

Research Department
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FDIC's Modified Payout Plan

With deregulation in banking, the FDIC (Federal Deposit Insurance Corporation), the Congress and others have become increasingly concerned about the deposit insurance fund's exposure to the risk of bank failures. One way in which the FDIC is attempting to reduce the cost of bank failures borne by the insurance fund is to force large deposit holders to share in those costs, and thereby eliminate what has been an implicit insurance guarantee on large deposits—those deposits in excess of the insurance limit of \$100,000.

In the past, the FDIC commonly has arranged for another institution to purchase the assets and assume the liabilities of a failed bank and thereby protected all depositors from losses. This has been particularly true when larger banks have failed—the notable exception being the failure of Penn Square Bank in 1982.

Such an implicit guarantee removes the incentive for large depositors to be concerned about the financial condition of banks. Consequently, these depositors do not devote resources to monitor risk-taking by banks, or demand interest-rate premiums that reflect the risk exposure of a bank. This situation, in turn, enhances the incentives for banks to engage in risky activities. This potential that providing deposit insurance would increase risk-taking is, in essence, the so-called "moral hazard" problem faced by all insurers.

The FDIC has decided to address this problem by shifting back to the private market (i.e., large depositors) more of the responsibility for monitoring and pricing bank risk. To this end, the FDIC is experimenting with a "modified payout" approach for dealing with bank failures. This *Letter* examines this modified payout plan and discusses whether using account size to determine which accounts should be insured is consistent with the basic purpose of deposit insurance.

Modified payout plan

Under the FDIC's plan, insured deposits will continue to be handled as they have in the past, either being assumed by another institution willing to buy the failed bank, or being paid off by the FDIC when no buyer can be found.

However, under the new modified payout approach, holders of large-denomination deposits will receive only *pro rata* shares of what the FDIC thinks it can recover from the liquidation of assets immediately after a bank has failed. With a greater chance of financial loss, holders of large-denomination deposits will have an incentive to monitor banks more closely, and serve to check bank risk-taking. The modified payout has the added advantage that depositors will not have their funds tied up in bankruptcy proceedings as is the case with ordinary payouts.

So far, modified payouts have been used only in the failures of relatively small commercial banks. Some question remains as to whether this approach to increasing the riskiness of large deposits can be successfully applied to the largest commercial banks. If it turns out to be impractical to use modified payouts when large banks fail, the FDIC has indicated that it will reevaluate its current experiment. It would be unworkable to leave large deposits at some banks truly uninsured and to provide such deposits at the biggest banks implicit coverage.

Functions of deposit insurance

Through the modified payout, the FDIC is attempting to address the undesirable moral hazard side effects of deposit insurance. However it is not clear at first glance that increasing the riskiness of large deposits to achieve this goal does not have undesirable side effects of its own, especially after taking into account the reasons why we have deposit insurance in the first place.

Federal Reserve Bank of San Francisco

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One objective often ascribed to deposit insurance is the protection of "small-depositors." It is based on the particular rationale that deposit insurance is needed to address the impact of bank failures on depositors *per se*, rather than on the economy in general. Because small depositors are thought to be unable to protect themselves, deposit insurance agencies assume the responsibility of checking bank risk-taking. The agencies are assumed to be better able both to acquire information on banks and to enforce constraints on their risk-taking. Large depositors are left uninsured because they are assumed to be at least as good as, if not better than, the insurance agencies at determining the riskiness of banks and pricing the risk accordingly. Such a limited objective argues for using account size as the criterion for insuring deposits.

In contrast, a second objective attributed to deposit insurance focuses on protecting the economy in general from the impact of disruptions in the banking industry. In particular, federal deposit insurance is thought to contribute to the overall stability of the economy by averting bank runs and their adverse effects. One reason the economic cost of bank runs could be widespread and pronounced is that banks are integral parts of the payments mechanism and constitute channels through which monetary policy operates. For example, a collapse of the banking system could lead to a large and

unexpected contraction in the money supply which, with a lag, would result in a severe and pervasive reduction in economic activity.

The monetary impact of bank runs, of course, has been used as a defense for deposit insurance for some time. However, some analysts argue that the adverse consequences of bank runs go beyond those associated with money and the money creation process. For example, recent articles by Bernanke (*AER*, June 1983) and Diamond and Dybvig (*JPE*, June 1983) point out that the breakdown of the intermediation process that would result from bank runs could impose real costs on the entire economy.

The connection between federal deposit insurance and economy-wide losses associated with bank runs raises some question about the FDIC's plan to increase the riskiness of large-denomination deposits. Under the economic-stability rationale, deposit insurance is warranted on the grounds that depositors protecting themselves is not sufficient to guarantee stability in the banking system. While putting large depositors at risk—as the FDIC's modified payout approach does—may reduce the moral hazard problem introduced by deposit insurance, it does not address the issue of bank runs or ensure that the *total* cost to society of bank risk-taking and bank runs will be considered. If one sees a need for deposit insurance because of the presence of some degree of market failure, it would seem somewhat contradictory to look to the market for a solution to a problem created by the existence of deposit insurance.

Insuring liquid deposits

The economic-stability rationale for deposit insurance dictates that the foremost role of deposit insurance should be to prevent bank runs. As a result, the goal of reducing the susceptibility of banks to runs should be the major criterion for determining which deposits are insured.

Kareken (*AER*, May 1983) has maintained that depository institutions are subject to runs because deposits are fixed-dollar claims against risky assets. With risky portfolios, depository institutions can incur losses that exceed net worth, while the fixed-dollar claim means that a depositor can avoid sharing in those losses if he can withdraw funds before other depositors.

The problem of "runs" is particularly acute for banks because they tend to hold a certain volume of liquid assets funded by deposits that essentially are available on demand—checking, savings, and money market deposit accounts—and short-term time deposits. The holders of these liquid deposits can react quickly to a real or a perceived deterioration in the financial condition of banks. This is true as much for depositors with large-denomination liquid accounts as for depositors with small liquid balances. Holders of longer-term deposits could "run" in the sense that they would not roll their accounts over at maturity. However, such a process would be drawn out over a period of time, allowing bank assets to mature and giving depositors and regulators an opportunity to assess more accurately the condition of the individual institutions. (While banks have the option to allow withdrawals from time deposit accounts prior to maturity, under current regulations, banks are not obliged to honor requests for early withdrawals except in the case of the death or mental incapacitation of the depositor.)

Within the context of the economic-stability argument for deposit insurance, the particular characteristics of bank assets and liabilities suggest that accounts should be insured on the basis of their terms of maturity. Such a distinction would satisfy both the desire to increase risk for the depositor and the desire to ensure a stable banking system. Liquid deposits, which precipitate runs on banks that in turn impose costs on the economy, should be insured. In principle, and without

convincing arguments explaining why the probability of runs should decline as the size of an account rises, liquid large-denomination accounts should be insured as well.

Conclusions

The FDIC's modified payout approach for handling failed banks delegates to large depositors at least part of the responsibility of monitoring and pricing bank risk. This shift reduces the moral hazard problem connected with the provision of deposit insurance, but only ensures that the cost of bank risk as it affects uninsured depositors will be taken into account.

The modified payout plan certainly is in keeping with the small-depositor protection justification for deposit insurance. However, if deposit insurance is thought to be needed to enhance the stability of the banking system, then the FDIC's plan is lacking. The foundation of the stability argument is that private market arrangements cannot be expected to solve the problem of bank runs and that bank runs lead to economy-wide losses. Putting large depositors at risk does not address the bank run issue and could well exacerbate the problem. If the economic-stability rationale suggests anything, it is that liquid deposits should be insured, which would include liquid large-denomination accounts.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities	Amount Outstanding	Change from	Change from 12/28/83	
			Dollar	Percent Annualized
Large Commercial Banks	5/2/84	4/25/84		
Loans, Leases and Investments ^{1 2}	180,066	1,477	4,041	6.6
Loans and Leases ^{1 6}	160,380	1,505	5,025	9.3
Commercial and Industrial	48,101	726	2,138	13.4
Real estate	59,691	77	792	3.8
Loans to Individuals	27,940	5	1,289	13.9
Leases	5,000	6	63	3.5
U.S. Treasury and Agency Securities ²	12,070	4	437	10.0
Other Securities ²	7,616	23	547	19.3
Total Deposits	187,856	3,266	3,141	4.7
Demand Deposits	46,226	3,083	3,011	17.6
Demand Deposits Adjusted ³	29,110	256	2,221	20.4
Other Transaction Balances ⁴	12,197	70	578	13.0
Total Non-Transaction Balances ⁶	129,433	113	448	1.0
Money Market Deposit Accounts—Total	39,308	309	289	2.1
Time Deposits in Amounts of \$100,000 or more	38,481	477	316	2.3
Other Liabilities for Borrowed Money ⁵	21,532	349	1,475	18.5
Weekly Averages of Daily Figures	Week ended 4/23/84	Week ended 4/9/84		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (-)	68	273		
Borrowings	102	118		
Net free reserves (+)/Net borrowed(-)	33	155		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

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

⁶ Includes items not shown separately

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