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# FRBSF WEEKLY LETTER

August 3, 1984

## The Federal Safety Net for Commercial Banks: Part II

This *Weekly Letter* continues last week's discussion of the problems involved in administering the federal safety net for commercial banks. Last week's *Letter* focused on the lender-of-last-resort function of the Federal Reserve. It concluded that there is no inherent conflict for the Federal Reserve between meeting the liquidity needs of depository institutions and achieving the goals of monetary policy. This *Letter* takes up the issue of federal deposit insurance for commercial banks.

### Deposit insurance

The Federal Deposit Insurance Corporation (FDIC) was established in the wake of the devastating banking panic of the early 1930s. From its inception, the FDIC has had two basic functions. The first has been to protect depositors of modest means from incurring losses when banks fail. The second has been to protect the economy in general from the adverse effects of bank runs. In meeting these goals, the effectiveness of the deposit insurance guarantee has been far greater than what might have been expected given the limited size of the insurance fund. At the end of 1983, the FDIC fund totaled only about \$15.4 billion, or less than one percent of total domestic deposits at insured commercial banks.

The impact of deposit insurance goes beyond the size of the insurance fund primarily because the major benefit of the insurance guarantee is that it averts bank runs and thus avoids the need for extensive payouts. Also, the system for administering deposit insurance can afford the FDIC some control over the cost it bears when a bank fails. The failure of even a large bank, in principle at least, does not have to force the FDIC to take on heavy losses. The size of the losses to the FDIC depends on the value of the net worth of the bank when it fails, which, in turn, depends partly on how promptly the FDIC and other regulatory agencies take action to close a troubled bank. Moreover, the FDIC has more resources at its disposal than the insurance fund itself, since the FDIC can borrow from the Treasury. Finally, the Congress has passed a resolution, albeit a non-binding one, placing the full faith and credit of the

federal government behind the deposit insurance guarantee.

### Incentives to risk-taking

Over the past 50 years, the FDIC clearly has been successful in achieving its assigned goals by alleviating depositors' concerns over the soundness of commercial banks. Nevertheless, the movement to reform the deposit insurance system has never been stronger because of the growing awareness that federal deposit insurance can affect the behavior of commercial banks. The problem is that as long as depositors and other creditors of banks know that depository institutions (or at least large banks) in trouble will be bailed out, depositors and others do not have to concern themselves with the condition of a bank's portfolio. Therefore, banks will not have to bear the full cost of their risk-taking, unless they are kept in check by the FDIC and the other bank regulatory agencies.

This point can be illustrated through a simple numerical example. Consider a bank with \$3 million in capital and an investment opportunity that will return \$3 million or generate a loss of \$3 million with equal probability. The expected value of the investment to the market (i.e., the shareholders) would be zero. As an alternative, consider a bank with \$2 million in capital and \$1 million in insured deposits. Now the shareholders at most can lose \$2 million. The expected value of the investment to the shareholder then would be the average of the \$2 million loss of capital and the \$3 million potential gain—which comes to \$500,000 instead of zero. The deposit insurance in this case increases the expected return of the risky investment, and thus makes the investment more attractive.

Another point that can be brought out through the example is that the *lower* the level of shareholder capital of a bank the greater the expected gain from risky loans. Continuing with the example, if capital in the bank were only \$1 million (and insured deposits were \$2 million), then the expected value of the investment would be \$1 million. With federal deposit insurance, the most

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leveraged institutions have the most to gain from a given risky investment. And, needless to say, institutions that are allowed by regulators to continue operating when net worth is negative can only stand to benefit from risky enterprises.

These incentives for risk-taking inherent in the federal safety net have been recognized for some time, and they have been kept in check to a large degree through supervision and regulation. However, with deregulation in banking, the task of curbing banks' desires to act on the incentives presented to them likely will be more difficult. This is not necessarily because deregulation means that banks have to pay more for funds and therefore must seek out higher yielding, riskier assets, or that all new activities sought by banks are inherently more risky than traditional lines of banking business. Indeed, in principle, many aspects of deregulation could reduce bank risk. For example, greater asset powers would allow more diversification, and the removal of deposit rate ceilings means that banks have more efficient ways of acquiring funds from a broader source.

What deregulation *does* is give institutions greater scope to act on the incentives for risk-taking. A case in point is the use of brokered deposits. Deposit brokers can obtain funds from investors throughout the country in units of up to \$100,000, and channel the deposits to commercial banks or thrift institutions. The deposits that a depository institution receives from a broker far exceed the insurance limit of \$100,000, but, since each unit is at the limit or below it, the entire pool is insured. Depositors therefore do not have to concern themselves with the financial condition of the depository institutions to which their funds are directed and can look for the highest interest rate paid. Thus, with fully insured brokered deposits, a bank has access to funds on a nationwide basis at a cost that will not fully reflect the riskiness of the bank's loans or its capital position. Once again, the institutions with the weakest capital positions would gain the most by acquiring insured brokered deposits.

To block the "abuse" of the deposit insurance guarantee, especially by weaker institutions, the FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) took steps to limit the insurance coverage on brokered deposits. Their attempt to limit insurance on brokered deposits to \$100,000 per broker per institution would have

taken effect October 1, 1984 had it not been challenged successfully in court. The deposit insurance agencies apparently are considering an appeal of the decision.

Without deposit insurance, banks, of course, still would fund some of their assets through "borrowings" in the form of deposits. However, in the absence of deposit insurance, the cost of deposits can be expected to reflect the riskiness of a bank. If depositors were not insured, the risk-return trade-off faced by a bank in its investment decisions would not change materially. Consequently, banks' risk-taking proclivities would not be encouraged.

## **Controlling risk-taking**

To mimic a "market" approach to checking bank risk-taking, it has been suggested that the FDIC replace the current fixed-rate insurance premium with a structure of variable rate premiums that reflect the risk exposure of an institution. In fact, the FDIC has had legislation introduced in the Congress that would give the insurance agency authority to use a system of risk-based insurance premium rebates. However, the impact of this proposal likely would be minimal since the differences in rebates among the risk categories for a bank would be quite small.

The FDIC has been especially sensitive to the impact of deregulation on risk-taking by banks and the consequent exposure of the insurance fund. In addition to the steps taken to curb brokered deposits, the FDIC attempted to reduce the distortions created by the deposit insurance through the "modified payout" plan for handling failed banks. (This plan was the subject of the May 18, 1984 *Weekly Letter*.) The plan was designed to make large depositors share in the losses of bank failures as a means of imposing greater market discipline on banks. However, the modified payout has only been used on relatively small banks. Its rejection in the handling of the troubled Continental Illinois bank raises grave doubts as to whether this plan would be applied to any large bank.

Developments at Continental Illinois strongly point out that the modified payout plan, with its emphasis on protecting small depositors, conflicts directly with the second objective of deposit insurance—to prevent bank runs. In reaction to the massive withdrawal of large deposits at Continental, the FDIC abandoned the principles

behind the modified payout approach and provided insurance coverage for all depositors. The FDIC's actions clearly were intended to address the problem of bank runs, which not only affect particular banks but the economy as a whole. The FDIC currently is evaluating the experimental modified payout, and it may be a couple of months before it announces a final verdict regarding the plan.

Perhaps recognizing the implications of the combination of a weak capital position and the availability of deposit insurance, the FDIC along with the Comptroller of the Currency also have proposed a rule that would require banks to maintain a primary ratio of capital to assets of 5.5 percent and a secondary capital minimum, including some convertible debt and the value of intangible assets in the definition of capital, of 6 percent. Prior to this proposal, the FDIC policy recommended a primary ratio of capital to assets of 5 percent.

While higher capital requirements could have some bearing on bank risk-taking, the proposed requirements continue the convention of considering the book value of net worth, rather than the market value. However, the gains from risk-taking in banking when deposit insurance is available are related to the *market value* of a bank's net worth. The continued focus on book value net worth is problematic because the book value of net worth can exceed the market value and, for some banks, the difference can be quite striking. For example, for the troubled Continental Illinois Bank at the end of the first quarter of this year, the ratio of its market value of equity to its book value of equity was far less than one-half.

There are, of course, problems with using a market evaluation of a bank for regulatory purposes (aside from the fact that most bank stocks are not traded regularly). For example, the market price of a bank's stock will reflect the presence of the deposit insurance guarantee, not to mention the possibility that, say, a large bank would be bailed out if it were to experience problems—bailed out even to the extent of providing some protection to shareholders, as in the case of the First Pennsylvania Bank. Nevertheless, more attention should be given to evaluating bank net worth on the basis of "market" rather than book value.

### **Conclusion**

The current problems facing banks have made us more aware of the importance of the federal safety net to the stability of the banking system. At the same time, the heightened role of the FDIC (and, as discussed in the preceding *Weekly Letter*, the Federal Reserve as lender of last resort) has raised concerns over the side effects of the safety net. Federal deposit insurance may increase the risk-taking proclivities of insured banks. In response, a number of methods for keeping bank risk-taking in check have been suggested. The arrangements announced on July 26, 1984 by the FDIC for dealing with Continental Illinois undoubtedly will add fuel to this ongoing debate over deposit insurance reform, particularly regarding the proper scope of the FDIC guarantee. In the end, however, the FDIC, in conjunction with the other bank regulatory agencies, probably will continue to rely on supervision and regulation—particularly capital requirements—as the main tools to restrain banks from engaging in excessively risky enterprises.

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### **MONETARY POLICY OBJECTIVES FOR 1984 AND 1985**

On July 25, Federal Reserve Board Chairman Paul Volcker presented a mid-year report to the Congress on the Federal Reserve's monetary policy objectives for the remainder of 1984 and proposals for 1985. The report includes a review of economic and financial developments in 1984 and the economic outlook heading into 1985. Single or multiple copies of the report can be obtained upon request from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco, CA 94120. Phone (415) 974-2246.

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### BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities	Amount Outstanding 7/18/84	Change from 7/11/84	Change from 12/28/83	
			Dollar	Percent Annualized
<b>Large Commercial Banks</b>				
Loans, Leases and Investments <sup>1 2</sup>	181,515	- 264	5,490	5.5
Loans and Leases <sup>1 6</sup>	162,430	- 239	7,075	8.1
Commercial and Industrial	49,066	- 224	3,103	12.1
Real estate	60,499	76	1,600	4.8
Loans to Individuals	28,763	51	2,112	14.2
Leases	5,009	- 22	- 54	- 1.9
U.S. Treasury and Agency Securities <sup>2</sup>	11,950	- 34	- 557	- 7.9
Other Securities <sup>2</sup>	7,135	8	- 1,028	- 22.5
Total Deposits	187,925	-1,844	- 3,072	- 2.8
Demand Deposits	44,014	-1,812	- 5,223	- 19.0
Demand Deposits Adjusted <sup>3</sup>	28,995	-1,619	- 2,336	- 13.3
Other Transaction Balances <sup>4</sup>	12,250	- 190	- 525	- 7.3
Total Non-Transaction Balances <sup>6</sup>	131,661	159	2,676	3.7
Money Market Deposit				
Accounts—Total	38,099	- 327	- 1,498	- 6.7
Time Deposits in Amounts of \$100,000 or more	40,205	396	2,040	09.5
Other Liabilities for Borrowed Money <sup>5</sup>	21,027	2,163	- 1,980	- 15.4
<b>Weekly Averages of Daily Figures</b>	Period ended 7/16/84	Period ended 7/02/84		
<b>Reserve Position, All Reporting Banks</b>				
Excess Reserves (+)/Deficiency (-)	- 23	140		
Borrowings	59	96		
Net free reserves (+)/Net borrowed(-)	- 81	44		

<sup>1</sup> Includes loss reserves, unearned income, excludes interbank loans

<sup>2</sup> Excludes trading account securities

<sup>3</sup> Excludes U.S. government and depository institution deposits and cash items

<sup>4</sup> ATS, NOW, Super NOW and savings accounts with telephone transfers

<sup>5</sup> Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

<sup>6</sup> Includes items not shown separately