

# *Deposit Insurance Reform or Deregulation Is the Cart, Not the Horse*

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Possibly, it is because I was raised in a city or because my uncle, on whose farm I passed a few hardly idyllic childhood summers, was too shrewd. Whatever the reason, I have never been able to understand how one puts a cart before a horse. Shrewd as he was, Uncle Clarence never once even tried. I suspect, though, that I do understand what it means to say, "You've put the cart before the horse." If I do, then that is what the Congress has done, perhaps not for the first time. Apparently intent on assuring fair competition, it has already managed, directly and indirectly, significant deregulation of our commercial banks (and savings and loan associations as well). Until very recently, U.S. banks were limited in what they could pay depositors. Now, with their money market deposit and super NOW accounts, they are much freer than they were. But having managed significant deregulation, the Congress has yet to make a start at changing the U.S. deposit insurance scheme. And changing that scheme is what it should have done first. Acting in the public interest, it should have begun by making the scheme consistent with less-regulated banks and only thereafter turned to deregulation.

In passing the Federal Deposit Insurance Act (FDIA), which it did in 1933, the Seventy-third Congress created the Federal Deposit Insurance Corporation (FDIC). It also imposed a pricing policy on its newly created public corporation. All insured banks—those with creditors protected against default by the FDIC—were to be charged alike. In other words, the FDIC was not to charge insured banks according to the riskiness of their

respective balance sheets. But with an insurance premium that is constant across balance sheets, the result may be excessively risky banks. Indeed, unless insured banks are prevented by regulation from becoming riskier, the result is excessively risky banks. Insured banks are riskier than they would be if none of their creditors were insured.

For any kind of company, having creditors is incentive enough to become riskier. Why not gamble with the money of others? That is why bond covenants (restrictions on what those who have issued bonds may do in the future) are so common. But an ordinary company, one without government-insured creditors, provokes an obvious response when it becomes riskier. Creditors demand more interest either immediately or, if holding long-term obligations, as soon as they can. So, whether formally (by imposing covenants) or by their market response, creditors limit riskiness.

The insured bank, though, has some creditors who, because they are protected by the FDIC, do not care what it does. In becoming riskier, it therefore does not provoke the response that the ordinary company does. Not all of the insured bank's creditors demand more interest. Unlike the ordinary company, it does then become riskier. With an insurance premium that is independent of its balance sheet, it does even if some of its creditors do care what it does. Uninsured creditors or depositors make a difference. But however watchful they may be, however ready to demand more interest, they do not keep the insured bank from being riskier than it would

be if none of its creditors were protected by the FDIC.

Thus, the Seventy-third Congress, which long ago gave us the original FDIA, provided a rationale for regulating insured banks. Since 1933, regulation has been essential, if only as a substitute for enough watchful bank creditors. And until the FDIC's pricing policy is changed, or the Congress gives up on trying to protect so many bank depositors, it will continue to be essential.

I do not say that over the years since 1933, bank regulatory policy has been near perfect or that all the statutes and administrative regulations that currently bind banks can be defended. Obviously, the FDIC's pricing policy does not justify the geographical restrictions to which banks (and bank holding companies) have been subject.

Yet, it would seem inescapable that if the Congress and the bank regulatory agencies deregulate further before the Congress has changed our present-day insurance scheme in some appropriate way or other, they will be inviting a banking crisis. Of course, there may still be time. Even if there is more deregulation in 1983, a crisis soon thereafter is by no means a certainty.

Apparently, some members of the Congress are willing now to at least consider a rewriting of the FDIA. In Title VII of the Depository Institutions (Garn-St. Germain) Act of 1982, the FDIC was directed, along with the Federal Home Loan Bank Board and the National Credit Union Administration, to provide answers to questions about its insurance scheme and, more specifically, about the feasibility of changing that scheme in certain ways. What, if anything, the Congress ought to do with the FDIC insurance scheme is therefore at this moment rather a practical concern, and my purpose in this paper is to explore what the Congress' options or alternatives are. I am mostly interested in feasibility. I do not go far toward an ordering of those congressional options that, as it seems to me, are feasible. To some, perhaps, at least a couple of the alternatives that I consider will appear wildly impractical. Before the FDIA is amended, though, we should consider all manner of alternatives to the deposit insurance scheme of the present.

What the alternatives are depends on why bank depositors or creditors are insured. In the first and second parts of this paper, I consider two possible objectives: in the first, protecting those who are both poor and financially naive and, in the second, preventing bank runs. As it happens, our present-day insurance scheme is

consistent with neither of those objectives. But as I argue in the first part of the paper, there is an alternative to the present-day scheme, easily managed, that is consistent with protecting those who are poor and, in matters financial, quite hopeless. Moreover, under that alternative further deregulation of banks may not be terribly risky. And as I argue in the second part of the paper, there is an alternative to the present-day scheme, also easily managed, that is consistent with preventing bank runs. Under it, however, further deregulation would be extremely risky.

If the objective of government-provided insurance for bank depositors is preventing bank runs, and we are to proceed with deregulation, then only a radical alternative to the present-day scheme will do. In the third and fourth parts of the paper, I consider several. Among them is the most oft-urged of radical alternatives, the essential feature of which is an insurance premium that depends on the risk of default. I argue, though, that we may not know enough to make the insurance premium depend on risk. So I go on to other radical alternatives. One of those alternatives is simply doing without government-provided insurance for bank depositors. Another, perhaps a little more appealing, is doing without government-provided insurance but making banks hold 100 percent reserves. The last is doing without government-provided insurance but requiring banks to value their assets continuously at market prices.

### **An Insurance Objective: Protecting the Naive Poor**

Why insure bank creditors? One answer to that question, which over the years has been given again and again, is that we must protect those who are poor and financially much too naive, who could never be expected to distinguish even the extremely risky from the riskless. Consider the following elegantly phrased assertion, made more than 150 years ago by an early advocate of insuring bank creditors:

The loss by insolvency of banks generally falls upon the farmer, the mechanic, and the laborer, who are least acquainted with the condition of banks and who, of all others, are most illy able to either guard against or sustain a loss by their failure.<sup>1</sup>

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<sup>1</sup>New York State Legislature, Assembly, *Journal* (Albany, New York: 1829), p. 439. I am indebted to Carter H. Golembe for calling the passage to my attention.

In 1829, bank notes dominated in exchange, and the problem was therefore to make sure that every note was worth its face value. Now, however, getting by with just notes would be too inconvenient. Instead of paying out notes, we mostly write checks. For all, checking accounts are virtual necessities. As I understand, that is the essential fact (if fact it be) for those who would protect the poor and financially naive by having the government insure bank deposits. They argue that even the poor and financially naive are, as it were, forced to have checking accounts and, further, that since those folks, being financially naive, cannot tell good banks from bad, their accounts have to be protected.

Perhaps the savings deposits of the naive poor should be protected too. With them in mind, one might propose changing the denomination of, say, the three-month Treasury bill from \$10,000 to \$50 or even \$5. (If handling the public debt would cost more than at present, regulating banks would presumably cost more than enough less.) But would doing that help? Allegedly, all the financially naive know is that banks—for them, an undifferentiated bunch—are where they are supposed to put their monies. More particularly, they are incapable of appreciating that acquiring a \$5 Treasury bill is quite unlike lending \$5 to a terribly mismanaged bank.

So should the government insure bank deposits to protect those who, besides being badly off, do poorly in managing their own financial affairs? How persuasive is the argument just summarized? Almost certainly, the financially naive are not now as large a proportion of the population as they were in 1829 or, indeed, in 1933. There may, however, still be many around. Even if not, going from relative poverty, coupled with financial naivete, to government protection is a leap of the heart, not the mind, and thus it may not matter how many there are.

#### *An Inconsistency*

If of the auto variety, a present-day mechanic may well appreciate a \$100,000 FDIC insurance limit. Why have to deal with two or three banks? Or have two or three deposits? From caring for wagons to caring for autos, mechanics (like women) have come a long way. Possibly, farmers have too, although it hardly seems so at the moment. For our laborers, however, and the others who are poor and financially naive, for those who "are most illy able to either guard against or to sustain a loss . . .," the \$100,000 limit would seem grossly excessive.

In a recent discussion of the Penn Square Bank spectacular, the chair of the FDIC told of a Methodist congregation that had a building fund of \$150,000, accumulated over many hard years, in the bank when it failed. That is sobering. Evidently, it never occurred to those responsible for the building fund to use two banks. Financial naivete cannot be entirely of the past. But no single instance, however heartrending, suffices to establish the proper upper limit for FDIC protection. If one instance did suffice, then, with enough diligence, someone of feeling could, I am sure, arrive at a limit of \$1,000,000. It is necessary to use an average, and \$100,000 would certainly seem to be way above the checking (and savings) deposit average of those "who, of all others, are most illy able . . . to sustain a loss . . ."

#### *Achieving Consistency*

If the purpose in having government-provided insurance for bank depositors is to protect those who are both hopelessly unsophisticated in financial matters and among our least affluent, then there is an easy way of getting an insurance scheme consistent with that purpose. A proper insurance limit, one that will appear ridiculously low to some, does the trick. We likely will never know the distribution of checking (and savings) deposits by the degree of financial sophistication of owners. A distribution by income or wealth is within reach, though, and at a guess, since the concern is for the least affluent, it will yield an insurance limit of a very few thousand dollars, perhaps only a couple.

With some doing, we might imagine no one ever wanting more on deposit in his or her bank than is insured. And if no one did, then there would be no possibility, just by lowering the limit of FDIC protection, of making regulation of banks largely or completely unnecessary. We can also imagine, though, and a good bit more easily, that for most bank creditors the limit of FDIC protection is not an upper bound for their deposits. And if a drastic change in the insurance limit, from \$100,000 to \$2,000, say, or \$3,000, were to result in most owners of bank deposits being only partially insured, then we might look forward to more deregulation of banks with a certain equanimity. Presumably, with most owners of deposits being at risk, virtually all banks would be subject to market discipline. Very few would be able, with no one noticing, to become riskier. In theory, of course, there is need for regulation whenever deposit insurance is provided by the government at a

risk-independent premium. Whatever the insurance limit may be, there is always that need. But in practice it may be good enough, even for complete deregulation, to have an insurance limit that is truly consistent with the circumstances of those who supposedly are to be protected.

When the FDIC insurance limit was increased from \$40,000 to \$100,000, it was partly with savings and loan associations in mind. In 1980, which is when the limit was increased, many associations were very badly off and, in consequence, were unable to issue large-denomination (\$100,000 minimum) certificates of deposit (CDs). But if the insurance limit were \$100,000, then all associations, even those near collapse, would be able to issue such certificates. The limit of the Federal Savings and Loan Insurance Corporation (FSLIC), which insures the deposits of our savings and loan associations, was therefore increased; and, to preserve equality, the FDIC's limit was increased too.

The implication is not, however, that the insurance limits of the FSLIC and FDIC must remain at \$100,000 or, if changed, be increased further. It is rather that cutting limits drastically, to \$2,000 or \$3,000, should perhaps be delayed briefly.

As most would belatedly concede, using savings and loan associations to subsidize housing was extremely poor public policy. So associations are no longer to be forced to lend long, in disregard of their being short-term borrowers; they are to have assets and liabilities of more nearly equal average maturities. With restrictions on their portfolios having been relaxed, some are even now working toward that end. And if not still protected by the FSLIC, all would be. But, again, the insurance limit of the FSLIC (and hence that of the FDIC) should perhaps be continued for a brief while at \$100,000; insisting that our savings and loan associations' balance sheets be rearranged overnight could be unwise.

### **Another Insurance Objective: Preventing Bank Runs**

For many who favor government-provided insurance for bank creditors, the purpose in having such insurance is to keep us from ever again experiencing a bank run. Nor is the concern that, with a run, the naive poor may suffer. They may. Whatever its implications for the distribution of wealth, though, any bank run is economically wasteful or costly. Allegedly, a loss of output results. That is why, in the view of some, another run is to be avoided and

why, although provided by the government, insurance for bank creditors is desirable.

Such insurance may not in general be necessary. Right or wrong, it is part of an academic orthodoxy that a central bank can prevent bank runs. As the argument goes, however, our central bank, the Federal Reserve System, failed us miserably in the early 1930s and even now, 50 years later, is still not to be trusted. That is, to say the least, arguable. But to a significant number of our academics, government-provided insurance of U.S. bank deposits appears necessary.

### *How Serious Is the Threat?*

Among the benighted, a bank run is invariably portrayed as the doing of a frenzied mob, and we must be skeptical of any happening alleged to result from a great many individuals behaving in a silly way. But a bank run may also be the doing of (in the economist's sense) rational individuals. Think of some folks who have just gotten word of the failure of a bank. If not perfectly informed about the balance sheets of their banks, they may reasonably revise their estimates of their risks and, depending on the costs, turn into currency whatever they have due them on demand. Doing that could be the best strategy.

Concern about bank runs cannot therefore be dismissed with a wave of the hand, nor regarded as pure fancy. If a bank run can occur in a laissez-faire economy populated exclusively by rational, but not perfectly informed, individuals, then the possibility of one occurring has to be taken seriously.

Some may insist that our history is conclusive. Since the United States has experienced so many bank runs, how can there be no danger of another? Great care is required, though, in arguing from the past. It delights in tricking us.

For a long time, the disposition, at least among academics who thought a bank run an ever-present possibility, was simply to accept that any widespread run would be economically costly. What, after all, could be intuitively more obvious? Recently, however, there has been some research done that makes it clearer than it was why with a run there may be a decrease in economic well-being.<sup>2</sup> We should then be concerned that a run may occur. Again, if there can be a run in an economy

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<sup>2</sup>It is not easy going, but see Douglas W. Diamond and Philip H. Dybvig, "Bank Runs, Deposit Insurance and Liquidity," *Journal of Political Economy* 91 (June 1983): 401-19.

populated by rational, but imperfectly informed, individuals, then that one will occur cannot reasonably be regarded as a zero-probability event. And we should take seriously, a little more seriously than formerly, what many have long accepted as intuitively obvious, that bank runs are economically costly.

#### *Another Inconsistency*

For a bank run to be a happening of virtually zero probability, all bank creditors must be fully insured. All deposits, the largest included, must be fully protected. Should they be, then there is no appreciable risk of even a silent run, a run conducted by owners of large-denomination CDs. (Owners of such CDs do not go clamoring into bank lobbies demanding their funds.) So again, the \$100,000 insurance limit appears as a curiosity. If the purpose of deposit insurance is to protect the naive poor, then, as was argued above, that limit is excessive. If, on the other hand, the purpose is to protect against bank runs, noisy and silent, then no dollar limit, be it \$100,000 or \$200,000, is appropriate.

There is always danger in being too literal minded and, in the present instance, of being guided entirely by what the FDIA says. Until recently, all depositors were, with probability very near to unity, fully insured. When a bank failed—a bank, that is, with more than a few creditors not (nominally) insured in full—then, if possible, it was merged into an ongoing bank. To merge was FDIC policy. The liabilities of the failed bank became the liabilities of the ongoing bank, and those with deposits of more than \$100,000 in the failed bank emerged whole.

The policy of the FDIC may still be to make sure that, whenever possible, no owner of large-denomination CDs loses anything. In the aftermath of the Penn Square Bank failure, however, one has to wonder. The FDIC may already have broken with the past. The official explanation is that Penn Square Bank creditors had to be paid off. The failed bank could not be merged into an ongoing one. It seems that the FDIC can tolerate only so much (contingent) risk! But the failure of the Penn Square Bank may have been a wonderful opportunity. The FDIC could put owners of large-denomination CDs on notice that they were at risk but, because the Penn Square Bank had been so wondrously mismanaged, without panicking them.

That the failure of the Penn Square Bank was seen by the FDIC as an opportunity is a little more plausible now than it was. Not long ago, in a report prepared for the

Congress (*Deposit Insurance in a Changing Environment*), the FDIC came out for putting owners of large deposits, those in excess of \$100,000, at risk.<sup>3</sup> There are, of course, many ways in which that might be done. The statutory insurance limit might be taken seriously. The FDIC appears, however, to favor having owners of large deposits in banks that have failed share equally with it whatever losses there have been.<sup>4</sup> The rationale is the obvious one. With deregulation or less regulation by government agencies, private market participants will have to do more than they have been to keep banks from becoming too risky; and if some of those participants are at substantial risk, they will.

In its report, the FDIC also recommended less secrecy about how banks—not as a group, but individually—are doing. So it wants private market participants to be concerned about how this bank and that are doing. And it would provide them with much of the information required for informed judgments.

As was observed above, all bank creditors have to be fully insured if a bank run is to be an event of virtually zero probability. Nor can owners of large deposits be left to infer from what FDIC policy has been that they are (or may be) so insured. Full protection for all bank creditors should be guaranteed by statute. Netting of loans against deposits should be prohibited by statute.<sup>5</sup> It follows that if the FDIC's alternative to the present-day insurance

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<sup>3</sup>Federal Deposit Insurance Corporation, *Deposit Insurance in a Changing Environment: A Study of the Current System of Deposit Insurance pursuant to Section 712 of the Garn-St. Germain Depository Institution Act of 1982*. Submitted to the United States Congress by the Federal Deposit Insurance Corporation (Washington, D.C.: Federal Deposit Insurance Corporation, April 15, 1983).

<sup>4</sup>Exactly what the FDIC has in mind is perhaps best revealed by an example. Imagine that an insured bank has failed and, further, that the FDIC has estimated that in the end, when the bank's affairs have at long last been all settled, its portfolio will turn out to have been worth 75 percent of book value. Imagine now that there is someone who had \$200,000 on deposit in the failed bank. When it has been merged, that individual will have a deposit in the ongoing bank not of \$200,000 but, rather, of only \$175,000 (\$100,000 plus 75 percent of the second \$100,000 or, more generally, of whatever amount there was on deposit beyond the first \$100,000). The individual will eventually get some of the lost \$25,000 back if the FDIC's estimate of 75 percent is shown to have been too low. Or the FDIC may find itself having lost more than 25 percent of its share of the assets of the failed bank. It will if its estimate is shown to have been too high.

<sup>5</sup>Netting is easily explained. Imagine an owner of a small business who had \$100,000 on deposit in a bank that has just failed and also a loan of \$50,000 from that bank due, say, in 90 days. There is the possibility of that individual being pressured to settle for \$50,000, the net of the deposit and the loan. Most would regard it as more reasonable, though, for the FDIC to do as it has been doing (except when very poor credit risks are involved)—to pay the \$100,000 immediately and, expecting payment in 90 days, take the note as its own.

scheme is adopted, we will be living again with the risk of a bank run. To its credit, the FDIC does not deny that. It believes, though, that if its alternative is adopted, there will be only an inconsequential risk. But that is a judgment and, if with no great confidence, can reasonably be disputed. Someone might judge that there will be a very substantial risk of a bank run if the FDIC's alternative is adopted. Certainly, owners of large deposits will be at very substantial risk.

The present-day insurance scheme (to be more exact, the scheme of the period before the failure of the Penn Square Bank) is inconsistent with further deregulation of banking and a crisis-free future. Under it, insurance coverage is, with probability only a little less than unity, de facto a 100 percent. But is it necessary to accept risk of a bank run to make further deregulation safe? There are alternatives to the present-day scheme, more radical than that proposed by the FDIC in its recent report, that have to be considered.

### **A Risk-Dependent Insurance Premium**

Since the FDIC first opened its doors, insured banks have all paid identical deposit insurance premiums. They may not go on doing so, though, if the FDIC has its way. In *Deposit Insurance in a Changing Environment*, it recommended that the insurance premium be made to depend, if only slightly, on its perception of bank risk (the quality of bank management). According to the FDIC, very poorly managed insured banks should in fairness pay the gross insurance premium; all other insured banks, all more or less well managed, should continue to pay the net premium.<sup>6</sup> Some, a few academic economists included, will applaud the FDIC. But most academics interested in deposit insurance will insist that it should have gone much further. For a long time now, the majority have advocated a genuinely risk-dependent insurance premium (which, being risk dependent, must be variable across banks). As has been argued so often, insured banks should be charged for insurance protection according to the riskiness of their respective balance sheets; and actual premium differentials should be whatever they have to be.

My concern is that we, economists and bank regulators, may not at present know enough to fashion an insurance premium schedule that might with considerable confidence be substituted for all present-day banking laws and administrative regulations. And "substituted" is the right word. At least among advocates of the

risk-dependent premium, the assumption has always been that it will replace laws and regulations. We will depend only on it to keep banks from becoming too risky.

There are various kinds of bank risks. If risk dependent, the insurance premium must therefore depend on many variables: among them, the riskiness of the loan portfolio; the difference, as best measured, between asset and liability maturities; and, to tick off but one more, the types of nonbanking activities being engaged in. But do we know how all the industries of the world economy rank as credit risks? Or, within any particular industry, how the companies rank? And what about interest rate risk? Is there a consensus on how it is to be measured?

Those are not the only questions. Another is how the insurance premium should depend on, for example, interest rate risk. Doubtless, the premium should be increasing. Saying that, however, does not suffice. At what rate should the premium increase? That would seem to be more an empirical question than a theoretical one. In any event, we are wanting in both theoretical results and empirical knowledge.

Nor is it evident how the FDIC should proceed in levying penalty insurance premiums or what its modus operandi should be. Suppose bank A has a loan portfolio that, as judged by FDIC examiners, is riskier than the loan portfolio of bank B. We thus have bank A paying a greater insurance premium than bank B. And suppose now that with the passage of time, bank A comes to have relatively more nonperforming loans than bank B. With that having been revealed, should bank A be charged still more for its FDIC insurance? The answer to that question might seem to be an easy "no." That larger proportion of nonperforming loans was to have been expected, and in the beginning, bank A, having been judged to hold the riskier portfolio, was charged accordingly.

Recall, though, how many casualty insurance companies, as insurers of automobile drivers, operate. We can start with two males, one a callow twenty and the other a mature fifty, paying different premiums. But if, for instance, the twenty year old has an accident, his

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<sup>6</sup> The gross and net insurance premiums differ by what can be thought of as a dividend. Currently, all insured banks begin by paying the gross premium. It and the eligible stock of deposits determine the FDIC's total revenue. From that total, it subtracts its operating expenses and losses and, possibly, some amount of dollars to be added to its reserve. Anything leftover is returned, in proportion to their original payments, to the banks. So when there is something leftover, gross and net insurance premiums differ.

premium is increased, at least relative to that of the fifty year old. And why? Supposedly, males twenty-five and younger have more accidents per capita than do those who are older. Yet, even as the insurer regards them, they (those twenty-five and younger) are a heterogeneous lot; and as we must presume, the company's operating assumption is that auto accidents reveal who in that population class are the good and bad drivers.

Again, then, should the FDIC simply disregard that observed relative increase in bank A's nonperforming loans? Having reminded ourselves of how auto insurers operate, a "yes" answer is less plausible than it appeared to be. What if the FDIC has nothing like complete information about its world? That relative increase in nonperforming loans may tell it something, possibly even about the quality of bank A's management. We might even imagine the FDIC starting off with identical premiums for banks A and B. (Understandably, it may not be willing to put unbounded trust in the judgments of its examiners.) Then, once having observed a relative increase in the nonperforming loans of bank A, it increases that bank's insurance premium.

Operating in the way just described could conceivably be sensible for the FDIC. But who is sure? We have to think more about what it is that we know and, admitting of the possibility of less-than-complete information, about what the modus operandi of the FDIC ought to be. Of course, I could be dead wrong. Determining that modus operandi may be remarkably easy; there might even now be someone out there in the weeds who knows what it should be. If I am right, though, a risk-dependent insurance premium is not at present a truly feasible option for the Congress. Nor will it do itself a favor by pretending. If it insists on further deregulation of banks, it will have to consider alternatives to our present-day insurance scheme even more radical than that of a risk-dependent premium (with full insurance for all bank creditors).

### **Other Radical Alternatives**

The most obvious of the even more radical alternatives is simply abolishing the FDIC. Letting banks and their creditors get along without any government-provided insurance is patently feasible. And were the Congress to abolish the FDIC, then, of course, there would be no risk-inducing insurance scheme barring the way to further deregulation of banks. But we cannot forget about wanting no more bank runs, and with no government-provided insurance for bank creditors nor any laws or

administrative regulations constraining banks, we could be particularly susceptible.<sup>7</sup>

### *Why Be First at the Teller Window?*

It is an oft-told tale that present-day British and hence U.S. bankers are descended from gold and silversmiths of a distant past. But they cannot be descended from the first generation of such smiths. The members of that generation were not really engaged in banking but rather, as the tale goes, only in keeping valuables safe. So their promises must have been of an obvious sort. Having handed over precious silver candelabra for safekeeping, one expects to get them back. And perhaps that is why a later generation of smiths, the first to be engaged in banking, issued promises for fixed amounts of specie. A patron handed over 10 coins and got a demand promise for 10 like coins. It is as if that later generation of smiths, although engaged in banking, could not forget their safekeeping forebears.

I do not expect to be taken too seriously in my elaboration of the tale of banking's beginnings. But it is, I believe, true that from their beginnings our banks have issued bondlike or state-independent promises. Their promises have always been to pay back, regardless of the state of the world, fixed numbers of dollars. That has been little remarked on, and why is puzzling. Our banking industry has been prone to runs—or, to use the classical phrase, "inherently unstable"—because our banks have issued fixed-dollar claims and, at the same time, held risky assets.

The issuing of fixed-dollar claims is not alone necessary for a banking industry to be prone to runs. But, despite assertions to the contrary, neither are fractional reserves. For a banking industry to be prone to runs, banks must have fixed-dollar claims and, if demand

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<sup>7</sup>There is, however, a possibility that may lessen fears—a possibility suggested by the debate of the years before the FDIA was signed into law. In that debate, many of the largest of the then-existing banks were joined in opposition to having any bank liabilities insured by the government. Ranked against them were the much smaller but ever so much more numerous independent banks. Some, it seems, knew what was necessary for their survival, and that they (the least efficient) are still around could well be due more to the creation of the FDIC than to antibranching laws. If the introduction of deposit insurance is the essential explanation, and the Congress did away with the FDIC, then, for better or worse, our banking industry might undergo a dramatic reorganization and come to approximate much better than currently the very concentrated banking industries of other highly industrialized countries. There may, of course, be political objections. But if it is right that our country has experienced many more bank runs, local and countrywide, than have those other countries, that is a decidedly interesting possibility, one that should be taken seriously. Too often we assume a fixity that is entirely fanciful.

claims, assets other than currency.<sup>8</sup> Why is readily explained. If banks issued equitylike claims (those of the sort issued by mutual funds) or had riskless portfolios, no demand creditor would ever see an advantage in being first at the teller window. To put the point another way, with banks issuing bondlike or fixed-dollar claims and having risky portfolios, being first at the teller window may be advantageous. Under certain circumstances, the creditor who is first will get what was promised but more therefore than a fair share, more than some of those farther back will get.

Thus, there are ways, other than by introducing government-provided deposit insurance, of freeing a banking industry from the threat of a run. For instance, banks might be made to hold riskless portfolios. There may, however, be a practical difficulty. Telling banks to hold riskless portfolios would be easy enough, but ensuring compliance could in actual practice be extremely difficult and hence costly. It is a decided complication that what a riskless portfolio is depends on the composition of liabilities.

Ensuring compliance could be made a trivial task. It would be if, independent of their respective liabilities, all banks were required to, in effect, hold only currency (freely convertible balances at the Federal Reserve). But the simplicity of a 100 percent reserve requirement is not as apparent now as it was 25 or 30 years ago. Bank liabilities are ever so much more diverse than they were. If there was ever any sense in defining a money supply, doing so has become an exercise in arbitrariness.

The other way of freeing a banking industry from the threat of a run is by requiring banks to value their assets at market prices, or to mark them to market, and not once or twice a year but more or less continuously. If required to do that, they would not be able to offer fixed-dollar promises. Offering such promises would virtually assure their bankruptcy.<sup>9</sup>

There is a difficulty, though, one that is too serious to be glossed over. We still do not have a secondary market in bank loans. And since at present there is such a one-sidedness in knowledge about any particular loan, a secondary market may be a long time in developing. So what is the market price of this or that loan?

We might think of leaving it to banks to decide the values of the loans they have made. There are ways of assuring honest appraisals. One way is to let the government, by its choice, be either a buyer or a seller at the appraisal price. The bank that quotes an unrealistically low price will see what it has disappear; it will suffer

a capital loss. The bank that quotes an unrealistically high price will too, for it will get more of what it fibbed about. For a bank, though, the only temptation is to overvalue its loans. To keep banks honest would therefore require being able to sell them more loans. And where is the government's stock of loans? Even if it had one, there would still be the difficulty, mentioned above, that assessing bank loans, unlike bankers' acceptances, is time-consuming—which is to say, costly.

What would seem to be needed, then, to make marking to market a workable way of eliminating the threat of a bank run is a rule, reasonably acceptable to all, for valuing loans. As a practical matter, however, finding such a rule could prove as troublesome as finding an appropriate FDIC insurance premium schedule. But both the comptroller of the currency and the chair of the FDIC want banks to switch from historic cost to current value accounting.<sup>10</sup> So the staff of the Office of the Comptroller of the Currency or that of the FDIC may one day produce a rule.

### In Summary

I end as I began, by pointing a finger at the Congress. It has done what my farming uncle never even tried to do, put the cart before the horse. Although having managed some deregulation of banks, it has not yet gotten down to modifying the FDIA or, more particularly, making it consistent with deregulation.

As I have argued, though, the Congress is in a tight spot. It can invite a wave of bank failures. All it has to do is deregulate further but without amending the FDIA in some appropriate way. Or it can do nothing more than decrease the insurance limit from the present \$100,000

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<sup>8</sup>It may seem that something more is required—namely, that banks must follow the rule of "first come—first serve" in dealings with creditors. And, indeed, they must. But they are bound to do so. Until a bank has sold off all its assets or, in anticipation of demise, suspended convertibility, it has no alternative. It cannot tell a creditor with, say, a demand claim to wait until it has rounded up all of his or her fellows.

<sup>9</sup>It might be argued that if required to value their assets at market prices, banks would continue making fixed-dollar promises but hold asset portfolios very different from those they currently hold. Of all conceivable asset portfolios, however, there is only one that literally does not ever change in value as interest rates change. And that portfolio, all cash, yields no interest income. A portfolio of instantly callable loans, made to individuals and companies, has default risk. Banks could hold just extremely short-term assets with no default risk. If they did, there would presumably be relatively little chance of a bank run, and requiring that assets be valued at market prices would have to be regarded as achieving the intended objective.

<sup>10</sup>See Teresa Carson, "Historic Cost: A Thing of the Past," *American Banker* (May 3, 1983): 10.

to, say, \$2,000 or thereabouts. If it does that, it will perhaps have made insuring poor and unsophisticated bank creditors consistent with near-complete or possibly even complete deregulation. But it will also have made a bank run more likely.

So the Congress is square up against having to do something radical (and possibly risky). It can insure all bank creditors in full. If it does, it will have reduced the probability of a bank run to near zero. But it will also have made the inconsistency between insuring bank creditors and the deregulation of banks even more glaring than it is now. It might then mandate a risk-dependent premium. The far from inconsiderable risk, however, is that the FDIC will not find an appropriate premium schedule and that, in consequence, the risk-dependent premium will substitute very poorly for present-day laws and regulations.

The Congress does have one clean option. It can simply do away with government-provided insurance for bank creditors. The risk is the obvious one. We might be transported back into the nineteenth century. I think not, but there is no denying the possibility.

There are finally two remaining alternatives, neither of which involves (in the usual sense of the word) any risk, only a disquieting element of arbitrariness. The Congress might require banks to hold riskless portfolios—in the extreme, only currency. We may, however, be past that being a practical option. Who knows now what a bank is? Or what money is? Alternatively, the Congress might require banks to value their assets at market prices. Someone will have to work out a rule for valuing loans, but living with the arbitrariness, great or slight, of whatever rule is used could be the Congress' best hope.

The views expressed herein are those of the author and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System.