The dramatic rise in interest rates during the late 1970s and early 1980s wreaked havoc on the balance sheets of savings and loan (thrift) institutions. As their cost of funds rose above what they could earn on their asset portfolios, thrift institutions began to lose billions of dollars. By the end of 1982, 237 thrifts (with $67.8 billion in assets) insured by the Federal Savings and Loan Insurance Corporation (FSLIC) were insolvent or in danger of failing. The cost of closing, reorganizing, or liquidating insolvent or capital-deficient thrifts was estimated at more than $124 billion. Furthermore, approximately 500 additional thrifts are above normal risks for failure. The expected future cost associated with these failures is not included in the FSLIC loss estimates.

In contrast, the fund of the Federal Deposit Insurance Corporation (FDIC), which implicit guarantees are issued to uninsured depositors, general creditors, subordinated creditors, and even stockholders. For a discussion of FDIC failure-resolution policies, see Dora Calugiare and James Thomson, “FDIC Policies for Dealing with Failed and Troubled Institutions,” Economic Commentary, Federal Reserve Bank of Cleveland, October 1, 1987.

By late 1988, nearly 500 thrifts were either GAAP-insolvent or in danger of failing. The cost of closing, reorganizing, or recapitalizing these institutions is estimated at more than $124 billion. Furthermore, approximately 500 additional thrifts are above normal risks for failure. The expected future cost associated with these failures is not included in the FSLIC loss estimates.
the federal deposit-insurance system that would help prevent another such crisis. Numerous proposals for deposit-insurance reform have been advanced. The purpose of this Economic Commentary is to assess the fundamental economic principles that should be used in evaluating these reform proposals.

The Purpose of Deposit Insurance
What are the policy objectives of deposit insurance? Are depository institutions specifically required to protect the savings and transactions balances of small savers? If small depositors lack the sophistication and resources to monitor the condition of their depository institution, are they simply special because they have access to these guarantees? While often ignored, these fundamental questions are important because different objectives for deposit insurance could correspond to different methods of implementing a deposit-insurance system.

One widely cited justification for federal deposit guarantees is the need to protect the savings and transactions balances of small savers. If small depositors lack the sophistication and resources to monitor the condition of their banks effectively (and the resources to absorb unpredictable losses), then perhaps their accounts should be safeguarded. Deposit insurance is but one of many ways to achieve this.

It has also been argued that federal deposit insurance is needed to improve the informational efficiency of the financial sector. If it is relatively costly for some depositors to evaluate the condition of their depository institutions, then it might be more efficient to have the monitoring performed by a centralized agency. In addition, a centralized agency is likely to have lower information costs than the total cost of the combined efforts of a mass of small depositors. However, federal deposit insurance is not needed to lower information costs. These costs could be reduced simply by having an agency collect and disseminate information without guaranteeing deposits.

A third motive for federal deposit insurance is to prevent destabilizing bank runs. Some economists believe that an individual bank run can become contagious and result in a run on the entire banking system. If so, deposit insurance could remove or reduce the incentives for bank runs and thus stabilize the banking system.

A rational bank is one that chooses depositors with good information that their depository institution has (or may) become insolvent. This type of run should not be contagious, and in fact should act as a form of market discipline on bank management. An irrational bank run is one that occurs because poorly informed depositors mistakenly believe that their depository institution has (or may) become insolvent. If the primary purpose of a deposit-insurance system is to prevent irrational bank runs, then the system should insure only the deposits of customers who are likely to act on poor information.

Unfortunately, deposit-insurance systems cannot differentiate between rational and irrational bank runs. Consequently, the desirable market discipline of occasional rational bank runs is sacrificed to remove the potentially destabilizing effects of irrational bank runs. Once again, however, deposit insurance is not the only solution. A properly functioning lender of last resort can prevent irrational bank runs from becoming systemic bank runs by providing liquidity to solvent institutions experiencing runs, thus removing the destabilizing effects of irrational bank runs without precluding rational bank runs on insolvent institutions.

The need to protect the nation's payments system is the fourth reason often cited to justify federal deposit guarantees. According to this view, a lack of the payments system could be triggered by the failure of a large bank, leading other banks to become insolvent. By guaranteeing the payments-related liabilities of banks, deposit insurance immunizes the payments system from bank failures. An objection to this view is that providing direct guarantees of payments-system transactions achieves the same result with greater efficiency. Furthermore, as in the case with systemic bank runs, a properly functioning lender of last resort could immunize other banks (and the payments system) from the effects of a single bank failure.

Clearly, the type of deposit-insurance system we should adopt depends critically on our goals. For example, if the purpose of deposit insurance is to protect the savings and transactions balances of informationally disadvantaged small savers, then the coverage necessary is less than the current explicit limit of $100,000. On the other hand, if the purpose of deposit insurance is to protect the payments system, then the type of account insured is more important than the coverage. For example, consumer and corporate checking accounts would be fully insured under this motive, while savings and investments vehicles such as money market deposit accounts and certificates of deposit would receive no, or only nominal, coverage.

Economic Consequences and Costs of the Current Deposit-Insurance System
The estimated $124 billion needed to resolve the crisis in 1982 is just the direct monetary cost of our current system of federal deposit guarantees. Other economic consequences and costs include an overinvestment in risky assets and the subsidization of depository institutions on the basis of size and risk. In fact, perverse incentives built into these subsidies contributed significantly to the current crisis. Without meaningful reforms to the deposit-insurance mechanism, the amount of explicit incentives for this situation to be repeated.

As presently priced and administered, federal deposit insurance subsidizes risk-taking by depository institutions in two ways. First, the FDIC and FSLIC provide a risk-related subsidy to all insured depository institutions. Second, insured institutions that are safe and well-managed subsidize the risk-taking behavior of the "high-flivers" of the industry. In both cases, the amount of the risk-related subsidies increases with the degree of risk assumed by the institution and leads to an overinvestment in risky assets in the economy.

Currently, the failure-resolution policies of the FDIC and FSLIC have resulted in a system of federal deposit insurance that is based in favor of large institutions. For example, the FDIC has never liquidated a bank with more than $200 million in assets, thereby providing deposit guarantees for depository institutions with relatively large amounts of insured deposits.

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Equity also implies that all depositors should be treated equally. That is, there should not be different treatment across banks of uninsured depositors, creditors, and equity holders when the institution fails. The key decision is that the depositors on the bank's assets should receive the same treatment irrespective of the size, location, or type of insured institution. Otherwise, the presence of deposit insurance changes the relative costs of funds and equity capital across institutions.

The allocative efficiency of deposit insurance is not directly observed. However, judgments about the relative efficiency of alternative deposit-insurance systems can be based on the incentives built into each one. From an allocative standpoint, the incentives built into deposit insurance, the pricing of the guarantees and the amount of explicit subsidies of the FDIC and FSLIC, should not subsidize risk-taking either through cross-subsidies between depository institutions or through the market (to the extent that the Treasury stands behind the FDIC and FSLIC).

The efficiency criteria that require that when circumstances warrant, regulators must allow banks and thrifts (regardless of size) to fail. Failure is the method by which the market corrects persistent and substantial inefficiencies. Failure does not imply that the institution always must be liquidated or otherwise disappear; rather, it means that the owners and management are replaced. As we have found in the thrift industry, the failure of close institutions when they are insolvent increases the ultimate failure-resolution costs and decreases the efficiency of the financial system.

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### TABLE 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of GAAP-Insured Thrifts</th>
<th>Assets (in billions $)</th>
<th>FDIC Loss Exposures (in billions $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>237</td>
<td>67.8</td>
<td>3.08</td>
</tr>
<tr>
<td>1983</td>
<td>293</td>
<td>83.9</td>
<td>4.98</td>
</tr>
<tr>
<td>1984</td>
<td>445</td>
<td>115.5</td>
<td>16.89</td>
</tr>
<tr>
<td>1985</td>
<td>470</td>
<td>136.0</td>
<td>22.14</td>
</tr>
<tr>
<td>1986</td>
<td>471</td>
<td>137.2</td>
<td>33.76</td>
</tr>
<tr>
<td>1987</td>
<td>520</td>
<td>200.1</td>
<td>69.51</td>
</tr>
</tbody>
</table>


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Some have argued for government intervention to move banks towards a system of markets on equity grounds. Equity can be used to justify federal deposit insurance if it corrects biases or favoritism existing in the absence of deposit insurance. Because equity is a relative concept, we typically judge the equity of a proposal relative to the market outcome.

For a deposit-insurance system to be equitable, it must meet all financial institutions alike. As discussed earlier, the current system of federal deposit insurance is not equitable because the failure-resolution policies of the FDIC and FSLIC are biased in favor of large depository institutions. A second example of the inequity of the current system is in the area of capital regulation. If capital is costly to obtain, then the equity criterion implies that all insured institutions should be subject to the same set of regulations as a condition for receiving deposit guarantees. For example, if a minimum capital ratio is specified as a condition for receiving deposit guarantees, then all insured institutions should be subject to the same capital requirements. However, most thrifts are currently required to hold only half as much capital as banks.

Equity also implies that all depositors should be treated equally. That is, there should not be different treatment across banks of uninsured depositors, creditors, and equity holders when the institution fails. The key decision is that the depositors on the bank's assets should receive the same treatment irrespective of the size, location, or type of insured institution. Otherwise, the presence of deposit insurance changes the relative costs of funds and equity capital across institutions.

Efficiency is the second criterion by which deposit-insurance reforms should be judged. Economists are usually concerned with allocative efficiency; that is, how close the resource allocation under each proposal is to some perceived optimal, usually unattainable, resource allocation.

The allocative efficiency of each reform proposal is then directly observed. However, judgments about the relative efficiency of alternative deposit-insurance systems can be based on the incentives built into each one. From an allocative standpoint, the incentives built into deposit insurance, the pricing of the guarantees and the amount of explicit subsidies of the FDIC and FSLIC, should not subsidize risk-taking either through cross-subsidies between depository institutions or through the market (to the extent that the Treasury stands behind the FDIC and FSLIC).