Banking on Markets

By Cornelius Chapman

After the S&L crisis, deposit insurance gets new scrutiny.

THE FINAL BILL FOR THE S&L CRISIS is being tallied up, and like the bar tab for a drunken night on the town, it is simultaneously sobering and stomach-churning: at least $200 billion in government funds to pay depositors' claims against the Federal Deposit Insurance Corporation and the now-defunct Federal Savings and Loan Insurance Corporation. And on top of that already staggering figure are less obvious costs—such as additional interest payments on the national debt, an overbuilt real-estate market financed by high-risk loans, and losses of personal net worth for people who bought homes shortly before the bubble burst—that will continue to act as a drag on the national economy for some time to come.

Now that the biggest banking crisis since the Great Depression is over, the question in some people's minds is how to reform the system of federal deposit insurance that grew out of the first major banking debacle of this century and was a contributing cause of the second. "The excesses of the 1980s would not have happened without the federal deposit insurance system," says University of Chicago law professor Geoffrey Miller. Federal deposit insurance, he argues, encourages the very behavior—risky lending—that it insures against, just as federal flood insurance encourages people to live in areas that are prone to flooding.

When depositors have recourse to "free" government insurance, they have no incentive to monitor the prudence of their financial institutions, because they cannot lose their money. And if banks are certain that the government will pay off depositors in the event of a failure, lenders have less reason to avoid high-risk ventures (with potentially higher investment returns). In effect, both depositors and bankers are playing an investment game with other people's—the taxpayers'—money.

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THE FISCAL IRRESPONSIBILITY INHERENT in federal deposit insurance prompted Rep. Thomas Petri (R-Wis.) to introduce the Deposit Insurance Reform, Regulatory Modernization, and Taxpayer Protection Act (H.R. 3570) late last year. The bill, which has five co-sponsors, would do away with the FDIC's insurance functions, replacing them instead with "cross-guarantee" contracts by which other banks, insurance companies, pension funds, and anyone else who could satisfy certain tests of financial strength would back bank deposits.

Petri's bill would effectively privatize both deposit insurance and bank regulation, since the federal government's role would be reduced to making certain that a cross-guarantee contract was in place for every bank. Syndicates of private guarantors would decide on the safety and soundness requirements to be imposed on each bank whose deposits they guaranteed, and they would price their services according to the varying levels of risk they chose to undertake. Individual banks could choose from a variety of insurance policies based on price and flexibility. Petri argues that would reduce the possibility of future "credit crunches," since no single insurer would be in a position to dictate what risks were acceptable for all banks across the entire country. But since private investors, unlike the federal government, do not have an effectively limitless supply of money, they have a vested interest in regulating the banks they back.

To avoid disrupting markets during the transition from public to private insurance, the plan would not go into effect until either banks with at least $500 billion in total assets signed on or the expiration of an 18-month period following the passage of the bill, whichever came first. The bill is currently being considered by subcommittees of the Ways and Means, Judiciary, and Banking committees.

"Mispriced federal deposit insurance contributed to a series of asset deflations that caused bank insolvency losses not seen since the Great Depression," says Petri. Until recently, the FDIC failed to use risk-based insurance premiums, argues Petri, enabling banks that were active lenders to "boom" sectors of the economy such as oil and real estate to attract deposits long after warning signs of coming "busts" would have otherwise scared off depositors. Even after the S&L wake-up call, the FDIC has been slow to implement a congressional mandate to do what any non-governmental primary insurer does as a matter of course: privately reinsure its liability to spread its risk.

A market-driven insurance system

would not only protect taxpayers from having to bail out failed banks, says Burt Ely, the Virginia-based banking consultant who helped Petri devise his plan, it would also allow banks to be more responsive to local economies and their needs. As it stands, the nationwide regulatory laxness that precipitated the S&L crisis has merely been replaced with a nationwide regulatory strictness. The result is an excessively tight credit crunch, with bank loans falling 2 percent since 1991, despite increased credit requests. "A market will price riskier loans at higher rates," says Ely. "One-size-fits-all regulation of banks resulted in enormous losses that could have been avoided."

Unlike the FDIC, which must by law apply equal standards across the country, private insurers wouldn't be in a position to dictate what risks were acceptable for all U.S. banks. "The political process doesn't understand the regional nature of bank insolvency losses," notes Petri. "Overall, commercial banking outside of the Southwest and New England actually performed reasonably well during the 1980s. But the regulatory pendulum swung so far in the opposite direction that the [national] economy suffered from a credit crunch."

SINCE A NUMBER OF FOREIGN GOVERNments, such as New Zealand and Argentina, have gotten out of the deposit-insurance business, Petri can buttress his case on Capitol Hill with more than theoretical arguments. Miller, the University of Chicago law professor, notes that Argentina has eliminated its deposit-insurance system and made a commitment not to rescue big banks that fail. While Argentina's depositors are thus completely unprotected by their federal government, its economy is booming, and, says Miller, "the banks are doing fine."

U.S. economic history also lends support to the idea: Private deposit insurance was once a staple of American banking. Before the Civil War, a number of states, including Ohio, Indiana, and Iowa, had insurance programs based on cross-guaranties resembling those in the Petri bill. While bank failures were frequent, depositor losses were minor. Despite their success, however, such plans were pushed out of business by the passage of banking laws that consolidated power in the federal government.

And in the areas of the country that still allow private deposit insurance for deposits greater than the federally insured maximum of $100,000, the results have been promising. For instance, a Massachusetts program currently in effect covered a number of savings-bank failures in the 1980s with no depositor losses. While this sort of private umbrella has worked well, it hasn't had much of a chance to develop, since throughout the 1980s the FDIC usually covered even the uninsured portion of deposits at large banks. This politically savvy but economically ruinous policy was predicated upon fears that a major bank failure would cause disruptions in the nation's banking system. At the same time that the "too-big-to-fail" policy gave big banks an unfair advantage over smaller ones, however, it also reversed the original intent of federal deposit insurance, which was to guarantee *small* depositors against losses.

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Of course, there have been some notable busts among private insurance plans, including some pre-Depression state systems and the high-profile failure of a private credit union in Rhode Island in 1990. A program in Canada recently went belly up as well. But the failures tellingly share a common element with the current federal deposit insurance system: All relied on a centralized authority rather than competition to assess risk.

In Rhode Island, for instance, the state enabled a single private insurer to maintain a monopoly on insurance for all banks and credit unions that didn't have federal insurance. In those states with private insurance prior to the Depression, a central fund assessed premiums on each bank that were computed without regard to losses suffered by particular members. As a result, individual members of the system had no incentive to monitor the activities of their fellow banks.

But if top-down federal regulation will never be able to prop up a banking system that subsidizes bad loans and rewards depositor indifference, why haven't bankers pushed to scrap a system that binds them up with restrictions they universally denounce as burdensome? "I told one of my banking clients that private insurance was the key to the asylum," notes Ely. "He responded by saying, 'What makes you think the inmates want to escape?' " As with most regulated industries, the primary beneficiaries are the suppliers, not the consumers whom the rules ostensibly protect. A world with fiscal winners and losers saddles bankers with much more responsibility and accountability.

A boom-and-bust banking system, of course, was the predictable result of a policy that, however well-intentioned, failed to address economic realities. Even Franklin Roosevelt, a man rarely praised for his fiscal acumen, understood this. In 1933, as he signed into law the bill that created the FDIC, he prophesied that federal deposit insurance would end up subsidizing bad banks at the expense of good ones, costing taxpayers money in the end. Fifty years later, that's an all-too-accurate description of the current banking scene. R

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Pilgrim's Regress

By Martin Morse Wooster

President Clinton's future depends on selling big government to a leery electorate.

As President Clinton celebrated his first year in office, some journalists admired his achievements, while others were skeptical. But for many journalists living inside the Beltway, President Clinton was not just a politician—he was a hero.

Journalists call a story a "beat sweetener" if it's meant to please a source or boost the ego of a powerful person. There were far too many writers whipping up sticky feasts of love in 1993, hoping that, if they were very good, Bill Clinton would pat them on the head and Hillary Rodham Clinton would reward them with a homemade cookie. While some writers, such as *The Washingtonian*'s Barbara Matusow, *Newsweek*'s Eleanor Clift, and *Time*'s Margaret Carlson, were content to deliver lollipops to the Clinton camp, *The New Yorker*'s Sidney Blumenthal wanted to deliver the entire candy store to the presidential partners.

Blumenthal was in an odd position. He had made his career as a liberal pit bull who saw conservatives and Perotistas as juicy raw meat. When attacking right-wingers, Blumenthal wouldn't usually stop until the bones were picked clean.

But now the Republicans were out of power, and diminutive billionaire Ross Perot had disappeared from the national political radar. Worse still, Blumenthal's good friend, Bill Clinton, was in the White House—and under attack. The revelations of the Arkansas state troopers had made the president's private parts fodder for comedians, and the smoldering scandal of the Whitewater Development Corporation threatened to burn the president, the First Lady, and several other White House staffers. Something had to be done!

HENRY PAYNE

So in the January 24 *New Yorker*, Blumenthal concocted a beat sweetener so sugary it threatened to give the magazine's readers diabetes. In his effort to become Clinton's best friend in the press, Blumenthal pulled out all the stops. He made comparisons between the president and Lyndon Johnson, John Kennedy, Dwight Eisenhower, Harry Truman, and Woodrow Wilson. Showing his mastery of history, Blumenthal wrote that "Clinton had the worst first week of any president since William Henry Harrison, who caught pneumonia while delivering a long inaugural speech and died a month later. Clinton suffered from attorney general nominees with nanny problems and from visceral opposition to gays in the military."

My favorite passage in Blumenthal's article described Bill Clinton's goals. The dilemmas Clinton faces, according to Blumenthal, "must be excruciating, because the issues he insists on confronting are so basic. Yet...he is open to recasting his methods in order to reach his goals. Honor and glory must remain ceremonial. If the glittering superficialities of the office entrance its occupant, he risks distraction from his arduous tasks. This pilgrim has to be a politician: it is the only way he knows how to progress."

In the midst of such high-minded praise, Blumenthal had one substantive point to make. If Clinton is to succeed, Blumenthal wrote, "he must revive belief in positive government. Not for a long time—not since the mid-1960s, really—have Americans been confident that government could help them deal with the significant problems of their lives."

The national lack of faith in "positive government"—more commonly called big government—will be difficult, if not impossible, to overcome. The New Dealers who were active in the Democratic Party during the Carter presidency are by now dead or retired. The Great Society advocates who could still pass themselves off as young Turks in the late 1970s are discredited graybeards now.

But the problem isn't just on the big government side. The Clinton administra-