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Bank Regulation and Deposit Insurance

The subject of government bank regulation is intimately intertwined with that of government deposit insurance. If the government is to insure bank deposits, it should also have some say in the risks that insured banks are allowed to take, otherwise it would leave itself wide open to unlimited potential losses.

John H. Kareken (in this issue) comes close to arguing that banks without government deposit insurance could provide satisfactorily safe transactions accounts. I would go one step further and argue that government deposit insurance is not just unnecessary but actually undesirable.

Banks that offer transaction deposits are supposedly subject to an “inherent instability problem” that makes them prone to self-realizing depositor panics. Traditionally, transaction deposits are denominated as a fixed number of currency units, while the assets corresponding to these deposits are mostly finite-term securities or commercial loans. If depositors all want their money at once, the banks simply do not have it. To the extent that their assets are marketable, the banks can sell them off to meet withdrawals with only minimal losses. But if there is a run on the banking system as a whole, the banks’ scramble for funds could conceivably drive interest rates up and asset prices down to the point at which the banks are actually insolvent simply because of depositor fears that they might fail. To the extent that bank assets consist of poorly marketable commercial loans, they are even more exposed to the risk of runs. This inherent instability problem is the most commonly cited argument for government deposit insurance and the careful government regulation it entails (or ought to entail).

However, the money market mutual fund (MMMF) is a recent market innovation that completely solves this inherent instability problem of the payments system. As Kareken points out in his paper, MMMFs, like all mutual funds, are run proof since their obligations to their investors are simply pro rata shares in the current market value of the

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fund's portfolio. To the extent that depositors/investors line up at the front door to take their money out, the rate of return to depositing new funds will increase, and new depositors/investors will line up at the back door to put their money in. As long as the fund sticks to very short term instruments (20 days is a common average maturity for existing MMMFs), fluctuations in the market value of the portfolio will hardly be perceptible, and balances will be predictable enough to make check writing practical.¹

Money market mutual fund balances like these have performed well as transactions balances throughout the turbulent past decade. In the early months of 1983 they actually weathered a run that depleted about 25% of their assets without a single mishap in spite of their lack of government deposit insurance.² Most MMMFs voluntarily restrict check writing to large amounts, leaving small checks to commercial banks subsidized by the Federal Deposit Insurance Corporation (FDIC). In the absence of government deposit insurance, however, one could imagine that for a suitable fee MMMFs would be willing to process checks of any size.

One important limitation of MMMFs is that their assets must be so highly marketable that there is at all times a clearly defined market price for each one, with only a small bid-asked spread. This means that MMMFs could not directly monetize the commercial loans that are an important staple of the traditional commercial bank's diet. Illiquid commercial loans could nevertheless still be monetized indirectly by MMMFs through a two-tier system similar to the one Kareken proposes: each existing commercial bank would be split into two firms. The first, as Kareken suggests, would essentially be a finance company, making illiquid term loans, financed by issues of its own commercial paper with comparable maturity. The second firm would not be the modified "100% reserve" bank Kareken proposes but rather an

1. Unfortunately, many MMMFs attempt to emulate traditional banks by engaging in "penny rounding," i.e., rounding the net share value to the nearest cent per dollar. This gives investors, particularly large institutional ones, an incentive to withdraw funds when interest rates have risen by less than enough to cause a penny change since then shares are overvalued relative to the shares of funds that do not penny round. The resulting shortfall will provide an even greater incentive for withdrawals, until either the penny limit is hit and the shares become undervalued, resulting in an instable influx of funds, or the fund's manager voluntarily makes up the shortfall. The latter was actually done for one penny-rounding fund a few years ago, at great expense to its sponsor.

2. The "run" alluded to occurred as depositors moved funds into the new money market deposit accounts (MMDAs) at banks and thrifts, which are guaranteed by the FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) against any loss of present value. Although MMDAs are even safer than MMMFs from the depositors' point of view, they are much riskier from the point of view of the economy as a whole since they may be used to finance loans of very long maturity, very low liquidity, or very high default risk.

MMMF holding, *inter alia*, the marketable commercial paper of other bifurcated commercial banks like itself.³

Kareken's proposed 100% reserve banks for transactions balances could in fact be very risky. Note first that Kareken's use of the term "100% reserves" is at variance with the usual meaning of the expression. Writers like Irving Fisher and Milton Friedman have used it to refer to a bank whose transactions balances are backed 100% by immediately available high-powered money. Kareken uses it to mean instead a bank whose transactions deposits are 100% backed by Treasury securities. While it is true that Treasury securities are free from default risk (at least under the post-1933 paper money standard), they are still subject to interest rate risk, and for long-term Treasury bonds this risk can be considerable. Note that 30-year Treasury bonds necessarily have an even greater Macaulay duration and, therefore, an even greater interest rate sensitivity than do the 30-year amortized mortgage loans that have gutted the net worth of the thrift industry in recent years. Long-term Treasury-backed zeroes would be even more volatile.

Banks holding 100% reserves in the traditional sense would be at least potentially available in the absence of government deposit insurance for those who want complete certainty of present value. However, if these reserves paid no interest, as would be the case under a metallic standard or under the Federal Reserve's current policy, banks could offer no interest on their transactions deposits and in fact might charge a small fee ("negative interest") for their trouble. My guess is that most depositors would prefer to receive healthy interest on an MMMF account and live with the minor inconvenience of slightly uncertain present value rather than to hold such accounts.⁴

Diamond and Dybvig (1983) have shown, in an article approvingly cited by Kareken, that, under sufficiently simplifying assumptions, fixed present value deposits with mandatory government deposit insurance may be Pareto superior to any voluntary contractual arrangement

3. There is no reason why these finance companies replacing the commercial loan function of commercial banks could not function as the managers of the MMMFs replacing the transaction deposit function. However, in order to prevent a potential conflict of interest, it would probably be necessary to prevent the MMMF from buying its own manager's commercial paper or at least from purchasing a disproportionate amount of it. Note that Kareken erroneously asserts that all MMMFs invest exclusively in Treasury bills. A few do so specialize, but most deal primarily in commercial paper and bank certificates of deposit (CDs).

4. If the central bank paid interest on reserves under a 100% reserve system, as proposed, e.g., by Friedman (1959), with a probability of one, the rate paid would either be too high, in which case money would dominate all other investments, or else too low, in which case MMMF deposits would begin to dominate the regulated money supply. Finding the right interest rate to set on reserves under such a system could be almost as destabilizing as setting an interest rate target rather than a monetary growth target under a conventional banking arrangement.

the market may come up with. Their argument is based on the tendency for voluntary insurance programs to be less than fully efficient (relative to a full-information ideal) when important state variables are observed by the insured but not by the insurers.

These theoretical benefits, however, must be weighed against the fact that noncontractual insurance may easily create externalities where none existed before. The individual taxpayers who must ultimately bear the costs of government deposit insurance have little incentive to monitor the risks any individual insured bank is taking. The bureaucrats who administer government deposit insurance will not personally take any losses and are only remotely answerable to the taxpayers who will. The depositors, who are insured, do not care what risks are being taken with their money. As a result, insured institutions may be induced to take on risks that are excessive in terms of their total social costs. If the risky investments pay off, the shareholders and/or management will reap the profits. If they fall through, the remote taxpayers will take the losses. If taxpayers had full information and could organize costlessly, this problem would not arise. However, the nature of the economic problem is that information and organization often are in fact very costly.

Largely as a consequence of the federal deposit insurance umbrella, banks and thrifts have engaged with impunity in all manner of excessive risks—foreign exchange speculation (Franklin National), speculative energy loans (Penn Square), inadequately investigated loans (Continental Illinois), insider loans (the Butcher banks), uncollectable Third World loans (almost every top ten bank), and so forth.

One particularly mischievous risky activity thrifts and, to a lesser extent, banks engage in is maturity transformation, which exposes them to interest rate risk. In McCulloch (1981*b*) I show that this activity, which I call “misintermediation,” can upset the macroeconomic equilibrium of the economy, resulting in a mismatch of the planned flow of aggregate production and consumption and leading ultimately to an aggregate excess supply of, or demand for, current output, that is, a recession or a boom. In McCulloch (1985), I demonstrate that the fair value of insurance against this type of risk far exceeds the 8.3 basis point premium that the FSLIC and the FDIC charge for insuring against all types of risk. Since the federal insurers do not bother to rate the premiums they charge according to the risks the insured institutions are taking, their insurance acts as a subsidy to misintermediation, making it artificially more viable than balanced intermediation.

In his new book *The Gathering Crisis of Federal Deposit Insurance*, Edward J. Kane estimates that by 1981 the economic value of the assets of insured savings and loans (S&Ls) and mutual savings banks had fallen short of their liabilities by approximately \$176.6 billion

(1985, pp. 101–2). Most of these losses were caused by interest rate speculation—misintermediation—in earlier years.⁵

By March 1982 (which was even before the status of loans to less-developed countries became apparent), the condition of federally insured institutions was so grim that Congress abandoned all pretense that the FDIC and the FSLIC were self-supporting corporations by passing a measure (House Concurrent Resolution [HCR] 290, 97th Cong., 2d Sess. [1982]) placing the “full faith and credit of the United States” behind federally insured deposits. Today federally insured deposits are as safe as the dollar; or, rather, since the Fed will probably ultimately be called on to monetize the “assets” of failing institutions, the dollar is only as safe as our federally insured banks and thrifts.

Thanks to federal deposit insurance and, in particular, to HCR 290, insured depositors have no need to concern themselves about the safety or riskiness of the particular bank with which they do business. One is as good as another, so far as depositors are concerned. Instead, bank customers must concern themselves, as taxpayers, with the safety of every bank in the country.

Complete elimination of federal deposit insurance, and, therefore, the replacement of federal regulation with private regulation by depositors and/or private insurers would be the ideal solution. However, this is probably not in the wings, nor is the division of commercial banks into finance companies and MMMFs. It is therefore pertinent to ask what less radical reforms might be attempted within the current institutional framework.

First, risk-rated deposit insurance is not as impractical as Kareken makes it out to be, at least not for interest rate risk, which is relatively easy to quantify and evaluate. In McCulloch (1985) I show how this may be done and provide actual estimates for a variety of degrees of duration mismatch and capital/asset ratios. This would at least eliminate the important problem of misintermediation. A small degree of maturity transformation is probably not significantly harmful, nor would it be prohibitively expensive with risk-rated premiums.

Second, the federal deposit insurance agencies should limit their efforts to protecting the legally insured depositors. In the Penn Square failure there was a commendable move in this direction, but with Continental Illinois the FDIC not only backslid to its old habit of bailing out all deposits but actually bailed out the holding company creditors as

5. By 1983, according to Kane's figures, the shortfall of the thrifts had fallen to “only” \$86.0 billion, and there has probably been further improvement since then. Nevertheless, it surely continues to far exceed the dwindling (and to an increasing extent the artificial) reserves of the FDIC and the FSLIC.

well, for which there was no excuse or even precedent.⁶ Indeed, the comptroller of the currency actually announced that the regulators would not allow any of the 11 largest banks to fail as a matter of policy. This gives an enormously anticompetitive edge to these large banks relative to smaller banks.

And third, federal deposit insurance should, at least marginally, be replaced by private insurance and/or self-insurance by depositors. I would not bother to reduce the \$100,000 limit as Kareken suggests, however. The flagrant abuse of "brokered deposits" shows us that it is all too easy to circumvent such limits. Rather, federal deposit insurance coverage should be limited to 90 or 95 cents on the dollar (up to the existing limit). Depositors could then either subscribe to private insurance for the remainder or else self-insure. At the same time, banks should be charged federal deposit insurance premiums only on that portion of their deposits that is actually guaranteed by the federal government. Depositors should be allowed to opt out of federal deposit insurance entirely in exchange for the somewhat higher rates banks could then afford to pay. There is no reason why depositors should not be offered the choice of more than one private deposit insurance carrier at any given bank.

I do not agree with Kareken that it has been a mistake to remove interest rate ceilings. It is true that the FDIC's and the FSLIC's ability in the past to tap the cartel profits these ceilings generated by finding willing merger partners for otherwise insolvent institutions has helped keep the federal insurance agencies afloat thus far. However, this has been a very expensive way to provide "safe and sound" deposits, compared to the reduced interest rates that would be paid under rate deregulation with risk-rated premiums.⁷ Nevertheless, deregulation does create an even more urgent need than existed before for risk-rated premiums.

Rate deregulation does greatly lessen the importance of one major case for federal deposit insurance that I have thus far not touched on, namely, the stability of the money supply and therefore the price level. Many economists are concerned that the possibility of losses on depos-

6. The rationale cited by Kareken, and which was given at the time by the regulators, for the bailout of Continental Illinois Corp., namely, that it was necessary in order to help banks attract capital in the future, is fundamentally flawed. As I pointed out in a letter published in the *New York Times* (September 24, 1984), "The function of bank capital is to serve as a buffer to protect the FDIC and depositors against losses. The argument made for protecting holding company creditors is therefore completely fallacious if these funds are in fact not at risk and thus not serving as capital from the FDIC's point of view. What automobile insurance company in its right mind would give drivers lower rates if they accepted a \$250 deductible because it encourages safer driving and reduces claims, and then make a policy of paying the deductible anyway in order to induce customers to accept it?"

7. For elaboration on this point, see McCulloch (1981a, p. 247).

its makes the bank multiplier, and, therefore, the money supply for any given volume of monetary base, unstable. Economic theory, however, predicts that deposits paying fully competitive interest in fact provide zero monetary services at the margin. In a world with completely deregulated deposit rates it is the zero-interest monetary base rather than the M1 or M2 money supply that would have the greatest degree of “moneyness.” Fluctuations in the latter would therefore be of little or no macroeconomic consequence.

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