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Mutual Deposit Insurance?

In 1989, mounting losses at weak and failing thrifts (at the rate of $1 billion per month) shocked the public and led to passage of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in August 1989. (The *Letters* of December 1, 1989, and January 19, 1990, discuss provisions of FIRREA.)

This legislation sought chiefly to resolve the immediate crisis of insolvent thrifts, and did not address its root causes. Unfortunately, however, FIRREA may prove insufficient even to take care of the immediate problems at all the troubled and failing institutions. Estimates of the total cost of the bailout now run as high $500 billion.

Clearly, more needs to be done to resolve these problems. However, it is equally important that the root causes also be addressed. If substantial changes in the deposit insurance system are not made, the current bankruptcy crisis may be repeated some time in the future.

To contribute to the debate concerning the best way to reform the deposit insurance system, this *Letter* briefly describes a variety of proposals and then offers one that has not received much attention, namely, that government-sponsored insurance be replaced by a mutual insurance program in which banks and thrifts would monitor each other's loans and investments and guarantee each other's deposits.

The current environment

Deposit insurance protects depositors' funds in the event the depository institution fails. However, the very fact that deposit insurance protects depositors means that the threat of deposit withdrawals no longer exercises discipline on the managers of banks and thrifts.

In theory, uninsured liability holders still provide market discipline since the government explicitly insures bank and thrift deposits only up to $100,000. In practice, however, the federal deposit insurance funds generally have extended insurance protection to *all* deposits and even to non-deposit liabilities. For example, in bank failures resolved through purchases and assumptions, the Federal Deposit Insurance Corporation (FDIC) generally has reimbursed most liability holders, including depositors whose accounts exceed the $100,000 limit. Moreover, in a recent decision, the FDIC agreed to insure pension fund deposits totaling tens and hundreds of millions of dollars by construing the $100,000 limit to apply to each individual beneficiary of the pension fund, not to each bank account.

The lack of market discipline poses a particularly serious problem in the case of institutions with low or negative net worth. These institutions have a clear incentive to undertake risky investments since their owners enjoy the benefits when the investments do well, and yet bear little or none of the costs when the investments fail. This "heads-I-win, tails-the-taxpayer-loses" implication of government-sponsored deposit insurance has played a major role in generating the current crisis, particularly since the personal liability of bank and thrift owners is legally limited to the value of their investment.

Given these incentives, the deposit insurance system can serve the interests of both depositors and taxpayers *only* if regulators are able and willing to shut down institutions *before* the net worth in those institutions actually turns negative.

The recent thrift crisis suggests that prompt closure of financially weak institutions cannot be taken for granted. In certain instances, political considerations prevented prompt intervention. Unforeseeable events like the collapse of the oil economy in Texas, which bankrupted many thrifts, played a part. The thrift regulators also have been critically understaffed. Finally, the limited resources of the thrift insurance fund itself curtailed the ability of regulators to act promptly. Accordingly, the thrift regulators were

poorly equipped to intervene as promptly as would have been required to safeguard the public interest.

Reform proposals

The fact that resolving the thrift crisis comes with such a high price tag does not mean that government-sponsored deposit insurance can never work without imposing a substantial burden on taxpayers. Capital requirements already have been raised, giving regulators more time to shut down capital-deficient institutions before they become insolvent. Greater use of (uninsured) debt also has been advocated as a way to insulate the insurance funds and, hence, the taxpayer from underperforming assets. Both of these changes diminish the incentive to take excessive risks. However, these reforms can be effective only if accompanied by vigorous regulatory and enforcement efforts. Even then, however, success would not be guaranteed, so it is worthwhile to consider other proposals.

The most drastic proposal is to do away with deposit insurance altogether. This measure would protect taxpayers, but would necessitate that depositors assume the risk of loss and monitor the solvency of the thrift or bank they choose as a repository for their savings. At first glance, it appears that requiring depositors to monitor depository institutions is inefficient because it would entail much duplication of effort. However, monitoring the financial condition of publicly-held thrifts and banks probably would not be particularly burdensome since information on the condition of these institutions is readily available and, presumably, is captured in share prices. Thus, the monitoring effort may involve little more than checking stock prices for abnormal drops. Many worry, however, that eliminating deposit insurance may reintroduce the problem of destabilizing runs on institutions. In any event, such a proposal probably is not feasible from a political standpoint.

Another proposed change would be to enforce the $100,000 limit on deposit insurance by requiring the FDIC to dispose of failed institutions in such a way that uninsured liability holders do not receive *de facto* protection. Some have even advocated reducing the *de jure* limit to $25,000 or $10,000, and have suggested that the limit be applied to each person rather than to each account held by a given person at different institutions. Advocates of this change contend that small depositors would remain protected, while large depositors, being uninsured, would have an incentive to monitor the riskiness of institutions. The prospect of withdrawals by large depositors would, it is argued, provide the discipline on managers needed to prevent the abuses seen in the recent thrift crisis. Ultimately, such a proposal will be effective only if the regulators take prompt action against all failing institutions, regardless of size.

A third possibility is to replace government deposit insurance with private insurance. Profit-maximizing insurance companies have strong incentives to monitor thrift and bank investments. Moreover, private insurers have considerable leverage to enforce desired changes on the part of bank and thrift management since they can terminate insurance coverage more promptly than a government insurer can.

However, private insurance is not without shortcomings. For example, the experience with medical insurance, where the insurer can monitor and discipline the practices of doctors and hospitals only with great difficulty, indicates that cost containment might pose serious problems.

Mutual insurance

A fourth possibility is to institute a system under which thrifts and banks collectively insure themselves. Mutual insurance differs from government-sponsored insurance in that the insured institutions themselves bear primary responsibility for monitoring capital adequacy. Depositors at failed institutions would be reimbursed from funds supplied through premiums paid by the member firms. In the event of widespread failures, additional assessments would supplement these funds to guarantee the adequacy of the reserves.

The attractiveness of mutual insurance stems from the fact that the depository institutions themselves are better equipped than anyone to detect and evaluate the extent of problems at their sister institutions. Further, they have the incentive to act promptly since the solvent institutions are ultimately responsible for the insolvent ones. Moreover, the fact that managers of thrifts have been far more successful in acting in the interest of thrift owners than regulators of thrifts have been in safeguarding the public

interest argues in favor of mutual deposit insurance over government-sponsored insurance.

But mutual insurance can succeed only if the insuring group has the power to terminate the insurance coverage of those institutions experiencing difficulties. In other words, solvent institutions must be able to shut down insolvent ones. There is a clear potential for abuse here, since solvent thrifts and banks have an incentive to eliminate competitors whether insolvent or not.

Also, legal difficulties may need to be overcome. Insolvent thrifts and banks should not be able to use the legal process to block termination of coverage, nor should they be allowed to engage in time-consuming appeals which impose long delays in the closure process.

To see whether mutual insurance might be workable, it is useful to look at the experiences of banks in the states that adopted mutual insurance plans prior to the establishment of federal deposit insurance. The experience with these plans is not uniformly favorable. For example, a study by Charles Calomiris provides some evidence that insured banks used the insurance protection to expand at unrealistically rapid rates during peak periods of prosperity, and subsequently experienced high failure rates when the prosperity ended. This apparent tendency to encourage excessive expansion was, of course, exactly the problem with government-insured thrifts in the decade just ended.

However, most of these state mutual insurance plans are not directly comparable to the kind of plans proposed today, and a comparison of the failure rates of institutions that participated in these mutual insurance programs with those that did not participate is highly misleading. First, these state plans were not nationwide in scope, implying insufficient risk-pooling, particularly in undiversified agricultural states. Second, many state plans were voluntary and allowed banks to exit at their own discretion. In a voluntary system, only the weakest banks tended to remain when problems arose since these were the ones with the most to gain from continued participation.

Also, the banks that participated voluntarily in these mutual insurance schemes had little incentive to force changes in the risk-taking behavior of the other members of the pool since the option of withdrawing generally was available to the solvent institutions. Indeed, several voluntary mutual insurance plans ended because the solvent members withdrew, and this led to losses for (supposedly) insured depositors. These problems with state mutual insurance plans are easily overcome by making mutual insurance mandatory.

Others have suggested that the experience with branch banking prior to the introduction of federal deposit insurance provides useful evidence on the potential benefits of mutual insurance. They argue that mutual insurance is similar to a bank with geographically-dispersed branches since both diversify risks and pool capital over a broad geographic area. In view of this similarity, they suggest that the lower failure rates of banks in states in which branch banking was permitted relative to those in unit banking states implies that mutual insurance would be an effective means of protecting depositors and controlling risk. During the banking panics that preceded the Civil War, for example, branch banks in several southern states experienced lower failure rates than did unit banks. Also, in the depressed economic conditions prevailing in agricultural states in the 1920s and 1930s, branch banks had lower failure rates and lower loss rates for depositors than did unit banks.

In sum, the evidence regarding the practicability of mutual insurance is not extensive, but it is sufficiently encouraging to warrant a closer look at this proposal. The problems involved in setting up a mutual insurance system, although not minor, seem less onerous than those created by the current deposit insurance system. Although it is not obvious that mutual insurance is the best alternative to the present system, it is one of the possibilities that should be considered.

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