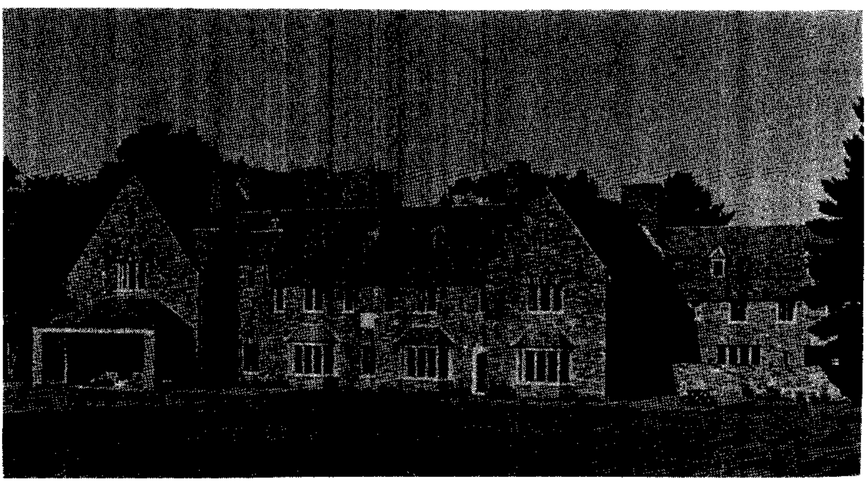
THE COLLAPSE OF DEPOSIT INSURANCE — AND THE CASE FOR ABOLITION

By
Richard M. Salsman



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I.

INTRODUCTION

THE American system of Federal deposit insurance has collapsed under the weight of its internal contradictions and perverted incentives. Left in its wake is a degree of wealth destruction unparalleled in banking history — reckless lending, wasted capital, widespread bank failures, depleted reserve funds, political corruption, and taxpayer bailouts.

Reformers who are groping for solutions to the American banking crisis face a stark choice. They can continue attaching patchwork "life support" systems to the fatally flawed corpse known as deposit insurance, or they can let the system collapse under the weight of its contradictions, thereby permitting safe and sound banking to flourish once again. The regenerative power of the American banking system is great — but it can only emerge in an atmosphere free of the deadening hand of deposit insurance.

The purpose of this booklet is to provide lawmakers and the public an explanation of why Federal deposit insurance has collapsed, why it has undermined sound banking, why it has strained government finances, and what can be done about it. The diagnosis presented, though grim, is realistic. The fundamental nature of the solution — complete abolition of deposit insurance — reflects the seriousness of the diagnosis. No case for abolishing deposit insurance should be made lightly. But the facts warrant nothing less than complete abolition.

Contrary to conventional wisdom, Federal deposit insurance is a fatally flawed system that never worked and cannot be made to work. Recent attempts to incorporate "market oriented" features into what is essentially a socialistic system, while laudable, do not go far enough. They are merely half-hearted attempts to do the right thing, to establish a truly market-based banking system. We can appreciate that the superiority of the market is conceded. But there is no case for going half-way by mixing markets in with statism. Mere tinkering or reform of a fatally flawed system simply will not do. Quick fixes of deposit insurance will only postpone its inevitable demise, further intensifying weaknesses in the banking industry, and further inflating the government's ballooning financial obligations.

The crisis in American banking and the collapse of deposit insurance were virtually ignored by President Clinton during his campaign. But in the spirit of its campaign's slogan, "Putting People First," the Clinton administration should be candid with the American people. The electorate deserve to know the extent of the crisis and to benefit by fundamental solutions. This approach, if adopted, would mark the arrival of genuine change in Washington.

The Nature of the Collapse

After 50 years of seemingly unblemished success, the past decade has seen the complete collapse of the deposit insurance system in the United States. The government deposit insurance funds for both the thrift and commercial banking industries have become insolvent by billions of dollars. Instead of scaling back or abolishing these perverse systems, the legislative response has been to forcibly bail them out with money from taxpayers and surviving banks.

At its peak in 1985, the reserve fund of the Federal Savings and Loan Corporation reached $6 billion, a small fraction of the $700 billion of deposits insured for thrift institutions. By 1989, after a cascade of thrift failures, the fund was estimated to be insolvent by as much as $300 billion ($150 billion on a "present value" basis over 30 years). Legislation passed in that year forced American taxpayers to bail out the system. As the situation deteriorated, government officials consistently underestimated the scope of the problem and the magnitude of the losses. Amidst the rubble, it was admitted that technically insolvent institutions were left open purposely by regulators, exacting greater costs on the fund. Other politicians, such as the "Keating Five" Senators, actively intervened on behalf of renegade thrift operators, allowing them to obtain special treatment from regulators.

As recently as 1987 the reserve fund of the Federal Deposit Insurance Corporation, intended to insure over $1.6 trillion of commercial bank deposits, reached a peak of $18 billion. Even at its peak, the fund covered only 1 percent of total insured deposits and the failure of any mid-sized bank would easily deplete the fund overnight. In fact, with the failure of more than 1,000 banks in the last decade alone (more than occurred in all the years since the Great Depression), the FDIC fund was left in deficit by $7 billion at the end of 1991. As with the thrifts, government officials consistently underestimated the magnitude of the losses at banks, despite warnings from outsiders.[1] Repeating earlier mistakes, regulators also permitted insolvent banks to remain open. The collapse of government deposit insurance has resulted not merely from temporary phenomena, such as a recession or a few bank failures, but rather from severe *structural* deficiencies in the U.S. banking system; that is, from its regulation and subsidization.[2] In fact, deposit insurance has promoted bank failures by promoting reckless practices and bad banking.

[1] "The Banking Industry in Turmoil: A Report on the Financial Condition of the U.S. Banking System and the Bank Insurance Fund," *House Subcommittee on Financial Institutions Supervision, Regulation, and Insurance, U.S. Congress*, James A. Barth, R. Dan Brumbaugh, Jr., and Robert E. Litan, December 17, 1990.

[2] To the extent today's subsidization and regulation remain in place, temporary reversals of FDIC losses will be due more to cyclical improvements in bank profitability than to any inherent strength in the concept of government deposit insurance.

II.

THE SHAKY ORIGINS OF FEDERAL DEPOSIT INSURANCE

BEFORE examining these propositions in greater detail, it will be helpful to review the debate that took place when Federal deposit insurance was enacted into law in 1933. Who defended the system, and why? Who opposed it, and what evidence did they cite? The answers to these questions can illuminate today's debate, for many of the same fallacies employed to establish the system are used today to maintain it.

Our present system of Federal deposit insurance was begun in 1934, when the FDIC was formed in the midst of the banking collapse and the Great Depression. Although it has since been widely recognized that the 1930s banking collapse was caused by inept monetary policy conducted by the Federal Reserve,[3] at the time vocal reformers believed that deposit insurance was the only way to instill confidence in the banking system, especially for the small depositor. Initial coverage was $2,500 per depositor and FDIC reserve funds came from flat "premiums" charged to all banks, as today. As the 1930s crisis abated, many concluded that deposit insurance was the cure. In fact, legislators had established a perverse system that promoted excessive risk-taking.

Early Experiments at the State Level

Many thoughtful observers in 1933 had warned that bad banking would result. Long before *Federal* deposit insurance was established in 1934, the United States had a very poor track record of deposit insurance at the *state* level. Critics cited America's first experience with government deposit insurance more than a century earlier. The Safety Fund System, established in New York in 1829, proved an unmitigated failure. Proponents of the fund argued that its members had a "common interest" in each other's solvency. Better banks never embraced the logic, but nevertheless faced mandatory premiums when the legislation was enacted. Instead of ameliorating the Panic of 1837, the Safety Fund was swamped by the losses that ensued. Stronger banks that survived the Panic understandably balked at bailing out weak banks that did not. In 1839, premiums became voluntary and, naturally, the better banks began to flee the Fund. By 1842, the Fund scaled back its coverage to insuring only bank currency — not checking accounts. By 1860, the Fund was approaching insolvency and could barely cover a tiny fraction of the currency issued by New York banks.

Despite the failure of the Safety Fund System, momentum for government coverage grew near the end of the 19th century. During the hard times

[3] Friedman, Milton and Anna Schwartz. *A Monetary History of the U.S., 1867-1960* (Princeton University Press, 1963).

of the 1890s, Charles G. Dawes, an up-and-coming banker, a future Comptroller of the Currency, and a future Vice President, advocated a tax on national banks for creating an insurance fund to reimburse depositors of failed banks.[4]

At the turn of the century, the inherent weakness of the National Banking System led to periodic "money panics," liquidity squeezes in which banks suspended cash payments for brief periods. The source of the problem was the National Banking Act, for it required banks to collateralize their currency issues with government bonds. Passed in 1863, the Act was primarily intended to raise funds to conduct the Civil War, although it was sold as a measure to guarantee sound currency. In any event, the collateral provision made the currency inelastic — banks could not issue currency in accordance with the needs of trade. Currency shortages were exacerbated when the government began retiring a large portion of the national debt after the war. The Panic of 1907 brought the greatest calls for bank and currency reform. But instead of repealing the destabilizing bond collateral provision, reformers called for government deposit insurance. In 1908 the Democratic Party wrote a plank recommending Federal deposit insurance.

Other critics of Federal deposit insurance in 1933 cited problems with state systems established in the early 20th century. Fourteen state systems suffered very short lives — bank failures depleted the funds and surviving banks balked at replenishing the funds to bail out reckless competitors.[5] In a 1908 speech, James B. Forgan, president of the First National Bank of Chicago, criticized mandated deposit insurance, and asked rhetorically,

> Is there anything in the relations existing between banks and their customers to justify the proposition that in the banking business the good should be taxed for the bad; ability taxed to pay for incompetency; honesty taxed to pay for dishonesty; experience and training taxed to pay for errors of inexperience and lack of training; and knowledge taxed to pay for the mistakes of ignorance?[6]

A 1933 study by the American Bankers Association of eight state guaranty systems that failed between 1908-1917 concluded that

> Eight large scale tests, by practical working experience ... are a matter of public record. Each one of these attempts failed of its purpose.... They created a sense of false security and lack of discrimination as between good and bad banking.... Greater numbers than ever of undercapitalized, ill-situated banks, as well as of persons wholly unfitted as to training, character or methods to be allowed to conduct banks, were able to command public trust and patronage and to attract

[4] Grant, James. *Money of the Mind: Borrowing and Lending in America from the Civil War to Michael Milken* (New York: Farrar, Straus, Giroux, 1992), pp. 135-144.

[5] Calomiris, Charles. "Deposit Insurance: Lessons from the Record," *Economic Perspectives*, Federal Reserve Bank of Chicago, May/June 1990, pp. 10-30.

[6] Forgan, James B. "Should Deposit Insurance Be Guaranteed by the Government?," Address to the Illinois Bankers Association, June 11, 1908, First National Bank of Chicago.

> large deposits to their institutions through high interest rates and trading on faith in the guaranty plan.[7]

Some banks tried to fight the state systems. In 1908, Oklahoma became the first state to pass a deposit insurance act. The mandatory premiums were challenged by good banks as an unconstitutional taking without compensation under the Fourteenth Amendment. The Noble State Bank in Oklahoma, in particular, sued the state of Oklahoma. Even the Oklahoma State Banking Commissioner conceded the perverted impact of the Oklahoma Fund, admitting that "the banking department was for a long time in politics," that "unsound banks were admitted and guaranteed at the outset," that "there has been procrastination in closing insolvent banks," and that "the guaranty of deposits has relieved depositors of all necessity for care in selecting banks."[8]

The case went to the Supreme Court, which ruled unanimously in 1911 that the Oklahoma system was constitutional, Justice Oliver Wendell Holmes arguing that the end (safe and sound banking) justified the means (insurance of deposits). Curiously, Holmes had a favorable impression of deposit insurance history, claiming success for state deposit guarantees and citing New York's Safety Fund System as an example! Holmes wrote,

> The power to compel, beforehand, cooperation, and thus, it is believed, to make a failure unlikely and a general panic impossible, must be recognized, if government is to do its proper work, unless we can say that the means have no reasonable relation to the end ... So far is that from being the case that the device is a familiar one. It was adopted by the States the better part of a century ago, and seems never to have been questioned until now.[9]

In 1913, a revised version of Charles Dawes's 1894 plan was introduced in the Senate. The idea was to tax the newly formed Federal Reserve Banks to build an insurance fund. This sparked substantive debate. Senator John Weeks of Massachusetts, a former banker, argued eloquently against government deposit insurance. "The whole system, in my judgment," he argued, "is the confiscation of good character. It is putting a man without reputation or record on the same level as a man who has a record and reputation." Further, he argued, under such a system the good would be dragged down by the bad:

> The banker appeals for business, using various arguments, such as the amount of his capital, the accumulation of surplus which he has made, and, especially, through the personality of the bank's management; but if we are to adopt this system, all of those elements will be waived, and people, closing their eyes, may

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[7] American Bankers Association. "The Guaranty of Bank Deposits," (Economic Policy Commission: American Bankers Association, New York, 1933). Quoted by Mark Flood (see below).

[8] Quoted in James Grant, *Money of the Mind*, p. 138.

[9] Quoted in James Grant, *Money of the Mind*, p. 136.

drop into the first bank they come to, make the best trade they can for the best rates of interest or unusual accommodation, and feel perfectly sure that they are going to receive their money when they need it. If it is well to make the individual a non-entity, this may be a desirable move, but, in my judgment, he should be taught to be solicitous for his own personal welfare by keeping his eyes open and his mind exercised to protect his personal interests. It is a form of socialism which must be repulsive to anyone who deplores the socialist tendencies of the day, and is added evidence that the socialist is looking to the State to provide for him what he has not been able to provide for himself.[10]

In debating the issue with Democratic Senator Key Pittman of Nevada, Weeks tried to defend the prudent, surviving banks who were unjustly taxed under deposit insurance to support the depositors of failed rivals. Weeks then faced the perennial moral argument that colored every appeal for deposit guarantees, before and since. Pittman stressed that it was far more important that "the depositors would not have lost their money," and added, "We consider the interests of the depositors above the interests of any bank." Weeks could only retort, timidly, that the measure was a futile attempt "to guarantee against folly." In fact, of course, the plan was a guarantee that folly would result, that good banks would be sacrificed for the benefit of bad ones.

In the following years, evidence accumulated that state deposit insurance systems brought reckless banking. When such a system was established in Texas in the 1920s, two leading banking professors said that,

The plan made too many banks and too few bankers. All kinds of incapable people tried to start a bank under the protection of the fund. The system gave rise to a false sense of security — people looked to the fund for protection and paid no attention to the soundness of the banks themselves, nor to the ability of the managers. Prosecution of bank wreckers and crooks was made impossible. The depositors got their money from the fund, so they were not particularly interested in prosecuting the unscrupulous or incompetent men who caused the banks to fail. Such an unsound system of banking weakened the financial structure of the entire state.[11]

As one editorialist observed of the state deposit guaranty plans in 1924:

It is to be feared that the adoption of deposit guaranty laws may have somewhat retarded the inevitably slow and unsensational process of strengthening the banking system by strict regulation, vigilant public opinion, and strict requirements.[12]

In states where no deposit insurance existed, banks were more prudent and financially stronger. Clearly, reckless banking was encouraged by the

[10] Quoted in James Grant, *Money of the Mind*, pp. 138-139.

[11] Harr, Luther and W. Carlton Harris. *Banking Theory and Practice* (McGraw-Hill, 1936), p. 141.

[12] *Saturday Evening Post*, August 9, 1924.

state deposit guarantees well before debate about the FDIC took place in 1933. This was the historical backdrop to the deposit insurance debate. But knowledge of this history was soon overwhelmed by those eager to stop the wave of bank failures in the early 1930s.

The Movement Toward Federal Insurance

According to one account, the idea of Federal deposit insurance was originated in 1932 for very personal reasons by Senator Arthur H. Vandenberg of Michigan. Vandenberg was the director of a troubled Grand Rapids bank and owned $50,000 of its stock. Under the double liability provision of the bank charter, Vandenberg had to contribute an additional $50,000 (more than $1 million in today's currency) to bail out the bank. "Double liability" provisions had been common in bank charters for decades. The provision made owners of banks responsible for any losses to depositors and ensured that the bank was prudently managed. Vandenberg was bothered by his bank's assessment and immediately began to lobby then-President Hoover and influential Senator Carter Glass to enact Federal deposit insurance and prohibit double liability provisions. Ultimately, his argument won the day.[13] In his effort to make the state pay for his own bad judgment, Vandenberg established the socialistic essence of government deposit insurance. This is the core of the system's foundation even to this day — and the reason the foundation is rotting.

Unfortunately, scheming politicians like Vandenberg had more influence over legislation than more rational observers. Objective scholars could see that prudent bankers would be penalized under a government insurance system and predicted it would happen more broadly if extended to the national level. In a 1933 speech to bankers, Princeton University economist E. M. Kemmerer warned against government deposit insurance:

> For it is always to be remembered that the weak banks get the same insurance as the strong ones, and, unlike the situation in other kinds of insurance, the bad risk pays no more for its insurance than the good one. This means competition among banks in slackness in the granting of loans. The bank with the loose credit policy gets the business and the bank with the careful, cautious credit policy loses it. The slack banker dances and the conservative banker pays the fiddler. If the conservative banker protests, the slack one invites him to go to a warmer climate. Soon all are dancing and the fiddler, if played at all, must collect from the depositors or from the taxpayers.[14]

According to one summary of the debate that occurred in 1933 prior to passage of Federal deposit insurance regulation, "The bankers declared

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[13] Kennedy, Theodore R. "Deposit Insurance: The Real Origin," Letter to the Editor, *The Wall Street Journal*, February 22, 1989. Kennedy is professor emeritus at Michigan State University.

[14] Quoted in Flood, Mark D. "The Great Deposit Insurance Debate," *Review*, July/August 1992, Federal Reserve Bank of St. Louis, p. 60.

that well-managed banks should not be forced to subsidize poorly run banks. Supporters of the legislation maintained that depositors should not have to bear the losses accruing to their bankers' mistakes."[15] Some politicians recognized the essence of the problem. President Franklin Roosevelt opposed government guarantees of bank liabilities. He had worked at a surety bond company in the 1920s and saw the dangers firsthand.[16] In his first news conference on March 8, 1933 Roosevelt said:

> As to guaranteeing bank deposits ... the general thought behind the use of the word "guarantee" with respect to bank deposits is that you guarantee bad banks as well as good banks. The minute the government starts to do that the government runs into a probable loss ... We do not wish to make the United States Government liable for the mistakes and errors of individual banks, and put a premium on unsound banking in the future.[17]

Some Congressional leaders at the time can be credited for echoing these concerns. They understood the perverse economic incentives deposit insurance fostered. Speaking before the U.S. Chamber of Commerce on May 4, 1933, Senator Robert Bulkley (D-Ohio) said:

> In the stress of the recent banking crisis ... there was a very definite appeal from the bankers for the United States Government itself to insure all bank deposits so that no depositor anywhere in the country need have any fear as to the loss of his account. Such a guarantee as that would have indeed put a premium on bad banking. Such a guarantee as that would have made the government pay substantially all losses which had been accumulated, whether by misfortune, by unwise judgment, or by sheer recklessness, and it might well have brought an intolerable burden upon the Federal Treasury.[18]

Some Congressmen even recognized that the Federal Reserve was the root cause of the boom-bust combination that precipitated losses for depositors. As Representative Lemke (R-ND) put it:

> The people know that the Federal Reserve octopus loaned to the gamblers of this nation in 1928 some sixty billion dollars of credit money —bank money — hot air ... and then when the crisis came in the last three months of 1929, cut that credit money — bank money — hot air — down to thirteen billion. No nation, no industry, can survive such an expansion and contraction of money and credit. Give to me the power to double the money at will, and then give me the power to cut it square in two at will, and I can keep you in bondage.[19]

Lemke's prescient interpretation implied that central bankers, not private bankers, should be restrained for their misdeeds. He implied, again

[15] Mark D. Flood, "The Great Deposit Insurance Debate," p. 56.

[16] Roosevelt was a vice president at the Fidelity and Deposit Co. of Maryland after his unsuccessful Vice-Presidential bid in the 1920 election.

[17] *The Public Papers and Addresses of Franklin D. Roosevelt* (Random House, 1938), p. 37.

[18] Quoted in Mark Flood, "The Great Deposit Insurance Debate," p. 51.

[19] Quoted in Mark Flood, "The Great Deposit Insurance Debate," p. 53.

with some foresight, that government should insure a stable currency, not bank deposits. But Lemke was in the minority. The majority of his colleagues blamed the bankers and supported government deposit insurance. Although many were aware of the risks it brought, they believed the risks could be mitigated by more intensive regulation of private banking activities. Besides enacting Federal deposit insurance, the Banking Act of 1933 (passed on June 16th) separated commercial and investment banking, restricted banks' securities activities, authorized regulators to remove incompetent bank managers, prohibited double liability, and capped the rate of interest that could be paid on deposits. Legislation passed in 1935 gave greater powers to the Federal Reserve.

Some Technical Objections

Technical objections to Federal deposit insurance were also made. For example, the new banking laws exempted banks from the bankruptcy laws and gave the FDIC full power over failure resolution decisions. Before deposit insurance was enacted, banks in financial trouble were generally treated like any other business. Most closures were declared by the directors of the bank, feeling pressure from depositors and creditors. By declaring bankruptcy and accepting a court-appointed receivership, the bank could be assured of winding up its affairs in an orderly manner, fair to the relative interests of depositors and creditors. At other times, temporary illiquidity might be resolved by a temporary suspension of cash withdrawals. But after 1933, deposit insurance officials would decide whether and when to close a bank, with the attendant risk that it would do so too late or too early, motivated more by political than by economic concerns.

Other technical objections were voiced. Money center banks and the American Bankers Association took exception to the plan because it was not actuarially sound (not truly insurance). "Insurance" signified a private fund, a reserve built up on sound actuarial principles, whereas a "guarantee" was a promise by government to make depositors of failed banks whole no matter the magnitude or source of the reserve fund. One discussant warned against "the inexcusable mixture of the two terms ... Guarantee is where you make the good bank pay for the poor one. Insurance is where you make those who get the benefit pay for it."[20] The Association of Reserve City Bankers also opposed the plan on actuarial grounds, did not consider the FDIC's capital as a reserve fund, and noted that,

> Insurance involves an old tried and true principle. The essence of insurance is the payment by the insured of premiums in actuarial relation to the risk involved. Under the terms of the permanent plan, however, the costs or premiums are not charged according to risk.[21]

[20] Quoted in Mark Flood, "The Great Deposit Insurance Debate," p. 57.

[21] Quoted in Mark Flood, "The Great Deposit Insurance Debate," p. 58.

Two prominent legislators who shaped the new banking laws of the 1930s, Senator Glass and Representative Steagall, both said government should play an on-going role in the deposit insurance system. As Glass stressed during the 1933 debate, "This is not a government guaranty of deposits ... The government is only involved in an initial subscription to the capital of a corporation that we think will pay a dividend to the government on its investment. It is not a government guaranty."[22] Steagall added, "I do not mean to be understood as favoring a government guaranty of bank deposits. I do not. I have never favored such a plan.... Bankers should insure their own deposits."[23]

To this day the FDIC admits that "actuarial precision has never been a part of setting premium rates or assessing the adequacy of reserves."[24] If the FDIC were ever examined under the same standards that are applied by regulators to private insurers, it would have been put out of business long ago. An FDIC history written in 1951 clearly recognized the distinction and claimed the FDIC was truly an insurer. Yet depositors, the ultimate beneficiaries of the system, have never paid an insurance premium for the benefit.

A Guaranty System

As it evolved, of course, the FDIC grew to become a guaranty system. Despite starting with a label as "insurance," in fact the FDIC today has become an actuarially unsound, guaranty system. But while it was labeled "insurance" at its inception, everything pointed to the FDIC as a guaranty system, not unlike what had failed at the state level. Despite the attention paid to the actuarial weakness of the Federal deposit insurance plan, nothing was done to improve it. Efforts at charging risk-adjusted premiums, or requiring deductibles and co-payments, or building an adequate reserve, were all dismissed. Every attempt was made to establish a plan with more guaranty than insurance features.

In answer to those who cited the failure of state insurance schemes, proponents of the Federal plan claimed that the FDIC's national coverage would diversify risk in a way the old failed state guaranty funds could not. According to Representative Bacon in 1933, "nationwide diversification of insurance risks would secure banking against any eventuality except such a national calamity as would destroy the government itself."[25] Arthur Vandenberg insisted that "there is no logical relationship between these old State Guarantees and this new Federal Insurance; no analogy; no parallel; and no

[22] Quoted in Mark Flood, "The Great Deposit Insurance Debate," p. 57.

[23] Quoted in Mark Flood, "The Great Deposit Insurance Debate," p. 57.

[24] "Deposit Insurance Reform for the 1990s: Meeting the Challenge," *Federal Deposit Insurance Corp.*, December 12, 1989.

[25] Quoted in Mark Flood, "The Great Deposit Insurance Debate," p. 59.

reason to confuse the mortality of the former with the vitality of the latter."[26]

The most consistent opposition to the establishment of Federal deposit insurance came from the bankers themselves, especially the prudent ones who had survived the 1930s collapse and still had a voice in the debate. Guy Emerson, an economist at Bankers Trust Company, had pointed out the actuarial flaws inherent in the system.[27] Benjamin Anderson, chief economist at Chase National Bank, had pointed out the economic distortions fostered by the Federal Reserve's policy of boom and bust.[28] He too saw the dangers in a government guarantee of deposits.

One banker was courageous enough to oppose deposit insurance publicly and by direct action. John M. Nichols, President of the First National Bank of Englewood, Illinois (nicknamed "100% Nichols" to describe the liquidity of his bank) had resented being lumped in with mismanaged suspended banks during Roosevelt's "banking holiday" in March 1933. Nichols countered by positively inviting his depositors to withdraw their funds. Later in the year he refused to pay the First's allotted share into the FDIC fund. He argued "I would just as soon give up this banking business, anyhow, as it is nothing but grief, troubles, and insults. I could invest my money more profitably in some other business, and maybe I will if I can find out what the government is doing."[29] Eventually, Nichols did leave the business. The fact that his type would be driven away, while the fly-by-night operators would be welcomed, was a testament to the kind of banker deposit insurance would punish, and the kind it would promote. Nichols called the Federal deposit insurance scheme "a damnable piece of trickery" and a pretext to engineer the nationalization of the banking industry. Nichols and many other bankers of the period could see what was coming. Few bankers today can even explain what has happened.

The American Bankers Association opposed Federal insurance from beginning to end. But these and similar warnings were not heeded — moral arguments, often laced with emotionalism, were more influential than actuarial and economics ones. Though the technical objections to deposit insurance were largely correct, they were outweighed by moral-socialistic arguments of the system's defenders. Despite government's culpability in the crisis, all bankers were lumped together, vilified, and made scapegoats for the collapse.[30] The views of opposing bankers in the

[26] Quoted in Mark Flood, "The Great Deposit Insurance Debate," p. 59.

[27] Emerson, Guy. "Guaranty of Deposits Under the Banking Act of 1933," *Quarterly Journal of Economics*, February 1934.

[28] Anderson, Benjamin M. *Economics and the Public Welfare* (New York: Van Nostrand, 1949).

[29] Quoted in James Grant, *Money of the Mind*, p. 362.

[30] Salsman, Richard M. "Bankers as Scapegoats for Government-Created Banking Crisis in U.S. History," in *The Crisis in American Banking*, edited by Lawrence H. White (New York University Press, 1993), pp. 97-103.

1930s were dismissed out of hand in purely *ad hominem* attacks. In 1933, Michigan Representative John Dingell reflected the derisive, *ad hominem* stance taken by many in Congress when he said,

> I believe that the myopic banker as an advisor should receive about as much consideration at the hands of the House as a braying jackass on the prairies of Missouri. They proved by their inability to maintain their own business that they have absolutely no right to advise the House as to what course we should follow.[31]

The opposition to Federal deposit insurance that did arise within government did not necessarily signify an appreciation of the free market or of its underlying ethic. From Congress to the President, free market capitalism was under attack. President Roosevelt used Biblical references to attribute the banking collapse to self-interest and the profit motive. Bankers, he complained, "know only the rules of a generation of self-seekers," and he added,

> The money changers have fled from their high seats in the temple of our civilization. We may now restore that temple to the ancient truths. The measure of the restoration lies in the extent to which we apply social values more noble than mere monetary profit.... The rulers of the exchange of mankind's goods have failed, through their own stubbornness and their own incompetence, have admitted their failure, and have abdicated. Practices of the unscrupulous money changers stand indicted in the court of public opinion, rejected by the hearts and minds of men.[32]

Roosevelt's animus against private banking made him very willing to submerge his initial skepticism toward deposit insurance and sign it into law. After all, he said, government was right to demand safeguards against what he called the "evils of the old order." Roosevelt signed on to Federal deposit insurance because it was embedded in legislation intended to punish and limit bankers, goals that fit his philosophy and met with his satisfaction. Yet by doing so, he guaranteed that the reckless actions of truly "evil bankers" (such as today's Charles Keating) would recur in future generations.

In the final analysis, despite the government's own culpability in the 1930s' banking crisis, despite the actuarial and economic objections of opponents, despite the courageous opposition of a few lone bankers, government deposit "insurance" was enacted in 1933 on the basis of faulty moral arguments, socialistic sympathies, and the populist, anti-banking posturing of some very powerful politicians.

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[31] Quoted in Mark Flood, "The Great Deposit Insurance Debate," p. 66.

[32] Roosevelt, Franklin D. *The Public Papers and Addresses of Franklin D. Roosevelt: Volume Two, The Year of Crisis, 1933* (Random House, 1938, pp. 11-12).

III.

WHY DEPOSIT INSURANCE UNDERMINES SOUND BANKING

IN the decades since its inception, we have learned much more about the internal contradictions and perverse incentives of Federal deposit insurance. The system has long been billed as a stabilizer of the banking system, as a buffer against risk-taking. But it achieves the precise opposite and encourages undue risk-taking by banks.

Some banking economists refer to the problem as characteristic of the "moral hazard" typical of insurance contracts.[33] In essence, an insured party is induced to raise the level of his risk-taking behavior once he is insured — precisely because losses will be borne by the insurer. In systems of private insurance, this moral hazard is effectively restrained by the judicious use of risk-based premiums, deductibles, policy exclusions, and programs suggesting ways insureds can lower their risks (and costs). As an example, insurers will charge safe drivers lower premiums, offer them higher deductibles, and sponsor highway safety programs. In these ways, "moral hazard" is contained.

Unfortunately, moral hazard cannot be effectively contained in the case of government insurance — it doesn't impose the type of risk-lowering incentives offered by a free market. Regulation is the major way government tries to constrain the moral hazard of deposit insurance. But regulation has proved to be singularly ineffective in this regard. Regulators have no financial incentive to minimize risk-taking, they cannot obtain the information required to do so, and the insureds have every incentive to evade the regulations. By the time evasions are discovered, it is often too late. The risks are already "on the books." With government guarantees in place, risk-taking that bears fruit benefits the bank while losses are borne by the taxpayer or by prudent banks.

A virtual cascade of studies in the last decade has documented the fact that banks have taken greater risks because of the widening "safety net" provided by government.[34] In my own book I show that the safety net includes not only deposit insurance, but access to the discount window, and the "too-big-to-fail" policy, and that all have contributed in some way to greater risk-taking.[35] Moreover, regulations have failed to contain the

[33] Ehrlich, Isaac and Gary S. Becker. "Market Insurance, Self-Insurance, and Self-Protection," *Journal of Political Economy*, July/August, 1972, pp. 623-648.

[34] These studies are reviewed by Eugenie D. Short in "Bank Problems and Financial Safety Nets," *Economic Review*, Federal Reserve Bank of Dallas, March, 1987, p. 17-28. See also James B. Thompson, "Equity, Efficiency, and Mispriced Deposit Guarantees," *Economic Commentary*, Federal Reserve Bank of Cleveland, July 15, 1986.

[35] Salsman, Richard M. *Breaking the Banks: Central Banking Problems and Free Banking Solutions* (Great Barrington: American Institute for Economic Research, 1990).

excessive risk-taking, and have actually made things worse by preventing branching and the prudent diversification of asset portfolios and funding sources. Throughout U.S. banking history, the "safety net" has encouraged unsafe banking practices, yet despite growing evidence of this principle, the scope of the net has been extended. Often, it is precisely the unsafe banking practices that are cited to justify widening the safety net still further. Self-regulation is a far more effective means of ensuring bank safety and soundness. Nothing concentrates the mind of a banker more effectively than the threat of a depositor run or the drying up of a funding source.

Deposit insurance was established in order to avert future bank runs. But its history has demonstrated a singular inducement to bankers to become reckless and pay excessive yields, while encouraging depositors to run *to* bad banks instead of *away* from them. Deposit insurance also made the banks more willing to extend long-term illiquid loans, such as on real estate.

Deposit insurance also encourages the private decapitalization of banking. More than 20 years ago, a study by University of Chicago economist Sam Peltzman showed that Federal deposit insurance offered banks a direct substitute of "public capital" for private capital.[36] Banks could leverage their balance sheets and increase their return on investors' capital without the attendant risks, because the market would take comfort in the guaranteed deposits. Bank investors could access low-cost government-insured deposits and leverage their purchasing power well beyond their original investment. Peltzman argued that there was no incentive for bank managers to maintain conservative capital ratios to attract depositor confidence and provide a healthy buffer of protection because the government insured deposits.

Breaking the Banks

The trend in bank capital ratios since the inception of deposit insurance only confirms Peltzman's analysis. During the same decades that banks were taking greater risks in their loan portfolios, they were also reducing their capital ratios. In 1932, the year before Federal deposit insurance was enacted, the average capital ratio in the banking industry was 15 percent. By 1992, it had declined by two-thirds, to 5 percent, due in large part to deposit insurance. Other measures of banking system health, including profitability, loan quality, liquidity, and management quality, show similar deterioration over the decades.[37]

To the extent banks have access to government guaranteed liabilities (and for many, core deposits are 50 percent or more of banks' funding

[36] Peltzman, Sam. "Capital Investment in Commercial Banking and Its Relation to Portfolio Regulation," *Journal of Political Economy*, January/February, 1970, pp. 1-26.

[37] See Richard M. Salsman, *Breaking the Banks*.

sources), then banks are effectively immune from an ongoing "market test" of their activities. Just as the syndication of loans helps a bank check the quality of its credit culture and assets against the market, thereby preserving credit quality, so would guarantee-free deposits offer a "market test" and encourage more prudent management. But this crucial "market test" is precisely what government deposit insurance prevents.

The distinction made by credit rating agencies between bank-specific risk and government risk is just one obvious example of how bank deposits are not market tested. When the rating agencies downgrade the securities of a weakening bank, they often downgrade every one of its liabilities *except* its "core deposits," defined as the low-cost, government-guaranteed portion of the deposit base. In such a case, the agencies obviously look to the credit of the government, not the bank, for investor protection. Yet the bank will proceed to minimize its funding sources that have been downgraded, and maximize its reliance on core deposits. Seen narrowly, this is a perfectly natural response. Seen more broadly, there is complete immunity from any "market testing" of deposit funding — and this only invites more risk-taking.

For many years it has been recognized that a significant part of the value of a banking franchise is the extent of its core deposits. In a recent study, the bank consulting firm First Manhattan estimated that core deposits represented 60 percent of the total market capitalization of the banking industry.[38] Yet this does not signify a strengthened system. As the perverse incentives of deposit insurance took hold over the decades, bank losses and bank failures began to accelerate. Over the same decades that deposit insurance coverage was expanded, the American banking system weakened substantially.

Those who believe, on the other hand, that Federal deposit insurance guarantees safe and sound banking, have yet to explain why reckless and imprudent banking expanded in step with insurance coverage. Those who simply attribute the collapse of deposit insurance to the failures of banks and thrifts do not go far enough in their analysis. They ignore the overwhelming evidence that bank failures are primarily a *result* of the excessive risk-taking that deposit insurance uniquely promotes. In this sense, deposit insurance is its own worst enemy — because it is an enemy of prudent banking. Those who blame "a poor economy" for the troubles in banking and deposit insurance fail to see that bank capital and reserves — and indeed, "insurance" —should be adequate precisely to weather business-cycle downturns. When they cannot, we have to look to the incentives that make them so weak to begin with. The 150 percent increase of deposit

[38] "Banking in the 1990s: Where Will the Profits Come From?," *First Manhattan Consulting*, 1991.

insurance coverage to $100,000 in 1980 had more to do with greater bank risk-taking — and subsequent losses — than the 1990-91 recession. By the same token, higher bank profits during the recovery will not serve as an endorsement of deposit insurance.

By insuring unsafe and unsound banking, the exact opposite of its stated purpose, government deposit insurance creates the precondition for its own demise. As bad banking expands and banks are broken under the incentives of deposit insurance, deposit insurance in turn is broken by bad banks. This collapse reflects the internal contradiction and perversity of the system.

Winners and Losers

The winners in such a system are the owners and managers of reckless banks, the depositors who flock to them, and the demagogic politicians who defend both in the name of the "little guy." The losers are the owners, managers, and depositors of prudent banks, and everyone who gets caught up in the maelstrom of chronic banking crises, credit crunches, and asset deflations.

Not surprisingly, the reckless and imprudent banks, those with depositors and funding sources most in need of government protection, have continued to favor Federal deposit insurance. Testifying before Congress in June of 1987, Walter Wriston, former Citicorp Chairman and so-called free market proponent, avidly defended government deposit insurance, saying "I think it's very important ... My suggestion was that it be limited to some reasonable amount which was designed to protect the small people." What does Wriston consider to be a small amount? "One hundred thousand dollars in an inflationary world is O.K. That's very important."[39] Of course, it *is* "important," not to the stability of the banking system, which is often alleged, but precisely to banks such as Citicorp reeling from chronic mismanagement and lending debacles.

Conservative, profitable, and well-capitalized banks, on the other hand, quite properly consider Federal deposit insurance redundant at best and a theft at worst. John Medlin, Chairman of First Wachovia, a rock-solid, well-respected, North Carolina bank, attributes many of the banking system's problems to "socialized public policies which have weakened private enterprise disciplines." In Medlin's view, "the prostitution of deposit insurance over time permitted the gradual deterioration of credit quality, risk pricing and capital cushions of the financial system."[40] Medlin is correct that this has been the disastrous effect of deposit insurance. He and his bank —

[39] Hearings before the Senate Committee on Banking, Housing and Urban Affairs, "Status of the U.S. Financial System," 100th Congress, 1st Session, June 18, 1987, pp. 77-78.

[40] "First Wachovia's Enviable Balance Sheet Sets It Apart," *The Investor's Business Daily*, May 8, 1991.

and others like them, are to be credited for resisting the temptation to lower standards at the expense of innocent victims. Competitors such as Citicorp have relied heavily on the subsidy — as the condition of the bank shows.

Didn't Deposit Insurance Work for 50 Years?

Some people wonder why it took 50 years for the troubles of Federal deposit insurance to surface. The fact is, it *didn't* take 50 years. The trouble had been surfacing in some form each and every decade since its inception. The secular deterioration in the financial condition of the banking system was one sign. The displacement of public capital for private capital was another. The decline of deposit reserves starting in the 1980s was a final warning.

According to financial historian James Grant, the "golden age" of deposit insurance in the 1940s and 1950s masked an underlying weakness, "the decline of the strong-and-silent type bank balance sheet in the competitive world. To the extent that the American depositor had come to believe that his money was really in the government's hands, to just that extent was an ultraconservative bank at a competitive disadvantage."[41]

No one can claim that the collapse of deposit insurance was a surprise. By the government's own measure, the system has been disintegrating slowly for the past quarter century. The FDIC usually measures its financial capacity to resolve bank failures by relating the size of the deposit insurance fund to total insured deposits, taking into account as well the number and deposit magnitudes of the "problem banks" designated as near failure by the agency. Meager as this coverage is to begin with, the decline of the coverage ratio has been unmistakable in recent decades. In 1965, the FDIC fund covered 1.45 percent of insured deposits, but the ratio fell consistently to 1.25 percent in 1970, 1.18 percent in 1975, 1.16 percent in 1980, 0.80 percent in 1988, and 0.20 percent at the end of 1991 before going into deficit in 1992. At the same time, the number of "problem banks" (defined by the FDIC as near insolvency) and the magnitude of the assets held in those banks, was increasing dramatically. Yet there was little fanfare about these trends in the 1960s, 1970s, or 1980s.[42] Despite the

[41] James Grant, *Money of the Mind*, p. 258.

[42] See "The Banking Industry in Turmoil: A Report on the Condition of the U.S. Banking Industry and the Bank Insurance Fund," House Banking Committee, December 1990, which touched off a spate of candor from government. A month later, the FDIC conceded it would run out of funds ("FDIC is Said to Forecast Deficit by 1993," *American Banker*, January 25, 1991). In March of 1991 the General Accounting Office predicted that the fund "at the end of 1991 will be somewhere between a high of $1 billion and a low of negative $5 billion. It is highly probable therefore that the fund will be insolvent at the end of 1991" ("Deposit Insurance: A Strategy for Reform," General Accounting Office, March 4, 1991). This was a much harsher assessment than its report of only a few months earlier ("Bank Insurance Fund: Additional Reserves Needed to Strengthen the Fund," General Accounting Office, September 1990).

obvious trend, the myth persists even today that deposit insurance was sound until only recently.

FDIC coverage has expanded significantly since its inception. In 1933, coverage was limited to $2,500 *per depositor*, covered 97 percent of all depositors but only 24 percent of all deposits.[43] Coverage expanded imprudently as the decades wore on, from $5,000 in 1934 to $10,000 in 1950, to $15,000 *per account* in 1965, $24,000 in 1970, $40,000 in 1975, and finally, $100,000 starting in 1980. These increases in coverage far exceeded the rate of inflation, since a deposit of $2,500 in 1934 was equivalent to $10,000 in today's depreciated money.

The portion of total commercial bank deposits covered by the FDIC also expanded enormously over the decades, from 41 percent in the 1940s to 60 percent in the 1970s, to 77 percent in the 1980s. Not only was statutory coverage expanded, but over these same decades, large depositors effectively obtained 100 percent coverage by splitting up their accounts into lesser, insurable amounts. Today, a family of four can combine accounts to get as much as $1.4 million of coverage at a *single* bank. Clearly, deposit insurance coverage is no longer intended to exclusively help the "small depositor," especially considering that the average deposit size in banks today is $8,500.

In recent years, the FDIC has justified its extended coverage on the grounds that it protects depositors, not owners, creditors, or managers. "When a bank is in trouble, the resources of the FDIC should be used to protect bank depositors, not shareholders or creditors of holding companies," former FDIC spokesman Alan Whitney once explained.[44] And yet, contradicting himself, he said that the FDIC provides assistance to prevent the failure of banks, big and small. But in fact the FDIC does no such thing. On the contrary it *fosters* bank failures.

Not only has insured coverage expanded enormously, but in the last 2 decades, even *uninsured* depositors have been covered by the FDIC in bank bailouts. The agency, together with the Federal Reserve and the Treasury Department, persists in covering the *uninsured* deposits of banks considered "too big to fail," as well as foreign deposits, which are presently uninsured. If the FDIC's uninsured obligations are included, it is insolvent by many more billions of dollars.

All along, the continual expansion of deposit insurance coverage itself, far beyond the rate of inflation, provided a crucial sign of weakness. After all, successively greater levels of coverage hardly would have been needed

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[43] Mark Flood, "The Great Deposit Insurance Debate," p. 62.

[44] Whitney, Alan. "Protecting Depositors, Not Bank Owners, Is FDIC's Business," Letter to the Editor, *The New York Times*, May 26, 1988.

if the banks were strong and the legislative intent was to protect only small depositors. In fact, of course, the opposite was true. The banks were weakening, and the futile legislative goal was to buttress the banks, for whom deposits were becoming an ever-greater portion of a ballooning money supply and an ever-greater source of funding. The policy was futile, because banks simply took the growing supplies of guaranteed funds and lent them recklessly, placing further strains on an inherently flawed system.

Myths About Free Banking

Some people saw pieces of this deteriorating puzzle over the years. But no one saw the big picture. After all, academics, regulators, and bankers alike were infused with the myth that government intervention imparts stability to the banking system, that banking left free is inherently unstable. That myth had been propagated heavily since at least the 1930s, when the banking collapse was misdiagnosed and falsely attributed to free market capitalism and laissez-faire finance. The myth that free banking is inherently unstable lives on today in the popular explanation for today's banking crisis: "deregulation."

Debate in the 1930s presumed that government intervention strengthened banking. Speaking before Congress in 1932, Yale economist Irving Fisher said "We got the guarantee of bank notes after having wildcat banking in connection with State bank notes and after having had people injured who held notes of the State banks.... It is much more important in principle to guarantee bank deposits, because the real circulating medium of the country is bank deposits."[45] Yet subsequent scholars have shown that losses were minimal in the State banking era, that where "wildcat banking" occurred, it did so due to state bond collateral provisions, an early form of government guaranty itself. In effect, in 1932 Fisher advocated a widening of government guarantees in banking and cited as evidence previous banking fiascos that had themselves arisen due to government guarantees! Had he known this, he might have advised an exactly opposite course: "it was bad enough that bad banknotes and bad banking were fostered from state government guarantees — it will be worse still should a national guarantee now be extended to bank deposits, the circulating medium of the land."

Today, even those who recognize that the deposit insurance system should be cut back base their reforms on old myths — thereby impeding reform. In its 1988 Annual Report, the Federal Reserve Bank of Minneapolis claims that "Before deposit insurance was in place, the banking system was in periodic turmoil. Bank panics, a large number of bank failures

[45] Fisher, Irving. Reprinted in *To Provide a Guaranty Fund for the Depositors of Banks*, U.S. Congress, House of Representatives, Committee on Banking and Currency, Hearings, 72nd Congress, 1st Session (U.S. Government Printing Office, 1932), p. 143.

caused at least in part by a general loss in confidence in the banking system and accompanied by a major economic contraction, were a regular feature of the U.S. economy." The implication is that uninsured banking caused this problem, when in fact legislation did so. The report concludes that reforms of the system will only be effective if they "involve a larger role for market involvement," but warns that "This, in turn, will mean the banking system will be more prone to depositor instability."[46] This misinterpretation explains the reluctance of reformers to abolish the system completely. The myth persists that free banking is inherently unstable.

In short, it didn't take 50 years before government deposit insurance collapsed. The recently revealed insolvency of Federal deposit insurance is not some leading indicator of its inherent weakness but rather the overwhelming, confirming evidence that it has finally succumbed to its pervasive, internal rot. Likewise, imagine a termite-infested house that is finally beginning to collapse on its startled occupants. Only those who are ignorant of its cause would see the collapse as the *beginning* of the problem. In fact, it is its culmination.

As I have written elsewhere,

> Our disastrous, countermarket deposit insurance system is linked inextricably to the central banking regime. Deposit insurance is a scheme put in place because the Federal Reserve mismanaged the discount window in the 1930s and it is a scheme that has been expanded ever since in concert with the Fed's inflation of the money supply (which consists predominantly of bank demand deposits). What is worse, deposit insurance embodies a form of parasitism — as reckless banks fail, their depositors deplete the fund; then the fund is replenished by the surviving, prudent banks. In effect, the bad banks and their depositors end up robbing the good banks, bringing the whole banking system down in the process. But notice this is *legalized* robbery, explicitly sanctioned by government policy. It is a system that takes "*from each* according to his ability" and gives "*to each* according to his need." In effect, deposit insurance is a direct application of Marxist theory. Is it any wonder that it bears the seeds of its own destruction?[47]

Today, people are surprised about the collapse of deposit insurance for the same reason people were surprised about the collapse of communism. Both systems are socialistic and undermine the basic requirements of human life and business success. For years people were taught that both systems were paragons of virtue, stability, and prosperity. Of course, reality says otherwise. In the 1930s, the Marxist line of reasoning was respected and widespread. Surely today, with its collapse as a model, we can begin to dismantle its offspring, deposit insurance.

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[46] Boyd, John H. and Arthur J. Rolnick, "A Case for Reforming Federal Deposit Insurance," 1988 Annual Report, Federal Reserve Bank of Minneapolis, pp. 3-16.

[47] Salsman, Richard M. "The Credit Crunch: Myth or Reality? Part II," American Institute for Economic Research, *Research Reports*, December 16, 1991.

The Nationalization of Credit

Where does a government deposit insurance system go after it goes broke? Consider the options available to a government that says it will guarantee the deposits of the banking system, a government that considers the majority of banks too big or too important to a community to fail, a government that, in making these assurances, and otherwise intervening in the money and credit system, ends up undermining the financial condition of the banking system. There is only one option available to such a government and that is to take over failed banks and run them as part of the government.

Critics of Federal deposit insurance during the 1930s, such as John Nichols, had warned about the nationalization of the banking system. His insight demonstrated keen foresight. Whether or not deposit insurance officials and bank regulators intended it, a discernible trend toward the nationalization of credit has developed in recent decades. By guaranteeing ever larger portions of the banking system's main funding source (deposits), the Federal government in effect has become the biggest creditor and an important "partner" to the banking system. More recently, with the expansion of its "too big to fail" and "early intervention" doctrines, the Federal government increasingly has become the owner and manager of a large number of failed banks.[48] In addition, the government itself has become a direct lender and loan guarantor in areas such as farming, housing and education over these same decades.[49] The growing number of controls on the lending practices of all banks also contributes to the trend.

[48] "As Deposit Insurance Dwindles, FDIC Wonders If It Should Start Running the Banks It Seizes," *The Wall Street Journal*, December 31, 1990. See also, "Needless Nationalization at the FDIC," by Jonathan R. Macey, *The Wall Street Journal*, February 14, 1992.

[49] See "How to Make Bad Loans and Get Away With It," American Institute for Economic Research, *Research Reports*, December 5, 1988.

IV.

SOME FUTILE REFORMS OF A FLAWED SYSTEM

SUPPORTERS of government deposit insurance who concede the dangers of its risk-promoting incentives believe the risk can be contained by enlightened regulation. Others claim the system can be reformed in some way, while retaining its basic features. Such arguments convey an undying faith in the power and effectiveness of government and a basic distrust of the market's ability to deliver safe and sound banking in an unsubsidized, unregulated setting.

Tighter Regulation?

The track record of banking regulation is nothing short of abysmal. No matter how pervasive the regulation has become, no matter how many agencies were put on the job, no matter how often the regulatory system was reformed, the banks became more and more reckless with each passing decade. In the 1980s, as bank conditions worsened, many regulators followed a policy of "forbearance," purposely leaving insolvent banks open. In a 1989 study the FDIC itself admitted that its own behavior would become more reckless when the reserve fund approached insolvency. "In a manner similar to that faced by bank and thrift owners," said the agency, "the closer the [FDIC] is to insolvency, the greater is the incentive to take risks. This phenomenon explains the way in which Federal Savings and Loan Corporation (FSLIC) approached dealing with problems in the thrift industry in the early 1980s. If thrifts could grow out of the problems, the FSLIC would become solvent and viable; if the strategy did not work, the insurer would just become more insolvent."[50] In many respects this is precisely the policy pursued by the FDIC in recent years.

Responding to criticisms about its forbearance policy, the FDIC then mixed in a policy of "early intervention." This means the FDIC will close down a bank if its capital ratio approaches a small fraction, not until it is fully depleted. This is no fundamental solution to the problem of failing banks and the incentives offered by deposit insurance. Instead it threatens bank owners with the possibility that value that does exist in a bank will be taken from them. This will surely scare away capital from the banking system and raise the threshold of risk-taking by desperate bank managers.

Bank regulators are prone either to go in to a failed bank too late (forbearance) or too early (early intervention) because government bureaucrats cannot possibly replicate the market. The root cause of the problem is that banks are not subject to bankruptcy laws and the valuation

[50] "Deposit Insurance Reform for the 1990s: Meeting the Challenge," Federal Deposit Insurance Corp., December 12, 1989.

decisions made by self-interested parties. Leaving failure resolution to the discretion of the FDIC and other regulators is an invitation for corruption and abuse. The problems inherent in political supervision of banking practices were seen decades ago by one astute observer:

> Bank examinations to be effective must be made by experienced men, free from political influence ... We will never have proper banking supervision, national or state, until it is taken entirely away from political influence.[51]

Private sector supervision is superior to bureaucratic intervention because the proper incentives are permitted to operate. Private auditors and bank rating agencies care about their reputation and banks who lend to other banks have the financial incentives to monitor banks and ostracize bad ones. Deposit insurance mutes these incentives as well as the incentive of depositors to monitor their institutions.

The far more common view has been that tough regulation and oversight can deter reckless behavior. As one writer posed the issue in the 1933 debate:

> Will banks under the federal plan be permitted the abuses which were tolerated in every one of the states where a guaranty was tried? If so, then failure is inevitable. If not, success is practically certain ... Let me assert unequivocally that the men who drew up the Federal plan profited by the mistakes of the state guaranty failures and avoided them.... None of the state laws had teeth in them. The federal law has teeth like a man-eating shark ..."[52]

And yet, more than 5 decades later, the FDIC head, William Seidman, would suggest that safe and sound banking could never be assured, that a complete breakdown is always a possibility, whenever a government guaranty of deposits is combined with government supervision:

> A deposit insurance system is like a nuclear power plant. If you build it without safety precautions, you know it's going to blow you off the face of the earth. And even if you do, you can't be sure it won't.[53]

Seidman also dismissed calls for greater depositor discipline, admitting that "[the FDIC] has a hard time figuring out a bank's financial condition. I don't see how you can expect a depositor to do it." As to the prospects for deposit insurance reform, Seidman remarks, "Next to Social Security deposit insurance is the government program least likely to be changed or tampered with."[54] In sum, Seidman believes Federal deposit insurance

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[51] Andrew, L. A. "Reconstruction: Individual Initiative," *American Bankers Association Journal*, January 1934, pp. 15-16.

[52] Stephenson, Rome C. "Making Banks Safe," *Rotarian*, September 1934, pp. 34-35, 46-48.

[53] "Thrift Industry Crisis May Force an Overhaul of Deposit Insurance," *The Wall Street Journal*, July 27, 1988, p. 1. Actually, Seidman's analogy insults the nuclear power industry. Sadly for American taxpayers, the safety record of the American deposit insurance system does not begin to approach the safety achievements of nuclear power firms.

[54] "Deposit Insurance System That is Out of Control Has Policy Makers Seeking Ways to Restrain It," *The Wall Street Journal*, August 30, 1989.

cannot prevent breakdowns in the banking system, depositors and other market participants are as stupid as government bureaucrats about the financial condition of banks, and nothing can be done about it. When deposit insurance officials themselves begin to express this degree of cynicism and resignation, one can be sure that the case for government deposit insurance finally has reached its dead end. There is nowhere else for it to go and no reason for resuscitating it.

Fingers in the Dike

When the FDIC's pending insolvency became apparent in late 1990, the Bush administration desperately recommended a series of haphazard quick fixes. In November 1990, the Treasury advanced a proposal in which banks would purchase preferred stock in the FDIC, a $25 billion "investment" of 1 percent of domestic deposits that would be double counted as both FDIC reserves and bank capital. The General Accounting Office rightly criticized the proposal as a sham.[55] In March of 1991, the Administration proposed that the Federal Reserve bail out the FDIC directly. Later that same month, the Administration proposed that the FDIC borrow $70 billion from the Treasury and repay over the years with proceeds from the sale of failed banks.[56] Such borrowings subsequently commenced.

A brief review of more broad-based reforms that have been proposed or legislated to "fix" the deposit insurance system reveals their basic futility. Nine distinct approaches, short of complete abolition, have been advanced. Four of them involve expanding or retaining current FDIC coverage and finding some victim to pay for its expanding cost. One involves still more regulation of the banks. The other four propose some scaling back of FDIC coverage or experiments in private deposit insurance. I have ranked these reforms in order from least reasonable to least unreasonable. None can achieve the kind of favorable, lasting improvement that complete abolition promises.

1) ***More Coverage*** — Remarkably, despite the failures of government deposit insurance, some lobbyists advocate the *extension* of coverage beyond existing levels. This logic says that the worse the banks become financially, the more coverage should be provided. Today this naive view is advanced most prominently by the Independent Bankers Association of America, a group of the Nation's small banks that has pushed for 100 percent coverage of all deposits. The group blames deregulation and big banks for the deposit insurance debacle and contends that Federal deposit insurance is "a key ingredient to maintaining a safe and sound banking system."[57] This view is positively disingenuous, given the overwhelming evidence that exists to the contrary.

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[55] "GAO Criticizes Proposal to Bolster Banking Fund," *The Wall Street Journal*, December 10, 1990. See also, "How Not to Save the FDIC," by Lawrence J. White, *The Wall Street Journal*, January 8, 1991.

[56] "U.S. Seeks Much Bigger Amount to Shore Up Bank Deposit Fund," *The New York Times*, March 22, 1991.

[57] Guenther, Kenneth. "Deposit Insurance Protects Savers," Letter to the Editor, *The Wall Street Journal*, July 17, 1988. Guenther is the IBAA's chief lobbyist.

2) ***Make the Taxpayer Pay*** — Many who recognize that Federal deposit insurance is actuarially unsound and bankrupt nevertheless stress that the system is backed by the so-called "full faith and credit of the U.S. Government." In fact, in Title IX of the Competitive Equality Banking Act of 1987, "The Congress finds and declares that since the 1930s, the American people have relied upon Federal deposit insurance to ensure the safety and security of their funds in federally insured depository institutions" and "the safety and security of such funds is an essential element of the American financial system." Therefore, "it is the sense of Congress that it should reaffirm that deposits up to the statutorily prescribed amount in federally insured depository institutions are backed by the full faith and credit of the United States."

In essence, this means the U.S. taxpayer is obligated to cover deposit insurance shortfalls, because "the full faith and credit of the United States" depends, in large part, on the U.S. taxpayers' ability to pay taxes. Of course, it was this option that Congressmen pursued in bailing out the thrifts in 1989 legislation, and voters were none too happy about it.

Apart from voter disapproval, this option is self-defeating. Clearly, the option involves a wider subsidy than even the FDIC has offered, a fact that will lead to further reckless banking. In addition, the "full faith and credit of the United States" itself is fast diminishing. Should present trends continue, some believe the Federal Government itself will approach bankruptcy due to its oppressive taxation, high and rising budget deficits, rapidly ballooning national debt, and interest payments on that debt that absorb a growing portion of annual tax receipts.[58]

3) ***Make the Fed Pay*** — In March 1991, the Bush administration recommended that the FDIC be permitted to "borrow" $25 billion from the Federal Reserve. By April the idea was nixed by Fed Chairman Alan Greenspan because "it might compromise the independent conduct of monetary policy." He was joined by Lee Hoskins, then president of the Cleveland Fed, who said Fed loans to the FDIC "could set us on the slippery slope of monetizing government outlays through central bank financing rather than through congressional appropriation." Of course, the Federal Reserve has already been commissioned to assist government in monetizing its other obligations, but it is worthy of Greenspan and Hoskins to oppose further extensions of the monetization process, given its vast potential for inflation.

4) ***Make the Banks Pay*** — Responding to outrage from taxpayers who were forced to bail out the thrifts in 1989 and inclined to make bankers scapegoats for the FDIC debacle, legislators in 1991 enacted law that makes the bankers pay. During debate on the law Utah Senator Jake Garn strongly opposed a taxpayer bailout of the banks and argued that, "We should bleed every dime we can out of the private sector." While recognizing that doing so would be unfair to owners of healthy banks who were no part of the debacle, Garn said "it is more fair than taking it from the taxpayers."[59] Echoes from the debates of the 1930s are obvious.

The misnamed FDIC Improvement Act of 1991, among other things, gave the FDIC power to raise assessments on the banks and sets a goal of rebuilding the

[58] Figgie, Harry E., Jr. and Gerald J. Swanson. *Bankruptcy 1995: The Coming Collapse of America and How to Stop It* (Boston: Little, Brown & Company, 1992).

[59] "FDIC to Get Treasury Loan To Pay for Bank Cleanup," *The Washington Post*, March 22, 1991.

FDIC reserve fund to 1.25 percent of insured deposits over 15 years. Of course, this ratio is arbitrary and has no actuarial basis whatsoever. Yet even if such a minuscule level of reserves were in place today, against existing levels of insured deposits, the fund would have to contain nearly $25 billion. The fund has never come close to this amount, and bank profits in any one year have never reached it.

Historically, FDIC assessments for deposit insurance have been minor in comparison to industry profits and capital, especially given the funding advantage the banks receive in low-cost deposit insurance for a large part of their liability structure.[60] But in recent years depletion of the fund has accelerated due to excessive risk-taking and bad loans promoted by deposit insurance. Assessments are sure to increase as the problem worsens. To replenish the fund by higher assessments on the banking industry will certainly be even more destabilizing. By forcibly taking capital out of the banking system, higher assessment would also require the liquidation of hundreds of billions of loans. With a 5 percent capital ratio, every dollar of capital supports $20 billion of bank assets, so if $25 billion of capital is taken, $400 billion in loans must be reduced to maintain existing capital ratios. This additional hit to bank capital adequacy would surely invite undue credit stringency, causing more borrower defaults, and more bank failures.

5) ***Impose More Regulation*** — The futility of imposing still greater regulation on the banks has already been discussed. Unfortunately, this approach was embodied in the FDIC Improvement Act of 1991. Starting in 1993 banks are subject to greater supervision, banks will have to raise more capital in order to gain greater operating freedoms, management will be ousted when regulators deem it necessary, and regulators will intervene early to shut down low-capitalized but solvent banks. Greater regulation is pursued with the mistaken belief that the banking troubles of the 1980s were due to "deregulation." In fact, although some minor deregulation was enacted, the main problem was the enormous extension of deposit insurance coverage and the "too-big-to-fail" doctrine starting in 1980.

6) ***Core Banking*** — Some reformers advocate reducing FDIC exposure by limiting coverage to a core bank or "narrow bank," which by definition only invests in government securities or other high-rated instruments. Deposits that fund other, riskier assets would not be covered or would be covered at substantially higher assessments. A core bank could be a subsidiary of an existing bank. This option has been advanced by Yale professor emeritus James Tobin,[61] Representative Charles Schumer, Robert Litan of the Brookings Institution, and bank consultant Lowell Bryan. While the proposal expresses good intentions, the sponsors seem not to recognize that deposits that fund high-grade assets do not require guarantees, precisely because the assets are low risk. The main problem is the accumulation of

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[60] "Estimating the Value of Federal Deposit Insurance," Office of Economic Analysis, Securities and Exchange Commission, March 29, 1991. The report concluded that the value of Federal deposit insurance was three to five times greater than the premium then being paid by the banks (19.5 cents per $100), "indicating that Federal deposit insurance represents a large contingent liability of the Federal government." At the same time, the study concluded, reduced coverage would be preferable to a premium increase.

[61] Professor Tobin has clearly been of two minds on the issue, however. See his articles "Deposit Insurance Must Go," *The Wall Street Journal*, November 22, 1989, and "Keep Deposit Insurance, But Protect Taxpayers," *The Wall Street Journal*, May 29, 1991.

poor loan portfolios that deposit insurance fosters. Here, the core bank proposal breaks down considerably into a case for government priced insurance, government credit allocation, and interest rate ceilings. Such proposals have been tried in the past and have failed badly.

7) ***"Market Discipline"*** — Various reform proposals, also well-intentioned, may be classified as attempts to preserve Federal deposit insurance while instilling some measure of "market discipline" into the system. Some advocate reduced coverage either by size of account or number of accounts insured. Others would have depositors share some fraction of a loss above a certain amount. Others would limit the "too-big-to-fail" policy in which even uninsured depositors are protected. One reform tries to cap the FDIC's obligations and encourages banks to trade their coverages, perhaps establishing "market prices" for a government guarantee.[62] Yet its author concedes that even under his plan, "the worst-managed institution would find insurance" and predicts that the deposit insurance system "would face a slowly moderating problem rather than one continuously growing." He then concludes that "taxpayers might be willing to come to the rescue if [a plan] results in permanent improvements." But a more slowly deteriorating system is not the same as an improving one. A slow-motion collapse is still a collapse. "Market discipline" proposals tend to offer a welcome finger in the dike, but pay little attention to the origins of the flood. They recognize the power of markets but are timid in embracing them fully and consistently.

8) ***Cross-Guarantees*** — Banking consultant Bert Ely has long advocated a "100% cross-guarantee" plan in which each bank would underwrite the deposits of every other bank in the system, thereby leveraging the entire $220 billion capital base of the industry.[63] The main problem is that the plan is not voluntary and therefore does not count on the financial self-interest and incentives of private banks. Conservative banks would still have to support bad banks. Moreover, the plan neglects the long, secular decline in bank capital ratios that occurred in this century due to government intervention, and yet relies completely on this diminishing source of strength.

9) ***Private Insurance*** — Some analysts have recommended that deposit insurance be privatized, to benefit fully from the risk control features private insurers impose.[64] But even private insurers have said such coverage would not be forthcoming in the amounts required because insurers cannot cover systemic risks — precisely the risks that are likely to arise in any wave of bank failures. Actuaries from the insurance industry have pointed out further that the reserves of the industry are too small for a $3 trillion deposit banking system.[65] Proposals for private deposit insurance place greater emphasis on privatization than on sound banking or practicality. In fact, deposit insurance is a government scheme that no free market would find necessary. Fully free, unregulated, uninsured private banks that can branch and diversify their risks, earn their own profits, and suffer their own losses, does not require private deposit insurance. Such a system enjoys a natural form of stability.

[62] Smith, Fred. "Cap the Financial Black Holes," *The Wall Street Journal*, September 29, 1988.
[63] Ely, Bert. "Federal Deposit Insurance is Beyond Any Fix or Reform," *American Banker*, August 27-28, 1990.
[64] England, Catherine. "A Proposal for Introducing Private Deposit Insurance," *Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago, May 1985.
[65] Lumpp, Roger. "Private Deposit Insurance is Not a Viable Alternative to Federal Deposit Insurance," *Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago, May 1985.

V.

ABOLISHING DEPOSIT INSURANCE

FROM every important perspective worth considering — moral, political, and economic — government deposit insurance deserves nothing less than complete abolition. *Morally*, it penalizes prudent bankers and rewards reckless ones. It encourages depositors to surrender their independent judgment about the status of their financial resources. *Politically*, the system fosters an unhealthy mix of politics and banking that breeds corruption, influence peddling, scandal, demagoguery, and voter antipathy. It undermines the Federal Government's credit standing and its ability to perform necessary functions. *Economically*, it promotes reckless lending, causing a massive malinvestment and waste of resources in uneconomic ventures. It politicizes the credit allocation process while generally undermining the financial condition of the banking system. The failure of government deposit insurance is a special case of the more general failure of government central planning, itself a failure that the entire world is increasingly coming to recognize. The sooner we recognize this connection in America, the better off we will be.

In order for bankers and depositors to rearrange their affairs, abolition of deposit insurance could take place in a few brief steps over a 5-year period. In the first year, the $100,000 coverage could be scaled back from each *deposit* account to each *depositor*. In each successive year, the coverage would be reduced by $25,000 until it was eliminated entirely. In the interim, banks would have ample time to adjust their deposit mix, their liquidity levels, and their capital where necessary. Depositors would also have the time and the capacity to adjust. In the past 2 decades they have already demonstrated an acute awareness of uninsured, relatively unregulated alternatives, namely, money market mutual funds. These safe, checkable funds have grown from virtually nothing in the late 1970s to almost $600 billion in size recently, a substantial portion of which was taken from the subsidized and regulated banking system. As recently as 1984, commercial banking had an 84 percent share of the entire retail deposit market versus 16 percent for the money funds. By 1990, banks fell to a 58 percent share, while money funds had 42 percent.[66]

Depositors are not unaware of the collapse of government deposit insurance. They are beginning to recognize that most of the banking system is effectively uninsured. Yet even insured banks cannot match the safer, more competitive alternatives available elsewhere. Many depositors with more than $100,000 at risk have moved their funds out of banks and into money market funds and other more reliable vehicles. Smaller depositors are beginning to join them.

[66] "Banking in the 1990s: Where Will the Profits Come From?," First Manhattan Consulting, 1991.

In short, uninsured, "run-resistant" money is not an impossible dream — it exists today, in the money market mutual fund business.[67] Banks should be deprived of their government deposit insurance subsidy while at the same time freed to provide comparable, competitive financial services. Banks with foresight should voluntarily drop government coverage and unjust premiums — and the malincentives they foster.[68]

Foreign banking systems offer further evidence that deposit insurance is superfluous; with little or no deposit insurance but widespread branching, foreign banking systems have always been far more stable and conservative than the U.S. banking system.

Of course, other money and banking reforms would be important to the success of uninsured, unsubsidized banking. For example, we must have banking without the current "too-big-to-fail" doctrine.[69] In addition, we must move toward a system of fully free banking based on gold-convertible money.[70] In such a system, banks would be free to lend, to issue currency, to branch, and to diversify their operations without political interference. In addition, failed banks must be subject to the bankruptcy law.[71] There are many favorable historical episodes of such a system that we can draw upon.

Conclusion

The American system of Federal deposit insurance has collapsed under the weight of its internal contradictions and perverted incentives. The system has undermined safe and sound banking by punishing the prudent and rewarding the reckless — be they bankers or depositors. The system is fundamentally unjust. This explains its complete impracticality.

Contrary to conventional wisdom, Federal deposit insurance is a fatally flawed, socialistic system that never did work and cannot be made to work. Recent attempts to incorporate "market oriented" features into the system, while laudable, do not go far or fast enough. They are attempts to do the right thing, to establish a truly market-based banking system. But mere

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[67] "The Case for Run-Resistant Money," *The Economist*, January 12, 1991.

[68] Hugh L. McColl, Chairman of Nations Bank in Charlotte, is doing just that. The bank is preparing to split into two entities, one of which is funded without insured deposits. In the uninsured unit, says McColl, "You may pay more for funds, but you get rid of the hidden costs of 800,000 regulations." See "Two Big Rival Banks in Southeast Take on New Age Competitors," *The Wall Street Journal*, July 8, 1993, p. A1.

[69] Salsman, Richard M. "Banking Without the 'Too-Big-To-Fail' Doctrine," *The Freeman*, November 1992.

[70] Salsman, Richard M. *Breaking the Banks: Central Banking Problems and Free Banking Solutions* (Great Barrington: American Institute for Economic Research, 1990), especially Chapter 9.

[71] Hetzel, Robert. "Too Big To Fail: Origins, Consequences, and Outlook," *Economic Review*, Federal Reserve Bank of Richmond, November/December 1991, pp. 3-15. Hetzel argues that removing the banks' exemption from bankruptcy law also removes the resolution of bank failures from bureaucrats, thereby depoliticizing the process and maximizing the outcome.

tinkering with a fatally flawed system simply will not do. Time is running short. If we are to prevent further injustice, innocent victims, and the politicization of the banking system, we must abolish deposit insurance.

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