ECONOMIC COMMENTARY

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Deposit Insurance and the Credit Shortage in Texas

One strategy to ease the present credit shortage in Texas—and to boost state economic growth—would be to close or recapitalize bankrupt financial institutions, thereby speeding the transfer of assets from weak financial institutions to healthy ones. Once this shift occurs, normal lending can resume. Problems inherent in the banking system are delaying the adjustment process. Bankrupt and capital-impaired financial institutions are offering depositors above-market interest rates to attract the funds necessary to remain afloat. They can do this because present banking regulations and insurance do not adequately restrict or price risk.

When Congress passed the Depository Institutions Deregulation and Monetary Control Act in 1980, the intent was to allow banks and savings and loans to pay market rates of interest on deposits. Banks and savings and loans were having a difficult time competing with other institutions that were not similarly constrained by interest rate regulations. By phasing out interest rate ceilings on deposits and allowing the introduction of interest-bearing deposits with some transactions capabilities, Congress enhanced the ability of banks and thrifts to compete in attracting deposits.

Unfortunately, some banks went well beyond the intent of Congress by offering exceptionally high interest rates. Because they wanted to pursue high growth strategies, some institutions often paid deposit interest rates considerably above those prevailing on U.S. Treasury securities or on deposits being paid by other banks and thrifts in their local market. This strategy was more difficult to pursue before deposit-rate deregulation because price ceilings on deposits required greater reliance on uninsured sources of funding which were sensitive to the potential riskiness of the institution.

Partly due to the comparative lack of external controls, many of these high growth depository institutions find themselves in a troubled financial condition. In a desperate attempt to survive, some troubled institutions are taking on high-risk investments. Their ability to do this has been aided and abetted by their continued access to insured deposits, although at rates as high as several hundred basis points above Treasury rates.

Insured financial institutions incur increased risk because they do not bear the full costs of their risk taking. Rather, the flat-rate insurance provided by the FDIC and FSLIC spreads the cost of any one institution's actions across the entire system. In the absence of any ceiling or tax on interest rates that a financial institution can pay on deposits, the federal deposit insurance safety net gives individual financial institutions an ability comparable to a license to print money, or when losses are incurred, a *de facto* license to levy taxes on society.

Several modifications to the pricing of federal deposit insurance would help reduce these moral hazard risks by shifting the costs back to those financial institutions taking the risks. Unfortunately, assessing the overall riskiness of a bank is an extremely difficult task. The true risks of many loans and investments are not discovered until *after* troubles are experienced. Similarly, a bank's interest rate risk exposure is not known with certainty until after interest rates actually change. Some risks, however, such as those associated with paying above market interest rates, can be gauged and taxed more easily.

One simple modification to the present flat-rate deposit insurance system would be to require higher insurance premiums from financial institutions that paid well above market rates to attract deposits. As interest rates offered on deposits rose above Treasury rates, insurance premiums also would rise proportionately. This simple change in deposit insurance would force institutions pursuing exceptionally high-growth strategies to bear a greater proportion of the costs of their actions. In addition, this change would indirectly reduce the impact of the perverse inventive structure inherent in the deposit insurance system; currently, insured depositors' only incentive is to seek the highest return without regard to the riskiness of the financial institution.

Such a modification would discourage excessive risk-taking in this one area of bank activity by more accurately pricing the costs individual institutions impose on other members of the financial system. In the long run, the overall safety and soundness of the banking system would be enhanced somewhat by this redirection of economic incentives. In addition, this modification would speed up the closure of troubled institutions because it would increase their short-run losses, thereby accelerating the deposit insurance agencies' need to resolve the problems.

Ultimately, the recapitalization and closure of bankrupt financial institutions, together with appropriate modifications of the deposit insurance system, should lower the cost of funds that *healthy* Texas institutions must pay. Making individual institutions bear the full cost of their actions would speed-up the rate at which deposits are rechanneled from financially weak institutions to healthy institutions. By reallocating deposits to banks and thrifts with a real capacity to lend, this deposit insurance modification would enhance the ability of the Texas banking system to once again function normally in the creation of credit to support the growth of commerce and industry.