Economic Commentary

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Deposit Insurance Reform

Financial industry observers and analysts increasingly agree that funds earmarked to pay for the thrift crisis will prove insufficient. Less agreement exists on the reasons for the shortfall or on the cause of the crisis itself. An emerging consensus, however, identifies one element of the problem: overall public policy encourages excessive risk-taking by depository institutions. In this view, deposit insurance is the major culprit because it insulates depositors and, in some cases, other creditors from risk. An analysis of our current deposit insurance system suggests that future crises are possible.

Prices and Incentives

The flaw in deposit insurance is well established: the premiums charged are unrelated to the riskiness of the insured institution's portfolio. Deposit insurance thus skews the risk-reward choice in favor of taking greater risk to secure a larger expected return on assets. In the absence of the current system of deposit insurance, a depository institution (hereafter called a *bank*) would face higher funding costs as the riskiness of its portfolio increases. By demanding a premium for funding risky assets, depositors would drive up the funding costs *in anticipation* of possible losses. Their actions would restrain risk-taking to appropriate levels and limit actual losses.

In reality, of course, deposit insurance immunizes depositors against risk. Indeed, it is a misnomer to call the immunization *insurance*, because the insurance actually constitutes a blanket guarantee to insured depositors against risk of loss. *Blanket guarantees of safety anesthetize credit markets, dulling the senses to risk.* The consequences are the losses, insolvencies and failures that we have seen among banks.

To reiterate, the flaw in deposit insurance is well established. The only question is whether regulatory and supervisory policies sufficiently constrain risk-taking by banks so as to offset the incentives provided by deposit insurance. Analysis suggests that stricter regulation and supervision—including more stringent capital requirements—are far from perfect substitutes for a market-based risk-reward incentive system.

Regulation and Incentives

Regulators confront an overwhelming task in constraining risk-taking by banks. First, bankers, acting on the signals sent by the incentives they face, innovate in ways that end up circumventing regulation designed to limit risk-taking. Second, the sheer number of banks precludes regulators from effectively monitoring all banks all of the time. Third, and most important, the economic solvency of banks depends on market values, while regulators utilize accounting (or book) values. The lesson of the thrift debacle surely is that the discrepancy between accounting and market values can easily exceed required capital.

All things considered, it is too much to expect any regulatory and supervisory system to offset the perverse incentives established by financial safety nets, such as deposit insurance. Unless there is meaningful reform of deposit insurance, we risk repeated episodes of large-scale losses among banks and insolvencies in deposit insurance funds. Recent strengthening of capital standards and buttressing of supervisory powers are laudable, but these changes cannot completely substitute for altering the incentives provided by deposit insurance.

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