

Chicago Fed Letter

The financial safety net: Costs, benefits, and implications

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On May 9–11, 2001, the Federal Reserve Bank of Chicago hosted its 37th annual Conference on Bank Structure and Competition. This year's theme, "The Financial Safety Net: Costs, Benefits, and Implications for Regulation," focused on the implications of the various explicit and implicit financial safety nets, ranging from deposit insurance and subsidies to government sponsored enterprises (GSEs) to the notion that some financial institutions are "too big to fail." The timing of the conference was opportune in light of the reform measures to the deposit insurance program introduced by the Federal Deposit Insurance Corporation in April 2001, the legislative undercurrents concerning the proposed new regulatory structures for the GSEs, and the slowdown in economic activity coupled with greater financial consolidation resulting from the Gramm–Leach–Bliley Act of 1999. This *Chicago Fed Letter* summarizes some of the issues discussed at the conference.

In his opening remarks to the conference on Thursday, May 10, Federal Reserve Bank of Chicago President Michael Moskow set the stage when he stated that the "general public has a better understanding of the benefits than the costs" of the financial safety net because of the positive connotations the term conjures. But, he suggested that "any thorough discussion of the financial safety net should include an analysis of both the implicit and explicit guarantees, the means by which those guarantees are delivered, and the changes in behavior resulting from those guarantees."

Key questions that were addressed during the conference include:

- Has the safety net expanded in recent years? And how has market behavior been altered as a result?
- How should we reform the deposit insurance program to better protect taxpayers from losses and to provide equitable treatment among insured depository institutions?
- What are the financial market distortions emanating from a perceived or actual too-big-to-fail doctrine?
- What are the implicit and explicit subsidies to GSEs, and how should regulatory oversight be handled?

A special theme panel was selected to address these issues, featuring Arthur J. Murton, director, Division of Insurance, Federal Deposit Insurance Corporation (FDIC); Laurence H. Meyer, governor, Federal Reserve System; Robert E. Litan, vice president and director, economic studies and Cabot Family Chair in Economics, Brookings Institution; Kenneth A. Guenther, president and CEO, Independent Community Bankers of America; and Thomas H. Stanton, fellow, Center for the Study of American Government, Johns Hopkins University. In addition to the conference theme panel, several other sessions provided presentations on GSEs and federal deposit insurance reform.

In his keynote address to the conference, Federal Reserve System Chairman Alan Greenspan discussed the central issue behind the explicit and implicit features of the financial safety net. Although the financial safety net has succeeded in "eliminating bank runs, in assuaging financial crises, and arguably in reducing the number and amplitude of economic contractions in the past 60 years ... these benefits have come with a cost: distortions in the price signals that are used to allocate resources, induced excessive risk-taking, and, to limit the resultant moral hazard, greater government supervision and regulation." To minimize the marginal costs of the financial

safety net, Chairman Greenspan warned that policymakers must be "very cautious about purposefully or inadvertently extending the scope and reach of the safety net."

Deposit insurance

The federal deposit insurance program is clearly the most recognized component of the financial safety net and has undoubtedly helped sustain the general public's confidence in the banking system. Since its inception in 1933, it has deterred liquidity panics, forestalled bank runs, and avoided instability in the economy.

This confidence, however, has not been obtained without cost. It has long been known that this feature of the safety net induces moral hazard. Because of the reality and perception that bank deposits are fully protected, banks are willing to engage in riskier activities, insured depositors are less willing *and* able to monitor the activities of banks, and creditors are less sensitive to the risks incurred by banks. Therefore, it is imperative to develop a system that appropriately prices this insurance and the risks associated with providing it.

Murton presented a brief overview of the history of the FDIC insurance fund, focusing on how insurance premiums have changed over the years. The Federal Deposit Insurance Improvement Act (FDICIA) of 1991 required the FDIC to maintain the insurance fund at 1.25% of all insured deposits. It also directed the FDIC to charge risk-based insurance premiums. Many researchers believe that the present system consistently underprices risk by restricting the FDIC's flexibility in setting premiums. The FDIC is prohibited from charging premiums on well-capitalized banks when the insurance fund increases above the 1.25% reserve ratio. The end result is that today, only one bank in 20 pays deposit insurance premiums.

The first concern with the current approach is that premiums tend to be procyclical. Banks are required to pay high premiums when the insurance fund experiences losses in times of economic distress. By diverting earnings to the insurance fund, these premiums would reduce bank earnings at the worst time and potentially restrain economic recovery. Another deficiency in today's deposit insurance system is that it does not allow for a meaningful risk-based pricing system. In good economic times most banks do not pay premiums, while in times of economic crisis, the FDIC will not be able to differentiate between premiums on distressed banks and well-performing banks. Finally, the current system provides an opportunity for newly chartered banks to insure deposits without contributing to the insurance fund. Yet, in times of economic crisis, newly chartered banks are more likely to fail.

Guenther argued that large financial institutions such as Merrill Lynch and Citigroup, are also "free riding" off of the current insurance program. Because Merrill Lynch owns two banks and Citigroup's Salomon Smith Barney owns six banks, their brokerage units are able to shift funds into accounts of federally insured banks. He argued that in the spring of this year, these financial institutions had moved about \$85 billion from their brokerage affiliates into their bank subsidiaries without paying premiums for the coverage.

Deposit insurance reform

Murton discussed the FDIC's recommendations for reforming the Deposit Insurance Fund. First, he suggested that the two funds, the Bank Insurance Fund and the Savings Association Insurance Fund, should merge. Although the two funds provide the same product, they set their insurance premiums separately. This dual insurance fund system increases the possibility that banks and savings institutions with the same level and characteristics of risk may pay different insurance premiums, potentially creating a misallocation of resources. Second, the FDIC proposes indexing insurance coverage to account for inflation. It further proposes that every bank be required to pay a premium every year, while the FDIC would institute a system of rebates and surcharges to

ensure that the insurance fund would not become too large or small. The FDIC's ultimate goal is to reduce the volatility of the insurance premiums by spreading them "more evenly and equitably across institutions."

George Pennacchi, professor of finance at the University of Illinois at Urbana-Champaign, spoke in one of the Thursday afternoon sessions in support of the FDIC's proposal to make deposit insurance premiums more equitable and stable.¹ The key to accomplishing this, according to Pennacchi, is to view a bank's insurance coverage as "multiple long-term contracts whose contract intervals partially overlap." The overlapping feature of the agreement allows the costs of insurance to be smoothed out over time.

Of the proposed reforms, indexing insurance coverage to inflation appeared to draw the greatest differences of opinion. Coverage levels have not been increased since 1980, while the overall price level in the economy has approximately doubled since that time. Guenther argued that neglecting to adjust for inflation essentially "kills" a program that has been essential to the stability of the banking system. In his view, by refusing to increase deposit insurance coverage, policymakers discourage individuals and corporations from using community financial institutions and encourage them to use large financial institutions, thereby increasing systemic risk.

Opponents of increasing insurance coverage argue that raising the ceiling from \$40,000 to \$100,000 in 1980 contributed to the savings and loan crisis, due to moral hazard. Litan noted that there is no political support for such a change, and from a consumer's point of view, it is unnecessary. He argued that people have access to accounts at other banks and, therefore, effectively have access to unlimited deposit insurance. In addition, he argued that an increase is unnecessary given the fact that the average size of a bank account is around \$10,000.

Too big to fail?

In his opening remarks to the conference, President Moskow said that "perhaps the most controversial feature of the safety net is the expectation that large banks may be 'too big to fail'." In order to avoid financial crises,

governments may be willing to bail out financial institutions even without explicit guarantees.

The central question here is whether uninsured depositors and non-deposit creditors of large failed banks should be required to incur losses. When deemed necessary, uninsured depositors and creditors may be made whole in order to prevent a mass flight by uninsured depositors from a large troubled bank. On that issue, Chairman Greenspan stated, "If the government protects all creditors, or is generally believed to protect all creditors, the other efforts to reduce the costs of the safety net will be of little benefit." Most analysts would agree that government should strive to avoid creating the perception that it will bail out large financial institutions so that uninsured bank creditors would not have the expectation that some financial institutions are too big to fail.

Guenther argued that the Federal Reserve, FDIC, and the Treasury have all contributed to the notion that there is an unspoken policy of "too big to fail" and it is up to them to eliminate this perception. As evidence, Guenther noted that depositors at all *major* failing banks have never been forced to incur a loss on uninsured deposits. Many critics also point to the "systemic risk exception" embedded in FDICIA. For example, under the "least cost requirement," bank failure resolutions must be made in such a manner that insured depositors are made whole in a way that is least costly to the insurance fund. This provision puts uninsured depositors and other creditors at greater risk, thereby encouraging them to monitor the activities of banks. While this has served to reduce moral hazard, least cost resolution may be circumvented in the event that such a resolution would "have serious adverse effects on economic conditions or financial stability." Critics maintain that this exemption formally reinforces the notion of too big to fail and undermines efforts to reduce moral hazard.

Meyer, on the other hand, argued that the effects of this exemption are overstated. In his view, the restrictions and limitations on the use of this exemption are adequate. In addition, the exemption does not require that uninsured depositors or creditors be made whole. He also pointed to the fact that of the

82 banks that failed between 1993 and 2000, uninsured depositors did indeed suffer losses in almost three-quarters of the resolutions.

Meyer added that policymakers can do little to reduce the perception of too big to fail other than to set the market's expectations by continuously reiterating that there are no financial institutions that can not be allowed to fail, regardless of size. But he conceded that, ultimately, regulators and policymakers have to perform in a manner that is consistent with these assertions.

Managing banking failures

The nation's last banking crisis during the 1980s brought about reforms aimed at addressing the unintended consequences of the financial safety net. Most adjustments tended to increase reliance on market discipline. Chairman Greenspan stressed the advantage of the reforms as they attempt "to simulate what markets alone might do, or at least create market-type incentives." He discussed the advantages of having banks managed as if there were no safety net present. The reforms, however, have not been tested during a period of economic distress.

Many of the participants agreed that one approach to avoid a bail out is to ensure a greater cushion of capital in financial institutions through revised capital standards. As institutions encounter difficulties, their losses would be absorbed first by bank capital. Therefore, a strong capital position is needed to deal with unexpected losses and to provide a countervailing force to moral hazard.

Currently, capital standards are being revised under the Basel Committee, a committee of regulators from 13 nations. Litan argued that many flaws exist with the proposed revisions. He noted that they are incredibly and needlessly complex, arbitrary, and do not rely sufficiently on market discipline. Of particular concern in the revisions, Litan said, was the fact that they effectively lower the largest banking organizations' required capital ratios. Responding to Litan's comments, Meyer acknowledged the complexity of the proposed reforms, but insisted that they reflect the reality that large banking organizations engage in a wide range of banking activities.

In Meyer's view, the new Basel Accord "should strike a better balance of requirements versus recommendations." Although he agreed that certain items such as capital ratios should be required to be disclosed, he also supported efforts to increase voluntary disclosure of credit management, credit risk, and trading positions at the largest and more complex financial institutions.

Government sponsored enterprises

GSEs are special purpose corporations chartered by Congress to carry out a specific mission. Because many GSEs are large, complex, and some would argue, risky organizations, many observers believe that they should have increased disclosure requirements and additional regulatory oversight. Although six GSEs exist, the conference theme panel focused on the two largest housing finance GSEs, Fannie Mae and Freddie Mac. Both of these institutions, along with the Federal Home Loan Banks (FHLB), were created to provide liquidity for the secondary mortgage market, thereby helping to enhance the flow of funds to finance mortgages.

Because of their government sponsorship and the perception among investors that the federal government will not allow them to fail, Fannie Mae and Freddie Mac are able to borrow money at lower cost than fully private enterprises. They also benefit from tax exemptions, security registration and fee exemptions, and the ability to hold emergency credit lines with the U.S. Treasury. Stanton commented on the lower capital required of GSEs compared with the requirements for other institutions operating in the same market. In his view, "the problem is that this system rewards the firm with the most favorable government charter, rather than necessarily the most efficient firm."

Stanton mentioned several factors that make supervision of the GSEs difficult. GSEs utilize their government subsidies to grow rapidly, they wield strong political influence, and government policymakers do not necessarily understand the complexities of the GSEs or their charters.

While acknowledging that the two housing GSEs benefit from their ability to borrow funds at a lower cost than comparably situated private sector

borrowers, Alden Toevs, executive vice-president of First Manhattan Consulting Group, who spoke in a session on the impact of GSEs on the underlying markets, indicated that GSEs actually pass through more benefits to mortgage borrowers than they retain. That is, the average homeowner receives substantial interest savings through GSEs' activities versus the benefits that GSEs receive from their government sponsorship. In this same session, Wayne Passmore, an economist at the Board of Governors of the Federal Reserve System, presented a model suggesting that, under certain conditions, GSEs can lower mortgage rates for some classes of borrowers. However, he questioned whether this is enough to justify the existence of housing GSEs.

Later in the same session, Mark Vaughan, an economist at the Federal Reserve Bank of Saint Louis, suggested that the FHLB's advances (loans) to depository institutions provide benefits by enhancing the flow of funds to the mortgage market, but these benefits may come at a cost. He expressed some concern about the recent increase in the reliance of commercial banks on FHLB funding. According to Vaughan, "access to advances reduces the effectiveness of market discipline in constraining bank risk-taking, and deposit insurance premiums do not adjust adequately to price the added risk."

Some concern was also expressed that Fannie Mae and Freddie Mac have

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grown so large that they may pose systemic risk to the economy. "Whenever large financial institutions become as large as that, it's reasonable that there ought to be concern," said Meyer. But many, including Meyer, are more concerned about the "resource allocation that comes from the subsidy... and how it is growing over time." As an example of this resource misallocation, Stanton pointed out that, "if we require a commercial bank to back its residential mortgages with 4% capital, while requiring much less capital for a GSE to hold the same mortgage, we create a system of regulatory arbitrage where it's to the advantage of both institutions to shift mortgages to GSEs for funding." Because banks tend to have greater product diversification than mortgage GSEs, this shift of residential mortgages could potentially increase systemic risk. Stanton concluded that as a result of the differing charters between GSEs and other financial institutions, "risk will migrate to the place where the government is least equipped to deal with it."

Reform measures for GSEs

Because the government, in Stanton's view, has shown an inability to adequately regulate the GSEs, he concluded that it needs an exit strategy. "We have created a government sponsored monopoly in the secondary mortgage market ... and the government does not display

significant ability to regulate either the public costs or the public benefits." The main difficulty in any reform strategy is convincing decision-making parties of the costs and benefits of GSEs.

During his luncheon presentation on Friday, May 11, Armando Falcon, Jr., director of the Office of Federal Housing Enterprise Oversight, the agency responsible for regulating mortgage GSEs, indicated that market discipline of GSEs' risk-taking propensity should not be seen as an adequate substitute for formal government regulation. The perceived implicit government guarantee would impede the effectiveness of relying on market discipline alone. In addition, oversight is necessary because the government has a stake in ensuring that GSEs, created to support affordable housing, do not disrupt U.S. housing markets.

In his address to the conference, Congressman Richard Baker, chairman of the U.S. House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, discussed pending legislation that would transfer regulatory authority over Fannie Mae and Freddie Mac to the Federal Reserve System. Although Congressman Baker recognized that his proposal would need modifications, he explained that its main goal is to create a regulatory structure that will be credible in the eyes of the market. It

also seeks to enhance transparency and market discipline as the growth and sophistication of the two largest GSEs increase.

Conclusion

Continual reevaluation of the safety net is important in a marketplace that is becoming increasingly complex through technological innovation, globalization, and increased financial sophistication. Policymakers must recognize that safety net reforms that extend its reach have both benefits from increased industry stability and costs from increased moral hazard induced risk-taking and possible resource misallocation. This delicate trade-off must be given serious consideration before introducing reforms. This year's Bank Structure Conference brought out many different opinions on how best to balance this trade-off and how to move forward.

¹In addition to the theme panel discussion, the conference had several other presentations highlighting the need to reform federal deposit insurance. See Federal Reserve Bank of Chicago, 2001, *The Financial Safety Net: Costs, Benefits, and Implications for Regulation*, proceedings of the 37th Annual Conference on Bank Structure and Competition, forthcoming.