing higher costs on risk-exposed banking institutions in a fragile financial structure are considered implicitly to be insignificant.

Most proposals see the difficulties that lead to insurance payoffs or interventions as arising because some institutions are able to free-ride on deposit insurance. The theoretical perspective is that the increase of risk exposure is idiosyncratic; that is, exposed institutions have been naughty or incompetent. If the behavior of these institutions is changed by altering incentives, then the developing crisis in deposit insurance can be averted.

None of the arguments for reform adequately explains why risk transference and moral hazard are problems today whereas they were insignificant in the first 40 years after the institution of Federal deposit insurance. What is missing from these proposals is a theoretical framework that analyzes the sources of banking instability.

II. Sources of Banking Instability

The instability of banks and other financial institutions is usually described in terms of runs and defaults at particular institutions without a clear explanation of why such strong asset substitution quite suddenly becomes the rule of the day.

When conceived in terms of bank runs and defaults, a particular bank fails because of its own, idiosyncratic attributes. Its management has been incompetent or committed fraud. Such a failure may have repercussions on other banking institutions, in that for a

time financial markets fail to work normally. This creates transitory refinancing problems for otherwise solvent banks. If refinancing problems persist and are sufficiently severe, they can cause a drop in asset prices large enough to cause otherwise solvent banks to fail. Thus, in the absence of intervention, idiosyncratic failures can trigger an epidemic of bank failures, imparting an adverse "depression-creating" shock to the economy. Interventions that prevent the spillover of refinancing difficulties by assuring that refinancing remains available can abort the potential contagion and subsequent depression. This is what the discount window at the Federal Reserve was set up to do.

Whenever bank failures are due to idiosyncratic behavior, actuarial estimates of the probability of payoffs are possible. In such cases, the insurance model is applicable and the proposed reforms of the structure of deposit insurance could be beneficial.

A more complete description of the instability of an "economy with banking" needs to look behind the runs and analyze the structure of balance sheets, payment commitments and position-making activities. Position-making for a bank consists of the transactions undertaken to bring the cash position to the level required by regulation or bank management. In the position-making view, bank failures do not arise simply because of incompetent or corrupt management. They occur mainly because of the interdependence of payment commitments and position-making transactions across institutions and units.

The shift in position-making from trading in liquid assets in the 1960s to transactions in liabilities in the 1970s was accompanied by a decrease in the margins of safety used to cushion fluctuations in the cash flows. As a result, payment commitments have become more closely coordinated with payment receipts so that small changes in conditions can cause a large increase in the need for units (households and businesses who are indebted to banks and banks that are indebted to depositors) to acquire cash by selling assets that may have thin markets. As asset sales in thin markets become necessary, the value of liquidity is enhanced and relative asset values change. Institutions that do not initially have a need for increased liquidity desire to increase their cash position as the market value of their assets declines. The fall of asset prices and the "tightening" of normal sources of financing are, in this view, the essential ingredient in financial crises and the process that leads to a deep depression.⁸

Why have margins of safety been narrowed with the introduction of financial innovations? In the position-making view, fragile financial characteristics of debtors, creditors and deposit units, such as we now observe, result from the evolution of asset and liability structures over periods of "good times". These evolved characteristics are responsible for deposit institution instability. While failed units will tend to be statistical outliers when examined *ex post*,⁹ many of the characteristics associated with insolvent firms, households

and banks would have been evident for entire classes of financing units *ex ante*.

In this framework, crises are not due to the special characteristics of any institution; crisis-prone situations emerge out of the normal profit-seeking activities of borrowers and lenders. The shift in the financial posture of units from hedge to speculative (rollover) and Ponzi (capitalizing of interest) characterizes the evolution from a robust financial structure, where most failures are due to idiosyncratic attributes, to a fragile one, where systemic conditions are responsible for a large number of failures.

The payoffs needed to contain a systemic crisis cannot be determined by a calculation of probabilities. The underlying relations that lead to payoffs cannot be forced legitimately into a "known risk" framework. Furthermore, the potential dollar amount of the possible payoffs from a systemic crisis would overwhelm any existing or feasible insurance reserve. This is what has happened to the FSLIC.

In a crisis due to systemic conditions, the need to sell assets to make position causes a fall in the prices of assets and decreases investment. Investment is determined by the prices of assets relative to the prices of current output. The former needs to be higher than the latter for investment to occur. A fall in asset prices relative to current output prices curtails investment. As investment decreases, profits of banks and businesses decline. This further decreases asset values.

A system-wide decline in asset values cannot be contained by a guarantee or bailout of some restricted class of deposits or institutions. If instabilities that can generate large, system-wide losses of output, employment, and asset values are to be contained, more than deposit insurance is needed. Federal Reserve interventions to maintain asset values and Treasury deficits large enough to sustain profit flows are necessary.

These two views of bank instability and the role of deposit insurance reflect the differences between "normal" and "depression" failures.¹⁰ "Normal" bankruptcies result from idiosyncratic attributes of individual banks while "depression" bankruptcies arise from systemic conditions that make entire classes of institutions vulnerable.¹¹ For "depression" or systemic bank failures, deposit insurance is viable only because it embodies a government guarantee. The conditional liability accepted by the government in 1934 is being presented for payment in 1987.

III. The Purpose of Deposit Insurance

Let us assume that an economy is a system that has the potential to exhibit explosive, self-reinforcing instability such as took place in the Great Depression of 1929-1933 and in various hyperinflations.¹² Apt interventions succeed in stabilizing such an economy.¹³ This diminishes the risks (uncertainty) associated with any liability and asset structure for borrowing units and owners of

real or financial assets. Units will recognize the stabilizing effects of the interventions with a lag. As this recognition spreads and is reinforced over time, asset and liability structures evolve to reflect the increased confidence bankers, borrowers, and depositors have in the stability of the system.

The belief in increased system stability is likely to lead to a greater willingness to acquire risky assets¹⁴ and to reduce the margins of safety that underlie decisions to borrow and lend.¹⁵ It follows that the asset and liability structures of insured financial institutions and their depositors and borrowers are different in 1987 than they would have been if there had been serious failures in recent years in which depositors had not been protected; income, employment, prices and profits are also different.

In a stable and predictable environment, financial innovation is a fact of economic life.¹⁶ Modern financial systems, reflecting the operation of profit-seeking financial "entrepreneurs", create new assets and liabilities that tend to overcome the reluctance to invest and to finance. One achievement of deposit insurance, along with stability provided by fiscal and monetary policy, has been to decrease the risk aversion that can be a barrier to investment and which can prevent the economy from realizing a close approximation to full employment. By stabilizing the flow of deposit liabilities into and out of deposit institutions, deposit insurance facilitates the financing of long term investments with short term instruments.

But attenuation of risk aversion involves systemic moral hazard. As the risk aversion of entrepreneurs, financiers and the ultimate holders of assets is diminished, the likelihood increases that payoffs by the insurance agencies will be needed.¹⁷

IV. Problems with Proposed Reforms

Our perspective is that the present problems of banks and thrifts are due to the evolution of system characteristics over the years since World War II, an evolution that has radically changed the extent of financial layering and the relation between payment commitments and cash flows required to validate those commitments. This evolution has been associated with increasing risk in financial intermediation, independent of the structure or existence of deposit insurance. As a result, an initially robust financial structure has become fragile. In this view, the current problems of deposit institutions and insurers are systemic.

Proposals to alter the structure of deposit insurance are intended to contain the relative risk-exposure of individual institutions. But in the current environment these changes are likely to feed back to all institutions. In a dynamic, innovative, profit-seeking economy with a complex financial structure, reforms to reduce exposure that are put in place in one period will be overridden by the tendency for the entire system to take more risk as the system successfully avoids financial trauma.

The Weakness of Examination Procedure

In order to implement risk-related premiums or capital requirements, fallible bank examiners must define risk classes, assign units to risk classes and determine appropriate premium differentials. Any weakness in bank examination procedure will be impounded into the risk premiums. To the extent that the examination procedure lags rather than anticipates financial innovation, higher insurance premiums on what examiners take to be riskier institutions may not be a deterrent to risk-taking. In an expanding economy the increased cost of doing business caused by higher deposit insurance premiums will be an incentive for banks to invent new, unregulated forms of financing. Anticipatory vigilance upon the part of the regulators is required to prevent increased risk exposure. But such vigilance, combined with intelligence, could contain particular unit risk exposure without the imposition of risk-related premiums or capital requirements.

Rather than grappling with the problem of determining the appropriate class of risks, the deposit base upon which each institution is assessed could be altered. Currently, banks are assessed on the basis of *domestic* deposits. A small bank with mainly domestic deposits could conceivably pay the same premium as a megabank funded predominantly with foreign, uninsured deposits. Moreover, the megabank would be more likely to be bailed out or merged than the small bank, further reducing the implicit cost per dollar of deposits guaranteed. Sprague argues that foreign deposits be included in assessing insurance premiums.¹⁸ In terms of equity, this proposal has merit. It would reduce the subsidy to large, multinational banks.

The Pro-Cyclical Effects of Reform

All the proposed reforms raise operating expenses or reduce profits of banks that examiners find to be in a higher risk class. Raising the operating costs of banks who, because of changes in systemic conditions, have become riskier will only make those institutions more vulnerable to failure. Risk-related premiums or risk-adjusted capital requirements would be pro-cyclical, worsening the condition of banks just when other operating costs are rising and profits are being squeezed. If implemented at all, risk-related premiums should be adjusted downward for systemic conditions even as they are raised for the presumed riskier institutions.

The Insurers Retain Discretionary Power

The Federal insurance agencies do not administer deposit insurance as insurance for depositors but as a mechanism to insure the safety and soundness of the U. S. banking system. One of their goals is to prevent bank failures.¹⁹ In this sense, deposit insurance is more like a performance bond rather than an insurance contract. Until these two functions are made independent--that is, the need to insure the safety and soundness of the entire system is separated from the protection of depositors and sound institutions from bank runs--the

discretionary actions of the deposit insurers will continue to allow for the exploitation of deposit insurance.

The Effects Reform would be Temporary

None of the reforms creates a mechanism to correct for disaster myopia.²⁰ Disaster myopia is the tendency for the subjective probability of disaster to decline with the passage of time as the experience of the previous disaster recedes from memory. Bank managers, depositors, stockholders and regulators share in assigning declining probabilities to a financial disaster. This is represented by the collective belief that "It Can't Happen Again", or better "THEY Won't Let It Happen Again".

The structure of deposit insurance and countercyclical monetary and fiscal policy that are used successfully to contain a crisis in one period are not likely to permanently stabilize a monetary economy in which financial innovations occur in response to profit opportunities. Recent innovations in the securitization of assets and the globalization of finance have introduced risks of financial dislocations that are only peripherally related to those the authorities are set up to handle.²¹

V. Institutional Considerations

In any evaluation of institutional reform it is necessary to know where the economy is. Effective deposit insurance depends not only upon the condition of depository institutions and the insuring agency but also on the cooperation of the Federal Reserve and the Treasury. This is particularly true if the problems that need to be faced are the result of systemic conditions.

The Condition of the Depository Institutions

Bank closings have been increasing since 1981. In 1982, 42 banks closed, 48 in 1983, 79 in 1984, 120 in 1985, and 138 in 1986. So far in 1987, 71 banks have failed.²² These statistics reflect the highest number of failures since 1940 when 48 institutions closed. (A similar experience rules for the thrifts). In contrast, from 1943-1973 the maximum number of failures in any year was 9, with an average number of failures being 5.5 per year. The failure rate for the 30 year period from 1943-1973 was .04%.²³ In contrast, the failure rate has risen to over 1% in recent years.²⁴

The number of problem banks also rose from 217 in 1980 to 1306 as of July 1986. Problem institutions represented 1.39 percent of total bank assets in 1980. As of 1986, they contained 12.53 percent of total bank assets.²⁵ The mere recitation of the magnitude of the problem is evidence that what we now have is systemic.

The unprecedented increase in bank closings has taken place during an economic expansion. This is atypical. Bankruptcies usually decline as the economy grows.²⁶ A number of special factors, including the the collapse of energy and farm prices, the decline of

commodities prices and the third world debt defaults have been blamed for the recent rise in bank failures.²⁷ The sharp rise in interest rates in the early 1980s and the subsequent decline in asset values, especially real estate, have been associated with higher rates of insolvency of the thrifts. Increased competition associated with financial deregulation is also attributed a role.²⁸

The current crisis cannot be understood by taking the short view, however. The financial condition of the deposit institutions in the early 1980s was the product of the financial innovations that have occurred since the end of World War II. The fragility of the deposit institutions is not the due to special, transitory factors but the result of a financial structure that has been evolving for many years.

The Condition of the Insurers

The FSLIC is insolvent and needs an infusion of funds. The current Congressional view seems to be to keep FSLIC independent and infuse some \$5 or \$7.5 billion into the fund. The FDIC is also vulnerable. A strict mark-to-market approach to bank asset valuation and the prompt liquidation and pay off of all insured banks that fail a mark-to-market solvency test is likely to be beyond the current resources of the FDIC. FSLIC is overtly, and FDIC covertly, bankrupt.

Bank failures drain deposit insurance reserves. In order to maintain fund reserves and keep insurance premiums low, the insuring agencies have preferred to avoid liquidation of failed banks, especially in the case of large institutions. Purchase and assumption of insolvent institutions whenever possible has been viewed as the least costly approach by the insurers. This means that institutions with literally nothing to lose remain open while the insurers search for an "assuming" institution. The moral hazard of this procedure is in the headlines.

Fear of initiating a major financial crisis by permitting the failure of a megabank or a giant thrift is another reason why regulators tend to reorganize and merge rather than liquidate failed institutions. Regulators do not have data to know how a megabank liquidation and payoff would affect other financial institutions and the economy. As a result, the FDIC and the FSLIC may have been too protective of uninsured depositors and creditors.²⁹ Regulator fear of triggering a crisis is reflected in the bailout of Continental Illinois. In order to prevent a run by uninsured depositors on other banks, all non-equity liabilities of Continental were protected.

One result of the whiplashing that banks and the thrifts have taken in the 1980s is that mark-to-market net worth is in many cases lower than the published book. Avoiding marking-to-market may be the result of a "conspiracy" by managers and the insurers to keep otherwise bankrupt institutions open. If neither higher costs nor the fear of crisis-creating consequences had constrained regulators, many institutions that are now open would either have been merged into other institutions or liquidated.

If the institutions that are being kept open, even though they have little positive or even a negative net worth, are stock companies then the market value of the shares is likely to reflect the mark-to-market value of assets. In this case it is possible to gain control of assets that are a very large multiple of the investment necessary to control a bank.

In a sense it always pays for those who control a corporate bank to convey the assets to their private purse. Law and ethics constrain such behavior. Partnerships with their unlimited liability are a superior form of organization of banks in an economy with a normal quota of scoundrels. As we have a normal quota of scoundrels, the technique of keeping otherwise insolvent institutions afloat is an invitation to larceny. The insuring agencies now are taking large losses due to the conveyance that occurs as failing institutions are kept afloat.

Depositor surveillance and bank examination are substitutes for unlimited liability. The authorities must be aware of the conveyance problem in examining and supervising banks and deposit institutions whose market or mark-to-market value is far less than the norm. In this view the function of the market value of bank shares, which depends upon the value placed on assets, is to give stockholders an interest in preventing conveyance. Once capital is significantly impaired, the only loser from the "looting" of an insured depository institution is the deposit insurance fund.

The interest of the insurance fund is best served by closing and liquidating institutions that fail a capital adequacy test when marked-to-market. It is also in the interests of the economy, for looting does not lead to an efficient allocation of resources. One implication of this policy rule is that institutions would disappear. A corollary to this rule is to ease entry, especially de novo chartering.

The Position of the Central Bank

The ability and willingness of the central bank to accommodate demands for liquidity by troubled banks through the discount window either prevents or forestalls bank insolvency. This buys time for insurers to reorganize, merge or liquidate problem institutions. Therefore Federal deposit insurance depends upon a lender of last resort to provide liquidity to insured institutions when failure rates rise unexpectedly. The infusion of Federal Reserve credit into failing institutions is an indirect, bridging loan to the deposit insurer.³⁰

Provision of liquidity to a small number of problem banks causes no problem for the central bank in terms of other policy objectives. Conflict with other policy objectives, including stabilizing the value of the dollar in foreign exchange markets, lowering domestic unemployment and containing inflation, arises if the banking system as a whole requires liquidity.

If monetary and fiscal policy fail to offset the contractionary effects of the increased costs of bank risk-taking due to a change in risk-related premiums, a recession is likely to develop. Risk-related

premiums and risk-adjusted capital adequacy that increase with the fragility of the system are likely to increase banking instability rather than reduce it. More banks would be on the problem list and marginal institutions would be forced into insolvency. If these marginal institutions are megabanks, bailouts would need to take place.

The Role of the Treasury

The Congress, administration, Federal Reserve, insuring agencies, and client organizations are struggling with how the Treasury is to meet its full faith and credit responsibility. According to law the full faith and credit commitment applies only to the mandated \$100,000 per depositor. Havoc would ensue if that were to become the rule in the present circumstance. Let us make the thought experiment and assume that an amendment to the legislation to refinance FSLIC included instructions that deposit insurance agencies liquidate all banks and thrifts with inadequate capital and pay off only \$100,000 per depositor. The ensuing panic would be quick and severe, and would force the withdrawal of the amendment.

The Treasury funds that are needed to make the banking system whole may well exceed the \$25 or even the \$40 billion that is being bandied about. Given the size of the Federal debt, \$25 or \$40 billion is really not that much. Viewed as an increase in government spending, it smashes the Gramm-Rudman limits.

A massive infusion of funds to insurers combined with a mark-to-market rule for banks would lead to a wave of liquidations and payoffs, decreasing the number of banks. This would leave the insurers with a massive debt to the Treasury and a huge holding of diversified, non-performing or marked down assets. Deposit insurance makes it unnecessary for units with negative net worth or even with current operating losses to sell performing assets in order to fulfill payment commitments. Bad as the situation may be where non-performing assets have led to the erosion of book value equity, it would have been much worse if failing units had been forced to market performing assets in an attempt to meet payment obligations. Institutions that are in good condition owe their positive equity to the asset values that have been sustained because deposit insurance prevented the dumping of assets.

In liquidating and paying off failed institutions, it is necessary for the insurer to keep their assets off the market. Given the magnitude of the problem, it might be necessary to reinvent the depression-era Reconstruction Finance Corporation (RFC) to replace both the management consignment programs that FSLIC is now using to keep insolvent institutions operating and the purchase and assumption programs that insurers use to finance the consolidation of the financial services industry.

In a structure with an RFC, the insurers could resolve a bank failure in one of two ways: 1) liquidate, pay off and take over the assets of the failed institution or 2) obtain a capital infusion from the RFC. Liquidation would be the rule if the size were modest, if

numerous alternatives existed, or if *de novo* entry would be likely to occur. The aim of the RFC would be to create a viable institution which could be privatized within a relatively short period of time. The RFC would be a formal mechanism in which to administer bankruptcy.

VI. Conclusions

Our present financial structure is the result of an evolutionary process that started from the initial conditions that ruled at the end of World War II. This evolution took place under a deposit insurance regime where it was not necessary to distinguish between deposit insurance as a bond against fraud and gross incompetence and deposit insurance as a government pledge that the generalized losses of a financial crisis will not occur. It may be true that a financial crisis has become more likely because deposit insurance was in effect during this process. We must also recognize that we, the economy in general, benefited. The forty years since World War II is a unique period in which a serious depression did not occur. Deposit insurance, by instilling confidence in the banking system and containing incipient crises, has played an important part in this achievement.

In the first 20 years of the post war period, the pledge of the full faith and credit of the government in support of insured liabilities was not required. The structure of the financial system was robust and deposit insurance reserves were sufficient to cover the payoffs associated with the infrequent, idiosyncratic bank failures that occurred. The main deposit insurance issue today, however, is that the full faith and credit of the Federal government has been called on. Bank failures associated with systemic conditions have increased the actual and expected claims on insurance reserves so that depositor confidence in the banking system now rests on the belief that deposit insurance liabilities are ultimately Federal government liabilities.

The open and above board way to handle the current problem is by a cash infusion from the Treasury that is big enough to enable the funds to pay off and close institutions with negative net worth. This would be combined with an RFC to handle institutions that are deemed too "important" or too large to liquidate. This cash infusion should not be financed by an increase in the depository institutions' insurance fees. In today's fragile and complex financial structure, the imposition of higher costs on the deposit institutions would be destabilizing. The costs should be general government costs, a tax we pay for the public good of avoiding a serious depression.

The answer to the question of how to get off the back of a tiger is, first, assess the nature of the beast and then, proceed very carefully.

FOOTNOTES

- 1 - Fisher, Irving. "Debt Deflation Theory of Depressions", Econometrica 1 (1933), pp. 337-357.
- 2 - See Henry Simons, "Rules versus Authorities in Monetary Policy", Economic Policy for a Free Society (Chicago: University of Chicago Press, 1948) and Milton Friedman and Anna Schwartz, The Great Contraction. (Princeton: Princeton University Press, 1965).
- 3 - Kane, Edward J. The Gathering Crisis in Federal Deposit Insurance. (Cambridge, Mass.: The MIT Press, 1985).
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PUBLIC POLICY TOWARD FAILING INSTITUTIONS:
THE LESSONS FROM THE THRIFT INDUSTRY

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Much has been said about problems in commercial banking and what can be done about them. But the problems of the bank pale in comparison with those being experienced by the thrift industry, in particular by savings and loan associations. This session will take a look at what lessons can be learned from the thrift crisis that may be useful in structuring public policy to deal with financially troubled commercial banks.

But first we have to convince people that there really is a thrift crisis and that it is a serious one. There is an old saying that "one should not fix something until it is broke." Well, the savings and loan industry is now broke (in more than one way) and needs to be fixed now. The deficit in the industry -- the difference between the market value of the assets of all SLAs and the par value of their deposits, almost all of which are de jure insured -- is estimated to be around \$40 billion. Some 450 associations are currently insolvent when measured according to generally accepted accounting principles (GAAP), which does not recognize losses until assets are actually sold. More than 700 associations are insolvent if we applied economic or market value accounting. The \$40 billion necessary to resolve the insolvencies is well beyond the FSLIC's currently available resources. The FSLIC itself is economically insolvent. And unlike the ever larger aggregate deficit and larger number of economic thrift insolvencies of the early 1980s, which were attributable to interest rate risk, today's deficit and insolvencies are almost entirely attributable to credit risk and are unlikely, under almost any reasonable scenario, to be reversed in the near future just by the passage of time.

To me this spells crisis, and one that is in bad need of repair. But despite these numbers and the recent experience of Ohio and Maryland, few public policy makers are urging major repairs and few members of the public are urging them to do so. Just today, the U.S. House of Representatives cut back sharply on the size of the proposed FSLIC recapitalization, which was too small to begin with. How could this be? One reason may be found in another saying, one that is often used at times of