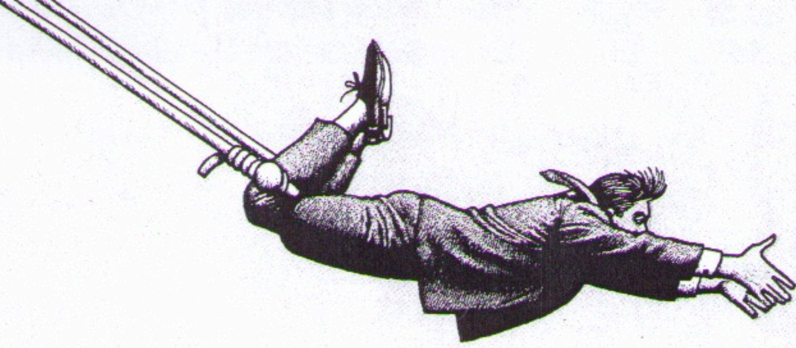


BANKING

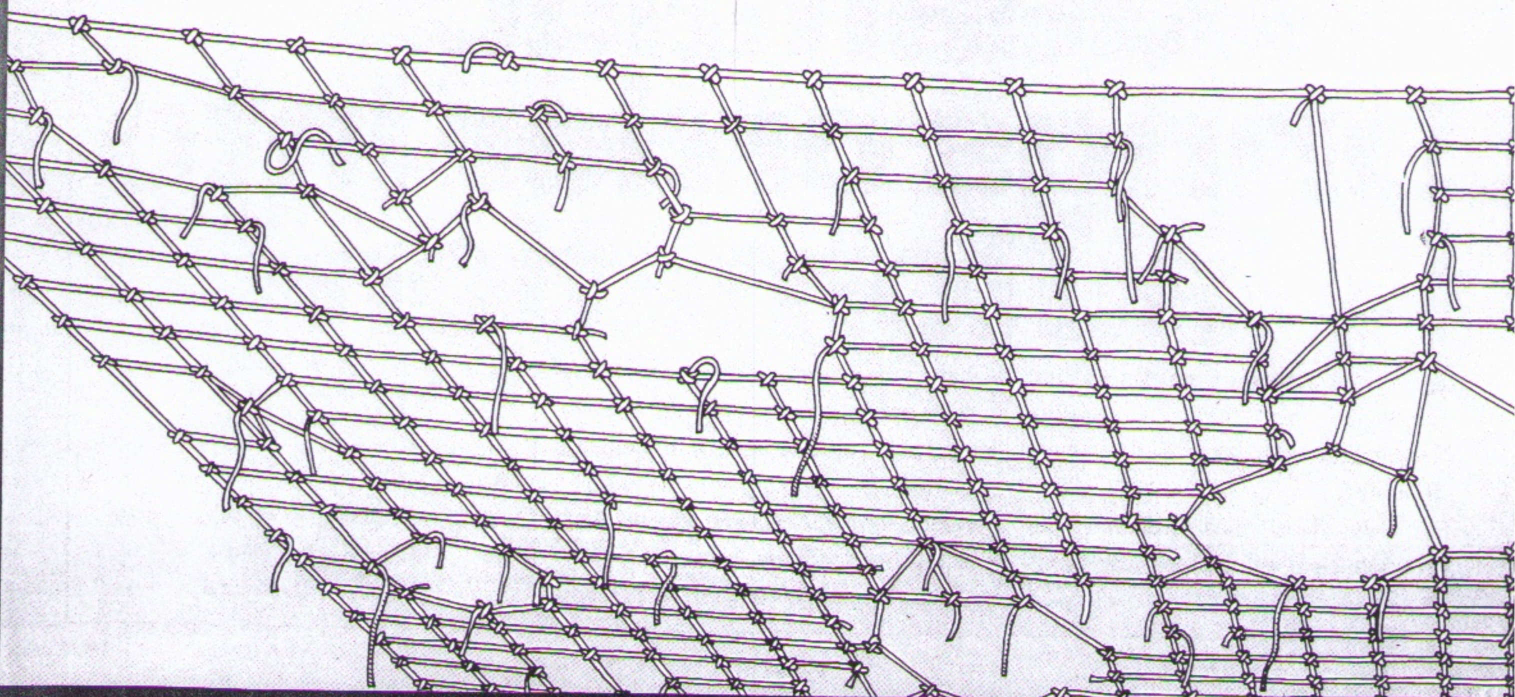
Is there any way out of the deposit insurance crisis?

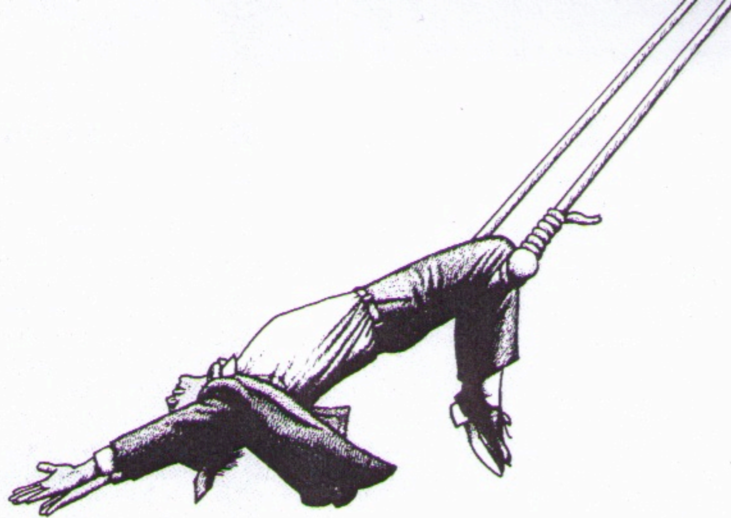
Not until Congress realizes that the FDIC and FSLIC have together become a sprawling, self-defeating financial welfare system. Don't hold your breath.

BY SUZANNA ANDREWS

What created the crisis in the nation's deposit insurance system? Most bankers, regulators and members of Congress still favor the standard answers: the ailing economy of the Southwest, the faulty supervision of banks and thrifts and incompetence and even criminality on the part of financial executives. But among a growing number of influential observers, a more fundamental explanation is now gaining acceptance: Federal deposit insurance is itself at the root of the problem.

The dimensions of the crisis are hard to ignore. In the thrift industry, an insolvent Federal Savings and Loan Insurance Corp. faces the staggering task of closing hundreds of bankrupt S&Ls and may need as much as $85 billion to clear away the mess. Meanwhile, the Federal Deposit Insurance Corp., saddled with a record number of bank failures, will lose money for the first time ever in 1988. Though it isn't yet as shaky as FSLIC, it has the same structural problems. "There are some real strains developing in the system," ac-





knowledges FDIC chairman L. William Seidman, who has ordered a study of deposit insurance that he hopes to present to the next president shortly after the election. With a taxpayer rescue of FSLIC a virtual certainty, the condition of the deposit insurance funds is becoming a national issue for the first time since they were established during the Depression.

As the issue's urgency grows with every failing thrift, there is a tendency to reach for the quickest fix, which Congress did last year when it gave FSLIC an additional $10.8 billion in borrowing authority. But experts are speaking out against simply pumping more money into the agencies. "Do we just plug FSLIC and have the whole thing hemorrhage again in ten years, or do we change the system?" asks Brian Smith, former counsel at the Office of the Comptroller of the Currency and now a partner with the Washington, D.C., law firm Stroock & Stroock & Lavan. These experts believe the system needs massive reform if a devastating financial crisis is to be averted. "We'd have a financial panic without insurance, but we'll have one with it if we don't do something," says consultant Lowell Bryan of McKinsey & Co.

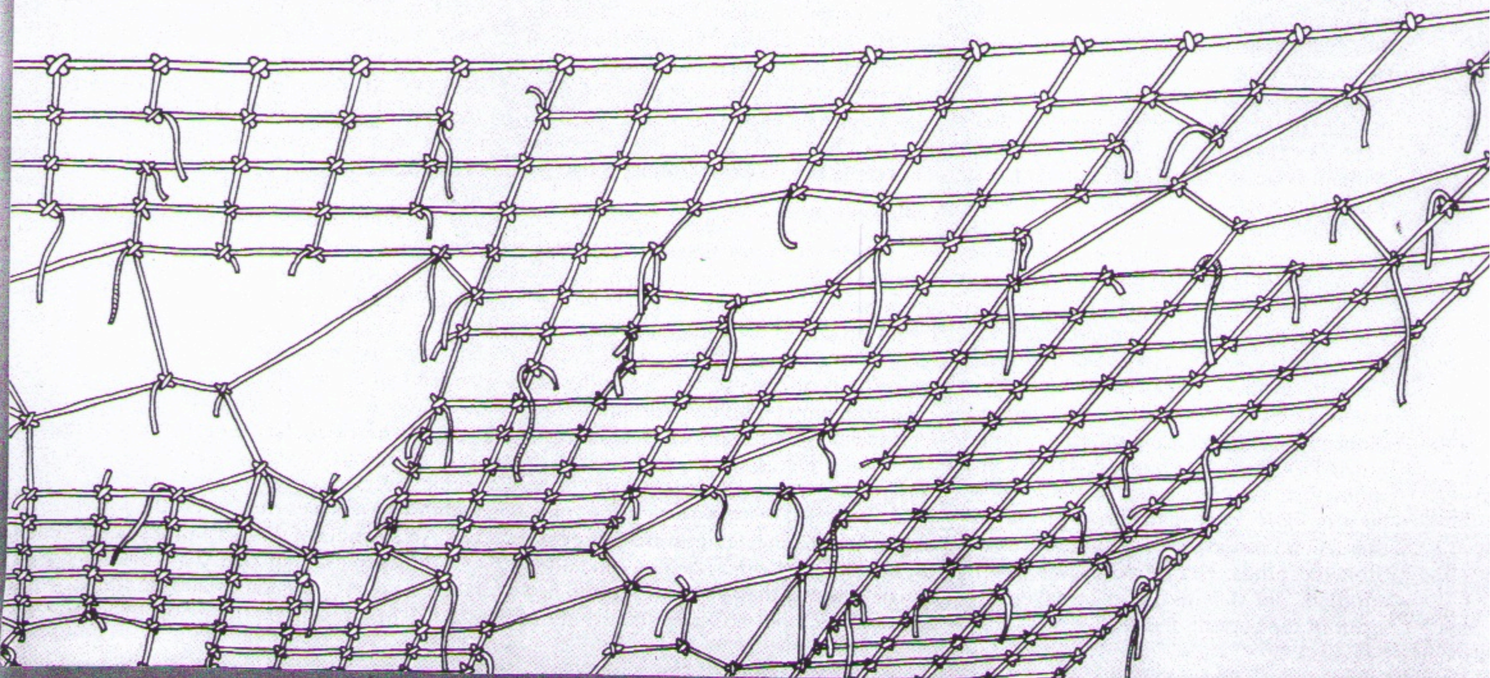
The real problem

Several remedies have already been proposed (see box, page 94), and more are on the way. Most are controversial, and few address the real problem. A lasting solution must begin with an understanding of what deposit insurance has become. Designed as a means of preventing runs on banks in a system that depended on the small saver, deposit insurance has undergone de facto extension into a sprawling financial welfare system that encourages depositors and bankers to gamble and bill the government when they lose. Unmodified since the early 1930s, the system can no longer bear the burden of insuring $3.5 trillion in today's sophisticated and risky financial arena.

To see how deposit insurance undermines sound banking, consider one of the most spectacular cases, that of American Diversified Savings Bank. In June the Federal Home Loan Bank Board shut down the insolvent California thrift and shelled out $1.14 billion to its depositors. By that time, the S&L had invested its $1.2 billion of deposits in assets that were worth about a third of that. In the previous eighteen months, American Diversified grew "a thousand times as fast as the average S&L," according to Sanford C. Bernstein & Co. thrift analyst Jonathan Gray.

The thrift's managers achieved much of this growth by setting the interest rates on their deposits 150 basis points higher than other thrifts', which attracted deposits from around the country. Insured for up to $100,000, the depositors could go for the higher rates without concerning themselves about the health of American Diversified's portfolio. It remained for federal thrift regulators to find that the S&L's managers had made almost no mortgage loans and were betting their expensive funds on such long shots as a couple of windmill farms and a plant that was

Mirko Ilic



"The weaker the institution, the greater the 'moral hazard' that it will start betting with federally insured money."

supposed to create energy out of cow manure.

At American Diversified and elsewhere, deposit insurance has produced such aberrations because of changes in the tight regulatory framework for which it was designed. One key change came in 1980, when Congress lifted interest rate ceilings to help depository institutions win back the money that was flowing out of their coffers into money market mutual funds. The unintended result was that suddenly institutions could compete for federally guaranteed money by boosting their rates — regardless of how well they were run. "You allowed incompetence to bid for money," says McKinsey's Bryan.

Incompetence naturally had to bid high and look for riskier investments with correspondingly higher returns. In 1982, with a deflationary economy battering the industry's earnings, Congress and several state legislatures helped out by broadening thrifts' investment powers, and manure plants became an acceptable part of an S&L's portfolio. Thrift supervisors, untrained in these new businesses, were ill-equipped to detect the risks.

Texas temptation

Probably the most dangerous result of these changes was the rise of brokered deposits, which today account for billions of dollars of federally insured funds. With institutions now bidding for deposits, money brokers could channel large flows of funds toward the highest returns — which, of course, are often paid by the worst-run banks and thrifts. Brokers such as Merrill Lynch can gather and place billions of dollars. As long as no individual has contributed more than $100,000, the whole fund is federally insured. Big corporations, on the other hand, take their millions in cash assets, split them up into insured $100,000 chunks and ship them off to those who pay the most. The heaviest users of this technique, says former FDIC chairman William Isaac, are banks, thrifts and credit unions themselves.

The tidal wave of federally insured, brokered money into troubled institutions has greatly increased the burden on the insurance funds. From 1982 to 1985, for example, as Texas thrifts floundered in a declining local economy, some $48 billion of federally insured money flowed into the state's S&Ls. Most of it was gathered by money brokers, according to Isaac, who is now CEO of the Washington, D.C., consulting firm Secura Group. In 1983, while he was FDIC chairman, Isaac proposed that federal insurance be withdrawn from brokered funds. His proposal was never adopted, but it is likely to be taken up again in the current debate.

Much as federal insurance gives weak institutions a big break in raising money, it further burdens itself by encouraging bad lending practices. Many economists and banking consultants agree that bankers have been able to make risky loans without properly evaluating them or charging for their true value because deposit insurance renders their cost of funds unrealistically cheap. If a bank's deposits pay 6 percent, a banker can ignore the risks on a loan that should be priced around 15 percent, charge the borrower 10 percent and still expect a profit. The tendency to do this, even among prudent bank managers, "has increased the risk in the banking business," says Joel Wells, an ardent advocate of deposit insurance reform and president of Atlanta's SunTrust Corp.

At poorly managed institutions the problem is much worse, says Booz Allen & Hamilton consultant Walter Jewett Jr. "Deposit insurance has become a put option," he observes, one that encourages executives to make bad loans in the hope of much-needed high returns. The weaker the institution, the greater the "moral hazard" that it will start betting with federally insured money. "They gamble like hell," says Jewett. "If they win, they make a lot of money. If they lose, they put it back to the feds, who pick it up."

On a macro level, says McKinsey's Bryan, the author of a new book about the crisis in today's credit system, deposit insurance is having a dangerous effect on the allocation of credit in the U.S. "Banks have sucked in more deposits than they would have without deposit insurance," Bryan contends, "and this has created an overcapacity of funds relative to the good credits available to lend against." In other words, much of the overflow has been channeled into loans that should never have been made in the first place, in markets such as Texas real estate and the country's farm belt. Today, those areas are among the funds' worst trouble spots.

Collision course

Since so many negative developments can be traced to changes in deposit insurance's formerly well-regulated world, recent moves to deregulate banking even further have experts deeply worried about new strains on the system. Warns former FHLBB counsel Thomas Vartanian, now a partner at Fried Frank Harris Shriver & Jacobson, "Deregulation and deposit insurance are on a collision course." Most fundamentally, there is anxiety about new competition generating more failures at the expense of the funds. "You can't allow banks to widen their risks, to get into new activities, without accepting that more of them will fail. We won't ever go back to the days before the 1970s when we had just a handful of failures," says Thomas Brown, a Smith Barney, Harris Upham & Co. bank analyst.

A more specific concern is this: What is the role of federal insurance in an environment where banks and thrifts engage in a host of risky activities that deposit insurance was never designed to cover? If banks, for example, are permitted into most areas of the securities business or into mutual funds, as Congress is currently considering, "will the insurance funds get stuck with the costs of the failure of a bank or its holding company because of these activities?" asks Dennis Aronowitz, director of the Morin Center for Banking Law at Boston University.

Congress is working on ways to segregate these proposed new businesses from the banks themselves. Even so, numerous experts question whether the insurance system would be sufficiently shielded from risk. Prohibiting the holding company from lending to its investment banking subsidiary or from buying its securities, as Congress has proposed, is a technically and legally useful means of separating the two. But BU's Aronowitz and others point out that this may not be enough to persuade depositors that all is well. "What if one of those holding-company subs took gigantic losses and depositors *perceived* the bank to be in danger, regardless of the facts?" he asks. "Would the insurance fund have to help the holding company to save the bank?"

Holding-company conundrum

The concept of the bank or thrift holding company, a legal entity first devised in 1956 to give these institutions more flexibility, today poses huge problems for the insurance funds, especially the FDIC. It allows for a company to exist above the bank or thrift, owning and running it separately from its other activities. Many large banks, especially those in states such as Texas that limit branching, use the device to control a vast web of banks.

According to its charter, the FDIC simply insures depositors in individual banks. But over time, banks and their holding companies have become so intertwined that no one is really sure where the FDIC's obligations end. In some instances, the FDIC has been manipulated into bailing out a holding company's bank when the company had the resources within its bank network to do the job itself. An example of this was Iowa's Hawkeye Bancorp., which two years ago was taken to court by bank regulators for refusing to shift resources from its healthy

banks into a sick one. Some regulators even believed that Hawkeye had been shifting bad assets from healthy banks into the ailing one, intending for the FDIC to pick up the tab. The regulators lost their case and had to take over the sick bank.

Another example of the burden imposed by bank holding companies came to light earlier this year during the FDIC's tussle with Wall Street arbitrageurs over the terms of its assistance package for First City Bancorp. The case revolved around the practice of "double leverage," something that nearly every holding company does these days. The company issues debt — which technically is not federally insured — and then funnels it into the banks as capital. If all goes well, or if all the

DEPOSIT INSURANCE AT A GLANCE

Federal deposit insurance is so much a part of the financial landscape that many people take it for granted (story); but although they know its outlines, they're less familiar with its particulars.

• **History.** "Bankers can never be free to extend credit for the support of trade and commerce," said Congressman Henry Steagall in 1933, "until they are permitted to retire at night without fear of mobs at their doors the next morning demanding cash for their deposits."

The House Banking Committee chairman spoke these words at a time during which 9,000 banks failed and depositors lost $1.3 billion, and he argued for deposit insurance as a means of preventing runs on banks by small depositors. It was a deeply controversial idea, initially opposed by President Franklin Roosevelt, numerous members of Congress and even the American Bankers Association. Opponents feared that federal insurance would steer funds to small banks that wouldn't otherwise get them. But the crisis got so bad that Congress and the administration were compelled to act. In 1933 the Federal Deposit Insurance Corp. was set up in the tight regulatory framework of the National Banking Act, which also included the Glass-Steagall Act. The Federal Savings and Loan Insurance Corp. followed in 1934, as part of the National Housing Act.

Today the system comprises three separate funds. The FDIC insures deposits in commercial banks and mutual savings banks. FSLIC insures money deposited in savings and loans and savings banks. And the National Credit Union Share Insurance Fund, created in 1970, covers deposits in the nation's credit unions.

• **Who's in charge.** FSLIC is an arm of the Federal Home Loan Bank Board, the thrift industry's regulator. FSLIC's executive director runs its daily affairs, but he is selected by the FHLBB chairman, who is one of three bank board members appointed by the president to four-year terms. The FDIC, on the other hand, is a stand-alone agency that performs two functions: It regulates state chartered non-Federal Reserve member

Bettmann News Photos

banks, and it insures all banks, including those regulated by the Fed and the Comptroller of the Currency. It is run by a three-person board: the chairman, who is named by the president to a five-year term; the Comptroller of the Currency himself and a third presidential appointee.

In the 50-odd years since they were founded, both agencies have become huge bureaucracies. The FDIC and FSLIC employ 9,000 and 450 people, respectively. They include accountants to evaluate the condition of failed institutions, lawyers to structure transactions, workout specialists to help clean up the bad loans in failed banks, administrators to run the funds and financial analysts and M&A specialists to help sell off troubled banks.

The FDIC and FSLIC do not close troubled institutions. They are called in around the time the regulators determine that one is insolvent. The insurance funds' staff then decide what to do with the institution; in FSLIC's case, any plan must get the approval of the FHLBB. The insurance funds can close a bank and pay off the depositors, close it and sell it, keep it open with financial assistance and then sell it or pump money into and run it themselves.

• **What's insured.** By law, federal insurance simply covers 100 percent of individual and corporate deposits up to and including $100,000 per financial institution, an amount set in 1980. By custom, however, the funds have come to insure much more than just these deposits. Together, the three agencies now guarantee some $3.5 trillion in deposits.

The funds are financed primarily by premiums from financial institutions, the revenues earned from investing those payments and proceeds from the sale of assets of failed institutions. Banks and thrifts are assessed a premium of one twelfth of 1 percent of their total deposits a year. Thrifts are currently required to pay an additional eighth of a percent into FSLIC because of their industry's problems. Although their operating budgets — $350 million at the FDIC last year and $218 million at FSLIC — are set by the Office of Management and Budget, the FDIC and FSLIC get no money from the government.

• **The federal guarantee.** Originally, the federal government was supposed to help only in capitalizing the funds. There is no legally binding statute that requires the government to guarantee these funds or protect depositors. There have been repeated statements from Congress, however (most recently in the 1987 Competitive Equality Banking Act), that it is the "sense of Congress" that these funds are backed by the full faith and credit of the U.S. government. No one believes that the federal government would back away from these funds if depositors' money were at risk.

banks in the holding-company network are shut down, no problem arises. But if some of the banks stay solvent while others fail and the FDIC tries to keep the whole company afloat and sell it, then the claims of the holding-company creditors — whose bonds are secured against the assets of the banks — have to be considered. If not, they can force the liquidation of the solvent banks.

In the case of Houston-based First City, which owned some solvent banks, the arbitrageurs who had bought up the holding-company debt after the FDIC stepped in threatened to do just that. A. Robert Abboud, the FDIC's chosen buyer, eventually had to sweeten his offer to the holding company's bondholders, thereby making it more expensive for the FDIC to turn around the bank.

The transaction angered many people, including the FDIC's Seidman, and in July the FDIC fought back. Like First City, the crippled $26.8 billion (assets) First Republic Bancorp owned solvent banks. But this time the FDIC took those banks as collateral for an earlier $1 billion loan to the holding company. It then took over the banks, employing a little-used technique called the "bridge bank," which allows the FDIC to run a failed institution for up to two years until it finds a buyer — in this case NCNB Corp., which will take over as soon as the transaction is completed. By shutting down the banks, the FDIC ensured that the holding company's bondholders will lose most of their investment (many of them are now suing the agency). "We have got to separate the bank from the holding company, which we haven't always done in the past," Seidman avers.

In another move to discipline holding companies that own troubled banks, the FDIC is proposing legislation that would allow it to force a holding company to merge the assets of a sick bank with those of the robust banks in its network. The goal is to make the parent company, and not the FDIC, the first line of defense. Though most regulators would love to have that power, getting the legislation approved could be tough, says David Hayes, deputy director of the industry and financial analysis division at the OCC. "It would empower regulators to order private citizens to shift their wealth. It raises profound constitutional questions."

Wholesale headaches

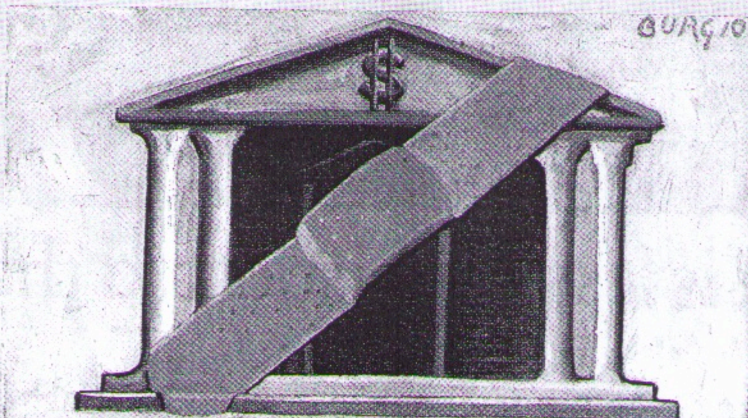
Nothing demonstrates the new strains on the federal insurance program more starkly than the rise of wholesale banks and thrifts, such as Citicorp and Franklin Savings Association. Using modern technology and the increasingly unified international capital markets, these institutions have grown massive by attracting billions of dollars in deposits from big investors around the world. Their growth, says Henry Peltz, a thrift analyst with Keefe, Bruyette & Woods, "has greatly increased the risk to the deposit insurance funds."

Nowadays the institutional depositors — and not the small depositors whom insurance was designed to reassure — are the ones who create runs on banks. By hitting a few computer keys, they can move their money in an instant and bring down a bank, as they did Continental Illinois

HOW NOT TO FIX DEPOSIT INSURANCE

The crisis at the Federal Savings and Loan Insurance Corp. as well as the mounting strains on the Federal Deposit Insurance Corp. (story) have spawned a wide range of proposals from consultants, academics, industry trade groups, economists and regulators. Some are utopian dreams, others stand a chance of being implemented, and still others might actually get at the underlying problems in the deposit insurance system. Herewith a look at some of the major ones.

• **Merging the FDIC and FSLIC.** It's been around for a while, but the idea of merging the two insurance funds to rescue the thrift industry has recently gained considerable momentum in Congress because it looks like a way to avoid using the taxpayer's money to bail out FSLIC. In its simplest form, the scheme would use the $18 billion in the FDIC's fund to close sick thrifts. In another variation, former FDIC chairman William Isaac has suggested funding the merged insurance funds by requiring the Federal Reserve to start paying interest on the reserves that financial institutions keep with the central bank. This approach, Isaac estimates, would net a combined fund an additional $2.5 billion this year alone. Others, including Representative Gerald Kleczka of Wisconsin, who has introduced a bill in Congress that would merge the agencies, see the idea as a long-term solution



Few of the solutions proposed to date get to the root of the problem

that would improve the efficiency and quality of management at the funds.

The drawback to this proposal, however, is that it is absolutely irrelevant to the underlying problem in deposit insurance today. "The insurance funds still wouldn't have the capacity to insure against the risks we've imposed on them," says Kenneth Thygerson, CEO of the $11 billion Imperial Corp. of America. Moreover, bankers hate the idea, as do the Treasury Department and even the Federal Home Loan Bank Board. "There is *no* economic benefit," says FHLBB chairman M. Danny Wall. "Surely the FDIC needs its resources."

Nevertheless, Congress will probably seriously consider a merger. Says Iowa Congressman Jim Leach: "Right now there's no desire to tap the FDIC. But given the option of merging the FDIC and FSLIC or tapping the taxpayer, personally I think the FDIC is more vulnerable to a legislative grab than many bankers would assume."

• **Tinkering with the current system.** Many of the plans under discussion would change aspects of the deposit insurance programs while leaving the structure of the system intact. Favored by the likes of Paul Horvitz, University of Houston economist and a former FDIC research director, these proposals are concerned mainly with the quality and quantity of bank and thrift supervision. They call for tighter capital standards, more and better-

Corp. in 1984. Technically, these wholesale deposits, amounting to millions of dollars from a single source, are not federally insured. The dilemma for deposit insurance is that no one has yet had the nerve to let those depositors run and watch a big bank fail. The assumption that the FDIC and FSLIC will pick up the tab adds nearly $1 trillion to the potential liabilities of those agencies.

The first bank that was considered "too big to fail," in the current parlance, was Detroit's Bank of the Commonwealth, which nearly collapsed in 1972. Until then, the FDIC had for the most part closed banks, paid off their depositors and liquidated the assets. But when the Detroit bank stumbled, says Secura's Isaac, "the FDIC got cold feet." Afraid to close it, the agency pumped capital into the bank and kept it open, effectively guaranteeing all deposits. Several years later it merged Commonwealth into another bank in the region. "With that, we started going to a de facto 100 percent deposit insurance system for banks of any consequence," says Isaac. During the ensuing decade, more large banks — U.S. National, Franklin National and First Pennsylvania — came crawling to the FDIC, and all of them won 100 percent coverage for their depositors.

This approach was justified by the FDIC and later FSLIC, because it is often cheaper to merge a large institution than to liquidate it. But by the time Isaac became FDIC chairman in 1981, he was concerned that the 100 percent guarantee was getting out of hand. So in 1982, when the Penn Square Bank in Oklahoma failed, Isaac tried a new technique that he hoped would impose some discipline on large depositors. Under the "modified payoff," as his approach was termed, the FDIC closed Penn Square and paid depositors with more than $100,000 only the estimated amount they would receive after the bank's assets were liquidated. Isaac planned to start limiting the coverage on large depositors even when insolvent banks were kept open and sold, he now says. But barely two years later Continental crumbled and, in the process, changed completely the country's expectations of deposit insurance.

It was the largest bank rescue in history, requiring an initial FDIC outlay of $4.5 billion. Bailing out the insured depositors alone would have cost the FDIC $3 billion. Even scarier were the unknown consequences of cutting off $30 billion of uninsured depositors' money from investors around the world, including, Secura's Isaac says, $6 billion from 2,500 small U.S. banks. Ever since the Continental bailout — in the cases of First City, First Republic and Financial Corp. of America — all deposits and the bulk of bondholders in large institutions have effectively been covered.

Unbearable burden?

This trend is deeply troubling. "Is deposit insurance doing too much?" asks FDIC chairman Seidman, who will explore this question when his report is ready in November. "We no longer have deposit insurance; we have *institutional* insurance," says Steven Roberts, former assistant to Federal Reserve Board chairman Paul Volcker and now a partner at

trained supervisors, more sophisticated data to predict failures and greater disclosure of financial data to the general public. By narrowing the opportunities and increasing the cost of taking risks, these schemes aim to devalue the risk subsidy that federal insurance provides.

A more radical plan — advocated by George Benston of Emory University and George Kaufman of Loyola University — seeks to limit insurance fund losses by closing banks and thrifts before they become insolvent. Though it is favored privately by more than a few regulators, the legality of the plan is open to question since it could involve forcing an institution to close while it is still solvent.

The common flaw in these plans is that none of them would eliminate the *incentives* to gamble with government-guaranteed money. Instead, they would depend on the supervisory process to catch any abuse before it got out of hand. Although the quality of supervision and regulation can and should be improved, the FSLIC fiasco indicates that regulators alone can't do the job.

A more practical approach, and one that actually would help to neutralize the incentive to take risks, is a proposal to impose risk-based insurance premiums on banks and thrifts. The idea, supported by many small institutions and the FHLBB, would discipline big risk takers by making them pay more into the insurance funds. The sticking point here is that risk is difficult to measure. "How are they going to compare my risk on $5 million in auto loans in Ventura to $10 billion in loans to Mexico? Will they say Mexico is safer because it's a government?" asks Harry Maynard, CEO of the $75 million American Commercial Bank in Ventura, California. Risks can also change fast. According to a 1979 study by several economists ranking banks by the risk premiums they would pay to the FDIC, Continental Illinois Corp. would have paid far less at the time than Citicorp.

- **Reinventing the bank.** In perhaps the least realistic of all the plans circulating, a few people propose to segregate insured deposits from the rest of the financial system. Though it would almost completely eliminate risk to the FDIC and FSLIC, this approach would likely disrupt the economy, not to mention the profitability of banks. Most recently advocated by Robert Litan of Washington's Brookings Institution and McKinsey & Co.'s Lowell Bryan, these plans for "narrow" or "fail-safe" banks would create a new form of institution that would invest insured deposits only in low-risk assets such as U.S. government securities and highly rated corporate debt with short maturities. The deposit-taking entities would be owned by holding companies with other financial service units, including loan-making companies that would raise their funds directly in the capital markets.

Numerous economists, consultants and bankers roundly condemn the concept. "You wouldn't have a bank. You'd have a mutual fund, and I don't see that it has any merit at all," snaps Isaac. A New York banker scoffs, "What you would create is a eunuch." Economists and banking experts, such as Jane D'Arista, associate director of Boston University's Morin Center for Banking Law, worry that the plan would jam up the nation's credit cycle. "What happens to the economy of Hoboken, to the local store that needs a loan, when its bank puts all its consumer deposits into Treasury bills?" she queries.

Even Brookings's Litan agrees that his concept has practical drawbacks. One, he concedes, is that "my narrow bank is unlikely to make money," although, as he sees it, it would be a magnet drawing consumers to the services of the holding company's other units. Another is that there isn't enough eligible low-risk debt in the market right now to absorb some $3 trillion in consumer deposits.

However drastic or impractical their solutions, you do have to credit Litan and others for trying to puzzle through one of the knottiest problems in the U.S. economy. At least they have one thing right: The current deposit insurance system must be changed.

"We have got to separate the bank from the holding company, which we haven't always done in the past."

accounting firm Peat Marwick Main. Roberts is one of many consultants, economists and regulators who are concerned about whether the current system can handle this burden. One worry, of course, is that the agencies don't have the resources to cope with the failure of several big institutions. And if wholesale deposits are insured, the system's other weaknesses are considerably magnified. Big depositors have no disincentive to avoid weak institutions, and the managers of those institutions have every incentive to grow and gamble.

Are these banks really too big to fail? Not everybody thinks so. Peat Marwick's Roberts, SunTrust's Wells and several regulators who wouldn't speak for attribution are among those who object to the idea that federal insurance should guarantee all the risks of large banks and sophisticated institutional depositors. "Right now we don't have the resources to let a big bank fail, but hopefully we would evolve to that point," says Isaac, who would like to see a version of his modified payoff — "giving depositors over $100,000 a haircut" — used on the large banks that fail.

Proposals to create mechanisms for permitting large banks and thrifts to go under are among a host of deposit insurance reform plans now circulating in Washington. Like the other plans that really come to grips with the problem, they are considered radical. But the reformers argue that the more politically palatable proposals are mere stopgaps and that nothing short of radical action can save the system.

The most politically sensitive of all the proposed plans are those that would scale back federal insurance coverage. These schemes go to the very heart of the crisis in deposit insurance: They reduce the incentives to abuse the government's guarantee by imposing more discipline on depositors, banks and S&Ls. The suggestions cover a broad spectrum, from imitating the British system, which insures 75 percent of a depositor's money, to cutting back the amount insured, to limiting interest rates on insured deposits, to withdrawing the safety net from corporate depositors. All of these proposals verge on political heresy. "Deposit insurance has become sacrosanct, something like Social Security," says Representative Stan Parris of Virginia. "It would be political suicide to propose reducing Social Security, and we are *very* close to that on federal insurance."

Even if Congress had more desire to lead than it apparently does, implementing these proposals would have to be done with great caution. Some people worry that federal insurance has become such a security blanket for depositors that any reduction in coverage would set the banks up for mini-runs at the slightest hint of bad news. "That would make the instability in the banking system even worse," according to Bert Ely, head of a Washington, D.C., consulting firm that bears his name and an outspoken critic of the current system. He favors a totally private insurance fund that would make banks entirely responsible for the risks they and their depositors take.

Others contend that a rollback of deposit insurance could work if done gradually. They point to the $265 billion that individual Americans have deposited in uninsured money market mutual funds as evidence that, for a price, depositors are willing to forgo insurance and take risks with at least some of their savings. Insurance could thus be cut back to cover only the core deposits of less sophisticated depositors — to $40,000, say, or to 75 percent of anything over $25,000. Indeed, many people question whether the large, sophisticated individual investor should be sheltered by the government at all. "Anybody who's got $100,000 in a bank is *not* a poor little old lady in tennis shoes," says an executive at a money center bank.

Expelling the institutions

Although people are divided over the question of rolling back insurance for individuals, nearly everyone believes in his heart of hearts that something must be done to restrict the amount of insurance that is being given de facto if not de jure to wholesale depositors. Says Congressman Parris: "Federal insurance is not for the security of corporate cash assets."

How to cut the institutional depositor out of the picture without disrupting huge segments of the economy is a tough question, however. Roberts of Peat Marwick suggests a gradual rollback that would start by limiting insurance to, for example, 90 percent of institutional deposits by 1992 and that would reduce the coverage by 5 percent each year for several years after that. At some point, the guarantee would be removed entirely. Jane D'Arista, associate directer of BU's Morin Center, would remove wholesale depositors from the insurance system entirely. "The potential liability is just too big," she says. "A new mechanism to deal with them should be thought through." One possibility, D'Arista suggests, would be to establish a separate liquidity-guarantee fund that would be financed by the large wholesale banks.

Using pieces from the many plans on the table, it's possible to outline a revamped and much more stable federal deposit insurance system. The best way to limit coverage could, ironically, turn out to be the original "permanent" deposit insurance plan in the 1933 National Banking Act — which never took effect because Congress replaced it two years later with the current "temporary" program. It called for full protection of the first $10,000 of deposits, 75 percent coverage of the next $40,000 and 50 percent coverage of all deposits in excess of $50,000. The numbers no longer apply, but the structure and intent of the plan are still valid.

Discipline

Clearly, Congress and the Roosevelt administration intended that large deposits be insured, but with some heavy discipline attached to the insurance. A modern version of the system might look like this: full insurance for deposits up to $100,000, 75 percent for the next $400,000 and 50 percent coverage for anything over half a million dollars. To restrict abuse by money brokers, insurance could be limited to coverage per *depositor,* regardless of how many institutions his money is spread across.

In tandem with a separate liquidity-guarantee fund for the wholesale market, such an approach just might prove a lasting solution to the deposit insurance crisis. The problem is that Congress isn't likely to undertake this or any other meaningful reform until things get much worse. "There is absolutely no political will to get into this issue. Congress will only do something if it is forced," says consultant Ely. Congress might bail out FSLIC, but then it will shut its eyes to the deeper problems in the system. Financial reform in general is long overdue, but "it involves a *very* tough series of political decisions, and Congress doesn't like to make them," says FHLBB chairman M. Danny Wall, who is also a former staff director for the Senate Banking Committee.

If the next president recognizes the gravity of the situation and quickly commits himself to a significant effort, meaningful change may be possible. This is what Seidman and others hope will happen. Without such an effort, the forecast appears to be: More stopgaps and a deteriorating financial system.

For this, too, the federal deposit insurance system probably deserves some of the blame. It has made the financial world so comfortable for so long that it has become a sort of opiate, lulling everybody into a false sense of well-being. "If you had people lined up outside failing banks and thrifts in Texas, Congress would certainly deal with this," scoffs a government official. But no one needs to bang desperately on the locked doors of bankrupt financial institutions anymore. Federal deposit insurance has taken care of that. ﬁ